

THE PROPOSED SEA-CHANGE IN NATURAL GAS REGULATION

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I. INTRODUCTION

On May 30, 1985 the Federal Energy Regulatory Commission (FERC) issued a Notice of Proposed Rulemaking¹ that would, if adopted, transform the natural gas industry. This paper will examine selected legal issues that seem to lie at the core of the rules' validity.

The proposals seek to render the industry more competitive. They employ devices in four areas of regulation:

1. *Non-discriminatory blanket certificate transportation.* Under Section 7 of the Natural Gas Act (NGA),² interstate transportation of natural gas is permissible only on issuance of a certificate of convenience and necessity by FERC. Section 311 of the Natural Gas Policy Act of 1978 (NGPA)³ creates a limited exception, allowing interstate pipelines to transport gas interstate, outside the requirements of Section 7, where the transportation is on behalf of an intrastate pipeline or local distribution company.⁴ Under the proposed rules, pipelines could provide transportation under "blanket certificates,"⁵ but the certificates would require their holders to do so without discrimination.

The rule would severely curtail pipelines' ability to pass on to their customers any gas costs exceeding current field prices. At least if the transportation available pursuant to the rule were as secure as the pipeline's transportation of its own gas, any customer served by a pipeline providing blanket certificate transportation could buy gas in the field at current wellhead prices. If any of the purchaser's pipeline suppliers priced its gas materially above current field prices (plus transportation expenses), the purchaser could make an end run around the over-priced pipeline supplier. Thus, a pipeline selling to such a customer would be unable to price its gas above current field prices plus transportation costs. Since spot market prices for gas have recently run in the range of \$2.20 to \$2.60,⁶ and many pipelines have average gas costs well above that level,⁷ the potential impact is great.

There is considerable reason to believe that most pipelines, perhaps all, would accept blanket certificates on these terms. Blanket certificates greatly reduce the burden of regulation, enabling a pipeline to engage in any transaction within the permitted class without going through elaborate Section 7 proceedings. Besides the reduction in regulatory burden, pipelines will be under intense competitive pressure to offer blanket certificate transportation. As soon as any pipeline offers a local distribution company such service, every other pipeline serving that distributor will be at risk; unless it offers blanket certificate transportation, it may lose a large

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¹50 Fed. Reg. 24,130 (June 7, 1985).

²15 U.S.C. § 717f (1982).

³P.L. 95-621, 15 U.S.C. § 3371 (1982).

⁴Section 311 also permits intrastate pipelines to transport gas interstate, on behalf of an interstate pipeline or local distribution company. *Id.*

⁵Transportation under blanket certificates has been available for some time, in special but steadily broadening categories. See generally *Maryland People's Counsel v. FERC*, 761 F.2d 768 (D.C. Cir. 1985) (*MPC I*), and *Maryland People's Counsel v. FERC*, 761 F.2d 780 (D.C. Cir. 1985) (*MPC II*).

⁶Foster's NATURAL GAS REPORT, No. 1534 (September 12, 1985).

⁷See Appendix A of this article.

portion of its revenue from that distributor.⁸ It will be able to hold that revenue only by lowering its gas prices. Once it has done so, it might as well obtain the flexibility of providing transportation under a blanket certificate. Besides, the Commission's proposals offer the pipelines additional bait, discussed below.

The proposals would also allow any local distribution company customer of a pipeline offering blanket certificate transportation to reduce its contract demand by 25% each year. At the end of a four-year period, it could be free of any obligation to purchase the pipeline's gas. By reducing the burden of demand and minimum bill charges, this measure would further increase customer flexibility and intensify the pressure on pipelines to keep their gas prices in line with current wellhead prices.

2. *Take-or-pay obligations.* Any pipeline offering non-discriminatory blanket certificate transportation would receive advantageous treatment for certain expenses incurred in extinguishing "take-or-pay" liabilities. The Commission, in setting "just and reasonable" rates under Sections 4 and 5 of the NGA,⁹ allows pipelines to pass on non-gas costs only if it finds them "prudent." To make blanket certificate transportation more attractive to pipelines, and to diminish the inhibiting effect of take-or-pay liabilities on pipelines' purchasing practices, the Commission would create a presumption of prudence for any sums paid by a pipeline to "buy out" its take-or-pay liabilities, provided that the payments fell within certain percentages¹⁰ of the pipeline's estimated "unrecoupable"¹¹ take-or-pay liabilities for 1986-87.

3. *Optional, expedited certificates.* In order to encourage competition and flexibility in the pipeline industry, the proposed rules would provide a simplified, accelerated form of Section 7 certification for any type of service a pipeline might offer, so long as the pipeline accepted the economic risk involved in such service.

If a pipeline offered any transportation under the expedited certification program, it would be bound by the same condition of non-discrimination as would apply to blanket certificate transportation.

4. *Block billing.* The Commission's proposals would end the system under which pipelines sell gas at a "rolled-in" price. Under the "rolled-in" system, a pipeline uses its weighted average cost of gas for the gas-cost component of its sales rate. While rolled-in pricing may seem natural enough,¹² it has had a variety of ill effects, all greatly aggravated by the wellhead price regulation that began under *Phillips Petroleum Co. v. Wisconsin*.¹³ Wellhead regulation has in effect given interstate pipelines entitlements to substantial quantities of gas priced below market. The

⁸This pressure is diminished by the pipeline's ability to recover a portion of its fixed costs through "demand charges" and minimum bills. See Order No. 380, 49 Fed. Reg. 22,778 (1984).

⁹15 U.S.C. §§ 717c & 717d (1982).

¹⁰The Commission has not specified the relevant percentages and has called for comment on what they should be. See 50 Fed. Reg. at 24,147.

¹¹I.e., liabilities that the pipeline estimates it will not be able to recoup by gas purchases within whatever "make-up" period is permitted by the contract in question. Purchases within the make-up period are charged against take-or-pay prepayments made in earlier years.

¹²It is the most obvious way of requiring the pipelines to transmit the purported benefits of wellhead price controls through to their customers, the local distribution companies, and in turn through to gas consumers.

¹³347 U.S. 672 (1954). The decision held that the Natural Gas Act's exemption of "production and gathering" did not exempt wellhead sales prices from the Act's provision for regulation of sales for resale in interstate commerce.

savings thus obtained enable the pipelines to buy other gas at prices *above* the level at which the gas could sell. Thus, if a pipeline is entitled to 500 bcf of gas at \$1.25 per mcf, and if it can sell virtually all the gas it secures at a price of \$2.50 (plus transport expenses), it can readily pay as much as \$3.75 for another 500 bcf. The pipelines' above-market bids distort producers' investment decisions, as detailed below.

Instead of rolled-in pricing, the Commission proposes to break pipeline gas costs into three blocks. Block 1 would encompass all gas within Sections 104, 106(a) and 109 of the NGPA, the vintages for which regulation holds the price below current market levels.¹⁴ This gas would be allocated to the pipelines' firm sales customers on the basis of their 1982-84 purchases.¹⁵

Block 2 would comprise all other gas, and Block 3 would consist of other gas costs (not identified in the Notice of Proposed Rulemaking). Assuming that the non-discriminatory access provisions were effective, a pipeline would sell its Block 1 gas at the weighted average of the prices provided by wellhead regulation and its Block 2 gas at approximately current market rates. Thus the pipelines could no longer use the savings on underpriced gas to finance payment of above-market prices for other gas.

Finally, once a pipeline offering non-discriminatory blanket certificate transportation had given its customers the opportunity to reduce their contract demand to zero (i.e., after four years), it would enjoy a presumption that whatever price it charged for its Block 2 gas was "just and reasonable" under Sections 4 and 5 of the NGA.

This paper will consider the legality of three key components of the proposals: (1) the block billing mechanism generally; (2) the "just and reasonable" presumption for Block 2 gas sold by pipelines that provide non-discriminatory transportation; and (3) the provision for expedited certification free of the trammels of conventional Section 7 procedures.¹⁶

II. BLOCK BILLING

The Commission's block billing proposal will inflict a severe impact on the pipelines. In essence, it prevents a pipeline from using its underpriced Block 1 supply to offset excessive contract prices in its Block 2 supply. The pipelines' current

¹⁴The average prices paid by interstate pipelines for gas in those categories in July 1985 were \$1.60, \$1.11 and \$2.67, per mcf, respectively. See Table 5, NATURAL GAS MONTHLY, June 1985. The ceilings for the remaining interstate categories were above current market prices; for Section 102(d) gas, \$4.045; for still regulated Section 103(b)(1) gas, \$3.024; for still regulated Section 103(b)(2) gas, \$3.535; for Section 107(d)(5) gas from tight formations, \$6.048; for Section 108 gas, \$4.33. See Table 11, NATURAL GAS MONTHLY, June 1985.

¹⁵Each firm sales customer would be entitled to a specified fraction of a pipeline's Block 1 supply in any period. The fraction would be calculated by dividing (1) the customer's 1982-84 firm purchases from the pipeline, by (2) that pipeline's total firm sales. See 50 Fed. Reg. at 24,153.

¹⁶The issues selected revolve about the theme of establishing a competitive market as a basis for diminished regulation. One issue central to that theme, but nevertheless omitted, is the question of FERC's power to condition blanket certificate transportation on the holder's commitment not to discriminate; the cases relating to this issue have been exhaustively compiled in Reiter, *Competition and Access to the Bottleneck: The Scope of Contract Carrier Regulation under the Federal Power and Natural Gas Acts*, 17 LAND & WATER L. REV. 1 (1983).

average cost for gas in Block 2 is \$3.60 per million Btu.¹⁷ When that gas is subject to competition from gas now available at the wellhead at a price of approximately \$2.60, the pipelines will obviously be unable to sell it at cost (plus transportation expense). The \$1 difference, applied to about five trillion cubic feet of gas to be sold in 1986,¹⁸ would amount to about \$5 billion in unrecoverable costs. This compares with \$3.2 billion in aggregate net income for the interstate pipelines in 1984.¹⁹

The \$5 billion of course overstates the likely aggregate pipeline loss. To minimize its losses on Block 2 gas, each pipeline would have to adopt a strategy combining the following: (1) renegotiating with its producers; (2) taking inventory losses on its portfolio of gas; and (3) sacrificing some sales, with an attendant reduction in recovery of fixed costs. The least costly combination, then, would presumably be much less than the \$5 billion calculated above, but nonetheless substantial.

The severity is obvious for a "high-cost" pipeline, i.e., one with purchased gas costs above average. "Low-cost" pipelines can also expect substantial losses.

Current average gas costs for Transcontinental Gas Pipe Line Co. (Transco) are \$3.04 per thousand cubic feet (mcf). If we take \$2.60 as the current market price, Transco's supply is overpriced by about \$.44 per mcf, or, for estimated annual volumes of 770 bcf, by a total of about \$340 million. When we apply the block billing system, however, the picture is a good deal worse. Transco's average price paid for its 510 bcf of Block 2 gas was \$3.60. Again taking \$2.60 as the current wellhead price, the difference is \$1 per mcf, or a total of \$510 million per year.

At the other end of the spectrum is KN Energy, with a current average gas cost of \$2.06. Thus it could readily handle competition at current market prices in the absence of block billing. But its Block 2 average in the same period was \$3.96. Total excess costs for its annual 36 bcf of Block 2 gas would be nearly \$50 million. At least if the Commission is successful in exposing pipelines to competition with producers and independent marketers, even KN Energy will face difficulties.

In assessing the validity of the block billing proposal, a critical background issue is the effect of rolled-in pricing on the pipelines' purchasing practices. Rolled-in pricing accounts in substantial part for the pipelines having entered into contracts requiring them to pay above-market prices; indeed, as developed below, it made those contracts a virtual necessity. Thus, an understanding of the relation between rolled-in pricing and the above-market contract prices leads to a rather jaundiced appraisal of the likelihood that the Commission's proposal would effect its aims, for the proposal would put local distribution companies in the same position as that occupied by the pipelines from 1978 to the present. Further, the inevitability of those above-market contract prices must color one's appraisal of Congress's purposes in enacting the NGPA, a critical issue in considering the validity of block billing.

