

FARMERS UNION II:
SISYPHUS STARTS UP THE HILL AGAIN

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After thirteen years of litigation, the Sisyphean labors of the Federal Energy Regulatory Commission¹ continue as it marches up the hill of oil pipeline regulation only to tumble down again with little undertaken and less done.² In its decision in *Farmers Union Central Exchange v. Federal Energy Regulatory Commission*,³ the Circuit Court of Appeals for the District of Columbia Circuit reversed the FERC's oil pipeline ratemaking methodology and remanded the case to the FERC for expeditious action to be completed within one year of the remand.

The D.C. Circuit Court of Appeals found three independent bases for its decision. Using the arbitrary and capricious standard of review,⁴ the Court stated that the FERC failed to satisfy its statutory mandate that oil pipeline rates be just and

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¹The Federal Energy Regulatory Commission (FERC) is the successor to the Federal Power Commission. The FERC was established on October 1, 1977, in Title IV of the legislation establishing the Department of Energy (DOE), Department of Energy Organization Act, Pub. L. No. 95-91 (August 4, 1977) 91 Stat. 565, 582, 42 U.S.C. § 7171. At the time of the establishment of the FERC and DOE, regulation of oil pipelines was transferred from the Interstate Commerce Commission to the FERC, DOE Organization Act, sections 306 and 402(b), 91 Stat. 581 and 584, 42 U.S.C. §§ 7155 and 7172(b).

²*Wisconsin v. Fed. Power Comm'n.*, 373 U.S. 294, 315 (1963).

³*Farmers Union Central Exchange v. FERC*, No. 82-2412 (D.C. Cir. March 9, 1984), *rehearing denied*, May 4, 1984 (Hereinafter *Farmers Union II*).

⁴The Court, at pages 24-29, discusses the appropriate standard of review. The Court concluded that the FERC proceeding constituted a rulemaking under the Administrative Procedure Act (APA). The standards to be applied are those of informal rulemakings, namely, whether FERC's order was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Farmers Union II* at 26. The Court, relying on the Supreme Court and its own precedents, noted that determinations of the justness and reasonableness of rates pursuant to section 15(1) of the Interstate Commerce Act must be only after "a full hearing" which is not equivalent to the formalities required by the APA (5 U.S.C. § 553(c)) that the rules be made "on the record after opportunity for an agency hearing." See *United States v. Allegheny-Ludlum Steel Corp.*, 406 U.S. 742 (1972); *United States v. Florida E. Coast Ry. Co.*, 410 U.S. 224 (1973); *Asphalt Roofing Mfrs. Ass'n. v. ICC*, 567 F.2d 994, 1002 n.5 (D.C. Cir. 1977) (per curiam); *Farmers Union II* at 26 n.39. As a result, the substantial evidence standard is inapplicable. The Court did note, however, that the issue is still not crystal clear since the section 15(1) requirement is for a "full hearing" while the *Allegheny-Ludlum* Court addressed the issue of a "hearing." Whether a full hearing is the same as the APA requirement of "one the record of an agency hearing" is left unresolved for a future date. *Id.* The Court in *Farmers Union II* stated at 27:

Under the "arbitrary and capricious" standard, the Court must conduct a "searching and careful" inquiry into the record in order to assure itself that the agency has examined the relevant data and articulated a reasoned explanation for its action including a "rational connection between the facts found and the choice made" (footnote and citation omitted).

Thus, the Court must ensure that the agency is engaged in reasoned decisionmaking which does not deviate from or ignore ascertainable legislative intent. "Beyond that, however, we are not at liberty to substitute our own judgment in the place of the agency's." *Id.* at 28.

reasonable.⁵ As in independent basis for the reversal and remand, the Court indicated that the FERC's decision was not the product of reasoned thought and was not based upon a consideration of the relevant factors.⁶ Finally, as if these bases were not enough, the Court found a third basis for the reversal, stating that the combination of the rate base and rate of return methodologies did not produce an acceptable end result as required by prior Supreme Court decisions.⁷ Thus, the Court not only reversed and remanded the case, but came as close as a court can come to substituting its judgment for the FERC's by providing strong guidance to the FERC regarding what it should do in the remanded proceeding.

The decision is an important one from the point of view of the entire industry and from the point of view of the development of regulatory principles. The oil pipeline industry has been struggling for thirteen years⁸ to determine whether the current ratemaking methodology is permissible⁹ or whether a new methodology must be established. The financial fate of the industry hangs in the balance until regulatory certainty is provided.

From a regulatory point of view, the ability of a regulatory agency to develop ratemaking principles which deviate from established methodologies is under intense scrutiny. The FERC attempted to develop a lighthanded regulatory framework which left much discretion with the regulated companies and permitted more rate flexibility than normally allowed under more stringent ratemaking

⁵Farmers Union II at 30.

⁶*Id.* at 50.

⁷*Id.* at 86. The prior Supreme Court decisions refer to Federal Power Comm'n. v. Hope Natural Gas, 320 U.S. 591 (1944) (hereinafter Hope) and its progeny.

⁸This proceeding began in 1971 when Williams Brothers Pipe Line Company, now Williams Pipe Line Company filed new rates for pipeline transportation through its midcontinent pipeline system and the rates were challenged by a group of shippers. The ICC upheld the rates and its method of ratemaking. Petroleum Products, Williams Brothers Pipe Line Co., 35 ICC 479 (1976). This decision was appealed to the Circuit Court of Appeals for the District of Columbia, which remanded the proceeding to the newly established FERC. Farmers Union Central Exchange v. FERC, 584 F.2d 408 (D.C. Cir. 1978), (cert. denied sub nom.) Williams Pipe Line Company v. FERC, 439 U.S. 995. (hereinafter Farmers Union I). In the remand, the FERC consolidated all pending rate cases and held an evidentiary hearing. Williams Pipe Line Company, Docket Nos. OR 79-1, order setting down the case for hearing issued February 23, 1979. After two oral arguments on June 30, 1980, and November 19, 1981, the FERC, under order from the U.S. District Court for the District of Columbia in response to a writ of mandamus, issued its decision on November 30, 1982. Williams Pipe Line Company, Opinion No. 154, Docket No. OR 79-1-000 *et al.*, 21 FERC par. 61,260, pp. 61,568-731 (November 30, 1982) (hereinafter Williams). See O'Neill and Knapp, *Oil Pipeline Regulation After Williams: Does The End Justify The Means?*, 4 Energy L.J. 61 (1983).

