

STUDENT NOTE

ELIMINATION OF VARIABLE COSTS FROM NATURAL GAS MINIMUM BILLS: *WISCONSIN GAS CO. v. FERC*

On May 25, 1984, the Federal Energy Regulatory Commission issued Order No. 380, which prohibited the use of minimum bills by interstate natural gas pipelines to the extent that the bills allow recovery of variable costs attributable to gas not actually purchased by customers.¹ The U.S. Court of Appeals for the District of Columbia Circuit, in *Wisconsin Gas Co. v. FERC*,² largely affirmed that order. This article consists of four sections. The first describes the economic environment in which the order was issued. The second summarizes the Commission's decision. The third analyzes the D.C. Circuit's opinion in the *Wisconsin Gas* case, and the fourth discusses recent cases which directly or indirectly have applied the rule.

I. THE ECONOMIC CONTEXT

Traditionally, minimum bills³ in pipeline tariffs have been permitted for three reasons. First, minimum bills operate in the same manner as an additional demand charge,⁴ shielding a pipeline from the risk of underrecovering

1. Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, Order No. 380, 49 Fed. Reg. 22,778 (1984).

2. *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985).

3. There are two types of minimum bills. The "minimum commodity bill" requires a customer to pay a commodity charge for a minimum volume of gas whether or not that amount is actually taken. *See, e.g., Wisconsin Gas*, 770 F.2d at 1150; *Mississippi River Transmission Corp. v. FERC*, 759 F.2d 945, 948-49 (D.C. Cir. 1985); *Lynchburg Gas Co. v. FPC*, 336 F.2d 942, 945 (D.C. Cir. 1964); Order No. 380, *supra* note 1, at 22,779; A. TUSSING & C. BARLOW, *THE NATURAL GAS INDUSTRY* 7, 19 (1984). A "minimum take" provision requires customers physically to take a minimum level of gas, without allowing the option of merely paying for gas not taken. *See, e.g., Wisconsin Gas*, 770 F.2d at 1150. The term "minimum bills" will hereinafter refer to minimum commodity bills and minimum take provisions interchangeably.

4. Most major pipelines recover costs through a two-part rate, divided between the demand charge and the commodity charge. The "demand charge" is a fixed amount which is generally levied as a proportion of the maximum amount of gas a customer has the contractual right to purchase on a given day. *See, e.g., Wisconsin Gas*, 770 F.2d at 1150; *Mississippi River*, 759 F.2d at 948; *Atlantic Seaboard Corp. v. FPC*, 404 F.2d 1268, 1269 n.1 (D.C. Cir. 1968); Order No. 380, *supra* note 1, at 22,779; TUSSING & BARLOW, *supra* note 3, at 7. The ceiling amount the customer has a right to purchase is generally known as the customer's "contract entitlement." *See, e.g., Order No. 380, supra* note 1, at 22,779 n.5. The "commodity charge" is a unit charge assessed on the amount of gas actually received by the customer. *See, e.g., Wisconsin Gas*, 770 F.2d at 1150; *Atlantic Seaboard Corp.*, 404 F.2d at 1269 n.1; *Lynchburg Gas Co.*, 336 F.2d at 944; Order No. 380, *supra* note 1, at 22,779; TUSSING & BARLOW, *supra* note 3, at 8. Therefore, while the demand charge is usually a fixed monthly amount, the commodity charge varies with purchase fluctuations.

Some pipelines utilize a three-part rate with a gas component in addition to the demand and commodity components. A gas rate "includes just variable gas supply costs and is billed on the basis of heat content of

the fixed costs⁶ chargeable to the commodity component of its rates.⁶ Second, minimum bills ensure that partial requirements customers⁷ bear an equitable share of fixed costs allocable to them, since the pipeline must maintain sufficient capacity to serve the customer's entire contract entitlement.⁸ Third, minimum bills insulate both full⁹ and partial requirements customers from incur-rence by the pipeline of increased take-or-pay liabilities resulting from the pipeline's inability to take the full contract volume from its suppliers.¹⁰

The environment in which the order partially outlawing minimum bills was issued consisted of rising gas prices,¹¹ occurring simultaneously with a severe recession and a corresponding drop in oil prices. Industrial and residential consumers began to conserve on oil and gas consumption, further exacerbating the problem. A deliverability surplus of natural gas ensued. Pipelines could not respond to changed market conditions because their long-term contracts, entered into during a time of scarcity, committed them to substantial take-or-pay obligations.¹² Other circumstances, including mild weather and increased com-

the volumes delivered." Tennessee Gas Pipeline Co., 27 F.E.R.C. ¶ 63,090 at 65,358 (1984).

5. A pipeline incurs two kinds of costs in providing service to its customers: variable and fixed. Variable costs are contingent upon the volumes of gas delivered by the pipeline—they vary with throughput. The cost of purchased gas is the main component of variable costs. See, e.g., *Mississippi River*, 759 F.2d at 948 n.3. Fixed costs do not vary with throughput; they relate to maintaining capacity of the plant and are incurred regardless of sales or delivery volumes. See, e.g., *id.* Fixed costs include depreciation, return on equity, interest expense and income taxes. See, e.g., TUSsing & BARLOW, *supra* note 3, at 7.

6. See, e.g., *Wisconsin Gas*, 770 F.2d at 1150; Order No. 380, *supra* note 1, at 22,780.

7. A partial requirements, or "swing," customer, because of favorable geographic location, need not rely on one pipeline supplier, but instead may swing between suppliers depending upon which supplier can provide less expensive gas. See, e.g., *Wisconsin Gas*, 770 F.2d at 1150; *Mississippi River*, 759 F.2d at 948; Order No. 380, *supra* note 1, at 22,780; Massella, *Elimination of Variable Costs in Natural Gas Minimum Bills: Cause and Effect*, PUB. UTIL. FORT., Aug. 3, 1984 at 51, 53.

8. See, e.g., *Wisconsin Gas*, 770 F.2d at 1150; *Atlantic Seaboard Corp.*, 404 F.2d at 1270; *Lynchburg Gas Co.*, 336 F.2d at 945; Order No. 380, *supra* note 1, at 22,780; TUSsing & BARLOW, *supra* note 3, at 20.

9. Full requirements, or "captive," customers purchase all of their gas from one pipeline because that pipeline is the only supplier in the geographic area. See, e.g., *Mississippi River*, 759 F.2d at 948; Order No. 380, *supra* note 1, at 22,780; Massella, *supra* note 7, at 53.

10. See, e.g., *Wisconsin Gas*, 770 F.2d at 1150; Order No. 380, *supra* note 1, at 22,780.

11. The rising prices occurred due to the enactment of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982), when pipelines and producers entered into new long-term contracts. These contracts incorporated both the increased ceiling prices allowed under the NGPA and high take-or-pay requirements. Accordingly, gas prices rose significantly in a few years' time. See, e.g., Order No. 380, *supra* note 1, at 22,781.

For discussions of the NGPA, see Hollis & Strohl, *Squaring the Circle: Implementing the Agricultural Use Exemption from Incremental Pricing Under the Natural Gas Policy Act*, 15 NAT. RESOURCES LAW. 419 (1981); Means, *Issues in the Debate Over Natural Gas Decontrol*, PUB. UTIL. FORT., Oct. 28, 1982, at 18; Mogel & Mapes, *Assessment of Incremental Pricing Under the Natural Gas Policy Act*, 29 CATH. U.L. REV. 763, 774-80 (1980); Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345 (1983); Ringleb, *The Natural Gas Regulatory Dilemma: A Market Solution, Another Complex Compromise, or the Status Quo?*, 6 J. ENERGY L. & POL'Y 107 (1985); Sawhill & Coda, *Responding to Competition—Regulators Trail the Gas Industry*, PUB. UTIL. FORT., Oct. 25, 1984, at 24; Tussing & Barlow, *The Rise and Fall of Regulation in the Natural Gas Industry*, PUB. UTIL. FORT., Mar. 4, 1982, at 15.

