

NOTE

THE RIGHT OF AN INDIRECT CUSTOMER TO CONTEST FERC-APPROVED RATE SETTLEMENTS

I. INTRODUCTION

Southern California Edison Company (Edison) is in an unusual position. As a result of natural gas restructuring, Edison is both a direct and an indirect customer of El Paso Natural Gas Company (El Paso).¹ As a direct customer, Edison purchases firm transportation directly from El Paso and then from Southern California Gas Company (SoCal), a local distribution company (LDC), to deliver gas to its generating stations.² As an indirect customer, Edison pays SoCal an Interstate Transaction Cost Surcharge (ITCS) ordered by the California Public Utility Commission (CPUC).³ This surcharge represents the difference between SoCal's capacity release revenues and the cost for its unused firm capacity on El Paso.⁴

In 1995, El Paso filed a Section 4⁵ rate case at the Federal Energy Regulatory Commission (FERC or the Commission), and Edison intervened.⁶ Subsequently, El Paso made an offer of settlement (the Proposed Settlement). Edison opposed the settlement in both these capacities, raising issues that the presiding administrative law judge (ALJ) ruled would have ordinarily entitled Edison to a hearing.⁷ The Commission determined that Edison was entitled to a hearing or severance only in its capacity as a direct customer of El Paso.⁸ As to its role as an indirect customer of El Paso, the Commission found no requirement of a hearing and approved the settlement over the objections of Edison.⁹

On Edison's petition for review, the Court of Appeals for the District of Columbia Circuit held in *Southern California Edison Co. v. FERC* that the FERC had erred in denying Edison either a hearing on the merits or severance of

1. *Southern California Edison Co. v. FERC*, 162 F.3d 116, 117 (D.C. Cir. 1998).

2. *Id.* at 118.

3. *Edison*, 162 F.3d at 118.

4. *El Paso Natural Gas Co.*, 79 F.E.R.C. ¶ 61,028, 61,128-29 n. 21 (1997), *reh'g denied*, 80 F.E.R.C. ¶ 61,084 (1997).

5. Natural Gas Act, 15 U.S.C. § 717c (1998).

6. Answer of El Paso Natural Gas Company to Motion of Southern California Edison Company for Rejection of Settlement and Immediate Establishment of Procedural Schedule at 2, *El Paso Natural Gas Co.*, FERC Docket No. RP95-363-000 (Feb. 3, 1999) [hereinafter *El Paso's Answer*].

7. *El Paso Natural Gas Co.*, 78 F.E.R.C. ¶ 63,006, 65,131 (1997).

8. 79 F.E.R.C. ¶ 61,028, at 61,127-28.

9. *Id.*

the issues it had raised as an indirect customer.¹⁰ The court limited its consideration to the FERC's failure to reject the settlement as contested or to grant Edison a severance in its status as an indirect customer on those issues.

The decision clarifies the rights of certain pipeline customers to block rate settlements before the FERC and also suggests that a more rigorous analysis must be employed by the FERC before dismissing the rights of an indirect (or perhaps any) customer to oppose the settlement. If this ruling is interpreted to grant an indirect customer of a pipeline an expanded right to challenge the rate paid by its LDC, the range of interests the pipeline must consider in reaching a settlement with the Commission has greatly increased.

II. STATEMENT OF THE CASE

El Paso Natural Gas Co. is an interstate natural gas pipeline servicing customers (primarily LDCs) in New Mexico and California, including Southern California Gas Co.¹¹ Southern California Edison Co. is a major California electric utility that buys gas transportation service on the pipelines of both El Paso and SoCal. Edison, therefore, is a customer of El Paso both directly and indirectly through its relationship with SoCal.¹²

Prior to natural gas restructuring, SoCal sold gas both to its "core" (primarily residential) customers and to "non-core" customers such as Edison. Following restructuring, however, SoCal now sells gas only to core customers and only provides transportation services to its non-core customers. Edison, as a non-core customer, buys gas and ships it to SoCal's system via El Paso and to its generating stations via SoCal.¹³ Since Edison uses SoCal's transportation system, and "a portion of SoCal's charges to Edison reflect El Paso's charges to SoCal," to the "extent SoCal pays more than the just and reasonable rate to El Paso, Edison will be forced to bear its proportionate share of SoCal's excess charges from El Paso."¹⁴ Edison asserted that SoCal's revenues necessarily fall below their costs because of the capacity still reserved by SoCal on El Paso to provide service to non-core customers that have switched to their own transportation.¹⁵ The CPUC allows SoCal to recover some of these revenues by charging non-core customers such as Edison the ITCS. Therefore, Edison would be harmed unless it can be assured that SoCal is not paying El Paso more than the just and reasonable rate.¹⁶

10. The issues that Edison sought to raise as an indirect customer concerned the allocation of El Paso's costs to SoCal which were, in turn, passed on to Edison through the ITCS. *Edison*, 162 F.3d at 117.

11. *El Paso, Customer Group Attack SoCal Ed's Unilateral Settlement*, INSIDE F.E.R.C., Apr. 15, 1996, at 12 (noting that the Southwest Customer Coalition, which supports the El Paso settlement offer, is composed of 38 parties and 95% of El Paso's firm load).

12. *Edison*, 162 F.3d at 117.

13. *Id.* at 118.

14. 79 F.E.R.C. ¶ 61,028, at 61,127-28.

15. *Edison*, 162 P.2d at 118.

16. 79 F.E.R.C. ¶ 61,028, at 61,128.

