NARRAGANSETT UPDATE: FROM *WASHINGTON GAS LIGHT* To *NANTAHALA*

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In an article published last year, entitled *The* Narragansett *Decision and Its Aftermath*,[1] Carl D. Hobelman explored the origins and the evolution of the so-called "*Narragansett* doctrine" which provides that state regulatory commissions, in setting retail rates, must allow recovery of the interstate wholesale utility rates that have been made effective by the Federal Energy Regulatory Commission (FERC) in the exercise of its exclusive jurisdiction over the regulation of such rates. He concluded that the courts that had considered the issue of possible conflict between state and federal regulation over interstate wholesale utility rates had, thus far, ruled in favor of federal preemption under *Narragansett*.[2] However, he noted that many of those decisions were pending on appeal. This note seeks to update last year's article by reviewing two significant recent opinions concerning *Narragansett*: the May 9, 1986, decision of the District of Columbia Court of Appeals in *Washington Gas Light Co. v. Public Service Commission*[3] and the June 17, 1986, decision of the United States Supreme Court in *Nantahala Power & Light Co. v. Thornburg*.[4]

The "*Narragansett* doctrine" derived from the "filed rate" doctrine first enunciated by the Supreme Court in *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*[5] The latter doctrine provides that, because Congress granted the FPC (predecessor to the FERC) exclusive jurisdiction to determine the reasonableness of interstate wholesale utility rates, federal courts must respect the integrity and inviolability of rates that are established in an exercise of that exclusive authority. The "filed rate" doctrine was extended to preempt state commission review of the reasonableness of FPC/FERC-approved rates, not as a matter of administrative deference, but rather as a matter of enforcing

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1. 6 ENERGY L.J. 33 (1985).
2. *Id.* at 57.
3. 508 A.2d 930 (D.C. 1986).
4. 106 S. Ct. 2349 (1986).
5. 341 U.S. 246, 251-52 (1951).

the Supremacy Clause of the Constitution.[6] In perhaps the clearest expression of this preemption logic that had occured to date, the Rhode Island Supreme Court, in *Narragansett Electric Co. v. Burke*,[7] determined that the state public service commission lacked the authority to question the reasonableness of FPC-approved wholesale rates for purposes of setting retail rates.[8] This holding—the now-familiar "*Narragansett* doctrine"—has been applied in a significant body of state supreme court cases, typified by *Northern States Power Co. v. Hagen*[9] and the related case of *Northern States Power Co. v. Minnesota Public Utilities Commission*[10] (*Northern States* cases), in which the courts explained that attempts by a state commission to assert indirectly jurisdiction over wholesale rates by investigating the reasonableness of the wholesale costs of local utilities would effectively undermine the Supremacy Clause and other preemption principles. The legal conclusion drawn in this line of cases was fully embraced in *Nantahala*.

The *Nantahala* opinion also served to dispel a misinterpretation of certain language in *Narragansett* that was becoming increasingly common at the state commission and state court level. The Rhode Island Supreme Court had stated in *Narragansett* that, while the state commission was obliged to treat FPC-sanctioned wholesale costs as reasonable operating expenses for retail ratemaking purposes, it was not obliged to ***automatically*** increase retail rates to reflect increased wholesale costs on a dollar-for-dollar basis under automatic adjustment clause provisions. Rather, the state commission could examine the utility's entire rate structure to determine if there were cost savings elsewhere that would offset the increased wholesale cost and obviate the need for a rate increase.[11] Certain commissions and courts, including the lower court in the *Nantahala* case, had placed an overbroad interpretation on the *Narragansett* language that would permit refusal to reflect wholesale cost increases in retail rates, even in the absence of offsetting cost savings. The *Nantahala* opinion set the record straight with respect to proper interpretation of the *Narragansett* language.

