

## THE NARRAGANSETT DECISION AND ITS AFTERMATH

Carl D. Hobelman\*

In its 1951 decision in *Montana-Dakota Utilities, Inc. v. Northwestern Public Service Co.*,<sup>1</sup> the United States Supreme Court stated what has since become known as the “filed rate” doctrine. The doctrine establishes that a rate filed with the Federal Power Commission (FPC or Commission) or its successor, the Federal Energy Regulatory Commission (FERC or Commission), in accordance with the procedures of the Commission and within the Commission’s jurisdiction, is the only legitimate rate for the transaction in question. No other rate may be charged. Ten years later, the Mississippi Supreme Court held that the Mississippi Public Service Commission was required to pass through to its retail customers costs incurred by a gas distribution company as a result of purchases made from a pipeline supplier pursuant to a rate schedule filed with the FPC.<sup>2</sup>

In the few instances where the question arose during the quarter of a century that elapsed between *Montana-Dakota Utilities* and *Narragansett Electric Co. v. Burke*,<sup>3</sup> the courts upheld decisions by the state commissions to pass through to retail customers costs incurred under rate schedules filed with the FPC.

In 1976, however, the Rhode Island Public Utilities Commission departed from this precedent. The State Commission refused to pass on to retail customers costs incurred by Narragansett Electric Company for power purchased from New England Power Company pursuant to an FPC rate schedule, where the Commission found such costs “strikingly” or “glaringly” unfair. On appeal, the Rhode Island Supreme Court reversed the Commission in *Narragansett*.

Since the Rhode Island Supreme Court’s decision in *Narragansett*, the issue of whether costs incurred by a wholesale supplier under FPC/FERC rate schedules must be passed through to the retail customers of a wholesale purchaser has arisen before other state courts and commissions. The issue arose out of rapidly increasing costs of nuclear power plants and/or their abandonment in North Dakota, Minnesota and Massachusetts, where the highest state courts followed *Narragansett*. The issue has arisen in North Carolina as a result of a dispute over the allocation of hydro resources owned by subsidiaries of Alcoa. In 1983, a Pennsylvania intermediate appellate court affirmed Pennsylvania Public Utilities Commission action disallowing purchased power costs incurred pursuant to a FERC rate schedule involving Pike County Light and Power Company. In May 1984, the Massachusetts DPU refused to pass through to retail customers in Massachusetts some of the costs of the Seabrook nuclear generating plant. In December 1984, the

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\*Partner, LeBoeuf, Lamb, Leiby & MacRae, Washington, D.C.; B.C.E. Cornell University; J.D. Harvard Law School; Member of the District of Columbia and New York Bars. M. Reamy Ancarrow, a partner at LeBoeuf, Lamb, Leiby & MacRae, and Jon Edwards, a student at Georgetown University Law Center, assisted in the preparation of this article.

<sup>1</sup>341 U.S. 246 (1951).

<sup>2</sup>United Gas Corp. v. Mississippi Pub. Serv. Comm’n, 240 Miss. 405, 127 So.2d 404 (1961).

<sup>3</sup>119 R.I. 559, 381 A.2d 1358 (1977), cert. denied, 435 U.S. 972 (1978).

Kentucky Public Service Commission refused to pass through the cost of power purchased from a new coal-fired plant by Kentucky Power Company, a subsidiary of American Electric Power Company ("AEP"), under a unit power sales agreement which had been accepted for filing by the FERC and, instead, limited the Company's recovery through retail rates to the costs of purchasing equivalent capacity and energy under the AEP Interconnection Agreement. The Massachusetts and Kentucky commission actions are being appealed. Litigation is also underway in Arkansas and West Virginia.

Attacks upon the *Narragansett* decision's "doctrine" that costs resulting from FERC-approved rates must be passed through to retail ratepayers have become more sophisticated than the "glaringly unfair" arguments advanced in Rhode Island in 1977. More recent attacks have been premised upon prudence in managerial choice among alternative sources of power and upon state approval as a condition precedent to any contract for the purchase of electricity.

### *The Filed Rate Doctrine*

In *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, the United States Supreme Court stated:

We hold that the right to a reasonable rate is the right to the rate which the Commission files or fixes, and that, except for review of the Commission's orders, the courts can assume no right to a different one on the ground that in its opinion, it is the only or the more reasonable one.<sup>4</sup>

Thus, the reasonableness of the rate governing an interstate transaction — in this case a sale of natural gas — can only be established by the FPC or its successor, the FERC. The Supreme Court of Mississippi followed the *Montana-Dakota Utilities* decision in *United Gas Corp. v. Mississippi Public Service Commission*.<sup>5</sup> The court held,

Pipe Line must charge and United must pay the filed rates. . . . *There is nothing to suggest that the FPC will not closely scrutinize this relationship, for the statutory purpose of protecting the public and consumers from exploitation.*<sup>6</sup>

The Mississippi Supreme Court cited *City of Chicago v. Illinois Commerce Commission*,<sup>7</sup> wherein the Supreme Court of Illinois held that Federal Power Commission approval of a sale by Natural Gas Pipeline Company of America to Peoples Gas Light and Coke Company, its parent, preempted any right that may have existed in the state to regulate such rates; and, *further*, that the Illinois Commerce Commission's decision to pass through the interstate pipeline rates to Peoples' retail customers did not abuse the Commission's discretion in determining that the rates fixed by the FPC should be allowed as an operating expense.

It is important to note that the Illinois Supreme Court pointed out:

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<sup>4</sup>341 U.S. at 251-52.

<sup>5</sup>240 Miss. 405, 127 So.2d 404 (1961).

<sup>6</sup>240 Miss. at 442, 127 So.2d at 420 (emphasis added).

<sup>7</sup>13 Ill.2d 607, 150 N.E.2d 776 (1958).

Even if it were conceded that the Commission may have power to enter into an independent determination of the reasonableness of the FPC rates, we see no reason to force it to do so. Congress has given the FPC the duty to protect the consumer against exploitation in this area and the Commission may properly assume that the FPC has performed that duty.<sup>8,9</sup>

The United States Supreme Court spoke again in *Northern Natural Gas Co. v. State Corporation Commission of Kansas*,<sup>10</sup> prohibiting indirect as well as direct interference by state agencies in the federal regulatory scheme.

A similar result was reached by the Illinois Supreme Court in *Natural Gas Pipeline Co. of America v. Illinois Commerce Commission*.<sup>11</sup> There the Illinois Supreme Court held that the Illinois Commerce Commission was preempted from exercising jurisdiction over securities issued by a company to finance the construction of a natural gas pipeline, when the pipeline itself was subject to the certification jurisdiction of the FPC. The Court stated:

[W]e recognize that when a State regulation would directly or indirectly "affect the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sale of natural gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act" or creates a "prospect of interference with the federal regulatory power," then the State regulation must yield "although collision between the state and the federal regulation may not be an inevitable consequence."<sup>12</sup>

In 1964, in its *City of Colton* decision, *Federal Power Commission v. Southern California Edison Co.*,<sup>13</sup> the Supreme Court stated that Congress meant to draw a "bright line easily ascertained, between state and federal jurisdiction."<sup>14</sup> By 1976, however, the Rhode Island Commission passing on Narragansett's rates saw this line but dimly.

The decision of the Supreme Court of Rhode Island in *Narragansett Electric Light Co. v. Burke*<sup>15</sup> is summarized as follows in *Northern States Power Co. v. Hagen*.<sup>16</sup>

Narragansett Electric Company was a retail electric utility company serving customers in Rhode Island. Its retail rates were regulated by the Rhode Island Public Utilities Commission. Narragansett purchased electrical power from New England Power Company [NEPCO], a Massachusetts corporation. Narragansett and NEPCO were wholly owned subsidiaries of New England Electric System [NEES]. Because NEPCO was an interstate wholesale supplier of electricity, its rates were subject to regulation by FPC (predecessor of FERC). NEPCO filed a rate increase request with FPC. Part of NEPCO's rate increase resulted from losses incurred when it abandoned construction of a generating station. Narragansett subsequently filed a request with the Rhode Island Public Utilities Commission to increase their rates, subject to a possible refund, to cover the increased cost of obtaining power which resulted from the rate increase filed by NEPCO with FPC. The

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<sup>8</sup>13 Ill. 2d at 615, 150 N.E.2d at 780 (emphasis added).

<sup>9</sup>See also *Citizens Gas Users Ass'n v. Public Util. Comm'n*, 165 Ohio St. 536, 138 N.E.2d 383 (1956).

<sup>10</sup>372 U.S. 84 (1963).

<sup>11</sup>33 Ill. 2d 214, 210 N.E.2d 490 (Ill. 1965).

<sup>12</sup>33 Ill. 2d at 222, 210 N.E.2d at 494 (citation omitted).

<sup>13</sup>376 U.S. 205 (1964).

<sup>14</sup>*Id.* at 215-16.

<sup>15</sup>119 R.I. 559, 381 A.2d 1358 (1977), *cert. denied*, 435 U.S. 972 (1978).