12. Take-or-pay obligations commonly occur in contracts between gas producers and pipelines. Under a take-or-pay clause, a pipeline must take or, if not taken, pay for a minimum volume of gas. They differ from minimum bills in that pipelines may make up penalty payments by offsetting the penalty charges

petition from alternative sources of energy, aggravated an already oppressive situation.¹³

Minimum bills became an anathema in this changing environment owing to their recovery of variable costs. Because gas purchase costs, the major component of variable costs, had risen so markedly, variable costs represented a much larger percentage of the minimum bill charge than ever before.¹⁴ This condition became especially troublesome when partial requirements customers, because of the size of minimum bills, were forced to remain on the system even when lower cost gas was available elsewhere. If a customer chose to swing off the system, it was forced to pay higher minimum bill charges for gas it did not receive, resulting in a windfall for the pipeline. In this environment, the Federal Energy Regulatory Commission (FERC or Commission) determined that the traditional justifications for minimum bills were not outweighed by the negative results of their use. Two impacts concerned the Commission. First, minimum bills result in the recovery of charges which are not actually incurred by the pipeline. Second, minimum bills serve as an obstruction to competition because market signals are not accurately transmitted from the burnertip (customer) to the wellhead (producer).¹⁵ As a result of these concerns, the Commission issued a Notice of Proposed Rulemaking in August of 1983,¹⁶ in which it proposed the removal from minimum commodity bills of variable costs not actually incurred.¹⁷

II. ORDER NUMBER 380: THE COMMISSION DECISION

The main issue with which the Commission dealt in Order No. 380 was whether the passthrough of variable costs via a pipeline's minimum commodity bill tariff provision was an "unjust and unreasonable rate or charge under sections 4 and 5 of the Natural Gas Act [NGA]."¹⁸ Section 4 of the NGA mandates that all rates and charges made by any "natural gas company,"¹⁹ and all rules and regulations applying to such rates and charges, must be "just and reasonable."²⁰ Pursuant to section 5, the Commission, upon a finding that a rate or charge is "unjust, unreasonable, unduly discriminatory, or preferential," has a duty to ascertain the just and reasonable rate to be complied with, and to

against subsequent gas purchases exceeding the take-or-pay minimum. Consequently, regardless of take-or-pay provisions, pipelines often avoid liability for gas not taken. See, e.g., *Wisconsin Gas*, 770 F.2d at 1150-51, 1160; Order No. 380, *supra* note 1, at 22,780.

13. See, e.g., Order No. 380, *supra* note 1, at 22,781. See also *Wisconsin Gas*, 770 F.2d at 1151.

14. To cite one example, Tennessee Gas Pipeline Company's filing in 1982 showed fixed costs of only 23% of total cost of service, while variable gas costs represented a resounding 73%. *Tennessee Gas Pipeline*, 27 F.E.R.C. at 65,358.

15. See *Wisconsin Gas*, 770 F.2d at 1151; Order No. 380, *supra* note 1, at 22,779.

16. 48 Fed. Reg. 39,238 (1983).

17. See Order No. 380, *supra* note 1, at 28,779.

18. *Id.* at 28,781. The NGA is codified at 15 U.S.C. §§ 717-717w (1982). The aim of the NGA is to "protect consumers against exploitation at the hands of natural gas companies." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).

19. A "natural gas company" may be defined as "a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." 15 U.S.C. § 717a(6) (1982).

20. 15 U.S.C. § 717c (1982).

"fix the same by order."²¹

The Commission held that the recovery of variable costs through minimum bills was anticompetitive and resulted in unjust and unreasonable rates and charges for the following reasons. First, there is a possibility that minimum commodity bills may result in a windfall to the pipelines as costs not actually incurred may be recovered. Second, because partial requirements customers can not swing to other suppliers if forced to pay for higher-cost gas not taken, the minimum bills act as a restraint upon competition. Third, the arguments of pipelines opposing the rule could not outweigh the benefits the Commission expected the rule to provide.²²

As to the first finding, the Commission considered the observations of commenters both in support of and in opposition to the rulemaking. Comments in favor of the proposal noted that: (1) potential variable cost incurrence for gas not taken in the future owing to the absence of demand could be substantial; (2) distributors are not likely to make an effort to conserve energy when they must pay for the gas whether or not they take it; and (3) the bills create a contrived market which conveys false price signals, resulting in more long-term contracts at high prices between pipelines and producers.²³

Arguments in opposition asserted that: (1) variable cost recovery is indispensable to cover take-or-pay liabilities stemming from a customer's failure to purchase its contract entitlement volume; and (2) there are less cumbersome methods of preventing windfalls to pipelines. Both of these arguments were rejected by the Commission, which concluded that even were it to find the arguments persuasive, the restraint-on-competition problem would remain unsolved.²⁴

In reference to the finding that minimum bills are anticompetitive, the Commission specifically determined that:

(a) The inclusion of variable costs in minimum bills immunizes pipelines and their suppliers from normal market risks, facilitating higher price levels than the market would otherwise tolerate.²⁵ This phenomenon is "fundamentally inconsistent with the increasingly competitive wellhead market mandated by Congress in 1978."²⁶

(b) The presence of variable costs in minimum bills hinders the exercise by customers of "least-cost gas purchasing polic[ies]."²⁷

(c) Variable cost recovery through minimum bills leads to higher prices, which in turn cause consumers to select lower-cost alternative energy sources. The result is larger fixed cost responsibility being placed upon the remaining customers.²⁸

21. *Id.* § 717d.

22. Order No. 380, *supra* note 1, at 22,778.

23. *See id.* at 22,781-82.

24. *See id.* at 22,782.

25. *Id.* at 22,782-83.

26. *Id.* at 22,783.

27. *Id.*

28. *Id.* A subsidiary concern regarding industry load loss is presented when oil is the selected alternative fuel. The Commission believes that increased utilization of oil may not be in the best interests of the nation because of the resultant additional reliance on foreign oil supplies. *Id.*

(d) Variable cost recovery is not necessitated by the traditional justifications for minimum bills. On the contrary, minimum bills were created to assure the recovery of some specified level of fixed—not variable—costs.²⁹

(e) Finally, the principle objective of the NGA, “to protect consumers from excessive rates and charges,”³⁰ is transgressed by the recovery of variable costs via minimum bills.³¹

Regarding its final determination that the benefits of the rule outweighed the negative effects, the Commission considered two main objections. The first concerned mutuality of obligations between pipelines and distributors. Some commenters were apprehensive that the rule would cause a “restructuring of the industry,” making a pipeline shoulder the obligation of maintaining a sufficient supply of gas to meet customer needs while discarding the concomitant obligation of the distributor to take all of its contract entitlement.³² Other commenters discredited this argument, noting that the demand charge compensates the pipeline for standing ready to serve and that curtailment plans allow pipelines to ignore the obligation to sell in times of scarce supply.³³ The Commission determined that a restructuring of the industry would be beneficial to the extent that it shifted some risks, fostered competition, and modified gas purchase planning procedures.³⁴

The second objection raised by commenters related to the impact of the rule on full requirements customers. For instance, suppose a pipeline over purchases gas based upon the demand estimates for all customers. If some of those customers do not buy their minimum entitlements, the resulting take-or-pay costs can be passed on to the remaining customers (primarily those who are captive) through the rate base. Additionally, suppose the pipeline reduces its purchases, owing to the risk that customers might swing off the system, and a curtailment situation occurs. If a swing customer returns to the system and claims its full entitlement, the scarce supplies will be apportioned among all customers, possibly falling short of filling the needs of captive customers who have no choice but to remain on the system.³⁵ The Commission concluded that even though these arguments have some validity, the rule should create “offsetting benefits and detriments” to full requirements customers, contingent upon whether they are supplied by a high-cost or a low-cost pipeline. It noted that this was of little help to customers of high-cost pipelines, but reiterated that in the long run, all customers would benefit “as the industry move[d] toward a

29. *Id.* at 22,783-84.

30. *Id.* at 22,784 (citing *Hope Natural Gas*, 320 U.S. at 610).

31. *See id.* at 22,784.

32. *Id.*

33. Curtailment has been said to occur “when an interstate natural gas pipeline company experiences a gas supply shortage which precludes it from meeting all the requirements of all its customers, and, as a result, allocates or rations its available supplies among its customers.” Mogel, *Food, Fuel, and Federal Curtailment Regulation*, 56 CHI.-[KENT L. REV. 789, 793 n.26 (1980) (citing 18 C.F.R. § 281.203(a)(6) (1979)).

For a discussion of the potential liability of pipelines which do indeed ignore the obligation to sell in times of scarce supply, see Note, *Contractual Liability of Pipelines for Damages Caused by Gas Supply Curtailments*: Texasgulf, Inc. v. United Gas Pipeline Co., 6 ENERGY L.J. 281 (1985).

34. *See id.* at 22,784-85.