¹⁷See Appendix A, derived from Tables A-1 and A-2 of the Comments of the Natural Gas Supply Association in Docket No. RM85-1-000, filed July 15, 1985. Those tables are in turn derived from the most recent purchased gas adjustment filings of the major interstate pipelines. Material for the data in the text on individual pipelines is also drawn from Appendix A.

¹⁸A million Btu is substantially equivalent to one thousand cubic feet (mcf) of gas. The terms are used interchangeably in this article.

¹⁹See Comments of the Interstate Natural Gas Association of America in Docket RM85-1-000, filed July 15, 1985, at 15.

After developing that background, this paper will examine the aims identified by the Commission in support of its block billing proposal. It will then consider whether, in light of those aims (and the proposal's likelihood of achieving them), the block billing proposal is within the Commission's authority under the NGA and the NGPA. Finally, it will consider a possible constitutional attack on block billing.

A. *Rolled-in Pricing and the Pipelines' Above-Market Purchase Contracts*

All the interstate pipelines bid supra-market prices for gas in 1978-82.²⁰ A natural question is what would have happened to a pipeline that refused to do so. The answer is — Disaster. Any pipeline that limited its bids to true market prices would have found itself short of gas and almost certainly in breach of both contractual and regulatory duties to supply gas. With rolled-in pricing and the NGPA system of wellhead controls, it was a mathematical *necessity*, for the natural gas market to clear, that some gas be bought at prices above market levels.

Under a price control scheme such as the NGPA's, with below-market prices for some vintages and deregulation for others, demand will exceed supply if prices are rolled-in and if all gas is bought at a price at or below the market-clearing price. In Figure 1, the hatched area represents economic rents that the government has decided to deny producers. If some producers were paid less than market-clearing prices (i.e., less than P_m), and all the rest were paid market prices (P_m), the average ("rolled-in") price would necessarily be less than P_m . At that price (shown as P_x , a randomly chosen average price lower than P_m), supply is clearly going to be no greater than Q_m (the quantity supplied at the market price), while demand will necessarily exceed Q_m (the quantity demanded at the market price). Thus the market does not clear. With rolled-in pricing, it was essential, for the market to clear, that the pipelines bid supra-market prices for some gas.²¹

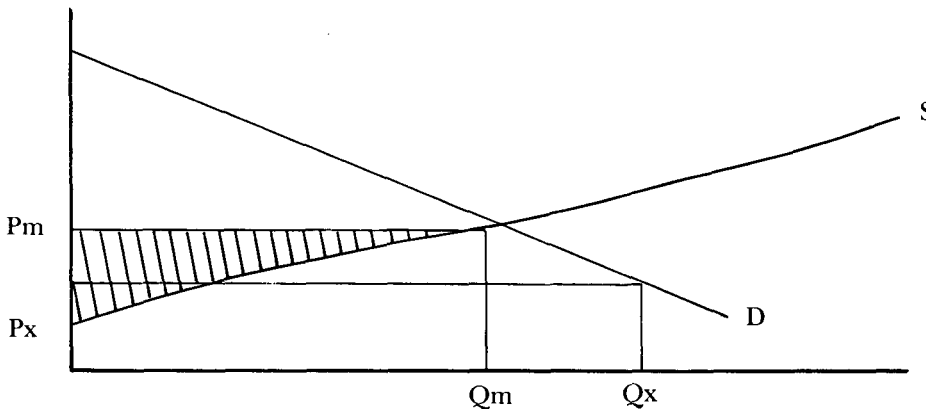


Figure 1
Disequilibrium Under Rolled-in Pricing

²⁰See Appendix A.

²¹See NATIONAL REGULATORY RESEARCH INSTITUTE, STATE REGULATORY OPTIONS FOR DEALING WITH NATURAL GAS WELLHEAD DEREGULATION 40-51 (1983), for an analysis in essential agreement with that in the text.

The mathematical necessity of such bids tells us something about the likely behavior of local distribution companies if block billing were adopted in the form proposed by the Commission. That in turn will tell us something about the prospects of the Commission's achieving its aims.

B. The Commission's Aims.

In its Notice of Proposed Rulemaking, the Commission suggested six aims that it sought to accomplish by block billing. These are explored below, with an assessment of the Commission's likelihood of success.

1. To flow economic rents through to consumers as Congress originally intended.²²

Economic rents constitute the difference between the market price of a commodity or service and the price necessary to elicit its production. Thus, if Wilt Chamberlain commands a market place of \$1 million a year as a basketball player, and could earn only \$100,000 in the next most lucrative occupation, he may be said to enjoy economic rents of \$900,000 a year. Similarly, if particular units of natural gas can be produced (with a normal profit) at a wellhead price of \$1.00, but the market price is \$2.50, those units generate economic rents of \$1.50.

It now appears to be generally understood that the function of wellhead price controls, and to a large extent their purpose, was to capture economic rents and transfer them to consumers.²³ In this transfer, the pipelines were intended to function as conveyor belts: so long as they were required to price their gas at its wellhead cost plus transport expense, the rents flowed through to distributors, and thence to consumers, along with the gas.²⁴

Adoption of the NGPA, however, led to the rents on "old" gas being offset by pipeline payments for "high-cost" and "new" gas. In December 1979, high-cost gas under Section 107(b)(1) through 107(b)(4) was completely deregulated; in 1982 the average price paid by the interstates for Section 107 hit \$7.31 per mcf.²⁵ Section 102 ceiling prices for "new" gas rose above market levels at least by 1982, and pipeline-producer contracts, tying the contract price to the statutory ceiling, assured that pipelines would actually pay those prices. For the interstate pipelines as a whole, the rent offset has been total: their average price paid in July 1985 was \$2.80 per mcf,²⁶ well above current wellhead prices for gas not controlled by prior contracts.

The supra-market prices make it possible to clear the market in part because they elicit additional production (supplies that would not be available if the top price paid were P_m) and in part because they choke off demand by raising the average price. For most pipelines, it is clear from Appendix A that the second effect has become dominant, since most have average gas costs exceeding current market prices.

²²See NOPR, 50 Fed. Reg. at 24,133, 24,136, 24,138, 24,139.

²³See S. BREYER, REGULATION AND ITS REFORM 240-60 (1982).

²⁴Even apart from the problem described above, it is doubtful whether a significant fraction of the rents could reach the intended beneficiaries. For example, given that a large fraction of the supply of residential rental housing is heated by non-gas sources, owners of gas-heated units may be able to charge rents based on more expensive fuels, so that they, rather than their tenants, will capture the rents. See BENJAMIN ZYCHER, POLICY ANALYTICS OF NATURAL GAS DECONTROL 16 (International Institute for Economic Research, May 1985).

²⁵See Table 5, NATURAL GAS MONTHLY, June 1985.

²⁶See *id.*

By denying pipelines the ability to offset supra-market prices with old gas rents, the Commission's block billing proposal, if effective, would restore the original purpose of transferring to consumers the rents that in the future accrue on old gas. Rents on Block 1 gas (the only gas as to which the price ceilings are capturing any rents) would flow through the pipelines to firm sales customers. Block 2 gas, instead of offsetting these rents, would be sold at current market levels.

In reality, however, local distribution companies (LDCs) would now occupy the position formerly held by the interstate pipelines. They would receive under-priced Block 1 gas and be free to go out into the market for the remainder of their supply. Since cost-of-service regulation limits their selling prices to average (rolled-in) gas costs plus other expenses, they could be expected at least partially to offset their under-priced gas with above-market purchases. Otherwise, their markets would not clear. Thus, just as did the pipelines, they would transfer part of the rents to natural gas producers, rather than to consumers.²⁷

2. To give producers correct price signals.²⁸

From the adoption of the NGPA until mid-1982 (when average gas prices hit such high levels that sales started to fall sharply), pipelines were ready to buy gas at prices far above true market levels. As a result, producers incurred expenses of, say, \$8 per mcf to produce gas that a consumer would buy, once rolled in with low-priced gas, for \$2.50 (plus transportation and distribution expenses). The result was that \$8 in resources were being consumed for tasks that could have been equally well accomplished by substitutes, such as residual fuel, costing about \$2.50. The false signal led producers to pour vast wealth into the ground for unnecessary gas wells.

But for rolled-in pricing at the LDC level, the proposed block billing system would correct this problem. If the rents are flowed through to consumers in Block 1, clearly the pipelines cannot use them to subsidize gas purchases.

The scope of the problem, however, is far less now than it was in 1978-82. Except for the few pipelines with average gas costs below current market level,²⁹ no pipeline now has any incentive to bid more than market value at the wellhead. And if the Commission's non-discriminatory transportation program works as intended, the penalty will be severe and automatic for any pipeline that indulges in excessive bids.

Although the old gas rents are now mostly committed by contract to producers, block billing can still somewhat improve the signals sent to the latter. Those contracts give producers an excess incentive to expend resources in *maintaining* production by reworking wells and engaging in secondary and tertiary recovery. The excess incentive will inspire expenditures that are not justified by the market value of the resulting gas. By greatly increasing the pressure on pipelines to renegotiate those

²⁷See Comments of Department of Energy, in Docket No. RM85-1-000, filed July 15, 1985, at 50.

²⁸See NOPR, 50 Fed. Reg. at 24,138, 24,139.

²⁹If we take \$2.60 as the current market price, only Arkla, Colorado Interstate, KN Energy, Natural Gas Pipeline, Northern Natural, Northwest Central, and Sea Robin enjoy this enviable position, and even they, with average costs of \$2.48, \$2.45, \$2.06, \$2.59, \$2.55, \$2.08, and \$2.51, respectively, have few rents left. See Appendix A. The volumes for the two pipelines with average costs seriously below current market prices, KN Energy and Northwest Central, add up to less than 350 bcf out of an interstate total of about 9,500 bcf.

contracts, an effective system of block billing would reduce the likelihood of such waste.³⁰

Again, however, substituting LDCs for pipelines as primary owners of the old gas cushion may simply alter the mechanism through which that cushion works its ill effects. Clearly that would be the case if distributors responded by making supra-market bids for gas not subject to binding wellhead price controls. Indeed, transfer of the old gas cushion to distributors could generate a whole new round of supra-market gas contracts, replicating the excesses of 1978-82. The resulting waste might well exceed what will occur if the cushion remains with the pipelines in its truncated form.

3. To give consumers correct price signals.³¹

Here the improbability of accomplishing the Commission's aims is more obvious than in relation to the two previous ones. Enforcement of its block billing scheme will result in distributors receiving gas at an *average* price well below the current market: Block 2 will sell at market (assuming success of the non-discriminatory transportation program) and Block 1 below. If distributors use their average costs in pricing their sales, consumers will receive more distorted price signals as a result of block billing than they would have in its absence.³²

The distributors could pursue pricing policies that would flow the rents through to consumers with relatively little distorting effect on consumer decisions.³³ For example, distributors could dole out the rent (the difference between Block 1 cost and market prices) on a straight per customer basis, in an annual lump sum (pre-Christmas?). The consumer would face a unit price based on market levels. Since his lump-sum bonus would not vary with his consumption, he would be likely to disregard it in his calculation of how much gas to consume and what substitutes to adopt.³⁴

The Commission proposals, however, do nothing to secure the adoption of distributor pricing methods that would assure correct signals for consumers in the face of block billing. They include no hint of any pressure on state regulatory agencies. The omission is presumably due to a concern for federalism, understandable but perhaps too punctilious. In any event, the upshot is that the

³⁰If improved signals to producers, in this limited form, are to be a significant support for the Commission's proposals, the courts may expect the Commission to produce some empirical data quantifying the effect. *See, e.g.,* *City of Detroit v. FPC*, 230 F.2d 810, 817-19 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956). The degree of judicial insistence on empirical data varies enormously, however. For a far more relaxed view, *see, e.g.,* *Permian Basin Rate Cases*, 390 U.S. 747, 814 (1968). The relaxed attitude is often being justified in terms of a program's experimental character. *See, e.g., id.* at 792; *Southern Louisiana Area Rate Cases*, 428 F.2d 407, 418, 439-44 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970); *Shell Oil Co. v. FPC*, 520 F.2d 1061, 1072 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976). In any event, an implausible exaggeration of the possible improvement in signals to producers might well attract judicial thunderbolts.

