DRAWING THE LINE ON RATE CONDITIONS UNDER SECTION 7 OF THE NATURAL GAS ACT: *NORTHERN NATURAL GAS CO. v. FERC*

I. INTRODUCTION

Section 7 of the Natural Gas Act of 1938 (NGA)[1] charges the Federal Energy Regulatory Commission (FERC or Commission)[2] with the duty to ensure that pipeline companies subject to its jurisdiction[3] do not implement new services unless the Commission has first issued a certificate of public convenience and necessity.[4] The Commission, in issuing the certificate, has the power to impose upon it "such reasonable terms and conditions as the public convenience and necessity may require."[5]

On its face, section 7 appears to give the FERC broad authority to place appropriate conditions on certificates for new services.[6] Nothing in the

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1. 15 U.S.C. § 717f (1982).

2. Congress originally conferred power on the Federal Power Commission (FPC) for the administration of the NGA. However, the FPC was replaced by the FERC in 1977 pursuant to the Department of Energy Organization Act, Pub. L. No. 95-91, 91 Stat. 565 (1977). As used herein, "Commission" refers to both agencies.

3. 15 U.S.C. § 717(b) (1982) limits the jurisdictional reach of the NGA:

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

Id. Wholly intrastate sales or transportation are exempt from the provisions of the Act. 15 U.S.C. § 717(c) (1982).

The NGA clearly provided for the regulation of interstate pipelines and the FPC almost immediately undertook to perform that task. *See, e.g.*, Natural Gas Pipeline Co., 2 F.P.C. 218 (1940). However, it was not until the decision in Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), that the Commission began to regulate sales for resale in interstate commerce by producers of natural gas.

4. Section 7(c)(1)(A) of the NGA mandates that:

> No natural-gas company . . . shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefore, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations . . . .

15 U.S.C. 717f(c)(1)(A) (1982). For a discussion of the criteria used to determine if a service is in the public convenience and necessity, see *infra* notes 32-33.

5. 15 U.S.C. § 717f(e) (1982).

6. The statute does not purport to place any limits on the type of conditions to be employed. Instead, Congress appears to have left this to the discretion of the Commission. It is well established that in such a case as this, the Commission must necessarily engage in "the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress." Morton v. Ruiz, 415 U.S. 199, 231 (1974). The Supreme Court has further stated that "the Commission's broad responsibilities . . . demand a generous construction of its statutory authority." FPC v. Louisiana Power & Light Co., 406 U.S. 621, 642 (1972) (quoting Permian Basin Area Rate Cases, 390 U.S. 747, 776 (1968)). "Any attack on a condition in a certificate issued by the Commission must confront the well established principle that generally the Commission has extremely broad authority to condition certificates of public convenience and necessity."

express language or history of the Act requires conditions imposed by the FERC to affect only the service to be certificated. Thus, in examining a proposal by Northern Natural Gas Company (Northern) for a new discount service,[7] the Commission attempted to impose a condition that would require Northern to credit certain revenue derived from the discount service to customers not receiving that service. However, on subsequent review, the United States Circuit Court of Appeals for the District of Columbia, in *Northern Natural Gas Co. v. FERC*,[8] invalidated the revenue-crediting condition imposed by the FERC. The court, relying on its earlier decision in *Panhandle Eastern Pipe Line Co. v. FERC*,[9] held that the FERC may not condition a section 7 certificate to alter previously approved rates for customers not receiving the service to be certificated.

II. STATEMENT OF THE CASE

Between 1981 and 1983, Northern, operator of an interstate natural gas pipeline, was faced with the loss of a significant portion of its sales volume in its service area because many large industrial consumers[10] were abandoning the existing natural gas service and switching to cheaper alternate fuels.[11] In an effort to retain or regain those consumers, Northern sought certification of a new discount service which would provide gas to those consumers at prices competitive with the alternate fuels.[12] Under Northern's proposal, consumers with fuel switching capability ("eligible consumers") would be entitled to

Transcontinental Gas Pipe Line Corp. v. FERC, 589 F.2d 186, 190 (5th Cir. 1979), *cert. denied*, 445 U.S. 915 (1980).

7. Northern Natural Gas Co., 27 F.E.R.C. ¶ 61,299 (1984).

8. Northern Natural Gas Co. v. FERC, 827 F.2d 779 (D.C. Cir. 1987) (en banc).

9. Panhandle E. Pipe Line Co. v. FERC, 613 F.2d 1120 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 889 (1980).

10. As used herein, "customer" refers to a utility that purchases gas directly from the pipeline. A "consumer" is one who purchases from the utility for ultimate consumption.

11. Evidence presented by Northern at the hearing before the administrative law judge (ALJ) indicated that, between 1981 and 1983, 24 billion cubic feet (Bcf) of natural gas sales were lost due to consumers switching to cheaper No. 6 fuel oil. Additional losses of approximately 8 Bcf were caused by recession. In Northern's market area, No. 6 fuel oil was available to consumers at a price of $3.64 - $3.94 per million Btu (MMBtu). Natural gas was concurrently available at a price of $4.15 - $4.70 per MMBtu. Northern Natural Gas Co., 26 F.E.R.C. ¶ 63,071 (1984) [hereinafter Initial Decision].