As noted above, the *Nantahala* opinion followed closely on the heels of the District of Columbia Court of Appeals opinion in *Washington Gas Light* (*WGL II*), which treated the same major issues in much the same way. The *WGL II* opinion marked the culmination of several years of litigation involving the proper treatment by the Public Service Commission of the District of Columbia (DCPSC), in retail rate proceedings, of the increment to wholesale natural gas costs representing interstate pipeline company contributions to the funding of Gas Research Institute (GRI). In *WGL II*, the D.C. Court of Ap-

6. Arkansas-Louisiana Gas Co. v. Hall, 453 U.S. 571, 581-82 (1981).

7. 119 R.I. 559, 381 A.2d 1358 (1977), *cert. denied* 435 U.S. 972 (1978). In that case, the Rhode Island Public Utilities Commission (Commission) refused to pass on to retail customers costs incurred by Narragansett Electric Company for power purchased from New England Power Company pursuant to an FPC rate schedule where the Commission found such costs "strikingly" or "glaringly" unreasonable. On appeal, the Rhode Island Supreme Court reversed the Commission on the basis of federal preemption.

8. *Id.* at 1361.

9. 314 N.W.2d 32 (N.D. 1981).

10. 344 N.W.2d 374 (Minn.), *cert. denied*, 467 U.S. 1256 (1984).

11. *Narragansett*, 381 A.2d at 1363.

peals confirmed that this increment to wholesale costs must be reflected in retail rates as a reasonable operating expense of the regulated distribution company, and rejected the DCPSC's erroneous interpretation of the aforementioned language in *Narragansett*, and an earlier opinion of the D.C. Court of Appeals involving similar issues, which the DCPSC contended would permit it to disallow recovery of a portion of that reasonable operating expense.[12]

The parallel development and consistent resolution of issues of the *Nantahala* and *WGL II* cases are addressed in greater detail below.

I. Administrative and Judicial Actions Leading to WGL II and Nantahala

A. *Background to* WGL II

The prolonged controversy with respect to the DCPSC's treatment of the GRI funding unit component of wholesale natural gas costs began with an order by the DCPSC denying recovery of that component of costs by Washington Gas Light Company (WGL). Although the FERC had approved the wholesale rates incorporating the GRI funding unit, the DCPSC refused to allow an adjustment to WGL's retail rates to reflect all of the increased wholesale costs attributable to the higher GRI funding unit. The DCPSC defended its decision to allow passthrough of only a portion of the GRI-related costs on two grounds. First, the DCPSC contended that because of a pending suit in the United States Court of Appeals for the District of Columbia Circuit, the FERC's authority to approve GRI charges was in question, and the portion of the wholesale costs attributable to GRI charges was not, therefore, a measurable or certain expense. Second, the DCPSC claimed that, in its opinion, few benefits would accrue to District of Columbia ratepayers from GRI's activities.

Upon review, in *Washington Gas Light Co. v. Public Service Commission*[13] (*WGL I*), the District of Columbia Court of Appeals held that the DCPSC had erred in disallowing the increased GRI charges as reasonable operating expenses.[14] In reaching its decision, the court found that "[i]t is well settled that the Natural Gas Act provides for exclusive federal regulation of interstate wholesales of natural gas."[15] Further, as a consequence, state and local commissions have "no authority . . . to inquire into the reasonableness of wholesale rates, but must allow them as reasonable operating expenses."[16] Because the court determined that the DCPSC had no authority to rule on the reasonableness of such wholesale charges, the court did not reach, and warned that the DCPSC was "unauthorized to consider,"[17] the issue whether GRI-related wholesale costs benefit District of Columbia ratepayers.

12. *Washington Gas Light*, 508 A.2d at 934-40.

13. 452 A.2d 375 (D.C. 1982), *cert. denied*, 462 U.S. 1107 (1983).

14. *Id.* at 385.

15. *Id.* (citing Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84 (1963); Illinois Natural Gas Co. v. Central Ill. Pub. Serv. Comm'n, 314 U.S. 498 (1942)).

16. *Id.* at 386 (citing, *e.g.*, Chicago v. Illinois Commerce Comm'n, 13 Ill. 2d 607, 150 N.E.2d 776 (1958); United Gas Corp. v. Mississippi Pub. Serv. Comm'n, 240 Miss. 405, 127 So. 2d 404 (1961); Citizens Gas Users Ass'n v. Public Util. Comm'n of Ohio, 165 Ohio St. 536, 138 N.E.2d 383 (1956).