In 1995, El Paso filed new transportation rates with the FERC under Section 4 of the Natural Gas Act (NGA).¹⁷ El Paso made an Offer of Settlement on March 15, 1996, which was supported or unopposed by roughly ninety-five percent of the parties involved in the proceeding, including a coalition of firm and interruptible customers of El Paso, the California and Nevada state commissions, and the FERC staff, but not Edison.¹⁸ The Proposed Settlement was claimed to resolve all the issues of the pending rate proceedings.¹⁹ The Proposed Settlement included a ten-year moratorium, during which El Paso could not "file a general rate change."²⁰

Edison objected to the Proposed Settlement, raising both procedural and substantive issues.²¹ In addition, Edison then proposed its own settlement offer. Edison's Settlement proposed a five-year moratorium rather than ten, a "re-investment" provision, a lower cost of service, and most significantly, a credit of fifty percent of El Paso's revenues from re-marketing unsubscribed capacity.²²

The ALJ issued an order in the *El Paso* rate proceeding refusing to allow Edison to object to the rate paid by SoCal.²³ The ALJ found that Edison's indirect customer argument "is totally without merit"²⁴; if "Edison were correct" in arguing that it had the right to litigate SoCal's rate paid under the settlement as a customer of SoCal, then "every gas ratepayer withing (*sic*) the State of California would be able to block a settlement and send a case to hearing by raising factual issues."²⁵ The ALJ did, however, order Edison severed in its

17. 15 U.S.C. § 717c. This section provides that:

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

15 U.S.C. § 717c(a). It goes on to require:

Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from June 21, 1938) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

15 U.S.C. § 717c(c).

18. 78 F.E.R.C. ¶ 63,006, at 65,130.

19. 79 F.E.R.C. ¶ 61,028, at 61,123.

20. *Id.* at 61,124.

21. *Edison*, 162 F.3d at 117. One other party, Williams Field Service Group Inc. (Williams), objected to the El Paso settlement, but the objection was based merely on "a narrow issue involving refunctionalization of facilities." *Comments in El Paso Rate Case Prove that Some Things Never Change*, INSIDE F.E.R.C., Nov. 25, 1996, at 8.

22. 79 F.E.R.C. ¶ 61,028, at 61,125.

23. 78 F.E.R.C. ¶ 63,006, at 65,131.

24. No one appeared prepared to argue that Edison had been anything less than persistent in asserting its dual positions. Indeed, at one point, the FERC staff claimed that "SoCal Edison is making a pest of itself and should be ignored." *SoCal Edison is Making a Pest of Itself and Should Be Ignored*, INSIDE F.E.R.C., Apr. 8, 1996, at 7.

25. 78 F.E.R.C. ¶ 63,006, at 65,131.

role as a direct customer of El Paso because it had raised "serious and complex factual questions" that "would benefit from an evidentiary hearing with cross-examination."²⁶ Severance would allow Edison to litigate these issues separately. Yet, the ALJ certified the settlement (with Edison severed) as "uncontested" with respect to the consenting parties.²⁷

The Commission, relying upon the ALJ's order, denied Edison any right to either severance or litigation arising from its role as an indirect customer of El Paso.²⁸ The Commission began by recognizing its power to sever opposing parties.²⁹ Pursuant to Commission Rule 602, contesting parties may be severed in order to give them the benefit of their bargain while also providing them the opportunity to have their objections decided on the merits.³⁰ The FERC has previously held that "where the settlement appears to be reasonable but the objections to the settlement raise a factual question that is complex and would benefit from an evidentiary hearing with cross-examination, then severing contesting parties should be considered."³¹ The Commission found that Edison's indirect customer interest was not entitled to severance and was legally insufficient to prevent certification of an otherwise uncontested settlement.³²

Edison sought rehearing,³³ and when the order denying rehearing was handed down, Edison then sought judicial review before the D.C. Circuit.³⁴ The sole issue before the Court of Appeals in *Southern California Edison Co. v. FERC* was whether the FERC's "refusal either to hold up the settlement pending resolution of Edison's merits claims as an indirect customer, or to sever Edison from the settlement in both its capacities" was proper.³⁵

III. THE DECISION OF THE COURT

A. Commission Rule 602: Settlements and Severance

Under Commission Rule 602, the FERC will entertain an offer of settlement by any participant in the rate proceeding.³⁶ Once filed with the

26. *Id.*

27. *Edison*, 162 F.3d at 117.

28. 79 F.E.R.C. ¶ 61,028, at 61,130.

29. *Id.* at 61,127.

30. Commission Rule 602(h)(2)(iv) provides that "[i]f any contesting parties or contested issues are severable, the uncontested portions of the settlement may be certified immediately by the presiding officer to the Commission for decision, as provided in paragraph (g) of this section." 18 C.F.R. § 385.602(h)(2)(iv) (1998).

31. *Koch Gateway Pipeline Co.*, 74 F.E.R.C. ¶ 61,088, 61,271 (1996), *order on reh'g*, 75 F.E.R.C. ¶ 61,132 (1996).

32. 79 F.E.R.C. ¶ 61,028, at 61,130.

33. 80 F.E.R.C. ¶ 61,084.

34. *Edison*, 162 F.3d 116.

35. *Id.* at 118.

36. 18 C.F.R. § 385.602(b) (1998). This section provides that "[a]ny participant in a proceeding may submit an offer of settlement at any time." *Id.* § 385.602(b)(1).

Secretary, any party may file comments on the proposed settlement; failure to comment constitutes a waiver of objections.³⁷

Based upon the comments received, if the FERC finds the settlement offer uncontested, it may approve if it further finds the offer "fair and reasonable and in the public interest."³⁸ If, however, the settlement is found contested, the Commission can take one of three courses of action: (1) decide the merits of the settlement issues on the available record; (2) solicit additional comments to complete the record; or (3) sever contesting parties or issues.³⁹

Prior to the *Edison* case, the Commission had found settlements that were challenged exclusively by indirect customers as uncontested, at least in part because of the likely congruence of interests between direct and indirect customers.⁴⁰ Specifically, in *Northwest*,⁴¹ the FERC held that the lone objector to a proposed settlement, as an indirect customer, presented no bar to approval on the merits because an indirect customer "does not have the independent right to litigate the settlement rates as a non-consenting party."⁴² The Commission has also looked unfavorably on severance, especially in the case of open access transportation service, as creating a "no lose" situation for contesting parties,⁴³

37. 18 C.F.R. § 385.602(f)(1) and (3) (1998).

38. 18 C.F.R. § 385.602(g)(3) (1998).

39. 18 C.F.R. § 385.602(h)(1). (1998) Rule 602(h) provides:

(h) Contested offers of settlement.

(1)(i) If the Commission determines that any offer of settlement is contested in whole or in part, by any party, the Commission may decide the merits of the contested settlement issues, if the record contains substantial evidence upon which to base a reasoned decision or the Commission determines that there is no genuine issue of material fact.