<sup>16</sup>314 N.W.2d 32 (N.D. 1981).

Rhode Island Public Utilities Commission ruled that it could investigate the reasonableness of the costs underlying NEPCO's rate increase filed with the FPC and could prevent Narragansett from passing through to its retail customers any portion of those costs which were "strikingly" or "glaringly" unreasonable.

Narragansett appealed and contended that the Rhode Island Public Utilities Commission lacked jurisdiction to inquire into the reasonableness of NEPCO's wholesale rate to Narragansett because the Federal Power Act preempted the authority of state commissions to investigate interstate prices. The Rhode Island Supreme Court agreed and held that for purposes of fixing intrastate retail rates, the Rhode Island Public Utilities Commission was required to treat NEPCO's interstate wholesale rate filed with the FPC as an actual and reasonable operating expense.<sup>17</sup>

The *Narragansett* court relied upon *Montana-Dakota Utilities, City of Colton, City of Chicago, and United Gas Corp.*, in reaching its conclusion.

The Rhode Island proceeding concerned a pass-through of an operating expense through a purchased power cost adjustment clause. The Rhode Island Supreme Court refused to order the Commission to pass through the increased cost of purchased power through the automatic adjustment clause. The court noted that the Rhode Island Public Utilities Commission,

under [Narragansett's] purchased power cost adjustment clause, may choose to adjust Narragansett's existing retail rates to reflect the changed cost of interstate power, but it need not do so. The Purchased Power Cost Adjustment Provisions specify that the operation of the clause is subject to "all powers of suspension, investigation and other regulatory authority" of the PUC. The commission, therefore, may treat the proposed rate increase as it treats other filings for changed rates under [the Rhode Island statutes] and investigate the overall financial structure of Narragansett to determine whether the company has experienced savings in other areas which might offset the increased price for power. . . . Therefore, we do not order the PUC to automatically adjust the retail rates in accordance with the purchased power cost adjustment clause. Rather, we remand the case to the PUC with the direction that no matter what method it adopts in considering Narragansett's proposed rate increase, it must treat the FPC filed and bonded purchase price . . . as an actual operating expense.<sup>18</sup>

As used in this article, the term "Narragansett doctrine" is encapsulated in the final sentence quoted above. For the purpose of fixing intrastate rates:

[N]o matter what method [a Commission] adopts in considering [a utility's] proposed rate increase, it must treat the [FERC] filed . . . purchase price . . . as an actual operating expense.

### *Tyrone Proceedings*

Two leading state court decisions following *Narragansett* arose out of the need to allocate the costs of abandoning the Tyrone nuclear power plant among consumers in several states.

Northern States Power (NSP) is a Minnesota corporation and Northern States Power-Wisconsin (NSP-W) is its wholly-owned subsidiary. The two corporations

<sup>17</sup>119 R.I. at 568, 314 N.W.2d at 35.

<sup>18</sup>381 A.2d at 1363.

coordinate operations as an integrated power system with NSP serving Minnesota, North Dakota and South Dakota, and NSP-W serving Wisconsin. Since 1970, the intercompany wholesale exchanges have been governed by a Coordinating Agreement, a formula rate contract, filed with and regulated by the FERC.

In the late 1960's, the Tyrone nuclear power project was planned to be built in Dunn County, Wisconsin. Originally, both NSP and NSP-W had an ownership interest in the Tyrone project. However, the Wisconsin Public Service Commission ruled that NSP could not own an interest in the project, because it was not a domestic corporation. Thereafter, NSP transferred its ownership interest in the project to NSP-W. The transfer did not alter the planned use of the project to serve the entire system. In 1979, the Tyrone project was abandoned. At the time of the abandonment, an estimated 75 million dollars in expenses had been incurred.

In August of 1979, NSP and NSP-W filed an amendment to their Coordinating Agreement with the FERC to allocate shares of the Tyrone abandonment loss. On October 22, 1979, the FERC accepted for filing the proposed amendment to the Coordinating Agreement and ordered public hearings on the "justness and reasonableness" of the amendment. After the hearings, in which the North Dakota and Minnesota public utilities commissions participated, the FERC approved abandonment cost allocation with certain exceptions.

#### *Northern States Power Company*<sup>19</sup>

Basically, the FERC ruled that abandonment was prudent and that the costs arising from abandonment should be allocated 87% to NSP and 13% to NSP-W. The net result of this order was an increase in utility rates for ratepayers in Wisconsin, Minnesota, North Dakota and South Dakota. Placing all of the burden on Wisconsin would have resulted in a 13% increase in rates for Wisconsin ratepayers. Spreading out the abandonment cost significantly reduced its impact in Wisconsin, but displeased the North Dakota and Minnesota commission. The FERC's order was affirmed by the Eighth Circuit, *per curiam*, in *South Dakota Public Utilities Commission v. FERC*.<sup>20</sup>

On November 1, 1982, the NSP Companies filed with the FERC an amendment to the Coordinating Agreement proposing a methodology for determining the rate of return on investment as a component of fixed costs shared by the companies under the Coordinating Agreement. The FERC approved the proposed amendment as part of a settlement agreement among the Company and its wholesale customers.<sup>21</sup> The Minnesota PUC and Attorney General objected on the grounds that rate of return is not a proper cost component under the Coordinating Agreement and is not subject to FERC jurisdiction. The State of Minnesota and the Minnesota PUC sought review by the Eighth Circuit, contending that the FERC lacked jurisdiction to review the proposed amendment because the Coordinating Agreement merely provided an accounting mechanism to allocate costs between a utility and its wholly-owned subsidiary and did not establish a "wholesale rate"

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<sup>19</sup>17 FERC ¶ 61,196 (1981).

<sup>20</sup>690 F.2d 674 (8th Cir. 1982).

<sup>21</sup>21 FERC ¶ 61,375 (1982); 23 FERC ¶ 61,026 (1983); 24 FERC ¶ 61,011 (1983).

subject to FERC jurisdiction. The Eighth Circuit rejected these contentions and once again affirmed the FERC order.<sup>22</sup>

While the initial FERC proceeding was pending, both the Minnesota and North Dakota state commissions refused to allow NSP to recover from retail customers the amortization of the Tyrone abandonment losses. However, the supreme courts of both states reversed the orders of the state commissions, holding that the state commissions were bound by the Supremacy Clause to treat the FERC wholesale rate as a reasonably incurred cost of purchased power.<sup>23</sup>

*Northern States Power Co. v. Hagen*

Citing *Narragansett*, the North Dakota Supreme Court held that the North Dakota PSC could not inquire into and determine the reasonableness of a wholesale rate filed with the FERC. The North Dakota Commission had eliminated from NSP's cost of service the amortization of the Tyrone abandonment losses. A lower state court upheld the PSC. The North Dakota Commission argued that because it alone has the authority to regulate intrastate retail rates and because it had not attempted to set aside the decision of the FERC regarding wholesale rates, it had not crossed the "bright line" between state and federal jurisdiction established by the United States Supreme Court in the *City of Colton* case, *FPC v. Southern California Edison Co.*<sup>24</sup>

The court and the PSC agreed that the FERC has exclusive authority to regulate all wholesale sales in interstate commerce except those which Congress has made explicitly subject to state regulation, and that individual states have the authority to regulate retail rates to the ultimate consumer. But the PSC asserted that, because it alone has authority to regulate intrastate retail rates, the wholesale rate set by the FERC, although the exclusive rate permitted for the wholesale transaction, is not binding as an operating expense in a proceeding before the Public Service Commission to establish reasonable intrastate retail rates.

The court pointed out that Congressional enactments that do not exclude state legislation in the same field nevertheless override state laws *with which they conflict*; and that the criterion for determining whether or not there is a conflict is whether the state's law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."<sup>25</sup>

The court went on to state that the Public Service Commission's duty to establish rates which are just and reasonable includes a duty to establish rates which provide a reasonable return, reflecting the cost of service rendered plus a reasonable profit. The court pointed out that the company was required by the FERC to pay a rate including the amortization of the Tyrone project loss as an operating expense. It also noted that the

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<sup>22</sup>State of Minnesota v. FERC 734 F.2d 1286 (8th Cir. 1984).

<sup>23</sup>Northern States Power Co. v. Hagen, 314 N.W.2d 32 (N.D. 1981); Northern States Power v. Minnesota Pub. Serv. Comm'n, 344 N.W.2d 374 (Minn.), *cert. denied*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S.Ct. 3546 (1984).

<sup>24</sup>376 U.S. 205 (1964).

<sup>25</sup>314 N.W.2d at 37 (citations omitted).

doctrine of preemption requires that the proper procedure to determine the reasonableness and prudence of the Tyrone loss as it relates to wholesale charges between NSP and NSP Wisconsin is to follow the remedies available in the proceeding before the FERC. No valid reason has been presented that a determination of the reasonableness and prudence of the Tyrone loss cannot be adequately resolved through that procedure, which includes appeals to the proper court.<sup>26</sup>

The court then found that the PSC has no direct jurisdiction over interstate wholesale rates, and that an effort to assert jurisdiction “indirectly” would undermine the supremacy clause and preemption doctrine:

[I]t would frustrate the purpose of Congress in establishing reasonable wholesale rates if the reasonableness of these rates as an operating expense were inquired into by and made subject to the North Dakota PSC in establishing reasonable retail rates.<sup>27</sup>

The court’s decision stands as the strongest analytic support for the *Narragansett* doctrine yet stated by another state supreme court. It is worth noting, that the court had before it a FERC proceeding which included an investigation of the prudence of cancelling the Tyrone project in which the state Public Service Commission had participated, although the court decision does not appear to have turned on that point.

