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TRANSFORMING AN INDUSTRY BY AGENCY RULEMAKING: REGULATION OF NATURAL GAS BY THE FEDERAL ENERGY REGULATORY COMMISSION

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Few periods in the history of natural gas regulation have been as fraught with problems and controversy as the past few years. Market pressures, the phasing out of producer price controls under the Natural Gas Policy Act of 1978[1] and an inclination toward experimentation on the part of the Federal Energy Regulatory Commission (FERC) have led to a great deal of ferment in the industry. Congress has yet to act on any major new legislation in the field.[2] Most of the turmoil has been engendered by FERC, a traditionally quiescent agency which has recently become as aggressively innovative as any independent regulatory commission in the government.

A great deal of FERC's innovation has been directed toward the natural gas industry, one of the primary industries under the regulatory power of FERC; and most of the innovations have taken place in the absence of any changes in the agency's underlying enabling acts. A small portion of these innovative measures have been overturned by the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit), but all in all the circuit seems to give FERC high marks for producing thoughtful, reasonable, properly-analyzed rules. Nonetheless, it remains to be seen whether FERC can get away with almost completely

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1. 15 U.S.C. §§ 3301-3432 (1982 & Supp. III 1985).

2. There is one exception; the repeal of the now-obsolescent Powerplant and Industrial Fuel Use Act of 1978, 15 U.S.C. § 796 (1978), 19 U.S.C. § 1202 (1978), 42 U.S.C. §§ 6211, 7193, 8301-8484 (1978), 45 U.S.C. §§ 821, 822, 825 (1978), 49 U.S.C. app. § 26(b) (1982) (repealed, Pub. L. 96-258, June 3, 1980).

restructuring the natural gas industry simply by writing new regulations. If FERC succeeds without an accompanying command to innovate from Congress, it will be a milestone in federal regulation. In virtually all other modern instances in which federal regulation has been transformed over a relatively short period of time (such as cable television,[3] railroads,[4] airlines,[5] and trucking[6]) Congress has first amended the agency's enabling act and then the agency has proceeded to write innovative rules.

A BRIEF HISTORY OF NATURAL GAS REGULATION

The natural gas industry is divided into three components: First, natural gas well owners or operators, who are normally referred to as *producers*; second, the transportation segment of the industry, the natural gas *pipelines;* third, the entities which receive the natural gas from the pipelines and deliver it to the ultimate consumers—the *local distribution companies* (LDC's).[7] Until 1938, the only segment subject to specific economic regulation was the local distribution companies, which were regulated as public utilities by state utility commissions. Because pipelines cross state lines, the interstate commerce clause in the United States Constitution forbade state regulation,[8] and the federal government took little interest in regulating natural gas transportation.[9]

It was not until Franklin D. Roosevelt's so-called Second New Deal that Congress decided to regulate the natural gas industry by enacting the Natural Gas Act of 1938 (NGA).[10] This legislation came three years after Congress regulated wholesale electricity rates by adding a second part to the Federal Power Act.[11] It also came three years after Congress determined that the huge utility holding companies which were then threatening to swallow up both the natural gas and electricity utility industries needed substantial regulation.[12] Under the NGA, jurisdiction to regulate natural gas pipelines was given to the Federal Power Commission (FPC or Commission).

3. Cable Communications Policy Act of 1984, 47 U.S.C. §§ 521-533 (1982 & Supp. 1985).
4. Staggers Rail Act of 1980, Pub. L. No. 98-216, § 6(b), 11 U.S.C. §§ 1170, 1172 (1982), 45 U.S.C. §§ 702-1008 (1982), 49 U.S.C. §§ 10101-10906 (1982), 49 U.S.C. app. § 1654a (1982).
5. 49 U.S.C. app. §§ 1301-1552 (1982) (repealed by the Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 98-443, 98 Stat. 1703, Oct. 4, 1984).
6. Motor Carrier Act of 1980, 28 U.S.C. §§ 2342 (1982), 49 U.S.C. §§ 507, 521, 526, 2301, 2313, 2314, 2501-2520, 3102, 10322, 10526, 10530, 10735, 10922, 10927, 10934, 11348, 11701, 11702, 11901, 11914 (1982).
7. W. FOX, FEDERAL REGULATION OF ENERGY § 15.02, at 424 (1983).
8. The Supreme Court created what became known as the "regulatory gap" in a series of three decisions written between 1911 and 1927. The Court held squarely that a state regulatory commission may not regulate either natural gas or electricity that crosses state lines. Since the federal government was not then regulating these industries, there were virtually no direct economic controls imposed upon them. *See* Rhode Island Public Util. Comm'n v. Attleboro Steam & Elec. Co., 273 U.S. 83, 89-90 (1927); Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924); West v. Kansas Natural Gas Co., 221 U.S. 229 (1911).
9. The Federal Trade Commission in 1928 submitted a report to Congress suggesting regulation of both producers and pipelines, but Congress failed to act on the suggestion. FEDERAL TRADE COMMISSION, REPORT ON THE INTERSTATE TRANSPORTATION OF NATURAL GAS (1935).
10. 15 U.S.C. § 717 (1982).
11. 16 U.S.C. §§ 791-823 (1982).
12. 15 U.S.C. § 79 (1982).