17. *Id.*

In reversing the DCPSC's decision, the court rejected the argument that such FERC-approved increments to wholesale rates were "uncertain" pending appeal. Noting that, subsequent to the DCPSC decision, the D.C. Circuit upheld the FERC's authority to approve contributions to GRI in *Public Utilities Commission v. FERC (PUC Colorado)*,[18] the court reminded the DCPSC that, unless they have been stayed, such final agency orders may not be ignored.[19]

Despite the clear import of the central holding in this case, confirming the FERC's exclusive jurisdiction over interstate wholesale rates and the effect of such rates in retail ratemaking determinations, a brief passage contained in a footnote to the decision was nevertheless to serve as a basis for subsequent attacks on the FERC's jurisdiction by state commissions.

In footnote 15 of the *WGL I* decision, in the course of addressing the D.C. Circuit's holding in the *PUC Colorado* case, the court stated that:

> We agree with [one of the intervenors] that nothing in the holding of the case can be read as extending FERC's jurisdiction to the issue of whether increased wholesale costs shall be passed through to retail customers by the local utility. The determination of the extent to which wholesale costs should be reflected in local utility rates lies exclusively with the local utility commissions.[20]

The court's footnote concluded that the DCPSC's refusal to allow the charges to be reflected in retail rates was unauthorized because it was based on the "erroneous conclusion that the increase in wholesale costs was not a just and reasonable operating expense, rather than upon a determination that the expense should not be passed through to retail customers."[21]

The uncertainty as to the proper interpretation of this footnote became evident in the lower court opinion in *Nantahala* and in the subsequent WGL case that culminated in *WGL II*. As will be shown, the DCPSC and the North Carolina Supreme Court seized upon this footnote, and the apparent misinterpretation of *Narragansett* reflected in it, as a basis for attempting to avoid the preemptive effect of the FERC's ratemaking authority.

In 1984, the DCPSC issued an order in which it adopted a policy, to be applied in all future WGL ratemaking proceedings, that would preclude WGL from recovering, as an operating expense, more than 25% of its wholesale natural gas costs attributable to GRI surcharges, unless it could prove that the surcharges specifically benefit District of Columbia ratepayers. In justifying its order, the DCPSC had relied on footnote 15 of *WGL I* for the proposition that, although it may not rule that the FERC-approved surcharges are unreasonable operating expenses, it may nevertheless refuse to allow WGL to pass those surcharges on to its retail customers on the grounds that, while such expenses may be reasonable, they are deemed not to be beneficial to ratepayers.

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18. 660 F.2d 821, 825 (D.C. Cir. 1981), *cert. denied*, 456 U.S. 944 (1982).

19. 452 A.2d at 386 (citing Ecee, Inc. v. FPC, 526 F.2d 1270, 1274 (5th Cir. 1976), *cert. denied*, 429 U.S. 867 (1976); Jupiter Corp. v. FPC, 424 F.2d 783, 791 (D.C. Cir. 1969), *cert. denied*, 397 U.S. 932 (1970).

20. 452 A.2d at 385 n.15 (citing *Narragansett*, 381 A.2d at 1358).

21. *Id.*

B. *Background to* Nantahala

The conflict that culminated in the *Nantahala* opinion reached the North Carolina Supreme Court in 1985. The dispute centered on the decision by the North Carolina Public Utilities Commission (NCPUC), in an exercise of its retail ratemaking authority, to allocate entitlements to low-cost hydroelectric power among retail customers in North Carolina and Tennessee in a manner inconsistent with the apportionment of those entitlements pursuant to agreements that had been filed with the FERC. Nantahala Power and Light Company (Nantahala) argued that the NCPUC's action was "tantamount to a disallowance of [wholesale] costs actually borne by Nantahala and as such constitute[d] an impermissible, indirect intrusion into the [FERC's] federal regulatory domain."[22]

In its opinion, *State ex rel. Utilities Commission v. Nantahala Power & Light Co.*,[23] the North Carolina Supreme Court rejected Nantahala's preemption claims based on the court's determination that the company's reliance, upon what the court referred to as, the "*Narragansett-Northern States*" line of authority to establish a Supremacy Clause violation, was misplaced.[24] In explaining its rationale for that ruling, the court said that the "*Narragansett* doctrine," or the rule requiring state commissions to treat costs based upon FERC-filed rates as reasonably incurred operating expenses, "has not been held to preclude state authority to determine whether these costs should be automatically passed through to retail consumers in the form of higher rates."[25]

From its reading of the *Narragansett* line of cases, the court concluded that, even in those cases, state commissions retained the authority to engage in a "benefit" analysis in deciding whether to increase retail rates. As explained by the court, local commissions retained the authority to investigate FERC-approved wholesale costs to determine if such costs were incurred for the benefit of the utility's shareholders, as opposed to its ratepayers, and to refuse to increase retail rates to the extent that such costs did not benefit ratepayers.