12. Whether certification under section 7 was the proper avenue for Northern to use in establishing the discount service was addressed by the Commission in response to questions by the court on appeal. In the Commission's opinion, a section 7 certification was appropriate because Northern was attempting to change the express terms of a previously certificated service. *See* Foster Natural Gas Report (Foster Associates) No. 1608, at 20 (Feb. 26, 1987).

receive the discount rates.[13] However, its captive[14] ("non-eligible consumers") would continue to pay the rate set in Northern's most recent rate case.[15]

Upon initial hearing,[16] the administrative law judge (ALJ) approved Northern's proposal subject to several important conditions. First, Northern would be required to maintain a record of all discount sales to provide for an estimate of their contribution to the cost of service[17] in the next rate case. Second, Northern must, after rates are set in the next rate case, track all discount sales and credit any net over-recovery of fixed costs to the non-eligible consumers. The purpose of these conditions was to ensure that, after the next rate case, the non-eligible consumers would receive the benefit of any recovery of fixed costs generated by the new service.[18] However, no other specific conditions were imposed to provide immediate benefits from the new service to the non-eligible consumers.[19]

The FERC, upon subsequent review,[20] accepted the ALJ's recommendations but felt the non-eligible consumers should not be required to wait until

13. Northern sought authorization to provide the discount service to utility customers who distributed to consumers with fuel switching capabilities. Two new rate schedules were proposed, the Flexible Pricing-Pipeline Option (FPO) and the Large Volume Contract Service (LVCS). The FPO rate applied to utilities who would pass the rate through to fuel switching consumers with boiler fuel usage in excess of 1500 Mcf per day. The minimum price would be equal to the variable cost component of the commodity rate paid by non-eligible consumers. The maximum price was set at the full commodity rate plus the corresponding fixed cost component. The LVCS rate applied to gas sold by the utilities under contract with fuel switching consumers requiring in excess of 199 Mcf per day. Maximum and minimum rates for the LVCS service were essentially the same as the FPO rates. Initial Decision, *supra* note 11, at 65,267-68.

14. Captive consumers are those who have no realistic alternative fuel supplies.

15. *See* Northern Natural Gas Co., 26 F.E.R.C. ¶ 61,198 (1983).

16. Initial Decision, *supra* note 11.

17. The cost of service principle forms the basis for pipeline rate regulation under the NGA. Under this principle, utilities may only charge rates sufficient to recover their actual costs plus a just and reasonable return on their investment. Pipeline rates are generally composed of a demand charge and a commodity charge. Pipelines recover their variable costs through the commodity charge which is paid by all customers. Fixed costs are partially recovered through the commodity charge (50-75%) with the balance recovered through the demand charge. The demand charge is paid primarily by those customers who have a contractual right to receive a specified minimum amount of gas. Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied sub nom.* Transwestern Pipeline Co. v. FERC, 476 U.S. 1114 (1986). For additional information on the cost of service approach, see W. FOX, FEDERAL REGULATION OF ENERGY § 16.09 (1983); M. SANDERS, THE REGULATION OF NATURAL GAS (1981); Pierce, *Natural Gas Regulation, Deregulation, and Contracts*, 68 VA. L. REV. 63 (1982); Note, *Elimination Of Variable Costs From Natural Gas Minimum Bills*: Wisconsin Gas Co. v. FERC, 7 ENERGY L.J. 131 (1986).

18. The ALJ correctly noted that while *Panhandle* prevented the conditioning of the certificate upon the crediting of fixed costs recovered by the discount service to the non-eligible consumers prior to the next rate case, there was no prohibition against imposing conditions to be applied in future rate cases. Initial Decision, *supra* note 11, at 65,285 n.2.

19. The ALJ did indicate that the non-eligible consumers would receive some immediate benefits including: (1) a reduction in Northern's take-or-pay exposure which would otherwise be borne by the non-eligible consumers; (2) a reduction in the average cost of gas which would be reflected through the Purchased Gas Adjustment (PGA) in the form of lower rates (*see infra* note 52 for a description of the PGA); and (3) recovery of a 10¢ per Mcf surcharge for unrecovered gas costs which would otherwise be borne by the non-eligible consumers. The ALJ concluded that these short-term benefits, coupled with other long-term benefits (e.g., the reduction in the amount of fixed costs borne by captive consumers following the next rate case), greatly outweighed any potential detriments and thus the new service was in the public convenience and necessity. Initial Decision, *supra* note 11, at 65,273.

20. Northern Natural Gas Co., 27 F.E.R.C. ¶ 61,299 (1984).

Northern's next rate case before receiving the benefit of any fixed cost recovery generated by the new service.[21] The FERC thus imposed an additional condition on the certificate that required Northern to credit the non-eligible consumers with all fixed costs recovered by the discount service prior to the next rate case.[22]

On request for rehearing,[23] Northern argued that the additional condition violated the rule established in *Panhandle* that the FERC may not condition a certificate to adjust the rate for another service not before the Commission in the certification proceeding. The FERC nevertheless distinguished *Panhandle*[24] and upheld the condition.