⁹The ICC methodology uses a hybrid fair value-original cost approach to valuation of the rate base with rate of return guidelines for crude (8 percent return on valuation) and product (10 percent return on valuation) pipelines. The ICC methodology uses a weighted average original cost and reproduction cost component multiplied by a condition percent surrogate for depreciation, all of which is multiplied by a 6 percent going concern value. The result of this is added to surrogates for the pipeline's present value of land, rights of way and working capital. Farmers Union II at 18 n.28. For a detailed discussion of the ICC methodology see, Navarro and Stauffer, *The Legal History and Economic Implications of Oil Pipeline Regulation*, 2 Energy L.J. 291 (1981).

approaches.¹⁰ While the Court did not overrule lighthanded regulation in principle, the application in this situation has been made much more difficult because of *Farmers Union II*.

This article will discuss the Court's opinion in some detail, developing the Court's reasoning for each of its bases for rejecting the FERC's decision. Then, the article will explore some of the implications of the decision.

I. BASIS ONE: THE JUST AND REASONABLE STANDARD

The first basis the Court found for overturning the FERC's decision was the failure to satisfy the statutory mandate that rates be just and reasonable.¹¹ The FERC gave a very liberal meaning to the just and reasonable term of the Interstate Commerce Act ("ICA")^{11a} in its application to oil pipelines. It developed reasons for interpreting the just and reasonable term in a manner different from its application to other entities under the ICA. FERC justified the difference, relying on three factors. It pointed out noncost factors which justified a different interpretation. It relied upon a different Congressional intent based upon the climate of opinion which led to the enactment of the Hepburn Act.¹² And, it examined the economic context of oil pipeline operations as another justification for different treatment. The Court rejected each and every one of these rationales, firmly indicating that the FERC failed in its justifications and that its different treatment, therefore, was arbitrary and capricious.

¹⁰The *Williams* approach used the ICC valuation rate base to which it applied a rate of return comprised of three elements — debt service (the amount required to pay the pipeline's interest on debt), a suretyship premium (the additional amount that would have been needed above actual debt service in the absence of a debt guarantee from the oil pipeline's parent), and a real entrepreneurial rate of return on the equity component of the valuation rate base (the valuation rate base less the face amount of debt). The pipeline can choose from among eight indices in determining the nominal rate of return on equity. The eight indices are the nominal rates on book equity realized over the most recent one- or five-year period for the oil industry generally, American industry generally, or the parent company(s) excluding pipelines. Two other measures are total returns (dividends plus capital gains) on a diversified common stock portfolio over the past 5 years or the long run (25, 50 years, or more). *Farmers Union II* at 18-22, *Williams* at 61,614-61,633 (rate base), and 61,636-61,650 (rate of return).

¹¹Section 1(5), Interstate Commerce Act, 49 U.S.C. § 1(5). The Interstate Commerce Act was recodified without substantive change by Pub. L. No. 95-473 (Oct. 17, 1978), 92 Stat. 1337, 49 U.S.C. §§ 10101 *et seq.* The recodification expressly provided that the previous codification or numeration would apply to oil pipeline matters. Revised Interstate Commerce Act, Pub. L. No. 95-473, § 4(c), 92 Stat. 1470 (1978).

^{11a}Section 1(5), ICA, 49 U.S.C. § 1(5).

¹²The Hepburn Act extended common carrier and rate regulation to petroleum pipelines. 34 Stat. 584 (1906); 49 U.S.C. § 1. For a succinct summary of the evolution of oil pipeline regulation, see, Coburn, *The Case for Petroleum Pipeline Deregulation*, 3 Energy L.J. 225 (1982).

The Court recognized that economic regulation permitted rate regulation within a zone of reasonableness.¹³ Regulatory agencies are free to establish rates

¹³The term "zone of reasonableness" grows out of legal precedents in which courts permitted regulators to use their judgment in setting rates.

In *Banton v. Belt Line Ry. Corp.*, 268 U.S. 413 (1925), the Court stated at 422-423:

A commission or other legislative body, in its discretion, may determine to be reasonable and just a rate that is substantially higher than one merely sufficient to justify a judicial finding in a confiscation case that it is high enough to yield a just and reasonable return on the value of the property used to perform the service covered by the rate. The mere fact that a rate is non-confiscatory does not indicate that it must be deemed to be just and reasonable. It is well known that rates substantially higher than the line between validity and unconstitutionality proper may be deemed to be just and reasonable and not excessive or extortionate. (Footnotes omitted)

The Court did not use the term "zone of reasonableness" in this decision, but the import of the decision was that commissions or legislatures could establish just and reasonable rates within a zone that was bounded by something above confiscatory on the low end and something below excessive or extortionate on the high end. This concept was stated in dicta in *Columbia Gas & Fuel Co. v. Public Utilities Commission of Ohio*, 292 U.S. 398 (1934) at 414:

In so far as a reasonable rate is something other or higher than one not strictly confiscatory (*Banton v. Belt Line Ry. Corp.* 268 U.S. 413, 423), the difference, if any, is determined with finality by the appointed officers of the state.

Interestingly, the phrase "zone of reasonableness" may have been used for the first time in the context of the Interstate Commerce Act. In *Atlantic Coast Line v. Florida*, 295 U.S. 301 (1935) the intrastate rates for certain rail transportation were under dispute. A master held that the rate level should be one level, the ICC at another. The difference was challenged. The Court stated at 317-318:

The field of inquiry is one in which the search for certainty is futile. Opinions will differ as the qualifications of experts, the completeness of their inquiry into operating costs, the accuracy of their methods of computation, the soundness of their estimates. *There is a zone of reasonableness within which judgment is at large.* *Banton v. Belt Line Ry. Corp.*, 268 U.S. 413, 422, 423. Only by accident would two courts or administrative bodies draw the line within the zone at precisely the same points. In a sense, then, it is true that there is support in fairness and reason for each of the two conclusions, the Commission's and the master's. More than this, however, must be made out to uphold the claims in suit. The claimants do not sustain the burden that is theirs by showing that the master set up a reasonable schedule. They must show that the other schedule, the one set up by the Commission, is unreasonable. (Emphasis added)

In a case examining the validity of rates established by the Secretary of Agriculture under the stockyards act, the Court in *Denver Stock Yard Co. v. U.S.*, 304 U.S. 470 (1938) stated at 483:

The Secretary is not required to prescribe rates so low as to be barely sufficient to withstand attack on the ground of confiscation, but is at liberty within limits that he may find to be just and reasonable to establish higher rates. *Banton v. Belt Line Ry.*, *supra*, 422 (other footnotes omitted).