(ii) If the Commission finds that the record lacks substantial evidence or that the contesting parties or contested issues can not be severed from the offer of settlement, the Commission will:

(A) Establish procedures for the purpose of receiving additional evidence before a presiding officer upon which a decision on the contested issues may reasonably be based; or

(B) Take other action which the Commission determines to be appropriate.

(iii) If contesting parties or contested issues are severable, the contesting parties or uncontested portions may be severed. The uncontested portions will be decided in accordance with paragraph (g) of this section.

Id.

40. *See, e.g., Northwest Pipeline Corp.*, 83 F.E.R.C. ¶ 61,001, 61,004 (1998).

41. *Northwest Pipeline Corp.*, 81 F.E.R.C. ¶ 61,242 (1997), *reh'g denied*, 83 F.E.R.C. ¶ 61,001 (1998). The lone objector, Pan Alberta Gas Ltd. (Pan-Alberta), is affected by Northwest Pipeline Company's (Northwest) rate because of a netback pricing system under which Pan-Alberta's price is calculated by subtracting the transportation charges paid by Pacific Interstate Transmission Co. (PITCO) to Northwest from a specified benchmark index gas price. 83 F.E.R.C. ¶ 61,001, at 61,001.

42. 83 F.E.R.C. ¶ 61,001, at 61,002. The Commission, in denying Pan-Alberta's motion for rehearing, clarified its strong stance of refusing to allow Pan-Alberta to pursue its objections as an indirect customer.

[S]ince Pan-Alberta is not a rate-payer, although it may be affected, as many others are, by the rates under the Settlement, the appropriate procedure to follow was to consider Pan-Alberta's objections to the Settlement, to determine if the Settlement should be approved, which objections the Commission had considered. Accordingly, there was no need for severance, and the Commission approved the Settlement.

Id. at 61,001-02.

43. *Trailblazer Pipeline Co.*, 85 F.E.R.C. ¶ 61,345, 62,340 (1998).

and therefore characterizing it as the "option of last resort."⁴⁴ The Commission is particularly concerned with severing indirect customers because there is a risk that the severance, which must also include the intermediate direct customers, may "unravel the settlement in general."⁴⁵

B. FERC Precedent: The United Case

In *United Gas Pipe Line Co. (United)*, the FERC addressed a challenge by United's indirect customers⁴⁶ to a settlement offer.⁴⁷ The FERC initially approved the settlement because, it argued, regardless of the rate methodology used, the filed rate doctrine could be waived with the consent of the parties.⁴⁸ The Commission determined that, since all but one of the direct sales customers of United had agreed to the resolution, the filed rate doctrine had been sufficiently waived, and that the indirect customers' issues could be heard separately.⁴⁹

United's indirect sales customers sought rehearing of the FERC's order arguing that direct customers should not be entitled to waive the filed rate doctrine on behalf of indirect customers.⁵⁰ On rehearing, the FERC determined that all parties must agree to waive the filed rate doctrine,⁵¹ and several of the indirect customers objected specifically to the purchase deficiency model ruled invalid by the court in *Associated Gas Distributors v. FERC*.⁵² The FERC ruled therefore that "[i]n light of the fact that these parties have asserted rights under the filed rate doctrine, we cannot approve the contested settlement."⁵³ The Commission clearly indicated that indirect customers are among those who can assert rights under the filed rate doctrine and are essential to the settlement agreement; it is not the direct customers alone who can assert rights.⁵⁴

44. 81 F.E.R.C. ¶ 61,242, at 62,041.

45. 83 F.E.R.C. ¶ 61,001, at 61,003.

46. The indirect customers in the *United* case included Baltimore Gas and Electric Co. and the Office of Consumers' Counsel, State of Ohio (Baltimore and OCC), Carnegie Natural Gas Co. (Carnegie), Columbia Gas Transmission Corp. (Columbia), and Laclede Gas Co. (Laclede). Another petitioner in the action was a direct customer of United, Texas Gas Transmission Corp. (Texas Gas).

47. *United Gas Pipe Line Co., Southern Natural Gas Co., and Texas Gas Transmission Corp.*, 55 F.E.R.C. ¶ 61,070 (1991).

48. *United Gas Pipe Line Co., Southern Natural Gas Co., and Texas Gas Transmission Corp.*, 51 F.E.R.C. ¶ 61,242, 61,674 (1990).

49. *Id.* The FERC described the difference between direct and indirect customers in this way:

The indirect customers do not purchase gas directly from United but from a pipeline that is either direct or indirect customer of United. A direct customer purchases directly from United and pays United its tariff rate for the gas.

55 F.E.R.C. ¶ 61,070, at 61,201, n. 7. The circumstances of the Edison-El Paso dispute are different because of natural gas restructuring. Now, LDCs such as SoCal and customers such as Edison purchase transportation on El Paso rather than buying gas directly.

50. 55 F.E.R.C. ¶ 61,070, at 61,201.

51. *Id.*

52. *Associated Gas Distributors v. FERC*, 893 F.2d 349 (D.C. Cir. 1989).

53. 55 F.E.R.C. ¶ 61,070, at 61,202.

54. The Commission reasoned that:

Section 4 of the NGA, the statutory basis for the filed rate doctrine, provides that no rate change shall

According to the order, “the mere fact that most of United’s direct customers, all regulated entities exercising market power, have chosen not to exercise their rights under the filed rate doctrine, does not support approving the settlement in spite of the fact that the settlement violates the filed rate doctrine.”⁵⁵

United also held that severance of the contesting customers was inappropriate, because it would not further the FERC’s policy goals of preserving the benefit of the bargain for the parties who agree to the settlement and protecting the interests of the contesting parties in subsequent litigation.⁵⁶ Because the indirect customers “contest on legal and policy grounds the allocation of take-or-pay costs to the direct customers and the relief they seek would require an allocation different from that of the settlement,” approving the settlement with respect to the contesting parties would not be an adequate solution.⁵⁷

Before the court, the Commission sought to distinguish *United* on two bases.⁵⁸ First, the FERC contended that the indirect customers in *United* were interstate customers under FERC jurisdiction while Edison’s complaint concerned SoCal’s intrastate rates, which were outside FERC jurisdiction.⁵⁹ Second, in *United*, the Commission argued it had determined that rejection of the settlement was proper because the indirect customers’ objections were essential to the outcome of the settlement.⁶⁰ By contrast, Edison could subsequently litigate the El Paso rate without affecting the rate paid by the consenting parties.⁶¹

