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FEDERAL PREEMPTION VERSUS STATE UTILITY REGULATION IN A POST-MISSISSIPPI ERA

*Clinton A. Vince**

*John S. Moot***

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* Partner, Verner, Liipfert, Bernhard, McPherson and Hand, Chartered; B.A., Trinity College (1971); J.D., Georgetown University 1974; Member, District of Columbia and New York State Bars. Mr. Vince has served as counsel of record to the City of New Orleans in several of the cases described in this article.

** Associate, Verner, Liipfert, Bernhard, McPherson & Hand, Washington, D.C.; B.A., St. Lawrence University (1983); J.D., American University (1988); Member, Maryland Bar.

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I. INTRODUCTION

In the jurisdictional tug-of-war that now exists between state and federal regulation of a great many utility matters, the federal preemption doctrine has begun to play a remarkably pervasive and controversial role. Born of the Supremacy Clause¹ of the United States Constitution, this doctrine makes federal statutory law and decisions of federal agencies acting pursuant to such law² binding upon the states.³ In the gas and electric utility industries, preemption has been applied in a startling number of diverse situations, attracting serious national attention in each instance.⁴

1. U.S. CONST. art. VI, cl. 2.

2. *Hillsborough County v. Automated Medical Laboratories*, 471 U.S. 707, 713 (1985); *Capital Cities Cable v. Crisp*, 467 U.S. 691, 699 (1984); *Fidelity Fed. Savs. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153-54 (1982).

3. *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 248 (1984); *Pacific Gas & Elec. Co. v. State Energy Resources Conserv'n & Dev. Comm'n*, 461 U.S. 190, 203-04 (1983).

4. A voluminous amount of literature has been generated on the preemptive effect of FERC orders. See, e.g., Boxall, *A Centennial of Public Utilities Regulation*, PUB. UTILS. FORT., Oct. 27, 1988, at 11 (interview with The Hon. Bruce Hagen discussing FERC preemption of state law); Duffy, *Will the Supreme Court Lose Patience with Prudence?* 9 ENERGY L.J. 83 (1988); Ercolano & Lesch, *Narragansett Update: From Washington Gas Light to Nantahala*, 7 ENERGY L.J. 333 (1986); Hobelman, *The Narragansett Decision and its Aftermath*, 6 ENERGY L.J. 33 (1985); Nixon & Johnston, *Nantahala Affirms Narragansett—Whither Pike County?* 8 ENERGY L.J. 1 (1987); Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity*, 132 U. PA. L. REV. 497 (1984); Trabandt, *Preemptive Tendencies at the FERC—An Insider's View*, PUB. UTILS. FORT., Sept. 29, 1988, at 9; Note, *Multi-State Electric Generating Plants: Should State or Federal Law Regulate?*, 55 U. CIN. L. REV. 529 (1986); Note, *Has the*

For example, such lively topics as nuclear plant construction and allocation, transmission, least cost planning, competitive bidding, independent power production, state take-or-pay pass-throughs, rates for purchases from qualifying facilities, regulation of utility security issuances, gasoline price decontrol, and, most recently, nuclear power plant emergency planning and state commission regulation of electric cooperative rates have attracted application of the federal preemption doctrine. Disputes involving the propriety of such application have just begun to percolate up through the judicial system, leaving a number of important legal and policy questions yet unresolved.

How do industry officials regard this phenomenon? Many utility executives, who have come to view the Federal Energy Regulatory Commission (FERC) as a "safe harbor"⁵ from what they perceive as "parochial" and "highly politicized" state regulators, have heralded the preemption doctrine as a welcome and potent weapon. These officials have warmly embraced such cases as *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*⁶ and *Nantahala Power & Light Co. v. Thornburg*,⁷ in which the doctrine has been employed with extraordinary effectiveness.⁸

For many state regulators, consumer activists and retail-level ratepayers, who perceive that the FERC is too often supportive of shareholder rather than ratepayer interests, expanded use of the doctrine has been viewed with increasing bitterness. In fact, the FERC has begun to utilize the preemption doctrine so aggressively that one of the leading members of the Commission recently wrote a scathing article against his brethren.⁹ In his introductory sentence, the Honorable Charles A. Trabandt stated: "The Federal Energy Regulatory Commission this year could federalize and preempt a significant portion of the legitimate and proper state regulation of the electric power industry."¹⁰ He continued, "Surely, there is no reason now to expect self-restraint from the FERC, as it figuratively tramples any state responsibility deemed inconvenient in its rogue elephant preemptive path."¹¹

A typical scenario for the tension between federal and state regulation occurs when the FERC approves interstate electric or gas rates for transac-

Supreme Court Pulled the Rug from Under the FERC's Electric and Natural Gas Regulation?, 4 ENERGY L.J. 251 (1983); Note, *The Role of the States in Energy Regulation*, 4 ENERGY L.J. 255 (1983).

5. An editorialist has proffered that investor-owned utilities should seek greater regulation by the FERC as a "safe harbor" against state prudence investigations. Radford, *The Grand Gulf Mess—State Prudence Reviews Thwart FERC Rate Settlements*, PUB. UTILS. FORT., May 28, 1987, at 4.

Just recently, one utility attempted, unsuccessfully, to restructure its corporate form in order to avoid state jurisdiction and "escape into the less-restrictive federal regulation." Solis, *PS of New Mexico Has Its Wings Clipped*, Wall St. J., Nov. 1, 1988, at A6, col. 1.

6. *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428 (1988).

7. *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986).

8. In *Nantahala*, the state public utilities commission was preempted from applying its own methodology for determining the proper allocation of low and high cost power for the local utility's retail cost of service. *Id.* at 971. In *Mississippi*, the Court precluded the state commission from considering the issues of prudence of construction and fairness of cost allocation relating to the retail utility's participation in the Grand Gulf nuclear power plant project. *Mississippi*, 108 S. Ct. at 2438.

9. Trabandt, *supra* note 4, at 9.

10. *Id.* at 9.

11. *Id.* at 13.

tions at wholesale and a utility seeks to recover the resulting expenses through retail rates regulated at the state level. Utility companies seeking to have federally approved rates implemented at the retail level generally have alleged that the federal preemption doctrine requires the state regulator to allow a full and immediate pass-through of the wholesale rates¹² under the "filed rate" doctrine.¹³

In many instances, state regulators¹⁴ have shown reluctance to pass through large wholesale rate increases without first conducting traditional retail regulatory proceedings.¹⁵ Nowhere has the issue been more sharply drawn than in disputes between interstate utility holding companies and state regulatory bodies, involving the proposed pass-through of costs associated with nuclear power plant construction. The companies, faced with extraordinary debt service requirements resulting from massive construction costs, typically have obtained FERC approval of contracts allocating wholesale cost responsibility for these nuclear plants, and then have sought full and immediate recovery of the costs at the retail level. State regulators, confronted with staggering rate increases, potential "rate shock"¹⁶ to consumers, and highly charged local political issues, have responded by deploying a panoply of retail regulatory measures and moderation procedures, including "phase-in" or "levelization" plans,¹⁷ prudence investigations,¹⁸ and excess capacity

12. See, e.g., *New Orleans Pub. Serv., Inc. v. City of New Orleans*, 798 F.2d 858 (5th Cir. 1986), *cert. denied*, 107 S. Ct. 1910 (1987); *American Elec. Power Co. v. Kentucky Pub. Serv. Comm'n*, No. 85-5129, (6th Cir. March 24, 1986).

13. The filed rate doctrine provides that the right to a reasonable rate is the rate that the FERC fixes, and no other. *Montana-Dakota Util. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251-52 (1951). This doctrine has been interpreted as requiring state commissions to treat FERC-approved wholesale costs as reasonable operating expenses for purposes of a utility's retail cost of service. *Northern States Power Co. v. Minnesota Pub. Util. Comm'n*, 344 N.W.2d 374, 378 (Minn. 1984), *cert. denied*, 467 U.S. 1256 (1984).

14. References to state regulation of utilities in this article also encompass regulation by a political subdivision of the state. In New Orleans, for example, the city council is vested with authority under Louisiana law to regulate the rates and other activities of public utilities providing services within the city, just as the Louisiana Public Service Commission regulates utilities serving the remainder of the state. LA. REV. STAT. ANN. § 33-4405 (West 1988).

15. See Pierce, *supra* note 4. Professor Pierce thoroughly discusses the myriad regulatory reviews conducted by state regulators concerning utility investment in large generating plants.

16. "Rate shock" refers to the economic and related sociological effects within a community that result from a substantial, and sudden, increase in retail electric rates. As detailed in expert testimony filed in the New Orleans litigation, the effects may be most severe in the case of low income residential customers, and marginal or energy-intensive businesses. The typical effects, which can be quantified, may include loss of jobs, an increase in the number of those who fall below the poverty line, an inability of a number of families to qualify for home mortgages, and attendant physical and mental health effects. In severe instances, a so-called "death spiral" can set in. That is, as jobs are lost, businesses close, and an increasing number of ratepayers are unable to pay their bills, the cost of power is distributed over a smaller group of paying customers, with higher costs per ratepayer. Such increased costs could then trigger a new round of failures and ratepayer losses, and so on, leaving the community and the utility in an untenable and unstable financial position.

17. Rate "phase-in" or "levelization" plans provide for rates to be increased gradually while the utility borrows to meet wholesale costs that are owed to the wholesale seller, but not being collected currently in retail rates. Deferred costs are then collected in rates in later years. The design of such a moderation plan is generally regarded as a state retail ratemaking function. See *Middle S. Energy, Inc.*, 26 F.E.R.C. ¶ 63,044, at 65,148 (1984).

18. A prudence inquiry is regarded as a traditional ratemaking function, based on the established

adjustments.¹⁹

It is not unusual for local regulators to express strong negative emotions regarding efforts to block these responses on federal preemption grounds.²⁰ Such local regulators may believe that the FERC lacks the sensitivity and the inclination to evaluate fully the impact of passing through federally approved rates to consumers at the retail level. In addition, it does not seem rational to many state regulators that arm's-length transactions among nonaffiliated utilities generally are subject to state review, whereas state review of non-arm's-length transactions among affiliates of a holding company generally is deemed preempted, once the FERC has allocated costs at the wholesale level. In the former situation involving nonaffiliates, there is a better opportunity for the competitive marketplace to play a significant and assumedly beneficial role. In

principle that costs may be passed on to ratepayers only to the extent they are prudently incurred. *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276 (1923). This reflects the policy that poor business judgment is not the risk of the ratepayers, but rather the risk of the owners. A recent study commented:

The concept of a prudent investment in public utility law is a regulatory oversight standard that attempts to serve as a legal basis for judging whether utilities meet their public interest obligations. . . .

The concept of prudence provides commissions with a principle that does not necessarily require an "all or nothing" decision in favor of some side, but can allow some sharing of the risks between investors and the ratepayers. The prudent investment test is a tool that regulators are using to provide an answer to the question of who should bear which risks and associated costs.

R. BURNS, R. POLING, M. WHITMAN & K. KELLY, *THE PRUDENT INVESTMENT TEST IN THE 1980s* iv, vi (1985).

19. See Vancrum, *The Wolf Creek Excess Cost—Excess Capacity Bill*, 33 U. KAN. L. REV. 475 (1985).

20. For example, in adopting a settlement under which wholesale expenses relating to the Grand Gulf I nuclear plant would be reflected in retail rates (after absorption of approximately 20% of the expenses by the utility, and with deferred recovery of certain first year expenses), the Arkansas Public Service Commission expressed its frustration with the threat that a different ruling would be overturned by a federal court on preemption grounds, stating:

The Commission would like to be in a position to reject this settlement. The record developed before us demonstrates that, as a matter of fairness rather than as a matter of law, the ratepayers of Arkansas should not have to contribute to the payment for Grand Gulf I.

If our decision could be based solely on our duties and discretion as provided by State law, we would reject this settlement.

If our discretion were not restricted by the rulings of a federal agency and certain decisions of federal courts, we would conclude that the rates established by this settlement constitute an overcharge to Arkansas consumers.

For these reasons we hate to approve this settlement, but under the circumstances we do not feel we have any choice.

Order No. 26, No. 84-249-U; Order No. 4, No. 85-198-U (Ark. Pub. Serv. Comm'n Sept. 9, 1985).

The City Council of New Orleans expressed a similar sentiment in the course of adopting a partial settlement of the local utility's application for recovery of Grand Gulf I expenses at the retail level, stating:

[T]he decision we adopt today is dictated, in large part, by circumstances beyond the City's control. Federal courts have clearly expressed their view that local regulatory bodies such as the Council do not have authority to alter or interfere with the FERC's allocation of Grand Gulf costs, even in the exercise by such local regulatory bodies of their traditional function to regulate local retail rates. Although we deeply resent such federal interference with our ability to fulfill our role as local regulator, we cannot ignore the substantial threat that a Council decision issued in the absence of settlement would be reversed on judicial review.

New Orleans, La., Res. No. R-86-112 (Mar. 20, 1986).

the latter situation, involving non-arm's-length transactions, there is a greater opportunity for corporate mischief, yet a more limited role for state regulators. As a matter of regulatory policy, this distinction seems unwise.

How has the United States Supreme Court responded when confronted with this controversy? The Court, to date, has sided overwhelmingly with advocates of the expanded use of the preemption doctrine. In *Mississippi*,²¹ the Supreme Court held that the Mississippi Public Service Commission was preempted from conducting an inquiry into the prudence of the construction of the Grand Gulf nuclear power plant and MP&L's allocation of high-cost power from the plant. Significantly, the Court in *Mississippi* extended its prior ruling in *Nantahala*²² to address preemption in the public utility holding company context.

In light of cases like *Mississippi* and *Nantahala*, it is unclear what avenues are left for state commissions that regulate multistate holding companies. One possibility is that the *Mississippi* decision allows a state regulator to review (1) whether a utility engaged in meaningful oversight of its power purchasing obligations; (2) whether the utility sought to reevaluate its risk exposure in light of new economic or regulatory developments in the industry; and (3) whether the utility reduced its risk exposure to high cost power by, among other options, selling its excess capacity off system when it had the opportunity to do so.²³ Arguably, such reviews may be permissible after *Mississippi* because they would involve retail rate matters that are beyond the traditional purview of the FERC. Nevertheless, litigants have already begun to present conflicting positions on these issues in lawsuits yet to be resolved²⁴ and in public symposiums.²⁵

Some observers²⁶ feel that the practical impact of the Supreme Court's recent decisions will be to encourage utilities to join multistate holding companies and spin off wholly-owned generating companies (with interstate power sales), thereby avoiding state regulatory review of certain power sales.²⁷ For example, in *Mississippi*, the Middle South Utilities holding company formed a new affiliated generating company to produce and sell power among its affiliated companies, thereby creating wholesale level sales subject to the FERC's

21. *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428 (1988).

22. *Nantahala Power & Light v. Thornburg*, 476 U.S. 953 (1986).

23. This is the position that the city of New Orleans has taken in its role as state regulator of the New Orleans Public Service, Inc. (NOPSI). The NOPSI was a party to the agreement that allocated power from the Grand Gulf nuclear plant. The Grand Gulf project, and Mississippi Power & Light's participation in it, was the focus of the dispute in *Mississippi*. The NOPSI has contested the City's ability to take any action relating to the FERC-approved power costs from Grand Gulf. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 850 F.2d 1069 (5th Cir. 1988), *cert. granted*, 109 S. Ct. 780 (1989).

24. *See id.*

25. A colloquium discussing preemption and the *Mississippi* decision was held at the 1988 mid-year meeting of the Federal Energy Bar Association (FEBA).

26. National Association of Regulatory Utility Commissioners (NARUC) President Bruce Hagen recently stated that the issue of federal preemption was the most challenging issue he faced during his tenure this past year as president. Boxall, *supra* note 4, at 11.

27. C. Vince, *State Regulation of Holding Company Affiliates and Multistate Power Pools After Mississippi Power & Light v. Mississippi ex rel. Moore* 4 (Oct. 21, 1988) (written presentation at the 1988 mid-year meeting of the FEBA).

jurisdiction.²⁸ Similarly, the American Electric Power holding company has formed an affiliated power generation company to sell power among its affiliates at the wholesale level, consequently avoiding state regulation.²⁹ As a result of heavy public criticism, one utility has recently abandoned a similar plan of corporate restructuring that would have brought it under the FERC's jurisdiction.³⁰

In one of the most highly publicized cases, Public Service of New Hampshire recently proposed a corporate restructuring to bring power sales from the much-litigated Seabrook nuclear power plant under the FERC's jurisdiction.³¹ The company would then seek a 30% rate increase in a proceeding before the FERC, even though the state commission had previously denied similar requests for staggering rate increases. The company's plan, filed in United States Bankruptcy Court, would establish a holding company with separate generation, transmission, and distribution subsidiaries, thereby allowing the company to make intracompany wholesale-level sales of power that would be subject to the FERC's jurisdiction.³² An obvious purpose of the proposed restructuring would be to avoid the state of New Hampshire's law prohibiting recovery of power plant costs in situations where the plant is not yet in service. The FERC's regulations, by contrast, would allow the company partial recovery for its nuclear plant investment prior to the date that the plant becomes operational.³³

Several leading lawmakers on Capitol Hill have expressed deep concern over this trend and have begun to consider legislation to redress the perceived jurisdictional imbalance between federal and state regulation created by the manner in which the federal preemption doctrine has recently been applied by the FERC and the Supreme Court. In the last three years, the House and Senate committees with oversight jurisdiction over the FERC, have held numerous hearings investigating, among other matters, the FERC's policies with regard to preemption of state public utility regulation.³⁴ In a 1986 letter

28. *Mississippi*, 108 S. Ct. at 2432.

29. The AEP holding company system took this action after the Kentucky Public Service Commission had denied Kentucky Power Company the authority to own a portion of the plant. *Kentucky Power Co.*, 36 F.E.R.C. ¶ 61,227, at 61,552 (1986).

30. The utility sought a corporate restructuring in order to avoid state jurisdiction and "escape into the less-restrictive federal regulation." Solis, *supra* note 5, at A6, col. 1.

31. See Ingrassia, *PS New Hampshire Files Plan to Exit Chapter 11 Requiring 30% Rate Increase*, Wall St. J., Dec. 28, 1988, at A3, col. 2; Hicks, *Seabrook Owner Sets Rate Plan*, N.Y. Times, Dec. 28, 1988, at D1, col. 4.

32. Ingrassia, *supra* note 31; Hicks, *supra* note 31.

33. In recent action, the bankruptcy judge was asked to determine whether federal bankruptcy law preempts state commissions from attempting to set rates while the utility is in the process of reorganization. See Ingrassia, *Judge in PS of New Hampshire Case May Address Pivotal Issue Tomorrow*, Wall St. J., Feb. 9, 1989, at B7, col. 1. In addition, the two United States Senators from New Hampshire have introduced legislation that prohibits a utility from using the Bankruptcy Code to reorganize in an effort to circumvent state regulation. See Elec. Util. Week, Feb. 6, 1989, at 2.

34. *Public Utility Regulatory Policies Act: Hearings Before the Subcomm. on Energy and Power of the House Comm. on Energy and Commerce*, 100th Cong., 1st Sess. 515-635 (1987) [hereinafter *PURPA Hearings*]; *Ratepayer Protection Act of 1985: Hearings Before the Subcomm. on Water and Power of the Senate Comm. on Energy and Natural Resources*, 99th Cong., 2d Sess. 8-16, 421-44 (1986) [hereinafter *Ratepayer Protection Hearings*]; *Power Plant Costs: Hearings Before the Subcomm. on Energy Conservation*

to the FERC Chairman, Martha Hesse, Senator Dale Bumpers (Democrat from Arkansas) criticized the FERC's support of New Orleans Public Service, Inc. (NOPSI) in its attempts to stop the prudence review being conducted by the New Orleans City Council.³⁵ In the aftermath of the *Mississippi* decision, the staff of Senator Bumpers has been quoted as looking into possible legislation to provide better protection for retail-level ratepayers. To date, however, no legislation reflecting these concerns has been enacted.

In light of the heightened attention being devoted to the preemption doctrine, this article seeks to: (1) articulate the legal underpinnings and background of the "bright line" between federal and state jurisdiction over power sales; (2) explain the evolution of the filed rate doctrine from its inception to its use in the *Mississippi* decision, including a discussion of the *Narragansett Elec. Co. v. Burke*³⁶ and *Pike County Light & Power Co. v. Burke*³⁷ interpretations; (3) examine the most recent federal-state jurisdictional controversies in the energy field; (4) discuss the major congressional hearings of the past few years involving the FERC's preemption of state level regulation; (5) provide insight into key policy considerations concerning federal preemption in the multistate holding company context; and (6) respond to the rhetorical question of what, if anything, is left of state regulation in the aftermath of the *Mississippi* case.

II. ESTABLISHMENT OF THE "BRIGHT LINE" BETWEEN STATE AND FEDERAL JURISDICTION OVER SALES OF POWER BY PUBLIC UTILITIES

Prior to 1935, there was no federal energy regulatory body and, thus, the gas and electric utility industries were regulated solely by state public service commissions. Under the Commerce Clause,³⁸ states were permitted to regulate only sales to ultimate consumers (retail sales) and were prohibited from regulating sales in interstate commerce for resale (wholesale-level sales).³⁹ To fill the gap in regulation of wholesale rates, Congress enacted the Federal Power Act (FPA)⁴⁰ and the Natural Gas Act

and Power of the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 230-31 (1986) [hereinafter *Power Plant Costs Hearings*].

35. Senator Bumpers stated:

In my view, it is clearly inappropriate to shield NOPSI or any of the MSU subsidiaries from local scrutiny, under the guise of federal preemption, when the federal agency seeking to exercise exclusive jurisdiction has never addressed these issues. FERC's participation in this case serves to underscore the widely-held perception that the interests which FERC seeks to protect are those of the shareholders, not ratepayers.

Letter from Senator Dale Bumpers to FERC Chairman Martha Hesse (Oct. 28, 1986).

36. *Narragansett Elec. Co. v. Burke*, 119 R.I. 559, 381 A.2d 1358 (1977), *cert. denied*, 435 U.S. 472 (1978).

37. *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 465 A.2d 735 (1983).

38. U.S. CONST. art. I, § 8, cl. 3.

39. *E.g.*, *Public Utils. Comm'n v. Attleboro Steam & Elec. Co.*, 273 U.S. 83, 89 (1927); *Missouri ex rel. Barrett v. Kansas Natural Gas Co.*, 265 U.S. 298, 309 (1924); *Pennsylvania Gas Co. v. Public Serv. Comm'n*, 252 U.S. 23, 28 (1920).

40. The Federal Power Act (FPA), as amended in 1935, gave the Federal Power Commission (FPC),

(NGA).⁴¹ These two acts gave the Federal Power Commission (FPC), which is now the FERC, the authority to regulate wholesale-level sales, but preserved the states' traditional authority over the regulation of retail rates. This federal-state division of authority over wholesale and retail sales comprises what is commonly called the jurisdictional "bright line."⁴²

A. Limitations on State Regulation Under the Commerce Clause

In the period prior to federal regulation of the electric and gas industries, local ratepayers were largely unprotected from abuses by utilities operating in several different states. The monopoly power that utilities possessed, unencumbered by wholesale-level regulation, provided the seeds for corporate mischief and overreaching. To combat this void in wholesale rate regulation, many state commissions asserted jurisdiction over wholesale purchases that affected local ratepayers. For instance, a state commission might have, in setting the utility's retail rate, ruled on the reasonableness of the costs underlying the company's wholesale purchases. This type of inquiry, in effect, reviewed the wholesale seller's cost of service. The Supreme Court early ruled, however, that state regulation of wholesale rates was invalid under the Commerce Clause of the United States Constitution. The following is a brief overview of this Commerce Clause jurisprudence.

In a series of cases, the Supreme Court developed a bright line test to determine whether a sale of gas or electricity was subject to state jurisdiction, and thus permissible under the Commerce Clause. The Court held that states could not regulate sales in interstate commerce for resale, even if such regulation had only an incidental effect upon interstate commerce.⁴³ Although the Court was sensitive to the need for regulation of wholesale rates, it explained that until Congress acted, wholesale level sales would have to remain unregulated.⁴⁴ This bright line test provided, however, that states could regulate

presently called the FERC, the authority to regulate sales of electric energy in interstate commerce for resale. 16 U.S.C. §§ 791-825r (1982).

41. The Natural Gas Act (NGA), enacted in 1938, gave the FPC the authority to regulate interstate sales of natural gas for resale. 15 U.S.C. §§ 717-717w (1982).

42. *Panhandle E. Pipeline Co. v. Public Serv. Comm'n*, 332 U.S. 507, 517 (1947).

43. *Attleboro Steam*, 273 U.S. at 89. The Court explained the difference between sales of a local nature and sales of national import:

The business of supplying, on demand, local consumers is a local business, even though the gas be brought from another state and drawn for distribution directly from interstate mains; and this is so whether the local distribution be made by the transporting company or by independent distributing companies. In such case the local interest is paramount, and the interference with interstate commerce, if any, indirect and of minor importance. But here the sale of gas is in wholesale quantities, not to consumers, but to distributing companies for resale to consumers in numerous cities and communities in different states. The transportation, sale and delivery constitute an unbroken chain, fundamentally interstate from beginning to end, and of such continuity as to amount to an established course of business. The paramount interest is not local but national, admitting of and requiring uniformity of regulation. Such uniformity, even though it be the uniformity of governmental nonaction, may be highly necessary to preserve equality of opportunity and treatment among the various communities and states concerned.

Kansas Natural Gas, 265 U.S. at 309-10.

44. *Kansas Natural Gas*, 265 U.S. at 308.

sales in interstate commerce if such sales were to ultimate consumers, and not for resale.⁴⁵ Thus, the line of permissible state regulation had been drawn: States could regulate direct sales by distribution companies to ultimate consumers, but could not regulate sales in interstate commerce for resale.⁴⁶

One exception to the bright line test was state regulation of wholesale level sales between holding company affiliates. In a line of decisions in the 1930s, the Supreme Court held that in light of the absence of arm's-length bargaining among holding company affiliates, one could not rely on the market to produce reasonable or competitive wholesale prices.⁴⁷ Therefore, the Court explained, in order for states to provide meaningful retail rate regulation, they must be allowed to regulate wholesale-level sales among holding company affiliates.⁴⁸

B. The Bright Line Between State and Federal Jurisdiction Under the Federal Power Act and the Natural Gas Act

The absence of federal regulation of interstate utility matters became an intolerable condition to the Congress of the 1930s. The Great Depression had witnessed the bankruptcies of many highly leveraged utility holding companies and the resulting destabilization of the electric utility industry. Consistent with the New Deal's objective of providing the government with greater control over the national economy, Congress enacted many new regulatory structures for various industries. Two of these regulatory mechanisms applied to the electric and gas utility field—federal regulation of wholesale electric and gas sales and federal regulation of public utility holding companies. What follows is an overview of the early Supreme Court opinions interpreting the federal-state jurisdictional divisions created under the FPA and the NGA.

With the enactment of the FPA amendments in 1935 and the NGA, Con-

45. *Pennsylvania Gas Co. v. Public Serv. Comm'n*, 252 U.S. 23, 30-31 (1920).

46. In *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission*, the Court abandoned the mechanical bright line test under the Commerce Clause for determining the permissible bounds of state electric and gas utility regulation. *Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375, 393 (1983). It adopted instead the modern Commerce Clause test, which balances state versus federal interests in determining whether a state has unduly burdened interstate commerce. *Id.* at 391. The effect of this decision on permissible state regulation, however, is small because the FPA and NGA adopted the bright line test as federal statutory law. *Illinois Natural Gas Co. v. Central Ill. Pub. Serv. Co.*, 314 U.S. 498, 504 (1942). Thus, the bright line between federal and state jurisdiction now operates by force of the Supremacy Clause.

47. *Lone Star Gas Co. v. Texas*, 304 U.S. 224, 237 (1938); *Columbus Gas & Fuel Co. v. Public Util. Comm'n*, 292 U.S. 398, 400 (1934); *Dayton Power & Light Co. v. Public Util. Comm'n*, 292 U.S. 290, 295 (1934); *Western Distrib. Co. v. Public Serv. Comm'n*, 285 U.S. 119, 124-25 (1932).

48. The Court in *Western Distributing Co. v. Public Service Commission* explained the rationale of why such state regulation is permissible under the Commerce Clause:

There is an absence of arms' length bargaining between the two corporate entities involved, and of all the elements which ordinarily go to fix market value. The opportunity exists for one member of the combination to charge the other an unreasonable rate for the gas furnished, and thus to make such unfair charge in part the basis of the retail rate. . . . Any other rule would make possible the gravest injustice, and would tie the hands of the state authority in such fashion that it could not effectively regulate the intrastate service which unquestionably lies within its jurisdiction.