*Northern States Power Co. v. Minnesota Public Utilities Commission*<sup>28</sup>

The Minnesota Supreme Court also held that NSP’s amendment to the Coordinating Agreement with NSP-Wisconsin, when approved by the FERC, constitutes a wholesale rate which cannot be reviewed as to reasonableness by a state regulatory body in setting retail rates and that costs incurred thereunder for purchased power must be considered reasonable operating expenses.

The Minnesota PUC, by order dated April 30, 1981, had refused to allow NSP to recover the portion of the Tyrone losses allocated to its Minnesota operations as expenses for purchased power. The Minnesota PUC contended that the FERC’s approval of the amended Coordinating Agreement was “merely an allocation of costs” and not a wholesale rate; and that, therefore, the FERC’s approval did not preempt the Minnesota PUC’s authority to review expenses allocated by the amended Coordinating Agreement for the purpose of retail ratemaking. A lower state court reversed the PUC and its decision was affirmed by the Minnesota Supreme Court.

The Supreme Court concluded that FERC’s approval of the amended Coordinating Agreement constituted the establishment of a wholesale rate, and that,

While that determination does not directly establish the return for retail rates, which is in the exclusive jurisdiction of the MPUC, the state utilities commission is required to treat the allocated abandonment costs as expenses for power purchased in determining the retail rates.<sup>29</sup>

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<sup>26</sup>*Id.* at 38.

<sup>27</sup>*Id.*

<sup>28</sup>344 N.W.2d 374 (Minn.), *cert. denied*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S. Ct. 3546 (1984).

<sup>29</sup>*Id.* at 382.

The Minnesota PUC pressed the position that the Coordinating Agreement pursuant to which a portion of the Tyrone project loss was allocated to NSP did not constitute a "sale of electric energy to any person for resale" under the Federal Power Act. It contended that there was no separate transaction, which is the "hallmark" of a wholesale sale. Similar arguments had been made before the FERC and rejected by the FERC, which had pointed out that the Coordinating Agreement "establishes the means by which the interstate transfer of power between the companies occurs and the intercompany charges for such transactions."<sup>30</sup> The court rejected all of the Commission's contentions, citing *Narragansett*.

The Minnesota Attorney General and Minnesota PUC sought a writ of certiorari from the United States Supreme Court to the Minnesota Supreme Court. In seeking the writ, the petitioners stated,

The Minnesota Court has drastically altered the federal/state balance with large financial consequences for retail ratepayers in Minnesota. It has also created a precedent under which a new mechanism for evading state regulation is created. The holding offers a mechanism whereby any utility, by separately incorporating its generating and transmission operations in a number of subsidiary companies and then establishing FERC-filed coordinating agreements with them, may circumvent traditional State retail authority rate regulation. If allowed to stand in an area of law where precedents are few and state supreme court opinions are afforded much persuasive value, it will sound the death knell for state regulation of utility rates.<sup>31</sup>

On June 18, 1984 the United States Supreme Court denied the petition for a writ of certiorari.<sup>32</sup>

Several recent decisions, following the reasoning of *Narragansett*, have held that state regulatory commissions must treat charges approved by the FERC as reasonable operating expenses, but have reached varying conclusions as to whether or not such a finding necessitates a pass-through of the increased costs of purchased power to retail customers.

In *Public Service Co. of Colorado v. Public Utilities Commission of Colorado*, the Supreme Court of Colorado concluded that "where the rate or acquisition cost is subject to federal regulation and authorized by a federal regulatory agency . . . the PUC may not question its reasonableness."<sup>33</sup>

The court went on to state that:

*If Public Service and Western Slope wish to receive natural gas from CIG, they have no choice but to pay CIG's FERC-approved tariffs to receive their supply. . . . Accordingly, we conclude that the GRI charge is an added cost of natural gas which the PUC is legally obligated to consider as a reasonable operating expense of Public Service and Western Slope.*<sup>34</sup>

At issue in that case were payments by natural gas companies, under FERC-approved rate schedules, to the Gas Research Institute (GRI) for a national research and development program related to natural gas. In the decision under

<sup>30</sup>Northern States Power Co. (Minnesota), 23 FERC ¶ 61,026 at 61,066 (1983).

<sup>31</sup>Petition for Writ of Certiorari, No. 83-1732, April 23, 1984, at 8.

<sup>32</sup>*Humphrey v. Northern States Power Co.*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S. Ct. 3546 (1984).

<sup>33</sup>644 P.2d 933, 939 (Colo. 1982).

<sup>34</sup>*Id.* at 940 (emphasis added).



review, the Colorado Public Utilities Commission had determined that, under the *Narragansett* doctrine, it was required to treat the payments in question as actual operating expenses for retail ratemaking purposes. However, the Colorado Commission declined to allow the costs to be passed through to ratepayers automatically, and held that under *Narragansett* it was free to determine to what extent the costs should be borne by retail ratepayers at all.<sup>35</sup> The Colorado Commission questioned the propriety of forcing retail customers to bear the expense, because customers would exercise no control over the expenditure of GRI funds, and customers would benefit from GRI's activities only in the future, if at all, with most benefits going to gas utilities themselves, to energy development corporations, and to related private interests. That Commission declared:

In the context of a general rate investigation, the commission will be able to consider the GRI charge vis-a-vis the promised benefits. In the event that the promised achievements of GRI are not forthcoming, this commission will consider requiring stockholders of the distribution companies under its jurisdiction to assume a fair share of the financial risks of GRI's research and development programs.<sup>36</sup>

The Colorado Supreme Court affirmed the Colorado Commission's holding, but indicated that it would probably not go quite as far as the Commission was prepared to go in disallowing a pass-through in a general rate proceeding:

We do not agree . . . that the PUC is legally obligated to flow through the GRI charge to natural gas consumers as part of the gas cost adjustments. . . . In our view, although the PUC is legally obligated to consider the GRI charge as a reasonable operating expense of [the gas companies], our decision does not mandate that the PUC must include the GRI charge as a flow-through item. In its decision, the PUC recognized its legal obligation. . . .

We believe that the manner in which a gas adjustment clause is treated is an administrative matter where there is broad latitude for sound discretion. *Accord, Narragansett Electric Company v. Burke*, R.I. 381 A.2d 1358 (1977). It is clear that the PUC, under the gas cost adjustment provisions, may choose to adjust [the gas companies'] existing retail rates to reflect the increased cost of interstate natural gas, though it need not do so. Since the PUC has established the gas cost adjustment provisions pursuant to its broad regulatory authority under [Colorado statutes], we cannot preclude the PUC from including, modifying, or suspending the particular charges passed on to the consumers by the cost adjustment provisions. . . .

We therefore conclude that the PUC may treat the GRI charge as it treats other filings for proposed rate increases in general rate proceedings. *In doing so, it is able to fully investigate whether [either of the companies] has experienced savings in other areas which might offset the increased price for natural gas to consumers.* The PUC does not abuse its discretion when it conducts such an investigation in order to balance the interests of the utility investors and the ultimate consumers in arriving at a just and reasonable rate for natural gas!<sup>37</sup> [Emphasis added]

We emphasize by way of limitation that this is not a case where the PUC has denied Public Service or Western Slope their right to have the GRI charges included as reasonable operating expenses in a general rate proceeding to increase the rates of natural gas to consumers. We would not condone PUC action which denies local distributing companies a

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<sup>35</sup>Re *Western Slope Gas Co.*, 31 Pub. Util. Rep. (PUR) 4th 93, 107 (Colo. PUC 1979), *aff'd*, Pub. Serv. Co. of Colo. v. Pub. Util. Comm'n of Colo., 644 P.2d 933 (Colo. 1982).

<sup>36</sup>31 Pub. Util. Rep. (PUR) 4th at 109.

fair return on the "investments they necessarily incur in servicing their customers while simultaneously incurring the increased producer prices." *Cities Service Gas Company v. Federal Energy Regulatory Commission*, 627 F.2d 1027 (10th Cir. 1980). Under the circumstances of this case, we decline to order the PUC to automatically adjust the retail rates for natural gas in this state to reflect the GRI adjustment charges billed to Public Service and Western Slope. So long as the PUC considers the GRI adjustment charges as a reasonably incurred operating expense of a local distribution company, as it is legally required to do, its decision to refrain from automatically passing such charges on to the ultimate consumers falls within its administrative discretion.<sup>37</sup>

<sup>(\*)</sup> Our decision today is limited to a consideration of whether the PUC abused its discretion in disallowing the GRI charge as a flow-through item in [the gas companies'] respective gas cost adjustment provisions. We do not comment upon the GRI charge as approved by the FERC. We do note, however, that the PUC was critical of the GRI funding process under which the end users of natural gas, *i.e.*, the consumers, provide 100% of GRI's research and development budget without any concomitant voting control over its expenditures. Conversely, the natural gas utility members of GRI, which provide none of the funding for GRI's research and development, exercise voting control over all of the research and development expenditures. *See Public Utilities Commission Decision*, No. C79-907 (June 14, 1979).