³¹NOPR, 50 Fed. Reg. at 24,138, 24,139.

³²This assumes that an effective program of nondiscriminatory transportation is holding the pipelines' selling prices at competitive levels.

³³This passage assumes that the controlling state regulatory authority is willing to go along.

³⁴Even such a distribution scheme would have some distorting effect, since consumers deciding between using gas at all, and refraining from any gas use, would be biased in favor of gas by anticipation of the lump-sum distribution. Ideally, the rents would be distributed to the population at large, without reference to gas consumption. That option, however, seems politically implausible.

Commission's current block billing proposal contradicts the purpose of giving correct signals to consumers.

4. To eliminate the pipelines' incentive to make imprudent purchasing decisions.³⁵

To a substantial extent, this is a rephrasing of the Commission's second and third purposes. Imprudent purchasing decisions, made possible by the inadequacy of inter-pipeline competition and by the existence of economic rents on old gas, have led to above-market purchases at the wellhead.³⁶ These decisions cause economic waste because of the erroneous signals they convey to producers. That concern has been fully considered in connection with the second purpose. The other ill effect of imprudent pipeline purchasing is that it inflicts supra-market gas costs on consumers. The Commission's non-discriminatory transportation program, if it works, should fully correct that problem.

5. To provide a "level playing field" between competing gas sellers, particularly between pipelines with access to large supplies of under-priced gas and all other competitors.³⁷

It is widely felt that a pipeline's possession of a large "cushion" of under-priced gas is more a fortuity of regulation than a sign of management acumen. Thus there is a felt unfairness in exposing small-cushion pipelines to competition from large-cushion ones. The Commission's block billing proposal, by shifting all the economic rents forward to the distributors, eliminates this unfairness.

The concern for a "level playing field" has roots in other goals as well. The unfair competition problem has in the past inhibited the Commission from stimulating gas-against-gas competition,³⁸ its Notice of Proposed Rulemaking also refers to that inhibition.³⁹ Further, the Commission argues, competition on a "level playing field" will result in purchase decisions being made on the basis of current market efficiencies rather than on access to old gas.⁴⁰ Thus correction of the unfairness not only facilitates the Commission's effort to establish competition, but will lead to a form of competition consistent with efficiency goals.

All this should, however, be put in perspective. As we have seen, most pipelines have entered into gas purchase contracts that dissipate the old gas rents. Since only a few pipelines have average costs below market, and since the pipelines with average gas costs significantly below market account for a diminutive share of total sales,⁴¹ the uneven playing field seems to entail only trivial unfairness and inefficiency. For most pipelines, the primary impact of block billing, as sketched by the Commission, is to deny them the ability to use economic rents on old gas to offset the excessive prices to which they are bound by contract. They may well perceive that denial as a

³⁵NOPR, 50 Fed. Reg. at 24,139, 24,140.

³⁶Although above-market purchases were to a degree necessitated by rolled-in pricing and the NGPA pricing tiers, there seems little doubt that pipeline purchasing practices were slack. One pipeline, for example, decided that it need only hold its average cost (plus transportation expenses) competitive with No. 2 heating oil, even though a large block of its customers could readily switch to the much cheaper No. 6 residual fuel oil. See *Columbia Gas Transmission Corp.*, 26 F.E.R.C. ¶ 61,034, at 61,101 (1984).

³⁷*Id.* at 24,131, 24,132, 24,133, 24,135, 24,138.

³⁸See Statement of Policy on Off-System Sales, 48 Fed. Reg. 20,124, 20,125 (1983).

³⁹50 Fed. Reg. at 24,133.

⁴⁰NOPR, 50 Fed. Reg. at 24,140.

⁴¹See note 29, *supra* and Appendix A.

considerably greater unfairness than exposure to competition from a handful of small pipelines with a large proportion — but a small total quantity — of underpriced gas.

6. To avoid the inequity of new customers benefitting from the old gas rents.⁴²

By allocating Block 1 in accordance with a customer's 1982-84 purchases, the Commission assigns the economic rents to the customers of that period. It is hard to see, however, any reason why those customers should have any special equitable claim to those rents, and the Commission gives none.⁴³

Thus, accomplishment of the Commission's first four goals, relating to rent transfer and incentives for producers, consumers and pipelines, is placed in doubt by uncertainty over what LDCs may do. They may simply replace pipelines in the chain of causation that originally led to dissipation of the rents and inaccurate price signals for all market participants. On the producers' side, the shift could generate a whole new cycle of excess bidding and wasteful drilling; in any event, much of the harm is past, since the resources wasted drilling wells in 1978-82 can never be recovered. For consumers, block billing as formulated by the Commission would lead to price signals more skewed than if the Commission merely induced pipelines to provide nondiscriminatory access to the wellhead market.

Much of the proposals' failure to achieve the first four goals could be cured by innovative pricing by distributors. Any device that would sever consumers' enjoyment of old gas rents from their present consumption would do the trick; producers and consumers alike would receive correct signals, transmitted by the intermediaries (pipelines and distributors alike). But the proposals contain nothing that would induce distributors to adopt such devices.

Although the Commission seems technically correct in its view that block billing would advance its fifth goal (attainment of a level playing field), the advantages seem modest in relation to the losses likely to be inflicted on pipelines. Finally, the proposal accords fully with the sixth aim, direction of old gas rents to old customers rather than new ones, but the reason for pursuing such a goal remains mysterious.

C. *The Mandates of the NGA and the NGPA.*

Administrative action is, of course, invalid if it exceeds the authority granted by Congress,⁴⁴ or, in the case of action under the NGA, if it is not supported by substantial evidence.⁴⁵ In establishing its block billing system, the Commission would be seeking to exercise its authority to establish "just and reasonable" rates for natural gas companies under Sections 4 and 5 of the NGA.⁴⁶

⁴²NOPR, 50 Fed. Reg. at 24,157.

⁴³On the other hand, by keeping old gas subject to the Commission's non-price sales jurisdiction, see NGPA § 601(a)(1), 15 U.S.C. § 3431(a)(1) (1982), Congress evidently intended to preserve local distribution companies' regulatory entitlements to low-priced gas certificated for sale to them. The Commission's purpose here, then, whether or not equitable, is in partial accord with that intent. Congress, of course, attached no special status to customers' purchases in 1982-84.

⁴⁴5 U.S.C. § 706(2)(C) (1982).

⁴⁵15 U.S.C. § 717r(b) (1982). This restraint is probably, however, no different from the requirement that Commission conduct not be arbitrary or capricious. See *Ass'n of Data Processing v. Board of Governors*, 745 F.2d 677, 683-84 (D.C. Cir. 1984).

⁴⁶15 U.S.C. §§ 717c,d(1982).

In construing the NGA, the Supreme Court has declared the congressional purpose to be “to protect consumers against exploitation at the hands of natural gas companies,”⁴⁷ and “to afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges.”⁴⁸

The concepts of “exploitation” and “excess,” however, lack cognitive meaning unless they can be fitted into some economic theory. So far as pipelines’ prices are concerned, the relevant theory is clearly that of natural monopoly. Since natural gas pipelines exhibit declining unit costs within a large range,⁴⁹ they are *prima facie* natural monopolies.⁵⁰ Accordingly, a pipeline’s prices may be deemed exploitative or excessive if they exceed the levels that would prevail under competition, to wit, the firm’s cost (including a normal profit).⁵¹

For natural gas producers, the monopoly label does not fit. The consensus is that workable competition operates at the wellhead to limit producers’ prices.⁵² Congress has given this view its apparent blessing by adoption of the NGPA, which provides, in effect, for the phasing-out of wellhead price controls.⁵³ In the absence of monopoly, it is fair to surmise that the congressional purpose for wellhead controls was the capture of economic rents and their transfer to consumers.⁵⁴ On this view, wellhead prices would be exploitative or excessive if they significantly exceeded the price necessary to elicit production.

The Commission’s use of block billing to restore the flow of economic rents to consumers appears, superficially, to fit these purposes perfectly. Congress’s rent transfer goals were thwarted as a result of the NGPA; the Commission’s proposed step would, if successful, cause the economic rents on future old gas production to flow as Congress intended.

This apparent fit, however, is deceptive. If the pipelines’ contractual commitment to pay supra-market prices for some gas conformed to the purposes underlying the NGPA, then it is hard to argue that Congress intended *full* transfer of the old gas rents to consumers.

As we have seen, the supra-market prices were a necessary consequence of the NGPA system of regulated and unregulated wellhead prices, coupled with rolled-in

⁴⁷Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944).

⁴⁸Atlantic Refining Co. v. Public Serv. Comm’n of New York, 360 U.S. 378, 388 (1959).

⁴⁹Declining unit costs arise, in this case, from the fact that the cost of a pipeline rises in direct proportion to its radius, while capacity increases as its square.

For a natural monopoly to exist, costs must decline over the entire range of the market. See 2 A. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 119 (1970). This appears to be the case for some natural gas pipeline markets, not for others.

⁵⁰Also supporting the characterization of natural monopoly is the fact that exit from the pipeline industry is costly; an owner will lose most of the value of an installed pipeline if it attempts relocation. See generally Baumol, *Contestable Markets: An Uprising in the Theory of Industry Structure*, 72 AM. ECON. REV. 1 (1982).

⁵¹Typically, rate regulation for a natural monopoly is based on cost, and thus may be seen as an effort to simulate competitive prices. Of course, under competition prices are based on current marginal costs, while under cost-of-service rate regulation they are based on historic average costs.

⁵²See S. BREYER, *REGULATION AND ITS REFORM* 242 (1982).

⁵³The NGPA provides a schedule for deregulation of most “new” gas, and old gas, in the nature of things, will tend to be exhausted relatively soon. The vintages allocated by the Commission to Block 1 (gas under Sections 104, 106(a) and 109), in 1984 amounted to just under one-half of the interstate supply (4,467 bcf out of a total of 9,050 bcf). See Table 22, *NATURAL GAS MONTHLY* (April 1985).

⁵⁴See S. BREYER, *supra* note 52, at 243-44.

pricing for pipelines. Congress mandated the NGPA regime for wellhead pricing, and it appears to have assumed the prevalence of rolled-in pricing.⁵⁵

Thus it may fairly be said that Congress intended the pipelines to contract for some gas at higher-than-market prices. Moreover, their doing so was necessitated by the regulatory program as actually enforced.

This analysis suggests serious doubt whether block billing, as articulated by the Commission, is within its authority to prescribe "just and reasonable" rates. On the one hand, the Commission's program would, if effective, restore the attempt to transfer rents to consumers. On the other, to the extent that the resulting pipeline losses derive from their inability to use old gas rents to offset supra-market prices, it penalizes pipelines for conduct implicitly mandated by Congress in the NGPA.

If the legality of the Commission's block billing scheme is questionable, might there nonetheless be a variant that would accomplish part of what the Commission has sought, but in a form less at odds with the system implicitly established by the NGPA?

One possibility is to adjust the Commission's block billing by allowing a pipeline to include limited quantities of overpriced gas in Block 1. The includible quantities would be subject to the following limits: (1) Only gas purchased pursuant to contracts entered into before, say, July 1, 1982, would be eligible. This would exclude above-market prices based on contracts entered into after pipelines went on notice that there was no call for further contracts at above market prices.⁵⁶ (2) Overpriced gas would be includible only up to the point where it raised the Block 1 average cost up to current market price, a figure that would necessarily be recalculated periodically. For most pipelines this would effectively equate their Block 1 and Block 2 prices (assuming the effectiveness of non-discriminatory transportation). For the few pipelines with below-market average gas costs, however, it would preserve the transfer of old gas rents to customers. As between these pipelines and all others, and between these pipelines and gas producers, it would establish the level playing field sought by the Commission.