The terms of the NGA were relatively simply. Under section 7 of the Act, each natural gas pipeline operating in interstate commerce was required to obtain from the Commission a certificate of public convenience and necessity prior to commencing operations.[13] Under NGA section 4, those pipelines' rates were required to be just and reasonable.[14] The Supreme Court confirmed the NGA's constitutionality in 1942,[15] and in a number of subsequent decisions, such as *FPC v East Ohio Gas Co.*,[16] held that the Commission's jurisdiction under the NGA was as broad as the commerce clause itself. Accordingly, the Commission could regulate the transportation of natural gas even within a state so long as the gas came from another state.[17] On this particular point, Congress disagreed with the Court. Four years after *East Ohio*, Congress created a class of pipelines known as "Hinshaw pipelines." These pipelines purchased gas within a state solely for sale in that same state, and the Commission had no control over them.

Interestingly enough, the *East Ohio*/Hinshaw controversy was practically the last time for the next thirty years that the Commission acted aggressively in determining the scope of its jurisdiction. It took a watershed decision in 1954 by the Supreme Court, *Phillips Petroleum Co. v. Wisconsin*,[18] to persuade the Commission that it had jurisdiction over the wellhead prices of natural gas and could thus regulate producers. There were additional controversies over producer prices extending from 1954 until 1978. These included, among other things, whether the Commission could regulate producer prices on a regional or national, rather than well-by-well basis.[19] Nevertheless, for nearly forty years the Commission simply preserved a stolid, almost perfunctory system of public utility-style regulation of natural gas pipelines.

This by-rote form of regulation was understandable. The public utility model of regulation had long since been confirmed by the Supreme Court. In *FPC v. Hope Natural Gas Co.*,[20] the Court gave the Commission much leeway in establishing pipeline rates by developing what is now called the "end result doctrine." Under this doctrine, judicial review of Commission rate actions would concentrate on "the result reached, not the method employed."[21] Put slightly differently, there is a fairly substan-

13. 15 U.S.C. § 717f(c)(1)(A) (1982).
14. 15 U.S.C. § 717c(a) (1982).
15. FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 582-83 (1942).
16. 338 U.S. 464 (1950).
17. *Id.* In *East Ohio*, the company transacted business solely within the state of Ohio and argued, for that reason, that the FPC could not regulate its tariffs. However, the Court held squarely for the Commission by pointing out that the gas purchased by East Ohio and subsequently sold within Ohio nonetheless was originally produced outside that state. *Id.*
18. 347 U.S. 672 (1954).
19. *See, e.g.*, Permian Basin Area Rate Cases, 390 U.S. 747 (1968); Shell Oil Co. v. FPC, 530 F.2d 1060 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976) (discussing the national rate cases).
20. 320 U.S. 591 (1944).
21. *Id.* at 602.

tial zone of reasonableness in regulating pipeline tariffs.[22] Absolute accuracy is not required. Nonetheless, new pipeline tariffs were always controversial and gave rise to massive fights among producers, pipelines and local distribution companies. These fights reflected the subtlety that the tiniest differences in rates meant millions and sometimes billions of dollars.

The other component of the Commission's regulation of natural gas pipelines—the NGA's section 7 requirement that pipelines obtain certificates of public convenience and necessity—was also dealt with in very traditional fashion. The only controversies were generated by the environmental movement in the late 1960s and early 1970's. Environmentalists forced the Commission to look much more closely at the environmental consequences of its authority to grant certificates for new facilities. Few petitions to abandon natural gas operations were applied for in the energy crises of the 1970's.

Thus, not until the late 1970's did Congress begin to take a fresh look at energy in general and natural gas in particular. In 1977 Congress abolished the Federal Power Commission and gave virtually all of its existing natural gas regulatory authority to a new creation, the Federal Energy Regulation Commission (FERC), set up as a component (albeit expressly an independent regulatory agency) within the Department of Energy.[23] This change was significant in that it attempted to unify federal energy policy and make federal regulation of energy more coherent. Merely replacing the FPC with FERC had no perceptible effect on traditional NGA regulation of natural gas. The first significant substantive change in the regulation of natural gas came in 1978 with the enactment of the Natural Gas Policy Act (NGPA).[24]