On appeal before the D.C. Circuit,[25] a three judge panel[26] concluded that the FERC had violated the rule of *Panhandle*.[27] While the panel expressed some misgivings regarding the *Panhandle* rule, it found the rule was applicable in this instance to prevent the FERC from imposing the revenue-crediting condition.[28] However, upon subsequent motion by the FERC and the Minnesota Department of Public Services (an intervenor), the full court vacated the panel decision and granted a rehearing en banc to reconsider the validity of the *Panhandle* rule and its applicability to Northern's certificate.[29]

III. PRIOR LAW

A brief examination of the certification and rate review framework provided by the NGA is needed before looking at the case law. In essence, three sections of the NGA pertain to rate review: sections 4, 5 and 7. Section 7 provides that prior to engaging in the transportation or sale of natural gas, a pipeline must first obtain authority from the FERC in the form of a certificate

21. The Commission noted that Northern's proposal was a "departure from the traditional concepts of natural gas rate regulation [and was] an experiment to determine if the pipeline [could] retain and recapture customers with alternate fuel capability." *Id.* at 61,554. Because of the experimental nature of this service, the Commission felt "obliged to ensure that Northern's customers obtain[ed] the appropriate benefits and protection." *Id.*

22. The FERC noted that the condition would prevent Northern from recovering any fixed costs from the discount service. This result was justified by the same logic used by the Commission to support the revenue-crediting condition in *Panhandle*. *See infra* note 53.

23. Northern Natural Gas Co., 28 F.E.R.C. ¶ 61,230 (1984) [hereinafter Order Denying Rehearing].

24. *See infra* note 79 and accompanying text.

25. Northern Natural Gas Co. v. FERC, 780 F.2d 59 (D.C. Cir. 1985) [hereinafter Panel Decision].

26. The panel consisted of Judges Wright, Bork, and Scalia.

27. The court interpreted *Panhandle* to proscribe the alteration, in a section 7 proceeding, of "rates previously approved by the Commission for customers not receiving *the services to be certificated*." Panel Decision, 780 F.2d at 62 (quoting *Panhandle*, 613 F.2d at 1130) (emphasis in original).

28. The court noted:

> The certification here was for flexible-pricing services; the rates for customers receiving other services could not be altered. It may be true that the consequences of this holding, in the present case and in many others, will be to compel the Commission to reject innovative certification proposals that benefit some customers while leaving others at least no worse off. But since that is *always* the effect of *Panhandle*, it is an argument for overruling the case rather than a guide to interpreting it. Whatever its merits, *Panhandle* is the law of this circuit, and we are required to follow it unless and until it is reversed by the court en banc.

Id. at 62-63 (emphasis in original).

29. Northern Natural Gas Co. v. FERC, 780 F.2d 64 (D.C. Cir. 1985).

of public convenience and necessity.[30] The initial rate for this new service is set by the pipeline and is subject to later adjustment by the Commission under sections 4 and 5.[31] However, the FERC must scrutinize the initial rates[32] and any other relevant factors[33] before granting the certificate and is empowered to attach to the certificate "such reasonable terms and conditions as the public convenience and necessity may require."[34] Section 4 of the Act requires that all rates and charges be just and reasonable.[35] If, after certification, the FERC believes the rates are unjust and unreasonable it may adjust them in a section 5 hearing upon such a finding.[36] The pipeline may also seek rate adjustment by filing for an increase under section 4.[37]

After enactment of the NGA, there appears to have been little controversy regarding the scope of sections 4, 5 and 7. The Supreme Court, in *FPC v. Hope Natural Gas Co.*,[38] made it clear very early that sections 4 and 5 served a purpose distinct from that of section 7.[39] Thus, with very few exceptions, the FERC did not use section 7 to tinker with rates but relied instead on

30. 15 U.S.C. § 717f(c) (1982).

31. United Gas Pipe Line Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1956).

32. The Court, in Atlantic Refining Co. v. Public Serv. Comm'n, 360 U.S. 378 (1959) [hereinafter Catco], stated that a sale "should not be permanently certificated unless the rate level has been shown to be in the public interest." *Id.* at 390 (quoting Continental Oil Co., 17 F.P.C. 563, 575 (1957)). The Commission must give "a most careful scrutiny and responsible reaction to *initial* price proposals under [section] 7." Catco, 360 U.S. at 391 (emphasis added). The name Catco is derived from the initials of four natural gas producers involved in the case: Continental Oil Co., Atlantic Refining Co., Tidewater Oil Co. and Cities Service Production Co.

33. Some of the factors to be considered by the Commission were initially set forth in Kansas Pipeline and Gas Co., 2 F.P.C. 29 (1939). The applicant must show, inter alia, adequate gas supply, sufficient market, ability to render full and complete service, adequate financial resources, reasonable and adequate cost estimates of both fixed and variable costs, anticipated rates and revenues, and public need or benefit. *See* Wheat, *Administration by the Federal Power Commission of the Certificate Provisions of the Natural Gas Act*, 14 GEO. WASH. L. REV. 194 (1945); J. M. Johnson, Federal Natural Gas Regulation (Nov. 1986). Other relevant factors include policies and laws administered by other agencies. *See, e.g.*, City of Pittsburgh v. FPC, 237 F.2d 741 (D.C. Cir. 1956). Of special importance is any adverse environmental impact. *See* 18 C.F.R. § 157.14 (1987). Antitrust implications are also of prime importance. *See, e.g.*, Northern Natural Gas Co. v. FPC, 399 F.2d 953 (D.C. Cir. 1968).

34. 15 U.S.C. § 717f(e) (1982).

35. 15 U.S.C. § 717c(a) (1982) provides:

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

Id.

36. 15 U.S.C. § 717d(a) (1982).

37. 15 U.S.C. § 717c(d) (1982).

38. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

39. In *Hope*, it was argued that the FPC failed to address conservation considerations in a rate hearing under section 5. The Court indicated that while conservation considerations may be appropriate in a section 7 proceeding, they were not material to a determination of the rate an operator should earn on a previously approved service. According to the Court, "[sections] 4 and 5, not [section] 7, provide the standards for that determination." *Id.* at 612. Thus, the Court made it clear that sections 4 and 5 are to be used for rate review and section 7 for certification; the considerations for these determinations should not be mixed. *Id.*

sections 4 and 5.[40]

Until the Supreme Court decision in *Phillips Petroleum Co. v. Wisconsin*,[41] extending the scope of the NGA to producers as well as pipelines, the regulatory scheme worked "smoothly."[42] However, in the years following *Phillips* there was a dramatic increase in the Commission's workload.[43] Because of this increased burden on the Commission, the rate review process under section 5 became "nigh interminable."[44] Consequently, the Commission was unable to adequately police the pipelines and the consumers were no longer assured of just and reasonable rates.

In an effort to ensure that pipelines' and producers' initial rates for new services were just and reasonable, the Commission began imposing an "in-line" pricing condition on section 7 certificates. This condition required the initial rate charged for a new service to be set at a level comparable with those in the area that had previously been found to be just and reasonable.[45] This practice was approved by the Supreme Court in *Atlantic Refining Co. v. Public Service Commission*[46] (*Catco*), as a valid exercise of the Commission's section 7 conditioning authority.[47] Since then, the Commission has frequently used the "in-line" pricing condition to require *initial rates* for the certificated service to be set at acceptable levels. However, not until *Panhandle* was the Commission's conditioning authority used to alter *existing rates* not at issue in the given certification proceeding.[48]

In *Panhandle*, the pipeline was faced with excess system capacity due to

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40. Northern Natural Gas Co. v. FERC, 827 F.2d 779, 788 (D.C. Cir. 1987) (en banc).

41. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

42. *Northern*, 827 F.2d at 788. Prior to *Phillips*, the FPC was faced with only about 700 pipeline rate filings per year. 1955 FPC ANN. REP. 108. With this relatively small number of filings, it was apparently no great task for the Commission to use section 5 to pursue rate reductions after an initial certification.

43. In the year following *Phillips*, the FPC was faced with 709 pipeline rate filings and 10,978 filings from producers. 1955 FPC ANN. REP. 108.

44. Catco, *supra* note 32, at 389. This point was also graphically illustrated in Phillips Petroleum Co., 24 F.P.C. 537 (1960), *aff'd sub nom.* Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1961), *aff'd*, 373 U.S. 294 (1963), wherein the Commission, describing its plight, stated:

> The producers have on file with us 11,091 rate schedules and 33,231 supplements to these schedules. . . . The number of completions of independent producer rate cases per man-year during the first 6 years following the Phillips decision indicate that nearly 13 years would be required for our present staff to dispose of the 2,313 cases pending on July 1, 1960. Within this 13-year period an additional estimated 6,500 cases would be received. . . . Thus, if our present staff were immediately tripled, and if all new employees would be as competent as those we now have, we would not reach a current status in our independent producer rate work until 2043 A.D. . . .

Id. at 545-46.

45. If the pipelines desired a higher rate, they were forced to file a request under section 4. While this did nothing to alleviate the Commission's backlog, and allowed the pipelines to charge the higher rates after the proper waiting period, it did provide the consumers with the refund protection available under section 4 but not under section 5.

46. Catco, *supra* note 32.

47. The Court emphasized that "in granting such conditional certificates the Commission does not determine initial prices nor does it overturn those agreed upon by the parties. Rather, it so conditions the certificate that the consuming public may be protected." *Id.* at 392.

48. This point was emphasized by the *Panhandle* court which stated that the "FERC has not cited, and our own research does not disclose, any judicial authority holding that the Commission may tinker with rates previously found just and reasonable in conditioning a certificate dealing with other sales or services."

the current shortage of natural gas. In an effort to utilize that capacity, the pipeline applied for a certificate of public convenience and necessity to transport gas for another pipeline.[49] By providing this new service, Panhandle would realize additional revenues while incurring little additional cost.[50] The proposal was approved by the Commission[51] subject to the condition that all revenue from the new service be credited to the account of the pipeline's resale customers.[52] Claiming authority under section 7, the FERC imposed this condition to prevent the pipeline from reaping a windfall.[53] On rehearing, the revenue-crediting condition was upheld and the pipeline subsequently appealed.[54]

On appeal to the D.C. Circuit Court[55] the pipeline claimed that the Commission's order violated the rate review requirements of section 5.[56] In its defense, the Commission claimed that, in light of *Catco*, it had validly exercised the broad conditioning power granted by Congress under section 7.[57] The court struck down the condition as an abuse of the section 7 conditioning power[58] and concluded that to allow such a condition would (1) emasculate the role of section 5,[59] (2) erode the protections against regulatory lag[60] and

Panhandle E. Pipe Line Co. v. FERC, 613 F.2d 1120, 1132 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 889 (1980).

49. Panhandle and its subsidiary, Trunkline, filed a joint application to transport up to 3000 Mcf.

50. Panhandle agreed to charge $7650 per month for the transportation service. Since the service was made possible by excess capacity in the pipeline, the only costs incurred by Panhandle were the administrative expenses associated with the service.