In *Washington Gas Light Co. v. Public Service Commission of the District of Columbia*,<sup>38</sup> the District of Columbia Court of Appeals faced the same question addressed by the Colorado Commission and Colorado Supreme Court: whether payments to GRI under FERC-approved wholesale rate schedules must be passed through to natural gas retail customers. The D.C. Commission had refused to include part of the GRI charge as an operating expense in cost of service. The court held that the

FERC's jurisdiction [does not extend] to the issue of whether increased wholesale costs shall be passed through to retail customers by the local utility. The determination of the extent to which wholesale costs should be reflected in local utility rates lies exclusively with local utility commissions. *See Narragansett Electric Co. v. Burke*, 381 A.2d 1358, 1363 (R.I. 1977), *cert. denied*, 435 U.S. 972, 98 S.Ct. 1614, 56 L.Ed.2d 63 (1978).<sup>39</sup>

However, the Court reversed the D.C. Public Service Commission, because it found that the Commission's

refusal to allow increased GRI charges to be reflected in retail rates . . . was based upon the Commission's erroneous conclusion that the increase in wholesale costs was not a just and reasonable operating expense, rather than upon a determination that the expense should not be passed through to retail customers.

The Court of Appeals added,

[s]tate and local commissions have no authority . . . to inquire into the reasonableness of wholesale rates, but must allow them as reasonable operation expenses.<sup>40</sup>

Because it is difficult to "allow" an operating expense except in retail cost of service, it is difficult to reconcile the foregoing citations from the *Washington Gas Light Co.* opinion. Prudence of choice among alternatives was not at issue. Perhaps

<sup>37</sup>*Id.* at 941.

<sup>38</sup>452 A.2d 375 (D.C. 1982), *cert. denied*, \_\_\_\_\_ U.S. \_\_\_\_\_, 103 S.Ct. 2454 (1983).

<sup>39</sup>452 A.2d at 385 n.15.

<sup>40</sup>452 A.2d at 386.

the court's use of the word "extent" means "manner", *i.e.*, through an adjustment clause or in a general rate proceeding. If so, the decision is consistent with *Narragansett*, which the Court of Appeals cited in support of its reasoning.

The Supreme Judicial Court in Massachusetts applied the *Narragansett* doctrine in *Eastern Edison Co. v. Department of Public Utilities*.<sup>41</sup> The court reversed the Massachusetts DPU and held that wholesale rate increases approved by the FERC for power purchased by Eastern Edison from its subsidiary, Montaup Electric Company, reflecting costs incurred in the abandonment of Pilgrim Nuclear Unit No. 2, must be treated as prudently incurred power costs and passed through to retail customers under Eastern Edison's purchased power cost adjustment clause. The court also held that the pass-through could not be deferred until the completion of FERC hearings, because the FERC-filed rate was in effect while the hearings were under way.

The court held that:

the Federal Power Act precludes department review of the reasonableness of the FERC-filed rate Montaup charged Eastern Edison. [citing the filed rate doctrine cases discussed above] We must conclude that Montaup's FERC-filed rate must be considered a prudently incurred reasonable power cost within the meaning of [the Massachusetts statute].

Courts which have considered this question have agreed that the Federal Power Act requires that a utility's costs based on an FERC-filed rate must be treated as a reasonable operating expense for purposes of setting an appropriate retail rate. [citing *Narragansett* and the decisions of the highest courts in Colorado, Mississippi, North Dakota, Minnesota and Ohio discussed above].<sup>42</sup>

The court went still further and held that the Department could not defer a pass-through, because it,

must accord the same deference to a rate which the FERC has accepted for filing as it would to a rate which the FERC has approved after a hearing. It cannot defer recovery by Eastern Edison on the ground that a final FERC decision is pending, because under *Montana-Dakota Utilities Co.*, the fact that the FERC allowed the rate to go into effect, not final FERC approval, is the decisive factor.<sup>43</sup>

The court noted the holdings in *Narragansett* and *Public Service Co. of Colorado* to the effect that the Rhode Island and Colorado Commissions were not legally obligated to flow through costs incurred under FERC rate schedules to retail rates through automatic adjustment clauses. The court ruled that these holdings were not relevant because, under Massachusetts law, automatic flow-through of reasonably incurred wholesale power costs was required.<sup>44</sup>

Finally, a recent variation on the filed rate doctrine can be found in *Arkansas Louisiana Gas Co. v. Hall*.<sup>45</sup> In that case, a natural gas producer filed a state court

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<sup>41</sup>388 Mass. 292, 446 N.E.2d 684 (1983).

<sup>42</sup>446 N.E.2d at 688-89.

<sup>43</sup>*Id.* at 691.

<sup>44</sup>*Id.* at 689.

<sup>45</sup>453 U.S. 571 (1981).

action for breach of a contract for sale of gas between the producer and a purchaser. During the period in question, the price for the gas subject to sale was filed under and regulated by the FPC. The contract in question contained a "most favored nation" clause. The producer sued on the basis that the purchaser failed to inform the producer when an event that would trigger the most favored nation clause, and hence an increase in price, had occurred. Had the producer known, it argued, it would have been able to increase the price it charged under the contract, and could have filed such modification with the FPC. The producer sued for the difference between the price actually in effect, and the price it should have been able to charge under the most favored nation clause.

The Louisiana state court upheld the producer's arguments, and allowed damages for the price differential. The United States Supreme Court reversed, holding that the state court allowance of damages was tantamount to allowing the producer to charge a rate different from that contained in the rate filed at the FPC for the period in question. While the Court recognized that there were some equities weighing on behalf of the producer, the Court nevertheless maintained that the state's action would in effect grant a retroactive rate increase, or permit collection of a rate other than the one on file with the FPC, in violation of the Natural Gas Act.

The foregoing cases constitute a coherent, well-defined body of law holding that state utility commissions must accept as reasonable a utility's purchased power costs incurred pursuant to a FERC rate schedule.

However, the *Narragansett* doctrine is being attacked in a number of jurisdictions. As in so many areas of ratemaking today, the attacks are often predicated upon arguments related to the managerial prudence of the purchasing utility. The only successful attack which has been upheld on court review occurred in a proceeding in Pennsylvania, where an intermediate appellate court upheld the State Public Utility Commission's departure from the *Narragansett* doctrine on the grounds of managerial imprudence.

*Pike County Light and Power Co. v. Pennsylvania Public Utility Commission*<sup>46</sup>

Pike County Light and Power Company (Pike) is a small (3000 customers), wholly-owned subsidiary of a New York utility, Orange and Rockland Utilities, Inc. (ORU). Pike purchased power at wholesale from its parent through a full-requirements power supply agreement filed with and approved by the FERC. The operations of the systems are fully integrated.

In a retail rate proceeding, the Pennsylvania Public Utility Commission disallowed almost \$600,000 of purchased power expense in setting Pike's rates. The Pennsylvania Commission concluded that Pike's reliance on ORU as a sole source of power represented an abuse of management discretion. The Commission said that alternative, more economical sources of supply were available from Pennsylvania Power & Light Company, although there was no evidence that an alternate supply had been offered.

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<sup>46</sup>77 Pa. Commw. 268, 465 A.2d 735 (1983). The author's firm represented Pike County Light and Power Co. in the court and commission proceedings.

The Pennsylvania Commission acknowledged that it was without power to find a FERC tariff unreasonable; and yet found that it “is within our power to determine the unreasonableness of expenses incurred by Pike.”<sup>47</sup>

On appeal, Pike asserted that the Commission could not avoid a clash with federal law by simply declaring due deference to the FERC’s jurisdiction, while in substance usurping the FERC’s role of determining the reasonableness of charges for the interstate sale of electricity.<sup>48</sup> Pike cited *Narragansett* and its progeny, *Public Service Co. of Colorado v. Public Utility Commission of Colorado*, and *Washington Gas Light Co. v. Public Service Commission of the District of Columbia*, but to no avail.

The court conducted an analysis much like that undertaken by the North Dakota Supreme Court in *Hagen* to determine whether or not there was a conflict in the exercise of state and federal jurisdiction. Unlike the North Dakota Court in *Hagen*, however, the Pennsylvania court found that the regulatory functions of the FERC and of the PUC do not overlap.