Western Distributing, 285 U.S. at 124-25.

gress filled the regulatory gap created by Commerce Clause limitations on state regulatory authority. The FPC was given the exclusive authority to regulate wholesale-level sales of electricity and natural gas in interstate commerce for resale.⁴⁹ The FPC was also given jurisdiction over the transportation of natural gas in interstate commerce.⁵⁰ Both Acts, however, restricted the FPC's jurisdiction to those sales not subject to regulation by the states.⁵¹

Subsequently, the Supreme Court established that Congress, in enacting the FPA and the NGA, had opted for a jurisdictional bright line between state and federal regulation.⁵² This bright line provides that the FERC has exclusive authority over any wholesale-level sale, so long as any part of that sale is in interstate commerce.⁵³ The FERC's jurisdiction to regulate wholesale-level sales is exclusive, regardless of a state's interest in the sale.⁵⁴ Moreover, state action that unduly burdens or frustrates the exercise of the federal regulatory power is preempted.⁵⁵

In a similar manner, the FPA and the NGA preserved the states' exclusive authority over sales from distribution companies to ultimate consumers.⁵⁶

49. 16 U.S.C. § 824(a) (1982); 15 U.S.C. § 717(b) (1982).

50. Recently, a federal district court held that the FERC's authority over the transportation of natural gas preempted the Michigan Commission from regulating certain bypass agreements. *National Steel Corp. v. Long*, 689 F. Supp. 729 (W.D. Mich. 1988). Bypass occurs where a local industrial concern seeks to purchase gas directly from a pipeline company, rather than purchasing its gas from the local distribution company. Here, the district court held that because the sale was not made in the Michigan, the state did not have jurisdiction to review the bypass contract. *Id.* at 733.

51. The FPA provides "such Federal regulation, however, [is] to extend only to those matters which are not subject to regulation by the states." 16 U.S.C. § 824(a). The NGA provides that federal regulation "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).

52. *United States v. Public Util. Comm'n*, 345 U.S. 295, 311 (1953); *Panhandle E. Pipe Line Co. v. Public Serv. Comm'n*, 332 U.S. 507, 517 (1947); *Illinois Natural Gas Co. v. Central Ill. Pub. Serv.*, 314 U.S. 498, 506-07 (1942).

The Court in *Southern California Edison Co.* explained the adoption of the bright line:

In short, our decisions have squarely rejected the view of the Court of Appeals that the scope of FPC jurisdiction over interstate sales of gas or electricity at wholesale is to be determined by a case-by-case analysis of the impact of state regulation upon the national interest. Rather, Congress meant to draw a bright line easily ascertained, between state and federal jurisdiction, making unnecessary such case-by-case analysis.

FPC v. Southern California Edison Co., 376 U.S. 205, 215-16 (1964).

53. *Southern California Edison*, 376 U.S. at 215-16; *Public Utilities Commission*, 345 U.S. at 311; *Illinois Natural Gas*, 314 U.S. at 509.

The Court interpreted enactment of the two acts as confirming the bright line drawn under the Commerce Clause analysis:

What Congress did was to adopt the test developed in the *Attleboro* line which denied state power to regulate a sale "at wholesale to local distributing companies" and allowed state regulation of a sale at "local retail rates to ultimate consumers."

Southern California Edison, 376 U.S. at 214.

54. *Southern California Edison*, 376 U.S. at 215-16; *Utah v. FERC*, 691 F.2d 444, 448 (10th Cir. 1982).

55. *Maryland v. Louisiana*, 451 U.S. 725, 751 (1981); *Northern Natural Gas Co. v. State Corp. Comm'n*, 372 U.S. 84, 91-92 (1963).

56. *Southern California Edison*, 376 U.S. at 214; *Panhandle Eastern*, 332 U.S. at 517. The Court held that Congress specifically preserved existing state regulation:

The two acts maintained the states' power (which had been developed under Commerce Clause jurisprudence) to regulate ultimate sales to customers, even if such sales traveled in interstate commerce.⁵⁷ Essentially, the FPA and the NGA transformed the bright line test from a constitutional Commerce Clause analysis to a statutory federal preemption analysis. The following cases illustrate the evolution of the Supreme Court's consideration of these vital issues.

1. *Illinois Natural Gas Co. v. Central Illinois Public Service Co.*:⁵⁸
Establishment of a Statutory Bright Line

In *Illinois Natural Gas*, the Supreme Court was presented with one of the first major cases requiring definition of the jurisdictional test established under the NGA. The Court held that Congress, in enacting the NGA, had established a mechanical test for distinguishing between federal and state jurisdiction, purposefully eschewing a case-by-case balancing of federal and state interests. The factual situation that the case presented is as follows.

Acting on a complaint filed by a local gas distribution company, the Illinois Commerce Commission ordered the Illinois Natural Gas Company to establish pipeline connections with and provide gas to the local distribution company.⁵⁹ Illinois Natural Gas, which was an interstate pipeline, challenged the Illinois Commission order, alleging that it was an attempt to regulate wholesale-level sales in violation of the Natural Gas Act. The Illinois Commission found that the interstate nature of the sale came to an end when Illinois Natural Gas reduced the pressure of the gas prior to delivery to the local distribution company.

The Supreme Court disagreed, holding that Congress, in enacting the Natural Gas Act, had opted for a mechanical test for determining when interstate commerce ends and intrastate commerce begins. The Court noted that in the absence of any congressional statute, it would have balanced the nature of the state concerns involved with the importance of the federal interest.⁶⁰ Instead, however, Congress mandated the regulation of a defined class of sales of gas without resort to recurring litigation over varying factual circumstances. The Court held that Congress established through the NGA that all sales in interstate commerce for resale would be subject to exclusive federal jurisdiction, whereas sales to ultimate customers would be subject to exclusive state jurisdiction. Consequently, the Court put in place the mechanics of the statutory jurisdictional bright line test; its application to two important factual settings, however, was as yet unclear.

Congress, it is true, occupied a field. But it was meticulous to take in only territory which this Court had held the states could not reach. That area did not include direct consumer sales, whether for industrial or other uses. Those sales had been regulated by the states and the regulation had been repeatedly sustained.

Id. at 519.

57. *Panhandle Eastern*, 332 U.S. at 523-24.

58. *Illinois Natural Gas Co. v. Central Ill. Pub. Serv. Co.*, 314 U.S. 498 (1942).

59. *Id.* at 501.

60. *Id.* at 506.

2. *Panhandle Eastern Pipe Line Co. v. Public Service Commission*:⁶¹
State Jurisdiction Over Interstate Sales to Ultimate Customers

The Supreme Court in *Panhandle Eastern* dispensed with allegations that would have placed a cloud over state utility regulation. In this case, the Supreme Court was called upon to consider whether states had jurisdiction over direct interstate sales to ultimate consumers. The Court held that the NGA had preserved states' authority to regulate sales of an interstate nature made to ultimate consumers, and not for resale, an authority which the states held prior to 1935 under Commerce Clause jurisprudence.

At issue in *Panhandle Eastern* was an interstate pipeline (Panhandle Eastern) that made direct interstate sales to industrial customers in Indiana. The Indiana Public Service Commission (PSC) found that, despite the interstate character of the sales, the sales by Panhandle Eastern were subject to state regulation.⁶² The Indiana Supreme Court upheld the PSC decision, finding that the PSC had the authority to regulate the sales.⁶³

In affirming the state supreme court, the Supreme Court reiterated its holding in *Illinois Natural Gas* that the jurisdictional analysis was not to be based upon a detailed factual inquiry, but rather was to be the mechanical test provided for in the NGA.⁶⁴ The Court found that under the Commerce Clause analysis applied prior to enactment of the NGA, the sale in question would have been subject to state jurisdiction, despite being interstate, because it represented a direct sale to an ultimate customer.⁶⁵ Determining that Congress had intended to adopt the Commerce Clause jurisdictional test into statutory law, the Court concluded that direct interstate sales to ultimate consumers were also subject to state jurisdiction under the NGA. In so holding, the Court enunciated perhaps its most famous description of the jurisdictional bright line test:

The line of the statute was thus clear and complete. It cut sharply and cleanly between sales for resale and direct sales for consumptive uses. No exceptions were made in either category for particular uses, quantities or otherwise. And the line drawn was that one at which the decisions had arrived in distributing regulatory power before the Act was passed.⁶⁶

The Court also rejected Panhandle Eastern's claim that Congress had intended to occupy the field of interstate gas sales. The company argued that although interstate sales made directly to customers were subject to state jurisdiction under the Commerce Clause, Congress, in enacting the NGA, mandated federal regulation of all interstate sales, even direct sales to ultimate consumers.⁶⁷ Rejecting this argument, the Supreme Court held that Congress intended only to occupy the field of regulation that was found to be outside the jurisdiction of the states under the Commerce Clause.

61. *Panhandle E. Pipe Line Co. v. Public Serv. Comm'n*, 332 U.S. 507 (1947).

62. *Id.* at 510.

63. *Public Serv. Comm'n v. Panhandle E. Pipe Line Co.*, 224 Ind. 662, 71 N.E.2d 117 (1947).

64. *Panhandle Eastern*, 332 U.S. at 513.

65. *Id.* at 514.

66. *Id.* at 517.

67. *Id.* at 59.

3. *Federal Power Commission v. Southern California Edison Co.*:⁶⁸
Federal Regulation of Sales Made Primarily Within One State

In *Southern California Edison*, the Court disposed of another major uncertainty facing state and federal regulators. The question presented was whether sales made entirely within one state were nevertheless subject to federal jurisdiction inasmuch as a portion of the power traveled interstate and the sales were to a distribution company for ultimate resale. The Court held that Congress intended to make such sales subject to exclusive federal jurisdiction.

In dispute were sales of electric power by Southern California Edison to the city of Colton. The city of Colton resold the majority of the power to residential, commercial, and industrial customers. Both the sale of power to the city of Colton and the subsequent sales to individual customers occurred wholly within the state of California. For years, the California Public Utilities Commission (PUC) had regulated the sales from Southern California Edison to the city of Colton as though they were subject to exclusive state jurisdiction.⁶⁹

In 1958, the FPC held hearings to determine whether it should assert jurisdiction over the Edison-to-Colton sale. The FPC concluded that a portion of the power in the sale to Colton was derived from an interstate sale from the Hoover Dam to Southern California Edison.⁷⁰ As a result, the FPC claimed exclusive federal jurisdiction over the Edison to Colton sale as a sale in interstate commerce for resale. The Court of Appeals for the Ninth Circuit reversed the FPC, holding that even if the sale was partially in interstate commerce it was nevertheless subject to exclusive state jurisdiction under the FPA.⁷¹ The court of appeals reasoned that the sale would have been subject to state regulation under the Commerce Clause because it did not affect any other state. Consequently, the court ruled, the sale must now have been subject to state regulation under the FPA.⁷²

The Supreme Court reversed, holding that the FPA contains a mechanical bright line jurisdiction test and that, under this test, the FPC had exclusive jurisdiction over the Edison to Colton sale. The Court rejected the view that the sale was not subject to FPC jurisdiction because it affected only the interests of California (i.e., was both sold and resold solely within California). Congress, according to the Court, provided that all sales for resale that were even of partial interstate origin would be subject to exclusive FPC jurisdiction.⁷³ As described by the Court, "Congress meant to draw a bright line easily ascertained between state and federal jurisdiction, making unnecessary such case-by-case analysis."⁷⁴

The three cases described above established the principal foundations for the bright line jurisdictional test, which have remained unchanged to date.

68. *FPC v. Southern Cal. Edison Co.*, 376 U.S. 205 (1964).

69. *Id.* at 206-07.

70. *City of Colton v. Southern Calif. Edison Co.*, 26 F.P.C. 223, 231.

71. *Southern Calif. Edison Co. v. FPC*, 310 F.2d 784 (9th Cir. 1962), *rev'd*, 376 U.S. 205 (1964).

72. *Southern California Edison*, 376 U.S. at 209-10.

73. *Id.* at 211.

74. *Id.* at 215-16.

The cases reduced future federal-state litigation by determining that Congress had chosen a mechanical test, rather than a case-by-case analysis, for determining whether a particular sale was subject to state or federal jurisdiction. The cases also preserved state jurisdiction over interstate sales made directly to ultimate local consumers, while assuring federal authority over sales for resale within a state if the sales were partially of interstate origin. The issue these cases did not address, however, was the preemptive effect of FERC wholesale rate orders on state regulation of retail rates.

III. THE FILED RATE DOCTRINE: THE PREEMPTIVE EFFECTS OF FERC WHOLESALE RATE ORDERS

Had the disputes over the demarcation of the bright line been the principal federal-state questions to be resolved in interpreting the FPA and the NGA, much of the debate over energy federalism would have ended 30 years ago. An unanticipated, and still-festering, problem arose, however, in the application of the bright line—under what circumstances do federal wholesale rate orders have a preemptive effect on state retail rate authority?

Beginning in the early 1950s, state courts began to strike down what they saw as state commission interference with federal wholesale rate regulation. In these cases, state regulators refused to pass through to local ratepayers all of the costs that the local utility had incurred in purchasing its wholesale power. The courts uniformly rejected such actions, holding that, even though the state commissions were regulating only retail rates, the retail rate orders nevertheless interfered with federal wholesale rate regulation. These developments comprised what is now called the "filed rate doctrine," as interpreted in the *Narragansett* line of cases.

The filed rate doctrine essentially provides that the right to a reasonable electric or gas rate is the rate which the FERC files or fixes, and no other.⁷⁵ In other words, no court or state commission has any power to fix a wholesale rate, except upon direct judicial review of a FERC order.⁷⁶ The filed rate doctrine involves a related but distinct legal concept from the bright line jurisdictional test. The bright line test determines only which entity, state or federal, has jurisdiction over a particular *sale* of power. Once it has been determined under the bright line test that the FERC has jurisdiction over a sale, the filed rate doctrine dictates how courts and state public service commissions must treat the FERC order.

The application of the filed rate doctrine to the disputes during the 1950s

75. *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 (1981); *Montana-Dakota Util. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251-52 (1951); *City of Cleveland v. FPC*, 525 F.2d 845, 853 (D.C. Cir. 1976); *People's Counsel v. Public Serv. Comm'n*, 444 A.2d 975, 976 (D.C. App. 1982); *Office of Pub. Counsellor v. Indiana & Mich. Elec. Co.*, 416 N.E.2d 161, 165 (Ind. Ct. App. 1981).

76. For example, in *Montana-Dakota* the utility claimed that its wholesale rate for purchase power was unreasonable because of fraud on the part of the seller. *Montana-Dakota*, 341 U.S. at 248. The Court rejected this claim, holding that Congress had given the FPC sole authority to set wholesale rates and the Court could not change the FPC-approved rate except upon direct judicial review. *Id.* at 252-53. In *Arkansas Louisiana* the state court had calculated damages in a contract claim under a different rate than had been approved by the FERC. *Arkansas Louisiana*, 453 U.S. at 573. The Supreme Court rejected this decision, holding that the right to a reasonable rate is the rate which the FERC fixes.

and 1960s was mundane in comparison to the doctrine's recent history. The filed rate doctrine, as interpreted in *Narragansett*, began in the 1970s to be applied to frustrate state authority over issues of intense concern to local communities—nuclear power plant construction, cancelled nuclear plant costs, imprudent utility purchasing decisions, and non-arm's-length transactions among holding company affiliates. Utilities invoked the filed rate doctrine in each of these instances to shield themselves from what they viewed as “parochial” state regulators. State regulators, on the other hand, decried their loss of authority to the federal government. From the perspective of state commissions, the FERC was adopting a hands-off policy toward scrutiny of utility management decisions that had an important local impact.

The birth of the *Pike County* doctrine, which was viewed as an exception to *Narragansett*, gave new life to state regulation. *Pike County* provided states with the authority to review a local utility's wholesale purchasing decisions to determine whether the company purchased the least expensive energy supplies available. Just recently, however, the *Pike County* doctrine has come under attack and has been narrowed significantly by the Supreme Court as not applicable to sales among affiliates of a multistate holding company. The following is a history of these struggles over the interplay between FERC wholesale rate orders and state retail rate authority.

A. *The Narragansett Doctrine: The Pass-Through of FERC-Approved Wholesale Expenses in Retail Rates*

The *Narragansett* doctrine involves the practical application of the filed rate doctrine by state administrative and judicial systems. It provides that state regulators must treat a utility's FERC-approved wholesale power costs as reasonable operating expenses in the company's retail cost of service. The issue arises when a utility seeks in its retail rate case to pass through its FERC-approved wholesale purchase power costs. Under the *Narragansett* analysis, the retail regulator cannot, in its retail rate hearing, question the reasonableness of the wholesale rate that the FERC has fixed.⁷⁷

1. *Narragansett Electric Co. v. Burke*:⁷⁸ Pass-Through of FERC-Approved Wholesale Costs

In *Narragansett*, the Supreme Court of Rhode Island decided what was to become a landmark case in the field of energy regulation. The court was confronted with the issue of whether the state PUC could investigate the reasonableness of costs underlying wholesale-approved wholesale purchases made by

77. *Northern States Power Co. v. Minnesota Pub. Util. Comm'n*, 344 N.W.2d 374, 378 (Minn. 1984), *cert. denied*, 476 U.S. 1256 (1984); *Eastern Edison Co. v. Department of Pub. Util.*, 446 N.E.2d 684, 689 (Mass. 1983); *Northern States Power Co. v. Hagen*, 314 N.W.2d 32, 38 (N.D. 1981); *United Gas Corp. v. Mississippi Pub. Serv. Comm'n*, 240 Miss. 405, 441-42, 127 So. 2d 404, 420 (Miss. 1961); *City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607, 616, 150 N.E.2d 776, 781 (Ill. 1958); *Citizens Gas Users Ass'n v. Public Util. Comm'n*, 165 Ohio St. 536, 538, 138 N.E.2d 383, 384 (Ohio 1956); *Peoples Natural Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 141 Pa. Super. 5, 16, 14 A.2d 133, 138 (Pa. 1940).

78. *Narragansett Elec. Co. v. Burke*, 119 R.I. 559, 381 A.2d 1358 (1977), *cert. denied*, 435 U.S. 972 (1978).

a local electric utility (Narragansett Electric Company). The court ruled that the state could not inquire into the reasonableness of the FERC-approved wholesale rate and, consequently, must treat it as a reasonable operating expense in the company's retail cost of service.

Narragansett was a member of the New England Electric System (NEES) holding company and purchased its wholesale power from the New England Power Company, another NEES affiliate. In reviewing Narragansett's retail rate application, the PUC admitted that it lacked jurisdiction to determine the reasonableness of the wholesale rate, but determined nevertheless to consider the costs underlying the wholesale rate.⁷⁹ The company appealed the PUC decision, alleging that the PUC lacked jurisdiction to review the reasonableness of the costs constituting the wholesale rate.⁸⁰

The Rhode Island Supreme Court reversed the PUC, holding that the filed rate doctrine prohibited the PUC from analyzing the underlying costs.⁸¹ The court ruled that only the FPC had authority to determine a reasonable wholesale rate, and thus the state PUC must treat such rate as a reasonable operating expense.⁸² The court implied that to investigate the underlying reasonableness of the wholesale costs was to judge the reasonableness of the wholesale rate, a function exclusively of federal jurisdiction. The court cautioned, however, that the state was not required to pass through immediately federally approved costs, but rather could consider these expenses in the context of a standard retail rate proceeding.⁸³ The opinion in *Narragansett* would prove to a bench mark by which state courts, and ultimately the Supreme Court, would judge the permissible bounds of state utility regulation.

2. The Northern States Controversy: Cancelled Nuclear Plant Costs

One important development in the *Narragansett* doctrine has been its application to FERC-approved costs from cancelled nuclear plants. Skyrocketing costs and increasing safety concerns have caused many utilities in the past decade to cancel nuclear power plant projects, often after the investment of substantial resources. These cancellations have engendered many legal battles over whether ratepayers or shareholders should bear the brunt of the utility's investment in the cancelled plant.⁸⁴

In some instances, utilities have undertaken joint ownership of nuclear plants through wholesale power agreements filed with the FERC. In these cases, once the utilities decide to cancel the nuclear project, they file for an amendment to their wholesale agreement to reflect the cancelled plant costs.

79. *Id.* at 563-64, 381 A.2d at 1361.

80. *Id.* at 564, 381 A.2d at 1361.

81. *Id.* at 565, 321 A.2d at 1362.

82. *Id.* at 565, 381 A.2d at 1362.

83. Currently, it is an issue in the natural gas industry whether a local distribution company may immediately recover take-or-pay costs in its purchased gas adjustment clause or must file for recovery of these costs in its general rate case. See Order No. 68269 (Maryland Pub. Serv. Comm'n Dec. 2, 1988).

84. Recently, the Supreme Court considered this issue in *Duquesne Light Co. v. Barasch*. *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989). The Court reaffirmed its earlier pronouncements that state regulators are free to use any method of reviewing utility rate filings that reasonably balances the interests of ratepayers and investors.

Once the FERC approves these costs, the issue arises as to whether the various state jurisdictions affected are required to pass the cancelled plant costs through to local consumers. Responding to these difficult issues, the state courts in *Northern States*, and in other situations,⁸⁵ have held that state commissions cannot selectively deny cancelled plant costs that previously have been approved in a FERC wholesale rate.

In the Northern States Power Company situation, two utilities⁸⁶ planned and began construction of the Tyrone nuclear power plant. When Northern States Power-Wisconsin applied to the Wisconsin PSC for construction approval, the PSC denied the application as failing to meet the state commission's tests for approving new utility plant construction.⁸⁷ The plant ultimately was abandoned after an investment of approximately \$75 million was expended.⁸⁸

Since the two utilities sold power to each other in interstate commerce, they filed with the FERC for recovery of their investment in the cancelled plant. The FERC approved the companies' request to amend their cost allocation contract in order to account for the losses resulting from the Tyrone plant abandonment.⁸⁹ The Eighth Circuit Court of Appeals later affirmed the FERC's allowance of full recovery for the cancelled plant costs.⁹⁰

When the companies sought to have the cancelled plant costs, which were included in the wholesale rate, recovered in retail rates, the Minnesota PUC and North Dakota PSC refused to pass through immediately the FERC-approved costs. On appeal to the Supreme Courts of Minnesota and North Dakota, both courts reversed their respective state commissions.⁹¹ The North Dakota Supreme Court found that to allow the state PSC to deny a rate increase for cancelled plant costs would be to empower it to regulate indirectly interstate wholesales and thereby frustrate the purpose of the FPA.⁹² The Minnesota Supreme Court ruled that the FERC order had established a

85. In addition to the *Northern States* controversy, in a similar situation, the Supreme Judicial Court of Massachusetts ruled that the state department of public utilities was required to pass through the FERC-approved wholesale power costs from the utility's investment in the abandoned Pilgrim II nuclear plant. *Eastern Edison Co. v. Department of Pub. Util.*, 388 Mass. 292, 446 N.E.2d 684, 688 (1983). The court held:

We conclude that, because Eastern Edison's fuel charges were based solely on its wholesale power costs attributable to Montaup's FERC-filed rate, and the Federal Power Act precludes department review of the reasonableness of Montaup's rate, the department should not have refused to pass these power costs through to Eastern Edison's customers in an appropriate fuel charge under [the applicable state statute].

Eastern Edison, 446 N.E.2d at 690.

86. The two utilities are Northern States Power Company (serving North Dakota, South Dakota, and Minnesota) and Northern States Power Company-Wisconsin (serving Wisconsin).

87. *Northern States Power Co. v. Minnesota Pub. Util. Comm'n*, 344 N.W.2d 374, 376 (Minn. 1984), *cert. denied*, 467 U.S. 1256 (1984) [hereinafter *Northern States II*].

88. *Northern States Power Co. v. Hagen*, 314 N.W.2d 32, 33 (N.D. 1981) [hereinafter *Northern States I*].

89. *Northern States Power Co.*, 17 F.E.R.C. ¶ 61,196 (1981), *aff'd sub. nom.* *South Dakota Pub. Util. Comm'n v. FERC*, 690 F.2d 674 (8th Cir. 1982).

90. *South Dakota Pub. Util. Comm'n v. FERC*, 690 F.2d 674 (8th Cir. 1982).

91. *Northern States II*, 344 N.W.2d at 378; *Northern States I*, 314 N.W.2d at 38.

92. *Northern States I*, 314 N.W.2d at 38.

wholesale rate, and not merely a cost allocation, and thus the state PUC was prohibited from examining the reasonableness of the cancelled plant costs.⁹³ The court suggested, however, that if the FERC order had constituted merely a cost allocation between the two utilities, the state PUC would have had authority to review the cost pass-through.⁹⁴

3. *Washington Gas Light Co. v. Public Service Commission*:⁹⁵ Pass-Through of Gas Research Institute Surcharges

The next scenario in the application of the *Narragansett* doctrine concerned the pass-through of wholesale charges from the Gas Research Institute (GRI). Once the FERC approved GRI expenses in the wholesale rates of interstate gas pipelines, the issue became whether state commissions were required to pass through such costs in their entirety. In *Washington Gas Light*, and in other cases,⁹⁶ the state courts held that FERC-approved GRI expenses must be fully passed through to retail ratepayers, even if all of the expenses could not be shown to benefit those ratepayers.

The Gas Research Institute is a nonprofit research arm of the natural gas industry. Its members are natural gas pipelines and distribution companies. GRI's costs are charged to its members, who in turn recover such costs in the wholesale rates that they charge to other pipelines and distribution companies.

In *Washington Gas Light*, the retail utility sought to pass through its wholesale purchase power costs, a part of which included charges to its pipeline suppliers by GRI. The local public service commission ordered the utility to prove that the GRI surcharges actually benefited the customers in the utility's service area.⁹⁷ The PSC had issued a rule that created a presumption that 25% of GRI surcharges would, directly or indirectly, benefit local ratepayers; the utility, however, bore the burden of proving that the remaining costs specifically benefited local ratepayers.⁹⁸

The District of Columbia Court of Appeals reversed the public service commission, holding that the commission had no authority to rule on the reasonableness of GRI surcharges or the issue of whether the Institute's research benefited local ratepayers.⁹⁹ The court concluded that under the filed rate

93. *Northern States II*, 344 N.W.2d at 381.

94. *Id.* at 377.

95. *Washington Gas Light Co. v. Public Serv. Comm'n*, 508 A.2d 930 (D.C. App. 1986).

96. In a situation similar to *Washington Gas Light*, the Colorado Supreme Court ruled that the public utilities commission was required to treat Gas Research Institute (GRI) surcharges as reasonable operating expenses in the retail utility's cost of service.

97. *Washington Gas Light*, 508 A.2d at 931. *Washington Gas Light Company* was appealing a generic rule that applied to all utilities seeking to pass through GRI surcharges in proceedings before the District of Columbia PSC. *Id.*

98. *Id.* at 933.

99. *Id.* at 937. The court explained that "the Commission has no authority to rule on the reasonableness of GRI surcharges, and likewise has no authority to consider whether, for purposes of rate treatment, GRI surcharges benefit District of Columbia ratepayers." *Id.* Much of the dispute in *Washington Gas Light* was over the interpretation of the court's previous decision on the same issue. *Washington Gas Light Co. v. Public Serv. Comm'n*, 452 A.2d 375 (1982), *cert. denied*, 462 U.S. 1107 (1983). In its first decision, the court held that the commission was required to treat GRI wholesale surcharges as reasonable operating expenses for the retail utility. *Washington Gas Light*, 452 A.2d at 386.

doctrine, the PSC was required to treat the GRI surcharges as reasonable operating expenses for purposes of the utility's retail cost of service.¹⁰⁰ As a consequence, reasoned the court, the PSC was required to pass through such costs in their entirety to the local ratepayers.¹⁰¹

B. The Pike County Doctrine: State Commission Authority to Investigate the Prudence of Utility Purchasing Decisions

Under a doctrine commonly referred to as *Pike County*, state commissions are deemed to possess the authority to review the prudence of a utility's wholesale-level purchasing decisions, notwithstanding prior FERC approval of the rate for the wholesale transaction. The *Pike County* analysis, which is often called an "exception" to the *Narragansett* doctrine, has been a source of great tension in the development of the filed rate doctrine.

Advocates of states' rights have hailed the decision, and its progeny, as necessary to maintain local control over the major power purchasing decisions made by utility management.¹⁰² Some advocates of federal preemption have attacked the doctrine directly as an impermissible interference with FERC's authority.¹⁰³ Others have acknowledged its validity in a narrow factual setting, while disputing its applicability to situations involving cost allocations and multistate holding company power purchases.¹⁰⁴ In all likelihood, *Pike County* will become the future touchstone for defining the limitations of the filed rate doctrine.

The *Pike County* doctrine examines, on a case-by-case basis, the specific inquiry that a state PSC sought to conduct. Under *Pike County*,¹⁰⁵ a state commission is not preempted from investigating the prudence of a retail utility's decision to purchase a particular quantity of power at a FERC-approved price. The analysis does not question the reasonableness of the FERC-approved wholesale rate, but rather asks whether such a purchase was prudent in light of the availability of less expensive power.¹⁰⁶ The premise is that when the FERC sets a wholesale rate between wholesale seller and buyer, it determines a just and reasonable price by reviewing the cost structure of the whole-

The court, in a footnote, added the observation that the FERC could not, by approving GRI surcharges, compel the state commission to pass through the costs to local consumers. *Id.* at 385 n.15. In its second decision, the court rejected the possible contradiction presented by the footnote and instructed that GRI surcharges were to be treated as reasonable operating expenses and passed through by the retail utility. *Washington Gas Light*, 508 A.2d at 938.