35. *See, e.g., id.* at 22,785.

competitive balance."³⁶ Thus, the benefits of the rule were judged to outweigh any potential problems, which the Commission believed would be "isolated and of short duration."³⁷

The Commission then addressed concerns as to the intended scope of the rule—exactly which costs would be excluded by its operation. In clarifying this issue, the Commission specified that purchased gas costs must be stated independently from other costs in the pipelines' sales tariffs.³⁸ The Commission also stated that any residual variable costs must be segregated from fixed costs and eliminated from minimum bills as of the effective date of the rule.³⁹ It is important to note that the recovery of fixed costs through minimum bills is not intended to be affected by the rule. Thus, swing customers continue to be obligated to pay any fixed costs imputable to their contract entitlements.⁴⁰

The issue of take-or-pay liability was of great concern to many commenters who requested the Commission to classify take-or-pay prepayments as variable costs *actually incurred*, removing them from the application of the rule. The Commission concluded that there is "no clear nexus" between take-or-pay obligations and minimum commodity bills, while there are ample reasons for differentiating between the two.⁴¹ First, it is frequently the case that no additional take-or-pay payments are incurred even when a customer fails to take gas up to the minimum bill levels.⁴² Second, experience indicates that increases in a pipeline's rate base because of take-or-pay carrying costs have nothing to do with collection of minimum bill charges. Instead, minimum bills are used as a prophylactic measure to avert the incurrence of take-or-pay liabilities in the first place.⁴³ Finally, under the make-up provisions present in take-or-pay clauses, if gas not taken by one customer is purchased at a later date by another, the pipeline may offset its prepayments. The Commission thus held that take-or-pay prepayments may not be recovered through minimum commodity bills.⁴⁴ However, the Commission also noted that take-or-pay carrying costs may need special attention. While it postponed a decision on this matter for a later date, it encouraged its staff to scrutinize carrying cost allocation in individual rate cases.⁴⁵

The Commission next turned to the question whether it had the legal authority to issue a rule changing existing tariffs, as opposed to adjudicating the tariffs on a case-by-case basis. The Commission found that under existing law,⁴⁶ it had the power to alter rates by rulemaking procedures as long as it provided for a hearing. This hearing requirement was deemed satisfied by giving interested parties fair notice and an opportunity to respond by written

36. *Id.* at 22,785-86.

37. *Id.* at 22,786.

38. *Id.*

39. *Id.* at 22,786-87.

40. *See Wisconsin Gas*, 770 F.2d at 1151-52.

41. Order No. 380, *supra* note 1, at 22,787.

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* at 22,787-88.

46. For a more extensive discussion of rulemaking vs. adjudication, see *infra* notes 137-44 and accompanying text.

comments.⁴⁷

Another area of interest to commenters concerned the rule's applicability to existing tariffs derived from settlement agreements. Some commenters asserted that the rule should not have any effect on prevailing settlements since settlements approved by the Commission were binding upon it. While the Commission agreed that the settlements were of an obligatory nature, it determined that once it found a settlement provision to be unjust and unreasonable under section 5 of the NGA, the provisions could be set aside. Thus, the Commission provided that a settlement agreement containing a minimum bill provision which recovered variable costs would come within the ambit of the rule.⁴⁸

The Commission deliberated further upon whether minimum bill issues in pending cases would be terminated by the operation of the rule. The Commission stated that although the ongoing cases would certainly be affected by the rule, these cases were to proceed, to be heard by the administrative law judges or settled whenever possible.⁴⁹

In short, the rule promulgated by the Commission has three effects:

First, it provides that currently existing sales tariffs shall be inoperative to the extent they provide for recovery of purchased gas costs for gas not taken by the buyer. Second, it stipulates that no tariffs filed in the future may provide for recovery of any variable costs associated with gas not taken by the buyer. Third, it requires purchased gas costs to be stated separately on pipeline sales tariff sheets.⁵⁰

III. ANALYSIS OF *Wisconsin Gas Co. v. FERC*

The Commission's primary concern had been whether the collection of variable costs in minimum bills was an unjust or unreasonable rate or charge. The *Wisconsin Gas* court's focuses were: (1) whether the Commission had the statutory authority to make this determination; (2) whether the Commission's determination was supported by substantial evidence; and (3) whether it was carried out using the proper procedures.

A. *Statutory Authority of the Commission to Abolish Variable Costs from Minimum Bills*

The controlling provisions regarding the Commission's power to regulate natural gas are found in sections 4 and 5⁵¹ of the Natural Gas Act. These provisions establish that rates must be just and reasonable, and they give the Commission authority to investigate the rates to ascertain whether the just and reasonable criterion has been met.⁵² Additionally, under section 16 of the

47. Order No. 380, *supra* note 1, at 22,788.

48. *Id.* at 22,789. The Commission gave brief consideration to several other issues, and in so doing refused to make exceptions from the rule for cost-of-service pipelines (pipelines allowed recovery of actually incurred costs at the time the costs are assessed), *id.*, and project-financed pipelines (those financed by a lender which uses the stream of income from the project as loan collateral), *id.* at 22,790.

49. *Id.*

50. *Id.* at 22,778.

51. Section 4 is codified at 15 U.S.C. § 717c (1982); section 5 is codified at 15 U.S.C. § 717d (1982).

52. See *Wisconsin Gas*, 770 F.2d at 1152.

NGA,⁵³ the Commission is authorized to take any action necessary to execute the mandates of the Act.⁵⁴

The court addressed two main attacks upon the Commission's authority to issue its rule. The contentions were: (1) that the Commission exceeded its authority in nullifying settlement agreements to which it was a party; and (2) that the promulgation of a rule which regulates rates charged for imported gas transported and sold in interstate commerce is solely within the province of the Economic Regulatory Administration (ERA), not of the FERC.⁵⁵

1. The Commission's Statutory Authority to Abrogate Settlement Agreements

Two petitioners, Transcontinental Gas Pipe Line Corporation (Transco) and ANR Pipeline Company (ANR), asserted that it is unlawful for the Commission to repeal settlement agreements to which it is a party.⁵⁶ In the settlements of their rate proceedings, the pipelines agreed to reserve the determination of certain disputed minimum bill issues for a later time. In each case, the issuance of Order No. 380 occurred after the settlement was approved by the Commission, but before a final determination as to the minimum bill issues had been reached.⁵⁷ When the administrative law judge rendered a final decision in the *Transco* case, he held that Order No. 380 was dispositive of the issue, and ordered variable costs to be eliminated from Transco's minimum bill charges.⁵⁸ In its comments in response to the Commission's proposed rulemaking, ANR's assertions were much the same as they were before the *Wisconsin Gas* court. ANR asserted that the Commission lacked the authority to reopen and redetermine by rule the minimum bill issues covered by a Commission-approved settlement agreement. The Commission disagreed, holding that its section 5 authority could not be restricted by a settlement, and therefore that the settlement provisions were not binding upon it.⁵⁹

The *Wisconsin Gas* court concluded that whether the Commission had the statutory authority to abrogate the agreements was irrelevant because the terms of neither settlement agreement had been violated. In reaching this conclusion, the court reasoned that while the minimum bill matter had been raised in the settlement agreements, it had merely been deferred for later resolution since the particulars of the determination were not stipulated by the parties. Thus, it was not mandatory that the minimum bill question be resolved in the individual rate cases, as long as they were resolved sometime in the future.⁶⁰ The court further reasoned that had the intention of the parties been to insulate the individual pipelines' minimum bills from a generic rulemaking with industry-wide ramifications, the parties could have done so explicitly by the terms of the set-

53. 15 U.S.C. § 717o (1982).

54. See *Wisconsin Gas*, 770 F.2d at 1153.

55. *Wisconsin Gas*, 770 F.2d at 1153.

56. *Id.*

57. *Id.* at 1153-55.

58. See *id.* at 1154.

59. See *id.* at 1153-54; Order No. 380, *supra* note 1, at 22,788-89.

60. *Wisconsin Gas*, 770 F.2d at 1154-55.

tlement agreements.⁶¹ In brief, the court chose not to reach the issue of the Commission's statutory authority with respect to settlement agreements, as it found that the agreements had not been infringed.

2. The Commission's Statutory Authority to Regulate Imported Gas

Until 1977, the Federal Power Commission (FPC) had sole responsibility for authorizing imports and exports of natural gas under section 3 of the Natural Gas Act.⁶² In 1977, Congress passed the Department of Energy Organization Act (DEOA),⁶³ which eliminated the FPC, created the FERC, and transferred authority over gas imports to the Secretary of Energy.⁶⁴ The Secretary in turn delegated shared authority over imports to the Economic Regulatory Administration (ERA) and the FERC.⁶⁵ The DEOA specified that the power to propose rules⁶⁶ and to use rulemaking procedures to establish rates⁶⁷ would remain in the FERC.

However, ample confusion over the rules of these agencies prompted the Secretary to issue in February of 1984, guidelines meant to alleviate the blurring of lines of authority between the ERA and FERC.⁶⁸ The new orders were intended to "make a clearer distinction between the responsibility of the [ERA] in exercising the Secretary's authority to *approve* natural gas imports and the

61. *Id.*

62. Section 3 requires the government to sanction the import of natural gas from a foreign country unless such importation "will not be consistent with the public interest." 15 U.S.C. § 717b (1982).

63. 42 U.S.C. §§ 7101-7375 (1982).

64. *See id.* §§ 7151, 7172.