On two material counts, such a system would fall short of the Commission's aims: (1) Rather than restoring the rent transfer program, it would only preserve its current remnants. (2) It would leave more overpriced contracts in place, and

⁵⁵The NGPA's one section relating to the point, its provision for "incremental pricing," 15 U.S.C. §§ 3341-3348 (1982), is unintelligible except in the context of rolled-in pricing.

It has been argued that the Congressional premise of rolled-in pricing was so clear that any abandonment of rolled-in pricing, regardless of purpose or effect, would be beyond the Commission's authority. *Interstate Natural Gas Ass'n of America v. FERC*, 716 F.2d 1 (D.C. Cir. 1983), cert. denied, 104 S. Ct. 1615 (1984). See Comments of Amoco Production Co. in RM85-1-000, filed July 15, 1985, at 47-49. My argument is the more limited one that it is simplistic to impute to Congress an intent to transmit all the old gas rents to consumers when the system that it established, coupled with rolled-in pricing, made the partial diversion of those rents to high-cost gas producers inevitable. Moreover, the *INGAA* decision seems distinguishable. There the court concluded that the Congressional specification of price ceilings was based on the assumption that the heat content of gas would be calculated as it had been previously. The inference that Congress intended continued use of an old method seems more powerful in applying ceilings articulated by Congress down to the penny than in the more general context presented here.

⁵⁶July 1982 seemingly represented the start of dramatic switching of industrial users to alternative fuels, and thus a signal to pipelines of the urgent necessity for controlling costs. See American Gas Association, *Competition in the Natural Gas Industry* 12 (ENERGY ANALYSIS, 1984-2, February 14, 1984).

accordingly would do less to correct the price signals received by some producers. Since the shift of old gas rents to LDCs seems likely to defeat those aims, however, these shortfalls seem of only modest significance.

On the other hand, this modified version of block billing would avoid several defects in the Commission's plan. (1) As it would protect much of the ability of pipelines to use old gas rents to offset overpriced contracts,⁵⁷ it would achieve a better balance between the NGA's rent-transfer purpose and the NGPA's implicit signal to pipelines to bid above-market prices. Thus it would seem to fit far more comfortably within the Commission's legal authority. (2) It would avoid the seeming unfairness of penalizing pipelines for conduct necessitated by the NGPA. (3) It would send correct price signals to consumers, except for those relying on gas supplied by the few below-market pipelines. (4) It would avoid the risk that distributors, as holders of a reconstituted old gas cushion, would recreate the distortions of 1978-82.

This modified block billing may seem to entail complications out of all proportion to its likely achievements. After all, except for the below-market pipelines, it results in prices substantially identical to those generated by rolled-in pricing. But the plan can claim serious positive benefits. Besides achieving the level playing field desired by the Commission, it establishes the theoretical and practical basis for the Commission's relaxed regulation of pipelines' gas prices.

So long as underpriced old gas is thrown indiscriminately together with other supplies, regulatory monitoring of pipeline gas prices appears necessary to assure that pipelines perform their role as conveyor belts of old gas rents. In fact, almost all pipelines have ceased to function as effective rent transmitters. But the hope — or the myth — lives on. A two-block billing system, with the old gas assigned to one, and all currently purchased gas assigned to the other, makes it possible to give the second block a regulatory treatment that is not distorted by rent-transfer objectives.⁵⁸

For Block 2, the sole purpose of FERC control over a pipeline's gas price is to assure that it does not use its market power in gas transmission to secure supra-competitive prices for gas. If the non-discriminatory transportation program can provide that assurance, then relaxation of the Commission's control over Block 2 gas is economically justified.⁵⁹ By segregating a portion of pipeline supply that contains no rents, a two-block system lays the groundwork for such a relaxation.

A slightly different angle on the conformity of the Commission's proposal with the NGA is suggested by judicial references to a Commission duty to preserve the financial integrity of the pipelines. Block billing may conceivably put some pipelines

⁵⁷It would protect their ability to do so except to the extent that their excess prices are based on misjudgments of the market.

⁵⁸Of course total deregulation of wellhead prices would go more directly to this result. The Department of Energy's policy arguments in favor of such deregulation seem to be compelling. See DEPARTMENT OF ENERGY, INCREASING COMPETITION IN THE NATURAL GAS MARKET: THE SECOND REPORT REQUIRED BY SECTION 123 OF THE NATURAL GAS POLICY ACT OF 1978 (1985), at 129-43. But there is no evidence that those arguments can prevail in the political arena.

FERC itself has power to raise ceilings of Block 1 gas to higher "just and reasonable" rates, pursuant to Sections 104(b)(2), 106(c) and 109(b)(2). It is most uncertain whether this includes the power to eliminate the whole rent transfer fiction, i.e., to allow those prices to rise to market levels. In 1982 FERC initiated a rulemaking aimed at exercising its authority under those sections, 47 Fed. Reg. 19157 (1982), but did not follow through.

⁵⁹The legal status of such regulatory relaxation is considered in section III below.

into bankruptcy. The \$510 million estimate for Transco's maximum losses in one year⁶⁰ represents about two-thirds of the company's book value.⁶¹ That estimate, to be sure, is extreme, since Transco will be able to reduce its losses by renegotiation with producers and by simply suffering loss of sales in some markets. Nonetheless, a pipeline bankruptcy is a possibility, and several pipelines having losses over an extended period is a likelihood.

Those prospects must be measured against the Supreme Court's observation, in the *Permian Basin Area Rate Cases*,⁶² that "just and reasonable" rates under the NGA must "reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed."⁶³ In a similar vein, the Court of Appeals for the Fifth Circuit has said, "Maintenance of a healthy industry structure is an important FPC responsibility."⁶⁴ Neither multiple bankruptcies nor prolonged years of negative income seem, *prima facie*, compatible with either standard.

Other decisions, however, somewhat counterbalance these relatively protective formulae. In *Market Street Railway Co. v. Railroad Commission*,⁶⁵ for example, the Court said of its decision in *FPC v. Hope Natural Gas Co.*:⁶⁶

All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully. There was no suggestion that less might not be allowed when the amount allowed was all that the company could earn The due process clause. . . has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.⁶⁷

And the *Permian Basin Area Rate Cases* in fact upheld an order setting price ceilings for natural gas producers on the basis of estimates of average exploration and development costs, with, as Justice Douglas noted in dissent, no assurance that such averages were in any way representative and no formula stating on what basis the Commission might provide relief for individual producers with higher costs.⁶⁸

The line between acceptable rates, and ones impermissibly threatening pipelines' financial integrity, may be quantitative or conceptual. If quantitative, i.e., based upon the scope of the disruption to the interstate gas pipeline industry or to a particular pipeline, then evaluation of the block billing proposal must await facts developed by litigation. If the line is a conceptual one, however, we may usefully explore what that concept might be.

A possible starting point is that rates need not be higher than those sufficient to maintain efficient firms in a competitive industry. Thus, even if the introduction of competition led to widespread pipeline bankruptcy, it seems doubtful whether such

⁶⁰See *supra*, at ____.

⁶¹See Appendix A, ENERGY INFORMATION ADMINISTRATION, STATISTICS OF NATURAL GAS PIPELINE COMPANIES—1982 (DOE/EIA-0145 (82)).

⁶²390 U.S. 747 (1968).

⁶³*Id.* at 792.

⁶⁴*Southern Louisiana Area Rate Cases*, 428 F.2d 407, 442 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970).

⁶⁵324 U.S. 548 (1945).

⁶⁶320 U.S. 591 (1944).

⁶⁷324 U.S. at 566-67.

⁶⁸390 U.S. at 831-36.

rates would run afoul of the “financial integrity” constraint. After all, despite myriad business failures, firms constantly enter industries where rates are set by competition.

Nor does the fact that competitive rates are novel to the industry seem to render them insufficient under the “financial integrity” standard. It is a commonplace that regulation of natural monopolies seeks to replicate the prices and output that would prevail under competition if it were present. Regulation may for a period be unable to attain that goal. But firms that have allowed their costs to get out of line, in reliance on their monopoly position and on the ineffectiveness of regulation, might be deemed on notice of the possibility of curative measures. If so, they may properly be held responsible for any resulting losses. Hence, if the Commission succeeds in creating competition by means of its non-discriminatory transportation program, any resulting losses seem consistent with the “financial integrity” precept.⁶⁹

Pipeline losses due to the Commission’s block billing proposal seem quite different. They would be due to the conflict between the block billing concept and pipeline behavior induced and necessitated by the pre-existing regulatory scheme. That conflict would seem to make the losses inconsistent with any meaningful duty to preserve the pipelines’ financial integrity.

Thus the “financial integrity” rule seems to raise, in a special context, the same issue discussed in connection with the more general issue of block billing’s apparent inconsistency with the NGA and NGPA. The same inconsistency appears in this context, aggravated by the economic implications for pipelines.

Block billing is brilliant in concept. Had it been adopted in 1978 and coupled with a requirement that LDCs distribute the rents in a manner that would not vary with gas consumption, it would have effected Congress’s intention to transfer old gas rents to consumers, while at the same time preventing the transmission of false price signals to producers and consumers in 1978-82. In the form proposed by the Commission, however, block billing imposes heavy penalties on pipelines for conduct clearly in accord with the rules prevailing in 1978-82. Accordingly, its conformity to the NGA and NGPA is doubtful, particularly in light of occasional judicial concern for the “financial integrity” of pipelines. If limited in the way proposed above, however, block billing would enable the Commission to establish a “level playing field” between large-cushion pipelines and all their competitors and would provide the technical basis for diminished regulation of pipelines’ gas prices.

D. Validity Under the Due Process Clause.

The uninitiated observer might think that any regulatory scheme was unconstitutional if it imposed rate ceilings on pipelines that (1) were lower in the aggregate than competitive levels and (2) penalized pipelines for behaving exactly as required by prior regulatory policy. He would almost certainly be wrong.

⁶⁹Pipelines might argue that the resulting losses are not consistent with the limited form of review of gas costs permitted under the “fraud or abuse” standard of NGPA § 601. *See* Columbia Gas Transmission Corp., 26 FERC ¶ 61,034 (1984). But while that provision may limit the Commission’s power to issue orders directly denying recovery of gas costs incurred, it can hardly be read as preventing the Commission from adopting rules that expose pipelines to competition.

*Usery v. Turner Elkhorn Mining Co.*⁷⁰ conveys the flavor of the Supreme Court's current attitude toward claims that legislation deprives persons of property in violation of the due process clause of the fifth amendment. In 1972 Congress made coal mine operators retroactively liable for compensation benefits to be paid to miners for pneumoconiosis arising out of employment for which the operator was responsible. (The finding that the disease arose out of employment is made virtually certain by a variety of presumptions, some irrebuttable and some nominally rebuttable.)⁷¹ The Court tested the statute by a standard of "irrationality" and had no difficulty finding it rational:

It is by now well established that legislative Acts adjusting the burdens and benefits of economic life come to the Court with a presumption of constitutionality, and that the burden is on one complaining of a due process violation to establish that the legislature has acted in an arbitrary and irrational way. . . .*Williamson v. Lee Optical Co.*, 348 U.S. 483, 487-488 (1955). . . .