In formulating this "benefit" test, the North Carolina Supreme Court relied, in part, upon a clear misreading of *Narragansett* and *WGL I*. Although it distinguished the *Narragansett* line of cases on the grounds that the NCPUC had not directly disallowed wholesale costs, unlike the local commissions involved in those cases, the court also relied on language in *Narragansett* and *WGL I* as supporting the NCPUC's discretionary authority to use a "benefit analysis" approach to determine that only a certain percentage of Nantahala's wholesale costs was incurred to serve retail customers.

The court noted that in *Narragansett* the state commission was found to be free to "treat the proposed rate increase as it treats other filings for charged rates under [state statute] and investigate the overall financial structure of Narragansett to determine whether the company has experienced savings in other

22. State *ex rel.* Util. Comm'n v. Nantahala Power & Light Co., 313 N.C. 614, 693, 332 S.E.2d 397, 444 (1985), *rev'd sub nom.*, Nantahala Power & Light Co. v. Thornburg, 106 S. Ct. 2349 (1986).

23. 313 N.C. 614, 332 S.E.2d 397.

24. *Id.* at 693, 332 S.E.2d at 444.

25. *Id.* at 693-94, 332 S.E.2d at 444.

areas which might offset the increased price for power."[26] On this basis, the North Carolina Supreme Court reasoned that while *Narragansett* required the state commission to consider the cost of power to a local distributor based on its supplier's federally-filed wholesale rate as a reasonable operating expense, it did not require the state commission to adjust the distributor's retail rates to reflect the increased wholesale costs. Moreover, the court concluded that, while *Narragansett* referred to the possibility of so-called "offsetting" savings, even in the absence of such savings, the commission possessed the authority to decline to authorize automatically increased retail rates to reflect operating expenses where it determines "that certain FERC-regulated costs were not, either in whole or in part, primarily incurred for the benefit of retail rate payers, but rather for the benefit of the utility's investors.[27]

In support of its "benefit" test, the court cited two cases involving GRI surcharges: *WGL I* and the decision by the Colorado Supreme Court in *Public Service Co. of Colorado v. Public Utilities Commission* (*PSC Colorado*).[28] In the latter case, the state supreme court had found that the state commission was obligated to treat GRI expenses as reasonably incurred operating expenses. As in *Narragansett*, the court also had found that the commission need not allow the retail rate to be increased ***automatically***, on the theory that, under *Narragansett*, it was free to determine whether offsetting savings would obviate the necessity for such an increase. The North Carolina Supreme Court noted that the Colorado Supreme Court, in a footnote to its opinion, had recognized the state commission's concern about whether the GRI costs benefit the utility's rate payers as much as the shareholders, and concluded that the opinion supported a "benefit" test.[29] Similarly, the North Carolina Supreme Court cited footnote 15 to the *WGL I* opinion for the proposition that although the DCPSC was obligated to treat increased GRI charges as reasonable operating expenses "on the grounds that the commission was without authority to disregard a FERC order which had not been stayed," it was also "quite clear that it remained within the local commission's authority to determine that the expenses should not automatically be passed through to retail customers."[30]

On the basis of this analysis, the North Carolina Supreme Court upheld the NCPUC's authority to determine that certain wholesale power costs did not benefit ratepayers, and consequently, should not be reflected in retail rates.

II. WGL II

As noted above, the DCPSC adopted a policy in 1984 that would preclude

26. *Id.* at 694, 332 S.E.2d at 444 (quoting *Narragansett*, 119 R.I. at 568, 381 A.2d at 1363).