65. *See* New Policy Guidelines and Delegation Order on the Regulation of Imported Natural Gas, 49 Fed. Reg. 6684, 6685 (1984) [hereinafter cited as Delegation Orders]. *See also Wisconsin Gas*, 770 F.2d at 1155; *West Va. Pub. Servs. Comm'n v. DOE*, 681 F.2d 847, 853 n.26 (D.C. Cir. 1982).

66. The DEOA, section 7173(a) stipulates that "[t]he Secretary [of Energy] and the Commission are authorized to propose rules, regulations, and statements of policy of general applicability with respect to any function within the jurisdiction of the Commission." 42 U.S.C. § 7173(a) (1982).

67. Section 7173(c) of the DEOA mandates that "[a]ny function . . . which relates to the establishment of rates and charges under . . . the Natural Gas Act . . . may be conducted by rulemaking procedures . . . [T]he procedures in such a rulemaking proceeding shall assure full consideration of the issues and an opportunity for interested persons to present their views." 42 U.S.C. § 7173(c) (1982).

68. Delegation Order No. 0204-111 pertains to the authority of the ERA Administrator. It provides in part:

[T]here is hereby delegated to the Administrator of the Economic Regulatory Administration ("Administrator") the authority under section 3 of the NGA to regulate the imports and exports of natural gas.

(a) The Administrator shall regulate imports . . . based on a consideration of such matters as the Administrator finds in the circumstances of a particular case to be appropriate, which may include, but are not limited to, the following matters:

1. Competitiveness of the import;
2. Need for natural gas;
3. Security of supply.

...

(c) In exercising the authority delegated by this Order, the Administrator may attach such terms and conditions as the Administrator shall determine to be appropriate.

Delegation Order No. 0204-111, 49 Fed. Reg. 6690 (1984).

Delegation Order No. 0204-112 delegates to the Commission authority over all functions under sections 4, 5, and 7 of the NGA with respect to "regulation of imports and exports of natural gas." Delegation Order No. 0204-112, 49 Fed. Reg. 6690 (1984).

FERC's responsibility to *regulate* the imported gas within the domestic natural gas system.⁶⁹ The Secretary explained that:

The FERC, under the revised delegation orders, maintains its responsibilities for exercising sections 4, 5, and 7 authority under the Natural Gas Act over gas authorized for import by the Administrator. Gas authorized for importation is subject to the FERC's review of issues pertaining to siting, construction, and operation of pipeline facilities, and to the rates proposed to be charged for the interstate transportation and sale of the gas. The FERC review, in effect, will address the regulatory matters relevant to the imported gas upon its entry into the United States and as it flows through domestic gas transportation systems. In its regulatory decisions on a gas supply authorized for importation, the Commission will . . . [act] consistently with the determinations made by the Administrator and the policy considerations reflected in the authorization.⁷⁰

Hence, the FERC was granted authority over ratemaking of imported gas which travels in interstate commerce,⁷¹ subject to the ERA's responsibility for policy considerations.⁷² It is therefore within the jurisdiction of FERC, pursuant to the section 3 authority delegated to it by the Secretary, to declare unlawful any rate or charge it finds to be unjust or unreasonable under sections 4 and 5 of the NGA. However, this determination must not be inconsistent with any policy considerations, terms, or conditions contained within the ERA's section 3 import authorization.⁷³

In the *Wisconsin Gas* case, Great Lakes Gas Transmission Co. (Great Lakes), which imports gas pursuant to a section 3 import authorization, contended that Order No. 380 was inconsistent with one of the terms approved by the ERA under its import authorization. The provision in dispute involved a take-or-pay clause. The assertion was that the inability to recover variable costs through minimum bills would prevent Great Lakes from recovering any take-or-pay payments from its swing customers.⁷⁴

The court rejected these contentions for the following reasons:

First, import authorizations refer to the contract between a foreign producer and a domestic pipeline. Order No. 380 had a direct effect upon the relationship between pipelines and their customers, but had no direct impact upon provisions in the contracts between pipelines and producers. As a result, the order cannot be said to be in contravention of terms or conditions of the section 3 import authorization.⁷⁵

Second, although some terms or conditions of contracts receiving ERA import approval may be rendered more cumbersome by the Commission order, this is not enough to find the order inconsistent with the terms of the import authorization. To so find would make the Commission's power under section 3 meaningless because all actions taken pursuant to its delegated section 3 au-

69. Delegation Orders, *supra* note 65, at 6689 (emphasis added).

70. *Id.*

71. This authority was granted to the FERC in recognition of the fact that imported gas must travel to the consumer through the same transportation systems that transfer domestic gas. Delegation Orders, *supra* note 65, at 6688.

72. *See id.*

73. *Wisconsin Gas*, 770 F.2d at 1155-56; *see also* Delegation Orders *supra* note 65, at 6688-90.

74. *Wisconsin Gas*, 770 F.2d at 1156.

75. *Id.*

thority will have some impact on pipelines purchasing imported gas, and thus will affect the relationship with their foreign suppliers. The court found that when "the impact upon the authorization is trivial, the Commission's action in no way intrudes upon the responsibilities delegated to the ERA,"⁷⁶ and the order is not inconsistent with the authorization. Accordingly, the court held that the Commission had not exceeded its authority to regulate imported gas by its order eliminating variable costs from minimum bills.⁷⁷ Having established that the Commission possessed the requisite statutory authority to alter rates, the *Wisconsin Gas* court turned its attention to application of the proper standard of review.

B. The Proper Standard of Review for Informal Rulemaking under the Natural Gas Act

1. The Substantial Evidence Requirement vs. the Arbitrary and Capricious Standard

Judicial review in natural gas rate cases developed from the "end result" test announced in *FPC v. Hope Natural Gas Co.*⁷⁸ This test was reformulated by the decision in *Permian Basin Area Rate Cases*,⁷⁹ where the Supreme Court delineated the ultimate functions and responsibilities of a reviewing court.⁸⁰ The Court enunciated that an order's essential elements must each be based upon substantial evidence. Section 19(b) of the Natural Gas Act also

76. *Id.*

77. *Id.*

78. 320 U.S. 591 (1944). The "end result" test postulates:

Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Hope Natural Gas, 320 U.S. at 602 (citation omitted).

79. 390 U.S. 747 (1968).

80. Stated briefly, the guidelines as to a court's functions are these: (1) a court's authority in examining the details of a Commission's proceedings is "essentially narrow and circumscribed," *Permian Basin*, 390 U.S. at 766; (2) a "presumption of validity" adheres to each discharge of the Commission's expertise, leaving one who challenges the Commission's judgment with "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences," *id.* at 767 (citing *Hope Natural Gas*, 320 U.S. at 602), and (3) the Constitution and the Natural Gas Act do not specify a particular rate level as just and reasonable; instead, any rate chosen by the Commission which falls within a "zone of reasonableness" cannot be abrogated by the courts, *id.* (citing *FPC v. Natural Gas Pipeline*, 315 U.S. 575, 585 (1942)).

Guidelines regarding a court's responsibilities are:

First, [the court] must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable.

Permian Basin, 390 U.S. at 791-92.

requires factual findings to be supported by substantial evidence.⁸¹

Nevertheless, in *Wisconsin Gas*, the parties disputed whether the substantial evidence or the more deferential "arbitrary and capricious" test should be used in the review of an informal rulemaking under the Natural Gas Act. In particular, one side asserted that the substantial evidence criterion must be applied to all determinations. The Commission argued that the factual findings must be supported by substantial evidence while the policy decisions need only meet the arbitrary and capricious test.⁸² The Administrative Procedure Act (APA),⁸³ which applies to judicial review of all agency activity, states that an administrative conclusion, finding or action must be overturned if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."⁸⁴

Although there appears to be a material inconsistency between the two standards, in reality the difference as applied to factual determinations in rulemaking is largely semantic. Indeed, in notice and comment rulemaking, the substantial evidence and the arbitrary and capricious criteria are "one and the same" as applied to factual determinations, converging into a rule of reasonableness.⁸⁵ What is required is that the reviewing court examine the evidentiary support for the Commission's factual determinations,⁸⁶ recognizing that "[t]he court's responsibility is not to supplant the Commission's balance of . . . interests with one more nearly to its liking, but instead to assure itself that the Commission has given *reasoned consideration* to each of the pertinent factors."⁸⁷

81. Section 19(b) is codified at 15 U.S.C. § 717r(b) (1982). Specifically, § 717r(b) provides that "[t]he finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive."

82. *Wisconsin Gas*, 770 F.2d at 1156.

83. 5 U.S.C.A. §§ 101-913 (West 1980 & Supp. 1985).