To be sure, insofar as the Act requires compensation for disabilities bred during employment terminated before the date of the enactment, the Act has some retrospective effect. . . . And it may be that the liability imposed by the Act for disabilities suffered by former employees was not anticipated at the time of actual employment. But our cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations.⁷²

Nominally, the Court took the position that retrospective legislation required more by way of justification than did prospective. In this case, it said, the justification "must take into account the possibilities that the Operators may not have known of the danger of their employees' contracting pneumoconiosis, and that even if they did know of the danger their conduct may have been taken in reliance upon the current state of the law."⁷³ But the Court had no difficulty finding the extra level of justification. The Act was "justified as a rational measure to spread the costs of the employees' disabilities to those who have profited from the fruits of their labor — the operators and the coal consumers."⁷⁴

Despite the reference to coal consumers, the Court explicitly acknowledged the operators' claim that they would not be able to pass the liability forward.⁷⁵ In a competitive market, price would be determined by marginal cost, and thus by the costs of new entrants who would be free of the retrospective burden. Even assuming that the operators could prevail on that factual issue (i.e., could establish that they could not *pass* the liability forward),

It is enough to say that the Act approaches the problem of cost-spreading rationally; whether a broader cost-spreading scheme would have been wiser or more practical under the circumstances is not a question of constitutional dimension.⁷⁶

The Court appears to be saying that where reallocation of a burden shifts wealth, the legislative decision is constitutional unless there is some overwhelming

⁷⁰428 U.S. 1 (1976).

⁷¹*Id.* at 10-12.

⁷²*Id.* at 15-16.

⁷³*Id.* at 17.

⁷⁴*Id.* at 18.

⁷⁵*Id.*

⁷⁶*Id.* at 19.

ethical or practical reason not to single out the chosen loss-bearers. Retroactivity does not qualify as such an overwhelming reason, regardless of the loss-bearers' reliance. In the case of pneumoconiosis, prior law was assumed to have allocated the burden to the employees and to have induced employer reliance, both in failing to take preventive measures and in setting their levels of production. (Anticipation of the liability would have required establishment of some sort of reserve, thus raising costs per ton and reducing the profit-maximizing output level.) In the case of natural gas, prior law similarly induced purchasing policies that dissipated the rent.

As the Court implicitly accepted Congress's decision that operators should bear the costs for past accruals of pneumoconiosis (as between operators, miners and taxpayers), so it would probably accept a decision that pipelines should bear the costs of past rent dissipation (as between pipelines and consumers).⁷⁷ If pipelines attacking the Commission's block billing scheme fail to have it struck down as beyond the Commission's statutory authority, they are most unlikely to find a back-stop in the Constitution.

III. "JUST AND REASONABLE" PRESUMPTION FOR BLOCK 2 PRICES

The wellhead market has until now been only potentially competitive. Old gas rents have forced pipelines to bid supra-market prices.⁷⁸ And their monopoly or oligopoly positions have relieved them of the competitive necessity to scramble for the lowest possible prices.⁷⁹

The Commission's non-discriminatory blanket certificate transportation proposal, if effective, will realize the full competitive potential. Thanks to the universal availability of transportation, any major gas user should be able to find gas at the wellhead.⁸⁰ No pipeline should be able to use its market power in gas transmission to obtain shelter from the natural consequences of inadequate skill in gas purchasing.

On the principle that effective competition is superior to regulation, the Commission would, under certain conditions, presume that a pipeline's gas sales prices were in conformity with the NGA's requirement that they be "just and reasonable." The necessary conditions are: (1) that the presumption commence no sooner than four years after the effective date of the proposed rules; (2) that the

⁷⁷The Court's most recent cases on the issue of retroactive burdens rely heavily on *Turner Elkhorn*. See *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry.*, 105 S. Ct. 1441, 1456-58 (1985); *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 104 S. Ct. 2709, 2717-20 (1984).

⁷⁸See *supra*, text at notes 20-21.

⁷⁹One can easily exaggerate the inadequacy of pipelines' incentives. Since the demand for gas is price elastic, excess gas costs cause load loss and thus adversely affect pipeline recovery of fixed costs (or force them to take a loss on some of their gas).

⁸⁰The qualifying adjective "major" reflects the concern that small purchasers will not be able to embark on such wellhead purchases. To the extent, however, that the intermediate links in gas transmission and distribution are competitive, small purchasers should enjoy the benefits. The fact that they are too small to purchase gas at the wellhead for themselves is irrelevant, for here as in other fields they could use the services of independent brokers and marketers. (Bread users do not buy grain for themselves, but enjoy the benefits of a competitive grain market due to competition among intermediaries.) In practice, however, state utility regulators will probably not force local distribution companies to engage in non-discriminatory transportation on behalf of independent gas sellers and will thus protect the LDCs' monopoly position.

pipeline offer non-discriminatory blanket certificate transportation; and (3) that the pipeline has provided its customers a chance to reduce their contract demand for firm sales by 100%.⁸¹

Courts have recognized three propositions that are central to the legal validity of the Commission's presumption: (1) A lightening of the regulatory hand is not to be equated with abdication. (2) Rate regulation that departs from the conventional standard of historic cost may conform to the NGA's "just and reasonable" criterion. (3) As regulation and competition are substitutes, creation or natural development of competition justifies a lightening of regulation.

A. *Lightened Regulation Is Distinct From Deregulation.*

While the Supreme Court has taken the position that the Commission lacks the power to *exempt* any jurisdictional sales from rate regulation, it has approved the concept of lightened regulatory control. In *FPC v. Texaco Inc.*,⁸² the Court reviewed FPC Order No. 428,⁸³ under which the Commission's only supervision of "small producer" rates would have been indirect — through issuing refund orders against a pipeline if it found the pipeline to have paid excessive prices. The Commission argued unsuccessfully to the Circuit Court of Appeals for the District of Columbia that the Act entitled it to exempt a specific class of producer sales. On appeal it abandoned that contention — "wisely," according to the Supreme Court.⁸⁴ The Court stated that it was "plain enough to us that the Act does not empower [the Commission] to exempt small-producer rates from compliance with [the just and reasonable] standard."⁸⁵

Nevertheless, the Court refused to invalidate the principle of indirect regulation: "[W]e cannot at this point say that the Commission has exceeded its powers by instituting a regime of indirect regulation of small-producer rates."⁸⁶ The sticking point for the Court was its uncertainty as to the standards that the Commission would apply in the indirect review process. The Order suggested that perhaps reasonableness would be tested "by the standard of the marketplace."⁸⁷ The Court, placing great stress on the notion that the natural gas market was distorted by "monopolistic forces,"⁸⁸ held that the marketplace standard was inadequate:

In subjecting producers to regulation because of anticompetitive conditions in the industry, Congress could not have assumed that "just and reasonable" rates could conclusively be determined by reference to market price.⁸⁹

We shall later consider whether the Court's derogation of the marketplace standard would survive if the Commission succeeded in establishing effective competition for

⁸¹NOPR, 50 Fed. Reg. at 24,167.

⁸²417 U.S. 380 (1974).

⁸³45 F.P.C. 454 (1971).

⁸⁴417 U.S. at 394.

⁸⁵*Id.*

⁸⁶*Id.* at 390.

⁸⁷*Id.* at 396.

⁸⁸*Id.* at 397-99. The passage seems deliberately to confuse monopoly in pipelining with monopoly in gas production. See especially *id.* at 398 n.8.

⁸⁹*Id.* at 399.

sales of gas to distributors.⁹⁰ For the moment, the critical point is that the Court recognized a clear distinction between deregulation and relaxed regulation resulting from procedural innovations.

In *Nader v. CAB*,⁹¹ the District of Columbia Circuit Court recognized the same principle in approving a decision of the Civil Aeronautics Board to establish a rate zone within which it would not exercise its discretionary power to suspend rate filings. The Airline Deregulation Act of 1978 had established one zone, the "standard industry fare level" (SIFL), within which rates were automatically "just and reasonable." As to rates falling outside that zone, the CAB retained power to review under the "just and reasonable" standard and discretion to suspend pending review. The CAB adopted guidelines to the effect that it would not exercise its suspension power with respect to rates unless they exceeded SIFL by 30% plus \$15, "except upon a clear showing of abuse of market power that the Board does not expect to be corrected through marketplace forces[.]"⁹² Because the Board retained its full authority to find rates outside the statutory zone unjust or unreasonable, the court rejected a claim that the guidelines constituted an abandonment of regulatory authority.⁹³

FERC would retain a similar power with respect to pipeline sales rates. Thus, although *Nader v. CAB* involves a different procedural innovation, i.e., diminished exercise of the suspension power rather than creation of a presumption, it provides significant support for the FERC proposal.

B. *Basing Rates on Factors Other Than Historic Cost Is Acceptable*

Rate regulation under the NGA has established unequivocally that the Commission may consider elements other than historic cost in enforcing the "just and reasonable" standard.

In *Permian Basin Area Rate Cases*,⁹⁴ the Supreme Court approved the Commission's first set of area rates, stating, "[I]t is quite plain that the Commission's rate structure is, and was intended to be, significantly influenced by 'non-cost considerations.'" ⁹⁵ The Court also acknowledged "the forceful argument that the computation of rates from costs is ultimately circular."⁹⁶ Since investors look to the rate ceilings in deciding what gas exploration ventures are worthwhile, the gas that is produced will be the gas with expected costs at or below the ceiling. Gas with higher expected costs will not be produced.⁹⁷

In the context of producer rates, the acceptance of non-cost factors was ultimately grounded in concern over supply. Given (1) a broadening of the gas market due to extension of the interstate network, (2) exhaustion of the least costly

⁹⁰See text at notes 122-27, *infra*.

⁹¹657 F. 2d 453 (D.C. Cir. 1981).

⁹²Quoted *id.* at 455. The guidelines also stated that the Board would not suspend rates below the SIFL "except under extraordinary circumstances." *Id.*

⁹³*Id.* at 458. (The panel consisted of Judges Wright (writing for the court), Bazelon and Wald.)

⁹⁴390 U.S. 747 (1968).

⁹⁵*Id.* at 815 n.97.

⁹⁶*Id.* at 816 n.99.

⁹⁷See also *Southern Louisiana Area Rate Cases*, 428 F. 2d 407, 426 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970).

reserves, and (3) gradual diminution in the pipelines' ability to extract monopsony prices from producers, a price based on historic costs was sure to generate shortages.⁹⁸ In a succession of cases running at least as far back as 1955, courts have approved the principle of departing from historic cost in order to avert supply shortages.⁹⁹

There is, of course, no suggestion that fear of prolonged shortages justifies relaxation of cost principles for the gas component of *pipelines'* sales rates.¹⁰⁰ In its Notice, the Commission does not spell out precisely what it expects to gain from the relaxed regulatory grip. It says the proposal "would recognize that when customers can purchase from alternative merchants, the oversight of gas purchasing practices can be effectively augmented by greater reliance on market forces."¹⁰¹ But pointing to the benefits of *adding* competition obviously does not ipso facto justify *subtracting* regulation, even in part.

The justifications, however, are readily conceived. First, out-of-pocket costs of regulation, both for the government and the affected firms, should be reduced.¹⁰²

Second, rapid movement of price signals between wellhead and burner-tip will increase the efficiency of gas use. Under the present system, payment for the gas component of pipeline sales is based upon the pipeline's most recent purchased gas adjustment (PGA) filing. If the filing period is semi-annual, then customers are likely to see summer prices based on winter conditions (including, obviously, greater scarcity), and winter prices based on summer conditions. This persistent tendency to be "out of sync" blunts the market's ability to ration scarce resources efficiently. More generally, rigid prices generate a risk of temporary gluts, when the rigidity is sustaining prices, and shortages, when it is suppressing them. Price flexibility reduces the likelihood of such distortions.

Third, price flexibility will level the playing field between pipelines and other gas vendors. The rates of gas producers are, for the most part, not subject to Commission jurisdiction. They have the right to adjust their prices immediately in response to market changes. Clearly pipelines will be at a competitive disadvantage if they lack equivalent flexibility. This argument, although couched in terms of fairness, also has an efficiency dimension. Where regulatory fettering of prices causes a pipeline to lose a sale it would otherwise make, the economy loses the efficiency gains that could have been achieved if the market were unfettered.

The analysis above depends for much of its force on the assumption that the Commission's efforts to establish competition with pipeline sales are effective.

⁹⁸See S. BREYER, REGULATION AND ITS REFORM 242-53 (1982).