By the time the Supreme Court applies this standard using the term "zone of reasonableness" to natural gas pipelines, prior Court decisions have laid the groundwork. Thus, in *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942) the Court stated at 585-586:

By long standing usage in the field of rate regulation, the "lowest reasonable rate" is

within this zone of reasonableness. FERC, on the other hand, attempted to establish a zone of commercial reasonableness for oil pipeline rate regulation as opposed to public utility reasonableness.¹⁴ The Court did not accept this distinction and found that FERC's rate ceilings which were higher than those allowed by statute.¹⁵ Within the context of what is a permissible zone of reasonableness, the zone is bounded by rates that must be above those that would be something less than compensatory on the low end and by rates that would be below those that would be excessive on the high end. Rates set beyond the zone at either end would be impermissible, since they would not fall within the statutory standard of just and reasonable. Rates beyond the low end would be confiscatory. Rates beyond the high end would be excessive. The Court stated that in order to find where the end points of the zone of reasonableness lay, the agency should examine the costs of providing the service. Such an examination is the departure point for cost-based regulation.¹⁶ The Court was quick to point out, however, that reliance only upon costs was not required. Noncost factors

one which is not confiscatory in the constitutional sense (footnotes omitted). Assuming that there is a zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate, see *Banton v. Belt Line Ry. Corp.*, 268 U.S. 413, 422, 423; *Columbia Gas Co. v. Commission*, 292 U.S. 398, 314; *Denver Stock Yard Co. v. United States*, *supra*, 483, the Commission is also free under § 5(a) to decrease any rate which is not the "lowest reasonable rate."

From this line of cases, we come to perhaps the definitive statement concerning what the FERC may do within the zone of reasonableness. In *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Court stated at 767:

Moreover, this Court has often acknowledged that the Commission is not required by the Constitution or the Natural Gas Act to adopt as just and reasonable any particular rate level; rather, courts are without authority to set aside any rate selected by the Commission which is within a "zone of reasonableness." *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585. No other rule would be consonant with the broad responsibilities given to the Commission by the Congress: it must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.

¹⁴FERC attempted to find a way out of the precedents establishing the limits of the zone of reasonableness. It concocted a difference by stating that these precedents, which were based upon cost, were within a zone of public utility reasonableness. Pipelines, on the other hand, should not be held to this standard, but should be permitted to set rates which would permit results that would exceed the upper bounds of this zone of reasonableness. By examining the history and climate of opinion at the time oil pipelines were subjected to regulation, the FERC concluded that what was meant was that rates could be established within a zone of ordinary commercial reasonableness, which would restrain gross overreaching and unconscionable gouging. *Williams* at 61,597. Since rates which would achieve this latter result would be beyond the upper end of the zone of reasonableness as prior courts used it, meaning rates which would be characterized as excessive or extortionate (see *Blanton*, *supra*, n.13), the FERC had to devise the commercial reasonableness concept to accomplish its goals.

¹⁵The FERC virtually admitted as much in its *Williams* decision. For example, FERC said, "It seems obvious to us that allowed real rates of return on oil pipeline equity investments should be appreciably higher than those the Commission awards to natural gas pipelines and to wholesalers of electric energy." *Williams* at 61,645. FERC then indicated that all the yardstick should do is to put "a cap on gross abuse." *Id.* at 61,645.

¹⁶This is the traditional concept of cost-of-service regulation applied to other regulated entities. See generally, Charles F. Phillips, Jr., *The Regulation of Public Utilities* (Public Utilities Reports, Inc., Arlington, Va. 1984).

were permissible departures from cost of service regulation. But the agency must be very specific concerning the noncost factors relied upon. Furthermore, the agency must provide a reasoned explanation of how the noncost factor justifies the resulting rates.¹⁷

The FERC provided a rationale for its nonadherence to strict cost-based ratemaking.¹⁸ It cited the need for additional pipeline capacity and investment as a justification for increased incentives through lighthanded regulation. The Court looked at this justification and easily found it wanting.¹⁹ FERC merely stated that "everybody agrees that the nation needs and will need more pipeline plant."²⁰ In the Court's view, this was wholly inadequate to support a noncost factor departure from cost-based ratemaking. The Court found no forecast or estimate regarding the extent of the nation's needs, the size of the investment required, or any supporting data. Without this data, the FERC's casual justification was insufficient for its reliance upon this noncost factor.²¹

The second justification for departing from the traditional just and reasonable standard was FERC's view that the legislative history and climate of opinion supported FERC's interpretation. FERC's decision provided a treatise on the sins of the Standard Oil Trust drawing upon the popular writers of the time.²² While the FERC may have portrayed the climate of opinion accurately, the Court reasoned that the legislative history underlying the passage of the Hepburn Act did not rely upon the climate of opinion. Rather, the legislative history pointed toward reliance upon the traditional usage of just and reasonable. The Court delved into the history and found that some versions of the legislation used different words, namely, fairly remunerative, rather than just and reasonable. This alternative language was dropped out of fear that something different from the traditional view of just and reasonable could be the result.²³ Finally, the Court indicated that the purpose and intent of Congress was crucial, the motives of the individual legislators were

¹⁷In *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Court condoned the use of noncost factors in determining the appropriate rate of return. For example, the Court stated, "We have already considered each of the points at which the Commission has given weight to noncost factors, and have found its judgments consistent with the terms and purposes of its statutory authority." *Id.* at 815. In *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974), the Court stated at 308 ". . . *Permian* reversed the Court of Appeals and sustained the Commission's order, although noting that the Commission had not adhered rigidly to a cost-based determination of rates, much less to one that based producer's rates on his own costs."⁴³ [43 Indeed, in addition to its general approval of such an approach, see 390 U.S., at 814-815, the Court in *Permian Basin* listed each of the noncost factors used by the Commission and approved them. See *id.*, at 815 n.98."] Again, in *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979) the Court approved its language in both *Permian* and *Mobil*, stating at 518, "It must be noted, however, that the methodology employed by the Commission in arriving at the area rates approved in *Permian Basin* was not a purely cost-plus approach. To the contrary, the Court recognized "deviation[s] from cost-based pricing" which it "found not to be unreasonable and to be consistent with the Commission's responsibility to consider not merely the interests of the producers . . . but also 'the relevant public interests' . . ." *Mobil Oil*, *supra*, at 308-309, quoting *Permian Basin*, 390 U.S., at 792."

¹⁸*Williams* at 61,614; *Farmers Union II* at 34.

¹⁹*Farmers Union II* at 34.

²⁰*Id.* at 35, *Williams* at 61,614.

²¹*Farmers Union II* at 35. Cf. *Permian Basin Area Rate Cases*, 390 U.S. 747, 815 (1968).

²²*Williams* at 61,578-61,583.