The Circuit Court rejected both of these arguments. The first argument was “blind to Edison’s claim.”⁶² Edison had challenged the allocation of El Paso’s costs to SoCal, a transaction which is interstate in nature. It is precisely this purchase that relates to Edison’s role as an indirect, rather than a direct, customer of El Paso.⁶³ Nor was it persuasive to argue that Edison’s CPUC agreement to

be made except on 30-days’ notice “to the commission and to the public.” [15 U.S.C. § 717c(d)] The “public” must include the pipeline’s indirect customers who will pay a portion of the costs allocated in the proceeding. Further, the Commission has consistently permitted indirect customers to participate in the take-or-pay proceeding of the upstream pipeline supplier for the very reason that they will be affected by the outcome of that proceeding. The indirect customer will pay a portion of the take-or-pay costs allocated to their direct pipeline supplier, and the amount they will pay is affected by the allocation approved in the upstream proceeding. Therefore, the indirect customers are within the protection of the filed rate doctrine and the indirect customers’ agreement to the settlement is necessary and it is not sufficient that only the direct customers have agreed not to assert their rights under the filed rate doctrine.

55 F.E.R.C. ¶ 61,070, at 61,202-03.

55. 55 F.E.R.C. ¶ 61,070, at 61,203.

56. *Id.*

57. 55 F.E.R.C. ¶ 61,070, at 61,203.

58. *Edison*, 162 F.3d at 118.

59. *El Paso Natural Gas Co.*, 80 FERC ¶ 61,084, 61,294 (1997). In the order denying rehearing, the Commission explained that Edison “is concerned about SoCal’s rate to its intrastate customers, . . . which is a matter over which this Commission has no jurisdiction.” *Id.*

60. 55 F.E.R.C. ¶ 61,070, at 61,203.

61. 80 F.E.R.C. ¶ 61,084, at 61,294.

62. *Edison*, 162 F.3d at 118.

63. As discussed previously, because Edison reserves transportation on El Paso, it is a direct customer.

bear some of the costs from the ITCS equated to a waiver of the right to challenge the interstate allocation.⁶⁴

The Commission's second argument was also rejected as an attempt "simply to change the subject."⁶⁵ The Commission had argued Edison could litigate its issues as a direct customer of El Paso without affecting the rate for the consenting parties.⁶⁶ The court, however, reasoned that Edison's severance and ability to proceed as a direct customer "does not enable it to pursue them as an indirect customer, even though, so far as appears, they go 'to the very basis of the settlement' every bit as much as the objections in *United*."⁶⁷

The court raised a third distinction *sua sponte*.⁶⁸ The court noted that in *United*, the Commission took account of the potential "trapping" of costs that could have occurred.⁶⁹ The court considered Edison's case "at least as compelling."⁷⁰ Here, "instead of the customer in the middle being stuck because of the upstream settlement, the indirect customer (Edison) will be stuck with the *fait accompli* of the costs SoCal has agreed to bear."⁷¹

C. Federal Case Law: *Tejas v. FERC*

The court compared the *United* case to its own decision supporting an indirect customer's challenges in *Tejas Power Corp. v. FERC*.⁷² In *Tejas*, the court addressed a gas inventory charge (GIC) proposed by Texas Eastern

This challenge of the FERC's order is based entirely on Edison's purchase of transportation on SoCal, which reflects El Paso's rates on the allocation of turnback capacity costs SoCal must negotiate with CPUC. These costs are paid by SoCal as a direct customer of El Paso—and then passed on inevitably to Edison—but cannot be contested by Edison.

64. *Edison*, 162 F.3d at 118. The Court goes on to explain that "Edison's agreement before CPUC to bear a share of costs being determined by FERC cannot possibly have waived its right to challenge the size of the cost it has agreed to share." *Id.*

65. *Id.*

66. *Edison*, 162 F.3d at 118. The Court here notes:

A similar misunderstanding underlies the Commission's second proposed distinction. In *United*, it said, "[t]he relief that the objectors sought would require a different allocation than the one provided in the settlement." Rejection of the settlement was proper because the indirect customers' objections went "to the very basis of the settlement." Here, by contrast, Edison "can litigate its rate with El Paso, without affecting the consenting parties' rate." This appears simply to change the subject.

Id. (citations omitted).

67. *Id.*

68. The Court of Appeals was clearly unconvinced by the FERC's arguments, which it called "blind" and an attempt to "change the subject." The court then suggests that the Commission also missed a third argument that it thought "suggests itself." The court ends its discussion with the almost inexplicable comment that "[w]hile *United* might perhaps be distinguished here, the Commission has not done so." *Edison*, 162 F.3d at 119.

69. *Edison*, 162 F.3d at 118. It seemed particularly unfair that a settlement could be approved over the objections of the downstream (or indirect) customers since the downstream proceedings had yet to occur. The Commission refers to this situation as leaving the upstream (or direct) customers "trapped" with costs they could not recover downstream. See, e.g., 64 F.E.R.C. ¶ 61,014, at 61,097-98.

70. *Edison*, 162 F.3d at 118.

71. *Id.*

72. *Tejas Power Corp. v. FERC*, 908 F.2d 998 (D.C. Cir. 1990).

Transmission Corporation (Texas Eastern).⁷³ The Commission's approval of a settlement accepting Texas Eastern's GIC appeared to be based in large part on the acquiescence of all twelve of Texas Eastern's resale customers (all LDCs), despite the objections of a group of end-use customers.⁷⁴ The court held this justification insufficient, noting that both Supreme Court⁷⁵ and its own precedent⁷⁶ obligate the Commission to give some weight to the contracts and settlements of the parties involved,⁷⁷ but that its decision must ultimately rest upon a finding of whether the new service "is or will be required by the present or future public convenience and necessity."⁷⁸ Therefore, the court imposed upon the Commission the more imposing "substantial evidence" test for a contested settlement.⁷⁹

As subsequently construed by *Edison, Tejas v. FERC* suggested an alternative evaluation of the degree of "congruency" between the interests of the direct and indirect customers.⁸⁰ Critically, in *Tejas*, the court made a deep analysis of the public interest and the interests of the indirect customers.⁸¹ Although acceptance of a settlement by most, if not all, of the other customers must be entitled to "some weight,"⁸² it is not sufficient to overcome a showing of an interest by an indirect customer,⁸³ or even a competitor.⁸⁴

73. *Texas Eastern Transmission Corp.*, 44 F.E.R.C. ¶ 61,413 (1988), *reh'g denied*, 47 F.E.R.C. ¶ 61,100 (1989).