⁹⁹*City of Detroit v. FPC*, 230 F.2d 810, 816-17 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956); *see also Mobil Oil Co. v. FPC*, 417 U.S. 283, 319-21, 325-27 (1974) (second set of Southern Louisiana area rates); *American Pub. Gas Ass'n v. FPC*, 567 F.2d 1016, 1043-49 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978) (second set of national rates); *Shell Oil Co. v. FPC*, 520 F.2d 1061, 1078-79 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976) (first set of national rates); *Public Serv. Comm'n v. FPC*, 467 F.2d 361, 368-69 (D.C. Cir. 1972) (advance payments to producers); *Southern Louisiana Area Rate Cases*, 428 F.2d 407, 425-27 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970).

¹⁰⁰The adjective "prolonged" is necessary, because in the absence of fully flexible prices there is a risk of temporary shortages or gluts. *See* text immediately below.

¹⁰¹50 Fed. Reg. at 24139.

¹⁰²*See Black Citizens for a Fair Media v. FCC*, 719 F.2d 407, 418 (D.C. Cir. 1983) (FCC "may consider regulatory burden in choosing between two procedures, each of which serves the public interest").

Under the proposal as currently drafted, however, that assumption is questionable. The source of doubts, and the general nature of the changes needed to remove them, are discussed in the next section.

C. *Establishment of Competition Justifies Lightened Regulation*

Diminished regulation of pipelines' Block 2 gas sales prices can be legitimate only if it is consistent with the fundamental purposes of the NGA and NGPA. This turns on two issues: (1) the extent to which the Commission's moves will establish competition as an effective substitute for regulation, and (2) the extent to which the NGA provides the Commission with the flexibility to respond to that development.

The effectiveness of competition as a substitute for regulation must be measured against the goals of federal regulation of natural gas. Historically, that regulation has served two quite distinct functions: (1) to capture economic rents in gas production, with the aim of transferring them to consumers, and (2) to prevent interstate pipelines from using their monopoly or oligopoly power to charge supra-competitive prices.

So far as the rent-capturing purpose is concerned, competition clearly could not substitute for regulation: in an increasing-cost extractive industry such as gas production, economic rents are completely consistent with perfect competition.¹⁰³ However, the NGPA initiated the phase-out of wellhead price regulation and the attempted capture of producer rents. Further, while rent-capturing purposes linger on in the form of price controls on old gas,¹⁰⁴ the Commission's proposed treatment of Block 1 gas serves to transmit those rents to customers.¹⁰⁵ As to Block 2 gas, such rent-capturing purposes either do not exist or, because the statutory ceilings exceed market prices, have become moot. Thus the only relevant purpose of continued rate regulation of Block 2 gas is to prevent pipelines from charging prices above competitive levels. The first issue, then, boils down to whether the Commission's proposed non-discriminatory blanket certificate transportation can effectively prevent pipelines from charging oligopoly or monopoly prices.¹⁰⁶

To do so, blanket certificate transportation must be equal in quality to the transportation provided by pipelines in the sale of their own gas. In fact, the proposed blanket certificate transportation seems not to meet that standard.

¹⁰³See, e.g., S. BREYER, *supra* note 98, at 21.

¹⁰⁴Price controls also continue on categories that cannot readily be classified as old or new, to wit, gas from new wells on old OCS leases, under Section 102(d), and gas from new wells but committed or dedicated to interstate commerce before adoption of the NGPA, under Section 103. In both cases, however, the statutory ceiling price exceeds what is obtainable in the market for gas not previously covered by contract, so any rent-capturing purpose is currently moot as to such gas. In the improbable event that free market gas prices should move above those ceilings, then fulfillment of the rent-capturing purpose would require reallocation of such gas to Block 1.

¹⁰⁵As argued in Part B, it carries that purpose further than the law requires and, in all probability, further than the law permits.

¹⁰⁶In its efforts on oil pipeline regulation, the Commission has run afoul of the courts by leaping to dubious conclusions as to the state of competition in the oil pipelining industry. See *Farmers Union Central Exch., Inc. v. FERC*, 734 F.2d 1486, 1508-09 (D.C. Cir.), *cert. denied*, 105 S. Ct. 507 (1984). In the present case, the finding that customers can secure the benefits of a competitive wellhead price seems to require only a careful analysis of the transportation options, rather than any fancy econometric work. Compare *National Tour Brokers Ass'n v. ICC*, 671 F.2d 528, 532-33 (D.C. Cir. 1982).

The Commission could establish equal transportation by providing identical solutions for shortfalls in capacity, whether in blanket certificate transportation or pipeline gas sales. The most plausible devices are either (1) price rationing, i.e., allowing pipelines to charge rates high enough to bring demand down to the level of available capacity, or (2) a priority system such as currently exists among firm sales customers.¹⁰⁷ So long as the allocation systems were identical (as between pipeline sales and any parallel non-discriminatory transportation), and so long as pipelines were prevented from favoring transportation of their own gas, blanket certificate transportation would deny pipelines any ability to charge supra-competitive prices.

The proposed rules fail to provide such equivalence. Although there is some uncertainty as to the precise status of blanket certificate transportation — one comment claims to have identified five different classes of priority¹⁰⁸ — it clearly has a lower status, at least for any specific customer, than conventional service certified under Section 7(c). The Commission states that customers may prefer to make special arrangements for Section 7(c) or “Cadillac” service.¹⁰⁹ Indeed, “Let them eat cake!” Of course a customer may well prefer transportation giving it as secure a claim to pipeline capacity as conventional firm sales service; the problem is that the pipeline may *refuse* to provide it. For a customer that must rely Commission’s anti-discrimination rule to induce pipeline consent, Cadillac service is not available — only a jitney.

A court might possibly find that the level of security afforded blanket certificate transportation in the current proposals is a sufficient basis for the Commission’s presumption. (The presumption might prove quite weak in application, with the Commission effectively insisting on straight cost-of-service rates whenever there was any doubt about the availability of transportation.) But a more interesting question is whether, if the final rule should provide security truly equivalent to that of regular service,¹¹⁰ the courts would accept this form of competition as an almost complete substitute for regulation.

The courts unquestionably recognize that competition and regulation are substitutes for performing the task of keeping prices at the level of cost.¹¹¹ In *NAACP v. FPC*,¹¹² for example, the court observed: “By doing whatever is within its power to enhance that competition [in the regulated industry], the Commission serves the same objective as it does by direct regulation of price. . . .”¹¹³ In *Office of Communication of United Church of Christ v. FCC*,¹¹⁴ the court noted the Commission’s

¹⁰⁷A third conceivable system is pro rata allocation among shippers (including, of course, the pipeline itself). Such a system can work, however, only if suitable tender rules are established, for otherwise all potential shippers may seek to inflate their entitlement to capacity by inflating their claims.

¹⁰⁸See FOSTER’S NATURAL GAS REPORT, No. 1527, App. p. 4 (July 25, 1985).

¹⁰⁹50 Fed. Reg. at 24,136.

¹¹⁰This could be achieved, at least for current regular customers of firm service, by providing those customers with a right to convert portions of their sales contract demand into an equally secure entitlement to transportation.

¹¹¹The precise type of cost to which prices are held may differ significantly. Characteristically, regulation enforces rates pegged at average historic cost, while under perfect competition price equals marginal current cost.

¹¹²520 F.2d 432 (D.C. Cir. 1975), *aff’d*, 425 U.S. 662 (1976).

¹¹³*Id.* at 441.

¹¹⁴707 F.2d 1413 (D.C. Cir. 1983).

findings that an increase in radio stations had increased inter-station competition and that radio had evolved into a secondary, and somewhat specialized, source of entertainment and information;¹¹⁵ it then accepted the Commission's arguments that competition could effectively replace regulation as a control over several potential evils, such as excessive commercialization.¹¹⁶

A case closely parallel to FERC's current effort is *Computer and Communications Industry Association v. FCC*.¹¹⁷ There the court upheld the FCC's decision to refrain from full-scale regulation of "enhanced services" and "customer premises equipment" (CPE), in large part because of the existence of effective competition in the market for both services. First, the Commission concluded that the competitive nature of the two fields was such that a firm providing them was not as such a "common carrier engaged in interstate or foreign communication by wire or radio,"¹¹⁸ the class of persons for which the FCC was required by statute to set "just and reasonable" rates. Second, the Commission contended that even if provisions of these goods and services should be viewed as common carrier communications activity, it was entitled to forbear from regulation. In the case of enhanced services, it justified its forbearance on the grounds that case-by-case determinations of which enhanced services were regulable would (1) generate regulatory uncertainty and limit the range of services available to consumers and (2) absorb Commission resources better employed elsewhere.¹¹⁹ In the case of carrier-provided CPE, it justified regulatory forbearance on the grounds (1) that the competitive market would assure the availability of CPE at reasonable prices and (2) that discontinuance of regulation would provide economic incentives for carriers to "structure services so that customers pay only for what they need."¹²⁰ The court upheld both grounds of decision as to both types of services.¹²¹

The peculiarities of the statutory scheme make it difficult to generalize from *Computer and Communications Industry Association*. The Commission's option to treat non-common carrier communications services as subject to its "ancillary" jurisdiction provided a sort of statutory half-way house that has no exact parallel in the NGA. On the other hand, in approving the second ground of decision, the court in essence held that the Commission's conclusions — that competition could do the job adequately and that regulation would be counterproductive — justified deliberate forbearance from the exercise of statutory jurisdiction. That principle would seem equally applicable to regulation under the NGA.

Judicial treatments of the same problem under the NGA are troubled by confusion of the two purposes of federal natural gas regulation. The leading case is *FPC v. Texaco Inc.*,¹²² which remanded to the Commission its proposal for indirect regulation of small producer rates. Much of the language of the opinion is extremely adverse to any deregulatory initiative. Above all is the following declaration by the Court:

¹¹⁵*Id.* at 1420.

¹¹⁶*Id.* at 1437-38.

¹¹⁷693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983).

¹¹⁸*Id.* at 209-14; the language quoted is that of the statute, 47 U.S.C. § 201(a) (1976).

¹¹⁹693 F.2d at 211.

¹²⁰*Id.*

¹²¹*Id.* at 209-14; *see also* *Western Union Tel. Co. v. FCC*, 674 F.2d 160 (2d Cir. 1982).

¹²²417 U.S. 380 (1974).

In subjecting producers to regulation because of anticompetitive conditions in the industry, Congress could not have assumed that “just and reasonable” rates could conclusively be determined by reference to market price.¹²³

This passage follows a long footnote comprised of quotations from the Federal Trade Commission’s 1935 report, which essentially identified the industry’s problems as deriving from pipeline monopoly in gas transmission and pipeline *monopsony* in purchases at the wellhead. The footnote ends on this rather lame note: “It [the FTC report] concluded that regulation, *at least of pipelines*, see *id.*, at 616, was required.”¹²⁴

Surely reference to a report endorsing regulation of pipelines is an odd basis for the Court’s sweeping statement, quoted above, about the necessary implications of “subjecting producers to regulation.”

The peculiarity arises out of the judicial pretense that monopoly conditions at the wellhead constituted the reason for producer rate regulation. The Court unquestionably sensed the existence of some other function — to wit, the capture and transfer of economic rents. It never, however, explicitly acknowledged that function. As a result, when confronted with claims that the market could replace regulation, the Court naturally insisted on continued regulation; otherwise the rent-capturing function could not go forward. But in so doing, it cast an unnecessary cloud on the thought that establishment of competitive conditions could justify a diminution in regulation.¹²⁵

Subsequent developments, of course, make it possible to disentangle this web. The NGPA put wellhead price regulation on the road to extinction; the Commission’s Block 1 proposal — as well as some alternative block billing possibilities¹²⁶ — segregate those gas vintages as to which a residual rent-capturing purpose can theoretically be achieved. The treatment of pipeline pricing of the remaining gas, Block 2, should be analyzed entirely by reference to the problem of pipeline monopoly in gas transmission.