²³*Farmers Union II* at 38-40.

irrelevant.²⁴

The Court also found no support in FERC's reliance upon changes in the economic setting of oil pipeline operations as justification for its interpretation of just and reasonable. FERC showed that the relationship between oil pipeline rates and oil prices was so small that any regulation of oil pipelines would have no impact on oil prices.²⁵ The Court summarily rejected this argument merely stating that meaningful regulation was required no matter what the relationship was between oil pipelines and oil prices.²⁶

FERC also argued that market forces, that is, competition, were sufficient to keep oil pipeline rates from reaching unduly lofty levels.²⁷ Here, the Court found that FERC's reliance on the marketplace was largely undocumented. No record citations were offered or studies cited to indicate the plausibility of this argument.²⁸ FERC's reliance upon market forces did not assure that rates will be just and reasonable. Furthermore, FERC's reliance upon competition created a false illusion of regulation, that is, that FERC was regulating, when, in fact, it was doing nothing.

By rejecting all three reasons for FERC's departure from the traditional concepts of just and reasonable, the Court stated that this in itself was sufficient reason to reverse FERC for its arbitrary and capricious action and remand the case to the FERC for further action. As the next sections indicate, however, the Court was not content to stop here. It went onto a second and third basis for reversing the FERC.

II. BASIS TWO: THE PRODUCT OF REASONED DECISIONMAKING

In reversing the FERC on the basis that the decision was not the product of reasoned decisionmaking, the Court relied upon three principal aspects of FERC's decision. They were FERC's analysis of rate base issues, its analysis of the Association of Oil Pipe Lines (AOPL) recommendations, and its analysis of rate of return issues. FERC's justifications for deciding each of the major issues in each aspect were found

²⁴*Id.* at 42. The point here is that the motives of some of the legislators were to get the Standard Oil Trust. This is the point of the FERC's lengthy discussion on the climate of opinion. But the Court deflects this discussion rather easily indicating that the general Congressional intent was to subject oil pipelines to the same type of regulation imposed upon railroads. From the Court's perspective it was irrelevant that John D. Rockefeller and his Standard Oil Company were acting as monopolists gouging everyone with whom they competed. It was enough that Congress responded to a problem in the traditional way of regulating oil pipelines and imposing a traditional solution, just and reasonable rates.

²⁵*Williams* at 61,599-61,609.

²⁶*Farmers Union II* at 43.

²⁷*Williams* at 61,608.

²⁸*Farmers Union II* at 44-45. One of the principal sticking points for the Court was the lack of record citations in what the FERC itself touted as "the longest and most elaborate" decision it had ever issued. *Id.* at 12. A survey of the 581 footnotes in *Williams* indicates that the opening brief of the Association of Oil Pipe Lines was cited nine times (notes 1, 358, 382, 467, 468, 527, 534, 536, 557), the shippers' initial post-hearing brief was cited once (n.401), and an Antitrust Division, Department of Justice, Memorandum in an earlier portion of this proceeding was cited once (n.526). But the *Williams* decision has an enormous number of citations to American and English legal precedents; economic, legal, and historical treatises; law reviews; biographies; newspapers; magazines; Congressional reports; Congressional record; encyclopedia; government, academic, and business studies; legal, economic, and social science papers; and The Bible.

not to be the product of reasoned decisionmaking.²⁹ Moreover, FERC's rejection of alternatives, especially in the rate base area, also was considered not to be the product of reasoned decisionmaking.³⁰

A. Rate Base Issues

The FERC decided to continue to use the methodology developed by the Interstate Commerce Commission (ICC).³¹ The Court, in its first examination of oil pipeline issues,³² strongly suggested to the FERC that it abandon this formula for the more traditional original cost methodology used in the regulation of other activities.³³ The FERC decided not to follow this advice.³⁴ Instead, it provided justifications for continuing to use the ICC methodology.³⁵

The Court found no rational justification for keeping the ICC methodology.³⁶ It went even further and stated that the FERC should consider alternatives and give reasoned explanations for the rejection of the alternatives, especially when its own choice was so substantially flawed. FERC had stated that oil pipeline regulation was not close work and therefore the "blunt" and "clumsy" ICC methodology was usable despite its lack of consistency and logic.³⁷ The Court rejected this inarticulate argument as insufficient justification. Moreover, the Court then went on in some detail regarding FERC's rejection of an original cost alternative.

FERC rejected the original cost methodology for four reasons. FERC found it difficult to account for the throughput guarantees of the parents.³⁸ FERC found that the major regulatory benefit of original cost accounting, comparable risk analysis, was not useful in the oil pipeline context because the nature of oil pipeline investors is different from other public utility investors.³⁹ FERC rejected original

²⁹*Farmers Union II* at 50.

³⁰*Id.* at 51-52.

³¹See note 9.

³²See note 8.

³³Original cost is a method of measuring the value of the property to be included in the rate base. Original cost methodologies start with the original cost of the property, that is, the amount actually paid for installing the original plant and equipment, plus additions, when first devoted to public service. Accrued depreciation must be deducted from the property's valuation. Other elements of value also are accounted for, including, working capital allowances, property held for future use, land, and intangibles. See Phillips, *op. cit.*, pp. 284, 311, and 315.

³⁴*Williams* at 61,614-61,633.

³⁵*Id.*

³⁶*Farmers Union II* at 54-55, 67.

³⁷*Id.* at 51.

³⁸*Williams* at 61,620-61,622. An industry practice which developed over the years and accelerated after the signing of the oil pipeline consent decree in 1941 was the parent company's guarantee of the subsidiary oil pipeline company's debt based upon the promise that the parent would ship sufficient volume through the pipeline to service the debt. In industry parlance these guarantees are known as throughput and deficiency agreements. See George S. Wolbert, Jr., *U.S. Oil Pipe Lines* (American Petroleum Institute, Washington, D.C., 1979), pp. 242-244 for a discussion of throughput and deficiency agreements. See Staff of Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 95th Cong., 2d sess., *Oil Company Ownership of Pipelines*, pp. 122-124 (Comm. Print 1978) for a discussion of the consent decree.

³⁹*Williams* at 61,623.

cost because of the front-end load problem.⁴⁰ And finally, FERC indicated that benefits accruing from a switch to original cost would not warrant the social costs involved.⁴¹ The Court rejected each of these arguments.⁴²

For its first reason for rejecting the original cost methodology, the FERC indicated that it would be a headache to determine the value of the parents' throughput guarantees and the appropriate debt/equity ratios in the absence of these guarantees. The FERC indicated that it would receive differing opinions from a variety of experts complicating its analysis.⁴³ The Court did not accept this reasoning. The Court indicated that the FERC could construct a hypothetical capital structure as a way of determining the value of the parents' throughput guarantees. The Court conceded that this estimation was not an easy task, but pointed to FERC's experience in doing this with the other industries it regulates.⁴⁴