84. 5 U.S.C. § 706(2)(A) (1982). For Supreme Court interpretations of the arbitrary and capricious standard, see *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 39 (1983); *Illinois Cent. R.R. v. Norfolk & W. Ry.*, 385 U.S. 57, 66 (1966). See also *Kennedy v. Block*, 606 F. Supp. 1397, 1405 (W.D. Va. 1985); *Association of Data Processing v. Board of Governors*, 745 F.2d 677, 683 (D.C. Cir. 1984).

The United States Supreme Court similarly has held that "[p]rice control is 'unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt.'" *Permian Basin*, 390 U.S. at 769-70 (citing *Nebbia v. New York*, 291 U.S. 502, 539 (1933)). The Court determined that the constitutional standard "coincides" with the NGA's just and reasonable criterion. *Natural Gas Pipeline*, 315 U.S. at 586 (1942) cited in *Permian Basin*, 390 U.S. at 770. If a rate selected by the Commission falls within the "zone of reasonableness," it will not be overturned. Thus, if the Commission considers all of the various issues required by Congress to be reconciled when it sets its rates, any resulting order will withstand constitutional attack. *Permian Basin*, 390 U.S. at 770.

85. *Ass'n of Data Processing*, 745 F.2d at 683, 684. See also *Mid-Tex Elec. Coop. v. FERC*, 773 F.2d 327, 338 (D.C. Cir. 1985); *Maryland People's Counsel v. FERC*, 761 F.2d 768, 774 (D.C. Cir. 1985); *Associated Indus. v. Department of Labor*, 487 F.2d 342, 348-50 (2d Cir.), cert. denied, 416 U.S. 942 (1973).

The crucial requirement is that "there be support in the public record for what is done," *American Public Gas Ass'n v. FPC*, 567 F.2d 1016, 1029 (D.C. Cir. 1977), cert. denied, 435 U.S. 907 (1978), which essentially means that the Commission "specify the evidence on which it relied and . . . explain how that evidence supports the conclusion it reached," *City of Charlottesville v. FERC*, 661 F.2d 945, 950 (D.C. Cir. 1981).

86. See, e.g., *Ass'n of Data Processing*, 745 F.2d at 683.

87. *Permian Basin*, 390 U.S. at 792 (emphasis added). For recent discussions of the scope of review of

While the *Wisconsin Gas* court cited the standard it used in *City of Charlottesville v. FERC*⁸⁸ as being appropriate, the scope of review in the latter case was in fact less deferential than was the scope of review in *Wisconsin Gas*. In *City of Charlottesville*, the court resolved that “[d]irect evidence of a causal relationship” between a proposition and a result must be “made part of the record in the agency proceeding.”⁸⁹ The majority in *City of Charlottesville* found that although the Commission possessed the requisite statutory authority to promulgate the rules in the case,⁹⁰ the orders were not based upon substantial evidence. It was therefore necessary for the *City of Charlottesville* court to reverse.⁹¹

In his dissent, Judge McKinnon stated that: “In my view, the majority misunderstands the nature of the Commission’s decision, and, consequently, the type of evidence needed to show that the decision was ‘arbitrary or capricious’ and the extent to which it must be supported by ‘substantial evidence.’”⁹² He argued further that “judgmental or predictive facts,” such as those upon which the Commission’s orders were based, were the types of facts “for which courts have traditionally declined to require specific record support.”⁹³ Thus, the dissent intimated that the standard of review utilized in *City of Charlottesville* was stricter than that customarily applied by the D.C. Circuit Court of Appeals.

Moreover, *City of Charlottesville* may be distinguished from *Wisconsin Gas*. The issue upon which the *City of Charlottesville* court reversed the Commission was very narrow: “An even more particular standard [than one conventionally used by this court] applies when the Commission seeks, as here, to encourage exploration and development through *increased rates* to consumers.”⁹⁴ In *Wisconsin Gas*, there was no attempt by the Commission to provide incentives for exploration and development, nor to increase rates to consumers.⁹⁵ Since the Commission order under review in *Wisconsin Gas* did not call for increased natural gas prices, it stands to reason that the more particular standard employed in *City of Charlottesville* was inappropriate for the review of Order No. 380.

agency actions in another circuit, see *Papago Tribal Util. Auth. v. FERC*, 773 F.2d 1056, 1058-59 (9th Cir. 1985); *Cities of Riverside and Colton v. FERC*, 765 F.2d 1434, 1438 (9th Cir. 1985).

88. 661 F.2d 945 (D.C. Cir. 1981). See *supra* note 85; *Wisconsin Gas*, 770 F.2d at 1156.

89. *City of Charlottesville*, 661 F.2d at 953 n.44 (emphasis added). See also *id.* at 951. In *Wisconsin Gas*, the court found a lesser standard applicable: “while an agency ‘is not required to make specific findings of tangible benefit,’ there must be ‘ground for reasonable expectation that [there will be] some beneficial impact.’” *Wisconsin Gas*, 770 F.2d at 1158 (quoting *FCC v. RCA Communications, Inc.*, 346 U.S. 86, 96-97 (1953)).

90. A fundamental premise underlying all Commission activity is that the proposition upon which the action is based must be “one with which the Natural Gas [sic] permits the Commission to be concerned,” and that the Commission must have the statutory authority to take action regarding that proposition. *City of Charlottesville*, 661 F.2d at 950 n.34 (citing *City of Chicago v. FPC*, 458 F.2d 731 (D.C. Cir. 1971)).

91. *City of Charlottesville*, 661 F.2d at 954. See also *id.* at 953.

92. *Id.* at 957.

93. *Id.*

94. *Id.* at 950 (emphasis added).

95. In fact, in Order No. 380, the Commission expressed its belief that greater competition and lower prices to consumers would result from the rule. Order No. 380, *supra* note 1, at 22,787.

2. Evidentiary Basis Underlying Order No. 380

After citing the applicable scope of review, the *Wisconsin Gas* court turned to the Commission's findings to ascertain whether the Commission had engaged in reasoned decisionmaking. As discussed earlier, the Commission concluded that the recovery of variable costs in minimum bills violated the NGA for the following reasons: (1) pipelines may recover via minimum bills variable costs which are not actually incurred, (2) minimum bills are anticompetitive in that they block price signals from the burner tip, keeping the prices charged by pipelines artificially high, and (3) the detrimental impact of the rule on some pipelines and full requirements customers is outweighed by the benefits to be derived from eliminating variable costs from minimum bills.⁹⁶

With respect to the recovery of unincurred costs, the court found unpersuasive the argument that pipeline customers rarely actually paid for gas not taken. Since the Commission's concern in issuing Order No. 380 was the "potential for overrecovery," whether or not the pipelines had actually recovered unincurred costs was irrelevant.⁹⁷ The court found the factual support for the Commission's finding to be "unassailable."⁹⁸ Hence, the petitioners' arguments could not controvert the finding that the rule will be advantageous "to the extent that it will prevent even the possibility that pipelines . . . will recover variable costs for gas not taken."⁹⁹

As to the determination that minimum bills have anticompetitive effects, the Commission's rationale was that with the elimination of variable costs from minimum bills, partial requirements customers would no longer be coerced into purchasing gas from a single supplier, but could swing to the pipeline with the cheapest available source of supply. As a result, pipelines would be forced to maintain competitive prices.¹⁰⁰ The petitioners challenged the factual basis for the Commission's finding, reasoning that the Commission had merely relied on an economic theory, which has been held to be no substitute for "substantial record evidence and the articulation of a rational basis for . . . decision."¹⁰¹ The court agreed that abstract allegations of the potential beneficial impacts of competition were not in themselves enough, but concluded that the Commission had provided "abundant evidence" that the presence of variable costs in minimum bills immunized pipelines from market risks, keeping prices abnormally high.¹⁰² Further, it has been held that concrete evidence of increased competition is not necessary, since the United States Supreme Court has recognized the importance of competition in industries which are regulated, as well as the duty of "regulatory agencies to encourage competitive forces."¹⁰³

96. See *supra* notes 22-37 and accompanying text.

97. *Wisconsin Gas*, 770 F.2d at 1157.

98. *Id.*

99. *Id.*

100. *Id.* at 1157-58.

101. *Electricity Consumers Resource Council v. FERC*, 747 F.2d 1511, 1514 (D.C. Cir. 1984).

102. *Wisconsin Gas*, 770 F.2d at 1158.

103. *Public Sys. v. FERC*, 606 F.2d 973, 982 (D.C. Cir. 1979) (citing *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 372 (1963)).