The NGPA was a true watershed. Its fundamental purpose was to get rid of the stultifying distinctions between the price of natural gas shipped in interstate commerce and intra state natural gas. Congress recognized—under the pressure of two energy crises—that price-controlled interstate natural gas was causing national shortages because producers were reluctant to sell at prices which were then moving below the costs of production. As a consequence, the NGPA invoked the United States Constitution's supremacy clause to merge regulation of inter- and intrastate natural gas and to give that regulatory authority to FERC.[25] The second goal of the NGPA, however, has proved to be just as significant in the long run. Congress ordered the phased decontrol of natural gas price controls at the wellhead, although in an aberration still not resolved, Congress left in place the price controls on natural gas which was flowing

22. *See, e.g.*, FPC v. Natural Gas Pipe Line Co., 315 U.S. 575, 585-6 (1942) (Public utility ratemaking is not sufficiently accurate to permit a court to insist on absolute precision. A ratemaking body's fixing of "reasonable" rates will be sustained so long as the action comes within a zone of reasonableness.).

23. The Department of Energy Organization Act, 42 U.S.C. §§ 7134, 7151, 7171, 7172 (1982).

24. 15 U.S.C. §§ 3301-3432 (1982).

25. W. Fox, *supra* note 7, § 15.07, at 437-38.

before the enactment of the NGPA.[26] This aberration continues to create problems. Nor did the NGPA directly address FERC's traditional regulation of interstate natural gas pipelines. That regulation remains largely tied to the traditional structures of the NGA.

Consequently, the picture in 1987 is somewhat incongruous. Except for NGA gas, wellhead price controls are almost completely gone. Producers are therefore, at least in theory, permitted to charge whatever the market will bear for natural gas. Most consumers of natural gas take their natural gas from local distribution companies. They are—again at least in theory—protected by the regulation of LDC's by state public utility commissions, who normally abide by traditional public utility models of regulation. Natural gas pipelines, the industry's person in the middle, are regulated as public utilities by FERC under the constraints of the NGA, now a nearly fifty year old statute.

INDUSTRY CHANGES SINCE 1938

Since the enactment of the NGA, the natural gas industry has undergone considerable structural change, caused mainly by decontrol of wellhead prices and the end of the energy crisis. There is now a surplus of natural gas in the United States. Statutes which were created either during a national depression or during an energy emergency are proving somewhat ill-suited to deal with current problems. In the past natural gas pipelines have usually owned the natural gas they transport, having purchased the gas from independent producers or having produced the gas from wells owned by the pipelines themselves. The gas is then sold either to large end users or LDC's. Thus, the industry functions nominally on the basis of contractual relationships, but those contracts are rigidly confined by the imposition of terms and conditions which are dictated by FERC. In other words, a producer-pipeline contract or a pipeline-LDC contract is valid only insofar as it is consistent with FERC's rules. FERC (more accurately, FERC's predecessor, the FPC) tended to treat pipelines gently. While it was clear that they dominated the natural gas market, the underlying assumption was that only public-utility style regulation was necessary to protect the consumer.

As a result, pipelines have come to regard themselves as private carriers. They own the product shipped and, until just recently, they could refuse access to all others. Further, because of the relatively gentle treatment that FERC accorded pipeline tariffs—and because of the energy emergencies in the 1970's—there were very few incentives for pipelines to hold down their costs or to seek out low-cost gas to buy and ship. These costs were invariably passed through to the consumers. In the shortage periods of the 1970's, pipelines scrambled to buy natural gas from any source at any price. Pipelines signed many long-term contracts in which they agreed to purchase specific volumes of natural gas at exceptionally high fixed prices. Large numbers of these long-term contracts contained

26. This problem is discussed in the context of FERC Order 451, text accompanying notes 84-92, *infra.*

provisions which obligated the pipelines to pay for natural gas proffered by the producer even if the pipeline did not actually accept the gas for shipment. These "take-or-pay" provisions have contributed to abnormally high natural gas prices paid by the ultimate consumers.

Accordingly, as FERC went about regulating the industry it found itself without wellhead price control authority and only outmoded tools with which to control the industry as it existed in the mid-1980's. Congress, for any number of reasons, has failed to act, forcing FERC to try to innovate without any significant change in this obsolescent statutory structure.

FERC INNOVATION PRIOR TO ORDER 436

By the mid-1980's, President Reagan had replaced every commissioner on FERC who had been appointed by President Carter. Most of these new commissioners came into the agency predisposed against traditional methods of federal regulation of business. They had in common a strong bent toward increasing competition, even within regulated industries. Moreover, even the most die-hard regulator could not look at the natural gas industry even superficially without concluding that it was in bad shape. Some of its problems were its own doing. For example, the pipelines' untoward signing of large numbers of take-or-pay contracts suggests a lack of good business judgment. Many of the industry's problems, however, could be directly traced to inept and outmoded regulation. So even before launching the radical changes which are the main subject of this article, FERC began some mild experiments in natural gas pipeline regulation.