Moreover, the Court pointed to a major inconsistency in FERC's approach. In its rate of return methodology, FERC relied upon a concept called a "suretyship premium" to account for the value of the parents' guarantees.⁴⁵ In setting the suretyship premium FERC would have to rely upon experts to provide the appropriate value. The Court questioned why this was any different from the expert testimony the FERC would receive in constructing a hypothetical capital structure. Additionally, the Court indicated that the FERC could use the suretyship premium analysis with an original cost formula to account for the value of the parents' guarantees. Thus, the Court dissected FERC's arguments, pointing out the glaring inconsistencies, and told the FERC that it could use its expertise to develop a surrogate for the value of the guarantees while at the same time relying upon an original cost methodology.⁴⁶

As its second reason for rejecting the original cost methodology, the FERC indicated that oil pipeline investors were a special breed of risk takers and required high returns regardless of risk. As a result, the comparable risk analysis which makes original cost so valuable a tool is useless in the oil pipeline context.⁴⁷ The Court quickly disposed of this argument as being unmeritorious. It found neither evidentiary support for the FERC's reasoning nor any common sense justification.⁴⁸ The Court examined the record, something the FERC apparently failed to do, and found that the evidence was to the contrary. Oil companies match returns with risks as other investors do. They are not a special breed of risk takers, but mere mortals following traditional concepts of risk analysis.⁴⁹

The FERC used as a third justification for rejecting original cost the front-end

⁴⁰*Williams* at 61,628-61,629. The front-end load problem stems from original cost reflecting high initial rates because the value of the new property is high with rates decreasing over time as the original value of the property depreciates. See Navarro and Stauffer, *supra*, note 9.

⁴¹*Williams* at 61,631.

⁴²*Farmers Union II* at 54-55.

⁴³*Williams* at 61,622.

⁴⁴*Farmers Union II* at 57.

⁴⁵*Williams* at 61,644.

⁴⁶*Farmers Union II* at 56-59.

⁴⁷*Williams* at 61,623.

⁴⁸*Farmers Union II* at 60-61.

⁴⁹*Id.* at 61-62.

load problem so common with original cost methodologies.⁵⁰ The Court, again looking at the record, indicated that FERC was presented with alternatives which rely on original cost, such as trended or inflation-adjusted original cost,⁵¹ which diminish the front-end load problem. Thus, the front-end load problem was overblown in the Court's view, and could be solved if the FERC only tried.

Finally, the FERC stated that the social costs of switching to a different rate base methodology clearly outweighed any perceived benefits from such a change. In addition, the FERC inveighed against the problems inherent in a transitional rate base in order to move to the new original cost methodology.⁵²

The Court questioned the need for a transitional rate base or why such a transition was such a difficult task. In the Court's view, these difficulties, if they were real, should not impede the introduction of a superior methodology. The Court could not find this adequate justification for continuing the error of relying upon an outdated rate base. Finally, the Court struck at the heart of this argument by examining the premises upon which the FERC based it and found them wanting. The Court clearly thought that the new rate base could produce substantial benefits.⁵³

Thus, the Court found all of FERC's arguments concerning the rate base spurious. Not only had the FERC failed to justify continuation of the ICC methodology, but the FERC failed utterly in rejecting a proven alternative. For these reasons, the Court concluded that the rate base component of FERC's decision was not the product of reasoned decisionmaking.⁵⁴

B. AOPL's Recommendations

FERC's decision also lacked reasoned decisionmaking, the Court found, because of FERC's treatment of the recommendations advanced by the Association of Oil Pipe Lines (AOPL) for altering the ICC methodology. The Court stated that FERC's rejection of the AOPL recommendations was arbitrary and capricious because it was not supported by reasoned findings based upon evidence of record.⁵⁵

The AOPL made a series of recommendations for improving the ICC methodology.⁵⁶ The FERC rejected some of these suggestions by saying that a series of inaccuracies in the ICC methodology is permissible because another series of inaccuracies systematically compensates for prior errors.⁵⁷ The Court found this

⁵⁰*Williams* at 61,628-61,629.

⁵¹*Farmers Union II* at 63-64. Trended original cost and inflation-adjusted original cost are variations on the original cost methodology. Both make some corrections in the rate base for inflation unlike original cost which leaves inflation adjustments solely to the rate of return. For more detailed explanation see Navarro and Stauffer, *supra* note 9.

⁵²*Williams* at 61,631 n.376.

⁵³*Farmers Union II* at 65-67.

⁵⁴*Id.* at 67.

⁵⁵*Id.* at 69.

⁵⁶The AOPL suggested six modifications to the ICC methodology in order to make it a more sudden ratemaking approach. Most dealt with changing indices relied upon to calculate reproduction cost to current measures rather than using old base years which are then updated in arbitrary ways. Also, AOPL suggested eliminating the six percent going concern value after the other adjustments were made. *Id.* at 67-68.

⁵⁷*Id.* at 69-70.

illogical, especially since the FERC made no finding that the errors will offset each other.⁵⁸ The Court used FERC's rejection of the AOPL suggestions as a basis for a finding that FERC's decision was not based upon reasoned decisionmaking. In making this finding, the Court went out of its way to indicate that it was neither endorsing nor rejecting the ICC methodology, but rather FERC's decision did not provide a cogent defense of it.⁵⁹ The Court's decision, therefore, turned on the inadequacies of FERC's decisionmaking process. The Court attempted to avoid substituting its judgment for that of the FERC. As discussed *infra*, however, one of the more controversial aspects of this decision concerns the extent to which the Court did substitute its judgment for that of the FERC.

C. Rate of Return Issues

Finally, with respect to the second basis for reversing FERC's decision, the Court delved into FERC's development of the rate of return formula. The FERC justified its use of the ICC rate base methodology by indicating that its end result could be adjusted through the use of a new, more specific rate of return formula.⁶⁰ Thus, rather than continuing the use of general rate of return guidelines applicable to all pipelines,⁶¹ the FERC established a formula which would lead to the development of rates of return for pipeline systems.⁶² FERC separated the rate of return formula into three components dealing with debt, parent company debt guarantees, and equity. The Court found no problem with the treatment of debt and quickly turned to the other two elements.⁶³

The parent company debt guarantees were denominated suretyship premiums. The Court had treated this subject to some extent in its discussion of the applicability of the original cost methodology and the construction of hypothetical debt structures. Both the Court and FERC took the view that a pipeline must show that the debt guarantees reduced the perceived investor risk in order for the pipeline to avail itself of a suretyship premium.⁶⁴ Therefore, even though the Court was not enamored of the concept, the Court at least acknowledged that the FERC did not automatically accept its use in the rate of return formula without an

⁵⁸*Id.* at 70.

⁵⁹*Id.* at 71-72.

⁶⁰*Williams* at 61,644-61,650.