100. *Washington Gas Light*, 508 A.2d at 936.

101. *Id.* at 938.

102. See *Nixon & Johnston*, *supra* note 4.

103. *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Serv. Comm'n*, 837 F.2d 600 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 365 (1988).

104. See Duffy, *supra* note 4; Abbott, *Nantahala/Mississippi Power & Light: Impact on Local Regulation* (paper presented at the 1988 FEBA mid-year meeting).

105. *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 274, 465 A.2d 735, 738 (1983).

106. *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 837 F.2d 600, 608 (3d Cir. 1988); *Commonwealth Elec. Co. v. Department of Pub. Util.*, 397 Mass. 361, 379, 491 N.E.2d 1035, 1045 (1986); *In re Sinclair Machine Products*, 126 N.H. 822, 825, 498 A.2d 696, 699 (1985); *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 274, 465 A.2d 735, 738 (1983).

sale seller, but does not determine whether the wholesale buyer was wise in purchasing the power in view of its other options.¹⁰⁷ As a result, state commissions may inquire into the prudence of the retail utility's purchasing decisions in determining whether to allow the utility full recovery of its purchase power costs in its retail cost of service.

Surprisingly, the *Pike County* doctrine had its genesis in the decisions of the FERC. In a long line of FERC opinions, the Commission decided that when it sets wholesale rates it decides only that the price of the sale is reasonable given the cost structure of the wholesale level seller, but does not decide whether it was wise for the purchasing utility to buy the power given its other options.¹⁰⁸ Specifically, the FERC has stated that it "is not empowered to disapprove or modify a power sales agreement on the grounds that the buyer may not be making the best possible deal."¹⁰⁹ Consequently, state public service commissions are free to examine the prudence of a retail utility's wholesale purchasing practices.¹¹⁰ Several courts have recently adopted the FERC's interpretation of its own authority and have upheld state commission orders reviewing the prudence of a retail utility's wholesale-level purchasing practices.

1. *Pike County Light and Power Co. v. Pennsylvania Public Utility Commission*:¹¹¹ Establishment of State Authority to Review the Prudence of a Utility's Wholesale Purchasing Decisions

In *Pike County*, the Pennsylvania appellate court was required to decide whether the state PUC could disallow certain wholesale purchase power costs on the ground that less expensive sources of supply were available. In a decision that would be heavily relied upon in the future as an example of proper state commission inquiry, the court held that the PUC could review the utility's wholesale purchasing practices without interfering with FERC's jurisdiction over wholesale rates.

The Pike County Light & Power Company purchased all of its power from Orange & Rockland Utilities, Pike County's parent corporation. The supply of power from Orange & Rockland to Pike County was governed by a

107. Monongahela Power Co., 39 F.E.R.C. ¶ 61,350, at 62,095 (1987); Pennsylvania Power & Light Co., 23 F.E.R.C. ¶ 61,006, at 61,019 (1983); 15 F.E.R.C. ¶ 61,264, at 61,601.

108. 39 F.E.R.C. ¶ 61,350, at 62,095; Pacific Power & Light Co., 27 F.E.R.C. ¶ 61,080, at 61,148 (1984); Southern Co. Servs., 26 F.E.R.C. ¶ 61,360, at 61,795 (1984); Pennsylvania Power & Light Co., 23 F.E.R.C. ¶ 61,325, at 61,716 (1983); 23 F.E.R.C. ¶ 61,006, at 61,019; Southern Co. Servs., 20 F.E.R.C. ¶ 61,332, at 61,694 (1982); 15 F.E.R.C. ¶ 61,264, at 61,601.

109. 26 F.E.R.C. ¶ 61,360, at 61,795.

110. 23 F.E.R.C. ¶ 61,325, at 61,716; 15 F.E.R.C. ¶ 61,264, at 61,601. The Commission explained its rationale as follows:

We do not view our responsibilities under the Federal Power Act as including a determination that the purchaser has purchased wisely or has made the best deal available. However, these are legitimate concerns of the State commissions and this Commission as well in determining whether purchases reflect prudently incurred expenses for purposes of determining the purchaser's rates for sales to others.

23 F.E.R.C. ¶ 61,325 at 61,716.

111. *Pike County Light & Power Co. v. Pennsylvania Util. Comm'n*, 77 Pa. Commw. 268, 465 A.2d 735 (1983).

power supply agreement filed with the FERC. When Pike County filed to recover its retail cost of service, the Pennsylvania PUC disallowed a portion of Pike County's purchase power costs. The Commission found that Pike County was imprudent in relying on Orange & Rockland as a supplier, and could have found more economical sources of power elsewhere.¹¹²

The Commonwealth Court of Pennsylvania affirmed, ruling that the public utility commission had the authority under the FPA to make such a determination.¹¹³ The court rested its decision on the distinction between the functions that state and federal regulators perform. The FERC analyzes the cost of service data of the wholesale-level seller in determining a reasonable rate, whereas the state PUC analyzes the purchaser's cost of service to determine if more economical sources of power were available. The court concisely stated its rationale, which has served as the basis for many subsequent affirmations of state commission authority to consider power purchasing decisions: "So while FERC determines whether it is against the public interest for Orange & Rockland to charge a particular rate in light of its costs, the PUC determines whether it is against the public interest for Pike to pay a particular price in light of its alternatives."¹¹⁴ As discussed below, the *Pike County* rationale has been followed by several courts, including the Court of Appeals for the Third Circuit.

2. *Kentucky West Virginia Gas Co. v. Pennsylvania Public Service Commission*.¹¹⁵ The Third Circuit Affirms the *Pike County* Analysis

In *Kentucky West Virginia*, the Court of Appeals for the Third Circuit recently faced the claim that a *Pike County* review of the prudence of a utility's wholesale purchasing decisions was preempted under the NGA. The case is significant in that it represents the first instance in which a United States Court of Appeals has ruled directly on the validity of *Pike County* (in a non-allocation context). The Third Circuit ruled that states are free to question whether a utility could have purchased power that was less expensive than the power it in fact purchased under a FERC-approved rate.

Equitable Gas was a gas transportation and distribution company operating in Pennsylvania. Equitable purchased gas at wholesale from an affiliated company, Kentucky West Virginia Gas.¹¹⁶ A Pennsylvania statute provided that if a utility purchased gas from an affiliated company, the state PUC must make an affirmative determination that the utility vigorously attempted to obtain less expensive gas.¹¹⁷ After a hearing, the PUC found that Equitable could in fact have purchased less expensive gas than the gas it purchased from its affiliate, Kentucky West. Consequently, the PUC disallowed \$14 million of

112. *Id.* at 271, 465 A.2d at 736.

113. *Id.* at 275, 465 A.2d at 738.

114. *Id.* at 274-75, 465 A.2d at 738.

115. *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 837 F.2d 600 (3d Cir. 1988), cert. denied, 109 S. Ct. 365 (1988).

116. *Id.* at 603.

117. 66 PA. CONS. STAT. ANN. § 1318(b) (Purdon 1988).

Equitable's purchase power costs as imprudently incurred.¹¹⁸

The Court of Appeals for the Third Circuit upheld the state PUC order, finding that it was not preempted under the NGA. The utility claimed that the PUC prudence review was an attempt to regulate indirectly the wholesale rate between Kentucky West and Equitable, which was subject to FERC jurisdiction.¹¹⁹ The Court of Appeals rejected this reasoning, concluding that the FERC's exclusive jurisdiction does not extend to all aspects of the wholesale transaction.¹²⁰ The court concluded that the FERC does not consider the prudence of the purchaser in entering into the wholesale transaction. Moreover, the court noted, the FERC has interpreted its own statutory authority as not including a review of the prudence of the purchaser's decision to enter into the wholesale contract.¹²¹ The Supreme Court recently denied the utility's petition for *certiorari*.¹²²

3. *In re Sinclair Machine Products*:¹²³ State Authority to Review Wholesale Purchasing Decisions Where Cancelled Nuclear Plant Costs Are Involved

In *Sinclair Machine Products*, the New Hampshire Supreme Court was confronted with an alleged direct conflict between the *Narragansett* doctrine and the *Pike County* analysis. In the underlying dispute, the state PUC denied the pass-through of cancelled nuclear plant costs on the grounds of imprudence, action which the utility alleged was prohibited under the *Narragansett* doctrine. The state court sustained the state commission order, holding that the PUC had properly investigated the prudence of wholesale purchasing decisions, rather than selectively disallowing FERC-approved cancelled plant costs.

Connecticut Valley Electric Company was a retail electric utility operating in New Hampshire. Connecticut Valley purchased most of its power from

118. *Kentucky West Virginia*, 837 F.2d at 604.

119. *Id.* at 607.

120. *Id.* at 608. The Third Circuit explained the federal-state division of regulatory authority under the filed rate doctrine:

Regarding the states' traditional power to consider the prudence of a retailer's purchasing decision in setting retail rates, we find no reason why utilities must be permitted to recover costs that are imprudently incurred; those should be borne by the stockholders, not the rate payers. Although *Nantahala* underscores that a state cannot independently pass upon the reasonableness of a wholesale rate on file with FERC, it in no way undermines the longstanding notion that a state commission may legitimately inquire into whether the retailer prudently chose to pay the FERC-approved wholesale rate of one source, as opposed to the lower rate of another source.

We note that FERC's interpretation of its statutory authority recognizes that wholesale rate-making does not as a general matter determine whether a purchaser has prudently chosen from among available supply options. FERC is called upon to pass upon the justness and reasonableness of wholesale rates and wholesale transactions, not whether a retailer acted prudently in making the purchase.

Id. at 609.

121. *Id.* at 609.

122. *Id.*

123. *In re Sinclair Mach. Prods.*, 126 N.H. 822, 498 A.2d 696 (1985).

Central Vermont Public Service Company, its parent corporation.¹²⁴ The wholesale rate paid for the power purchased by Connecticut Valley from Central Vermont was approved by the FERC. This wholesale rate included the approval of costs relating to abandoned investments in the Pilgrim II and Montague nuclear power plants.¹²⁵

When Connecticut Valley sought to pass through the wholesale power costs in its retail cost of service, several industrial customers intervened. The customer,s alleged that, under the state's statute prohibiting allowance for construction work in progress,¹²⁶ Connecticut Valley was prohibited from passing cancelled plant costs on to consumers.¹²⁷ The state PUC held that the FERC's approval of the wholesale rate preempted the state from applying its statute, and thus the PUC must treat the cancelled plant costs as reasonable operating expenses.¹²⁸

The Supreme Court of New Hampshire reversed, holding that there were lines of inquiry that the PUC could legitimately pursue without interfering with FERC's exclusive authority over wholesale rates.¹²⁹ The court acknowledged that under the *Narragansett* doctrine the PUC could not selectively disallow portions of the wholesale costs that represented cancelled plant expenses.¹³⁰ The PUC could, however, question the prudence of Connecticut Valley's participation in the entire wholesale purchase agreement with Central Vermont in light of available alternatives.¹³¹ Thus, the court resolved the apparent conflict between application of the *Narragansett* and *Pike County* doctrines.¹³²

Despite *Pike County*'s present vitality, some state officials predict that it may represent the next area where utilities, or the FERC, seek to limit state public utility jurisdiction.¹³³ The next two sections of this article address the limits that the FERC and the Supreme Court have placed on *Pike County*-type prudence reviews to date.

C. Application of the Filed Rate Doctrine to Wholesale Purchases Among Affiliates of a Multistate Holding Company

Difficult policy questions arise when the filed rate doctrine is applied to a retail utility's wholesale-level purchasing decisions within a multistate holding company. For example, the most recent clashes over the scope of *Narragansett* and *Pike County* have occurred in the holding company context.

Pike County provided state regulators with an effective answer to the

124. *Id.* at 824, 498 A.2d at 698.

125. *Id.* at 825, 498 A.2d at 699.

126. N.H. REV. STAT. ANN. § 378:30-a (1984).

127. *Sinclair Machine*, 126 N.H. at 825, 498 A.2d at 699.

128. *Id.* at 825, 498 A.2d at 699.

129. *Id.* at 825, 498 A.2d at 699.

130. *Id.* at 830, 498 A.2d at 702.

131. *Id.* at 830, 498 A.2d at 703.

132. On similar grounds, the Massachusetts Supreme Judicial Court resolved any potential conflict between the two doctrines. *Commonwealth Elec. Co. v. Department of Pub. Utils.*, 397 Mass. 361, 379, 491 N.E.2d 1035, 1045 (1986).

133. See *Nixon & Johnston*, *supra* note 4.

restrictions imposed by *Narragansett*. When several state commission's attempted to conduct *Pike County*-type reviews of the local affiliates of holding company systems, however, they were rebuffed by the FERC. The Commission basically determined that state commissions did not have authority, even under *Pike County*, to review wholesale purchases among affiliates of a holding company system. The FERC's rationale was, *inter alia*, that these affiliates lacked the discretion to select other sources of power because of their "captivity" within the holding company structure. To many state commissions, the repudiation of *Pike County* in the holding company context seemed to be an unwise policy, considering that it involves an area where affiliates engage in non-arms-length transactions.

A multistate holding company is a group of utilities which, by affiliating, can coordinate power generation and transmission decisions for the entire holding company system.¹³⁴ Multistate holding companies are, in addition to being subject to the FERC's ratemaking authority, subject to SEC regulation under the Public Utility Holding Company Act of 1935 (PUHCA).¹³⁵ Multistate holding company systems typically will file a power pool agreement or power allocation agreement with the FERC that determines which power plants (or portions thereof) will serve each of the affiliated utilities.¹³⁶ The issue of state versus federal jurisdiction arises when a state commission seeks to determine the prudence of its retail utility's purchasing decision within the holding company system.¹³⁷ The question becomes whether a state commission is entitled to conduct the standard *Pike County* prudence review or whether such prudence review is preempted by the FERC's approval of the power pool or power allocation agreement?

The issue was first presented to the FERC in *AEP Generating Co.*¹³⁸ The American Electric Power Company (AEP) was a multistate holding company, composed of several operating utilities, which operates on an integrated basis under a system interconnection agreement.¹³⁹ Under the agreement, the affiliated utilities shared power from their individual generating plants and transferred payments among each other to compensate for the power purchased and sold.¹⁴⁰ The dispute occurred when the AEP System filed a unit power

134. The common stock of the affiliated utilities of a holding company system is usually owned in its entirety by the parent corporation. Thus, each utility is not an autonomous entity; rather, decisions for the holding company system are typically made by one common board of directors.

135. 15 U.S.C. §§ 79 to 79z-6 (1982).

136. See *Mississippi Indus. v. FERC*, 808 F.2d 1525, 1529 (D.C. Cir. 1987); *American Elec. Power Serv. Corp.*, 32 F.E.R.C. ¶ 61,363 (1985).

137. See *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428, 2435-38 (1988); *New Orleans Pub. Serv. Inc. v. Council of New Orleans*, 850 F.2d 1069 (5th Cir. 1988), *cert. granted*, 109 S. Ct. 780 (1989); *Opinion No. 266-A*, *AEP Generating Co.*, 39 F.E.R.C. ¶ 61,158, at 61,629-30 (1988).

138. *AEP Generating Co.*, 29 F.E.R.C. ¶ 61,246 (1984). The issue of state versus federal jurisdiction over sales on the American Electric Power System arose over the course of several years under several different FERC dockets.

139. *Kentucky Power Co.*, 36 F.E.R.C. ¶ 61,227 (1986).

140. *Id.* at 61,552. The FERC has described the System Agreement as follows:

The AEP System operates on an integrated basis pursuant to the terms of the AEP System Interconnection Agreement (System Agreement). While the individual operating companies own and operate the facilities that comprise the AEP System, the facilities are planned on a systemwide

sales agreement with the FERC that provided, in pertinent part, a method for the sales of power from a large generating plant between various affiliates.¹⁴¹

Subsequent to the AEP System filing of its unit power sales agreement for approval by the FERC, the intervening parties, including state parties, requested a declaration by the FERC that it would not consider the prudence of Kentucky Power Company (one of the AEP affiliates) in entering into the agreement.¹⁴² Citing its prior orders holding that the FERC does not consider the prudence of a purchaser in a wholesale transaction,¹⁴³ the FERC ruled that it would not make any findings related to Kentucky Power's prudence.¹⁴⁴ As it had in its previous orders, the FERC explained that it would only consider whether the proposed rate from AEP Generating Company (seller) to Kentucky Power (buyer) was just and reasonable.¹⁴⁵

In a later decision involving the same AEP interconnection agreement, however, the FERC changed its interpretation of its jurisdiction.¹⁴⁶ The FERC held that a state commission could not rule on the prudence of an AEP retail utility's entrance into the transmission agreement without ruling on the merits of the agreement itself (which was subject to exclusive FERC jurisdiction).¹⁴⁷ In a related decision, the FERC explained that because an agreement between affiliated utilities raises complex and interrelated questions, matters of

basis and operated on central dispatch, generating the lowest cost energy to meet total system load. The System Agreement provides, among other things, for payments among the operating companies to account for capacity deficiencies and surpluses. Monthly cash payments are made by those members which have a "primary capacity deficit," as defined in Article 5 of the System Agreement, to those which have a "primary capacity surplus" at a rate equal to the surplus members' cost of steam capacity.

Id. at 61,551-52.

141. AEP Generating Co., 36 F.E.R.C. ¶ 61,226 (1986). The unit power sales agreement covered the sales of power between AEP Generating Company (AEP), Indiana & Michigan Electric Company, and Kentucky Power Company with respect to the Rockport Generating Station, a 1300 MW facility located in Spencer County, Indiana. *Id.* at 61,549.

142. AEP Generating Co., 29 F.E.R.C. ¶ 61,246, at 61,500-01 (1984). The Kentucky Public Service Commission, which regulates Kentucky Power, initially denied Kentucky Power's request to own a portion of the Rockport plant. As a result, Kentucky Power entered into a unit power sales agreement with AEP to buy power from the plant. Subsequently, the Kentucky Commission disallowed Kentucky Power's cost of purchase power from Rockport on the grounds that its cost was in excess of the cost of power elsewhere on the AEP system. 36 F.E.R.C. ¶ 61,227, at 61,552.

143. Pacific Power & Light Co., 27 F.E.R.C. ¶ 61,080 (1984).

144. 29 F.E.R.C. ¶ 61,246, at 61,501. The Commission stated, "However, in this proceeding, we do not intend to make or consider any findings concerning KEPCO's prudence in entering the agreement, in light of the availability of alternative power supplies." *Id.*

145. *Id.*

146. American Elec. Power Serv. Corp., 32 F.E.R.C. ¶ 61,363 (1985).

147. *Id.* at 61,818. The FERC ruled that membership in the multistate holding company was governed by SEC regulations and that the transmission agreement was under the exclusive jurisdiction of the FERC.

Transmission and the allocation of costs of the established AEP transmission network are integral parts of the operation of the AEP pool. Therefore, the prudence of being a party to the EHV transmission agreement cannot be considered separately from the prudence of being a party to the entire AEP pool relationship. A challenge to the membership in a public utility holding company power pool of a member of the holding company is a federal [SEC] matter.

Moreover, a state commission could not review the prudence of an AEP operating company in entering into the EHV transmission agreement without invading our jurisdiction by ruling to some extent on the merits of the agreement itself. . . . Commission precedent leaving to the state

the prudence of each utility is most properly considered under the FERC's exclusive jurisdiction.¹⁴⁸

More specifically, the FERC later held in another related decision that the *Pike County* analysis was inapplicable in the holding company context because the retail utility in issue had no choice to buy power from other sources.¹⁴⁹ Since the holding company decided the manner in which power would be allocated among its affiliates, those affiliates had no option to purchase power elsewhere. As a result, held the FERC, the prudence of those purchases was within the exclusive jurisdiction of the FERC.¹⁵⁰ The Court of Appeals for the Fourth Circuit upheld the FERC's interpretation as applied to the AEP System.¹⁵¹

commissions the question of the prudence of an operating company in making a particular purchase is not applicable under the facts of this case.

Id. (footnote omitted).

148. AEP Generating Co., 36 F.E.R.C. ¶ 61,226, at 61,550 (1986). The FERC explained:

The continuing controversy that has ensued, however, makes it clear that where, as here, the transaction involves affiliated, jurisdictional utilities, which are members of an integrated interstate holding company arrangement, performing diverse functions on a coordinated basis, and particularly where differing interpretations are advocated concerning the parties' rights and obligations under the basic system agreements, the relevant issues may not be so readily segregated. Under these circumstances, more complex, interrelated questions arise and, whether one characterizes the questions as related to prudence, interpretation or cost allocation, they are clearly resolved by this Commission as part of its overriding authority to evaluate and implement all applicable wholesale rate schedules.

Id.

149. Opinion No. 266, AEP Generating Co., 38 F.E.R.C. ¶ 61,243, at 61,821 (1987). The FERC stated:

[The state commission's argument] erroneously assumes that equalization charges are a substitute for the addition of new capacity on the system and that KEPCO possesses "autonomy" to choose between the assignment of Rockport capacity and continued reliance upon the other members for that portion of capacity represented by the Rockport purchase. In the circumstances of this case, KEPCO does not have the "option" of relying upon the capacity equalization charge in lieu of purchasing power from the Rockport plant.

Id.

150. Opinion No. 266-A, AEP Generating Co., 39 F.E.R.C. ¶ 61,158, at 61,630 (1987). The FERC explained why an affiliate of a multistate holding company's lack of autonomy frustrates the application of the *Pike County* analysis:

[T]he absence of choice under the Interconnection Agreement in this holding company context underscores why the Kentucky Commission erred in considering KEPCO's prudence. Thus, while we agree that the lack of autonomy on the part of individual members of a registered public-utility holding company system heightens the need for regulatory scrutiny over arrangements such as the Rockport unit power sales agreement, that scrutiny can only take place at the Federal level.

Id. at 61,627.

The *Pike County* doctrine, reflected in the above passage, is inapplicable to the facts of this case. . . . Because the essence of the *Pike County* inquiry is whether a particular choice was wise, the lack of choice here makes such inquiry an empty one.

Id. at 61,630.

151. *Appalachian Power Co. v. Public Serv. Comm'n*, 812 F.2d 898, 903 (4th Cir. 1987). The Fourth Circuit held that the *Pike County* analysis is inapplicable in the holding company context and that state regulation of an affiliated company's wholesale purchasing decisions would raise the potential for conflict with the FERC's authority. *Id.* at 903-04.

D. *Nantahala and Mississippi: The Supreme Court Rules on the Preemptive Effect of the FERC Cost Allocation Orders*

In two recent cases, *Nantahala Power & Light Co. v. Thornburg* and *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, the Supreme Court reviewed state commission¹⁵² decisions that allegedly conflicted with the FERC's allocation of costs among affiliated utilities. In both cases, the Supreme Court ruled that state commission attempts to interfere with FERC decisions regarding cost allocations among affiliated utilities are preempted by the FPA.¹⁵³

1. *Nantahala Power & Light v. Thornburg*:¹⁵⁴ State Commission Review of FERC Cost Allocations

The Supreme Court's 1986 decision in *Nantahala* came on the heels of the brewing controversy over the FERC's adoption of a separate preemption rule for purchases among holding company affiliates. It would be two full years, however, before the FERC's holding company rule would reach the Supreme Court via *Mississippi*. At the time, *Nantahala* could have been viewed as involving a fairly unique and obscure factual situation—the FERC's cost allocation of power from the Tennessee Valley Authority (TVA). Despite these inauspicious beginnings, however, *Nantahala* proved to foreshadow fully the Supreme Court's 1988 decision in *Mississippi*.

In *Nantahala* the Supreme Court was presented with the question of whether a state commission could, for retail rate purposes, prescribe an allocation of power that was different than the allocation established by FERC. A retail utility, Nantahala Power & Light Company, and its affiliate, Tapoco, Inc. (Tapoco), both purchased amounts of low cost entitlement power and high cost purchase power from a single wholesale seller, TVA.¹⁵⁵ Nantahala and Tapoco were both wholly owned subsidiaries of the Alcoa Company. Nantahala and Tapoco negotiated an agreement to apportion the two sources of power between themselves.¹⁵⁶

Because the sales of power at wholesale were in interstate commerce, Nantahala and Tapoco filed with the FERC the agreement allocating to each a specific percentage of the low cost and high cost power. The state commission, North Carolina PUC, with regulatory authority over Nantahala Power & Light participated in the FERC proceedings, arguing that a different allocation methodology should be approved.¹⁵⁷ In view of the fact that Nantahala

152. In *Mississippi*, it was actually the Mississippi Supreme Court that ordered the state public service commission to investigate prudence. *Mississippi*, 108 S. Ct. at 2436-37. The public service commission had previously interpreted the FERC's orders as preempting a prudence inquiry. *Id.* at 2437.

153. *Mississippi*, 108 S. Ct. at 2438; *Nantahala*, 476 U.S. at 955.

154. *Nantahala*, 476 U.S. 953.

155. *Id.* Both Nantahala and Tapoco owned hydroelectric power plants, which produced inexpensive power. Under agreement, the Tennessee Valley Authority (TVA) operated those facilities for Nantahala and Tapoco. The power generated from those facilities was poured into TVA's power grid. In exchange, TVA provided a specified amount of low cost entitlement power to Nantahala and Tapoco. Nantahala and Tapoco also had the option to buy higher cost purchase power from TVA. *Id.*

156. *Id.*

157. *Id.* at 957. The state argued before the FERC that Nantahala and Tapoco should have been

and Tapoco were affiliates, the North Carolina PUC petitioned the FERC to treat them as a single entity for ratemaking purposes in order to prevent abuse of the corporate form.

Under the state PUC methodology, Nantahala would have received a greater share of the low cost power, thereby reducing retail rates to local customers. The FERC concluded, however, that the allocation agreement was the result of arms length bargaining and that the two companies, therefore, should be treated as separate entities. After slightly raising Nantahala's share of low cost power, the FERC approved the allocation.¹⁵⁸

After the FERC approval of the allocation, the North Carolina PUC held hearings to consider the pass-through of these wholesale power costs in Nantahala's retail cost of service. The PUC determined that the allocation agreement was not fair to Nantahala, and concluded that the two companies should be treated as a single entity for ratemaking purposes.¹⁵⁹ The methodology used by the PUC was the same urged upon the FERC in the federal proceedings. The PUC's final order computed Nantahala's retail cost of service as if it had received a slightly higher portion of low cost power.¹⁶⁰ On appeal to the North Carolina Supreme Court, the court affirmed the PUC order, holding that the PUC order in no way altered or interfered with the FERC-approved allocation contract.¹⁶¹

The Supreme Court, however, reversed the state supreme court, ruling that the PUC retail rate order resulted in an impermissible interference with the FERC allocation. The Court interpreted the filed rate doctrine as requiring the North Carolina PUC to give effect to the FERC-approved allocation of low and high cost power.¹⁶² The filed rate doctrine, the Court asserted, was not limited to rates per se, but also required recognition of FERC cost allocations.¹⁶³ The Court found that the North Carolina PUC order resulted in an impermissible "trapping" of the FERC-approved costs in that Nantahala Power could not, under the retail order, recover the full cost of its wholesale power purchases.¹⁶⁴

In its holding, the Supreme Court approvingly relied on the decisions of

treated, because of their affiliation, as a single entity for determining the proper allocation. The state asserted that Nantahala and Tapoco had used the corporate form to the disadvantage of Nantahala's retail customers. The FERC, however, declined to pierce the corporate veil. *Id.*

158. *Id.* at 956. Under the FERC order, Nantahala was allocated 22.5% of the low cost entitlement power. *Id.*

159. *Id.* at 957.

160. The PUC order structured Nantahala's retail cost of service to reflect a 24.5% allocation of low cost power. *Id.* at 960.

161. *State ex rel. Util. Comm'n v. Nantahala Power & Light Co.*, 313 N.C. 614, 332 S.E.2d 397 (1985).

162. *Nantahala*, 476 U.S. at 966. The Court described the *Narragansett* filed rate doctrine decisions as necessary to enforce the FERC's exclusive authority over wholesale rates under the FPA's bright line. *Id.* at 966.

163. *Id.* at 966-67.

164. *Id.* at 970. The Court explained why the North Carolina PUC order would result in a trapping of FERC-approved costs:

The filed rate doctrine ensures that sellers of wholesale power governed by FERC can recover costs incurred by their payment of just and reasonable FERC-set rates. When FERC sets a rate between a seller of power and a wholesaler-as-buyer, a State may not exercise its undoubted

state courts under the *Narragansett* doctrine.¹⁶⁵ The Court also referred to the *Pike County* doctrine, but stated that it was inapplicable in the present case. The Court concluded that Nantahala Power's purchasing practices could not have been imprudent because the utility had no choice but to accept the amount of low cost power provided for in the FERC allocation. The Court then made the often-cited statement that:

Without deciding this issue, we may assume that a particular *quantity* of power procured by a utility from a particular source could be deemed unreasonably excessive if lower-cost power is available elsewhere, even though the higher-cost power actually purchased is obtained at a FERC-approved, and therefore reasonable, *price*.¹⁶⁶

As a result of this language, the Court arguably left open to state commissions the use of the *Pike County* prudence inquiries in cases involving different factual settings. One product of this uncertainty was the litigation in the *Mississippi* case.