51. Panhandle E. Pipe Line Co., 1 F.E.R.C. ¶ 61,249 (1977).

52. The FERC originally required that the gross revenue generated by the new service be credited to the Purchased Gas Adjustment (PGA) account. The purpose of the PGA is to allow pipelines to adjust their rates to compensate for changes in the cost of purchased gas without making frequent rate filings under section 4. Under this system, purchased gas costs are monitored over a six month period. If actual costs exceed the latest estimate of gas costs, the consumers must pay a surcharge. If actual costs fall below current estimates, consumers are given a credit. *See* 18 C.F.R. § 154.38(d)(4) (1987); Purchased Gas Cost Adjustment Provisions in Natural Gas Pipeline Companies' FPC Gas Tariffs, Order No. 452, 47 F.P.C. 1049 (1972). By crediting the revenue from the transportation service to the PGA account, the revenue was thus effectively passed on to the consumers either in the form of a lower rate or a smaller increase in rates upon the next rate adjustment.

53. The Commission's rationale for the condition was that the rates set in Panhandle's most recent rate case were based on the cost of existing services and did not include the transportation service. Since the rates already in place were designed to cover Panhandle's costs, and Panhandle could recover those costs through existing operations, any revenue generated by the transportation service should "inure to the benefit of all [Panhandle's] resale customers." *Panhandle*, 613 F.2d at 1123.

54. Panhandle E. Pipe Line Co., 2 F.E.R.C. ¶ 61,156 (1978). The Commission did however amend its original order by allowing Panhandle to recover any out-of-pocket expenses resulting from performance of the new service. *Panhandle*, 613 F.2d at 1123.

55. *Panhandle*, 613 F.2d 1120.

56. Panhandle also alleged that the Commission's orders violated its own regulations regarding the PGA clause and that the condition was unfair, discriminatory and contrary to precedent. *Id.* at 1127.

57. The Commission also maintained that the condition was required to prevent a double recovery of fixed costs by Panhandle and that it did not violate PGA regulations or precedent. *Id.*

58. The court indicated that the section 7 conditioning power might permit such conditions in the absence of sections 4 and 5. However, in practice, section 7 must be read in light of sections 4 and 5 to bar such conditions. *Id.* at 1128-29.

59. In the court's view, if a certificate could be conditioned to adjust rates for services not under consideration, there would be little need for section 5. The FERC could instead condition certificates on

rate instability,[61] and (3) circumvent the section 5 requirement of a hearing and findings.[62] The court interpreted *Catco* to allow the Commission to "hold-the-line" only on *initial rates* pending a determination of just and reasonable levels.[63] The court thus held that the Commission may not order adjustments in previously approved rates for services not before the Commission in the certification proceeding.[64]

IV. The *Northern* Decision

After recounting the facts and holding in *Panhandle* and the earlier *Panel Decision*, the court first addressed the issue of whether *Panhandle* should be overruled. Guided by the parameters of *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[65] the court endeavored to determine whether the *Panhandle* court was correct in concluding that the Commission's interpretation of its section 7 conditioning authority was unreasonable.[66]

In support of its interpretation of section 7, the FERC claimed that (1) the condition did not serve to adjust previously certificated rates, and that (2) its interpretation was justified under *Catco* since it was the Commission's intent to prevent the pipeline from reaping a windfall and to hold-the-line on the pipeline's rate of return prior to the next rate case. The court summarily dismissed the first contention[67] and focused on what it considered to be the real issue: "whether the *Panhandle* court properly held that the [section] 7(e) 'conditioning power does not extend to adjusting rates for services not before the Commission in the relevant certificate proceeding.' "[68] The court looked

rate reductions for other services and use section 5 as a stopgap device only when the pipeline makes no new certificate filings. *Id.* at 1129.

60. The court reasoned that one of the aims of the NGA is to provide for recovery of costs and a reasonable rate of return by the pipelines. In this light, Congress granted certain protections against regulatory lag. Specifically, in the event the FERC fails to act on a section 4 rate proposal by the pipeline, after a five month waiting period the pipeline may nevertheless charge the higher rate subject to a refund of those amounts later determined to be in excess of just and reasonable levels. *Id.* at 1129-30.

61. *See infra* note 99.

62. The court noted that the "law seems clear" that previously approved rates may not be adjusted under sections 4 and 5 unless they are found to be unjust and unreasonable. To allow the Commission to use section 7 to adjust rates previously found to be just and reasonable without a specific finding that they are not so would be "ironic." *Panhandle*, 613 F.2d at 1130.

63. The Supreme Court's concern in *Catco* with initial rates was warranted because the consumers had no protection against excessive initial rates other than a section 5 action which could drag out for years and provided no refund protection. When dealing with previously approved rates, however, this danger is not present since consumers are paying rates which have already been subjected to just and reasonable review. *Id.* at 1131-32.

64. The court noted that it was not addressing the issue of whether the FERC may condition a certificate on the reduction of rates previously certificated but not yet found to be just and reasonable. *Id.* at 1130 n.50.

65. Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

66. *See infra* notes 84-86 and accompanying text.

67. The court indicated that rate means the "amount that a customer pays and a utility receives for a unit of a particular service." *Northern*, 827 F.2d at 786. The condition in *Northern* as well as in *Panhandle* lowers the amount paid. The fact that this is done by requiring unanticipated revenues to be disposed of through the PGA is "of utterly no moment - 'a difference without distinction.' " *Id.* (quoting *Panhandle*, 613 F.2d at 1130 n.52).