The United States Supreme Court has stated that:

To restrict the Commission's action to cases in which tangible evidence appropriate for judicial

In *Maryland People's Counsel v. FERC (MPC I)*,¹⁰⁴ the District of Columbia Circuit Court of Appeals held the Commission's authorization of "an experimental increase in [natural gas] pipeline competition"¹⁰⁵ to be arbitrary and capricious, and consequently invalid.¹⁰⁶ However, the standard of review applied by the court was, in truth, identical to that employed by the court in *Wisconsin Gas*.¹⁰⁷ Contrary to the court's findings in *Wisconsin Gas*, the *MPC I* court simply determined that each of the Commission's arguments were inadequate in the face of the objections raised by the Maryland People's Counsel (MPC).¹⁰⁸ The court in *MPC I* was not asking that the Commission's arguments be more persuasive than those asserted by MPC, but merely that the Commission's arguments be reasonable.¹⁰⁹ Since the Commission's decision in *MPC I* was not, in the court's view, reasonable, it was held to be invalid.¹¹⁰

Conversely, in *Wisconsin Gas*, there was a great deal of evidence in the record tending to show that minimum bills prevented pipeline customers from switching to less expensive sources of supply.¹¹¹ Additionally, the Commission appeared to be reasonable in predicting that the elimination of variable costs from minimum bills would encourage competition by allowing those customers to shop for lower cost gas.¹¹² These factors were more than enough to satisfy the evidentiary standard.¹¹³ Arguments that market imperfections would keep the rule from having the intended effect, because some pipelines would buy higher-priced gas in their efforts to avoid take-or-pay penalties, were found

determination is available would disregard a major reason for the creation of administrative agencies, better equipped as they are for weighing intangibles. . . . In the nature of things, the possible benefits of competition do not lend themselves to detailed forecast, . . . but the Commission must at least warrant . . . that competition could serve some beneficial purpose

RCA Communications, 346 U.S. at 96-97 (1953) (citations omitted).

104. 761 F.2d 768 (D.C. Cir. 1985) [hereinafter cited as *MPC I*].

105. *Id.* at 770. This experiment involved a "special marketing program," whereby a pipeline and its producer entered into an agreement to "amend the high-priced gas purchase contracts entered into between them in earlier years, so as to permit the producers to sell the committed gas elsewhere (at current market prices), crediting the volume of such sales against the pipeline's high-priced purchase obligations." *MPC I*, 761 F.2d at 781.

For a brief discussion of special marketing programs, their purposes and effects, see Allison, *Natural Gas Pricing: The Eternal Debate*, 37 BAYLOR L. REV. 1, 67-68 (1985).

106. *MPC I*, 761 F.2d at 779. See also *Maryland People's Counsel v. FERC*, 761 F.2d 780, 781 n.1 (D.C. Cir. 1985) [hereinafter cited as *MPC II*].

107. The *MPC I* court determined that "[t]he law governing our review does not demand an impossible predictability, but does demand an articulation, in response to serious objections, of the Commission's reasons for believing that *more good than harm* will come of its action" *MPC I*, 761 F.2d at 779 (emphasis added). Compare this with the standard utilized in *Wisconsin Gas* ("while an agency 'is not required to make specific findings of tangible benefit,' there must be 'ground for reasonable expectation that competition may have some beneficial impact,'" *RCA Communications*, 346 U.S. at 96-97 (1953), quoted in *Wisconsin Gas*, 770 F.2d at 1158).

108. See *MPC I*, 761 F.2d at 775, 777, 778 & 779. The Court in *MPC II* granted, for substantially the same reasons, a petition by the Maryland People's Counsel for review of FERC orders, stating that "[i]nspection convinces us that highly relevant factors . . . have been brushed aside without warrant by the Commission." *MPC II*, 761 F.2d at 786.

109. See *MPC I*, 761 F.2d at 779.

110. *Id.*

111. See *Wisconsin Gas*, 770 F.2d at 1158.

112. See *id.*

113. *Id.*

similarly unpersuasive. The court reasoned that "the issue is not whether a particular pipeline will pursue a least-cost purchasing strategy but is instead whether the customer will have the ability to do so."¹¹⁴ Since the Commission had presented evidence that many customers would pursue a least-cost purchasing strategy, the court found that the Commission had "presented a sensible theory supported by substantial evidence."¹¹⁵

The final Commission determination concerned a balancing of the beneficial effects of the rule against the harm that some pipelines and full requirements customers would suffer. The *Wisconsin Gas* court addressed the evidentiary basis of this finding in the same categories as did the Commission: (1) the impact upon pipelines operating under take-or-pay provisions and (2) the implications for full requirements customers of high-priced pipelines.

In reference to the take-or-pay issue, it was argued by the pipelines that the failure of the Commission to eliminate take-or-pay clauses along with the certain minimum bill provisions amounted to "piecemeal reform," unduly discriminating against pipelines.¹¹⁶ Because the Commission found that there was no real connection between the take-or-pay liabilities of a pipeline and the minimum bill obligations of its customers, the court stated the issue to be "whether the take-or-pay clauses are so inextricably related to minimum bills that *simultaneous resolution* of the issues is required."¹¹⁷

In its discussion the court noted that an agency is not required to settle all germane issues in the same proceeding unless the Commission fails to take into account "an issue whose resolution might seriously undercut the . . . rationale for its final action."¹¹⁸ The court found that the Commission had considered the problem and advanced sound reasons for its conclusion that there is no real relationship between minimum bills and take-or-pay clauses.¹¹⁹ In so doing, the Commission had undertaken the required "explicit assessment of the relationship between the action taken and the issue deferred," and had reasonably found that the "public interest [could] best be advanced by the measured step taken."¹²⁰

In regard to the impact upon captive customers, the Commission concluded that some harm to captive customers of high-priced pipelines was unavoidable, but that there would be "offsetting benefits and detriments" as an immediate result of the rule.¹²¹ In the long run, the Commission believed, all customers would benefit.¹²² The petitioners did not directly dispute the Commission's reasoning, but disagreed with its balancing of the respective interests. The court resolved that the Commission had candidly addressed the problems facing full

114. *Id.* at 1159.

115. *Id.*

116. *Id.* For a discussion of the take-or-pay issue, see *supra* notes 41-45 and accompanying text.

117. *Id.* at 1159 (emphasis added).

118. *Id.* at 1159-60 (quoting *Neighborhood TV Co. v. FCC*, 742 F.2d 629, 642 (D.C. Cir. 1984)).

119. See *id.* at 1160. For a discussion of the Commission's reasons, see Order No. 380, *supra* note 1, at 22,787.

120. *Wisconsin Gas*, 770 F.2d at 1160.

121. See Order No. 380, *supra* note 1, at 22,785-86.

122. See *id.* For a discussion of the impact on full requirements customers, see *supra* notes 35-37 and accompanying text.

requirements customers and had exhaustively balanced the costs.¹²³ In *American Public Gas Association v. FPC*,¹²⁴ the D.C. Circuit held that the Commission "may tolerate inequities where it 'squarely faced' up to the problem and deemed it less significant than the pursuit of broad advantages to the public interest."¹²⁵ Accordingly, the court held that the Commission was required to make these difficult choices, and in so doing had "adequately addressed the concerns" of full requirements customers.¹²⁶

The *Wisconsin Gas* court also considered the claims by individual pipelines that unique circumstances rendered the rule inapplicable in their cases. The court found only two claims worthy of discussion. First, the court discarded assertions by certain petitioners concerning the Commission's exemption of Northwest Alaskan Pipeline Company's (Northwest's) sales tariffs from the effects of Order No. 380.¹²⁷ The petitioners contended that the exemption unduly discriminated against them and other similarly situated pipelines which purchased gas from Canadian suppliers.¹²⁸ The court found the only real similarity between the petitioners and Northwest was that "they all import Canadian gas."¹²⁹

The petitioner's import operations did not rest on any Commission guarantee that the calculation of the revenue stream would not change during the authorization of imports. However, Northwest's operations involved a series of agreements between the regulatory bodies of the U.S. and Canada which were necessary to ensure that the trans-Canada pipeline would be completed. If the rule were applied to Northwest, a breach of U.S. commitments to Canada could have occurred.¹³⁰ Accordingly, the court concluded that the Commission's distinction between Northwest and the petitioners was not unreasonable, nor did it unreasonably discriminate against the petitioners.¹³¹

Second, the court considered the dilemma facing downstream pipelines (those who do not buy gas from a producer, but from another, "upstream," pipeline). In Order No. 380-A, the Commission held that a downstream pipeline may not include the fixed cost portion of an upstream pipeline's commodity charge as a fixed charge in its own bill, but rather that it must consider this charge as a cost of purchased gas, making it a variable cost as to the downstream pipeline for purposes of the rule.¹³² *Midwestern Gas Transmission Co.* (Midwestern), which purchased most of its gas from an upstream pipeline, challenged this holding. The Commission's reasoning was that treatment of the upstream pipeline's charges (regardless of their type) as anything but purchased gas costs and hence variable, "would constitute a departure from consis-

123. *Wisconsin Gas*, 770 F.2d at 1161.

124. 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978).