2. *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*.¹⁶⁷
Federal Preemption of State Inquiries Into Wholesale
Purchases Among Holding Company Affiliates

The Grand Gulf nuclear power plant controversy was not only one of the hottest issues facing the Southeast region in the late 1970s and 1980s, but by the mid-1980s had reached the level of national concern. For the states involved (Louisiana, Mississippi, Arkansas, and Missouri), the Grand Gulf plant represented unneeded and unwanted power that was the highest priced in the region—a commodity with the potential for an extremely destructive impact for some of the poorest states in the nation. For utility executives, the controversy and litigation surrounding Grand Gulf constituted evidence that the traditional regulatory compact had been breached by state commissions employing twenty-twenty hindsight to protect the “parochial” interests of their constituents. The pitch of the struggle reached such heights that Grand Gulf was the center of at least two congressional hearings in 1986.¹⁶⁸

The ultimate issue regarding Grand Gulf would be whether the individual state commissions on the Middle South Utility (MSU) system would have authority to require the utility's shareholders to bear some of the cost of what the state commissions viewed as the pinnacle of utility mismanagement. When the FERC approved an allocation of power from Grand Gulf to the affiliates of the MSU holding company, the prospect of federal preemption of state prudence reviews was the immediate concern.

The decision in *Mississippi*, which was the first of the state commission appeals to reach the Supreme Court, was followed closely by commentators

jurisdiction over retail sales to prevent the wholesaler-as-seller from recovering the costs of paying the FERC-approved rate.

Id.

165. *Id.* at 965-66.

166. *Id.* at 972.

167. *Mississippi*, 108 S. Ct. 2428.

168. *Ratepayer Protection Hearings*, *supra* note 34; *Power Plant Costs Hearings*, *supra* note 34.

and, indeed, the entire electric utility industry. As early as 1984, a year before the FERC issued its allocation order, Professor Richard Pierce noted the Grand Gulf litigation as one case to watch in the evolving pattern of tension over utility creation of corporate arrangements to avoid state jurisdiction.¹⁶⁹ In 1987, in an article in this Journal, Dr. Robert Johnston and Walter Nixon sharply criticized the FERC's asserted authority to preempt state prudence reviews through its Grand Gulf allocation order and predicted that the issue ultimately would have to be decided by the Supreme Court.¹⁷⁰ Just this past year, also in this Journal, Kevin Duffy cited the Supreme Court's acceptance of certiorari in the *Mississippi* case as an opportunity to clarify *Nantahala*, and suggested that the Court might likely overrule the Mississippi Supreme Court.¹⁷¹

In *Mississippi*, the Supreme Court was faced with an issue not present in *Nantahala*—whether the FERC approval of a cost allocation methodology involving nuclear plant power costs preempts state commission consideration of issues of the prudence of the construction of the plant or the purchase of the power by affiliates of a holding company. The Supreme Court, in a 6-3 decision, held that states could not review the prudence of plant construction or wholesale power purchases where the FERC has allocated a specific quantity of power among affiliates of an integrated, centrally planned holding company system.

Mississippi involved the MSU holding company system, a system comprised of four operating utilities (Arkansas Power & Light, Louisiana Power & Light, Mississippi Power & Light (MP&L), and New Orleans Public Service Company). Together, the four MSU operating utilities served the ratepayers of the states of Arkansas, Louisiana, Mississippi, and Missouri.

MSU decided in 1974 to construct two large nuclear generating stations in Port Gibson, Mississippi. The company created System Energy Resources, Inc. (SERI) solely to finance and construct the two nuclear units, to be called the Grand Gulf project. During the construction years, the accident at Three Mile Island occurred and shook the entire nuclear industry. The federal government enacted stricter safety regulations, construction and regulatory delays ensued, and nuclear plant costs escalated. As a result, many nuclear plants were cancelled by utilities due to excessive construction costs.

When MSU received approval to construct the Grand Gulf project, the System projected a total cost of \$800 million. Eleven years later, in 1985, Grand Gulf I went into operation at a cost in excess of \$3.6 billion. Construction of Grand Gulf II has been suspended, with approximately \$1 billion invested, and the unit's cancellation is expected. The extreme cost overruns created a public outcry from the participating states of Arkansas, Louisiana, Mississippi, and Missouri. With intense anxiety over the imminent possibility of rate shock, the voters of New Orleans went so far as to reinvest the New Orleans City Council with regulatory authority over the local utility, New

169. Pierce, *supra* note 4, at 547-48.

170. Nixon & Johnston, *supra* note 4, at 17.

171. Duffy, *supra* note 4, at 85-86.

Orleans Public Service Company, to better protect themselves from the impact of Grand Gulf related rate increases.

When Grand Gulf I was complete, MSU applied to the FERC for approval of an agreement allocating the costs of the nuclear plant among its four affiliated retail utilities. As a result of Grand Gulf power being the most expensive power available, each affected state commission intervened to protect the interests of its local ratepayers. After protracted litigation, the FERC approved a modified allocation agreement, which remains the subject of appeals to the Court of Appeals for the District of Columbia.¹⁷²

When MP&L, one of the MSU System affiliates, filed an application with the Mississippi PSC for pass-through to retail customers of its Grand Gulf costs, the PSC approved the rate increase.¹⁷³ The Supreme Court of Mississippi reversed the PSC order, holding that before granting a rate increase the PSC must investigate the prudence of the management decisions that led to the construction and completion of Grand Gulf.¹⁷⁴ The court reasoned that such a prudence inquiry was not preempted by the FERC allocation order because the FERC had not investigated the prudence of the Grand Gulf investment and because *Nantahala* did not address state authority over the prudence of power plant construction.¹⁷⁵

The Supreme Court reversed the decision of the Mississippi Supreme Court, holding that its prior decision in *Nantahala* required that the state PSC treat the Grand Gulf costs as reasonable operating expenses in MP&L's retail cost of service.¹⁷⁶ The Court found the facts in *Mississippi* to be materially

172. In Opinion No. 234, the FERC allocated the costs of Grand Gulf to the four MSU operating utilities, with 36% allocated to Arkansas Power & Light, 14% to Louisiana Power & Light, 33% to MP&L, and 17% to New Orleans Public Service Company. Opinion No. 234, Middle S. Energy, Inc., 31 F.E.R.C. ¶ 61,305 (1985). In its order, the FERC did not rule on the prudence of the construction of Grand Gulf. On rehearing, the FERC rejected arguments that the allocation of Grand Gulf power should be based on the degree to which the operating companies needed the power. Opinion No. 234-A, Middle S. Energy, Inc., 32 F.E.R.C. ¶ 61,425, at 61,958 (1985). The FERC ruled that the allocation should be based on principles of just, reasonable, and nondiscriminatory rates. *Id.*

On appeal, the D.C. Circuit affirmed the FERC allocation. *Mississippi Indus. v. FERC*, 808 F.2d 1525 (D.C. Cir. 1987). The D.C. Circuit then granted rehearing en banc to consider the FERC's methodology for determining the reasonableness of the allocation. *Mississippi Indus. v. FERC*, 814 F.2d 773 (D.C. Cir. 1987). The granting of rehearing en banc was then dismissed. *Mississippi Indus. v. FERC*, 822 F.2d 1103 (D.C. Cir. 1987). At the same time, the panel granted rehearing and remanded the FERC's order for further explanation for why Order No. 234 set a just and reasonable allocation. *Mississippi Indus. v. FERC*, 822 F.2d 1104 (D.C. Cir. 1987). On remand, the FERC in Opinion No. 292 reaffirmed its allocation in Opinion No. 234. Opinion No. 292, System Energy Resources, Inc., 41 F.E.R.C. ¶ 61,238 (1987). The FERC's affirmation of its prior allocation order in Opinion No. 292 is presently on appeal to the D.C. Circuit. *City of New Orleans v. FERC*, No. 88-1067 (D.C. Cir.).

173. *Mississippi*, 108 S. Ct. at 2436. The PSC order passing through the Grand Gulf costs was based solely on MP & L's need for additional revenue to cover its wholesale power purchases. The order did not address the prudence of MP&L's participation in the Grand Gulf project. The PSC explained that it would continue to contest the FERC allocation in the appeal of Opinion No. 234. *Id.*

174. *State ex rel. Pittman v. Mississippi Pub. Serv. Comm'n*, 506 So. 2d 978 (Miss. 1987). The Attorney General of Mississippi, among others, appealed the Mississippi PSC order, alleging that the PSC was first required to consider the prudence of the Grand Gulf purchase power. *Id.* at 979.

175. *Id.* at 985-87.

176. *Mississippi*, 108 S. Ct. at 2438.

indistinguishable from those in *Nantahala*,¹⁷⁷ and reiterated its holding that a state cannot question the prudence of a particular wholesale purchase when the FERC has expressly allocated to the retail utility a specific quantity of power.¹⁷⁸ In so holding, the Court again rejected the viability of a *Pike County* prudence inquiry where the FERC has allocated specific quantities of power. In explaining the scope of its ruling, the Court stated that the Mississippi PSC could not evaluate the company's decision to invest in Grand Gulf or the company's decision to be a party to the agreement to construct and operate the plant.¹⁷⁹

The Mississippi Attorney General argued that the FERC allocation order did not preempt a state prudence inquiry because it did not specifically consider prudence.¹⁸⁰ The Supreme Court rejected this reasoning, finding this point to be an irrelevant consideration. The Court ruled that under the jurisdictional bright line test, state commissions could not regulate a matter within the FERC's exclusive jurisdiction, even if the FERC had failed to consider or rule on the matter.¹⁸¹

The dissenting opinion, written by Justice Brennan and joined by Justices Marshall and Blackmun, is noteworthy in that it contests the majority's characterization of *Mississippi* as a mere mechanical extension of *Nantahala*. The dissent agreed with the majority that the state commission could not question the FERC-approved allocation of power among the affiliated companies.¹⁸² The dissent disagreed, however, with the majority's conclusion that the state commission could not investigate the prudence of MP&L's participation in the Grand Gulf project. Justice Brennan pointed out that the FERC opinion had not ordered the company to participate in the project.¹⁸³ Citing *Pike County*, the dissent concluded that a state PSC could question the prudence of a retail utility's decision to buy power from a particular source, even though it could not question the wholesale rate.¹⁸⁴ Moreover, the dissent argued, states have traditionally had control over the critical issue of whether operating expenses

177. *Id.* at 2439. The Court reasoned that in both cases, the state commission was attempting to set retail rates on the assumption that the retail utility was able to purchase a different quantity of power than that which the FERC had allocated. *Id.*

178. *Id.* at 2439-50. As in *Nantahala*, the Court assumed that the *Pike County* analysis was valid, but held that it was inapplicable where the FERC has allocated specific quantities of power:

As we assumed [in *Nantahala*], it might well be unreasonable for a utility to purchase unnecessary quantities of high cost power, even at FERC-approved rates, if it had the legal right to refuse to buy that power. But if the integrity of FERC regulation is to be preserved, it obviously cannot be unreasonable for MP&L to procure the particular quantity of high-priced Grand Gulf power that FERC has ordered it to pay for.

Id. at 2440.

179. *Id.* at 2441.

180. *Id.* at 2440-41.

181. *Id.* at 2440. The Court asserted that although prudence was not raised by the parties in the FERC hearings, the FERC had considered and rejected certain issues that would have been considered in a Mississippi PSC prudence inquiry. *Id.* at 2441.

182. *Id.* at 2445 (Brennan, J., dissenting).

183. *Id.* at 2445 (Brennan, J., dissenting).

184. *Id.* at 2446 (Brennan, J., dissenting).

should be borne by ratepayers or shareholders.¹⁸⁵

Mississippi will likely be regarded as one of the seminal cases on preemption under the filed rate doctrine. Indeed, the proper interpretation of *Mississippi's* scope has already become the subject of intense disagreement. At the 1988 mid-year meeting of the FEBA, several panelists squared off and debated the potential scope and application of the decision.¹⁸⁶ The *Council of New Orleans*¹⁸⁷ case, discussed below, among others, has already begun to test the limits of *Mississippi* in various state and federal courts.

IV. CURRENT ISSUES INVOLVING FEDERAL PREEMPTION IN THE ENERGY FIELD

In addition to the *Mississippi* scenario, a number of other significant federal-state jurisdictional embroglios have recently arisen in the energy field. These controversies cover virtually the full spectrum of energy regulation: (1) application of the *Mississippi* decision to new factual situations; (2) preemption of state regulation under the Public Utility Regulatory Policies Act of 1978 (PURPA);¹⁸⁸ (3) federal deregulation of wholesale-level sales by independent power producers; (4) the pass-through of take-or-pay costs; (5) FERC preemption of state regulation of utility security issuances; (6) state authority regarding price controls over wholesale and retail gasoline sales; (7) Federal Emergency Management Agency (FEMA) preemption of state and local nuclear emergency planning responsibilities; and (8) Rural Electrification Administration (REA) preemption of state rate regulation over rural electric cooperatives. Taken together, these cases illustrate the comprehensive application of the federal preemption doctrine in the energy field, highlighting the need to balance carefully federal and state jurisdictional concerns.

A. *The City of New Orleans Litigation*.¹⁸⁹ *Is It Covered by the Mississippi Decision?*

The pending litigation between the city of New Orleans and New Orleans Public Service Inc. (NOPSI), an affiliate of MSU holding company, presents questions left unanswered by the Supreme Court's decision in *Mississippi*. In a sense, the litigation will test whether the Court is willing to largely eviscerate state regulatory authority over a holding company affiliate's retail level responsibilities. At present, the litigation over New Orleans Public Service's conduct with respect to the Grand Gulf plant is in its fourth year of litigation

185. *Id.* at 2448 (Brennan, J., dissenting).

186. See Vince, *State Regulation of Holding Company Affiliates and Multistate Power Pools After Mississippi Power & Light Co. v. Mississippi ex rel. Moore* (Oct. 21, 1988) (written presentation at the 1988 mid-year meeting of the FEBA); Abbott, *Nantahala/Mississippi Power & Light: Impact on Local Regulation* (Oct. 21, 1988) (paper presented at the FEBA 1988 mid-year meeting).

187. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, No. 88-559 (E.D. La. Mar. 10, 1988), *aff'd*, 850 F.2d 1069 (5th Cir. 1988), *cert. granted*, 109 S. Ct. 780 (1989).

188. Public Utility Regulatory Policies Act of 1978 (PURPA), Pub. L. No. 95-617, 92 Stat. 3117 (codified in scattered sections of 15 and 16 U.S.C.).

189. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, No. 88-559 (E.D. La. Mar. 10, 1988), *aff'd*, 850 F.2d 1069 (5th Cir. 1988), *cert. granted*, 109 S. Ct. 780 (1989).

and is presently before the Supreme Court on a procedural issue and before two Louisiana state courts on the substantive state administrative and federal preemption issues.

The Grand Gulf plant, and NOPSI's involvement with respect thereto, has been a continuing irritant in the relationship between NOPSI as local utility and its New Orleans customers. When the ratepayers of New Orleans first learned that they would be obligated to pay for a large share of the high cost Grand Gulf power, there was a sense that the company had betrayed the public trust. In fact, the citizens of New Orleans expressed their alarm by divesting the Louisiana Public Service Commission's regulatory jurisdiction over NOPSI and voting to reinvest the New Orleans City Council (City Council) with rate regulatory authority over NOPSI.¹⁹⁰ On the other hand, MSU has repeatedly expressed resentment at what it sees as the city's "parochial" and "highly politicized" attempt to interfere with holding company matters that are within the exclusive jurisdiction of the FERC.

Specifically, the case will test whether a state commission has any authority to require an affiliate of an interstate holding company to reduce the risks it faced from a commitment to a large share of a high-cost nuclear generating plant. Accepting the fact that NOPSI was obligated to purchase a portion of Grand Gulf power, the City Council nevertheless maintains that it has authority to find NOPSI imprudent for the company's failure to reduce the risks concomitant to that obligation, once the risks became known. One option that was available to NOPSI, the City Council posits, was to resell a portion of its Grand Gulf power outside the holding company system.

Although much of the history of the Grand Gulf litigation was described earlier, a review of NOPSI's specific role is necessary for an understanding of the unique facts in the New Orleans litigation. In 1980, NOPSI entered into an agreement among the MSU affiliates that allocated shares of power from the Grand Gulf I nuclear plant. In this agreement, NOPSI agreed to purchase a 29.8% share of Grand Gulf power.¹⁹¹ As mentioned previously, the Grand Gulf nuclear project was constructed and is operated by System Energy Resources, Inc. (SERI), a MSU subsidiary created solely for the Grand Gulf project.

Because SERI sells Grand Gulf power to the MSU operating subsidiaries at wholesale, the agreement allocating the power sales was subject to FERC approval. After lengthy hearings on the fairness of the allocation of power between the four MSU operating subsidiaries, the FERC reduced NOPSI's share to 17%.¹⁹² The FERC determined that a greater share of power for NOPSI would have been unjust and discriminatory.¹⁹³ In the FERC proceedings, the City Council argued vigorously that its constituents should be

190. The New Orleans charter vests the city with "all powers of supervision, regulation and control over any street railroad, electric, gas, heat, power, waterworks, and other public utilities within the City of New Orleans." NEW ORLEANS, LA., HOME RULE CHARTER § 4-1604.

191. New Orleans, La., Rate Order No. CD-85-1 (Feb. 4, 1988).

192. Opinion No. 234, Middle S. Energy, Inc., 31 F.E.R.C. ¶ 61,305, at 61,666 (1985), *aff'd*, Opinion No. 234-A, 32 F.E.R.C. ¶ 61,425 (1985).

193. 31 F.E.R.C. ¶ 61,305, at 61,656.

responsible for no more than 9% of the costs of Grand Gulf—the percentage consistent with NOPSI's share of MSU system load. The City Council felt that NOPSI's ratepayers were being abused by the larger companies in the System that had greater influence over System allocation decisions.

Subsequent to the FERC's approval of the Grand Gulf allocation agreement, NOPSI filed an application with the New Orleans City Council requesting a retail rate increase to cover the costs of its 17% allocation of Grand Gulf power. The rate application sought a \$160 million increase per year, which represented a 60-70% increase over then existing rates.¹⁹⁴ The City Council, deeply concerned over the potential "rate shock" impact of such a rate increase, decided to review the rate application in a traditional retail rate proceeding.¹⁹⁵ The City Council sought primarily to consider a phase-in of the rate increase, the rate design among classes of customers, and the prudence of NOPSI's exercise of its retail level obligations.¹⁹⁶ The City Council also afforded NOPSI an opportunity to seek interim rate relief.

After extensive hearings on NOPSI's involvement in the Grand Gulf project, the City Council in 1988 issued its rate order.¹⁹⁷ The order provided for a one-time disallowance and write-off by NOPSI of \$135 million for its imprudence regarding its retail-level obligations.¹⁹⁸ The City Council found that NOPSI's oversight and review of its Grand Gulf obligation was uncritical and severely deficient. The City Council determined that, even though additional capacity may have been needed, NOPSI's indeterminate commitment to an uncertain share in one massive project was not prudent.¹⁹⁹

The City Council expressly stated that it had no authority, under the federal preemption doctrine, to alter or interfere with the FERC allocation of Grand Gulf costs among MSU subsidiaries.²⁰⁰ In recognition of the preemptive effects of the FERC allocation order, the Council did not base its disal-

194. New Orleans, La., Rate Order No. CD-85-1, at 106 (Feb. 4, 1988).

195. "Rate shock" is the economic and social impact on a local community of substantial and sudden rate increases. The increases cause severe hardship for energy-intensive businesses and low income residential customers. See *supra* note 16.

196. After NOPSI completed its rate application filing and the City Council granted NOPSI interim rate relief, the City Council issued a resolution initiating a prudence investigation. New Orleans, La., Resolution No. R-85-636 (Oct. 17, 1985). In its prudence inquiry, the City Council sought to consider: (1) justifications for NOPSI's decision to purchase a portion of Grand Gulf I; (2) NOPSI's consideration of alternatives to Grand Gulf power; (3) NOPSI's efforts to minimize its total exposure to the high cost Grand Gulf power; (4) NOPSI's need for Grand Gulf capacity; and (5) NOPSI's decision to mothball and/or decommission existing generating facilities within its jurisdiction. *Id.* The City Council stated, however, that it would "not seek to invalidate any of the agreements surrounding Grand Gulf or to order NOPSI to pay MSU a rate other than that approved by the FERC." *Id.*

197. New Orleans, La., Rate Order No. CD-85-1 (Feb. 4, 1988).

198. *Id.* at 220.

199. The City Council's order discussed how generating plant diversification by NOPSI was limited by its commitment to an indeterminate share of Grand Gulf. Diversification of fuel supply is a standard practice for retail utility management.

200. The City Council's order concluded that the FERC order approving the Grand Gulf allocation agreement concerned only the allocation of costs from Grand Gulf. The City Council stated that its prudence inquiry, by contrast, was based only upon retail rate issues. The principal retail rate issue for the City Council was whether NOPSI could have taken any action to reduce the risks of its Grand Gulf responsibility for high cost power. *Id.* at 44-45.

lowance on NOPSI's purchase of Grand Gulf power. Instead, it based its \$135 million disallowance on NOPSI's failure, in the critical 1979-1980 time period,²⁰¹ to reduce its risks by reselling a portion of the Grand Gulf power off system. The City Council's rate order assumed NOPSI's responsibility to accept the FERC-allocated power, but held the company imprudent for failing to resell such power outside the MSU system, as the company had promised the City Council it could.²⁰²

Subsequent to the City Council's issuance of the imprudence disallowance, NOPSI moved in federal district court²⁰³ to enjoin implementation of the rate order.²⁰⁴ NOPSI alleged that the FERC allocation order wholly preempted the City Council's rate order and required the City Council to pass through the FERC-allocated costs in their entirety. Instead of ruling on the merits of NOPSI's claim, the district court ruled that under the abstention doctrine the state court system was the proper initial forum in which judicial review of the City Council's retail-level rate order should proceed.²⁰⁵ The abstention doctrine provides that where important state interests are involved, a federal court should decline to exercise its jurisdiction over a federal claim

201. In 1979, the notorious accident occurred at the Three Mile Island nuclear plant in Pennsylvania. This accident caused heightened safety concerns regarding nuclear power, which in turn resulted in more stringent regulations promulgated by the Nuclear Regulatory Commission.

The City Council found that even before the accident at Three Mile Island, statistical analyses showed major upward cost trends for nuclear power plants. *Id.* at 1209. It ruled that NOPSI never considered whether the industry changes in the wake of Three Mile Island incident would substantially increase the costs for the Grand Gulf project. It was in this 1979-80 period that the City Council found NOPSI to be imprudent in not attempting to sell a portion of its Grand Gulf commitment off system. *Id.* at 131.

202. In September 1980, NOPSI's President, James Cain, testified before the City Council that:

If it is in the wisdom of this Council that it is not appropriate for New Orleans Public Service to participate in this agreement, which they will reflect on through either approval or disapproval of the capacity adjustment clause, through the approval or disapproval of any rate relief we seek as per Grand Gulf, then NOPSI has the option of selling the capacity and marketing it which, we think, will be a very attractive commodity to other electric utilities who will view this as very, cheap, reliable power for the future.

In the Matter of NOPSI Rate Hearing—Public Hearing on Electric and/or Gas Rates 547 (Sept. 17, 1985) (testimony of James Cain before the New Orleans City Council).

203. Prior to the federal court filing, the City Council and NOPSI had engaged in several rounds of contentious federal court litigation over the City Council's authority regarding the Grand Gulf project. When the City Council first initiated a rate proceeding with respect to the proposed rate increase, NOPSI sued in federal district court seeking \$1 billion in damages from the City Council on preemption grounds, individually and collectively. The district court abstained from hearing the case, a ruling which the Fifth Circuit ultimately upheld. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 798 F.2d 858 (5th Cir. 1986). NOPSI then filed a petition for writ of certiorari to the Supreme Court to appeal the Fifth Circuit decision. The Supreme Court denied NOPSI's petition. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 481 U.S. 1023 (1987).

When the City Council thereafter began its prudence hearing, NOPSI sought in federal district court to enjoin the inquiry, alleging that the City Council's actions were preempted. The district court dismissed for lack of ripeness and on abstention grounds. The Fifth Circuit affirmed on the ripeness issue, without reaching the abstention claim. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 833 F.2d 583 (5th Cir. 1987).

204. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, No. 88-559 (E.D. La. Mar. 10, 1988).

205. *Id.* at 15. The court determined that the types of abstention set forth in *Burford v. Sun Oil Co.* and *Younger v. Harris* were appropriate. See *Younger v. Harris*, 401 U.S. 37 (1971); *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943).

and, instead, should allow pending state proceedings to be completed, with ultimate review available in the Supreme Court.²⁰⁶ The district court held that abstention is appropriate in a preemption case where there is no direct facial state and federal law.²⁰⁷

On the preemption issue, the district court found that the rate order on its face determined only retail rate issues and did not prohibit NOPSI from paying for its FERC-approved power.²⁰⁸ The court held that although the City Council was preempted from altering the FERC allocation, it was not preempted from reviewing NOPSI's actions in light of the unwanted FERC allocation of high cost power.²⁰⁹

On appeal to the Court of Appeals for the Fifth Circuit, the Fifth Circuit affirmed on abstention grounds.²¹⁰ Because *Mississippi* was decided by the Supreme Court during the pendency of the Fifth Circuit appeal, NOPSI argued that *Mississippi* had now made clear that the City Council's prudence inquiry was wholly preempted. Although the Fifth Circuit noted that *Mississippi* concerned a prudence inquiry related to the Grand Gulf project, it recog-

206. The three principal forms of abstention are set forth in *Burford v. Sun Oil Co.*, *Younger v. Harris*, and *Railroad Comm'n of Texas v. Pullman Co.* *Younger*, 401 U.S. at 37; *Burford*, 319 U.S. at 315; *Railroad Comm'n of Tex. v. Pullman Co.*, 312 U.S. 496 (1941). A court may abstain for reasons of comity or equity or to prevent the disruption of state efforts to resolve difficult and important policy questions. For example, in both *Nantahala* and *Mississippi*, the companies each obtained final review of their state court appeals in the Supreme Court after allowing the state court proceedings to run their course.

In *Burford*, the Supreme Court declined to exercise its jurisdiction over a federal claim and thereby refused to interfere with the Texas Railroad Commission's regulation of the oil and gas industry in Texas. *Burford*, 319 U.S. at 315. The essence of this doctrine is that federal courts should avoid premature review of, or intervention in, state efforts to develop a policy or particularized response to a complex subject of local concern, so long as the state court system provides a fair avenue of appeal. See *Alabama Pub. Serv. Comm'n v. Southern Ry. Co.*, 341 U.S. 341, 347-49 (1951).

In *Younger*, the Court enunciated a doctrine that requires federal courts to abstain from hearing constitutional claims that would interfere with ongoing state criminal proceedings in the interests of equity, comity, and federalism. *Younger*, 401 U.S. at 43-44. The *Younger* doctrine was later extended by the Court to bar interference with important state civil proceedings, *Huffman v. Pursue, Ltd.*, 420 U.S. 592, 604 (1975). It was also extended to bar interference with important state administrative proceedings. *Ohio Civil Rights Comm'n v. Dayton Christian Schools*, 106 S. Ct. 2718, 2723 (1986). Just last year, the Supreme Court strengthened the *Younger* doctrine by admonishing the courts not to view "important state interests" narrowly and by stressing the competence of the state courts to resolve federal questions fairly. *Pennzoil Co. v. Texaco, Inc.*, 107 S. Ct. 1519, 1527-28 (1987). The test under *Younger* is (1) whether there is an on-going state proceeding; (2) whether the proceeding implicates important local interests; and (3) whether there is an adequate opportunity in the state proceeding to raise and preserve constitutional challenges.

In *Railroad Comm'n of Texas v. Pullman Co.*, the Court held that a federal court ordinarily should stay its hand when state court action on unresolved issues of state law might render unnecessary the litigation of federal constitutional issues. *Pullman*, 312 U.S. at 498. Because federal preemption issues normally require the interpretation of federal statutes, and not the Constitution, the principles of *Pullman* abstention are implicated to a lesser degree in the preemption context than is true of *Burford* and *Younger* abstention. In particular cases, however, the policy of judicial restraint underlying *Pullman* may weigh heavily against intervention by a federal court in state proceedings involving utility rates.

207. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, No. 88-559, slip op. at 14 (E.D. La. Mar. 10, 1988).

208. *Id.* at 14.

209. *Id.* at 12-13.

210. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 850 F.2d 1069, 1080 (5th Cir. 1988).

nized that factual differences existed between the two cases.²¹¹

NOPSI has now filed a petition for writ of certiorari with the Supreme Court, which the Court recently granted, contesting the Fifth Circuit decision.²¹² NOPSI has claimed that state regulators have no jurisdiction to disallow any of the costs related to the Grand Gulf nuclear project.²¹³ In its petition, NOPSI has argued that *Mississippi* "conclusively decided" that all questions of prudence relating to the Grand Gulf project must be decided by the FERC.²¹⁴ In response, the City Council has argued that there is no facial conflict between the City Council's rate order and the FERC allocation order.²¹⁵ The City Council has explained that the critical facts in *Mississippi* were not present in the New Orleans situation, noting that the City Council's order nowhere interfered with NOPSI's ability to make its full federally approved power purchases.²¹⁶ Finally, the City Council has taken the position that the FERC has no authority to examine whether a retail utility should have sold its power off system.²¹⁷ On invitation by the Supreme Court pending its consideration of NOPSI's petition for certiorari,²¹⁸ the United States Solicitor submitted a brief arguing that the company is correct in its contention that the City Council's rate order is preempted.

The city of New Orleans litigation should provide the next chapter in the evolution of the filed rate doctrine. A ruling against the city on preemption grounds would signal a virtual end to state regulatory control over holding company affiliates who purchase power within a holding company pursuant to FERC allocation orders. Underlying the legal struggle, however, is the larger policy question of whether the FERC ought to exert authority over issues that essentially involve local retail rate matters.

B. FERC Preemption of State Regulation Under the PURPA

The FERC's current policies with regard to the PURPA have created a storm of controversy. FERC Chairman Martha Hesse has spoken out in the press, to industry trade conferences, and before members of Congress in support of the FERC's recent decisions and proposed reforms. Chairman Hesse, along with Commissioner Stalon, have advocated that the FERC's new policies are necessary to achieve a consistent implementation of the PURPA and to allow for further competition in the electricity generation market. According to the Chairman, the electricity generation market is no longer a natural monopoly; therefore, federal regulatory policy must encourage the entry of new market participants in order to provide the generation capacity growth necessary for the Nation's energy future. To this end, the proposals seek to

211. *Id.* at 1076.

212. *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 850 F.2d 1069 (5th Cir. 1988), *cert. granted*, 109 S. Ct. 780 (1989).

213. Petition for Certiorari at 3, *Council of New Orleans*, 850 F.2d 1069 (No. 88-348).

214. *Id.* at 13.

215. Brief for Respondent at 24, *Council of New Orleans*, 850 F.2d 1069 (No. 88-348).

216. *Id.* at 26.

217. *Id.* at 27.

218. Memorandum Order Inviting Solicitor General to Participate (Oct. 17, 1988), *Council of New Orleans*, 850 F.2d 1069 (No. 88-348).

preempt state PURPA implementation plans that are inconsistent with the FERC's present objectives.

By contrast, FERC Commissioner Charles Trabandt has described the Commission's proposed reforms as unnecessary. The Commissioner has criticized the FERC for failing to conduct a comprehensive study to document the alleged changed nature of the electricity generating sector. In addition, he has denounced the FERC as acting like a regulatory "rogue elephant" with respect to the states' role under the PURPA, trampling everything in its preemptive path.²¹⁹ State commissioners also have lashed out at the FERC for disrupting carefully planned state PURPA implementation programs. For example, Peter Bradford, Chairman of the New York PSC, called one recent decision a "regulatory Pearl Harbor to most states."²²⁰

Before it is possible to discuss the states' specific role under the PURPA, a brief background of the structure of the statute is necessary. The PURPA was enacted in response to a perceived nationwide energy crisis in the late 1970s.²²¹ The PURPA sought to encourage the development of cogeneration and small power production facilities.²²² A cogeneration plant is a facility that produces both electric energy and some other form of useful thermal energy, such as heat or steam.²²³ A small power production plant is a generating facility, of limited size,²²⁴ that produces electric power from biomass, waste, geothermal, or renewable resources.²²⁵ In the PURPA, Congress determined that the greater use of cogeneration and small power production could reduce our dependence on traditional fossil fuels, the most important of which was imported oil.²²⁶

Prior to the enactment of the PURPA, cogenerators and small power producers faced several constraints in dealing with public utilities: (1) utilities were often unwilling to purchase power from these facilities, or not willing to purchase the power at a fair price; (2) utilities could charge discriminatory rates for backup power to these facilities; and (3) when cogenerators and small power producers were able to sell electricity to the local utility, they risked being subject to complex state and federal public utility regulation.²²⁷ In response to these problems and pursuant to its statutory authority under the

219. Trabandt, *supra* note 4, at 13.

220. *Id.* at 11.

221. Pub. L. No. 95-617, 92 Stat. 3117 (1978) (codified at scattered sections of 15 and 16 U.S.C.).

222. See *American Paper Inst. v. American Elec. Power Serv. Corp.*, 461 U.S. 402, 404-05 (1983).

223. 16 U.S.C. § 796(18)(A) (1982). The direct combustion of fossil fuels in industrial processes typically produces heat of unacceptably high magnitude for the steam that is desired. Thus, industry typically burns the fuels at a lower, and less efficient, temperature. Fuel savings occur, however, if the high-temperature energy is used to generate electric power, while the remaining heat is used for the industrial process. This is the essential savings provided by cogeneration. Notice of Proposed Rulemaking, *Regulations Governing the Public Utilities Regulatory Policies Act of 1978*, IV F.E.R.C. Stats. & Regs. ¶ 32,465, 53 Fed. Reg. 31,021, 31,023 n.3 (1988) [hereinafter PURPA NOPR] (references hereinafter are to the Federal Register).

224. Small power producers, by definition, are limited to a production capacity of no greater than 80 MW. 16 U.S.C. § 796(17)(A) (1982).

225. Renewable resources include wind, solar, and water. *Id.*

226. *FERC v. Mississippi*, 456 U.S. 742, 750 (1982).

227. PURPA NOPR, *supra* note 223, at 31,023.

PURPA, the FERC promulgated regulations encouraging the development of these facilities, including: (1) regulations requiring a public utility to purchase electricity from "qualifying"²²⁸ cogenerators and small power producers at a rate equal to the utility's full avoided cost;²²⁹ (2) regulations requiring utilities to sell backup electricity to qualifying facilities and provide transmission of such electricity where necessary;²³⁰ and (3) regulations exempting qualifying facilities, in whole or in part, from the FPA, the PUHCA, and certain state laws and regulations.²³¹

The states' regulatory role under the PURPA is somewhat unique. Under the FPA, state commissions have no authority to set rates for whole-sale-level sales in interstate commerce.²³² Under the PURPA, however, states may set rates for sales from qualifying facilities to public utilities, even though such sales are in interstate commerce.²³³ The PURPA specifically provides that the FERC may exempt sales by qualifying facilities from regulation under the FPA, the PUHCA, and state laws and regulations.²³⁴

Section 210 of the PURPA provides that the rate for purchase by utilities of power from qualifying facilities shall not be greater than the incremental cost to the utility of alternative energy.²³⁵ The "incremental cost" is defined as the utility's cost of generating power or purchasing power were it not for the purchases from the qualifying facilities.²³⁶ Pursuant to this authority, the FERC promulgated rules providing that no utility shall be required to pay more than its full avoided cost for purchases from qualifying facilities.²³⁷

Under the FERC's PURPA regulations, state commissions can set rates at the full avoided cost or can set lower rates if it is found that the lower rate would nevertheless encourage cogeneration and small power production.²³⁸ Although the FERC's regulations under the PURPA generally provide that rates must not be set at higher than a utility's avoided cost, the FERC initially

228. A "qualifying facility" is defined as a cogeneration facility or small power production facility that is entitled under the FERC's rules to receive PURPA protection and benefits. 18 C.F.R. § 292.101(b)(1) (1988).

229. 18 C.F.R. § 292.304(b)(2) (1988).

230. 18 C.F.R. § 292.303 (1988).

231. PURPA NOPR, *supra* note 223, at 31,023.

232. 16 U.S.C. § 824(a) (1982); *FPC v. Southern Cal. Edison Co.*, 376 U.S. 205, 215-16 (1984).

233. 16 U.S.C. § 824a-3(f)(1) (1982). The FERC has held that although state commissions have no discretion in deciding whether to implement the FERC's PURPA regulations, states do have some discretion in determining how to implement the rules. *Orange and Rockland Utils.*, 43 F.E.R.C. ¶ 61,067, at 61,186 (1988). The state commissions ultimately may determine the price to be paid by a utility for qualifying facility power. *Opinion No. 234, Middle S. Servs.*, 24 F.E.R.C. ¶ 63,119, at 65,209 (1983), *modified*, *Opinion No. 234-A*, 33 F.E.R.C. ¶ 61,408 (1985). As FERC Judge Zimmet explained, "The Commission's regulations, which endeavor to spell out the meaning of avoided costs, leave a lot of room for play in the joints. Each state authority, therefore, has wide discretion in weighing the factors specified in the regulations to determine avoided costs." *Id.*

234. *Orange and Rockland Utils.*, 43 F.E.R.C. ¶ 61,067, at 61,193-94 (1988).

235. 16 U.S.C. § 824a-3(b) (1982). The section also provides that such rates shall be just and reasonable to electric consumers of the public utility, in the public interest, and not discriminatory of cogenerators and small power producers. *Id.*

236. *Id.* § 824a-3(d).

237. 18 C.F.R. § 292.304(a)(2) (1988).

238. 18 C.F.R. § 292.304 (1988).

recognized exceptions to this rule. In the preamble to its regulations implementing the PURPA, the FERC explained that states, under their own authority, could set utility rates for purchases from qualifying facilities at higher than a utility's avoided cost.²³⁹ Subsequently, in *Middle South Services* the FERC noted that state commissions may have authority, under state law, to set rates at higher than avoided cost, and thereby encourage cogeneration and small power production to an even greater degree.²⁴⁰ As the following case study indicates, however, the FERC has recently reversed this policy, and now will seek to prohibit states from setting rates at higher than a utility's avoided cost.

1. *Orange and Rockland Utility*:²⁴¹ FERC Preemption of State Authority to Set PURPA Rates at Higher Than Avoided Cost

The widely reported *Orange & Rockland* case presented the FERC with the question of whether states could, under FERC avoided cost regulations, set the PURPA rates at higher than a utility's avoided costs. Instead of following its prior trend of allowing states such authority, the FERC used the *Orange & Rockland* decision to reverse its PURPA policy. The FERC held that states could no longer set rates in excess of a utility's avoided costs.

To many utilities, the FERC's initial policy allowing states to set rates at higher than avoided cost was contrary to congressional intent in that it forced sales to inefficient, high cost cogenerators and small power producers. The FERC's policy was viewed as encouraging the creation of wasteful generating capacity. For many state commissions, however, the FERC's original policy was seen as allowing local regulatory bodies the necessary flexibility to formulate a PURPA program suited to the unique needs of a particular region. These states accordingly were deeply distressed over the *Orange & Rockland* decision. For example, New York PSC Chairman Peter Bradford, whose Commission was at issue in *Orange & Rockland*, expressed resentment at what he termed FERC sitting as a "star chamber" to review state PURPA imple-

239. Order No. 69, *Small Power Production and Cogeneration Facilities; Regulations Implementing Section 210 of the Public Utilities Regulatory Policies Act of 1978*, [1977-1981 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,128, at 30,875 (1980) (codified at 18 C.F.R. § 292.304 (1988)) [hereinafter Order No. 69]. The full text of the FERC's statement read:

This Commission has set the rate for purchases at a level which it believes appropriate to encourage cogeneration and small power production, as required by section 210 of PURPA. While the rules prescribed under section 210 of PURPA are subject to the statutory parameters, the States are free, under their own authority, to enact laws or regulations providing for rates which would result in even greater encouragement of these technologies. . . .

If a State program were to provide that electric utilities must purchase power from certain types of facilities among which are included "qualifying facilities," at a rate higher than that provided by these rules, a qualifying facility might seek to obtain the benefits of that State program. In such a case, however, the higher rates would be based on State authority to establish such rates, and not on the Commission's rules.

Id.

240. Order No. 234-A, *Middle S. Servs.*, 33 F.E.R.C. ¶ 61,408, at 61,789 n.51 (1985).

241. *Orange & Rockland Utils.*, 43 F.E.R.C. ¶ 61,067 (1988).

mentation plans.²⁴²

In order to understand fully the flavor of this debate, the extended, and somewhat tortuous, history of the *Orange & Rockland* litigation must be explained. Subsequent to the enactment of the PURPA, New York passed a law requiring utilities to purchase power from qualifying cogenerators and small power producers.²⁴³ Generally, those facilities that qualified for PURPA benefits under the FERC regulations qualified under the New York program as well.²⁴⁴ Nevertheless, some facilities qualified under the New York program but were not covered by the FERC's PURPA regulations.²⁴⁵ The New York statute set a uniform minimum price for sales from qualifying facilities to public utilities.²⁴⁶ In some cases, this minimum price would exceed a utility's avoided cost, which is the highest rate that can be set by the FERC under the PURPA.²⁴⁷

Consolidated Edison Company, a public utility subject to the New York statute, challenged the New York statute on the grounds that states are preempted by federal law from forcing a utility to pay a rate exceeding its avoided cost for power from a qualifying facility.²⁴⁸ In a hearing before the state public service commission, the PSC determined that the utility's avoided cost was less than the minimum rate set by the state statute.²⁴⁹ As a result, the utility argued, the PURPA's prohibition on the FERC setting rates higher than a utility's avoided cost preempted the state from setting a higher rate.

The New York intermediate appellate court held that the PURPA preempted the PSC decision. The New York Court of Appeals reversed the appellate court's ruling in part, holding that New York was permitted to set rates at higher than avoided cost.²⁵⁰ The court reasoned that the PURPA prohibition on setting rates above avoided costs applied only to rates set by the FERC.²⁵¹ The FERC's regulations under the PURPA exempted qualifying facilities from the FPA and, therefore, states could set rates for such sales even if the sales were in interstate commerce. Hence, the court concluded, if the PURPA limitation on rates applied only to FERC rates and states had independent power to set rates, then the states were free to set rates at higher than avoided cost.²⁵² The court's analysis was supported by the preamble to

242. Trabandt, *supra* note 4, at 11.

243. N.Y. PUB. SERV. LAW § 66-c (McKinney Supp. 1988).

244. Consolidated Edison Co. v. Public Serv. Comm'n, 63 N.Y. 2d 424, 483 N.Y.S. 2d 153, 472 N.E.2d 981 (1984).

245. *Id.*

246. The New York statute provided that the minimum price paid by a utility to a qualifying facility for its power would be six cents per kilowatt hour. N.Y. PUB. SERV. LAW § 66-c (McKinney Supp. 1988).

247. Consolidated Edison, 63 N.Y. 2d 424, 483 N.Y.S. 2d 153, 472 N.E.2d 981.

248. *Id.* Consolidated Edison alleged that the New York statute was preempted because (1) there was a direct conflict between the PURPA's prohibition on rates exceeding a utility's avoided cost and (2) the state statute interfered with the PURPA's policy of not requiring ratepayers to subsidize the development of cogeneration and small power production. *Id.*

249. The PSC determined that Consolidated Edison's avoided cost at certain off-peak hours was 4.17¢/kw-hr, whereas the statute's minimum rate was 6¢/kw-hr. *Id.*

250. *Id.*

251. *Id.*

252. *Id.* In addition, the court held that the purposes of the PURPA and the New York statute were

the FERC's PURPA regulations, which expressly provided that state commissions can set rates, under state authority, that exceed a utility's avoided cost.²⁵³ On appeal to the Supreme Court, the Court dismissed for lack of a substantial federal question.²⁵⁴

Orange & Rockland Utilities, a utility unrelated to Consolidated Edison, brought a subsequent challenge to the New York avoided cost statute before the FERC.²⁵⁵ Orange & Rockland was a utility subject to the New York law, but also was integrated with two other utilities located in New Jersey and Pennsylvania.²⁵⁶ For purposes of its FERC petition, Orange & Rockland conceded that New York could apply a rate higher than avoided cost to utilities located exclusively in New York. The utility contended, however, that the New York statute was preempted by the PURPA and the FPA when applied to a multistate utility system. Accordingly, since power supply costs were allocated between Orange & Rockland and its sister utilities in New Jersey and Pennsylvania under a FERC-approved interconnection agreement, the utility maintained that the New York rate would affect wholesale rates in other states. As a result, Orange & Rockland argued, the New York statute was preempted because it had the effect of imposing New York's local policies on utilities operating in other states.²⁵⁷

On review of Orange & Rockland's petition for a declaratory order, the FERC expressly reversed the rule that it had enunciated in the 1980 PURPA Regulations Preamble and held that states were now preempted from setting rates at higher than avoided cost. The FERC bases its holding on the finding that it was no longer consistent with the PURPA's intent for states to set rates exceeding a utility's avoided costs. The FERC explained that the purpose of its prior rule was to allow states to encourage the development of cogeneration and small power production at a time when the industry was still struggling.

the same, i.e., to foster the development of cogeneration and small power production. The court recognized, however, that rates above avoided costs would result in higher rates for public utility ratepayers. The court concluded that such a result was permissible given PURPA's goal of encouraging alternative energy production methods. *Id.*

The court also reviewed the validity of New York's regulation of sales by qualifying facilities that were subject to the state statute but did not qualify under the FERC's PURPA regulations. The court found such regulation was preempted by the FPA. The court reasoned that the FERC's PURPA regulations exempted only FERC-approved qualifying facilities from the FPA. Thus, sales in interstate commerce from those state qualifying facilities not exempted under the FERC rules remained subject to exclusive federal jurisdiction under the FPA. *Id.*

253. Order No. 69, *supra* note 239, at 30,875.

254. Consolidated Edison Co. v. Public Serv. Comm'n, 470 U.S. 1075, 1077 (1985), *dismissing appeal from* 63 N.Y.2d 424, 483 N.Y.S.2d 153, 472 N.E. 2d 981 (1984). Two Justices dissented, finding that the New York Court of Appeals' ruling was in direct conflict with a recent ruling of the Kansas Supreme Court. *Id.* at 1831 (White & Blackmun, JJ., dissenting). The Kansas Supreme Court held that states could not set rates for purchases from qualifying facilities at higher than a utility's avoided cost. Kansas City Power & Light Co. v. Kansas Corp. Comm'n, 234 Kan. 1052, 676 P.2d 764 (1984).

255. Orange & Rockland Utils., 43 F.E.R.C. ¶ 61,067 (1988).

256. Orange & Rockland is connected by an interstate transmission grid with Rockland Electric Company, in New Jersey, and Pike County Light & Power Company, in Pennsylvania. *Id.* at 61,185. Orange & Rockland owns all of the generation plant for the system and provides full requirements power to Rockland Electric and Pike County. *Id.*

257. *Id.*

In the intervening eight years, however, the FERC concluded "[t]he industry has come of age and does not need the competitive advantage of the subsidies that result from rates exceeding avoided cost."²⁵⁸ The effect of the FERC's change in policy was to deny exemption status from the FPA, for preemption purposes, to the rates for sales by qualifying facilities.²⁵⁹ As a result of the *Orange & Rockland* decision, state commissions no longer have independent state authority to set rates above avoided cost.²⁶⁰

In a vigorous dissent, FERC Commissioner Trabandt took issue with several aspects of the majority's holding.²⁶¹ First, the Commissioner argued that it was inappropriate for the FERC to consider the issue of avoided cost preemption given the fact that the FERC had recently issued a notice of proposed rulemaking regarding the avoided cost issue.²⁶² Second, the Commissioner suggested that the FERC majority had not confronted the central issue in the case: whether states had independent authority prior to the enactment of the PURPA to regulate sales by cogenerators and small power producers.²⁶³ Finally, Commissioner Trabandt concluded that preemption in this instance was flawed from a policy standpoint because the New York PSC had displayed an ability to respond to the changing local environment with respect to qualifying facility sales.²⁶⁴

258. *Id.* at 61,195.

259. *Id.*

260. *Id.* at 61,196. The FERC commented only briefly on the effect of the Supreme Court's summary dismissal in the appeal of the New York Court of Appeals' decision in *Consolidated Edison*. *Consolidated Edison Co. v. Public Serv. Comm'n*, 63 N.Y.2d 424, 483 N.Y.S.2d 153, 472 N.E.2d 981 (1984). The FERC concluded that the dismissal by the Supreme Court of an appeal is a decision on the merits only on the specific questions presented. The *Consolidated Edison* case was an action alleging preemption of the New York statute under the PURPA. By contrast, the FERC explained, its decision in *Orange & Rockland* concluded that the New York law was preempted under the FPA. In *Orange & Rockland*, the FERC reversed its own prior PURPA rule that exempted qualifying facility sales from FPA jurisdiction. Thus, the PURPA exemption present in *Consolidated Edison* was no longer an issue, and the critical issue, the FERC argued, was now preemption under the FPA. 43 F.E.R.C. ¶ 61,067, at 61,196.

261. 43 F.E.R.C. ¶ 61,067, at 61,199-217 (Trabandt, C., dissenting).

262. One month prior to the decision in *Orange & Rockland*, the FERC issued a notice of proposed rulemaking in an effort to formulate a generic policy position covering, in part, the issue of avoided cost determinations. Notice of Proposed Rulemaking, *Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Interconnection Facilities*, IV F.E.R.C. Stats. & Regs. ¶ 32,457, 53 Fed. Reg. 9331 (1988) (to be codified at C.F.R. pt. 298) [hereinafter ADFAC NOPR] (references hereinafter to the F.E.R.C. Statutes and Regulations). Commissioner Trabandt also criticized the majority for its failure to consult with state public service commissions regarding the advisability of its preemption decision. 43 F.E.R.C. ¶ 61,067, at 61,201 (Trabandt, C., dissenting).

263. 43 F.E.R.C. ¶ 61,067, at 61,203. The Commissioner explained that, under his view, Congress did not address the broader preemption question when it enacted the PURPA:

No specific provision of [the PURPA] removes the state's authority [to set rates higher than avoided cost], so no exemption from the statute's provisions could restore it. Moreover, section 210(e) lists the Federal Power Act in the context of federal and state laws governing utility regulation in its diverse forms: rates, financial dealings and organizational structure. Thus, the exemption authority Congress granted permitted the Commission to declare that cogenerators and small power producers would not become utilities, with all the regulatory burdens that status would bring, simply because they took advantage of PURPA. Section 210(e) has nothing to do with the question at hand, whether states may set rates at higher than avoided cost.

Id.

264. *Id.* at 61,204.

The New York Public Service Commission has sought appeal of the FERC's decision in *Orange & Rockland* to the United States Court of Appeals for the Second Circuit.²⁶⁵ The PSC has argued that (1) the FERC's decision is in direct conflict with the decision of the New York Court of Appeals, which was upheld by the U.S. Supreme Court when it denied an appeal for want of a substantial federal question; (2) the FERC violated administrative procedural requirements when it failed to provide for notice and comment to a decision that would reverse prior regulations; and (3) the FPA does not preempt state regulation of qualifying facilities to which it does not apply.²⁶⁶ The National Association of Regulatory Utility Commissioners (NARUC) has joined in the PSC appeal, alleging that New York's regulations were not subject to preemption under the FPA.

In opposition to the New York PSC, the FERC has argued that its decision was a correct interpretation of the PURPA and the FPA. The FERC also argued that the Second Circuit should remand the case to allow for further consideration by the FERC in the context of its proposed rulemaking on administrative determinations of avoided cost. The Second Circuit just recently rejected the FERC's motion to remand.²⁶⁷

The debate over the authority of state commissions to set rates higher than avoided costs should prove to be a stubborn controversy, with the parties ultimately seeking review in the Supreme Court. What makes the *Orange & Rockland* case unique is the difficulty in focusing on the particular federal statute in issue. As the foregoing discussion illustrates, several issues regarding two important statutes are unclear. Would the FPA, in the absence of the enactment of the PURPA, preempt state regulation of all sales by qualifying facilities? If not, would it preempt state regulation over some sales? If the FPA preempts state regulation of qualifying facilities, did Congress intend in the PURPA to provide states with an exemption from FPA requirements? Would Congress have prohibited the FERC from promulgating regulations that allow rates exceeding a utility's avoided cost, while at the same time providing states with an exemption from this prohibition? The correct answers to these questions will be debated in the Second Circuit, and any subsequent appeal to the Supreme Court, and in the FERC's current proposed rule on avoided cost determinations.

2. FERC NOPR's on Avoided Cost and Competitive Bidding

In March 1988, the FERC issued two notices of proposed rulemaking under PURPA: (1) a notice on the administrative determination of full avoided costs,²⁶⁸ and (2) a notice on regulations governing competitive bidding programs.²⁶⁹ The Commission also issued a third rulemaking notice con-

265. *Occidental Chem. Corp. v. FERC*, No. 88-4086 (2d Cir. Feb. 2, 1989).

266. *Federal Court Asked To Overturn FERC Orange & Rockland Decision*, Elec. Util. Week, Sept. 19, 1988, at 7.

267. *Occidental Chemical*, No. 88-4086; see *Court Rejects Bid for Remand of Orange & Rockland Decision*, Elec. Util. Week, Dec. 5, 1988, at 5.

268. ADFAC NOPR, *supra* note 262.

269. Notice of Proposed Rulemaking, *Regulating Government Bidding Programs*, IV F.E.R.C. Stats. &

cerning the deregulation of IPP's.²⁷⁰

The notices have been heavily debated in the press, at industry conferences, and on Capitol Hill. FERC Chairman Hesse defended the proposals as necessary vehicles of regulatory reform in light of changes in the electricity generation sector. The proposal on avoided cost determination would, according to the FERC, clarify existing FERC-promulgated PURPA regulations to provide for more uniform PURPA implementation by the states.²⁷¹ With respect to the proposals on competitive bidding and deregulation of independent power producers, the FERC has concluded that they would allow for more market-based pricing of electricity generation.²⁷² The FERC believes that this approach will encourage sufficient electric generating capacity to meet future energy demand.

Commissioner Charles Trabandt dissented to both PURPA proposals, criticizing their creation of strict federal guidelines for state implementation of the PURPA.²⁷³ The Commissioner stated that in preempting creative state initiatives under the PURPA, the FERC had displayed again that "[i]nstitutionally, we are really quite full of our federal selves at the FERC."²⁷⁴

In congressional hearings on the FERC electric initiatives, Congressman Phil Sharp, Chairman of the House Subcommittee on Energy and Power, urged that the FERC remain sensitive to the states' role under the PURPA. The FERC's proper role under PURPA, he concluded, was to "provide guidance with advice—where appropriate—not to mandate any particular model or approach [for the states]."²⁷⁵ Moreover, Senators Bennett Johnston and James McClure, Chairman and Ranking Minority Member of the Senate Energy Committee, cautioned the FERC to slow its consideration of these initiatives and not assume favorable congressional relaxation of regulation under the PUHCA.²⁷⁶

The outgoing President of the NARUC, Bruce Hagen, urged the FERC to abandon the issuance of new electric policy initiatives, citing the lack of need for a "one size fits all" federal policy.²⁷⁷ Subsequent to the FERC's publication of the electric proposals, the NARUC adopted a resolution concluding that the preemptive effects embodied in the proposals represented a clear breach of the assurance given by the FERC over the previous year.²⁷⁸ In testi-

Regs. ¶ 32,455, 53 Fed. Reg. 9324 (1988) [hereinafter RGBP NOPR] (references hereinafter are to the F.E.R.C. Statutes and Regulations).

270. Notice of Proposed Rulemaking, *Regulations Governing Independent Power Producers*, IV F.E.R.C. Stats. & Regs. ¶ 32,456, 53 Fed. Reg. 9327 (1988) [hereinafter RGIPP NOPR] (references hereinafter are to the F.E.R.C. Statutes and Regulations).

271. ADFAC NOPR, *supra* note 262, at 32,157.

272. RGBP NOPR, *supra* note 269, at 32,022; RGIPP NOPR, *supra* note 270, at 32,103.

273. Trabandt, *supra* note 4, at 9-10.

274. *Id.* at 9.

275. *Id.*

276. Letter from Senators J. Bennett Johnston and James A. McClure to FERC Chairman Martha O. Hesse (Oct. 20, 1986).

277. Boxall, *supra* note 4, at 11-12.

278. Trabandt, *supra* note 4, at 10. At the NARUC conference in November 1988, the FERC electric

mony before Congress, the Maine PUC and the Florida PSC both stated their alarm at the sweeping preemptive effect of the FERC proposals.²⁷⁹

Similarly, many utility executives have expressed outrage at what they see as the sweeping nature of the FERC policy initiatives, although such criticism is not leveled directly at the preemption issue. For example, the Chairman of the American Electric Power Co., W.S. White, stated that the deregulation proposals "would lead to the disintegration of the electric utility industry that has led this nation's growth."²⁸⁰ Merle Borchelt, Chairman of the Central and South West Corporation, argued that the proposals are "hasty and dangerous to our energy future."²⁸¹

In the proposed rulemaking on the administrative determination of full avoided costs, the FERC proposed giving states stricter guidance on the implementation of the full avoided costs standard.²⁸² The FERC concluded that there was substantial controversy as to how states should determine full avoided costs, and thus more definitive FERC standards were necessary.²⁸³ The FERC stated, however, that states remain the regulatory bodies best situated to make the avoided cost determination.²⁸⁴

The FERC's existing rules on avoided cost determinations provide that states should take into account several FERC-promulgated standards "to the extent practicable."²⁸⁵ In the proposed rule, the FERC suggested the deletion of this proviso, which would have the effect of mandating state consideration of the FERC-promulgated avoided cost criteria.²⁸⁶ Under the proposal, states now would be required to specify in writing the manner in which each federally specified factor was considered in the determination of avoided cost.²⁸⁷

Through the proposed rule on competitive bidding, the FERC again purported to provide states with further guidance in determining a utility's avoided cost under the PURPA.²⁸⁸ Specifically, the FERC advanced the idea that competitive bidding could be used by states to determine which qualifying suppliers would receive avoided capacity payments.²⁸⁹ Although states could

policy initiatives were a major focus of discussion. See also *States Gird Themselves To Do Battle as Regulatory Reforms Unfold*, INSIDE F.E.R.C., Oct. 31, 1988, at 5.