The court stated:

In carrying out its regulatory function, the FERC examines the cost of service data of Orange & Rockland to determine that its wholesale rates provide a fair return to the utility’s stockholders without being unfair to Orange & Rockland’s purchasers. The FERC does not analyze Pike’s cost of service data or purchased power alternatives in making its determinations. The FERC focuses on Orange & Rockland to determine whether it is just and reasonable for that company to charge a particular rate, but makes no determination of whether it is just and reasonable for Pike to incur such a rate as an expense. The PUC, on the other hand, has no jurisdiction to analyze Orange & Rockland’s cost of service data and makes no determination as to the reasonableness for Orange & Rockland to charge its rates. The PUC focuses on Pike and its cost of service data to determine whether it is reasonable for Pike to incur such costs in light of available alternatives. So while the 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. The regulatory functions of the FERC and the PUC thus do not overlap, and there is nothing in the federal legislation which preempts the PUC’s authority to determine the reasonableness of a utility company’s claimed expenses. In fact, we read the Federal Power Act to expressly preserve that important state authority.<sup>49</sup>

In a footnote to the foregoing, the court held, citing *New England Power Co. v. New Hampshire*,<sup>50</sup> that the Federal Power Act does not alter the limits of state authority otherwise imposed by the Commerce Clause and that the effect on interstate commerce of the action by the Pennsylvania PUC “is incidental and indirect and does not violate the Commerce Clause.” The Company sought review by the highest court in Pennsylvania, but its petition was denied.

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<sup>47</sup>Re: Pike County Light and Power Co., Docket No. R-821857 (Oct. 15, 1982), slip op. at 3.

<sup>48</sup>In an earlier decision involving West Penn Power Company, Pa. Pub. Util. Comm’n v. West Penn. Power Co., 32 Pub. Util. Rep. (PUR) 4th 277 (1979), the PUC had refused to impute revenues to West Penn Power for sales to an affiliate which were regulated by the FERC on the grounds that “[t]o allow such imputation of revenues, this commission would be determining the reasonableness of the wholesale rates, a matter over which it has no jurisdiction.”

<sup>49</sup>77 Pa. Commw. at 274, 465 A.2d at 738.

<sup>50</sup>455 U.S. 331 (1982).

In considering the applicability of the court's reasoning to other situations, it should be noted that the FERC *has* examined the reasonableness of allocating costs (Tyrone abandonment costs, for example) to different purchasers when dealing with multi-state pooling or coordination agreements.

*Cambridge Electric Light Company*<sup>51</sup>

The Pike County Light & Power Company decision has been cited in support of a similar result by the Massachusetts Department of Public Utilities.

Cambridge Electric Light Company, a subsidiary of Commonwealth Energy, filed for Massachusetts Department of Public Utilities approval of a change in its quarterly fuel charge, which included purchased power costs. In this instance, the change in purchased power cost was occasioned by the execution of a contract to accept cost responsibility for a portion of the Seabrook nuclear plant, including a portion of its construction work in progress. The subject contract (the Power Contract) permitted Canal Electric Company, another subsidiary of Commonwealth Energy, to sell Seabrook capacity to Cambridge pursuant to a FERC-filed rate schedule which had been established to include construction work in progress in accordance with the FERC's recent rulemaking order in FERC Docket No. RM81-38-000. Cambridge argued that FERC acceptance of a filed contract conclusively establishes that the purchaser has been reasonable and prudent in entering into the contract; that FERC acceptance satisfies the purchaser's burden of proof under state statutes; and that the Massachusetts DPU must find such cost to be reasonable and prudently incurred and must permit recovery from retail ratepayers through the fuel charge.

The Massachusetts DPU rejected the position taken by Cambridge, both on the substantive legal issues and with respect to its failure to carry its burden of proof. The Department determined that the Federal Power Act preserves the retail ratemaking authority that the states had legitimately exercised up to the time the Federal Power Act was enacted and that subsequent Supreme Court interpretations have confirmed this intent, citing the *City of Colton* case.<sup>52</sup>

Then, citing *Pike County Light and Power Co.*, the Department stated:

There is however, no indication in the Congressional Record, in the FPA itself, or in subsequent Supreme Court decisions that the FPA was intended to preclude the legitimate exercise of a state's authority to review the prudence of the incurrence of costs by a retail electric company.<sup>53</sup>

The Commission also cited the FERC's orders in *Philadelphia Electric Co.*,<sup>54</sup> and *Pennsylvania Power & Light Co.*,<sup>55</sup> and the Commission's regulations which it stated focus the FERC investigation on the *seller* of electric energy *not upon the purchaser* or

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<sup>51</sup>Docket No. 84-2B-2 (Mass. D.P.U. May 10, 1984).

<sup>52</sup>Federal Power Comm'n v. Southern Cal. Edison Co., 376 U.S. 205 (1964).

<sup>53</sup>Cambridge Elec. Light Co., slip op. at 18.

<sup>54</sup>15 FERC ¶ 61,264 (1981).

<sup>55</sup>23 FERC ¶ 61,006 (1983) (discussed below).

the purchaser's customers. The Department stated that FERC requests no information and makes no determination concerning the

purchaser's decision to acquire the power, decision to enter a contract, decision to make a particular purchase, or the availability to purchaser of less expensive or more efficient alternatives to this particular wholesale purchase. The regulations are aimed solely at the cost structure of an alternative available to the seller.<sup>56</sup>

The Department concluded that, although the FERC must adjudge the reasonableness of the *rate charged* for a particular transaction, the Department has jurisdiction to determine whether the *transaction itself* is reasonable:

Specifically, the Department retains the authority and responsibility to rule for retail ratemaking purposes on the prudence of a retail company's actions in incurring costs. This responsibility is distinct and independent from the FERC's authority to determine what a reasonable rate may be for any particular wholesale rate schedule. The fact that the rate charged for a wholesale power transaction is reasonable does not bear on the determination of whether that transaction was prudently incurred by a retail electric company or whether the transaction was to the benefit or detriment of the retail company's ratepayers. . . . The department . . . must . . . determine whether a company was prudent in deciding to incur the expenses, that is, prudent in entering into the wholesale contract given the broad range of alternatives available to the company and given the company's responsibility to secure power supplies in a manner that results in the lowest possible cost consistent with reliable service.<sup>57</sup>

The Department dismissed the "filed rate" doctrine as inapplicable, on the grounds that it does no more than establish that the level of rates for interstate wholesale transactions could only be approved by the FERC, although it noted that the "doctrine has been especially useful in resolving squabbles between states," citing the decisions of the North Dakota Supreme Court and the Minnesota Supreme Court in the Tyrone project litigation.

The Department found no conflict between state and federal regulation under its interpretation of the filed rate doctrine,

as long as the local regulator, . . . looks only to a company's prudence in incurring all its costs, some of which may also happen to have federal status, there will be no collision or conflict, direct or otherwise, with the FERC's jurisdiction or the Commerce Clause.<sup>58</sup>

The Department then went on to find that Cambridge had not carried its burden of proof to demonstrate the prudence of its decision to enter into the Power Contract and incur the costs of Seabrook.

The Department conceded that it "is preempted from adjudicating the reasonableness of either a FERC-approved wholesale rate or any of the costs underlying such an approved rate."<sup>59</sup> But, it stated that the FERC's established "practices, procedures and regulations to extend the FERC's jurisdictional mandate

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<sup>56</sup>Cambridge Elec. Light Co., slip op. at 21 (footnote omitted).

<sup>57</sup>*Id.*, slip op. at 22-23.

<sup>58</sup>*Id.*, slip op. at 23.

<sup>59</sup>*Id.*, slip op. at 22.

do not include a review of the prudence of wholesale transactions *from the perspective of the purchasing utility and its ratepayers*.<sup>60</sup> The Department found that, if it were to accept the FERC-filed rate as an operating expense without an investigation of the prudence of the transaction underlying the rate, "a clear void in the regulation of retail utility companies would be created."<sup>61</sup>

Cambridge relied upon *Eastern Edison*. The Massachusetts DPU has challenged the Supreme Judicial Court's decision. Objectively, it appears that the only difference between *Eastern Edison* and *Cambridge* is that the prudence of the underlying contract was not questioned in *Eastern Edison*. It was an issue in *Cambridge*. The DPU decision has been appealed.

The Supreme Court of Wyoming recently upheld a pass-through to retail customers of a purchased power increase charged by the Bonneville Power Administration (BPA) to Lower Valley Power & Light Company (LV), a rural electric distribution cooperative serving customers in Wyoming.<sup>62</sup> BPA's rates are approved by the FERC. Because the question arose in the context of "pass-through" proceeding and not in a general rate case, a majority of the Court, following *Northern States Power Co. v. Hagen*, affirmed the Commission's decision to permit the pass-through of the increased purchase power cost, as follows:

[t]hat court determined, as do we, that the proper place to question the reasonableness and prudence of a wholesale rate is in the proceeding before the FERC. The PSC is preempted by the Federal government from reviewing the reasonableness of the components of the BPA wholesale electric rate increase. . . . Once the FERC proceedings are complete, the PSC is required to accept those rates as reasonable, and the PSC can do nothing but accept those rates as given.<sup>63</sup>

However, in *dictum* the court went on to point out that its use of the word "prudence" in the foregoing citation is not all-encompassing:

All of the foregoing is not to say that LV is required to purchase its electricity from BPA. During a full rate hearing, it may be shown that there is a cheaper source of supply available.