125. *Id.* at 1030 (citing *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 321-23 (1974)).

126. *Wisconsin Gas*, 770 F.2d at 1161.

127. This exemption was granted in Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Provisions, Order No. 380-A, 49 Fed. Reg. 31,259 at 31,278 (1984) [hereinafter cited as Order No. 380-A].

128. *Wisconsin Gas*, 770 F.2d at 1163.

129. *Id.*

130. *Id.*

131. *Id.* at 1163.

132. Order No. 380-A, *supra* note 127, at 31,266.

tent Commission rate design practice.”¹³³ The court found this explanation to be insufficient because it was inconsistent with the “as-billed” principle governing pipeline supplier charges.¹³⁴ Additionally, the “consistent rate design” practice alluded to in Order No. 380-A did not explain why the Commission in this case did not adhere to the Order No. 380 objective to exempt fixed cost recovery from the ambit of the rule. Finally, the Commission did not consider Midwestern’s assertion that it would suffer competitive disadvantage if the fixed costs charged by the upstream supplier had to be recouped through increased commodity rates. The court consequently concluded that the Commission had not engaged in reasoned decisionmaking and remanded the issue for further consideration.¹³⁵ In short, the court found that each of the components of the rule, with the exception of the downstream pipeline issue, was supported by substantial evidence.

C. *Procedural Objections to the Commission’s Use of Informal Notice and Comment Rulemaking*

In its examination of the procedural correctness of the Commission’s action, the *Wisconsin Gas* court addressed two contentions by petitioners: (1) that the Commission abused its discretion in employing a generic rulemaking procedure rather than engaging in individualized case-by-case adjudication, and (2) that the substantial evidence requirement of section 19 of the NGA mandates that the Commission may not proceed by informal notice and comment rulemaking.¹³⁶

1. Rulemaking vs. Adjudication

The Supreme Court, in *SEC v. Chenery Corp.*,¹³⁷ ruled that: “the choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency.”¹³⁸

This principle remains in full force and effect today, having been elevated

133. *Id.*

134. The “as-billed” principle says that “the cost classification, allocation, and rate design methodology specified by the Commission for that pipeline supplier governs the classification of these costs by the recipient interstate pipeline.” *Wisconsin Gas*, 770 F.2d at 1164-65 (quoting *Northwest Alaskan Pipeline Co.*, 11 F.E.R.C. ¶ 61,088 at 61,182, *reh’g denied*, 11 F.E.R.C. ¶ 61,302 (1980)).

135. *See Wisconsin Gas*, 770 F.2d at 1164-65.

136. *Id.* at 1165.

137. 332 U.S. 194 (1947).

138. *Chenery Corp.*, 332 U.S. at 203. In *Chenery Corp.*, the Court also observed that:

Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon *ad hoc* adjudication to formulate new standards of conduct The function of filling in the interstices of the [Natural Gas] Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future. . . . In performing its important functions . . . an administrative agency must be equipped to act either by general rule or by individual order. To insist upon one form of action to the exclusion of the other is to exalt form over necessity.

Id. at 202.

to the status of "hornbook administrative law" by at least one court.¹³⁹ There will be, certainly, some circumstances in which case-by-case adjudication would be more properly applied than would rulemaking. In general, adjudication would be appropriate when facts concerning individual parties must be retrospectively determined,¹⁴⁰ when there exists a potential for the appearance of unforeseeable problems, when the Commission has had little experience with a specific issue, or when the matter under consideration is so specialized in nature as to be unmanageable within the parameters of a broad rule.¹⁴¹ Conversely, notice and comment rulemaking methods "are especially suited to determining legislative facts and policy of general, prospective applicability."¹⁴²

In *Wisconsin Gas*, the court determined that because substantial evidence buttressed the Commission's finding that minimum bills had industry-wide ramifications,¹⁴³ notice and comment rulemaking was a "manifestly reasonable" method for consideration of the problems of the natural gas market.¹⁴⁴ The court's final concern involved the application of section 19(b) of the Natural Gas Act to notice and comment rulemaking.

2. Informal Notice and Comment Rulemaking and the Application of the Substantial Evidence Requirement of Section 19 of the NGA

In *Wisconsin Gas*, the petitioners contended that in rulemakings in which substantial evidence is required, the methods used must be somewhat more precise than those used in informal notice and comment rulemaking.¹⁴⁵ The petitioners relied on *Mobil Oil Corp. v. FPC*,¹⁴⁶ which stood for the proposition that the creation of a record which would satisfy the section 19 substantial evidence requirement could not be accomplished through informal comments.¹⁴⁷ This principle was, however, rejected by the Supreme Court in *Vermont Yankee Nuclear Power Corp. v. NRDC*,¹⁴⁸ which clearly enunciated that a rulemaking proceeding could not be overturned as a result of the "procedural devices employed (or not employed) by the Commission," assuming that the method utilized satisfied the minimum statutory requirements.¹⁴⁹

In *Public Systems v. FERC*,¹⁵⁰ the Court of Appeals construed the substantial evidence criterion of section 19(b):

Courts initially restricted § 19(b) to appeals of adjudications, but we think the statute's language does not support the distinction between orders derived from adjudications and those growing out of rulemaking. As one court has observed, the Natural Gas Act

139. *National Small Shipments Traffic Conference v. ICC*, 725 F.2d 1442, 1447 (D.C. Cir. 1984). See also *Airmark Corp. v. FAA*, 758 F.2d 685, 692 (D.C. Cir. 1985).

140. *Nat'l Small Shipments*, 725 F.2d at 1447.

141. See *Chenery Corp.*, 332 U.S. 202-03.

142. *Nat'l Small Shipments*, 725 F.2d at 1447-48.

143. See *Wisconsin Gas*, 770 F.2d at 1166.

144. *Id.*

145. *Id.* at 1167.

146. 483 F.2d 1238 (D.C. Cir. 1973).

147. See *American Pub. Gas*, 567 F.2d at 1066.

148. 435 U.S. 519 (1978).

149. *Id.* at 548.

150. 606 F.2d 973.

"refers more or less indiscriminately to 'rules,' 'regulations,' and 'orders. . . .'"

In response to these considerations, this court began to review . . . rulemaking under § 19(b) so long as . . . there was sufficient evidentiary record to permit review by an appellate court. . . . [T]his standard can raise problems, however, because the record produced in notice and comment rulemaking frequently lacks designated factual findings. As a result, it becomes crucial that the Commission's order include a reasoned opinion detailing those factual elements in the record that underlie the Commission's actions.¹⁵¹

The *Public Systems* court added that the requirement did not mandate the procedures that the Commission must follow in creating the record.¹⁵² Since the *Wisconsin Gas* court had already determined that all of the Commission's findings of fact and policy were supported by substantial evidence, it found that the notice and comment rulemaking satisfied the Act's procedural requirements.¹⁵³

IV. RECENT APPLICATION OF THE RULE

Since the promulgation of Order No. 380, there has been a rash of cases which, at the very least, represents attempts by administrative law judges and the Commission to ensure that pipelines are neither acting in contravention to the specific mandates of the rule, nor to the spirit underlying it.¹⁵⁴ In the rule's present application, some new issues have come to the surface.

In *Northwest Pipeline Corp. v. Colorado Interstate Gas Co.*,¹⁵⁵ Colorado Interstate Gas Company (CIG) requested a hearing on the issue of whether Northwest Pipeline Corporation (Northwest) should be allowed to sustain *any type* of minimum bill. In other words, CIG was asking for a complete abolition of Northwest's minimum bill, including that portion limited to recovery of fixed costs. The Commission granted the hearing,¹⁵⁶ noting that in Order No. 380, the Commission had made it clear that "parties are free to make arguments in individual cases for the total elimination of minimum commodity bills."¹⁵⁷

In June of 1984, an administrative law judge held that pipelines should not be permitted "automatically to collect under the minimum bill the fixed costs that have been classified to the commodity charge part of its . . . rates."¹⁵⁸ She then determined that, under the circumstances in the case, Ten-

151. *Id.* at 979.

152. *Id.* at 979 n.32. See also *American Pub. Gas*, 567 F.2d at 1067 ("[T]his requirement, found in the judicial review provision of the [Natural Gas] Act, does not dictate the procedure to be followed, or the nature of the hearing to be held. . . . [W]hen rulemaking is based on written submissions the weight to be accorded the evidence may be affected by that method of presentation, but the standard of substantial evidence may be satisfied by written submissions.").

153. *Wisconsin Gas*, 770 F.2d at 1167.