For example, in 1983 FERC established a special marketing program (SMP). The program was designed in response to an application from a pipeline to be permitted to escape mounting take-or-pay liability. The pipeline proposed exercising a force majeure clause in its contract with a large producer in order to renegotiate the terms of that agreement. The effect of the renegotiation would be to permit the pipeline to escape the consequences of the take-or-pay provision while transporting quantities of the producer's gas directly to end-users. In other words, rather than buying the gas and then shipping it, the pipeline wanted to function merely as a carrier for gas sold by the producer directly to the end user.[27] FERC approved this application and announced that other pipelines would be treated similarly if they sought to escape the worst consequences of their take-or-pay contracts.

Unfortunately, this innovation arguably shifts a greater burden for paying for pipeline operations to those customers of the pipeline who cannot find other sources of transportation—typically small businesses and residential consumers. As a result, the special marketing program was challenged by, among others, a group of Maryland natural gas consumers who were represented by a state agency called the Maryland People's Counsel (MPC). MPC's technical objection was that the creation of the

27. Columbia Gulf Transmission Co., 25 F.E.R.C. (CCH) ¶ 61,220 (1983).

special marketing program would benefit only a few entities, including the largest end-users, and would thereby increase the costs of natural gas borne by residential consumers. This disparity, MPC argued, constituted undue discrimination in violation of sections 4 and 7 of the NGA.[28]

The dispute was taken to the United States Court of Appeals for the D.C. Circuit where, in an opinion written by now-Justice Antonin Scalia, the court applied the conventional test for judicial review of agency action to find that FERC's action was arbitrary and capricious. After taking a hard look at the entirety of FERC's justification for its actions, the court simply could not accept most of the arguments advanced as a reasoned basis for the SMP. As the court stated in overturning the program: "The law governing our review does not demand an impossible predictability, but it does demand an articulation, in response to serious objections, of the Commission's reasons for believing that more good than harm will come of its action—even experimental action. . . . That [justification] has not been provided."[29]

But as damning as this language appears to be, there were some hopeful signs in the opinion. First, the court did not forbid experimentation per se, but merely asked FERC to provide a reasoned basis for its experiments and to address the concerns of objecting parties before putting the experiment into effect. Second, the court seemed to accept the proposition that competition in the industry was healthy, would benefit consumers, and was within FERC's regulatory jurisdiction. Thus, the seeds of approval were sown for even more comprehensive FERC action.

Some of these same helpful hints were contained in the companion case, *Maryland People's Counsel v. FERC*,[30] (generally referred to as "MPC II"). In that case, the D.C. Circuit reviewed a series of individualized FERC orders which authorized a number of pipelines to transport direct sale natural gas (i.e., gas already sold directly by the producer to the consumer buyer) to the end users, bypassing the local distribution companies and, by definition, not buying the gas themselves. As the court characterized this action, "the orders permit pipelines to transport gas at lowered prices to 'non-captive consumers' — large industrial end users capable of switching to alternative fuels—without any obligation to provide that same service to 'captive consumers,' a group that includes local distribution companies . . . and their residential customers."[31]

In almost cryptic fashion, the court held that permitting this type of blanket certificate authority[32] was improper. The court reasoned that

28. Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985). For additional discussion of this case and the special marketing program, see Tiano & Bonnifield, *The Impact on Gas Distribution Companies of Federally Approved Special Marketing Programs*, 5 ENERGY L.J. 287 (1985) and Nowak & Leitch, *Maryland People's Counsel: Will It Spur Changes in FERC's Regulation of the Natural Gas Industry?*, 6 ENERGY L.J. 265 (1986).

29. *Maryland People's Counsel*, 761 F.2d at 779.

30. *Id.* at 780.

31. *Id.* at 781.

32. This rudimentary program should not be confused with the blanket transportation certificates set out in Order 436. *See infra*, text accompanying notes 65-70.

FERC failed to keep uppermost in its mind the interests of its "prime constituency—the consumers whom the [NGA] was designed to protect."[33] The court also said FERC had not fully explored the possible anti-competitive effects of the action.[34] But the later language in the opinion was much more gentle. For example, the court went out of its way to suggest that some kind of blanket authority may be a proper action so long as the competitive effects are thought through and addressed in the agency's justification for its action. In addition, the court noted that the natural gas market poses "baffling problems" for the agency. The court stated that FERC is charged with regulating under two statutes "that sometimes seem at cross-purposes" and that "whatever it does, it subjects itself to the slings and arrows of outraged producers or pipelines or LDC's or consumers . . . an arduous task."[35]

Even though statements such as these are dicta, since they do not constitute language necessary to the opinion, they are nonetheless compelling. Judge Williams and the writer of the MPC II opinion, Judge Ginsberg, were both on the record in statements and activities before they went onto the D.C. Circuit as heavily favoring streamlined government regulation and greater competition even in regulated industries. It is clear that what the D.C. Circuit was really saying to FERC was: "Go back and try again. Your instincts are correct and you probably have the power to do what you're trying to do. Just make your policy in a more workmanlike fashion and we'll in all likelihood approve it." To a very great extent, FERC seems to have accepted and mastered the lessons of MPC I and II. When the far more radical Order 436 was appealed, the court treated the agency with a great deal of respect.