⁶¹In one of the rare examinations of oil pipeline rates during the course of ICC regulatory oversight, the ICC established rate of return guidelines for oil pipelines. In *Reduced Pipe Line Rates and Gathering Charges I*, 243 ICC 115, 142-143 (1940) the ICC established a maximum rate of return of 8 percent for crude oil pipeline companies. See also, *Minnelusa Oil Corp. v. Continental Pipe Line Co.*, 258 ICC 41, 53-57 (1944); *Reduced Pipe Line Rates and Gathering Charges II*, 272 ICC 375, 384 (1948). In *Petroleum Rail Shippers' Ass'n. v. Alton & Southern R.R.*, 243 ICC 589, 663 (1941) the ICC established a maximum rate of return of 10 percent for product pipeline companies. The higher rate of return for product pipelines was justified on the greater riskiness of product pipelines.

⁶²The ICC regulated on a company-wide basis. As long as the total return to all pipelines within the company did not exceed the maximum permitted (see note 59), the ICC would not examine the individual rates. The FERC maintained the applicability of the regulation to an entire pipeline system and did not impose point-to-point regulation. It changed, however, the regulation by applying the methodology to systems and not companies. Thus, if a company consisted of a system in California and a separate system in Illinois, the methodology applied to each and not the average of the two.

⁶³*Farmers Union II* at 73.

⁶⁴*Id.*

affirmative showing by the pipeline.

The Court's discussion of the equity component of the formula was particularly severe. The FERC called this component a real entrepreneurial rate of return on the equity component of the valuation rate base.⁶⁵ The Court was unable to find any rhyme or reason for this methodology and found no linkage between FERC's regulatory purposes and rate of return indices.⁶⁶ The Court focused on FERC's risk analysis, or total lack thereof, to determine whether there was any justification for the "buffer" approach to the selection of a rate of return index. The Court, finding no risk analysis, also found no rational link between the "buffer" approach and the rate of return determination.⁶⁷ The approach chosen by FERC did not prevent overcompensation for inflation, did not indicate why the indices were relevant, and did not prove that the chosen index would provide a reasonable return on investments. In point of fact, the Court noted that this approach would yield returns that likely would be very large.⁶⁸

The Court's opinion came down very hard on the concept of the equity component of the valuation rate base. The Court found that this equity component consisted of subtracting the face value of the debt from the valuation rate base. This meant that any increase in the rate base in addition to the original paid-in equity was attributable to equity. None of the rate base write up was attributable to debt. Thus, if the pipeline is highly leveraged, which many oil pipelines are, the equity component is likely to be magnified to spectacular proportions.⁶⁹

The Court noted the apples and oranges application of FERC's approach. The "buffer" of rate of return indices normally applied to book equity, an original cost concept, while the equity component to which the chosen index is applied is a completely different measure of net worth, namely, a valuation concept.⁷⁰ The Court, relying upon all these arguments, stated that FERC's rate of return formulation failed to meet the standards of reasoned decisionmaking.

II. BASIS THREE: THE END RESULT STANDARD

The Court was not content to let FERC off the hook. Fearing that FERC would attempt on remand to issue a decision which relied upon the same rate base and rate of return standard by improving upon its justification, the Court added a third basis for rejecting FERC's approach. The Court said that the combination of the rate base and rate of return methodologies did not produce an acceptable end result.⁷¹ Thus,

⁶⁵The equity component of the valuation rate base was to be calculated by determining the present valuation, including any and all write-ups, less the face value of the debt. Thus, all increases in the rate base are attributable to the equity component. *Williams* at 61,646-61,649.

⁶⁶*Farmers Union II* at 75.

⁶⁷*Id.* at 76-78.

⁶⁸*Id.*

⁶⁹*Id.* at 81-82. Using the example in the Court's opinion, "consider an oil pipeline, originally financed with \$900,000 debt and \$100,000 equity. The original cost of the pipeline is one million dollars. Over time, the pipeline's valuation rate base increases to, say, \$1,500,000. Under FERC's method, the equity component of the rate base amounts to \$600,000, six times its book equity, even though the valuation rate base as a whole has appreciated *only by half*." *Id.* at 82.

⁷⁰*Id.* at 83.

⁷¹*Id.* at 86.

even if FERC could justify its approach from the viewpoint of reasoned decisionmaking, it still would not be acceptable to the Court because the end result test would not be met.

IV. OTHER ISSUES

Before summing up and sending the case back to the FERC, the Court commented on a number of miscellaneous issues. In one of the rare approvals of FERC action, the Court agreed with the FERC that the purchase price of a pipeline should not be used for ratemaking purposes, but that the original cost of the pipeline should be used in the rate base.⁷²

The Court then concluded that FERC's decision to apply its ratemaking concepts on a systemwide basis, rather than on a point-to-point basis, was inappropriately decided.⁷³ From the Court's perspective, this was a question of rate design which the FERC had deferred to a follow-up proceeding.⁷⁴ While this question could be dealt with in the original proceeding, adequate notice was required that this issue would be raised. Since adequate notice was not given, the issue could not be raised in the original proceeding.

Finally, the Court approved FERC's decision with respect to how it dealt with tax normalization and rejected the AOPL's challenge.⁷⁵ With that, the Court summed up and sent the case back to the FERC for expeditious treatment stating that since FERC already had the benefit of an extensive record it should be able to issue a new order within twelve months.⁷⁶

⁷²*Id.*

⁷³*Id.* at 87-90.

⁷⁴At the commencement of the *Williams* proceeding the Administrative Law Judge (ALJ) split the proceeding into a generic proceeding examining the principles of ratemaking, known as *Williams I* and a specific application of these principles to the Williams Pipe Line, known as *Williams II*. For excellent discussion by the *Williams I* and *II* ALJ, of the reasons for bifurcating the proceeding, see Isaac D. Benkin, *Hybrid Rulemaking and Other Bureaucratic Misadventures*, speech before *Oil Pipeline Ratemaking Conference*, June 19-20, 1984, Houston, Texas, Executive Enterprises, Inc., New York.

⁷⁵*Farmers Union II* at 90-91. FERC permitted oil pipeline companies to decide for themselves whether to use tax normalization accounting or flow-through accounting. The differences stem from the way depreciation is determined for regulatory and tax purposes. For regulatory purposes depreciation usually is computed on a straightline basis, that is, the same amount is deducted from the original cost over the life of the property. The tax rules permit accelerated depreciation, that is, the depreciation in early years is very high and very low in later years. Under normalization, the business uses accelerated depreciation for tax purposes, but for ratemaking purposes it figures its tax costs as if it were paying higher taxes based upon straightline depreciation. The difference between the two amounts is placed in a deferred tax reserve account to be used in the future to pay taxes when the taxes based on straightline depreciation are actually lower than the taxes based on accelerated depreciation. In the meantime, the business collects interest on the reserve account. With flow-through accounting, the lower taxes attributable to accelerated depreciation are reflected immediately in the rate base. No tax reserve is required. *Williams* at 61,653-61,657.