154. For some recent examples, see *Northwest Pipeline Corp. v. Colorado Interstate Gas Co.*, 33 F.E.R.C. ¶ 63,076 (1985); *Felmont Oil Corp. v. Essex Offshore, Inc.*, 33 F.E.R.C. ¶ 61,333 (1985); *Northwest Cent. Pipeline Corp.*, 33 F.E.R.C. ¶ 63,067 (1985); *Panhandle E. Pipe Line Co.*, 33 F.E.R.C. ¶ 61,297 (1985); *MIGC, Inc.*, 33 F.E.R.C. ¶ 61,262 (1985); *Tennessee Gas Pipeline Co.*, 33 F.E.R.C. ¶ 61,199 (1985); *Transcontinental Gas Pipe Line Corp.*, 33 F.E.R.C. ¶ 63,035 (1985).

155. 29 F.E.R.C. ¶ 61,227 (1984).

156. However, in the subsequent hearing, the total elimination of Northwest's minimum bill was not considered by the administrative law judge because CIG and Northwest had come to an agreement that this issue was no longer in dispute. *Northwest Pipeline*, 33 F.E.R.C. at 65,289.

157. *Northwest Pipeline*, 29 F.E.R.C. at 61,477 (citing Order No. 380, *supra* note 1, at 22,790)).

158. *Tennessee Gas Pipeline*, 27 F.E.R.C. at 65,386 (1984) (pending Commission review).

nessee Gas Pipeline Company's (Tennessee's) entire minimum bill, including the recovery of both variable and fixed costs, was unjust and unreasonable.¹⁵⁹ The ALJ nevertheless provided for the contingency that she might be overturned in Commission review, by making findings concerning the level at which the minimum bill should be set, and on what time basis the bill should be assessed.¹⁶⁰

At least one commentator¹⁶¹ is of the opinion that the Commission may indeed overrule the ALJ in the *Tennessee Gas Pipeline* case, for two reasons: (1) the issue was not discussed in Order No. 380,¹⁶² and (2) the Commission rejected, in another case, the imposition of a 100% demand charge to recover fixed costs.¹⁶³ While it is possible that the Commission will disagree with the ALJ's elimination of Tennessee's minimum bill, the District of Columbia Circuit appears to take a different view. In *Mississippi River Transmission Corp. v. FERC*,¹⁶⁴ the court recently held that the Commission's authorization of a pipeline's minimum bill was not based upon substantial evidence.¹⁶⁵

The court seemed to take the same stance as did the ALJ in *Tennessee Gas Pipeline*,¹⁶⁶ stating that it did not "believe that the Commission can reflexively approve any minimum bill limited to fixed cost recovery in the absence of actual evidence indicating that the supplier could not otherwise recover those costs."¹⁶⁷ Relying on its decisions in *Atlantic Seaboard Corp. v. FPC*¹⁶⁸ and *Lynchburg Gas Co. v. FPC*,¹⁶⁹ the court determined that the Commission must engage in two inquiries regarding a proposed minimum bill. First, the Commission must find, based on substantial evidence, that a pipeline needs a minimum bill on the basis of one of the traditional justifications for the existence of

159. See *id.* For a concise discussion of this case and the ALJ's rationale for finding no justification for automatic recovery of fixed costs through Tennessee's minimum bill, see Massella, *supra* note 7, at 54-55.

160. *Tennessee Gas Pipeline*, 27 F.E.R.C. at 65,387.

161. Massella, *supra* note 7, at 55.

162. *Id.* at 55. It would appear that the commentator is in error on this point, since the issue regarding total elimination of minimum bills was explicitly addressed by the Commission in the rule; the Commission preferred to defer a rulemaking on the subject for a later date, but directed that the issue may be argued in individual cases. See Order No. 380, *supra* note 1, at 22,790.

163. Massella, *supra* note 7, at 55. The case in which the Commission rejected an imposed 100% demand charge was *Colorado Interstate Gas Co.*, 27 F.E.R.C. ¶ 61,315 at 61,583 (1984) (decided the same day Order No. 380 was issued). The Commission agreed with the ALJ that CIG's minimum bill was unjustified, but stated that finding a minimum bill to be unjust and unreasonable did not outlaw the use of a reasonable minimum bill, which in the Commission's view was a minimum bill limited to recovery of fixed costs. The Commission found the imposition of a demand charge to recover 100% of a pipeline's fixed costs was not an appropriate remedy—the proper remedy was simply the elimination of variable costs from the minimum bill. The main rationale for this finding was that the 100% demand charge would not provide the pipeline with incentive to maintain or increase its sales, because the pipeline could recover all fixed costs regardless of its sales level. See *Colorado Interstate*, 27 F.E.R.C. at 61,583.

164. 759 F.2d 945 (D.C. Cir. 1985).

165. *Id.* at 947.

166. It should be noted that the *Tennessee Gas Pipeline* case was not mentioned in *Mississippi River*, nor should it be assumed that the *Mississippi River* court relied on *Tennessee Gas Pipeline* in reaching its determination.

167. *Mississippi River*, 759 F.2d at 954.

168. 404 F.2d 1268 (D.C. Cir. 1968).

169. 336 F.2d 942 (D.C. Cir. 1964).

minimum bills;¹⁷⁰ second, the Commission must warrant that the proposed minimum bill is designed for the purpose of achieving that traditional justification, but nothing more.¹⁷¹ The court further observed that the Natural Gas Act does not require that pipelines be protected from "risk or competition through a guarantee of *total* fixed cost recovery."¹⁷² Thus, the court invalidated the use of a minimum bill for recovery of any kind of cost, without turning to Order No. 380 for its rationale.

V. CONCLUSION

As noted by the rendering court, the decision in *Wisconsin Gas* will have industry-wide implications. The promulgation of Order No. 380 represented a means to an end; the objective the Commission sought to achieve was to provide the opportunity for partial requirements natural gas distribution companies to exercise least-cost purchasing strategies without being subjected to charges for gas they did not purchase.¹⁷³ According to the Commission, the result to be derived from customer pursuit of the cheapest available gas supply will be stimulation of competition among pipelines: "the Commission expects pipelines to make vigorous efforts to compete in the market, which efforts should result in proper transmittal of price signals and lower prices for natural gas."¹⁷⁴

A fundamental point is that a broad-reaching rule such as the one discussed here is going to have both beneficial and detrimental repercussions on individual parties in the gas industry. The Commission succinctly summarized its expectations in stating that the order would give rise to "[p]rohibition of collection of unincurred gas 'costs;' removal of market constraints; greater competition; more accurate price signals to the wellhead; and increased quantities of lower-priced gas supplies, all leading to reasonable overall prices that can compete in the market."¹⁷⁵

170. See *Mississippi River*, 759 F.2d at 950. For a summary of the traditional justifications for minimum bills' existence, see *supra* text accompanying notes 3-10.

171. See *Mississippi River*, 759 F.2d at 950.

172. *Id.* at 955 n.13.

173. See Order No. 380, *supra* note 1, at 22,778.

174. *Id.* at 22,786.

175. Order No. 380, *supra* note 1, at 22,786. One administrative law judge has recently claimed that Order No. 380, among other things, has:

[G]reatly facilitated the ability of gas purchasers to acquire supplies from alternative suppliers, thereby fostering the development of a national market. We also find that gas now competes much more actively with other fuels. Gas users with the ability to switch fuels have been very sensitive to swings in natural gas prices and quickly respond to price increases by switching to available cheaper fuel sources.

Felmont Oil Corp. & Essex Offshore, Inc., 33 F.E.R.C. ¶ 61,333 at 61,656 (1985) (footnotes omitted).

In a more pessimistic view of the effects of the rule, the Committee on Natural Gas Imports and Exports predicted that:

Order No. 380 appears to have significant potential impact on the ability of exporters to finance major new export projects to the U.S. . . . Additionally, it appears that Order No. 380 has encouraged exporters to restructure their gas export contracts to provide for a two-part demand-commodity rate structure in the hopes of receiving some assurance of recovering at least the fixed costs associated with the export facilities. Further, since the effect of Order No. 380 is to abrogate the obligation of customers of pipelines to take-or-pay for gas, importers may be in the position of being required to take-or-pay for imported volumes pursuant to ERA authorizations without any

Clearly, the future of minimum bills in pipeline suppliers' rate tariffs is uncertain. At the very least, a proponent of a particular minimum bill will be required to satisfy the tests¹⁷⁶ set forth by the court in *Mississippi River*. It should also be noted that the total elimination of minimum bills by Commission order is not out of the question. As the Commission stated in Order No. 380, it "does not rule out the possibility of such a rule in the future."¹⁷⁷

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corresponding obligation of their customers to purchase the supplies.

Report of The Committee on Natural Gas Imports and Exports, 6 ENERGY L.J. 149, 150-51 (1985).

176. See *supra* text accompanying notes 170-71. These requirements, as dictated by the court, are fairly stringent. See *Mississippi River*, 759 F.2d at 953, 955.

177. Order No. 380, *supra* note 1, at 22,790.