279. Trabandt, *supra* note 4, at 10.

280. Wamstead, *No Economic Reason for FERC Electricity Proposals*, AEP Says, Energy Daily, Oct. 20, 1988, at 1.

281. FERC Electric Proposals "Hasty and Dangerous to Our Energy Future," Energy Daily, Nov. 2, 1988, at 4.

282. ADFAC NOPR, *supra* note 262, at 32,163.

283. *Id.*

284. *Id.* at 32,164.

285. 18 C.F.R. § 292.304(e) (1988).

286. ADFAC NOPR, *supra* note 262, at 32,168.

287. *Id.* The FERC also proposed that states be required to consider "the quantity and characteristics of a utility's energy or capacity needs, and the QF's ability to meet those needs, when determining an avoided cost rate." *Id.* Moreover, the proposed rule provided that avoided cost determinations must consider the availability of purchases from other wholesale sources. *Id.*

With respect to interconnection agreements, however, the FERC preserved existing state jurisdiction. The Commission concluded that states were best situated to define necessary interconnection facilities and ensure the reasonableness of interconnection charges. *Id.* at 32,180.

288. RGBP NOPR, *supra* note 269, at 32,021.

289. *Id.* at 32,025.

choose not to employ competitive bidding, if a state elected to adopt a competitive bidding process, the system chosen would have to be consistent with the FERC's bidding regulations.²⁹⁰ Once a state determined a rate through a FERC-approved competitive bidding mechanism, however, the FERC disclaimed authority to review the justness or reasonableness of the rate.²⁹¹

Describing the proposed rules as a "parade of preemption horrors," Commissioner Trabandt dissented from the FERC's proposals.²⁹² He criticized the competitive bidding proposal on the ground that it would allow states only two choices, either adoption of the new avoided cost regulations or the competitive bidding regulations. As a general matter, he faulted the FERC for failing to conduct a comprehensive review of all existing state PURPA programs, in order to measure the preemptive effects of the proposals.²⁹³

The proposed rules represent the first major effort by the FERC to revise the PURPA regulatory scheme. In so doing, the FERC clearly is seeking to alter the federal-state relationship that existed during the first ten years of the FERC's PURPA authority. The FERC, based on its perception of changing industry needs, has expressed the conviction that existing state regulations evidence a need for stricter federal guidance. By contrast, many congressional leaders, industry executives, states commissions, and consumer advocates have voiced varying degrees of concern over the prudence of the proposals. Whatever the FERC's final rules produce, it appears likely to be challenged in court, and perhaps on Capitol Hill, on both substantive and procedural grounds.

3. *Industrial Cogenerators v. Florida Public Service Commission*:²⁹⁴ The FERC's First Enforcement Action Under the PURPA

In *Industrial Cogenerators v. Florida Public Service Commission*, the FERC commenced its first PURPA enforcement action since the statute's enactment.²⁹⁵ The FERC held that the Florida PSC regulations, or the interpretation of those regulations, on the provision of interruptible service, the rates for backup and maintenance service, and the application of discriminatory ratchets, conflicted with applicable FERC regulations.²⁹⁶ Commissioner

290. *Id.* at 32,027-28. The FERC stated:

The Commission has the authority under section 210 of PURPA to require states and nonregulated electric utilities that voluntarily wish to adopt new (or to continue preexisting) bidding procedures, to implement the Commission's regulations on bidding. . . . Bidding procedures adopted by states pursuant to either PURPA or state law are invalid to the extent the state procedures are inconsistent with PURPA and the Commission's rules and regulations.

Id.

291. *Id.* at 32,028. In addition, the FERC proposal would require states to certify the bid selection procedure for each sale of qualifying power. The FERC reasoned that such certification process would ensure state involvement in the process, lessen the probability for subsequent controversies over the pass-through of a utility's wholesale power costs, and assist the FERC in monitoring the state bidding program.

292. *Id.* at 32,081 (Trabandt, C., concurring and dissenting).

293. *Id.* at 32,080.

294. *Industrial Cogenerators v. Florida Pub. Serv. Comm'n*, 43 F.E.R.C. ¶ 61,545 (1988).

295. *Id.* at 62,355 (Trabandt, C., dissenting).

296. *Id.* at 62,349-50, 62,353.

Trabandt, again in a stinging dissent, criticized the FERC for seeking to federalize the implementation of the PURPA.²⁹⁷ The Commissioner alleged that the decision was "catastrophic" and that "[t]he flexibility that PURPA envisioned for the states has gone right out the window"²⁹⁸

At issue in *Industrial Cogenerators* were Florida PSC regulations issued in 1987 to implement the PURPA.²⁹⁹ The cogenerator group appealed those regulations to the Florida Supreme Court, alleging numerous conflicts with FERC's regulations under the PURPA. While the case was being litigated before the Florida Supreme Court, the cogenerator group filed for a declaratory order for the FERC to review the PSC regulations under its enforcement and review authority.³⁰⁰

First, the FERC held that the Florida PSC improperly denied the cogenerators' request for interruptible service.³⁰¹ The FERC reasoned that federal regulations³⁰² placed the burden on the utility to show that interruptible service was not in the public interest, whereas the PSC had required the cogenerators to bear the burden. Second, the FERC found that the PSC had improperly allowed utilities to charge qualifying facilities the same rate for backup service and maintenance service.³⁰³ Again, the FERC reasoned that, in contrast to the PSC regulations, the burden must be on the utility to prove that the same rate is justified. Finally, the FERC faulted the Florida PSC for failing to examine whether the qualifying facilities were subject to discrimination in having a ratchet applied to their reservation charges, whereas such a ratchet was not applied to nongenerating customers.³⁰⁴

It may be an understatement to note that the FERC's decision to review the Florida rates has evoked considerable ire. Opponents of federal preemption have observed that in *Industrial Cogenerators* the cogenerators won, whereas in *Orange & Rockland* the utility won; the similarity was, however, that in both cases the states found themselves preempted.³⁰⁵ Given the unique role that Congress provided to the states under the PURPA, it is predictable that many states will strenuously object to FERC "guidelines" that purport to prescribe a uniform implementation of the PURPA. In terms of legal trends, it seems likely that these recent cases represent not the pinnacle of federal-state controversy under the PURPA, but rather signal only the beginning of what will soon become a full-blown preemption war.

C. Deregulation of Sales by Independent Power Producers

In a third notice of proposed rulemaking, the FERC recommended that traditional cost of service regulations be relaxed for wholesales-level sales by

297. *Id.* at 62,355 (Trabandt, C. dissenting).

298. Trabandt, *supra* note 4, at 12.

299. Florida Public Service Commission Order No. 17159 (Feb. 6, 1987).

300. 16 U.S.C. § 824a-3(h)(2)(A) (1982).

301. 43 F.E.R.C. ¶ 61,545, at 62,349.

302. 18 C.F.R. § 292.403(a) (1988).

303. 43 F.E.R.C. ¶ 61,545, at 62,350.

304. *Id.* at 62,353.

305. Trabandt, *supra* note 4, at 13.

independent power producers (IPPs).³⁰⁶ Under this proposal, the FERC is seeking to deregulate certain wholesale level sales of electricity in order to encourage future development of generation capacity.

FERC Chairman Hesse has supported this proposal principally as a means to increase supply options in the wholesale market.³⁰⁷ On the other hand, critics of this proposal have contended that the IPP proposal addresses a problem (generation undercapacity) that has not been proven to exist.³⁰⁸ More importantly, this proposal, coupled with the possibility for reform of the PUHCA,³⁰⁹ could result in fundamental structural changes for the electric industry. For state regulators, such deregulation almost certainly will result in less local control over a retail utility's wholesale-level purchasing decisions.

In its proposed rulemaking, the FERC identified a class of wholesale electric suppliers who lack substantial market power, and, therefore, should not be subject to traditional cost of service regulation.³¹⁰ The FERC defined a seller without market power as one that sells power to a customer that (1) is not located in the franchised retail service territory of the seller; and (2) is not served by transmission facilities essential to the customer and controlled by the seller.³¹¹ The FERC included in its definition of an IPP three types of independent producers: (1) industrial IPPs; (2) nontraditional utility IPPs; and (3) franchised utility IPPs.³¹² The FERC made a preliminary finding that it could rely upon competitive forces to prevent price manipulation by this group of independent producers.

The FERC concluded that deregulation of IPPs would not alter the jurisdictional authority of state regulators.³¹³ According to the FERC, states would retain their authority to approve the siting and construction of power plants and could examine the prudence of a retail utility's decision to purchase a particular supply of power. The FERC cautioned, however, that state commissions would not have control over wholesale purchase by nonautonomous affiliates of a multistate holding company system.³¹⁴

D. State Commission Pass-Through of Take-or-Pay Liability

The digestion of huge amounts of take-or-pay liability is presently a major burden for the natural gas industry. Only recently have local distribution companies (local utilities) begun to file for recovery of these FERC-approved costs in retail rates. Consequently, only a few state commissions

306. RGIPP NOPR, *supra* note 270.

307. *Id.* at 32,103.

308. RGBP NOPR, *supra* note 269, at 32,067 (Trabandt, C., dissenting).

309. See Freudmann, *PURPA or PUHCA Reform? "Whatever it Takes," Says One IPP*, *Energy Daily*, Nov. 8, 1988, at 1.

310. RGIPP NOPR, *supra* note 270, at 32,108.

311. *Id.* at 32,110.

312. *Id.* at 32,112.

313. *Id.* at 32,118.

314. *Id.* at 32,143 n.121. This proposed rulemaking was issued prior to the Supreme Court's decision in *Mississippi*. As a result, the FERC relied on its prior decisions in the *AEP Generating Company* litigation for distinguishing state prudence determinations in the holding company context. See *AEP Generating Co.*, 38 F.E.R.C. ¶ 61,243 (1987).

thus far have considered their authority under the filed rate doctrine to require the shareholders of distribution companies to absorb a portion of these costs. Interestingly, these commissions have reached diametrically opposed conclusions regarding their authority in this developing area of preemption jurisprudence.

The take-or-pay problem arose from the dramatic fluctuations in the supply of natural gas over the past two decades. In the 1970s, the industry experienced sharp shortages in the supply of natural gas. After 1978, which witnessed sharp passage of the Natural Gas Policy Act (NGPA)³¹⁵, the price of natural gas increased substantially, which in turn encouraged greater exploration and production. The growing supplies, however, soon exceeded demand and caused the prices of natural gas to drop quickly.³¹⁶

The take-or-pay provisions of gas supply contracts were creatures of the fluctuating nature of the gas supply market. In return for long-term commitments to finance exploration and deliver gas supplies to natural gas pipeline companies, gas producers demanded that their supply contracts provide protections against shifts in demand. The take-or-pay provisions of the contracts required that pipelines pay for a specified amount of gas over time, regardless of whether the pipeline company actually needed the supply given changes in price or consumer demand.

The take-or-pay provisions of these contracts, however, soon became an immense financial burden to the pipeline companies. The excess supplies of gas in the early 1980s were coupled with low prices on the spot market, but the pipeline companies were locked into high-cost, long-term supply contracts with producers. When these pipelines chose to purchase inexpensive gas on the spot market, they accordingly reduced their purchases under the long-term supply contracts. This caused pipelines' take-or-pay liability to skyrocket; they were now obligated to pay for high-cost gas which they had not in fact purchased.

The FERC responded to these huge amounts of take-or-pay liability with Order No. 500.³¹⁷ In Order No. 500, the FERC decided that the financial burden of take-or-pay should be shared equitably throughout the natural gas industry. The order provided pipeline companies with two different options for recovering take-or-pay costs in their wholesale rates. First, a pipeline company could seek to recover its full take-or-pay costs, but in so doing would likely be required to establish the prudence of its purchasing practices that led to the incurrence of this liability. Alternatively, a pipeline company could choose to absorb a portion (between 25% and 50%) of its take-or-pay liability, and in passing through the remainder of the costs, there would be a presump-

315. Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982).

316. AMERICAN GAS ASSOCIATION, GAS RATE FUNDAMENTALS 206 (4th ed. 1987).

317. Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. Stats. & Regs. ¶ 30,761, 52 Fed. Reg. 30,334 (1987) (codified at 18 C.F.R. pts. 2 & 284), *modified*, Order No. 500-A, 41 F.E.R.C. ¶ 61,013, *further modification*, Order No. 500-B, 41 F.E.R.C. ¶ 61,024, *further modification*, Order No. 500-C, 41 F.E.R.C. ¶ 61,351 (1987), *further modification*, Order No. 500-D, 42 F.E.R.C. ¶ 61,302, *reh'g denied*, Order No. 500-E, 43 F.E.R.C. ¶ 61,234 (1988) [hereinafter Order No. 500].

tion that the pipeline's purchasing practices were prudent.³¹⁸

Regulatory reforms in the natural gas industry also have affected the states' role in gas supply regulation. Prior to 1978, local distribution companies purchased gas primarily from pipeline companies, which in turn purchased gas under long-term supply contracts with gas producers. The NGPA gave local distribution companies the right to purchase gas directly from producers. As a result, local utilities now could bypass purchases from pipeline companies and use the pipelines only for transportation service.

State commissions viewed this new purchasing discretion for local utilities as accompanied by an increased responsibility to make such decisions prudently. With state commission exercising greater review of local utilities' gas purchasing decisions, the pass-through of take-or-pay costs inevitably has become an issue. In Order No. 500, the FERC approved a system for pipeline companies to pass through their take-or-pay liability in sales to local distribution companies. Now, state commissions must determine the extent of their authority under the filed rate doctrine to require the shareholders of the local utilities to bear a portion of these immense costs.

The pass-through of take-or-pay costs by local distribution companies to local ratepayers presents two important preemption questions. First, did the FERC, through its policy of equitable sharing of take-or-pay costs, intend to waive the filed rate doctrine's preemptive effects and allow state commissions to require, regardless of prudence, the shareholders of distribution companies to absorb a portion of the take-or-pay costs? Second, and on the other end of the preemption spectrum, if the FERC did not waive the application of the filed rate doctrine, are the states completely preempted by *Mississippi* and *Nantahala* from disallowing recovery of a portion of these costs under the theory that Order No. 500 "allocated" the financial burden of take-or-pay and thereby precluded all state commission review of these matters?

The Maryland Public Service Commission recently addressed these issues in a rulemaking proceeding to establish its policy toward pass-through of take-or-pay liability.³¹⁹ This was an important matter for the PSC in view of the fact that one Maryland utility, Baltimore Gas & Electric Company, would be responsible for \$60 million in take-or-pay costs over the next five years. In essence, the Maryland PSC determined that the pass-through of take-or-pay costs was to be treated no differently, for preemption purposes, than ordinary state commission review of gas and electric purchasing decisions. Under the filed rate doctrine the PSC would be required to fully pass through all FERC-approved take-or-pay costs to retail ratepayers, unless the FERC determined that the costs were the result of imprudent purchasing practices.

The Maryland People's Counsel (MPC), the public advocate, argued before the Commission that the PSC had the authority to deny pass-through of an equitable portion of these costs without a finding of imprudence. The

318. Order No. 500, *supra* note 317, at 30,875.

319. Order No. 68269, *In the Matter of the Investigation by the Commission on its Own Motion of the Jurisdictional and Policy Issues Relevant to the Recovery by Local Distribution Companies of Pipeline/Producer Take-or-Pay Costs and Charges* (Md. Pub. Serv. Comm'n Dec. 2, 1988) [hereinafter Maryland PSC Order].

MPC relied on several statements by the FERC that indicated a willingness by the Commission to waive the preemptive effects of the filed rate doctrine in order to further its policy of industry-wide sharing of take-or-pay liability.³²⁰ The PSC, however, rejected this contention, holding that there is no evidence that the FERC was seeking to waive the filed rate doctrine in this instance. The state commission also noted that in the absence of a thorough explanation by the FERC, it would question the FERC's authority to waive the preemptive effects of its own orders.

The Maryland Commission went on to conclude, however, that states were not completely precluded from reviewing the pass-through of take-or-pay costs. The PSC found that under *Mississippi* and *Nantahala* it was free to question the wholesale purchasing practices of local distribution companies. The state commission determined that the notion of "equitable sharing" expressed in the FERC order was not equivalent to a FERC "allocation" decision, as was present in both *Mississippi* and *Nantahala*. The *Pike County* doctrine, the PSC held, applies to state prudence inquiries into wholesale purchasing practices as they related to incurrence of take-or-pay liability. If the local utility could show that by purchasing low cost power directly from producers it had saved the ratepayers money, even given the resulting take-or-pay liability, the local utility could fully recover its take-or-pay costs; if the opposite was true, the state commission had the authority to issue a finding of imprudence and deny recovery of a portion of those costs.

In a recent decision, the Illinois Commerce Commission came to the opposite conclusion of the Maryland PSC.³²¹ The Illinois Commerce Commission found that states are completely preempted under *Mississippi* and *Nantahala* from reviewing any aspect of take-or-pay pass-throughs.

The Illinois Public Counsel argued before the state commission that the *Pike County* doctrine allowed state commissions to review the prudence of local distribution companies' gas purchasing plans that contributed to take-or-pay liability. The Illinois Commission dismissed the argument, and instead characterized FERC Order No. 500 as "allocating" the take-or-pay liability among the various segments of the natural gas industry. Because the FERC had allocated these costs, the Illinois Commission found the Supreme Court's decisions in *Mississippi* and *Nantahala* controlling and found the *Pike County*

320. The FERC had stated that:

As we have pointed out, there appears to be ample evidence indicating that, taking the industry as a whole, there is much responsibility to be shared.

....

... The method and extent of flowthrough by local distribution companies will be determined by the responsible state regulatory agencies consistent with applicable law.

Notice of Issuance of Proposed Policy Statement and Opportunity for Public Comment, *Recovery of Take-or-Pay Buy-Out and Buy-Down Costs by Interstate Natural Gas Pipelines*, 38 F.E.R.C. ¶ 61,230, at 61,728-29 (1987).

In addition, the FERC Chairman had said in congressional hearings on Order No. 500, "It would be nice if the LDC's also have to absorb a portion [of take-or-pay costs] so that fewer costs are passed on to customers." See Maryland PSC Order, *supra* note 319.

321. Order No. 88-0103, *Illinois Commerce Commission on its Own Motion Investigation Into the Appropriate Recovery by Illinois Gas Utilities of Costs Associated with Take-or-Pay Charges from Interstate Pipeline Companies* (Ill. Commerce Comm'n July 20, 1988).

doctrine inapplicable. The Illinois Commission concluded that the FERC's allocation of responsibility for take-or-pay costs preempted states under *Mississippi* and *Nantahala* from questioning the prudence of local utilities' gas purchasing practices in this context.³²²

The Indiana Utility Regulatory Commission (URC) at present seems torn between the differing approaches of the Maryland and Illinois commissions. The Indiana URC suggested recently that states under the *Pike County* doctrine arguably could review the prudence of gas purchases in the take-or-pay context.³²³ The Indiana URC cautioned, however, that *Pike County's* applicability to take-or-pay pass-throughs is questionable in light of the nature of FERC Order No. 500. The Indiana URC seemed to agree with the contention by the company that the FERC has "determined cost responsibility and allocated the costs" of take-or-pay accordingly, and therefore Order No. 500 would constitute a preemptive allocation under *Mississippi*. The Indiana URC concluded, however, that the issue of prudence had not been raised properly and, accordingly, it would not issue a final order deciding the issue of federal preemption.³²⁴

The differing conclusions represented in these early cases indicate that the issue of preemption in the take-or-pay context will be one for fruitful future debate. Did the FERC intend to waive the operation of the filed rate doctrine for take-or-pay costs? If so, does it possess the authority to do so? On the other hand, if the filed rate doctrine is applicable, did the FERC truly "allocate" take-or-pay liability in the manner contemplated by the decisions in *Mississippi* and *Nantahala*? If so, how would this vastly broadened notion of "allocation" affect the electric side of the industry? Would all the FERC's decisions regarding shareholder versus ratepayer responsibility become questions of "allocation" with concomitant preemptive effects? At present, it appears unlikely that the allocation principle will be extended this far, but state regulators will be wise to follow closely the developments in the litigation over take-or-pay pass-throughs to local ratepayers.

E. Schneidewind v. ANR Pipeline Co.:³²⁵ *FERC Preemption of State Regulation of Utility Security Issuances*

In *Schneidewind*, the Supreme Court ruled that the Michigan state commission was preempted by the NGA from requiring preissuance state review of securities offerings by an interstate pipeline and storage company. The Court found that the purposes of the Michigan law were the same as the purposes of the NGA, which occupied the field of wholesale rate regulation, and thus the Michigan law was preempted.³²⁶ As a result, states may not have the

322. *Id.* The Illinois Commerce Commission also rejected, as did the Maryland PSC, the argument that the FERC had intended to waive the effects of the filed rate doctrine in order to further its goal of equitable sharing. *Id.*

323. Order No. 38380 *Northern Ind. Pub. Serv. Co.* (Ind. URC Sept. 28, 1988).

324. *Id.* Similar to the Maryland and Illinois commissions, the Indiana URC dismissed as gratuitous the FERC's statements that indicated a willingness to waive the operation of the filed rate doctrine. *Id.*

325. *Schneidewind v. ANR Pipeline Co.*, 108 S. Ct. 1145 (1988).

326. *Id.* at 1155.

authority to review interstate gas pipelines' capital structure insofar as such review is perceived as intruding into the FERC's exclusive jurisdiction.

The Michigan Public Utilities Securities Act³²⁷ provided that a public utility that transports natural gas in Michigan for public use must obtain Michigan PSC approval before it issues long-term securities.³²⁸ ANR Pipeline Company and ANR Storage Company challenged the Michigan law, alleging that it was preempted under the NGA. The federal district court concluded that there was no federal preemption nor any conflict with the Commerce Clause.³²⁹ The Court of Appeals for the Sixth Circuit reversed, holding that by omitting preissuance review of securities in an otherwise comprehensive federal scheme Congress had intended to preempt similar state regulation.³³⁰

The Supreme Court affirmed the court of appeals, finding that the Michigan law attempted to regulate in a field wholly occupied by the FERC.³³¹ The Court noted that the FERC was not given authority to review (prior to issuance) securities offerings by natural gas companies,³³² but concluded that Congress had nevertheless intended the FERC to occupy the field. The Court likened securities regulation with the regulation of a company's capital structure, over which the FERC has authority in three principal areas: (1) in fixing a reasonable rate of return on capital, the FERC reviews the reasonableness of the ratio between debt, common stock, and preferred stock; (2) through its approval of a certificate of public convenience and necessity, the FERC examines the plans for financing a new facility; and (3) the FERC has control over utility accounting practices.³³³

The Michigan PSC argued that its regulation of securities issuances was necessary to protect investors and ratepayers from unwise utility investment decisions. Although the Supreme Court recognized that such a purpose was consistent with the NGA, the Court held that the state law nevertheless was preempted because the NGA had wholly occupied the field. The plain implication of the decision is that states with laws of a similar nature likely will be prohibited from seeking to regulate a utility's capital structure. These states now can anticipate the need to protect their constituent's interests in the District of Columbia in proceedings before the FERC.

327. MICH. COMP. LAWS ANN. § 460.301 (West Supp. 1988).

328. MICH. COMP. LAWS ANN. § 460.301(3) (West Supp. 1988). Under the statute, the Michigan PSC was required to approve securities offerings when it:

is satisfied that the funds derived . . . are to be applied to lawful purposes and that the issue and amount is essential to the successful carrying out of the purposes or that the issue of the stock fairly represents accumulated and undistributed earnings invested in capital assets and not previously capitalized.

Schneidewind, 108 S. Ct. at 1147.

329. *ANR Pipeline Co. v. Schneidewind*, 627 F. Supp. 923 (W.D. Mich. 1985), *rev'd*, 801 F.2d 228 (6th Cir.) (1986), *aff'd*, 108 S. Ct. 1145, 1151 (1988).

330. *ANR Pipeline Co. v. Schneidewind*, 801 F.2d 228 (6th Cir. 1986).

331. *Schneidewind v. ANR Pipeline*, 108 S. Ct. 1145, 1151 (1988).

332. *Schneidewind* 108 S. Ct. at 1153.

333. *Id.* at 1152.

F. *Puerto Rico v. ISLA Petroleum Co.*:³³⁴ *State Authority Regarding Price Controls for Wholesale and Retail Gasoline Sales*

The *Puerto Rico* decision explained the effect that federal decontrol of gasoline prices had on the authority of states to enact gasoline price controls. The decision is noteworthy for its analysis of the difficult issue of determining what Congress intends with regard to federal preemption when it repeals a statutory scheme of federal regulation. As the opinion illustrates, two possibilities exist: (1) Congress may intend to leave the market entirely unregulated, thereby preempting state regulation, or (2) it may intend to eliminate the federal regulatory structure, while at the same time allowing states to later enter the same field of regulation. In view of the increasing movement toward federal deregulation of various industries, the analysis employed in *Puerto Rico* will likely grow in significance.

In *Puerto Rico*, the Supreme Court ruled that Puerto Rico was free to impose taxes upon oil refiners and regulate the profit margins on gasoline sales by wholesalers. The Court rejected the ISLA Petroleum's claim that when Congress repealed the price and allocation controls under the Emergency Petroleum Allocation Act (EPAA),³³⁵ it intended to prohibit similar state regulation. As a result, states are free, in the present era of federal deregulation of gasoline prices, to impose local regulation on gasoline prices, including limits on wholesale profit margins and enactment of gasoline excise taxes. The factual situation presented in *Puerto Rico* is discussed below.

In 1973, Congress enacted the EPAA, which provided for presidential issuance of regulations concerning the allocation and pricing of petroleum products.³³⁶ The EPAA expressly preempted all state regulation in conflict with the federal scheme.³³⁷ In 1975, Congress passed the Energy Policy and Conservation Act (EPCA) to provide for the gradual decontrol of gasoline prices, with all regulation ceasing in 1981.³³⁸ After the federal price and allocation controls had ceased, Puerto Rico enacted an excise tax on oil refineries and imposed maximum profit margins on wholesalers.³³⁹

ISLA Petroleum challenged the Puerto Rico statute, alleging that by ending all federal regulation, Congress intended that the field be completely unregulated and that state regulation be preempted. The Court held that preemptive intent must be derived from statutory language, rather than the absence of such language.³⁴⁰ Certain legislative history indicating a desire for a deregulated market was entitled, in the Court's opinion, to little consideration given the lack of statutory text to interpret. The Court reiterated its long-standing rule that a clear and manifest purpose to preempt is required.³⁴¹ The

334. *Puerto Rico v. ISLA Petroleum Co.*, 108 S. Ct. 1350 (1988).

335. 15 U.S.C. §§ 751-760(h) (1982).

336. 15 U.S.C. § 753; see *Puerto Rico*, 108 S. Ct. at 1352.

337. 15 U.S.C. § 755(b) (1982).

338. Energy Policy and Conservation Act (EPCA), Pub. L. No. 94-163, 89 Stat. 871 (codified in scattered sections of 42 U.S.C.).

339. *Puerto Rico*, 108 S. Ct. at 1352.

340. *Id.* at 1354.

341. *Id.* at 1355. The Court distinguished statements in its prior holding in *Transcontinental Pipe Line*

Supreme Court concluded, therefore, that the taxes and regulations imposed by Puerto Rico were not preempted because when Congress exited the field of gasoline price regulation it did not display an affirmative intent to impose complete deregulation on state governments.

The *Puerto Rico* decision is significant in areas far beyond gasoline price controls. With the present political climate being one of persistent demands for federal deregulation of various industries, the situation present in *Puerto Rico*, that is, elimination of a federal regulatory scheme, will likely reoccur. When Congress decides to relax or eliminate federal regulation a particular industry, under *Puerto Rico*, this action in itself does not mean that states will be prohibited from similar regulation. It is possible that states, as in *Puerto Rico*, may have greater regulatory authority (absent dormant Commerce Clause restrictions) after federal deregulation removes the preemptive effect of the prior regulatory scheme. In addition, legislative strategies designed to achieve federal deregulation likely will now include fervent attempts to include specific preemptive, or nonpreemptive, language or legislative history into enactments that repeal prior federal regulatory schemes. In the electric utility industry, these possibilities may manifest in the current attempts to repeal portions of the PUHCA.