THE EVOLUTION OF ORDER 436

On Christmas Eve, 1984, FERC launched one of the largest rulemakings in its history. It announced, in the context of a Notice of Inquiry, an investigation of "the effects on the natural gas industries of the congressionally-mandated transition to competitive pricing of natural gas at the wellhead."[36] The inquiry was originally docketed as RM 85-1 and initially purported to examine FERC's regulation of natural gas transportation by interstate pipelines of natural gas owned by shippers other than the pipelines themselves. Subsequent notices were scheduled to look into related issues such as pipeline rate structure, design, and business risks and rate of return for regulated pipelines as wellhead controls dropped out of the equation.

In the initial inquiry, FERC made a number of assumptions that underlie virtually everything that has happened over the past three years. First, it read the NGPA as a comprehensive natural gas regulatory

33. *Maryland People's Counsel*, 761 F.2d at 781-82.
34. *Id.*
35. *Id.* at 789.
36. Interstate Transportation of Natural Gas for Others, Notice of Inquiry, 50 Fed. Reg. 114 (1985) [hereinafter Jan. 2, 1985 NOI].

statute;[37] second, it cited as the NGPA's fundamental purpose the elimination of a dual (interstate and intrastate) market for natural gas; third, and perhaps most importantly, it viewed section 601(a)(2) of the NGPA[38] as a mandate to establish some kind of regulatory program which would insure "more efficient transportation of natural gas."[39] It is somewhat questionable that this relatively obscure section of the NGPA could really bear all the weight of FERC's subsequent complete revamping of natural gas transportation regulation. Nevertheless, invoking section 601 showed at least an *attempt* by FERC to find express legislative authority in the most recent congressional pronouncement on natural gas regulation.

It is important to recall at this juncture that FERC was not acting completely out of the blue. From 1978 through 1984, it had issued a series of orders such as the blanket certificate program,[40] transportation of natural gas by so-called Hinshaw pipelines,[41] and controls on natural gas transported from Outer Continental Shelf facilities.[42] In incremental fashion these programs wrought significant changes in the status and prerogatives of the interstate pipelines. Moreover, as a factual matter the amount of natural gas conveyed by interstate pipelines on behalf of others had escalated sharply from 74,000 million cubic feet (mcf) to an estimated 1.6 *trillion* cubic feet by 1983.[43] These "others" for whom pipelines were transporting gas almost exclusively were intrastate pipelines or local distribution companies, but included direct deliveries to end-users. Many of the seeds of what was to come had been sown long before the launching of the 1984 Christmas Eve inquiry.

FERC began the inquiry expansively by requesting comments on nothing less than "how regulation of interstate transportation of gas under the Natural Gas Act should be structured to ensure that the natural gas

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37. FERC cited for its authority on this point, the Supreme Court's decision in Public Svc. Comm'n of N.Y. v. Mid-Louisiana Gas Co., 463 U.S. 319 (1983) (a 5-4 decision in which the Court reversed FERC's determination that pipelines which were also producers may not receive first-sale treatment on natural gas which they both produce and transport). Jan 2, 1985 NOI, *supra* note 36, at 114 n.2.

38. 15 U.S.C. § 3431(a)(2) (1982). This section is entitled "Coordination with the Natural Gas Act." Subsection (a)(2) specifically addresses transportation of natural gas by providing:

> For purposes of section 1(b) of the Natural Gas Act, the provisions of such Act and the jurisdiction of the Commission under such Act shall not apply to any transportation in interstate commerce of natural gas if such transportation is—(i) pursuant to any order under section 3362(c) [emergency purchase authority] or section 3363(b), (c), (d), or (h) [allocation of general pipeline supplies of natural gas] of this Act; or (ii) authorized by the Commission under section 3371(a) [authority given to FERC to order any interstate pipeline to transport natural gas on behalf of intrastate pipelines or local distribution companies] of this Act.

Id.

39. Jan. 2, 1985 NOI, *supra* note 35, 50 Fed. Reg. at 114.

40. 18 C.F.R. §§ 284.4, 284.107, 284.221 (1980) (FERC Order No. 60, 44 Fed. Reg. 68819 (1979)).