74. *Tejas*, 908 F.2d at 1000. These end-use customers objected specifically that (1) the Commission should have held a hearing to determine if the GIC and settlement were reasonable, (2) the settlement "forecloses competition in a significant part of Texas Eastern's market," (3) the agreement was based in large part on the lack of any viable alternatives, and (4) the transportation and storage services provided by Texas Eastern were not "substantially comparable" to the sales service. The Commission stated that it would consider this last issue of comparability in a separate proceeding, but that it was not necessary to complete the proceeding prior to approval of the GIC. *Tejas*, 908 F.2d at 1002.

75. *See, e.g.*, *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 312-14, 94 S.Ct. 2328, 2347-49 (1974), *United Gas Pipe Line Co. v. Mobil Gas Serv. Corp.*, 350 U.S. 332, 76 S.Ct. 373 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 76 S.Ct. 368 (1956).

76. *See, e.g.*, *Union Elec. Co. v. FERC*, 890 F.2d 1193, 1194-95 (D.C. Cir. 1989).

77. *Tejas*, 908 F.2d at 1003.

78. *Id.* This requirement can be found in the Natural Gas Act § 7(e). 15 U.S.C. § 717f(e).

79. The Commission's rules require that a contested settlement be approved only if the record contains substantial evidence upon which to base a reasoned decision or the Commission determines there is no genuine issue of material fact.

18 C.F.R. § 385.602(h)(1)(i) (1998). By contrast, an uncontested settlement may be approved merely "upon a finding that the settlement appears to be fair and reasonable and in the public interest." 18 C.F.R. § 385.602(g)(3) (1998).

80. *Tejas*, 908 F.2d at 1003. The court in *Tejas* held that the Commission must, at a minimum, address the question of whether the LDCs' interests are sufficiently likely to be congruent with those of ultimate consumers that it may rely upon the LDCs' agreement as dispositive of the consumers' interests, notwithstanding the claim of some large and sophisticated consumers to the contrary.

Id. at 1004.

81. *Id.* at 1003. It is clear in *Tejas* that the court intended "the public interest" to include both direct customers as well as indirect customers.

82. *Tejas*, 908 F.2d at 1003. The *Tejas* court held further that [t]he Commission's reliance upon the LDCs' agreement is misplaced in the absence of a showing that their markets are so structured that they have adequate incentives to keep costs down.

Interpreting this precedent, the *Edison* court emphasized two obligations for the Commission that were recognized in its *Tejas* decision: (1) “to examine the potential impact of the [settlement] upon the [indirect customers’] interests” and (2) “to support its conclusion with substantial evidence.”⁸⁵ The Commission can satisfy the obligation either by “deciding on the merits any genuine issue of material fact” or “executing a severance that would fully protect the objecting party’s interests.”⁸⁶ In the alternative, *Tejas* stood for the proposition that the Commission must at least show a sufficient congruence between the interest of the direct customers and the indirect customers as to be “dispositive of the consumers’ interests.”⁸⁷

Neither of these criteria had been met. The Commission had not considered the settlement’s impact on Edison, and, according to the court, could “point to no such congruence of interests here.”⁸⁸ The FERC characterized the parties who agreed to the settlement as fitting into three categories—the state regulatory agencies,⁸⁹ the direct customers of El Paso, and SoCal.⁹⁰ The court summarily rejected the notion that any of these three groups could adequately protect the interests of Edison.

With respect to the direct customers, the court relied on *Laclede*, as well as *Tejas*, for the proposition that support for the settlement by direct customers, even if unanimous, is not decisive.⁹¹ As to the regulatory agencies, an apparent suggestion that such agencies could look out for indirect customers’ interests

Tejas, 908 F.2d at 1006 This further illustrates the court’s concern that no matter how many parties agree to the settlement, if these parties do not have interests sufficiently similar to those of the non-consenting parties, the settlement should not be approved. The *Laclede* court, reaffirming its decision in *Tejas*, rejected the Commission’s argument that since a settlement was agreed to by all of the approximately 140 customers except *Laclede*, it should be approved: “Indeed, we have squarely rejected the notion that any settlement, solely because of its status as such, is reasonable.” *Laclede*, 997 F.2d at 946.

83. *Laclede*, 997 F.2d at 945. According to the court, “[e]ven when customer support is unanimous, however, FERC retains the responsibility of making an ‘independent judgment’ as to whether the settlement amount constitutes a reasonable remedy.” *Laclede*, 997 F.2d at 946 (quoting *Mobil Oil*, 417 U.S. at 312-13, 94 S. Ct. at 2348).

84. *NorAm Gas Transmission Co. v. FERC*, 148 F.3d 1158 (D.C. Cir. 1998). In *NorAm*, a competitor challenged the rate settlement approved by the FERC for Tennessee Gas Pipeline Co. (Tennessee) because of the anti-competitive effect it would have on the gas industry. The Commission continued to give little or no weight to *NorAm*’s contentions. The court expressed serious concern with the FERC’s “notion of disregarding arguments simply because they are made by competitors.” *Id.* at 1164. Therefore, the court held that the Commission must consider the contentions of the competitor:

Given that a primary goal of Order No. 636 was to create ‘a regulatory environment in which no gas seller has a competitive advantage over another gas seller,’ it was incumbent on the Commission, when considering the settlement offer, to give serious consideration to the alleged anticompetitive effects of Tennessee’s rate system.

Id.

85. *Edison*, 162 F.2d at 119 (quoting *Tejas*, 908 F.2d at 1003). These two obligations arise from two sources: the Natural Gas Act, § 7, and the Commission rules, as codified at 18 CFR § 385.602(h)(1)(i). *Id.*

86. *Id.*

87. *Tejas*, 908 F.2d at 1004.