G. *Federal Emergency Management Agency Preemption of State and Local Emergency Planning Responsibilities for Nuclear Power Plant Accidents*

One of the most recent examples of the application of the federal preemption doctrine has been with respect to the emotional and litigation-prone issue of evacuation plans for potential nuclear power plant disasters. Many commercial nuclear power plants are located near heavily populated communities. To these communities, there looms the potential danger of a nuclear meltdown or lesser disaster. In an attempt to provide such localities some degree of protection, federal law requires that there be a plan for evacuation of all citizens within the vicinity of a nuclear plant.

A November 1988 executive order signed by President Reagan empowers a federal agency to develop its own evacuation plan for a locality, whereas, originally, creation of evacuation plans was the responsibility of state and local governments. The importance of this development is that states will no longer be able to delay, or ultimately stop, the granting of an operating license to a local nuclear power plant by failing to submit an evacuation plan. In light of the public opposition, through the media, public demonstrations, and litiga-

Corp. v. State Oil & Gas Board as inapposite. *Transcontinental Pipe Line Corp. v. State Oil & Gas Bd.*, 474 U.S. 409 (1986). In *Transcontinental*, the Court found no preemption, but went on to suggest that "[a] federal decision to forgo regulation in a given area may imply an authoritative federal determination that the area is best left unregulated, and in that event would have as much preemptive force as a decision to regulate." *Id.* at 422, quoting *Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375, 384 (1983). The Court instructed that, despite this observation, preemption does not occur in a vacuum, i.e., without reference to specific congressional text. If, however, a comprehensive federal regulatory scheme leaves one aspect unregulated, then a preemptive inference may be drawn. *Puerto Rico*, 108 S. Ct. at 1355.

tion, to several highly unpopular nuclear plants, this executive order will further fuel the federal-local fire over nuclear plant safety.

As a result of the accident in 1979 at Three Mile Island, Congress directed the Nuclear Regulatory Commission (NRC) to promulgate new regulations to ensure the orderly evacuation of citizens in the event of a commercial nuclear accident.³⁴² The NRC adopted regulations providing that no commercial operating license would be issued until the NRC had "reasonable assurance" that adequate evacuation measures were in place.³⁴³ The regulations further provided that the NRC shall base its finding on a review by the Federal Emergency Management Agency (FEMA) of emergency plans developed by state and local governments.³⁴⁴ A favorable finding by the FEMA constitutes a rebuttable presumption of "reasonable assurance" in the subsequent NRC licensing proceeding.

As a consequence of intense concern surrounding several troubled nuclear power plants (e.g., Seabrook, Shoreham, Pilgrim), a few states have refused to prepare evacuation plans in an effort to keep the plants from receiving NRC licensing approval.³⁴⁵ In response, the NRC issued a rule in 1987 providing that in the absence of a state evacuation plan a utility could submit its own plan to the FEMA.³⁴⁶ The NRC has decided that states and localities would likely follow a utility-developed emergency plan in the event of a radiological disaster because such a plan would be the best strategy available.³⁴⁷

The November 1988 executive order³⁴⁸ signed by President Reagan further dilutes state emergency planning authority. It empowers the FEMA with authority to design and implement off-site emergency evacuation plans when state and local regulators refuse to participate.³⁴⁹ Thus, the federal government has the authority to, in effect, preempt a state or local decision not to participate in emergency planning.

Officials from the State of New Hampshire already have begun to respond to the President's executive order. New Hampshire is particularly sensitive to an erosion of state emergency planning authority because of its prolonged litigation with the local utility over the troubled Seabrook nuclear power plant. The present Governor of New Hampshire, Judd Gregg, recently stated that in July 1988 the state congressional delegation put pressure on the President not to issue the executive order, which transforms the FEMA from evaluator to initiator of emergency preparedness plans.³⁵⁰ In addition, one public interest

342. NRC Authorization Act of 1980, § 109, Pub. L. No. 96-295, 94 Stat. 780 (1980) (uncodified).

343. 10 C.F.R. § 50.47(a) (1988).

344. *Id.* § 50.47(a)(2).

345. *In re Long Island Lighting Co.*, 17 N.R.C. 741 (1983).

346. 10 C.F.R. pt. 50 (1988).

347. *In re Long Island Lighting Co.*, 24 N.R.C. 22 (1986).

348. Exec. Order No. 12,657, 53 Fed. Reg. 47,513 (1988).

349. At least one commentator foresaw the likelihood that the federal government would intervene and provide a mechanism for federally developed emergency plans. K. Manne, *Federal Development and Implementation of Offsite Emergency Evacuation Plans for Nuclear Power Plants* (Mar. 9, 1988) (doctoral paper).

350. Egan, *Reagan Gives FEMA Broad Powers to Set Evacuation Plans*, *Energy Daily*, Nov. 21, 1988, at 1-2.

representative has reminded lawmakers that the inquiry conducted after the Three Mile Island accident concluded that state-developed evacuation plans would be more successful than federally sponsored plans.³⁵¹ Given the intense debate and concern over the future of safety in the nuclear power industry, this new FEMA authority is likely to be challenged in the courts.

H. Rural Electrification Administration Preemption of State Rate Regulation of Rural Electric Cooperatives

The issue of federal preemption has recently emerged in a new and unexpected area of the electric utility industry—state public utility commission regulation of rural electric generation and transmission cooperatives involved in interstate commerce. The doctrine has been applied in at least two situations (one in Indiana and one in Colorado) involving generation and transmission cooperatives. If the cooperatives financed by the Rural Electrification Administration (REA) succeed in either of these cases, widespread application of preemption relating to electric cooperative rates can be expected.

In assessing the merits of these recent claims of federal preemption, a brief overview of the history of rate regulation of cooperatives is essential. The REA was created in order to assist in bringing electric power to rural areas of the country not served by public utilities.³⁵² The REA provides, among other things, loans to rural electric cooperatives to assist them in developing the rural power supply. The REA has not to date, however, asserted authority to regulate the rates of electric cooperatives. In addition, the Federal Power Commission (now FERC) in 1967 ruled that it did not have jurisdiction to regulate wholesale rates charged by electric cooperatives.³⁵³ The Supreme Court in *Arkansas Electric Cooperative Corp.* held that states have the authority to regulate both the wholesale and retail rates of electric cooperatives.³⁵⁴

In December 1988, the Colorado-Ute Electric Cooperative filed with the Supreme Court an appeal from a Colorado Supreme Court decision.³⁵⁵ Colorado-Ute is a rural electric cooperative that receives loans from the REA and sells power interstate at wholesale to its members in several states. The Colorado PUC asserted jurisdiction over Colorado-Ute's wholesale rates and the Colorado Supreme Court affirmed.³⁵⁶ In its appeal, Colorado-Ute has alleged that the Colorado PUC wholesale rate order impermissibly interferes with REA's jurisdiction.

The basis for the cooperative's preemption claim is that the PUC order burdens its ability to repay loans issued by the REA: "[t]he implementation of the PUC-ordered rate design will severely compromise Colorado-Ute's finan-

351. *Id.*

352. *Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375, 381-82 (1983).

353. *Dairyland Power Coop.*, 37 F.P.C. 12, 67 P.U.R.3d 340 (1967).

354. *Arkansas Electric Cooperative*, 461 U.S. at 395.

355. Jurisdictional Statement, *Colorado-Ute Elec. Ass'n v. Public Utils. Comm'n*, 760 P.2d 627 (Colo. 1988), *appeal filed*, 57 U.S.L.W. 3503 (U.S. Dec. 14, 1988) (No. 88-977) [hereinafter Jurisdictional Statement].

356. *Colorado-Ute Elec. Ass'n v. Public Utils. Comm'n*, 760 P.2d 627 (Colo. 1988).

cial situation and consequently its ability to repay the federal government."³⁵⁷ Colorado-Ute's claim addresses directly the issue that the Supreme Court failed to decide in *Arkansas Electric Cooperative*. There, the Supreme Court refused to rule on the possibility that "a particular rate set by the [state PSC] may so seriously compromise important federal interests, including the ability of the [electric cooperative] to repay its loans, as to be implicitly pre-empted by the Rural Electrification Act."³⁵⁸ Seizing on this quote, Colorado-Ute alleges that the Colorado PUC order now presents the Supreme Court with a fully developed factual record to define the ambiguities left by the Court in *Arkansas Electric Cooperative*, which involved only a facial challenge to state regulation of wholesale cooperative rates. If the Supreme Court hears the appeal on the merits, the decision will represent a landmark in state regulation of rural cooperatives.

In another situation, the REA itself has asserted preemption of state rate regulation of electric cooperatives. This case will, in the same manner as *Colorado-Ute*, test the parameters of *Arkansas Electric Cooperative*. In this instance, however, the REA's initiation of the preemption dispute will raise the stakes: the REA's current interpretation of its jurisdiction over rates will be directly in issue.

In informal action taken just prior to completion of this article, the REA informed Indiana regulators in a letter that it would move to preempt the Indiana Utility Regulatory Commission from denying the local electric cooperative a rate increase.³⁵⁹ The REA Acting Administrator alleged that Indiana's failure to grant a rate increase caused the cooperative to default on federal government loans. Indiana regulators immediately responded in disappointment, alleging that the REA action would deprive Indiana "of [its] right to meaningful participation in utility ratemaking." A spokesman for Indiana vowed to contest preemption all the way to the Supreme Court, if necessary.

The fates of the Indiana and *Colorado-Ute* disputes will likely be intertwined. Colorado-Ute, in its appeal to the Supreme Court, has cited the Indiana notification letter as evidence that the REA has changed its policy and now asserts jurisdiction over electric cooperative wholesale rates. The significance of the Indiana case is that the REA can use it as a vehicle to redefine its jurisdiction under the REA. This potential reversal of REA policy takes on added significance when coupled with the possibility that a party may argue that the REA's new interpretation of its policy is due deference by the courts.³⁶⁰ These two cases promise to redefine the permissible bounds of state rate regulation of rural electric cooperatives.

357. Jurisdictional Statement at 15, *Colorado-Ute* (No. 88-977).

358. *Id.* at 389.

359. *REA Preempts States, Asserts Rate Jurisdiction Over Wabash Valley*, Elec. Util. Week, Dec. 5, 1988, at 14.

360. Whether a federal agency's interpretation of the scope of its own authority to preempt state regulation should receive judicial deference will likely be an important issue in the future. A prelude to the debate over this issue occurred in the concurring opinion of Justice Scalia and dissenting opinion of Justice Brennan in *Mississippi*. A full airing of the issue, however, would necessitate an entire law review article and will not be attempted here.

V. CONGRESSIONAL ACTIVITY REGARDING THE FERC'S POLICY ON PREEMPTION OF STATE LAW

The divisive nature of the debate over the impact of the federal preemption doctrine on energy federalism, not surprisingly, has attracted the attention of several leading members of Congress. The past few years have witnessed several congressional hearings focusing, in large or small part, on the FERC's policies regarding federal preemption of state regulation. In each instance, the FERC commissioners have been called up to Capitol Hill to justify their policies. Tough questioning by sometimes openly hostile committee members and terse rebuttals to the FERC's positions by state public service commissioners have typified these hearings.

Two sets of hearings in the past few years have been of particular interest in the debate over energy federalism: (1) hearings on the FERC's prudence reviews, or lack thereof, of the construction of large nuclear generating stations and (2) hearings on the FERC's preemption of state regulation of large nuclear plants constructed by multistate holding companies, focusing principally on Grand Gulf. Each of these hearings has helped to crystallize, in a public forum, the arguments swirling around the FERC's policies under the federal preemption doctrine. In none of the cases discussed, however, has legislation actually been enacted, and therefore it is difficult to assess the ultimate import of the hearings.

A. *House of Representatives Hearings on Power Plant Costs: The FERC's Policy Toward Prudence Reviews of Large Nuclear Generating Plants*

As discussed many times throughout this Article, cost overruns from large nuclear power plants has been perhaps the most troublesome regulatory issue for the electric utility industry in the 1980s. State regulators, disquieted by the phenomenon of nuclear generating plants coming on line sometimes by as much as ten times the original cost estimates,³⁶¹ have utilized every available regulatory tool to protect local ratepayers. Disallowances based on imprudent forecasts resulting in unneeded capacity, construction delays, and nuclear plant management inefficiencies have reached into the billions of dollars.³⁶² Many utilities, stung by what they view as state regulators use of twenty-twenty hindsight, have refused to construct new capacity for the 1990s for fear of future disallowances.³⁶³ To many observers, the traditional regula-

361. The construction of the Waterford 3 nuclear plant, located in Louisiana, was originally projected to cost approximately \$230 million. When it began commercial operation in 1985, its ultimate cost was \$2.84 billion. New Orleans, La., Resolution No. R-87-28 (1987).

362. The Kansas Corporation Commission denied recovery of \$2.16 billion from the Wolf Creek nuclear station. No. 120,924-U (Kan. Corp. Comm'n Sept. 27, 1985), *aff'd*, Kansas Gas & Elec. Co. v. State Corp. Comm'n, 239 Kan. 483, 720 P.2d 1063 (1986), *appeal dismissed*, 107 S. Ct. 3280 (1987).

The New York Public Service Commission originally disallowed \$1.395 billion of investment for the Shoreham Nuclear Plant. No. 85-23 (N.Y. Pub. Serv. Comm. Dec. 16, 1985). This disallowance was later reduced to \$635.6 million. No. 54452 (N.Y. Pub. Serv. Comm. Dec. 30, 1987).

The Georgia Public Service Commission disallowed \$951 million from the cost of the Vogtle Unit 1 nuclear generating plant. No. 3673-26 (Georgia Pub. Serv. Comm'n Sept. 30, 1987), *aff'd*, Georgia Appeals Court (July 21, 1988).

363. The congressional hearings on the FERC's recent proposed rulemakings illustrated this problem.

tory compact has been severely damaged, if not irrevocably broken.

In contrast to the reaction by many state regulators to nuclear plant cost overruns, the FERC has proceeded in a manner that suggests "business as usual." For nuclear power plants whose construction costs fall under federal jurisdiction, the FERC regulatory process has been a welcome haven from state scrutiny. Indeed, many utilities have adjusted their corporate form to create a structure that will subject major construction projects to exclusive FERC jurisdiction.³⁶⁴ At the time of the 1986 hearings on powerplant costs discussed below, the FERC had never disallowed a portion of a nuclear power plant's costs. As of the printing of this article, this number had increased to only one or two instances where the FERC had disallowed such costs.

This dichotomy in treatment of powerplant costs did not escape congressional attention. In 1986, the House Subcommittee on Energy Conservation and Power of the Committee on Energy and Commerce held hearings to review the FERC's policy on prudence reviews of construction costs.³⁶⁵ The Subcommittee summoned the FERC commissioners, leading utility executives, and representatives of state and consumer interests. What followed was essentially a full ranging symposia, albeit before a legislative body, on the FERC's policies in reviewing nuclear powerplant construction.

Congressman Markey, Chairman of the Subcommittee, opened the hearings by expressing dismay at the illogic in differing state and federal treatment of powerplant costs.³⁶⁶ The Congressman explained that in his home state of Massachusetts, the state PUC and the FERC had come to opposite conclusions over the same cancelled nuclear plant (Pilgrim 2). The Massachusetts PUC disallowed (as imprudently incurred) \$75 million of Pilgrim 2 over costs over which it had jurisdiction, whereas the FERC allowed full recovery of Pilgrim 2 costs over which it exerted jurisdiction.³⁶⁷ Congressman Markey also exhibited concern that state commissions could have devoted immense resources to prudence reviews resulting in billions of dollars of utility investment being disallowed, while the FERC had expended few agency resources to conduct prudence inquiries and had never disallowed costs from a nuclear generating plant. Naturally, the Congressman noted, this federal-state policy conflict had resulted in forum shopping by utilities seeking to recover fully their investments.³⁶⁸ As a topic for discussion, the Congressman wondered

PURPA Hearings, *supra* note 34. Many view the FERC's recent policy initiatives as designed to encourage future construction of generating capacity, capacity that utility executives are reluctant to build.

364. As explained in the introduction to this article, this type of corporate restructuring of power sales has been successfully achieved by the Middle South Holding Company and the American Electric Power Holding Company. Public Service of New Mexico has recently been rebuffed in its plan to reorganize its corporate arrangements to bring its power sales under the exclusive purview of the FERC. Most recently, Public Service of New Hampshire has proposed to restructure its operations to create a holding company with power sales subject to the FERC's jurisdiction—to avoid state regulation of the troubled Seabrook nuclear power plant.

365. *Power Plant Costs Hearings*, *supra* note 34.

366. *Id.* at 2.

367. The litigation over the cancelled plant costs from the Pilgrim 2 plant was discussed in *Eastern Edison Co. v. Department of Pub. Util.*, 388 Mass. 292, 446 N.E.2d 684 (1983).

368. *Power Plant Costs Hearings*, *supra* note 34, at 3.

out loud whether the failures in federal-state cooperation in the past decade called for the creation of a new regulatory system.

In response to questioning from Subcommittee members, Acting FERC Chairman Anthony Sousa explained the FERC's policy regarding prudence. The Commissioner stated that the FERC does not investigate prudence in every case, but rather ordinarily assumes that the utility's management has been prudent.³⁶⁹ Consequently, the FERC will usually not consider prudence unless it is raised by one of the parties to the proceeding.³⁷⁰ The Commissioner defended the FERC's policies, asserting that the FERC was a more objective regulator than the typical state commission. Because state commissions were subject to intense political pressures from consumers, he charged, state regulators were not positioned to reach fair results with respect to utility investments.³⁷¹

Richard Disbrow, President of the American Electric Power Company,³⁷² testified in support of the FERC's policies. He proffered that the skyrocketing construction costs had been caused by the rampant inflation of the 1970s, rather than utility imprudence.³⁷³ Mr. Disbrow suggested that consumers should bear the costs of electricity rate increases just as consumers bore the costs of inflation in all other industries. He also called for reestablishment of the bright line between federal and state jurisdiction, criticizing the *Pike County* doctrine³⁷⁴ as allowing state regulators to take a second bite at the apple.³⁷⁵ He also criticized any suggestion of potential regional regulation of utility matters as only further complicating jurisdictional conflicts. Mr. Disbrow summed up the current fights over nuclear power plants as caused by politicized state regulators using twenty-twenty hindsight to discover infirmities in past utility decisions.³⁷⁶

Paul Levy, Chairman of the Massachusetts PUC, presented arguments in defense of state prudence reviews. He countered charges by utility executives that states were engaging in Monday morning quarterbacking, asserting instead that prudence reviews are indispensable in reviewing management decisions by a regulated monopoly.³⁷⁷ The Commissioner admitted that political pressures may have influenced some state commission decisions, but contended that this fact did not detract from the necessity of prudence reviews. Commissioner Levy concluded by suggesting that utilities will continue to "engage in power purchase contracts or corporate restructurings that will

369. *Id.* at 49.

370. *Id.* at 62.

371. *Id.* at 49.

372. As mentioned previously, the American Electric Power Company is a multistate holding company operating in seven mid-western states. The AEP holding company has successfully structured certain of its power sales in a manner that avoids state regulation. See Opinion No. 266, AEP Generating Co., 38 F.E.R.C. ¶ 61,243, at 61,821 (1987).

373. *Power Plant Costs Hearings*, *supra* note 34, at 130.

374. A lengthy discussion of the *Pike County* doctrine is provided in an earlier section of this article. See *supra* section III(B).

375. *Powerplant Costs Hearings*, *supra* note 34, at 139.

376. *Id.* at 141.

377. *Id.* at 37.

enable them to be subject to FERC's, rather than State PUC's regulatory authority."³⁷⁸

Andrew Varley, Chairman of the Iowa State Commerce Commission, offered some additional views from the perspective of a state regulator. Mr. Varley opined that the Supreme Court's search for a jurisdictional bright line was misguided in view of the diverse and dynamic nature of federal-state regulation of the electric utility industry. He challenged the subcommittee members to realize that in an industry subject to constant change, "consistency and uniformity is not necessarily a standard in and of itself."³⁷⁹ State regulation that differed from federal policies was not, in his view, a problem, but rather was the inevitable outgrowth of our federal system. The Commissioner also explained that many state regulators felt a significant erosion of their authority vis-a-vis the federal government, with no accompanying shelter from the political pressure to which they are subjected by local ratepayers.³⁸⁰

Although many persuasive arguments were offered at these hearings, no legislation has yet been enacted in the House to redress the problem of power-plant cost overruns. The following discussion in Senate hearings directly addressed the FERC's policy of preemption of state prudence reviews.

B. Senate Hearings on the Ratepayer Protection Act: Giving States the Authority to Review Construction Decisions by a Multistate Holding Company

One predictable outgrowth of the Grand Gulf nuclear power plant controversy was congressional scrutiny of the FERC's policies on preemption. Naturally, congressional interest was led by those legislators whose states were deeply affected by the troubled nuclear plant. As discussed in preceding sections, the extreme cost overruns associated with the Grand Gulf nuclear plant threatened to wreak havoc on the depressed economies of Mississippi, Louisiana, Arkansas, and Missouri. When it became clear that the FERC would deny those states meaningful review of the Middle South Holding Company affiliates' participation in Grand Gulf, the local ratepayers vented their anger on local Congressmen and Senators, their protectors in Washington, D.C. It was only a matter of time before congressional leaders either initiated oversight hearings of the FERC's decisions regarding Grand Gulf or introduced legislation to strip the FERC's authority to preempt state regulation of holding company affiliates.

One congressional leader in particular, Senator Dale Bumpers of Arkansas, led a congressional assault directed at the FERC's jurisdiction over construction projects undertaken by multistate holding companies. The Senator introduced legislation in 1985 entitled "the Ratepayers Protection Act of 1985,"³⁸¹ that would have vested states with statutory jurisdiction over multistate generating plants such as Grand Gulf.³⁸² The bill provided that in a

378. *Id.* at 38.

379. *Id.* at 39.

380. *Id.* at 41.

381. S. 1149, 99th Cong., 2d Sess. (1985).

382. In July 1986, at the time of these hearings, appeals from the orders of the state commissions in

situation where an interstate sale involving the allocation of production or energy costs is made among affiliates of a holding company, any state commission (that had not approved the construction of the plant) having jurisdiction over one of the affiliates would be given authority to disapprove the pass-through of any part of a federally approved rate or cost allocation.³⁸³ The bill was, of course, aimed directly at the FERC's assertion of preemptive jurisdiction in the Grand Gulf case,³⁸⁴ and accordingly won praise from state regulators and indignation from the FERC and various holding companies.

To aid the Subcommittee members in evaluating the merits of the bill, hearings were held to solicit the views of the FERC, holding company executives, and state regulators. Senator Bumpers opened the hearings by expressing his resentment of the FERC's role in the Grand Gulf allocation proceeding. The Senator commented that the Grand Gulf plant had produced an excess capacity margin of 65% in Arkansas and 100% in Mississippi, two of the poorest states in the nation.³⁸⁵ He condemned the ability of holding companies to evade state jurisdiction through corporate restructuring, pointing out that the "company" (SERI) created to construct Grand Gulf was a paper tiger that had never hired a single employee.³⁸⁶ Senator Bumpers noted the growth industry of consultants and attorneys that provided advice to utilities for evading state regulation through corporate arrangements.³⁸⁷ In concluding, he warned legislators and regulators of other states that corporate structures mirroring Grand Gulf would begin to crop up with greater frequency.³⁸⁸

Chris Warner, Associate General Counsel to the FERC, testified in defense of the FERC's preemptive jurisdiction over transactions between holding company affiliates.³⁸⁹ Mr. Warner pointed out that the FERC has an obligation to consider the views of state regulators that petition for review of holding company rate filings.³⁹⁰ He argued that, as a result, state commissions have adequate protection from the potential for imprudent holding company decisionmaking. The practical effects of the Ratepayer Protection Act would, according to Mr. Warner, allow for conflicting regulatory decisions by the various states served by a holding company.³⁹¹ He warned that the potential for conflicting state regulation would discourage coordination and integration by holding company affiliates and thereby reduce the benefits obtained through efficiencies of scale.³⁹²

Louisiana, Mississippi, and Arkansas had only just begun. In mid-1986, it was clear that the FERC, through its allocation order, was seeking to preempt state prudence reviews. The FERC's authority, however, had not yet been fully tested in the courts.

383. *Ratepayer Protection Hearings*, *supra* note 34.

384. The FERC's role in the Grand Gulf allocation case is discussed fully in the section of this article devoted to the *Mississippi* decision. See *supra* section III(D)(2).

385. *Rate Payer Protection Hearings*, *supra* note 34, at 20.

386. *Id.*

387. *Id.* at 21.

388. *Id.* at 22.

389. *Id.* at 147.

390. See 16 U.S.C. §§ 791-828c (1982).

391. *Ratepayer Protection Hearings*, *supra* note 34, at 148.

392. *Id.* at 148.

Testimony provided by two executives of the Middle South Holding Company vigorously defended the company's actions regarding the Grand Gulf plant and fervently defended the FERC's federal jurisdiction over it. George White, a Middle South Vice President, explained that the company decided to build Grand Gulf in order to diversify its energy supply, which at the time of the first oil crisis in 1973 existed mostly of oil- and gas-based generation capacity.³⁹³ He disputed the level of rate increases that Senator Bumpers had predicted for Arkansas, countering that the company was projecting rate increases of 12% to 16%, increases he considered reasonable. Mr. White criticized the unfairness of requiring MSU to submit to state prudence reviews that it had not contemplated.³⁹⁴ He concluded by indicating that if the FERC's decisions regarding Grand Gulf were misguided, they would surely be overturned by the federal courts on judicial review.

Regis Trumps, another Middle South Vice President, submitted a written presentation that articulated six principal weaknesses in the proposed Senate bill. He argued that the bill: (1) was clearly aimed at Grand Gulf; (2) encouraged protectionism within the United States; (3) discouraged power pooling; (4) conflicted with the purposes of the Federal Power Act; (5) was retroactive in application; and (6) addressed a nonexistent problem.³⁹⁵ Mr. Trumps' written presentation was accompanied by extensive studies conducted at the University of Arkansas that discounted the impact of the Grand Gulf rate increases on the Arkansas economy.

Bill Clinton, the Governor of Arkansas, provided testimony on the local impact of the Grand Gulf rate increases. The Governor began by noting that the National Governors Association had unanimously endorsed a resolution similar to the Ratepayer Protection Act. Governor Clinton recalled the day in 1977 when he witnessed the President of Middle South testify under oath that Arkansas ratepayers would not have to pay for Grand Gulf power if Arkansas allowed AP&L to build additional coal-fired generating capacity, which it did.³⁹⁶ He illustrated the effects of a Grand Gulf rate increase on a poor family with a monthly income of only \$200 per month, while decrying the insensitivity of the Washington, D.C. federal bureaucracy to such real life concerns.³⁹⁷ The Governor added the specter of one of the poorest states in the nation attempting to attract industry while at the same time offering nearly the highest electric rates in the country.³⁹⁸

The Ratepayer Protection Act of 1985 never was enacted into law. Neither was a subsequent amendment offered by Senator Bumpers that would have denied the FERC the authority to allow a utility the recovery of cancelled power plant costs where applicable state law would have denied such

393. *Id.* at 331.

394. *Id.* at 331.

395. *Id.* at 337.

396. *Id.* at 58.

397. *Id.* at 59.

398. *Id.* at 61.

recovery.³⁹⁹ Although neither of the above-described hearings resulted in legislation, they both served an important public function—open public participation in the legislative process before duly elected federal legislators. Previously, only a few utility executives and attorneys representing each of the parties had the opportunity to express their views before a federal body, namely the FERC. These hearings provided a forum for many new voices, including state governors, public interest groups, professors, individual state regulators, and the congressmen themselves. Without such hearings, Congress would have little knowledge of the FERC's interpretation of its authority under the Federal Power Act, authority that Congress delegated to the FERC some fifty years ago.

VI. UNANSWERED QUESTIONS IN A POST-MISSISSIPPI ERA

Although the Court in *Nantahala* and *Mississippi* resolved many of the federal-state jurisdictional issues regarding FERC cost allocations, several questions remain either unanswered or inadequately explained. For example, while the Court expressed approval of the *Narragansett* doctrine and implicitly assumed the vitality of the *Pike County* analysis by distinguishing it, are these two doctrines truly compatible? Second, has the FERC laid an adequate foundation for its assumption of authority to preempt, through approval of cost allocation agreements, state retail prudence inquiries into purchases among affiliates of a multistate holding company? Finally, is the filed rate doctrine, as presently interpreted, consistent with the application of the federal preemption doctrine in other fields of regulation?

A. *Narragansett* and *Pike County*: Are They Compatible?

The *Narragansett* doctrine holds that FERC-approved wholesale costs must be treated by state commissions as reasonable operating expenses in a utility's retail cost of service. The *Pike County* analysis provides that state commissions may inquire into the prudence of a retail utility's wholesale purchasing decisions, and thereby may disallow certain wholesale costs as imprudently incurred. Facially, the two doctrine seem to be contradictory: one mandates the pass-through of wholesale costs while the other allows for the disallowance of certain wholesale costs. On closer analysis, however, it is apparent that the two doctrines should be compatible because they arise in different factual settings.