⁷⁶*Farmers Union II* at 92.

V. IMPLICATIONS OF *FARMERS UNION II*

This article began using the words of Justice Clark in *Wisconsin v. Federal Power Commission*.⁷⁷ The Sisyphean labors of the Commission continue as it marches up the hill of oil pipeline regulation only to tumble down again with little undertaken and less done. For thirteen years two regulatory commissions strove to master the hill, only to find the road slippery and the effort unsuccessful. After interminable litigation, the oil pipeline industry finds itself in no better regulatory position than when first challenged in 1971 by a group of shippers disgruntled over the rate increases of one pipeline.^{77a} This litigation is reminiscent of the FPC's efforts with respect to natural gas wellhead regulation. By the time *Wisconsin v. Federal Power Commission* reached the Supreme Court the producer portion of the natural gas industry was without effective regulation for nine years. It was to take another five years before the Supreme Court upheld the FPC's chosen regulatory scheme.⁷⁸ Oil pipelines now have thirteen years behind them with no end in sight.

From the viewpoint of the regulatory lawyer, the *Farmers Union II* decision is an important milestone in the struggle to master the hill. Observers of and participants in the oil pipeline regulatory debacle are divided over this decision. Some state clearly and loudly that the ICC methodology is dead and that original cost or some version based upon original cost is the only viable alternative available to the Commission.⁷⁹ Others state equally clearly and perhaps less loudly that the ICC valuation methodology is not dead. It only needs some important alterations and better justification by the Commission.⁸⁰ The interpretations of these questions raised by the decision are predictable and may be equally valid. But if both may be valid, then the decision has not helped Sisyphus achieve the crest of the hill.

The most striking aspect of *Farmers Union II* is the Court's outrage over the

⁷⁷373 U.S. 294, 315 (1963).

^{77a}See note 8, *supra*.

⁷⁸Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

⁷⁹Remarks of John M. Cleary before the *Oil Pipeline Ratemaking Conference*, June 19-20, 1984, Houston, Texas (hereinafter "Oil Pipeline Ratemaking Conference").

⁸⁰Remarks of Steven H. Brose before the *Oil Pipeline Ratemaking Conference*, and remarks of Eden Martin before the Federal Energy Bar Association, May 3, 1984, Washington, D.C.

Apart from the regulatory lawyers' perspectives, there is another perspective to this struggle over which methodology is more appropriate. In a single word the struggle is over "money." It makes a substantial difference to a pipeline whether it uses the ICC methodology or an original cost methodology. The rate levels which can be established using the ICC methodology are likely to be substantially above those permitted under an original cost methodology. For example, using the Trans-Alaska Pipeline System (TAPS) as an example, some monetary value can be derived from the different methodologies. Using 1979, the TAPS shipped approximately 1210 MBPD through the line at an average tariff of \$6.20. Based on the ICC methodology with an 8 percent return on valuation, this produces revenues of about \$2.74 billion. Using the original cost methodology with an 11.5 percent rate of return developed in the Initial Decision of Trans-Alaska Pipeline System, OR78-1, February 1, 1980, the weighted average tariff would be \$4.93 or 20.48 percent lower. The revenues generated by this tariff would be about \$2.18 billion. If the entire industry switched to original cost, and assuming that the original cost tariffs were on average 20 percent lower than the ICC valuation tariffs, then for 1979 the total revenue of about \$5.78 billion would be reduced to about \$4.62 billion or about \$1.16 billion less. From any perspective this is a great deal of money. Thus, the stakes are very high in this game, the value of the chips to be won or lost are large, not trivial amounts not worth squabbling over.

result reached by the FERC. The Court repeatedly cites the FERC and adds its own characterizations of this result. Thus, the result is couched in a litaney of phrases, which include, gross overreaching,⁸¹ unconscionable gouging,⁸² outrageously high rates,⁸³ prohibitive rates or pricing,⁸⁴ generous returns,⁸⁵ gross abuse or cap on gross abuse,⁸⁶ creamy returns,⁸⁷ egregious or extraordinary exploitation,⁸⁸ profits too high to be reconcilable with legislative command,⁸⁹ profits far more generous than FERC or others give elsewhere,⁹⁰ rate levels or ceilings so high they would seldom be reached in actual practice,⁹¹ excessive rates,⁹² extraordinarily high price ceilings,⁹³ egregiously extortionate,⁹⁴ and seemingly outlandish returns.⁹⁵ From this outpouring of the Court's distaste with the result reached in this proceeding,⁹⁶ the Court appeared to stretch the law to the limit of what an appellate court can do without abusing its discretion. One of the questions raised by *Farmers Union II* is whether the Court went too far.

Some participants in the oil pipeline struggle have opined that *Farmers Union II* has turned the *Hope* decision on its head.⁹⁷ *Hope* made it very clear that the courts were more concerned with the result of the regulatory process rather than the

⁸¹*Farmers Union II* at 12, 15, 33.

⁸²*Id.* at 12, 15, 33.

⁸³*Id.* at 14.

⁸⁴*Id.* at 14, 16, 40, 42.

⁸⁵*Id.* at 22.

⁸⁶*Id.* at 13, 20, 33, 36, 40, 76, 77, 84.

⁸⁷*Id.* at 21, 34, 48.

⁸⁸*Id.* at 33, 36, 40.

⁸⁹*Id.* at 33.

⁹⁰*Id.* at 34.

⁹¹*Id.* at 22, 35, 43, 48.

⁹²*Id.* at 32, 33, 38, 40.

⁹³*Id.* at 49.

⁹⁴*Id.* at 50, 77.

⁹⁵*Id.* at 84.

⁹⁶From the Court's perspective, the result reached by *Williams* was untenable. There is a clear tension between what the FERC attempted to achieve in this proceeding and what the Court viewed as permissible. FERC would just as soon deregulate the entire industry and at one point in *Williams* pleads with the Congress to do just that. *Williams* at 61,586-61,587. But given the Congressional mandate to regulate, FERC chose to regulate in as lighthanded, nontraditional manner as possible without overstepping the bounds of the statutory mandate. The Court, on the other hand, is unconcerned with deregulation or other options available to a future Congress. It is concerned with Congressional history (legislative intent) and the application of that intent to the statutory scheme the FERC is responsible for enforcing. Thus, the Court views its duty from a very nontraditional perspective. The Court's holdings in this case indicate that the FERC went too far and reached a result which was untenable in view of the traditional concepts of regulation.