68. *Northern*, 827 F.2d at 786 (quoting *Panhandle*, 613 F.2d at 1129).

primarily to *Catco* to resolve the issue.

Upon examining the purpose of the NGA[69] and the resulting regulatory framework at the time of *Catco*, the court concluded that *Catco* represented an innovative approach to section 7 required by the inordinate delay in section 5 proceedings, and that *Catco* indicated the "extremely limited nature of the Commission's rate setting authority under section 7."[70] The court stressed that the in-line pricing condition did nothing more than hold-the-line on initial rates pending a determination of their validity under the just and reasonable standard; the in-line condition did not allow the Commission to set rates outside of the mechanism provided in sections 4 and 5. Instead, the condition is simply an "interim measure"[71] whereby sections 4 and 5 are given their full effect of guaranteeing just and reasonable rates to consumers. Thus, the court concluded that *Catco* indicates the Supreme Court intended to "preserve the integrity of 'just and reasonable' rate review."[72]

The court next concluded the Commission's interpretation of *Catco's* hold-the-line proposition was faulty.[73] The revenue-crediting condition in *Panhandle* did not hold-the-line on rates but rather replaced "a rate previously determined to be just and reasonable with one that [had] not been put to that test."[74] Thus, unlike the condition in *Catco*, the revenue-crediting condition did not preserve the integrity of rate review under sections 4 and 5. The court further rejected the FERC's attempt to read *Catco* to allow it to hold-the-line on the pipeline's rate of return.[75]

The court next summarily confirmed the conclusions in *Panhandle* that the revenue-crediting condition (1) emasculated the role of section 5, (2) eroded the protections against regulatory lag and rate instability, and (3) circumvented the section 5 requirements of a hearing and findings. As a result, the court found that the revenue-crediting condition was not based on a "reasonable interpretation" of section 7 and was thus invalid under *Chevron*.[76]

Upon affirming *Panhandle*, the court focused on whether *Panhandle* pre-

69. The court stated:

> Congress' concern in regulating the provision of services and facilities under section 7 was to avoid "the possibilities of waste, uneconomic and uncontrolled extensions," thereby "conserving one of the country's valuable but exhaustible energy resources" as well as ensuring "the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest."

Id. at 787 (citations omitted).

70. *Id.* at 790.

71. *Id.* (citing United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 227 (1965)).

72. *Id.* at 790.

73. The Commission's argument was apparently based on Judge Wright's dissent in *Panhandle* that revenue crediting was the "classic situation in which the Commission employs the [s]ection 7 conditioning power—to 'hold the line' or maintain the status quo—until" the next rate case. *Panhandle*, 613 F.2d at 1146 (Wright, J., dissenting).

74. *Northern*, 827 F.2d at 791.

75. The court noted that there is nothing in *Catco* to indicate that the Supreme Court was attempting to allow the Commission to "hold-the-line" on rate of return. More important to the court however, was that, contrary to the Commission's conclusion that the condition was the only "practical means" of preventing the pipeline from reaping a windfall, the Commission had other sufficient means under the Act to limit the pipeline's rate of return. *Id.* at 792.

76. *Id.* at 792 (quoting *Chevron*, 467 U.S. at 844).

cluded the condition imposed by the FERC in Northern's certificate. The FERC argued that the condition was necessary to prevent rate instability[77] and to avoid undue discrimination[78] and that without it the Commission would be forced to deny the certificate as not required by the public convenience and necessity. However, the court concluded that these reasons, if valid, would not overcome the mandate of *Catco* that the statutory integrity be preserved.

The court also rejected the Commission's argument that the rates for the non-eligible consumers were necessarily before the Commission in the section 7 proceeding and that to properly evaluate the discount service it was necessary to analyze the non-discount service.[79] In the court's view, although it was entirely proper to *consider* Northern's overall rate structure, as well as any other factors bearing on the public convenience and necessity,[80] it was improper to *adjust* previously approved rates. According to the court, the "clear import" of *Panhandle* was that the "Commission may condition only the rate of the particular service for which certification is sought"[81] such as is done with the in-line price condition. The Commission may not adjust previously approved rates for customers not receiving the service to be certificated. Since this is what the FERC attempted to do in *Northern*, the court held that the condition was invalid.

V. ANALYSIS

Northern and *Panhandle* concern the struggle between the Commission and the pipelines over the *extent* of the FERC's rate setting authority under section 7.[82] The boundaries of this encounter are set by *Chevron* while the battle itself is fought over the meaning of *Catco*.

Under section 7, the conditioning power of the FERC seems broad indeed and it is thus implicit that the FERC attempt to define the scope of its authority thereunder.[83] Courts are required to give great deference to the stat-

77. The Commission claimed that Northern was trying to change previously approved rates and that the condition was necessary to correct for the resulting rate instability caused by Northern. *Northern*, 827 F.2d at 793.

78. The Commission also argued that, without the condition, the rates would become unduly discriminatory in violation of section 4(b). 15 U.S.C. § 717c(b) (1982). However, in his initial decision the ALJ clearly explained that, since both eligible and non-eligible consumers would benefit from the new service, the pricing difference was warranted and thus, there was no *undue* discrimination. *See* Initial Decision, *supra* note 11, at 65,277-78.