41. 18 C.F.R. § 284.222 (1987) (FERC Order No. 63, 45 Fed. Reg. 1872 (1980)).

42. 18 C.F.R. §§ 280.101, 284.241-284.246 (1987), FERC Order No. 92, 45 Fed. Reg. 40247 (1980).

43. Dep't of Energy, Energy Infor. Admin., NATURAL GAS MONTHLY (Sept. 1984) (Table 22).

market becomes a viable and competitive market in which consumers are provided adequate supplies of gas at the lowest reasonable cost."[44] But the bulk of the first stage was limited to an examination of four basic issues: (1) a reexamination of the criteria spelling out eligibility of various entities to obtain transportation of natural gas (*eligibility criteria*), (2) comments on how rate structures might be altered, (3) an investigation of certain competition and market protection matters, and (4) an analysis of mandatory carriage of natural gas for non-owner shippers.

The first-phase inquiry concentrated exclusively on the question of whether FERC's regulation of transportation services was adequate in an increasingly competitive market. Recall that the word "competitive" in this sense means both competition between producers, pipelines, local distribution companies and end users and competition between various fuels. The price of oil was dropping significantly over this period; and the Powerplant and Industrial Fuel Use Act of 1978,[45] which was intended to prevent fuel switching to oil, was simply not enforced. Phases Two and Three of the inquiry were launched in late January, 1985 and requested comments on pipeline ratemaking, and on financial and risk concerns for the interstate pipeline companies themselves.[46]

Interstate natural gas pipeline ratemaking is an arcane topic which formerly constituted probably the bulk of FERC activity involving gas pipelines. The statutory authority for approving rates under the NGA simply requires FERC to ascertain whether the rates are *just and reasonable*.[47] The Supreme Court has merely required rates to be within a zone of reasonableness.[48] However, the actual rate approval process requires FERC to apply the cost of service ratemaking model to such factors as rate stability, allocation of revenues, and avoidance of preferential treatment or undue discrimination among classes of purchasers.

In Phase Two of RM 85-1, FERC wanted an expanded discussion to include not only these traditional cost of service factors but also three other topics as well. First, whether its ratemaking policies communicated "clear market signals" to all participants. Second, whether the system contained appropriate incentives to minimize costs, at least insofar as lower costs were consistent with reliable long term service. Finally, whether the system permitted "maximum flexibility" in making choices among services and suppliers.[49]

The third line of inquiry—risk and financial implications for the interstate pipelines—generally flows from FERC's ratemaking policies. In that rulemaking FERC seeks to ensure each pipeline a fair rate of return on its capital so that the pipeline company can continue to attract in-

44. Jan. 2, 1985 NOI, *supra* note 35, 50 Fed. Reg. at 116.
45. 42 U.S.C. §§ 8301-8484 (1982).
46. Phases Two and Three were announced in the January 28, 1985 Federal Register. Natural Gas Pipeline Ratemaking, Risk, and Financial Implications After Partial Wellhead Decontrol, Notice of Inquiry, 50 Fed. Reg. 3801 (1985) [hereinafter Jan 28, 1985 NOI].
47. Natural Gas Act § 4, 15 U.S.C. § 717c (1982).
48. *See, e.g.*, FPC v. Natural Gas Pipe Line Co., 315 U.S. 575, 585 (1942).
49. Jan. 28, 1985 NOI, *supra* note 45, 50 Fed. Reg. at 3803.

vestors and raise capital in competition with other industries competing for the same sources of capital. In addition, FERC in recent years—as it became more and more aware that its policies have a major impact on the ultimate consumers of electricity and natural gas—has become more sensitive to the allocation of risk between a pipeline's investors and its customers. Dealing as it does with a heavily regulated industry functioning essentially as a public utility, FERC recognized in Phase Three that its policies may be inappropriately allocating risk between investors and consumers. This means that consumers may bear a disproportionate amount of the risk while investors are simply guaranteed a relatively high rate of return. But public utility-style ratemaking is a delicate process at best, so a companion line of inquiry requested comments on the consequences that might follow some significant shifts in risk allocation. Those consequences could include wholesale changes in the structure of the industry, including radically different industry approaches to mergers and acquisitions, diversification and vertical integration.

There are some hidden, unaddressed questions here which were not expressed by FERC in these first stages. For example, may the mere enactment of the NGPA plausibly serve as a command to new commissioners appointed in a very different political atmosphere to push for competition and deregulation? Bear in mind that the NGPA was enacted by a Congress under emergency conditions and was then focusing on disruptive energy shortages. Second, FERC was then in something of a hurry to get things done because Congress was breathing over its shoulder. A number of bills, particularly dealing with the take-or-pay and the "contract" carriage issues had already been introduced in Congress. Should FERC simply sit still and do nothing, waiting for Congress to change its mind, or should it scamper about trying to get its own house in order by way of its rulemaking power in the hope that Congress would back off in its attempts to cope with natural gas pipelines? And what about the reaction of the courts? How would the D.C. Circuit receive whatever final rules FERC implemented? These questions continue to fester. The answers will ultimately depend on many intangibles, including the outcome of 1988's elections, the court's continuing review of the programs, and the unpredictable natural gas market.