Thus, if the Commission developed a nondiscriminatory gas transportation program that gave its users assurance of transportation as secure as that involved in pipeline gas sales,¹²⁷ it would have established competition sufficient to keep pipeline gas sales prices down to competitive levels. Given the legislative purposes with respect to Block 2 gas, evidence of competition of that quality would seem to validate a very high degree of Commission forbearance. It might, in effect, justify the Commission in deciding virtually never to limit pipeline gas sales prices.

¹²³*Id.* at 399.

¹²⁴*Id.* at 398 n.8 (emphasis added).

¹²⁵For the same phenomenon at work, see *Permian Basin Area Rate Cases*, 390 U.S. 747, 792-95 (1968); *Southern Louisiana Area Rate Cases*, 428 F.2d 407, 416, 432 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970); *Shell Oil Co. v. FPC*, 520 F.2d 1016, 1083-84 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976).

¹²⁶See the author’s own proposal *supra*, text at notes 56-59.

¹²⁷This of course also assumes that the price of the transportation will be non-discriminatory and limited to cost. The definition of cost may, however, be flexible. Peak-period pricing aimed at equalizing demand and supply of capacity might well recover more than historic cost, but it would incorporate the opportunity costs incurred by users cut off by virtue of capacity constraints. The pipelines might be limited to historic cost either by ceilings imposed on off-peak rates or by some sort of redistribution of excess revenues.

IV. EXPEDITED CERTIFICATION

The Commission proposes, in special circumstances, to expedite the issuance of certificates of convenience and necessity under Section 7(c). The necessary conditions put the risk of the venture upon the applicant. In making rates for the proposed service, the pipeline is to be able to include only costs truly allocable to the service itself; in making rates for any other service it is not to use costs properly allocable to the service allowed under expedited certification. The pipeline is to be disabled from reducing the "representative volumes" originally calculated for the service, so that it will not be able to raise rates on the service merely because of disappointing results. In addition, the pipeline is not to be allowed to recover past losses in future rate cases.¹²⁸ Further, a pipeline offering service under this program will have no entitlement to complain at the certification of any competitive new service.¹²⁹

Where an applicant meets the specified criteria, the Commission would entertain a presumption as to the key findings necessary for certification under Section 7: that the applicant is willing and able to perform the service and that the proposed service is or will be required by the public convenience and necessity.¹³⁰ Notice will be given of the application and of the Commission's scheduling of a hearing. Protestors may be heard, but will have the burden of proof to show that the proposed service will not be in the public convenience and necessity.¹³¹

The Commission proposes this relaxation of entry barriers in order to provide consumers "greater options in the array of gas services available," and to help consumers gain "the full benefits of greater competition."¹³² These include flexibility, innovation, and the avoidance of delay.¹³³

The Commission also argues that by removing barriers to entry, the availability of expedited certification will induce pipelines to select an efficient scale for new facilities. Choice of suboptimal size would lead to higher unit costs and expose a firm selecting such a size to competitive threats facilitated by the expedited certificate program.¹³⁴

To appreciate the potential value of this move, one must have some idea of the burdens of the conventional certification process. The Commission has construed Section 7 to authorize a global inquiry into the benefits and costs of the proposed service. Disputable topics include: (1) the wisdom of the buyer's decision to buy; (2) the ability of the seller to provide the service, with particular reference to whether it has adequate supplies;¹³⁵ (3) benefits that the new service will provide the customers

¹²⁸50 Fed. Reg. at 24,138. In addition, the Commission would limit the pipeline to charging "volumetric" rates. Such rates seem completely inappropriate for firm service, at least whenever there is any possibility that the rates will not equalize demand with capacity at peak periods. Volumetric rates give possible shippers an incentive to claim excess quantities of service in order to attain a preferred position in the capacity allocation that will result. I criticize the volumetric rate concept in more detail in S. WILLIAMS, *THE NATURAL GAS REVOLUTION OF 1985* (American Enterprise Institute 1985).

¹²⁹§ 157.103 (a) (proposed); 50 Fed. Reg. at 24,163.

¹³⁰§ 157.104 (b) (proposed); 50 Fed. Reg. at 24,164.

¹³¹§ 157.104 (c) (proposed); 50 Fed. Reg. at 24,164.

¹³²*Id.* at 24,137.

¹³³*Id.* at 24,137, 24,140.

¹³⁴*Id.* at 24,137.

¹³⁵*See, e.g.,* Tennessee Gas Pipeline Co., 22 F.E.R.C. ¶ 61,174 (1983).

who receive it;¹³⁶ (4) disadvantages that provision of the new service may impose on current customers of the supplying firm (as through increasing its average gas cost);¹³⁷ and (5) detriments imposed upon the pipelines whose sales may be displaced as a result of the new service, and detriments imposed upon their customers.¹³⁸

These main issues are, of course, divisible into many subissues. For example, even though the wisdom of the buyer's decision to buy is something that one might expect to be left to the buyer itself, FERC consideration of this issue may lead to examination of whether the buyer has an adequate market for the gas to be supplied,¹³⁹ whether its current supplier is providing "adequate" service,¹⁴⁰ whether the buyer has a "present need" for the new supply,¹⁴¹ and whether it is able to finance the investments it is expected to undertake.¹⁴²

Further, resolution of the issues often turns on highly iffy factual contentions (such as whether proposed new service will come at the expense of existing sales by the present supplier or will constitute incremental sales to its customers) and elusive normative categories (whether the resulting competition will be "ruinous" or healthy).¹⁴³

Within this system, the Commission sometimes pursues policies that at least are nominally pro-competitive. For example, it purports to welcome non-ruinous competition; it also recognizes that some increase in a pipeline's average gas cost, occurring as part of an increase in service,¹⁴⁴ is an inevitable consequence (under rolled-in pricing) of the evolution of wellhead prices from regulation to free market levels.¹⁴⁵

Nonetheless, the system as a whole is oppressively anticompetitive. So long as the issues are legion, the factual contentions complex and uncertain, and the standards slippery, every certification proceeding will, by its nature; constitute a serious obstacle to competition. The time element alone is a major barrier. In a recent case, for example, two-and-a-half years elapsed between Natural Gas Pipeline's application for approval of modest service expansions and final Commission approval.¹⁴⁶ Expenses for lawyers and expert witnesses are a serious additional obstruction to competition.

¹³⁶See, e.g., *Atlantic Seaboard Corp. v. FPC*, 397 F.2d 753, 756 (4th Cir. 1968).

¹³⁷See, e.g., *Tennessee Gas Pipeline Co.*, 22 F.E.R.C. ¶ 61,174 (1983).

¹³⁸See, e.g., *Natural Gas Pipeline Co.*, 20 F.E.R.C. ¶ 61,324 (1982), at p. 61,675, *reh'g denied*, 21 F.E.R.C. ¶ 61,223 (1982), *amended* 21 F.E.R.C. ¶ 61,231 (1982); *Columbia Gulf Transmission Co.*, 37 F.P.C. 118, 131, *reh'g denied*, 37 F.P.C. 591 (1967), *aff'd sub nom. Atlantic Seaboard Corp. v. FPC*, 397 F.2d 753, 757-59 (4th Cir. 1968).

¹³⁹See, e.g., *Natural Gas Pipeline Co.*, 20 F.E.R.C. ¶ 61,324 at p. 71,675 (1982), *reh'g denied*, 21 F.E.R.C. ¶ 61,223 (1982), *amended*, 21 F.E.R.C. ¶ 61,231 (1982).

¹⁴⁰See, e.g., *Transcontinental Gas Pipe Line Co.*, 21 F.P.C. 138 (1959).

¹⁴¹See, e.g., *Cincinnati Gas & Elec. Co.*, 41 F.P.C. 530, 535 (1969).

¹⁴²See, e.g., *Transcontinental Gas Pipe Line Corp.*, 21 F.P.C. 138 (1969).

¹⁴³See, e.g., *Columbia Gulf Transmission Corp.*, *supra* note 138.

¹⁴⁴Expansion of sales by a large-cushion pipeline leads it to substitute gas at current market prices for gas drawn from a portfolio of supplies priced, until recently at least, below the current market average.

¹⁴⁵See *Northern Natural Gas Co.*, 16 F.E.R.C. ¶ 61,233 (1981).

¹⁴⁶See *Natural Gas Pipeline Co.*, 30 F.E.R.C. ¶ 61,017 (1984) (Commission approval on January 14, 1985 of application filed June 22, 1982). On December 17, 1984, Northern Natural applied for

There can, at this stage, be no doubt about the validity of using a rulemaking to identify in advance a set of applicants upon which the Commission will look favorably. The Commission initiated the approach at least as early as 1975, when it established special criteria for evaluating applications to transport gas interstate for direct sales. The Circuit Court for the District of Columbia approved in *American Public Gas Association v. FERC*.¹⁴⁷ In a succession of cases, courts have approved this approach, against complaints that it deprived protestants of hearings to which they were entitled by statute.¹⁴⁸

The issue is thus whether the Commission's substantive decisions are within the scope of its mandate under the NGA. Is there an adequate relation, in light of that mandate, between the Commission's predicate (namely, the applicant's assuming the full financial risk of the proposed service) and the presumed conclusion (that the public convenience and necessity are served)?¹⁴⁹

The Commission's mandate under Section 7 is very broadly phrased. In review of other agency decisions to relax licensing requirements, courts have naturally found similar breadth of language to give the agency a great deal of leeway. For example, in *Black Citizens for a Fair Media v. FCC*,¹⁵⁰ the court reviewed an FCC decision loosening the criteria for renewal of radio and television licenses. The FCC was statutorily required to find that "the public interest, convenience and necessity would be served" by a license renewal, and in a rulemaking it had removed longstanding program-related questions from the renewal application form. Upholding the decision, the court said that "the FCC is entitled to reconsider and revise its views as to the public interest and the means needed to protect that interest, though it must give a sufficient explanation of the change."¹⁵¹ *New York State Commission on Cable Television v. FCC*¹⁵² went further, holding that the FCC could adopt an "open entry" policy for satellite master antenna television in order to fulfill its public interest mandate.¹⁵³

certification of firm sales to another pipeline. On April 16, 1985 the Commission ruled that the matter must be heard before an administrative law judge, mandating another global inquiry into, for instance, the purchasing practices that Northern should implement for future reserve acquisitions and gas purchases in support of the sale. *See Northern Natural Gas Co.*, 31 F.E.R.C. ¶ 61,084 (1985).

¹⁴⁷587 F.2d 1089 (D.C. Cir. 1978).

¹⁴⁸*National Tour Brokers Ass'n v. ICC*, 671 F.2d 528 (D.C. Cir. 1982); *American Trucking Ass'n v. ICC*, 602 F.2d 444, 450-51 (D.C. Cir.), *cert. denied*, 444 U.S. 991 (1979); *Bell Tel. Co. v. FCC*, 503 F.2d 1250, 1264-65 (3d Cir. 1974); *Chemical Leaman Tank Lines, Inc. v. ICC*, 368 F. Supp. 925, 932-38 (D. Del. 1973). In the latter case, the court also rejected a claim that the generic approach violated the statutory requirement of agency "findings" as to fitness, etc.

¹⁴⁹Courts have occasionally found moves by other agencies towards selective open entry to be invalid for want of support in relation to the statutory mandate. *See, e.g.*, *Chemical Leaman Tank Lines, Inc. v. ICC*, 368 F. Supp. 925, 938-46 (D. Del. 1973). This outcome can be distinguished from the present case on two bases: (1) the agency in question had adopted an extremely incumbent-protective policy, and (2) in the rulemaking it had done little or nothing to establish either that there were grounds for modifying the policy or that the proposed rules were consistent with that policy.

¹⁵⁰719 F.2d 407 (D.C. Cir. 1983).

¹⁵¹*Id.* at 411.

¹⁵²749 F.2d 804 (D.C. Cir. 1984).

¹⁵³*Id.* at 811 (upholding exercise of statutory authority to preempt state and local entry restriction on SMATV); *see also FCC v. WNCN Listeners Guild*, 450 U.S. 582 (1981) (finding that an FCC decision to disregard changes in entertainment programming format, in approving radio license transfer or renewal (under a "public interest, convenience, and necessity" standard), was a legitimate exercise of its discretion).