The court went on to discuss the *Pike County Light and Power Co.* case, distinguishing it upon the grounds that it "was a full rate case," which presumably provided the proper forum and adequate time for appropriate consideration of alternative sources of supply. The court did not see fit to require the Wyoming Commission to consider alternatives in a "pass-through" proceeding.

### *FERC Proceedings*

The FERC has not hesitated to deal with issues of prudence in construction planning and implementation, as evidenced by the Tyrone project proceedings; and has approved the allocation of prudently incurred costs among several power

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<sup>60</sup>*Id.*, slip op. at 26 (emphasis added).

<sup>61</sup>*Id.*

<sup>62</sup>*Spence v. Smyth* \_\_\_\_\_ Wyo. \_\_\_\_\_, 686 P.2d 597 (1984).

<sup>63</sup>686 P.2d at 600.



purchasers — the “squabbles between states” referred to by the Massachusetts D.P.U. However, in recent cases the FERC has been reluctant to undertake an examination of the purchaser’s prudence of choice among competing power supplies in reviewing simple bilateral sales contracts.

In *Philadelphia Electric Co.*,<sup>64</sup> the FERC had under consideration a contract for the purchase and sale of energy and related capacity. The FERC accepted the contract as a rate schedule, but found only that it appeared to be equitable as between the immediate parties. The FERC stated:

[W]e wish to make it clear that our decision to accept the contract . . . does not, in our view, bind us or the Pennsylvania Public Utility Commission to any particular treatment of these items in the cost of service for wholesale and retail requirements customers of [the purchasers].

Further, our decision to accept the contract rate and service arrangement is not predicated on a determination that, over the initial term of the contract, [the purchasing company] could have done no better buying from someone else, or that the transaction over this period will rebound to the benefit of the retail and wholesale customer of the two respective parties to the contract. It does appear that [the purchasing company’s] other customers will realize a net benefit from this transaction over the initial term of the contract; *but we do not mean by this order to prejudge, for our own purposes or those of the respective state commissions, a determination of the prudence of either party in entering into this transaction.*<sup>65</sup>

In a more recent case, *Pennsylvania Power & Light Co.*,<sup>66</sup> the Commission once again discussed the issue of prudence of choice.

Pennsylvania Power & Light (PP&L) submitted to the FERC for filing a contract to sell to Atlantic City Electric Company (AC) a portion of the capacity and energy from PP&L’s Susquehanna Steam Electric Station. Filing was complete March 1, 1983. The agreement was to become effective as of the date the Susquehanna plant became operational (April 1, 1983) and was to run through 1991.

AC notified FERC on March 28, that the New Jersey Board of Public Utilities Commissioners had issued an order on March 25 which found: (1) that AC did not need the Susquehanna purchase; and (2) that the most economic capacity expansion plan for AC did not include the PP&L purchase. The New Jersey Board concluded that, because the purchase from PP&L was unneeded and uneconomical, it would be unjust and unreasonable to allow AC to recover its costs under the Susquehanna Agreement in retail rates. The Board, based on these findings, “disapproved” the agreement. AC filed a notice of termination of the agreement, contending that the agreement was effective subject to securing necessary governmental regulatory approval and that the New Jersey Board’s “disapproval” had terminated the agreement.

The FERC rejected AC’s notice of withdrawal of its certificate of concurrence in PP&L’s rate filing and accepted the PP&L/AC contract for filing. The FERC stated that the contract provided for a sale at wholesale in interstate commerce subject to its exclusive jurisdiction:

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<sup>64</sup>15 FERC ¶ 61,264 (1981).

<sup>65</sup>15 FERC at 61,601 (emphasis added).

<sup>66</sup>23 FERC ¶ 61,005 (1983).

*While the Board has the authority to evaluate the prudence of AC's purchase in retail rate proceedings, it does not have the authority to disapprove PP&L's contract with AC. . . . Because we do not believe the Board had the authority to approve or disapprove the agreement, we also find that AC may not terminate its agreement because of a failure to secure necessary governmental approvals. . . .*

[W]e wish to make clear that our decision to accept the agreement for filing is premised on the fact that the formula rate for this jurisdictional sale will not produce excessive revenues. *Our decision is not, however, based on a determination that AC's purchase is prudent.*<sup>67</sup>

In its order denying rehearing of the foregoing order, the Commission was even more explicit in dealing with the issue of the prudence of the purchaser under the filed rate schedule in light of alternatives available to it. The Commission stated:

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 purchase's rates for sales to others.<sup>68</sup>

In a similar circumstance, in the face of these orders, Pennsylvania Power & Light and Jersey Central Power & Light executed a contract on March 9, 1984 under which JCP&L agreed to purchase 945 Mw of capacity and related energy entitlements from PP&L. The contract expressly provides in Article III that in order for the agreement to become effective, the New Jersey Board of Public Utilities Commissioners must find and/or determine that the agreement is in the public interest and that JCP&L is authorized to incur the indebtedness to PP&L.

The FERC accepted the agreement for filing on May 29, 1984. The Public Advocate of New Jersey had filed on April 16, 1984 an intervention stating that he did not object to the filing as long as it was understood that Article III of the agreement stands as a condition precedent to the initiation of service. The FERC noted the Public Advocate of New Jersey's intervention position and stated:

Please be advised that if service is not initiated under the agreement because of failure to meet the conditions precedent in Article III of the Agreement, you are required to file a notice of cancellation of the rate schedules under Section 35.15 of the Commission's Regulations.<sup>69</sup>

The FERC expressly refused to consider the issue of whether or not a purchaser was prudent in entering into a long-term agreement for the purchase of generating capacity in *Pacific Power & Light Co.*<sup>70</sup> Pacific Power & Light Co. filed a rate schedule providing for such service in February 1984 and the purchaser, Black Hills Power and Light Company, filed a certificate of concurrence in the purchase. A customer, the City of Gillette, Wyoming, intervened seeking suspension of the filing and a hearing on a number of issues including allegations that Black Hills was

<sup>67</sup>23 FERC ¶ 61,006 at 61,019 (emphasis added).

<sup>68</sup>23 FERC ¶ 61,325 at 61,716 (footnote omitted).

<sup>69</sup>See Acceptance of Filing No. ER84-343-000 (FERC May 29, 1984).

<sup>70</sup>27 FERC ¶ 61,080 (1984).

imprudent in entering into the agreement. The prudence issue was stated by the Commission as follows:

that the purchase may be imprudent for Black Hills in that it is uneconomical, not competitive with other alternatives, and will leave Black Hills in an excess capacity situation, to the potential detriment of Gillette.<sup>71</sup>

The Commission denied Gillette's request for suspension and hearing, accepted the rates for filing without suspension, and terminated the docket. Significantly, in doing so, the Commission stated as follows, after citing the language quoted above from its Order on Rehearing in the *Pennsylvania Power and Light Co.* proceeding:

At this juncture, the Commission need not rule on the prudence or feasibility of Black Hills' capacity purchase. Rather, we must determine whether the filed Agreement represents a reasonable basis for PP&L's charges for the service requested by Black Hills. The proper forum for Gillette concerns is a Black Hills' rate case pertaining to Gillette's rates. This is particularly appropriate since Gillette will bear none of the fixed costs associated with the purchase unless and until Black Hills files to include such costs in Gillette's rates.<sup>72</sup>

The FERC once again reiterated the position taken in *Pacific Power and Light Co.* and *Pennsylvania Power and Light Co.* in *Kentucky Power Co.*<sup>73</sup> in an order issued on November 23, 1984. That proceeding involves a fifteen-year capacity purchase by Kentucky Power Company under a unit power sales agreement with its affiliate American Electric Power Generating Company. In an order clarifying a prior order accepting the rate schedule for filing, the FERC stated that:

The Intervenor's cite *Pacific Power and Light Company*, as an indication of Commission policy consistent with the limitation and clarification sought in this proceeding. The Commission there stated, "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, the Commission also noted in that case that "... 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."

Therefore, while the order correctly noted that the issue before the Commission in this proceeding concerns only the justness and reasonableness of the proposed rates and terms for AEGCo's sales of power to KEPCo, the question of prudence on the part of KEPCo in entering into the agreement could arise in the context of a rate proceeding before this Commission involving KEPCo's wholesale rates. 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.<sup>74</sup>

These FERC decisions to refrain from considering the issue of a purchaser's choice among alternative sources of power in a proceeding to establish a "just and

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<sup>71</sup>27 FERC ¶ 61,079 at 61,147.

<sup>72</sup>27 FERC at 61,148.

<sup>73</sup>Docket No. ER84-579-001.

<sup>74</sup>Kentucky Power Co., Docket No. ER84-579-001, Order Clarifying Prior Order, slip op. at 3 (Nov. 23, 1984) (emphasis in original; footnote omitted).

reasonable" rate under Section 205 of the Federal Power Act have not been subjected to court review.