Under the procedural terms of the Administrative Procedure Act, FERC was required to take two further steps in the promulgation of these broad new policies: first it must issue a notice of proposed rulemaking which announces a proposed rule and solicits comments on the proposals; and second it must issue a final rule after it considers the comments.[50] There are some other procedural routes, such as the announcement of a statement of policy or the promulgation of an interpretative rule, which allow an agency to provide guidance to the industries it regulates without seeming to be so compulsory as a final rule. These last two alternatives carry some risks. First, they clearly do not have the same force and effect of law as do final substantive agency rules.[51] Second, they are men-

50. *See* Administrative Procedure Act, § 4, 45 U.S.C. § 553 (1982).
51. *See* United States v. Nixon, 418 U.S. 683 (1974).

tioned in the Administrative Procedure Act but not specifically defined. Thus, regulated parties are never quite sure of the differences between each or the consequences or either. Of course, no rational lawyer or business executive these days disregards anything an agency says, irrespective of the label placed on the agency's pronouncement. Third, both statements of policy and interpretative rules are generally regarded as referring back to some pre-existing policy or substantive rule.[52] In the case of all the matters involved in the RM 85-1 inquiry, however, it might be fairly said that FERC had nothing in place previously.

Nonetheless, the first step taken by FERC in implementing the lessons learned in its RM 85-1 inquiry came on April 10, 1985 when FERC announced a statement of policy and an interpretative rule on the take-or-pay aspects of natural gas pipeline regulation. There are some justifications for this approach. Neither statements of policy nor interpretative rules need be published for comment and neither requires the 30-day advanced notice of implementation required for substantive rules. Take-or-pay was a stressful issue in the 1983-1986 period and FERC recognized that something had to be done quickly, even though it had not yet completed final action on the whole of RM 85-1. As a consequence, the statement of policy/interpretative rule merely determined that payments made by interstate pipelines to natural gas producers for the purpose of getting out of or modifying existing take-or-pay contract provisions would not be treated as "purchased gas costs" or "first sale" payments.[53] Instead, FERC was willing to treat these payments simply as expenses related to obtaining natural gas by the pipelines.

Even without plowing through the nuances of pipeline ratemaking, the benefits of such a rule are readily apparent. The pipelines would be permitted, albeit on a case-by-case, tariff-by-tariff basis to pass some if not all of these expenses through to their customers. However, "[t]he customers . . . will have the full opportunity contemplated by section 4 of the NGA to raise questions as to the prudence of such payments, the apportionment of costs among customers proposed by the filing pipeline and any other reasonably related matters."[54]

But this was an interim scotch tape and bailing wire attempt at resolving only a single issue then faced by the industry. A much more comprehensive notice of proposed rulemaking was issued on May 30, 1985,[55] and the dimensions of FERC policymaking began to be known to the industry. By the middle of 1985 it was clear that the FERC Commissioners, by now all appointed by President Reagan, were taking a single minded approach to the problem. They were concluding, "up front," as it were, that FERC's goal was:

52. *See generally* W. FOX, UNDERSTANDING ADMINISTRATIVE LAW § 44(d), at 154 (1986).
53. Regulatory Treatment of Payments Made in Lieu of Take-Or-Pay Obligations, Statement of Policy, 50 Fed. Reg. 16077 (1985) (to be codified at 18 C.F.R. pt. 2) [hereinafter April 1985 Policy Statement].
54. *Id.*
55. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Notice of Inquiry, 50 Fed. Reg. 24130 (1985) (to be codified at 18 C.F.R. pts. 2, 154, 157, 161 & 284).

> to make such adjustments in our regulation of interstate transportation of natural gas as are required to ensure that the natural gas markets are viably and sufficiently competitive so that consumers are provided natural gas at the lowest reasonable rates consistent with reliable, long-term service . . . [and to foster] a more efficient allocation of scarce resources among the energy production, transmission and consumption segments of the economy."[56]

If FERC were writing on a blank sheet of paper these sentiments would likely be admirable. But read in light of the fact that Congress had taken no legislative action in this area since 1978 when it enacted the NGPA, and that even then had refused to repeal the NGA, FERC was clearly going way out on a limb. Neither the NGA nor the NGPA emphasize the fostering of competition as their primary purposes, although they might be viewed as consumer protection measures.