The typical *Narragansett* doctrine case involves an attempt by a state commission to disallow FERC-approved costs in a manner which, directly or indirectly, reviews matters over which the FERC has exclusive authority and, in fact, has already decided. For example, in *Narragansett* the state PUC investigated certain components of a wholesale seller's cost of service, a matter already decided by the FERC.⁴⁰⁰ In *Northern States Power v. Minnesota Pub-*

399. S. 3127, 99th Cong., 2d Sess. (1986). This amendment was defeated 53-45. CONG. REC. S14,692 (daily ed. Oct. 2, 1986).

400. *Narragansett Elec. Co. v. Burke*, 119 R.I. 559, 563, 381 A.2d 1358, 1361 (1977) cert. denied, 435 U.S. 472 (1978). In setting rates for the retail utility (*Narragansett Electric*), the Rhode Island PUC

lic Utilities Commission, the state PUC sought to determine whether the ratepayers or the shareholders of the utility should have to pay for the costs of an abandoned nuclear power plant.⁴⁰¹ The FERC, however, had previously passed through in the wholesale rate to the retail utility the cancelled plant costs.⁴⁰² Similarly, in *Eastern Edison Co. v. Department of Public Utilities*, the state commission was precluded from disallowing a portion of wholesale cancelled plant costs, where a wholesale rate schedule approving such costs was on file with the FERC.⁴⁰³ In *Washington Gas Light Co. v. Public Service Commission*, the state public service commission adopted a procedure which would have permitted the disallowance of a percentage of Gas Research Institute surcharges.⁴⁰⁴ Nevertheless, the state court held that the PSC was preempted because the FERC had approved in its wholesale rates the full pass-through of GRI surcharges and the state commission did not purport to question the prudence of the entire purchase of wholesale power.⁴⁰⁵

In contrast to the factual situation in the typical *Narragansett* case, the classic *Pike County* case involves a state inquiry into the prudence of a utility's choice of one supplier of power versus another supplier of power. In this situation, there should be no direct conflict because, as the FERC has held, it merely examines the wholesale seller's costs in determining a reasonable price; it does not have the authority, in this context, to inquire into the reasonableness of the wholesale buyer's actions.⁴⁰⁶ For example, in *Kentucky West Vir-*

investigated the costs underlying the wholesale rate charged by New England Power Company to Narragansett. *Id.* at 563, 381 A.2d at 1361. The PUC acknowledged that it could not set the wholesale rate, but asserted that it could nevertheless inquire into the reasonableness of the costs underlying the rate. *Id.* at 563-64, 381 A.2d at 1361. The state supreme court reversed the PUC's determination. *Id.* at 564, 381 A.2d 1361.

401. *Northern States II*, 344 N.W.2d 374, 377 (Minn. 1984). Various methods exist for determining whether the costs of cancelled power plants should be passed through to ratepayers as reasonable operating expenses. See generally Pierce, *supra* note 4. In *Northern States*, the state commission's method for allowing recovery for cancelled plant costs may have differed from, and thus conflicted with, the FERC's methodology.

402. *Northern States II* at 375.

403. *Eastern Edison Co. v. Department of Pub. Utils.*, 388 Mass. 292, 297, 446 N.E.2d 684, 687 (1983).

404. *Washington Gas Light Co. v. Public Serv. Comm'n*, 508 A.2d 930, 932 (D.C. 1986). The PSC promulgated a rule that required the utility to prove, if it desired to pass-through more than 25% of GRI surcharges, that GRI research was benefitting the local consumers. *Id.*

405. *Id.* at 938. Even if the PSC had attempted a *Pike County* prudence investigation, it likely would not have succeeded in view of the fact that almost all gas pipelines were GRI members. *Id.* at 941. As a result, alternative power sales would also have included GRI surcharges.

406. *Monongahela Power Co.*, 39 F.E.R.C. ¶ 61,350, at 62,095 (1987); *Pacific Power & Light Co.*, 27 F.E.R.C. ¶ 61,080, at 61,148 (1984); *Southern Co. Serv.*, 26 F.E.R.C. ¶ 61,360, at 61,795 (1984); *Pennsylvania Power & Light Co.*, 23 F.E.R.C. ¶ 61,325, at 61,716 (1983); *Pennsylvania Power & Light Co.*, 23 F.E.R.C. ¶ 61,006, at 61,019 (1983); *Southern Co. Serv.*, 20 F.E.R.C. ¶ 61,332, at 61,694 (1982); *Philadelphia Elec. Co.*, 15 F.E.R.C. ¶ 61,264, at 61,601 (1981).

The FERC has held that it is without the *authority* to determine the reasonableness of a wholesale purchaser's decision. "This preference issue is irrelevant to this case because the Commission is not empowered to disapprove or modify a power sales agreement on the grounds that the buyer may not be making the best possible deal." 26 F.E.R.C. ¶ 61,360, at 61,795 (emphasis added).

If the wholesale purchaser turned around and resold the power in interstate commerce for resale, the FERC would of course have the authority, in setting a wholesale rate, to inquire into the prudence of the utility's (now the wholesale seller's) purchasing decisions. Even this determination would not, however,

ginia Gas Co. v. Pennsylvania Public Utilities Commission, the FERC approved the sale of gas between two affiliated companies, but the court held the state commission was free to examine the prudence of its retail utility's purchasing decision because such an inquiry was outside of the FERC's jurisdiction.⁴⁰⁷ Therefore, the state's authority under *Pike County* rests on the specific finding that the FERC does not consider the reasonableness of a retail utility's purchasing decisions when it sets the wholesale rate for power sales to that utility.

The compatibility of *Narragansett* with *Pike County* has been recognized, at least implicitly, by several courts. The Supreme Court in *Nantahala* and *Mississippi* assumed the validity of the *Pike County* analysis, even though it ruled in each case that the states were preempted under the *Narragansett* doctrine.⁴⁰⁸ The Supreme Judicial Court of Massachusetts has adopted both doctrines in the appropriate factual situations.⁴⁰⁹ In addition, the Supreme Court of New Hampshire, in *In re Sinclair Machine Products*⁴¹⁰ resolved any apparent tension between the two doctrines. Moreover, the FERC has cited *Pike County* and *Narragansett* approvingly in the same decision.⁴¹¹

B. FERC Preemption in the Multistate Holding Company Context: Has the FERC Adequately Explained its Rationale?

The FERC has adopted two different policies regarding state prudence reviews of a utility's wholesale purchasing decisions. The FERC has held that when it approves a wholesale rate, it does not consider the prudence of the wholesale buyer's purchasing practices, and thus a state retail-level prudence inquiry is not preempted. When the FERC approves an allocation of power among affiliated utilities, however, the Commission has held that the allocation order preempts state review of the wholesale buyer's purchasing practices.

The FERC's principal rationale for this distinction is that where affiliated utilities buy their power only from within the holding company system, the utilities have no choice but to accept the type of power (either high or low cost) which they are allocated.⁴¹² This caused the FERC to conclude that the

preempt a state's consideration of the prudence of the utility's purchasing practices, according to a recent FERC decision:

Conversely, if PEPCO were to sell the OE system power both at wholesale and directly at retail, any future Commission decision of whether PEPCO prudently purchased the OE system power, for the purpose of determining the lawfulness of PEPCO's rates for sale of that power at wholesale, would not as a general matter bind a state commission in setting rates for PEPCO's sale of the power at retail.

39 F.E.R.C. ¶ 62,350, at 62,096.

407. *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 837 F.2d 600, 608 (3d Cir. 1988).

408. *Mississippi*, 108 S. Ct. at 2440; *Nantahala*, 476 U.S. at 972.

409. *Eastern Edison Co. v. Department of Pub. Util.*, 388 Mass. 292, 299-300, 446 N.E.2d 684, 689 (1983) (adopting *Narragansett*); *Commonwealth Elec. Co. v. Department of Pub. Utils.*, 397 Mass. 361, 375, 491 N.E.2d 1035, 1045 (1986) (adopting *Pike County*).

410. *In re Sinclair Mach. Prods.*, 126 N.H. 822, 498 A.2d 696 (1985).

411. Opinion No. 266-A, *AEP Generating Co.*, 39 F.E.R.C. ¶ 61,158, at 61,630 (1987).

412. *Id.*

Pike County type inquiry into the prudence of a holding company affiliate's purchasing decisions is an empty one, and is therefore preempted.

Although this logic has facial appeal, and indeed was accepted by the Court in *Mississippi*, its fundamental soundness is unclear. As a policy matter, is it wise for the FERC to prohibit state regulation in the absence of arms-length bargaining, but allow state regulation where some degree of market forces is present?⁴¹³ To say, as the FERC does, that holding company affiliates simply have no choice in their purchasing practices is to invite tension with the notion that there is a true sale of power, which is necessary for the FERC to assert jurisdiction. Moreover, the FERC's emphasis on the lack of discretion of holding company affiliates only encourages the argument that the FERC is forcing purchases upon these affiliates, an allegation which it has denied.

The FERC and interstate holding companies would likely argue that the FERC has recognized the need for increased scrutiny of non-arms-length transactions, but this scrutiny must occur at the federal level. The argument is that the FERC is the only regulatory body that can conduct an impartial review of utility decisions that are interstate in nature.

The flaw in the FERC's rationale is that it ignores the traditional regulatory responsibilities of the states. It is true that the FERC is the only body that can review the entire scope of interstate holding company activity. To begin and end the analysis here, however, is to create a syllogism. Regardless of the corporate form governing a retail utility's wholesale power purchases, the utility does not shed its responsibility to provide reliable, low cost power to its retail level customers. These responsibilities remain the *quid pro quo* that the regulatory compact exacts for giving the utility an exclusive retail franchise territory. There is no conceptual inconsistency in recognizing the FERC's role in scrutinizing the non-arms-length, interstate nature of holding company affiliate transactions, while at the same time recognizing the states' traditional role of overseeing a local utility's retail-level decisions.⁴¹⁴

The FERC also takes the position that a state commission cannot evalu-

413. The Supreme Court's early Commerce Clause decisions reflected an appreciation for the states' need to regulate transactions between holding company affiliates. In those decisions, states were held not to violate the Commerce Clause when regulating wholesale transactions between holding company affiliates. *Lone Star Gas Co. v. Texas*, 304 U.S. 224, 237 (1938); *Columbus Gas & Fuel Co. v. Public Util. Comm'n*, 292 U.S. 398, 400 (1934); *Dayton Power & Light Co. v. Public Util. Comm'n*, 292 U.S. 290, 295 (1934); *Western Distrib. Co. v. Public Serv. Comm'n*, 285 U.S. 119, 124-25 (1932). Although this Commerce Clause analysis has been superseded by the FERC's authority to govern wholesale transactions, its policy considerations weigh heavily against unnecessary preemption of state regulation in the holding company context.

414. There also exists a basic structural weakness to the FERC's review of a utility's wholesale power purchasing decisions. The FERC typically regulates only a small percentage (10-15%) of a utility's total sales of power. The FERC, as a result, has less knowledge than a state commission of a utility's total operations. This hinders the FERC's ability to review whether a utility could have purchased less expensive power elsewhere. The FERC is arguably, therefore, in a poor position to investigate the prudence of the utility's purchasing decisions. As Professor Richard J. Pierce has observed, the FERC is ill-equipped to decide, for example, the important issue of whether companies have imprudently created excess, high cost generating capacity. "Since FERC jurisdiction typically encompasses only a small portion of any utility's generating capacity, FERC is poorly positioned to determine whether additional generating capacity

ate the prudence of a utility's decision to enter into an agreement with its affiliates without somehow ruling on the merits of the agreement itself.⁴¹⁵ To rule on the merits of the interstate wholesale agreement would, according to the FERC, defeat the Commission's jurisdiction over the contract.

The FERC's argument here again focuses on only one aspect of the transaction—the interstate, and consequently federal, nature of the sale. What the argument does not acknowledge, however, is that *Pike County* allows a state to review the merits of a wholesale purchasing decision without interfering with the FERC's federal authority. A *Pike County* inquiry questions an aspect of the transaction that is outside the FERC's review of the wholesale rate: whether the utility could have purchased cheaper power from another wholesale supplier. Moreover, while the FERC has expressly recognized that a state commission's imprudence disallowance under *Pike County* may have an indirect wholesale impact, it has not held that such impact defeats state jurisdiction.⁴¹⁶

The FERC and holding company executives might counter that to allow state review of affiliated transactions will ultimately cause the break up of most interstate holding companies and interstate power pool agreements. This, in turn, would eliminate the economic efficiencies of scale achieved through the construction of large generating facilities and the coordination of power supplies traditionally associated with utility affiliation.

It is not entirely clear, however, whether this gloom and doom scenario is warranted. The effect of a prudence disallowance of certain expenses of a holding company affiliate is in most respects the same as a disallowance of the expenses of a nonaffiliated utility. In both cases, the typical remedy is to require the utility's shareholders, rather than the ratepayers, to bear the cost of the imprudently incurred expenses. Neither remedy seeks to void the wholesale purchase contract, which in both cases is an interstate wholesale transaction subject to the FERC's jurisdiction. In this manner, state regulatory review of holding company affiliates may put strain on the finances of the holding company in the event of a finding of imprudence, but it is no more strain that the nonaffiliated utility must bear when its state regulator finds its purchasing decisions faulty.⁴¹⁷

obtained through an interstate contract to purchase capacity from a multijurisdiction plant creates undesirable excess capacity on the system of each participating utility." *Pierce, supra* note 4, at 551.

415. *Id.*

416. In *Pennsylvania Power & Light Co.*, the FERC held that its wholesale rate order would not preclude a state commission from considering the prudence of the utility's purchasing decision. *Pennsylvania Power & Light Co.*, 23 F.E.R.C. ¶ 61,006, at 61,019 (1983). The FERC went on to note that a state prudence disallowance could adversely affect the ratepayers of the wholesale seller's state. The FERC did not, however, conclude that the potential effect on another state would preclude a state prudence inquiry. *Id.*

It is unclear, however, why the FERC would have concluded that such an impact would occur. The state would not have the option to abrogate the contract itself because it was approved by the FERC. A state commission disallowance would merely require the purchasing utility's shareholders to pay the wholesale expense, rather than the ratepayers. Such an order would typically allow the wholesale expense to be paid in full, with no resulting impact on the out-of-state wholesale seller.

417. In addition to these policy issues, there is a conceptual flaw in the FERC's differing treatment of affiliated and nonaffiliated transactions. For the FERC to assert jurisdiction under the FPA, there must be

It is instructive to apply the FERC's rationale for holding company affiliate transactions to *Pike County* prudence reviews of nonaffiliated transactions. Advocates of preemption could argue that *Pike County* prudence disallowances will inevitably lead to a refusal by utilities to purchase power in the wholesale market, and cause them instead to rely on construction of additional plants. But this argument does not seem tenable; in fact, the electric utility industry is witnessing competitive changes that will increase wholesale purchase opportunities.

It seems more likely that regulation of a particular transaction, in both the affiliated and nonaffiliated contexts, does not necessarily portend the elimination of such transaction. State commission regulation in the holding company context need not be seen as interfering with the wholesale market.

The comparisons between affiliated and nonaffiliated transactions raises another troublesome issue. If the two types of transactions are indeed similar, will the advocates of preemption seek to extend the doctrine to preclude state commission review of nonaffiliated transactions? In other words, will *Mississippi* encourage proponents of exclusive federal regulation to seek a complete reversal of the *Pike County* doctrine? Although it is difficult at this time to answer the question, the lessons of *Mississippi* instruct state regulators to monitor closely future developments under the *Pike County* doctrine.

C. *FERC Preemption in the Multistate Holding Company Context: Is it Consistent With Federal Preemption In Other Fields of Regulation?*

One seldom examined issue is the degree to which the FERC's preemptive authority differs, if any, from the preemptive authority of other federal agencies. The federal preemption doctrine governs the relationship between state and federal law in every regulatory field. Given the current intense

a wholesale level "sale" of power. The decisions asserting FERC's exclusive jurisdiction in the holding company context, however, emphasize the absence of choice and the lack of a true buyer or seller in transactions between holding company affiliates. Thus, the FERC's own rationale for preemption of state prudence inquiries invites tension with its very jurisdictional authority over the sale.

The FERC readily acknowledges the lack of choice in the holding company context: "[W]e concluded that the absence of choice under the Interconnection Agreement in this holding company context underscores why the Kentucky Commission erred in considering KEPCO's prudence." AEP Generating Co., 39 F.E.R.C. ¶ 61,158 at 61,627 (1987). The Fourth Circuit, in affirming the FERC's position, went so far as to explain that in a holding company system there is no real buyer or seller of energy. *Appalachian Power Co. v. Public Serv. Comm'n of W. Va.*, 812 F.2d 898, 904 (4th Cir. 1987).

In *Mississippi*, Justice Brennan in dissent recognized the tenuous logic of the FERC's argument. *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 108 S. Ct. 2428, 2448 (1988) (Brennan, J., dissenting). Justice Brennan explained:

FERC does not, after all, have any jurisdiction over a utility that simply builds its own generating facility and retails the electricity. FERC nonetheless asserts jurisdiction over transactions between a pool's generating facility and the utilities belonging to the pool on the theory that the pool and the member utilities are sufficiently separate to deem the transaction a wholesale transaction rather than an internal transfer. In some tension with this position, it then asserts jurisdiction to allocate power in a way that forces purchases from the pool on the theory that the member utilities are sufficiently integrated in the pool so that it is merely allocating cost rather than forcing purchases on retail utilities.

Id.

debate over preemption in the energy field, it would be a disservice to study these federal-state controversies without stepping back to view their place in the context of the broad spectrum of preemption law.

Accordingly, the following section will juxtapose some of the most recent, and soon to be seminal, cases on the federal preemption doctrine against the Supreme Court's decision in *Mississippi*. The inevitable conclusion from this analysis is that the Supreme Court's decision in *Mississippi* reflects less appreciation for the states' traditional role in the regulation of the electric utility field than these leading Supreme Court cases display for state authority in other fields of regulation.

Federal preemption analysis principally involves an inquiry into congressional intent.⁴¹⁸ Therefore, a caveat to the following discussion is that FERC preemption under the filed rate doctrine will be unique insofar as it is derived from interpretations of the FPA and the NGA. Reference to the broader realm of federal preemption doctrine, however, provides a deeper analytic framework for evaluating the soundness of the FERC's preemption rule in the holding company context. Such reference suggests that the "trapping" of federally approved costs found impermissible by the Court in *Mississippi* should not, alone, be sufficient to sustain preemption.

Under the federal preemption doctrine, state law may be preempted in two principal ways. First, Congress may evince an intent to occupy the field of regulation, thereby preempting all state regulation in that field.⁴¹⁹ Second, if Congress has not completely displaced state regulation, then state laws which directly conflict with federal law or frustrate the purpose of federal law are preempted.⁴²⁰ Under the FPA and the NGA, Congress granted the FERC exclusive authority over the regulation of wholesale rates, i.e., Congress occupied the field of wholesale rate regulation. Congress, however, preserved the states' exclusive authority over retail rate regulation. Therefore, states should be free to regulate retail rates, unless such regulation directly conflicts with the FERC's federal regulation or frustrates the federal purpose.

In *Mississippi*, the Court held that the State of Mississippi's attempt to exercise retail jurisdiction over MP&L's purchasing practices would cause an impermissible "trapping" of federally approved costs.⁴²¹ In other words, although Congress did not occupy the field of retail regulation, and indeed never entered the field, the Supreme Court found that the proposed state prudence inquiry would frustrate the purpose of federal regulation by trapping federally approved costs. To the Court in *Mississippi*, a trapping of costs was equal to a frustration of the FERC's federal purpose.

A review of the recent major Supreme Court federal preemption cases suggests that the trapping discussed in *Mississippi* need not have been fatal to

418. *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 369 (1986); *Fidelity Fed. Savs. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141 (1982).

419. *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 248 (1984); *Pacific Gas & Elec. Co. v. State Energy Resources Cons'n & Dev. Comm'n*, 461 U.S. 190, 203-04 (1983); *Fidelity Federal*, 458 U.S. at 153.

420. *Silkwood*, 464 U.S. at 248; *Pacific Gas & Electric*, 461 U.S. at 203-04; *Fidelity Federal*, 458 U.S. at 153.

421. *Mississippi*, 108 S. Ct. at 2439 (quoting *Nantahala*, 476 U.S. at 970).

the State of Mississippi's regulatory jurisdiction. These cases provide an analysis that differs from *Mississippi's* focus on the mechanical nature of the trapping costs. As the following cases illustrate, a state regulatory decision may foreclose in some way the application of a federal regulatory decision, such as standard setting, licensing, or permit approval, without necessarily running afoul of the Supremacy Clause. State regulation will not be deemed to frustrate the federal purpose if the state acts within its traditional regulatory sphere and does not step over into a field occupied by the federal government. In each of these cases, the state regulation at issue could have been viewed as frustrating, or trapping, a scheme of federal regulation, but the Supreme Court in each case upheld the state authority.

For example, in *Silkwood v. Kerr-McGee* the Court allowed the state to assess punitive damages for tortious conduct by a nuclear power plant operator, even though Congress had completely preempted the field of nuclear safety and had established a system of federal penalties for safety violations.⁴²² Arguably, the state punitive damage award in *Silkwood* frustrated the federal decision of whether or not to assess a federal penalty for alleged violations of safety rules.⁴²³ In *Pacific Gas & Electric* the Court allowed the state to adopt a moratorium on nuclear plant construction until an economical method for disposal of nuclear waste could be found, even though the federal government had completely occupied the field of nuclear safety regulation.⁴²⁴ Arguably, a federal decision to license a nuclear reactor as safe for operation could have been frustrated by a state finding that no economical method of waste disposal was available.

In *Louisiana Public Service Commission v. FCC*, the Supreme Court allowed the state to select a different depreciation method than the method employed by the FCC, even though both state and federal regulations applied to the same facilities and required the utility to keep two different sets of books.⁴²⁵ In this case it was arguable that state regulation frustrated the effectiveness of the federal depreciation method, and thereby frustrated the federal purpose of moving toward a more competitive market.⁴²⁶ In *California*

422. *Silkwood*, 464 U.S. at 257. The Court stressed that because tort law was a traditional form of state jurisprudence, the burden was on the company to prove that Congress intended to supplant state law. *Id.* at 255.

423. The federal regulations in issue included a scheme for the assessment of penalties for safety violations, but the Court held that this scheme would not be frustrated by state tort damage awards:

The United States, as *amicus curiae*, contends that the award of punitive damages in this case is pre-empted because it conflicts with the federal remedial scheme, noting that the NRC is authorized to impose civil penalties on licensees when federal standards have been violated. . . . However, the award of punitive damages in the present case does not conflict with that scheme. Paying both federal fines and state-imposed punitive damages for the same incident would not appear to be physically impossible. Nor does exposure to punitive damages frustrate any purpose of the federal remedial scheme.

Id. at 257 (citations omitted).

424. *Pacific Gas & Electric*, 461 U.S. at 205.

425. *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374 (1986).

426. *Id.* at 369. The Court rejected the argument that the federal agency (FCC) could preempt congressionally authorized state regulation merely to further its federal policy goals:

With respect to the present cases, respondents [industry and the FCC] insist that the refusal of the

Coastal Commission v. Granite Rock Co., the Supreme Court allowed a state commission to condition mining operations on state approval of an environmental permit, even though the National Forest Service had already approved the mining operation.⁴²⁷ Arguably, the environmental restrictions imposed by the state here could have frustrated the federal decision to allow the mining operation to commence.

Although these cases do not dictate the proper preemption analysis under the FPA and the NGA, they do present a rationale that conflicts with the application of a mechanical-based preemption test for the electric utility industry. The potential for a trapping of federally approved wholesale rates is only of jurisdictional significance if that is what Congress intended. The bright line between federal and state jurisdiction is, indeed, to be applied in a mechanical fashion. But this test only provides the basis for which instrumentality will regulate a particular *sale* of power.

In the holding company context, the bright line is clear: the FERC regulates interstate sales among affiliates for resale and the states regulate sales by affiliates to ultimate consumers. The critical policy issue that remains, however, is what should be the preemptive *effect* of the FERC's wholesale decisions on the retail authority of state regulators if the bright line is to retain its significance? In other words, under the filed rate doctrine should the FERC's wholesale rate preempt most of a state's regulatory review of a holding company affiliate's retail sales? As discussed in the previous section, it has yet to be proven that the assertion of state jurisdiction over an affiliated utility's purchasing decisions has any greater impact on federal regulation than state jurisdiction over nonaffiliated transactions.

VII. CONCLUSION

A recent editorial⁴²⁸ compared energy federalism in the 1980s to two vaudeville clowns on stage in a horse suit. The conclusion reached was that federal and state regulators are inextricably linked—but not very well coordinated. Regrettably, the “two clowns in a horse suit” imagery is probably a flattering depiction of the relationship that now exists between many state regulators and the FERC.

States to employ accurate measures of depreciation will have a severe impact on the interstate communications network because investment in plant will be recovered too slowly or not at all, with the result that new investment will be discouraged to the detriment of the entire network. . . .

The short answer to this argument is that it misrepresents the statutory scheme and the basis and test for pre-emption. While it is certainly true, and a basic underpinning of our federal system, that state regulation will be displaced to the extent that it stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress, . . . it is also true that a federal agency may preempt state law only when and if it is acting within the scope of its congressionally delegated authority. . . . Thus we simply cannot accept an argument that the FCC may nevertheless take action which it thinks will best effectuate a federal policy. To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress.

Id. at 373-75 (citations omitted).

427. *California Coastal Comm'n v. Granite Rock Co.*, 480 U.S. 572, 579 (1987).

428. Editorial, *Two Clowns in a Horse Suit: Energy Federalism*, 1 ELEC. J., Aug.-Sept. 1988, at 48.

In consideration of the strong policy issues that advocates on each side of the energy federalism debate have been able to marshal, this may be an opportune time for the FERC, state regulators, and the Congress to take a fresh look at the uneasy balance between state and federal regulation in the electric and gas utility industries. The new composition of the FERC, and the new composition of the key House and Senate Committees with oversight of energy-related matters, enhances the possibility that constructive new ideas could emerge.

For example, does it really make sense for the FERC to seek to preclude meaningful state regulation of affiliated utilities with regard to non-arm's-length transactions when it is willing to allow state regulation of transactions among non-affiliated utilities under the *Pike County* doctrine? While the FERC is equipped to regulate wholesale level transactions, does it really possess the expertise and sensitivity to evaluate issues of downstream retail-level impact? Is it appropriate to completely deny recourse at the retail level to a community that may have been abused by a holding company decision, even if the state regulator can demonstrate mischief, misrepresentation, or mismanagement by the local operating unit of the holding company? Can the FERC or the Congress develop some practical limitations on the filed rate doctrine so that the primary goals of the doctrine can be achieved without eviscerating the *Attleboro* "bright line"? If state regulators are deemed too "parochial" and "politicized" to function rationally in a multistate utility holding context and the FERC is deemed ill-equipped to exert dominance over traditional retail-level issues, could "regional" regulation of multistate holding companies provide a more effective solution?

The starting point for improvement in our existing structure of energy federalism is greater administrative dialogue between federal and state regulators. Comity between the two camps at the moment is rather low, as demonstrated by recent cross-invective in the trade press. The perception that matters of extreme local concern are being treated at the federal level without sufficient sensitivity, and without important social policy perspective, is becoming widely held. It may be that federal prominence in many of the areas discussed in this article is warranted, but the goal should be the development of a judicially reviewed balancing test rather than total eclipse of state commission involvement, which is the result generally achieved by application of the preemption doctrine.

In matters involving utility purchasing decisions, *Pike County* should be the norm rather than the exception. Issues involving plant construction and allocation, transmission, least-cost planning, competitive bidding, independent power production, state take-or-pay pass-throughs, rates for purchases from qualifying facilities, utility securities issuances, and nuclear plant emergency planning also are matters of intense concern for local communities, which warrant some degree of state level accountability, if energy federalism is to continue as a viable concept. Should federal regulators remain unwilling to share greater responsibility with their state level counterparts, as manifested by continued aggressive application of the federal preemption doctrine, then legislative adjustments will need to be considered.

It may be time for Congress to consider the appropriateness of the FERC's current interpretation of the jurisdictional division created under the FPA and the NGA. Many in Congress are uncertain whether the bright line created fifty years ago continues to shine on state regulation; for some, it has now begun to overshadow substantial areas of legitimate state commission authority. Congress may need to consider whether, in light of the recent conflicts, a new statutory division between state and federal authority needs to be created. One option for reform might include congressional authorization for regional regulatory compacts that would allow various state commissions to join in regulating a multistate holding company. Although there may not be, at present, sufficient momentum for legislation reform, a prolonged continuation of the present conflicts may alter the political landscape to the degree necessary to produce a legislative consensus.