27. *Id.* at 700, 332 S.E.2d at 448 (citing *WGL I* and *PSC Colorado*) (The court also noted two other instances where state commissions could deny pass-through of wholesale costs. However, neither of these involved a determination that such costs were not beneficial to ratepayers; rather, they dealt with the prudency of buying from a particular *source of, rather than paying a particular rate for*, FERC-approved power. *See* Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n, 77 Pa. Commw. 268, 273-74, 465 A.2d 735, 737-38 (1983); Kansas-Nebraska Natural Gas Co. v. State Corp. Comm'n, 4 Kan. App. 2d 674, 679-80, 610 P.2d 121, 127 (1980)).

28. 644 P.2d 933 (Colo. 1982).

29. 313 N.C. at 695, 332 S.E.2d at 445 (citing 644 P.2d at 941 n.10).

30. *Id.* at 695-96, 332 S.E.2d at 445.

recovery by WGL of the GRI funding unit increment to wholesale rates unless WGL could prove the "perfected benefit" of the GRI program to District of Columbia ratepayers. The D.C. Court of Appeals' decision in *WGL II* rejected this "perfected benefit" analysis on federal preemption grounds, noting that the DCPSC's order directly violated the court's conclusion in *WGL I*. The court stated that its holding in *WGL I* was "simple and straightforward: the Commission has no authority to rule on the reasonableness of GRI surcharges, and likewise has no authority to consider whether, for purposes of rate treatment, GRI surcharges benefit District of Columbia ratepayers."[31] The court dismissed the DCPSC's interpretation of footnote 15 as being inconsistent with the Due Process Clause and the concept of just and reasonable rates. As explained by the court, if the DCPSC is without authority to treat these wholesale costs as unreasonable expenses, "then it is also without authority to prohibit WGL from passing those expenses"[32] to retail ratepayers because, under the Due Process Clause, public utilities cannot be required to absorb their own costs,[33] and implicit in the concept of just and reasonable rates is the right to recoup expenses in their entirety.[34]

Moreover, in holding that the DCPSC is preempted under the Natural Gas Act from reviewing the reasonableness of FERC-approved wholesale rates under the "perfected benefit" test, the court found the DCPSC's reliance on *Narragansett* to be misplaced. While acknowledging that, under *Narragansett*, the state commission was not compelled to permit the utility automatically to increase retail rates to reflect increased wholesale costs, the court also noted that the commission could prevent such a rate increase "*only if* 'the company has experienced savings in other areas which might offset the increased price for power.' "[35] The court noted that, contrary to this principle, the DCPSC's rule did not make retail rate increases contingent upon the absence of offsetting cost savings; rather, such increases were made contingent on WGL proving a so-called "perfected benefit."[36] Thus, the court found the *Narragansett* language in question to be inapposite.

Finally, the court addressed the essence of the Supremacy Clause violation. Although the DCPSC's rule, on its face, did not question the reasonableness of the wholesale GRI costs, in substance the effect of the rule was the same. By requiring WGL to prove the "perfected benefit" of the GRI-related expenses, the DCPSC was attempting to make its own determination of the reasonableness of such costs. If WGL did not meet the burden of proof imposed by the DCPSC, WGL would be forced to absorb a portion of the FERC-approved

31. 508 A.2d at 937.

32. 508 A.2d at 938 (citing Public Serv. Comm'n v. FPC, 467 F.2d 361, 370 (D.C. Cir. 1972).

33. *Id.*

34. 508 A.2d at 938 (citing Mississippi River Fuel Corp. v. FPC, 163 F.2d 433, 437 (D.C. Cir. 1947); *Northern States Power Co.*, 314 N.W.2d at 37).

35. *Id.* at 940 (quoting 119 R.I. at 568, 381 A.2d at 1363).