88. *Edison*, 162 F.3d at 119.

89. This included both the “CPUC and its Nevada regulatory counterpart.” *Id.*

90. *Edison*, 162 F.2d at 119.

91. *Laclede*, 997 F.2d at 946, and *Tejas*, 908 F.2d at 1003.

was rejected as a “misreading” of *Tejas*.⁹² The Commission’s argument that SoCal was sufficiently aligned with Edison because of the threat of future competitive effects from electric deregulation⁹³ was termed “too confused to pass muster.”⁹⁴

IV. IMPACT OF THE DECISION

The D.C. Circuit’s decision in *Southern California Edison Co. v. FERC* has clarified the relationships among pipelines and their customers before the Commission with reference to rights to object to settlements. The court certainly confirms the Commission’s analysis in *United* as well as its own approach in *Tejas* that indirect customers may assert their otherwise unrepresented issues even to the point of blocking a settlement or obtaining severance of their issues. But these decisions and orders were very directed in their scope relying upon the particular facts and circumstances of the cases.⁹⁵

In giving further guidance to the Commission, the court certainly suggests a deeper analysis of the nature of all indirect customers’ interests before their objections to a settlement may be set aside. The Commission must recognize a broad-based right on the part of indirect customers to contest the settlement. The court has stated clearly that (a) even unanimous consent of direct customers is not in itself sufficient to allow the Commission to accept a settlement and (b) indirect customers are within the meaning of “the public interest,” which the Commission must protect.⁹⁶ The decision has not, however, resolved the issue entirely as to the parties to this case.

Indeed, the controversy appears likely to continue, even with the court’s clarification. Edison has since insisted that considering the length and contentious nature of the four-year-old proceeding, the Commission should reject El Paso’s offer outright.⁹⁷ Edison interprets the decision as giving the FERC one of three options in approving the contested settlement: (1) decide the contested issues on the merits, (2) execute a severance that will protect Edison’s interests completely, or (3) address the question of whether Edison’s interests are sufficiently congruent with those of the direct customers so that those interests

92. *Edison*, 162 F.3d at 119.

93. The Commission had accepted El Paso’s congruency argument based on a common interest among California’s LDCs and their customers:

We believe there is merit in El Paso’s contention that as a result of recent decisions by the CPUC and the California legislature, electric energy sold in the future in California is likely to be subject to market competition. LDCs in California may no longer be able to assume that they will be able to automatically pass through generation costs, including gas costs, that they have incurred, and any regulatory shield that those LDCs might have enjoyed in the past may be diminished. Thus, LDCs, at least in California, have an incentive, as do end-users, to negotiate the most favorable interstate rate.

79 F.E.R.C. ¶ 61,028, at 61,130. The court flatly rejects this “confusing” argument.

94. *Edison*, 162 F.3d at 119.

95. See, e.g., 55 F.E.R.C. ¶ 61,070, and 64 F.E.R.C. ¶ 61,014, and *Tejas*, 908 F.2d 998.

96. *Edison*, 162 F.3d at 119, and *Tejas*, 908 F.2d at 1003.

97. *FERC Has No Choice But to Reject the El Paso Turnback Settlement*, INSIDE F.E.R.C., Jan. 25, 1999, at 16.

would be protected.⁹⁸ In this case, the FERC can not satisfy any of the obligations according to Edison, so it must reject the settlement.⁹⁹ On the other hand, the settlement, according to El Paso, has not been affected because the court did not address the merits of the settlement, and it is, therefore, "still a proposal to be acted on in accordance with proper procedures."¹⁰⁰

The main parties to the El Paso settlement still have a long haul in reaching a rate settlement. Although Edison and El Paso vehemently disagree over the impact of the Circuit Court's decision, the court certainly has expanded on the rights of Edison as an indirect customer. When the Commission ultimately rules on these post-reversal motions, it will have to address these expanded rights.

A. *The Scope of the Decision in General*

As evidenced by the previous discussion, the decision has not resolved the El Paso rate proceeding. It may still be too early to predict exactly what impact, if any, this decision will have on other proceedings, but there are some implications that may be addressed at the present. The first, and most important, of these is the scope of the decision. The 1990s have been a hectic and confusing time for the natural gas industry in general, and LDCs specifically.¹⁰¹ With Order 636's¹⁰² sweeping attempt to level the playing field in the gas industry,¹⁰³ LDCs have faced all new challenges, including gas procurement and management, end-user transportation, curtailment procedures, and cost recovery.¹⁰⁴ This decision could add another headache for the gas industry—now

98. Motion of Southern California Edison Company Pursuant to Court Reversal and Remand for Rejection of the Settlement and Immediate Establishment of Procedural Schedule at 5-6, El Paso Natural Gas Co., Docket No. RP95-363-000 (Jan. 21, 1999) [hereinafter *Edison's Motion*].

99. *Edison's Motion*, *supra* note 98, at 6. Edison's argument that the Commission will be unable to meet any of the three obligations with respect to the El Paso Settlement is as follows:

But in this case: (1) the Commission has already determined that the record lacks sufficient evidence to permit the Commission to decide the contested issues on the merits; (2) it is impossible for the Commission to craft a severance that vindicates Edison's interests as an indirect customer consistent with the Court's opinion; and (3) there is no evidence in the record that would permit the Commission to conclude that the interests of El Paso's other customers are congruent with Edison's interests. Accordingly, the Commission cannot approve the settlement and therefore must reject it and set the case for hearing before a Presiding Administrative Law Judge. *Id.*

100. *El Paso's Answer*, *supra* note 6, at 5.

101. One writer put it this way:

Surely 1993 has no peer in the annals of the natural gas industry. A scramble driven by edict of the [FERC] resulted in the complete restructuring of the interstate pipeline industry. Entirely new pipeline tariffs emerged with completely new services, new rate designs, new terms and conditions of service, and new contracts. Most important, the pipelines were relieved of their historic merchant function. The pipelines now provide firm transportation and storage services for gas purchased and sold by others. Stephen L. Huntoon, *To the Bunkertip?*, 132 No. 13 FORT., July 1, 1994, at 22, 22.

102. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of The Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. STAT. & REGS. ¶ 30,939, 57 Fed. Reg. 13,267 (1992) (codified at 18 C.F.R. Part 284).

103. Harold Glenn Drain, Note, *Union Pacific Fuels, Inc. v. FERC: The FERC's Ability To Abrogate Natural Gas Transportation Contracts*, 33 TULSA L.J. 931, 935 (1998).

104. Huntoon, *supra* note 101, at 22.

a pipeline's rate settlement can be blocked not only by its customers, but also by its customers' customers.

The significance of the decision can be viewed in either of two ways. This case could be read narrowly to require that when an indirect customer who is also a direct customer contests a rate paid by its LDC to the pipeline, the FERC must give the customer an opportunity to be heard within the rate-setting process.¹⁰⁵ Also limiting the scope of the decision could be the specific circumstances in the case. Both the court and the Commission seem willing to presume that Edison would not be entitled to contest the El Paso rate to SoCal at all if not for the ITCS that is passed directly to Edison. Additionally, and as may be suggested by the court's *sua sponte* point, if the purchase from the LDC does not occur within interstate commerce, the decision would be left to the public utility commission of the state in which the transaction occurred, and the FERC would have no jurisdiction.

Alternatively, if read broadly that all indirect customers are entitled to contest a settlement—and the support of direct customers is irrelevant—the Commission could now be required to either hold up the entire proceeding or grant the indirect customer a severance. Although such a broad reading may be unwarranted, *Edison* definitely stands for the proposition that agreement of the direct customers alone is not a sufficient basis for settlement.

The Commission had an opportunity to react only five days after *Edison* was handed down. Trailblazer Pipeline Company (Trailblazer) had submitted an offer of settlement stated to resolve issues concerning a proposed \$3.3 million increase in jurisdictional transportation revenues. Only one party to the proceeding, Amoco Energy Trading Co. (Amoco), objected.¹⁰⁶ The FERC considered *Edison* in its order and stated that *Edison* required the Commission to consider a settlement as contested if an indirect customer challenges “settlements agreed to by the pipeline's direct customers.”¹⁰⁷

Further, the Commission in *Trailblazer* analyzed the court's decision with respect to the requirements of approving a settlement once classified as contested under Commission Rule 602. The Commission can satisfy the requirements of Rule 602 with respect to an indirect party in one of three ways:

- (1) deciding on the merits the issues raised by the indirect customer; (2) “if it were possible, executing a severance that fully protects” the indirect customers' interests, or (3) “at a minimum, address[ing] the question of whether the [direct customer's] interests are sufficiently likely to be congruent with those of ultimate customers that it may rely upon the [direct customers'] agreement as dispositive of the consumer's interests.”¹⁰⁸

These standards were set out in the *Edison* decision and appear on their way to becoming Commission policy.

105. The Court here actually only decided that before the FERC could approve the settlement with respect to El Paso, it had to first hear the arguments of Edison as an indirect customer. The Court remanded the case to the Commission for further review. *Edison*, 162 F.3d at 120.

106. 85 F.E.R.C. ¶ 61,345, at 62,377.

107. *Id.* at 62,341.

108. *Id.* (citing *Edison*, 162 F.3d at 118). Edison's argument in its post-reversal motion submitted to the Commission appears to be closely patterned after these requirements set forth in *Trailblazer*.

In *Trailblazer*, the Commission established a new set of procedures for setting forth the “rationale [which] is available for approving the settlement despite the objections of a consenting party” when it has already determined that a settlement is appropriate.¹⁰⁹ First, the Commission can, if the record is adequate, address each of the contentions of the contesting parties on the merits, and can, if the contentions lack merit, approve the settlement on that ground. Second, the Commission can approve a settlement despite the valid objections of contesting parties if “the overall result of the settlement is just and reasonable.”¹¹⁰ Third, the Commission can approve a settlement even though the just and reasonable standard has not been satisfied if “it determines that the contesting party’s interest is sufficiently *attenuated* that the settlement can be analyzed under the fair and reasonable standard applicable to uncontested settlements.”¹¹¹ Fourth, the Commission can consider severance of contesting parties.¹¹²

Although this four-step approach has been suggested by the Commission rules, and the specific approaches have been used in various decisions, the *Trailblazer* order is important as a statement of FERC policy for contested settlements, including objections by indirect customers. This order also seems to propose a current answer to the question of the scope of *Edison*—the Commission must consider a settlement as contested if an indirect customer objects. It does still leave unanswered questions with respect to the third approach, however, because the term “attenuated” does not appear in the *Tejas* or *United* precedents. It is unclear whether this approach sufficiently addresses the *Tejas* congruence requirement.

B. Severance

Another problem that *Edison* left unresolved to some degree is the role of severance in the Commission’s process. Both the administrative law judge and the Commission agreed that Edison and the other objectors be severed as direct customers, with El Paso’s settlement being approved only with respect to the consenting parties.¹¹³ However, no severance was granted as to Edison’s role as an indirect customer.¹¹⁴ In the case before the D.C. Circuit, the court framed the issue as whether the Commission erred in failing to hold up the settlement pending resolution of the objections raised by the indirect customers *or by failing to sever the parties*. In its decision, however, the court never fully addressed that part of the issue.

The relative lack of attention given by the court to the issue of severance might be interpreted in different ways. The court briefly mentions severance as an alternative to a decision on the merits.¹¹⁵ The holding of the case must be

109. 85 F.E.R.C. ¶ 61,345, at 62,342.

110. *Id.* at 62,342.

111. 85 F.E.R.C. ¶ 61,345, at 62,343 (emphasis added).

112. *Id.* at 62,344.

113. 78 F.E.R.C. ¶ 63,006 and 79 F.E.R.C. ¶ 61,028.

114. 79 F.E.R.C. ¶ 61,028, at 61,127-30.

115. *Edison*, 162 F.3d at 119. The Commission can fulfill its obligation to the indirect customer by

interpreted as finding that the Commission erred in failing to satisfy *either* of the requirements—hearing the objections of Edison *or* severing Edison as an indirect customer. Certainly, this holding can be found within the court’s reasoning, although severance is only mentioned once after being framed as one-half of the issue presented by the court in the case.¹¹⁶ Based on this likely reading of the decision, the Commission is obligated to consider the interests of an indirect customer either within the contested proceeding at hand or in a separate proceeding on the merits. What remains unclear is the specific circumstances that would give rise to a severance. The Circuit Court has provided no guidelines to instruct the FERC as to when a severance would be an appropriate remedy.