### *Current Litigation*

#### *Arkansas.*

On April 30, 1982, Middle South Services, Inc. tendered for filing with the FERC a revised System Agreement among Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company, Mississippi Power & Light Company and New Orleans Public Service Inc. in Docket No. ER82-483-000. The new System Agreement is intended to govern operating transactions among the parties.<sup>76</sup>

The four operating companies are all wholly-owned subsidiaries of Middle South Utilities, Inc. (MSU). In early 1974, Middle South Energy, Inc. (MSE) was created to finance, construct and operate new generating projects for the system companies. The first such project was the Grand Gulf nuclear plant located in Mississippi Power & Light Company's service territory.

As construction of Grand Gulf Unit No. 1 continued into 1982, MSE entered into a Unit Power Sales Agreement (UPSA) which requires three of the operating companies to purchase shares of power from Grand Gulf. AP&L's share under the UPSA is zero. The UPSA was filed with FERC in June 1982 as a wholesale power sales agreement in Docket No. ER82-616-000. The State Public Service Commissions in Arkansas, Louisiana, Mississippi, and Missouri all intervened and actively participated in hearings in Docket No. ER82-616-000. The Presiding Administrative Law Judge reviewed the impact of various proposals to reallocate Grand Gulf power purchasers and other MSU subsidiaries' production costs upon the operating companies. His Initial Decision in Docket No. ER82-616-000<sup>77</sup> rejected the Grand Gulf allocation percentages agreed upon by the MSU companies in the UPSA, changed them, and determined that AP&L would be obliged to purchase 36% of the power from Grand Gulf Unit No. 1.<sup>78</sup> The decision caused a political uproar from the Gulf of Mexico to southern Missouri.

As one result, the Arkansas PSC (APSC) issued an order to show cause why 36 agreements relating to the Grand Gulf project should not be held void *ab initio* as a matter of law. If they were, default clauses in several of the key financing documents threatened to trigger a collapse of the MSE financing program for Grand Gulf.

In issuing its show cause order to AP&L, the APSC relied on an assertion of state statutory authority to regulate AP&L's participation in the Grand Gulf project. Pursuant to Ark. Stat. Ann. § 73-202(a) (Repl. 1979), the APSC is

vested with the power and jurisdiction, and it is hereby made its duty to supervise and regulate every public utility in this Act defined, and to do all things, whether herein

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<sup>75</sup>See also Southern Co. Services, Inc., 20 FERC ¶ 61,332 at 61,694 (1982).

<sup>76</sup>The author's firm represents Arkansas Power & Light Company in the FERC proceedings referred to herein.

<sup>77</sup>26 FERC ¶ 63,044.

<sup>78</sup>Arguably, then, if it were to uphold the Initial Decision, the FERC, by dictating the "purchase (by AP&L)" and its extent (by all the operating companies) would preempt any subsequent consideration of the prudence of the purchases from Grand Gulf by the state commissions.

specifically designated, that may be necessary or expedient in the exercise of such power and jurisdiction, or in the discharge of its duty. . . .

The Arkansas Commission's jurisdiction is further set forth in Ark. Stat. Ann. § 73-253 (Repl. 1979), which states that a public utility may not "sell, acquire, lease or rent any public utility plant or property constituting an operating unit or system" without the consent and approval of the Commission. Nor may a public utility "issue stock, bonds, notes or other evidence of indebtedness payable at periods of more than thirty-six (36) months . . ." without the authorization of the Commission.<sup>79</sup>

As noted above, the APSC Order to Show Cause cited 36 contracts, which the APSC alleged all related to Grand Gulf project financing arrangements, and which APLI argued included agreements for the sale of power for resale in interstate commerce, subject to the exclusive jurisdiction of the FERC. The Commission took the position that its jurisdiction to review "leases" and "evidences of indebtedness" had been ignored and that the contracts thus appeared to be void *ab initio*.

After motions to dismiss the proceeding were denied by the PSC, MSE filed suit in the United States District Court for the Eastern District of Arkansas, asserting federal preemption of the entire matter under the Federal Power Act and seeking a declaratory judgment and injunctive relief to prevent the APSC from conducting further proceedings in the show-cause docket.<sup>80</sup> AP&L intervened. On September 14, 1984, the District Judge issued his judgment permanently enjoining the APSC from conducting the show-cause proceedings.<sup>81</sup>

The court agreed with the companies' federal preemption arguments, concluding that because the subject agreements are

inextricably bound to the wholesale sale of power in interstate commerce . . . [and] so integrally related to such purchases that they are subject to the exclusive jurisdiction of the FERC. The other documents which the APSC seeks to review and regulate are essential to the interstate wholesale sale of power and therefore are not subject to state jurisdiction.<sup>82</sup>

The decision has been appealed to the United States Court of Appeals for the Eighth Circuit.<sup>83</sup>

The *Narragansett* doctrine has also been raised during the course of the FERC proceeding on the Middle South System Agreement, Docket No. ER82-483-000, in connection with resolution of a dispute about the equalization or redistribution of production costs among the operating companies. In his Initial Decision issued February 4, 1985, the Presiding Administrative Law Judge defined the doctrine as follows:

once this Commission allows a utility to charge a rate reflecting investment in a particular plant, the State commission with regulatory authority over the utility is required by the Supremacy Clause of the United States Constitution to allow the utility to recover the cost of

<sup>79</sup>Ark. Stat. Ann. § 73-255 (Supp. 1983).

<sup>80</sup>Jurisdiction was based on 28 U.S.C. § 1331 (federal question) and § 1337 (Act of Congress regulating commerce). Both MSE and AP&L are incorporated in Arkansas.

<sup>81</sup>Middle South Energy, Inc. v. Arkansas Pub. Serv. Comm'n, 593 F. Supp. 363 (E.D. Ark. 1984).

<sup>82</sup>*Id.* at 366.

<sup>83</sup>Middle South Energy, Inc. v. Arkansas Pub. Serv. Comm'n, Nos. 84-2356-EA, 84-2409, 84-2410, 84-2480.

the FERC approved rate in its retail rates, *Washington Gas Light Company v. Public Service Commission*, 452 A.2d 375, 385-86 (D.C. App. 1982), *cert. denied*, 103 S. Ct. 2454 (1983); *Eastern Edison Co. v. The Department of Public Utilities*, 388 Mass. 292, 446 N.E.2d 684, 690 (1983); *Northern States Power Co. v. Hagen*, 314 N.W.2d 32, 38 (N.D. 1981); *Narragansett Electric Co. v. Burke*, 119 R.I. 559, 564-65, 568, 381 A.2d 1358, 1361, 1363 (1977), *cert. denied*, 435 U.S. 972 (1978) (hereinafter referred to as the "Narragansett doctrine"). Under the *Narragansett* doctrine, should this Commission order that production costs be equalized as a result of a revision of the 1982 System Agreement, which is subject to Federal jurisdiction, the State commissions would be compelled to reflect that ruling in their retail rates. As a result, State commissions will not be at liberty to ignore the FERC ruling and exclude portions of the equalized production plant from rate base.<sup>84</sup>

#### *North Carolina.*

A case similar to that presented by the Tyrone nuclear project proceeding is the action of the North Carolina Utilities Commission involving the hydro resources of two subsidiaries of the Aluminum Company of America (Alcoa). Nantahala Power and Light Company is an electric public utility operating in western North Carolina. It serves customers at wholesale under rates regulated by the FERC and at retail under rates set by the North Carolina Utilities Commission. Under the facts in issue at the time, Nantahala generated power at its own hydro facilities in North Carolina, which power was exchanged with TVA for TVA power entitlements. Nantahala also purchased supplemental TVA power when its entitlements were insufficient to meet its load.

Tapoco, Inc. is a Tennessee corporation whose sole function is to manage the power supply to an aluminum smelting and fabricating facility owned by Alcoa near Knoxville. Tapoco owned hydro plants in both states and had a similar arrangement with TVA.

Nantahala and Tapoco are both wholly-owned subsidiaries of Alcoa. The arrangements of both companies with TVA were included in an agreement called the New Fontana Agreement, which was filed with and regulated by the FERC.<sup>85</sup> The entitlements of each company to TVA power given in exchange for the output of Tapoco's and Nantahala's plants were divided between Nantahala and Tapoco through an apportionment agreement, which was also regulated by the FERC as part of the New Fontana Agreement.

In retail rate proceedings involving Nantahala in the 1970s, in Docket No. E-13, Sub. 29, the North Carolina Utilities Commission investigated the impact of these FERC-regulated agreements upon North Carolina customers and confirmed their reasonableness. Thus, the North Carolina Utilities Commission allowed Nantahala to recognize in its retail rates the costs incurred under these wholesale transactions. On appeal, however, the North Carolina Supreme Court held that Nantahala's arrangements under the apportionment agreement should be reexamined to determine whether Nantahala should have received more entitlements of TVA power.<sup>86</sup> On remand, the Commission found that Nantahala should have received

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<sup>84</sup>FERC Docket No. ER82-483-000, Initial Decision, Feb. 4, 1985, slip op. at 60-61.