79. *Northern*, 827 F.2d at 794. This rationale was used by the Commission to distinguish *Panhandle*. *See* Order Denying Rehearing, *supra* note 23. The Commission claimed that, unlike the *Panhandle* situation which involved two distinct types of services, here the services were similar. Because of this similarity the Commission felt that the rate impact of all Northern's customers was necessarily before it.

80. *See supra* note 33 for the factors bearing on a certificate of public convenience and necessity.

81. *Northern*, 827 F.2d at 795.

82. As noted in the Panel Decision, "once it is acknowledged that the Commission has authority to fix *some* rates under section 7, *see Atlantic Refining* [*Catco*], . . . one is merely arguing over *how much* section 7 will be permitted to override the purposes of sections 4 and 5." Panel Decision, *supra* note 25, at 62 (emphasis in original).

83. *See supra* note 6.

utory interpretation made by an administrative agency[84] and may not "substitute [their] own construction of a statutory provision for a reasonable interpretation made by the administrative agency."[85] If the agency's choice represents a "reasonable accommodation of conflicting policies [the court] should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned."[86] It was under this directive that the *Northern* court correctly set about determining the reasonableness of the FERC's revenue-crediting condition. Whether the FERC's interpretation of its authority to impose the revenue-crediting condition was reasonable must turn on the respective roles sections 4, 5 and 7 were intended by Congress to play in the overall statutory scheme. *Catco* is the key to discerning this intent.[87]

The Supreme Court in *Catco* gave section 7 "only that scope necessary for a 'single statutory scheme under which all rates are established initially by the natural gas companies, by contract or otherwise, and all rates are subject to being modified by the Commission.' "[88] In other words, the in-line condition was carefully devised to remain consonant with the aims of the act — to allow the pipelines to independently bargain for and set initial rates while allowing the FERC to provide full protection of the public interest under just and reasonable rate review. Viewed by the court, the in-line price condition of *Catco* supported these goals but, at the same time, did not act in derogation of sections 4 and 5. Thus, the condition served to "preserve the integrity of just and reasonable rate review."[89]

The thrust of the *Northern* decision is that the FERC, by imposing the revenue-crediting condition, had violated the integrity of the statutory scheme. In effect, the FERC had destroyed those protections which were *expressly* given the pipelines by Congress under section 5, to-wit: "[w]henever the Commission, *after a hearing* . . . shall *find*"[90] any rate unjust or unreasonable it may then decrease it to proper levels. This is an *express* directive from Congress that the Commission may not lower rates without a hearing and findings to support its action. As required by *Chevron*, "the court, as well as the agency, *must* give effect to this unambiguously expressed intent of Congress."[91]

Once section 5 is given that scope which was clearly expressed by Congress, the construction given to section 7 must not denigrate the function of

84. *Chevron*, 467 U.S. at 844.

85. *Id.* There may of course be more than one permissible construction of a statute. An agency's construction, so long as it is reasonable, should be upheld regardless of whether it is the one preferred by the court. *Id.* at 843 n.11.

86. *Id.* at 845 (quoting United States v. Shimer, 367 U.S. 374, 383 (1961)).

87. The court noted: "The *Panhandle* court, the dissent in that case, and the Commission all agree that the key to resolving this question is the Supreme Court's decision in [*Catco*], but they disagree fundamentally on what that case stands for." *Northern*, 827 F.2d at 786.

88. *Id.* at 790 (quoting *Catco*, 360 U.S. at 392).

89. *Northern*, 827 F.2d at 790.

90. 15 U.S.C. § 717d(a) (1982) (emphasis added).

91. *Chevron*, 467 U.S. at 842-43. (emphasis added).

section 5.[92] The *Northern* court simply construed the *generally* worded section 7 so as to take nothing away from the *specific* provisions of section 5. In this way, the court preserved the integrity of the statutory scheme as did the court in *Catco*, while at the same time it gave reasonable effect to all the statutory provisions. It is this process of preserving statutory integrity that is the lesson to be learned from *Catco*.[93]

If *Catco* were to extend beyond providing for the preservation of the statutory integrity to permit broad rate conditioning under section 7, then a key question must be addressed: why did the Supreme Court in *Catco*, to give the protections of the section 4 refund provisions, require the FPC to use the circuitous method of imposing the in-line pricing condition?[94] If section 7 is as broad as the FERC contends, shouldn't the Supreme Court simply have taken the direct approach and allowed the Commission to impose a refund condition on the certificate that would require the pipeline to refund any charges in excess of the just and reasonable rates established in the next section 5 proceeding? Clearly the court could not take the direct route because section 5 *implicitly* did not allow for it.[95] So too, the FERC may not alter previously approved rates in a section 7 proceeding because section 5 *expressly* tells the Commission how to go about changing rates.[96]

While the above is perhaps the best rationale supporting the *Northern* court's decision, the other factors adopted by the court from the *Panhandle* decision cast further doubt on the validity of the revenue-crediting condition. First, and perhaps equally as important, the condition would "emasculate the role of section 5 in the ratemaking scheme [thereby reducing it] to a stopgap device."[97] While this may be somewhat of an overstatement[98] it is doubtless that the role of section 5 would be greatly diminished. Here too, the fact that

92. This is, of course, the accepted method of statutory construction. Both sections must be construed so as to give effect to each. However, the specific provisions must control over the general. *See, e.g.*, Pitzak v. Office of Personnel Management, 710 F.2d 1476 (10th Cir. 1983); Castanada-Gonzalez v. INS, 564 F.2d 417 (D.C. Cir. 1977). As noted in *Panhandle*, "section 7's broad conditioning power must be read in conjunction with sections 4 and 5." *Panhandle*, 613 F.2d at 1128-29.