⁹⁷Remarks of Steven H. Brose, *supra* note 78.

methodology.⁹⁸ Courts since then have repeated that holding.⁹⁹ Even the Court in *Farmers Union II* repeats *Hope's* teachings and the cases following *Hope*.⁹⁹ An examination of precedents makes it very clear that prior Courts meant what they said.¹⁰⁰ Thus, *Hope* and its progeny teach that the methodology used by the Commission is less important than the end result. The Commission had wide discretion to implement a methodology that provided just and reasonable rates within the meaning of a particular regulatory scheme. While cost-based methodologies were preferred, they were not the only basis upon which the Commission could reach a just and reasonable result. Departures from cost-based

⁹⁸In *Hope* at 602, the Court stated:

We held in *Federal Power Commission v. Natural Gas Pipeline Co.*, *supra*, that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover, involves the making of "pragmatic adjustments." *Id.*, p. 586. And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. *Id.*, p. 586. Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. [Emphasis added]

⁹⁹*FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979); *Mobil Oil Corp. v. FERC*, 417 U.S. 283, 306-308 (1974); *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 775 (1968); *Wisconsin v. Fed Power Comm'n.*, 373 U.S. 294, 309 (1963); *City of Chicago, Illinois v. Federal Power Commission*, 458 F.2d 231, 749, 751 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972); *City of Detroit, Michigan v. Federal Power Comm'n.*, 230 F.2d 810, 814 (D.C. Cir. 1955), *cert. denied sub nom.* *Panhandle Eastern Pipe Line Co. v. City of Detroit*, 352 U.S. 829 (1956).

¹⁰⁰*Farmers Union II* at 30-31.

¹⁰¹In *Wisconsin v. Federal Power Commission*, 373 U.S. 294 (1963), the Court had the first opportunity to review the FPC's efforts in regulating natural gas producers since its decision in *Phillips Petroleum Corp. v. Wisconsin*, 347 U.S. 672 (1954) holding that producers were subject to regulation under the Natural Gas Act. While the area rate methodology was not specifically before the Court, the Court noted the FPC's situation was difficult and hoped that the area rate approach was the answer. But the court reaffirmed *Hope* "that no specific method need be followed by the Commission in considering the justness and reasonableness of rates." *Wisconsin v. Fed Power Comm'n.*, at 309. In *Permian Basin, supra*, the Court went to great lengths to reaffirm *Hope* and *Wisconsin*, 390 U.S. at 767, 775, 791. In delineating the appropriate criteria for assessing the FPC's use of area ratemaking for the regulation of natural gas producers, the Court stated, at 791-792:

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

The following language immediately following the above quotation is particularly relevant to the issue here:

The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors.

ratemaking utilizing noncost factors were permissible within the confines of reaching a just and reasonable result.

The question, then, is whether the *Farmers Union II* Court deviated from these precedents. The Court had no choice but to repeat the precedents of forty years' standing. It was clear that the Court found that result of FERC's decisionmaking process exceeded the bounds of principled ratemaking. The result led to rate deregulation that did not comport with the traditional view of just and reasonable. The FERC apparently was too innovative in one opinion for the Court's liking. It might have succeeded in introducing some new concepts into the ratemaking process. But to introduce so many all at once with the end result it reached was too egregious for the Court. It forced the Court to state with unusual clarity what it thought the FERC should do.

But did the Court go too far? In my view, the *Hope* decision and its progeny still are alive and well in the judicial process. The end result is still the guiding principle of ratemaking. The methodology used to reach that result still can be varied. But the result must be just and reasonable within the regulatory framework. FERC's judgment still is paramount, but not unlimited.

It is the abuse of its judgment which led the FERC astray in its *Williams* decision. By abandoning the traditional just and reasonable standard and perverting the regulatory scheme of the Interstate Commerce Act with a result that was so unconscionable, the FERC brought down the wrath of the Court.¹⁰² While the Court went to great pains to tell the FERC what it thought was an appropriate ratemaking methodology, the Court must remain true to *Hope* and its progeny. The Court must yield ultimately to the FERC's ratemaking discretion as long as the FERC produces a reasoned decision with a result that is just and reasonable within the ICA regulatory framework.

Thus, it is conceivable that FERC could rely on an altered ICC methodology, adopting many of the AOPL recommendations, and reordering its rate of return formulation to produce a just and reasonable result. Also, it is conceivable that the FERC will take the Court's advice and abandon the ICC methodology and actually wipe the slate clean (as it wanted to do in 1978)¹⁰³ and implement a rate-base methodology based upon original cost. Either approach would be justifiable if the *Farmers Union II* decision is applied literally as long as the end result of using either rate base formula is just and reasonable.

VI. CONCLUSION

In *Farmers Union II*, an appellate court is so outraged at a regulatory agency for

¹⁰²As indicated in note 96, *supra*, the FERC's result may not have been unconscionable if its result was to deregulate the oil pipeline industry. Its extensive *Williams* decision, in the view of this writer, was an attempt to justify deregulation. The rates which could have been charged by pipelines under the *Williams* methodology would not have been constrained by anything but competition. Thus, where pipelines faced competition from other modes, rates would have risen to the level of the alternative. Where pipelines faced competition from other pipelines in a competitive market, rates probably would have risen, but not by much. In markets where pipelines faced no or limited competition, rates very likely would have risen substantially above present levels. The Court did not view this prospect as being within the just and reasonable standard envisioned by Congress and interpreted by the courts.

¹⁰³*Farmers Union I* at 421, *Farmers Union II* at 10.

a decision that is so lacking in intellectual rigor and so oblivious to its own precedents that the Court had no alternative but to reverse and remand. The Court also viewed the FERC's decision as the first time the FERC had the opportunity to interpret the just and reasonable standard of a statute new to the FERC but not new to the Court. Thus, the Court viewed its responsibility to instruct the FERC on the appropriate just and reasonable standard in applying the Interstate Commerce Act. There is no doubt left from the Court's decision that the FERC must fashion an oil pipeline ratemaking method that falls within the traditional zone of reasonableness permitted by the ICA's just and reasonable standard. There is also little doubt of the Court's aversion to the ICC methodology and its preference for original cost. But the Court could not substitute its judgment that original cost must be used or should be used. The FERC can take the easy way out in the remand and select from one of the original cost methodologies. It also can alter the ICC methodology to comport with more modern suggestions. This latter approach requires more rigorous justification but it is not insurmountable.

Farmers Union II attempts to give the FERC the direction it has been searching for these many years. While the Court attempted to provide only one course for the FERC to take, a literal reading of the opinion leaves the FERC with the ability to implement an oil pipeline ratemaking methodology that comports with *Hope* without strict adherence to only one methodological approach. Whether the FERC will choose the easy way out or try the more difficult way only time will tell. No matter what the FERC does, it, like Sisyphus, finds itself at the bottom of the hill again confronting the arduous climb to the top.