The *Trailblazer* order has somewhat clarified the role of severance, filling in some of the gaps left by the court. This order confirms that severance still is a viable option for the Commission to consider. However, the FERC itself still considers severance to be the “option of last resort.”¹¹⁷ In order for the FERC to sever a party, it must first thoroughly review any settlement. If either the settlement can be approved on the merits as to both consenting and contesting parties, or the contesting parties have raised valid concerns that would modify the decision as to all parties, then severance is not an available alternative.¹¹⁸

C. *The Future of this Issue for the FERC*

A final concern is the fact that the court may have further muddied the waters regarding the rights of indirect customers by selectively stating the Commission’s arguments. In all fairness, the Commission’s arguments for distinction are somewhat more persuasive than the court would admit. The first argument, that SoCal’s rate to Edison is under state jurisdiction because it is intrastate in nature, does appear to make an odd distinction in the way the court framed it. The Commission’s actual decision stated that it had already determined that the settlement was just and reasonable, and the only impact Edison could have on that decision was to provide input for the Commission to consider.¹¹⁹ The Commission did not find this additional input persuasive. The court seems to ignore that portion of the Commission’s decision entirely. Had the court responded, it could have ruled that since the settlement should be contested due to the comments of the indirect party, the standard for the Commission is to consider is no longer “just and reasonable,” but instead the more formal requirements of a decision on the merits.¹²⁰

This again raises the issue of scope. If it is not enough that the FERC finds the settlement just and reasonable as to all parties, and must hear the factual disputes of each indirect customer who objects to the settlement, where does the

deciding its contentions on the merits, presumably while holding the settlement as to all other parties, or by executing a severance.

116. *Id.* at 119.

117. 85 F.E.R.C. ¶ 61,345, at 62,344.

118. *Id.*

119. 80 F.E.R.C. ¶ 61,084, at 61,294.

120. 18 C.F.R. § 385.602(g) and (h) (1998).

court draw the line? The FERC appeared to be working within an imperfect system as best it could. The court, perhaps asserting a role of championing the rights of the "underdog" customer, has really just muddied the waters further. In theory, it is quite true that even the indirect customer is affected by the rate process and should be given an opportunity to be heard. But the court seems to expand these expectations. A single dissenter, even indirectly affected by the settlement, can now hold up the entire process. If the court were to look at the situation more practically, it would seem that if all the direct customers agreed to the rate settlement, and the Commission found it just and reasonable, nothing more should be required.

The Commission's second argument was also misstated to some extent by the court. The court concentrates only on the point that the objections do not go to "the very basis of the settlement."¹²¹ The Commission also argued that the challenge in *United* was based on objections from both direct and indirect customers.¹²² Although Edison was both a direct and an indirect customer of El Paso in this case, Edison petitioned the court for review of the Commission's decision only in its capacity as an indirect customer. This distinction was more striking than the court acknowledged.

The bottom line in this decision is that it raises as many questions as it answers. The court has adopted a rule that the FERC must find a settlement to be contested based upon the objections of an indirect customer and either decide the customer's interests on the merits or grant a severance (unless it can find a sufficient congruence of interests). In doing so, the court offers no clear guidance for the FERC to consider in determining whether severance might be the appropriate choice. Here, it was not enough that the Commission found the settlement to be just and reasonable based on the agreement of nearly all the direct customers because Edison, also an indirect customer, felt that its transportation supplier, SoCal, was being allocated too much by the proposed settlement. From this perspective, the decision may appear as too broad. The Commission has already taken into account the position of Edison and "the public interest" in determining that the rate was just and reasonable. For the court to interject the more stringent requirements for a contested settlement based solely on indirect customers' objections seems to make an already complicated and time-consuming process that much more difficult.

VI. CONCLUSION

The Federal Energy Regulatory Commission has a great task before it when it attempts to determine whether a natural gas settlement is just and reasonable. The Commission is loaded down with briefs and potentially evidence presented by a host of state agencies, pipelines, LDCs, utilities, and perhaps even end-users. This complicated process has become a little more difficult with the D.C. Circuit's decision in *Southern California Edison Co. v. FERC*. In this case, the court clarified that the FERC must either determine the factual contentions made by an indirect customer on the merits or grant a severance to protect its interests.

121. *Edison*, 162 F.3d at 118.

122. 80 F.E.R.C. ¶ 61,084, at 61,294.

Both the Commission and the courts had recognized the right of an indirect customer to challenge rates to its provider under certain (somewhat well-defined) circumstances, but this case imposes the requirement of a more rigorous analysis of the indirect interest before denying certification or severance.

It will be interesting to see how this decision plays out in the coming years. The Commission must still rule on the El Paso settlement, and the aftermath of the case has shown that the issues and parties remain contentious. In addition, the future of rate settlements may be substantially altered. It is likely that most indirect customers (particularly end-users) may have interests sufficiently congruent with those of the direct customers that the FERC can approve a settlement over their objections. But as the *Trailblazer* and *Northwest* settlement proceedings of 1998 illustrate, there will be at least a few instances where the indirect customers have interests wholly independent of the intermediate direct customers. *Edison* appears to crack the door for these customers to block rate settlements.

In following *Edison*, the FERC could also have interpreted the court's guidance very narrowly based on the fact that Edison was both a direct and an indirect customer. Perhaps this dual role would have provided the Commission some room to limit the decision in future proceedings. Instead, the approach presented in *Trailblazer* demonstrates that the Commission feels constrained by the *Edison* decision to always recognize an indirect customer's right to block a settlement. Thus, there is a definite threat that this case has increased the likelihood for litigation by a wider range of natural gas consumers. If the Commission's greatest fears are realized, then it may be true that "every gas ratepayer" in every state will "be able to block a settlement and send a case to hearing by raising factual issues."¹²³ More likely, the FERC in the future will simply have to take a much closer look at the interests of both direct and indirect customers in considering rate settlements.

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123. 78 F.E.R.C. ¶ 63,006, at 65,131.