93. The *Northern* court noted:

> [W]hat mattered was that the Commission's exercise of section 7 conditioning authority negated the requirements of sections 4 and 5. The approach taken by the Supreme Court in *Catco* and by this court . . . [is] to determine the propriety of [the] Commission's activities under section 7 by anticipating their impact on the interests implicated in sections 4 and 5 . . . .

Northern, 827 F.2d at 790 n.37.

94. The purpose of the in-line condition was to force the pipelines to file a section 4 rate action instead of relying on the Commission to bring a section 5 action. This would insure consumer protection through the refund provision available under section 4 but not available under section 5. *Id.* at 792.

95. Congress expressly provided for a refund under section 4. Because of this, it must be assumed that Congress, by not providing for a refund under section 5, intended for there to be no refunds in a section 5 proceeding.

96. "[T]he revenue-crediting condition replaces a rate previously determined to be 'just and reasonable' with one that has not yet been put to that test, thereby violating the dictate of section 5 that a rate remain in place until the Commission, after having conducted an evidentiary hearing, finds it no longer 'just and reasonable.' " *Northern*, 827 F.2d at 791.

97. *Panhandle*, 613 F.2d at 1129.

98. As noted by Chief Judge Wald in his dissent, "proceedings under section 4 and 5 will continue to govern the vast majority of rate determinations." *Northern*, 827 F.2d at 797 (Wald, C.J., dissenting).

Congress expressly tells the Commission how to change rates indicates that Congress could not have intended such a diminished role for section 5. Second, the condition would seriously affect rate stability.[99] Finally, the condition would substantially dilute the protection against regulatory lag.[100] These factors, when taken together, militate strongly against the FERC's revenue-crediting condition—especially in light of the crucial fact that the FERC had various alternative means of effectively protecting the consumers without destroying the statutory integrity.

The FERC asserted that without the revenue-crediting condition it would be forced to deny the certificate because it could not otherwise adequately protect the consumers.[101] However, the court correctly concluded that the Commission had "ample authority, apart from the revenue-crediting condition, to ensure that an operation would earn 'just and reasonable' rates on its existing and proposed services."[102] First, the Commission could, immediately after the certification, initiate a section 5 proceeding to alter the rates of both the existing and proposed services. In this way, the Commission could legitimately consider both rates together in determining just and reasonable levels. While it is true that a proceeding under section 5 would result in some delay before final rates could be determined, it must be remembered that the consumers are currently paying rates that have already been determined to be just and reasonable. Thus, the consumers are adequately protected in the interim period. Second, the Commission could impose an in-line pricing condition as in *Catco*, coupled with a condition that would require any subsequent rate review under section 4 to encompass both the existing and the new services. This would force the pipeline to immediately file a section 4 rate action encompassing rates for both services and thus provide the consumers with the refund protection of section 4. Finally, at least in dealing with transportation services, the Commission could, as suggested in *Panhandle*, use rulemaking power to establish a tracking mechanism similar to the PGA clause[103] and thus ensure that any unexpected revenue or costs incurred in connection with transportation services would be reflected in the rate paid by consumers. These alternatives surely allow the Commission ample means to protect the consumers without violating the statutory integrity of the NGA.

99. In this context it is critical to note that rate changes under section 5 are prospective only and the pipeline cannot be required to issue refunds. In other words, once a rate is approved, the pipeline can count on receiving that rate until the next section 4 or 5 proceeding. If rates could be altered in a section 7 certificate, this measure of stability would be destroyed. *Panhandle*, 613 F.2d at 1129-30.

100. If previously approved rates could be reduced by section 7 conditioning, the pipeline would be forced to file a section 4 rate increase. As noted by the *Panhandle* court, this is a time consuming process. *Id.* at 1130 n.48. Thus, "[i]n addition to the thirty-day filing period and five-month rate suspension period prescribed by the Act, a pipeline would be deprived of the revenues from previously approved rates during the time necessary to prepare new section 4 filings." *Id.* at 1130.

101. The FERC contended that failure to impose the revenue-crediting condition would upset rate stability and would be unduly discriminatory, and that either result would force them to deny the certificate. The court, however, reiterated that *Catco* would not provide support for the Commission to ignore the requirements of sections 4 and 5 even to prevent these "evils." *Northern*, 827 F.2d at 793-94.

102. *Id.* at 792.

103. *Panhandle*, 613 F.2d at 1133.

VI. Conclusion

Although the overriding purpose of the NGA is to protect the consumer, Congress, as part of its comprehensive statutory scheme, also provided various safeguards which allow the pipelines some measure of stability and protection. The *Northern* decision emphasizes that the Commission may not ignore those safeguards and violate the integrity of this statutory scheme in blind pursuit of its ultimate goal of consumer protection. In the end result, the revenue-crediting condition could not be sustained because it seriously overstepped the bounds of section 7 conditioning authority in order to accomplish a result that could be achieved through less offensive means.

ROBERT JOSEPH JOYCE