<sup>85</sup>The author's firm represents Tapoco, Inc. and Aluminum Company of America in the North Carolina proceedings and Tapoco, Inc. before the FERC.

<sup>86</sup>State ex rel. Util. Comm'n v. Edmisten, 299 N.C. 432, 263 S.E.2d 583 (1980).

more TVA entitlements and, thus, should not have had to purchase as much supplemental TVA power. The Commission, through an allocation different from the FERC-regulated allocation, disallowed 74% of the costs Nantahala paid for supplemental power from TVA. The Commission reasoned that Nantahala should have received more TVA entitlements under the New Fontana Agreement and the apportionment agreement, both FERC-filed rate schedules, and thus should have incurred lower supplemental purchase costs.<sup>87</sup> The Commission took essentially the same approach in Nantahala's next retail rate proceeding in E-13, Sub. 35. As a result of the two retail rate proceedings, Nantahala has been directed to refund over forty million dollars to its retail customers.

Both Utilities Commission rulings have been upheld by an intermediate appellate court, the Court of Appeals of North Carolina.<sup>88</sup> Both proceedings have been appealed and argued to the North Carolina Supreme Court and are pending before that court for decision. Nantahala has argued that the Supremacy Clause prohibits the action taken by the North Carolina Commission, citing the *Narragansett* line of cases and relying in particular upon *Northern States Power Co. v. Minnesota Public Utilities Commission*,<sup>89</sup> which also involved a federally-regulated allocation of costs among states.

While the state proceedings were under way, in January 1982, Alcoa and Tapoco filed suit in Federal District Court contending that the Utilities Commission's rate and refund orders contravene the Federal Power Act, the Supremacy Clause, and the Commerce Clause. The District Court dismissed the action on abstention grounds, never reaching the *Narragansett* preemption issues.<sup>90</sup>

The court based its abstention on the doctrines established in *Burford v. Sun Oil Co.*,<sup>91</sup> relying on the fact that state judicial proceedings had been initiated and were under way, providing an adequate opportunity to litigate the federal claims. Ominously, the District Court stated:

The NCUC's orders on their face do no more than establish intrastate retail rates for Nantahala using a particular method of determining Nantahala's cost of production. Plaintiffs have offered and the Court has found no controlling authority for the proposition that the NCUC is bound to accept in its independent regulatory bailiwick a rate of purchasing electricity approved by the FERC as Nantahala's cost of service. This does not mean, however, that the NCUC's orders have not impermissibly interfered with interstate commerce or that they have not indirectly affected matters exclusively within the FERC's jurisdiction.<sup>92</sup>

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<sup>87</sup>*Id.*, Final Order Overruling Exceptions (Jan. 28, 1982). *State of North Carolina v. Nantahala Power and Light Co.*, No. E-13, Sub. 35, Order Increasing Rates and Requiring Refunds (June 8, 1982).

<sup>88</sup>*State of North Carolina v. Nantahala Power and Light Co.*, 65 N.C. App. 198, 309 S.E.2d 473 (1983); *State of North Carolina v. Nantahala Power and Light Co.*, 66 N.C. App. 546, 311 S.E.2d 619 (1984).

<sup>89</sup>344 N.W.2d 374 (Minn.), *cert. denied*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S. Ct. 3546 (1984).

<sup>90</sup>*Aluminum Co. of America v. N.C. Util. Comm'n*, No. 82-376-Civ-5, (E.D.N.C. July 29, 1982), *aff'd*, 713 F.2d 1024 (4th Cir. 1983), *cert. denied*, \_\_\_\_\_ U.S. \_\_\_\_\_, 104 S. Ct. 1326 (1984).

<sup>91</sup>319 U.S. 315 (1943). *See also* *Younger v. Harris*, 401 U.S. 37 (1971).

<sup>92</sup>*Aluminum Co. of America*, slip op. at 12.

In 1976, while the first state rate proceeding in E-13, Sub. 29 was pending, Nantahala had filed for a wholesale rate increase with the FERC. Also, a complaint was filed at the FERC to compel Tapoco to supply power to Nantahala. The FERC considered and rejected this effort to divert Tapoco's power, holding that Tapoco and Nantahala constitute separate systems and that Tapoco's power should not be made available to Nantahala.<sup>93</sup> Since then, these prior agreements have expired. A second wholesale rate filing before the FERC involving replacement agreements has been the subject of extensive hearings in FERC Docket Nos. ER82-774-000, *et al.*

Thus, no dispositive treatment of federal preemption issues has occurred to date in Alcoa's North Carolina proceedings in either State or Federal court.

### *Kentucky.*

Kentucky Power Company was denied full recovery of its costs of purchased power from the new coal-fired Rockport generating unit owned by its affiliate, American Electric Power Generating Company, in a December 4, 1984 decision by the Kentucky Public Service Commission in Case No. 9061. As noted, *supra*, the FERC had accepted the unit power sales agreement in question for filing as a rate schedule under the Federal Power Act. However, in doing so, the FERC expressly refused to consider the issue of Kentucky Power Company's prudence in entering into the agreement.

The prudence issue was litigated before the Kentucky Public Service Commission. Issues considered, among others, included the rights and obligations of parties under the AEP Interconnection Agreement; the costs of purchasing capacity under the Interconnection Agreement relative to the costs of purchasing capacity pursuant to the unit power sales Agreement; and the impact upon the pooling concept and the other members of the pool of undue reliance upon capacity purchases from the AEP intra-system pool.

The Kentucky Commission concluded as follows on the issue of the prudence of Kentucky Power Company in entering into the unit power sales agreement:

This Commission has made no findings on the justness or reasonableness of the rate set forth in the Rockport unit power agreement nor has any attempt been made to examine the cost of service supporting that rate. The Commission has, within the bounds of its jurisdiction, examined the availability of alternative power supplies to meet Kentucky Power's needs. Based on the evidence in this record, the Commission finds that Kentucky Power can acquire power sufficient to meet its needs by either purchasing Rockport unit power or continuing to purchase power from the AEP pool. The Commission further finds that to continue purchasing power from the AEP pool will be less costly to Kentucky Power and its ratepayers than the purchase of Rockport unit power. Consequently, for rate-making purposes the Commission finds that Kentucky Power's decision to purchase Rockport unit power is unwise and imprudent since it is more costly than alternative power supplies. Kentucky Power can recover through its retail rates its actual cost of purchased

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<sup>93</sup>19 FERC ¶ 61,152, *reh'g denied*, 20 FERC ¶ 61,430 (1982), *aff'd*, Nantahala Power and Light Co. v. FERC, 727 F.2d 1342 (4th Cir. 1984). The Commission did find that Nantahala should have received somewhat more entitlements under the apportionment than it received, and thus "imputed" those entitlements to Nantahala's cost of service. The federal agency, however, stopped well short of the rolled-in rate treatment and imputation of greater levels of entitlements which would be required by the NCUC.



power not to exceed the cost which would be incurred if power is purchased from the AEP pool rather than Rockport unit power.<sup>94</sup>

Later in December, Kentucky Power Company filed an action in the United States District Court for the Eastern District of Kentucky (Civil Action No. 84-83) challenging the action by the Kentucky Commission on a number of grounds including a usurpation of the FERC's authority over wholesale power rates.<sup>95</sup> The action was dismissed on abstention grounds. The Company is now pursuing an appeal in the Kentucky state courts.<sup>96</sup>

#### CONCLUSION

The courts which have looked at the *Narragansett* preemption issue carefully have undertaken an analysis of federal and state regulatory statutes and procedures to determine whether or not state action refusing to recognize purchased power expense as an operating cost for retail ratemaking purposes would conflict with federal regulation in fact or in law. Every court of last resort which has decided that issue thus far has found that such a conflict would exist and has followed the *Narragansett* doctrine. The Massachusetts Department of Public Utilities and the Kentucky Public Service Commission looked for conflicts only in fact and found none; therefore, they found none in law — no direct or indirect violation of a comprehensive federal regulatory scheme. These decisions are being appealed, and the issue will come before other state courts in the next year or two.

If the FERC continues to back away from a determination of the purchaser's prudence in choosing among competing sources of power in proceedings involving bilateral wholesale power transactions, the United States Supreme Court may have to decide whether the current FERC position is correct and/or whether a state commission has usurped exclusive regulatory responsibilities of the FERC.

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<sup>94</sup>Case No. 9061, slip op. at 17-18 (Dec. 4, 1984).

<sup>95</sup>The civil action also challenged the concurrent action by the Kentucky Commission in allowing only partial recovery through retail rates of carrying charges upon certain transmission facilities when the transmission agreement had also been accepted for filing by the FERC.

<sup>96</sup>The preemption issue has also arisen in a West Virginia proceeding involving another AEP subsidiary. *See* Appalachian Power Co., Case No. 83-697-E-42T (W. Va. PSC Dec. 28, 1984); American Elec. Power Serv. Corp., Docket No. ER84-348-000, -001; *Appalachian Power Co. v. Public Serv. Comm'n of W. Va.*, Civil Action No. 2:85-0098 (S.D. W. Va., Preliminary Injunction Issued Feb. 22, 1985).