The “public interest” criterion appears throughout the NGA (including Section 7), as well as the Federal Power Act. The Supreme Court has read it in those contexts as “a charge to promote the orderly production of plentiful supplies of electric energy and natural gas at just and reasonable rates.”¹⁵⁴ Clearly this construction does little, in the current context, to constrain the Commission.

The special context of Section 7, however, might be deemed to impose more serious restrictions on the Commission’s room for maneuver. Most seriously, the NGA language might be found to reflect either a desire to protect incumbent sellers, or to avoid “ruinous” or destructive competition.¹⁵⁵

Section 7(g) in fact goes far to dispell any claim that incumbent protection is authorized:

Nothing contained in this section shall be construed as a limitation upon the power of the Commission to grant certificates of public convenience and necessity for service of an area already being served by another natural-gas company.¹⁵⁶

The cases reviewing Commission certification decisions typically cite Section 7(g), recognizing that it precludes treatment of an existing certificate as a monopoly franchise.¹⁵⁷

On the other hand, the cases derive from the statute — not surprisingly — the thought that uncontrolled competition is not necessarily in the public interest. The Commission has applied, with court approval, a “balancing” test, in which gains from the certification (cost savings for consumers, typically measured in dollars, plus intangibles such as the benefit of competition) are weighed against losses inflicted upon the incumbent seller (e.g., unamortized pipeline that is likely to receive no further use).¹⁵⁸ The incumbent has typically been able to project some load growth over the next several years, and the Commission and courts have regarded such growth as offsetting the expected losses from competition and tending to justify the Commission’s certifying the challenger.¹⁵⁹

¹⁵⁴NAACP v. FCC, 425 U.S. 662, 670 (1976) (rejecting contention that take public interest criterion should be viewed as a mandate to eradicate racial discrimination).

¹⁵⁵FERC’s mere adoption of the expedited certification program may well not create a ripe issue. The exact scope of the burden faced by protestors cannot really be known until a hearing occurs. *Compare* Toilet Goods Ass’n v. Gardner, 387 U.S. 158 (1967) (finding that Food & Drug Administration regulations providing that the FDA would suspend certification of additives whenever a manufacturer refused to permit access to FDA employees were not ripe for adjudication), *with* American Pub. Gas Ass’n v. FERC, 587 F.2d 1089 (D.C. Cir. 1978) (giving immediate review to FPC Order No. 533, which established the forerunner of all current blanket certificate programs and set forth the criteria that the Commission would apply in considering applications for certificates to transport gas in direct sales). Nonetheless, it seems appropriate briefly to consider the program’s possible legal vulnerabilities.

¹⁵⁶15 U.S.C. § 717f(g) (1982).

¹⁵⁷*See* Alabama-Tennessee Natural Gas Co. v. FPC, 417 F.2d 511 (5th Cir. 1969), *cert. denied*, 397 U.S. 917 (1970); Atlantic Seaboard Corp. v. FPC, 397 F.2d 753 (4th Cir. 1968); Panhandle Eastern Pipe Line Co. v. FPC, 169 F.2d 881 (D.C. Cir.), *cert. denied*, 335 U.S. 854 (1948); Home Gas Co. v. FPC, 231 F.2d 253 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 831 (1956); Kentucky Natural Gas Corp. v. FPC, 159 F.2d 215 (6th Cir. 1947). A case that oddly omits reference to Section 7(g) is Cincinnati Gas & Elec. Co. v. FPC, 389 F.2d 272 (6th Cir.), *cert. denied*, 393 U.S. 826 (1968), but the decision is emphatic in its declaration that the focal point is the public interest, *not* the impact upon competitors.

¹⁵⁸*See, e.g.*, Alabama-Tennessee Natural Gas Co. v. FPC, 417 F.2d 511 (5th Cir. 1969), *cert. denied*, 397 U.S. 917 (1970).

¹⁵⁹*See, e.g.*, Atlantic Seaboard Corp. v. FPC, 97 F.2d 753 (4th Cir. 1967).

While this exercise is evidently intended to sort “ruinous” competition out from the non-ruinous variety, it is hard to see either that it properly does so, or that it advances the public interest. The public is by no means necessarily harmed by the ruin of a particular competitor. Such ruin is the natural course of competition; that is the way competition sifts the adequate competitors from the inadequate. To seriously advance the public interest, the Commission would have to distinguish between useful ruin and counter-productive ruin.

The existence of natural monopoly in gas pipelining makes such a distinction possible on a theoretical basis. In an industry with *constant* returns to scale, the failure of a firm is clear evidence either of overcapacity or of some sort of entrepreneurial defectiveness. In a natural monopoly, however, it would be quite possible for a firm to fail even though it was perfectly managed and total industry capacity was at or below the optimal level.¹⁶⁰ Thus, one might justify licensing requirements in a natural monopoly industry such as gas pipelining on the theory that uninhibited competition might lead to failures that were “undeserved” and that left industry capacity below optimal levels.

Similarly, one might justify entry control as avoiding “wasteful duplication” of facilities. A new entrant might mistakenly suppose there to be room in the market for additional capacity and construct new facilities, only to find that competition between it and existing firms drove prices too low to recoup its investment. At that point, the theory evidently presupposes, consumers would be injured because the regulatory agency would allow the new entrant, and incumbent firms, to make up the losses with higher prices in other markets. Without the last step — makeup from other markets — the theory is extremely dubious. If the new entrant were to bear any losses it incurred, surely its management would enter only when it considered the prospects of profitable operation adequate. Since the new entrant’s ability to evaluate those prospects is presumptively superior to any regulatory agency’s, regulatory control over entry would be superfluous. The possibility that the new entrant’s other customers would be called on to make up the losses, however, gives some colorable point to regulatory screening.

The Commission’s traditional Section 7 licensing policy cannot, however, be sustained by this analysis. That policy has given considerable weight to the expected effect of the proposed new entry on the incumbent. But the Commission did little to inquire into whether that fate, if severe, was deserved or undeserved; whether the incumbent’s vulnerability was due to its incompetence or to a problem genuinely arising out of natural monopoly conditions; or whether addition of the challenger’s service would bring industry capacity to optimal, suboptimal, or supra-optimal levels.

It is no wonder, of course, that the Commission has not embarked on such inquiries. The time needed would make the current system, sluggish as it is, seem positively brisk. And the data would be out of date by the time it had been assembled.

Clearly the Commission’s expedited service proposal seeks to develop a system of pipeline incentives, closely akin to those of a garden variety competitive market, under which pipelines will enter markets under expedited certification only in cases where it is *relatively likely* that the entry is indeed in the public interest. By excluding

¹⁶⁰H. MOHRING, *TRANSPORTATION ECONOMICS* 5-14, 62-67 (1976).

cross-subsidization between the proposed service and all other pipeline service, it tends to rule out the situations most likely to generate competition that is not in the public interest (competition where any likely "ruin" may be counterproductive). For example, there has been considerable concern that pipelines may seek to construct new pipe in order to put the cost in their rate base and increase charges throughout their system.¹⁶¹ The rule against cross-subsidization would seem to preclude entry based on such a motivation. The same phenomenon can be described from the opposite point of view: if new construction goes into the pipeline's general rate base, then the pipeline may be subsidizing competition in the new market with revenues generated by the rest of its system. Again, the preclusion of cross-subsidization would seem to rule out such effects.

With cross-subsidization removed, the challenger's determination that the market can handle both suppliers is powerful evidence in support of that conclusion. This is especially so as the challenger is likely to be at a structural disadvantage compared to the incumbent; it will have new costs, higher than those of the incumbent unless the latter is quite inefficient.

In short, the Commission's generic criteria seem far more aptly designed to weed out cases of undesirable competition than its ponderous system of case-by-case adjudication. Consequently, the Commission should have a winning argument that its expedited certificate program falls within its mandate to advance the public interest. Indeed, as the courts have been prodding the Commission for nearly twenty years to be more alert to the possibilities of competition in natural gas markets,¹⁶² it would be ironic if they were to invalidate such a dramatically pro-competitive step.

V. CONCLUSION

The Commission's proposals have the potential to move the natural gas industry radically in the direction of effective competition. Though subject to serious defects in its present form, the block billing proposal segregates, for the first time, gas as to which rents are to be captured from all other gas. It thus lays the groundwork for relaxed regulation of the latter. Relaxed regulation of pipelines' gas sales prices is justified, so long as the Commission assures customers adequate access to the wellhead market. Finally, expedited certification can enable the Commission to cease operating as an incumbent protection agency.

¹⁶¹See comments filed in phases II and III of Notice of Inquiry, RM85-1-000, by United States Department of Energy at 3; by Natural Gas Supply Association at 15-17; and by Association for Equal Access to Natural Gas Markets and Supplies and Independent Petroleum Association of Mountain States at 4.

¹⁶²See *Northern Natural Gas Co. v. FPC*, 399 F.2d 953 (D.C. Cir. 1968); *Maryland People's Counsel v. FERC*, 761 F.2d 768 (D.C. Cir. 1985); *Maryland People's Counsel v. FERC*, 761 F.2d 870 (D.C. Cir. 1985).

APPENDIX A

PGA Effective Date	Pipeline	Block 1 Cost	Block 1 Volume	Block 1 % of Total	Block 2 Cost	Weighted Average Cost
5/85	ANR Pipeline Company	\$1.62	320.3	48.5%	\$4.04	\$2.87
4/85	Arkla, Inc.	1.36	61.3	27.0	2.90	2.48
10/84	Colorado Interstate Corp.	0.84	133.4	48.9	3.99	2.45
3/85	Columbia Gas Transmission Corp.	1.65	206.8	32.7	3.77	3.08
3/85	Consolidated Gas Supply Corp.	1.89	37.1	6.5	3.58	3.47
4/85	El Paso Natural Gas Co.	1.29	370.9	38.4	3.54	2.68
4/85	Florida Gas Transmission Co.	1.50	84.7	37.5	3.80	2.93
12/84	K.N. Energy, Inc.	0.84	56.4	61.0	3.96	2.06
5/85	Mississippi River Trans. Corp.	2.00	11.9	7.2	3.38	3.28
2/85	National Fuel Gas Supply Corp.	1.20	6.6	3.7	3.82	3.73
3/85	Natural Gas Pipeline Co. of America	1.52	436.6	42.9	3.40	2.59
1/85	Northern Natural Gas Co.	1.04	326.1	47.8	3.94	2.55
4/85	Northwest Central Pipeline Corp.	0.85	147.3	58.4	3.79	2.08
4/85	Northwest Pipeline Corp.	1.25	70.0	23.2	3.42	2.92
6/85	Panhandle Eastern Pipeline Co.	1.06	125.9	33.6	3.83	2.90
1/85	Sea Robin Pipeline Co.	1.72	82.3	64.7	3.96	2.51
5/85	Southern Natural Gas Co.	1.47	181.0	36.9	3.49	2.75
1/85	Tenneco, Inc.	1.87	454.7	51.0	3.87	2.85
3/85	Texas Eastern Trans. Corp.	0.78	237.6	25.3	3.38	2.72
2/85	Texas Gas Trans. Corp.	1.78	165.2	33.7	3.77	3.10
5/85	Transcontinental Gas Pipeline Co.	1.92	269.6	33.7	3.60	3.04
4/85	Transwestern Pipeline Co.	1.38	41.3	15.6	3.14	2.86
9/84	Trunkline Gas Co.	2.01	189.7	64.6	4.36	2.84
1/85	United Gas Pipeline Co.	1.70	136.6	24.2	3.20	2.84
5/85	Williston Basin (Montana-Dakota Util.)	1.50	8.6	20.7	3.15	2.83
	All Pipelines Listed	1.46	4,161.9	36.1	3.60	2.83

Source: Tables A-1 and A-2 of Comments of Natural Gas Supply Association, filed in Docket RM85-1-000, July 15, 1985. Volumes are in 10⁶ MMBtu; costs are in dollars per MMBtu.