36. *Id.* The court also distinguished the *Pike County* line of cases (see *supra* note 27). As noted in the court's discussion, that line of cases allows for denial of passthrough of some costs on the grounds that it may constitute an abuse of management discretion to purchase power from a particular wholesale supplier when alternative, more economical sources of supply are available. The court found the DCPSC's rule did not focus on alternative sources of gas available to WGL. *Id.* at 940-41.

expenses rather than pass them along to its ratepayers. The court concluded that this type of second-guessing of FERC-approved rates constituted encroachment upon the FERC's jurisdiction in violation of the Supremacy Clause: "Thus we conclude that the [DCPSC] exceeded its authority in requiring WGL to prove anything at all with respect to the reasonableness of the GRI surcharges. That issue has been preempted *in toto* by the [FERC]."[37]

III. SUPREME COURT OPINION IN NANTAHALA

In *Nantahala*, the Supreme Court reversed the North Carolina Supreme Court and held that the NCPUC's allocation of power had been preempted. In discussing the line of cases that led to *Narragansett*, the Court stressed that those "decisions are properly driven by the need to enforce the exclusive jurisdiction vested by Congress in FERC over the regulation of interstate wholesale utility rates."[38]

As the Court said, once the FERC sets the wholesale rate, a state may not interfere with the FERC's authority by concluding that the FERC-approved wholesale rate is unreasonable when setting retail rates. Moreover, the Court extended this preemption analysis by adding that the "filed rate" doctrine is not limited to "rates *per se*,"[39] but applies with equal force to any interference with the FERC's exclusive authority. In this case, the FERC's decision directly affected Nantahala's wholesale rates by determining the amount of low-cost power it could obtain, and the FERC required Nantahala's wholesale rate to be filed in conformity with that allocation. Thus, the Court concluded that the FERC's treatment of power allocation was "presumptively entitled to more than the negligible weight given it by [NCPUC]."[40]

As explained by the Court, the essence of the *Narragansett* doctrine is avoiding the risk of "trapped costs." That doctrine ensures that purchasers of wholesale power at rates regulated by the FERC can recover in their retail revenues the costs incurred by their payment of such FERC-set rates. Under *Narragansett*, when the FERC sets a wholesale rate between the seller and purchaser of power, a state may not exercise its jurisdiction over retail rates to prevent the purchaser from recovering the costs of paying the FERC-approved rate. The Court's analysis here is similar, in effect, to the rationale of the Court of Appeals in *WGL II*; *i.e.*, the concept of just and reasonable rates requires that the purchaser at wholesale be allowed to recover its expenses in their entirety. Because NCPUC's order would prevent Nantahala's full recovery of costs, in the same manner that failure to prove a "perfected benefit" in *WGL II* would have prevented WGL's passthrough of a percentage of the GRI costs, the local commission's order impermissibly interfered with the FERC's authority.

The Court also found unpersuasive the lower court's interpretation of the *Narragansett* line of cases to the effect that local utility commissions need not automatically pass through increased wholesale costs because they retain the

37. *Id.* at 941.
38. *Nantahala*, 106 S. Ct. at 2356.
39. *Id.* at 2357.
40. *Id.*

discretionary authority to consider the benefit to local ratepayers of such expenses at the retail level. The Court characterized that reading of the *Narragansett* doctrine as "at best an oversimplification."[41] The Court reached the same conclusion with respect to the extent of local commission discretion allowed under the decisions in *Narragansett* and *PUC Colorado* that was drawn by the D.C. Court of Appeals in *WGL II*: an increase in FERC-approved wholesale costs need not lead to increased retail rates *only if* costs "*other than* those resulting from the purchases of FERC-regulated power or gas were to decrease,"[42] thereby offsetting the increased wholesale costs.

IV. CONCLUSION

In these recent contests over regulatory jurisdiction between the FERC and local utility commissions, the courts have defended the FERC's exclusive regulatory authority over interstate rates against state commission encroachment. Moreover, in *Nantahala*, the Court applied an expansive interpretation of what constitutes an "impermissible interference" with the FERC's jurisdiction. By not limiting the holding to "rates *per se*" the Court drove home the message that local public utility commissions have a duty not to interfere, *in any manner*, in the area of the FERC's exclusive domain—regulation of interstate wholesale rates.

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41. *Id.*

42. *Id.* (emphasis in original). The Court also noted that the North Carolina Supreme Court erred in relying on the *Pike County* line of cases (discussed *supra* notes 20-21) which treat "the reasonableness of purchasing from a particular source of, rather than a particular rate for, FERC-approved power." 106 S. Ct. at 2357. Although the Court found that line of cases inapposite in this particular factual situation, it left open the possibility of future consideration of the *Pike County*-type analysis:

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

Id. at 2360.