Nonetheless, the notice proposed a substantial revision of FERC rules, with the emphasis on four areas of regulation. First, non-discriminatory transportation was to be implemented for all shippers, including non-owner shippers. Second, FERC proposed relaxing ratemaking treatment of pipelines' take-or-pay buyouts. Third, FERC would grant expedited and easier treatment of both new construction applications and abandonments for those pipelines who voluntarily adopted volumetric rates, allowing recovery of fixed pipeline costs from the pipeline's customers only on the basis of the proportion those costs bear to the customer's gas purchases. Fourth, the preservation of some price protection for those customers of pipelines who are currently enjoying the benefits of so-called "old" gas—gas whose price is controlled under the NGA.

Thus the truly massive issues raised by RM 85-1 were not finally and squarely addressed for another five months when, on October 9, 1985, FERC announced its now-famous Order Number 436.[57] This commenced perhaps the most radical restructuring of an American industry ever attempted by a regulatory agency in the absence of new congressional authority. Whether FERC has been fully successful in its attempts still remains to be seen over two years after the Order's promulgation.

ORDER 436 - AN EXCURSUS

Briefly stated, Order 436 covers three important facets of natural gas pipeline regulation: transportation, take-or-pay, and the FERC certificate of public convenience and necessity process. It attempts to get around

56. *Id.* at 24131.

57. 18 C.F.R. §§ 2.76, 2.77, 157.100-157.106, 157.201-157.207, 157.209, 157.211, 250.15, 284.7-284.12, 284.102-284.107, 284.122-284.127, 284.221-284.224, 284.243-284.245, 375.307, 381.404 (1987); FERC Order 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Final Rule, 50 Fed. Reg. 42408 (1985) [hereinafter Order 436]. The rulemaking process was a voluminous undertaking: FERC received over 500 individual comments and held two days of oral hearings at which over 100 persons spoke. *Id.* at 42422. It would seem that FERC truly listened to many of these people because a sizeable number of modifications of the proposed rule were made as a result of the comments, although the bulk of the rule as originally proposed was retained in final Order 436. *See, e.g., id.* at 42410, *passim.*

any argument that the rule is confiscatory or in excess of the agency's statutory authority by tying special benefits for pipelines in the certificate process to their "voluntary" compliance with the regulations on transportation and take-or-pay. It was this theme of voluntariness that persuaded a FERC attorney to predict that Order 436 would pose no problems for FERC on judicial review, because the entire process was purely voluntary. Pipelines which did not appreciate the benefits of the new system could simply opt for traditional regulation. This is a novel approach to selling a regulatory program (the carrot rather than the stick) and arguably had much to do with the D.C. Circuit's preserving much of the Order.

The final rule is further bottomed on twin assumptions by FERC. First, that the enactment of the NGPA constituted a legislative reversal of the authority to regulate wellhead prices given FERC by the *Phillips* decision[58] and suggested that FERC stay away from interference with pipeline activities at the "city gate." Second, that the industry had changed so significantly in terms of technology since the enactment of the NGA that pipelines no longer constitute the natural monopoly that the NGA was enacted to police.[59] Natural gas may be transported anywhere in the country through the pipeline network, and so is now essentially a "national" market.

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58. FERC stated:

> The NGPA expressly removed the Commission's NGA jurisdiction to establish just and reasonable rates *at the wellhead* for new gas supplies not committed or dedicated to interstate commerce prior to enactment. The NGPA also severely limited the Commission's jurisdiction to review the purchase costs of such new gas by pipelines at the city-gate. The NGPA, however, did not remove or restrict the Commission's remaining NGA jurisdiction and the responsibility to establish just and reasonable rates for the transportation of all categories of gas in interstate commerce, or for the sale of natural gas committed [or] dedicated to interstate commerce prior to enactment. (emphasis in the original; footnotes omitted).

Order 436, *supra* note 57, at 42411.

59. The primary justification for this finding was FERC's assertion that natural gas is essentially a commodity which is now (unlike electricity, for example) divorced from its transportation system or storage systems. A spot market for natural gas now exists because of wellhead decontrol and the technological innovations in the natural gas transportation system. Thus end-users or local distribution companies are no longer locked into a single source of supply which travels over a single fixed route from wellhead to burner tip. Moreover, the economic realities of the natural gas system in 1985 show enormous gains in engineering and technical sophistication. Pipelines are large enough and efficient enough that they have excess capacity and no longer need to refuse the transportation requests of non-owner shippers simply because of the size and technical limitations of their operation. *See, e.g.*, Order 436, *supra* note 57, at 42412-13.

There is also some judicial support for this conclusion which pre-dates Order 436. In Pennzoil Co. v. FERC, 645 F.2d 360 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982), the court concluded that the enactment of the NGPA constituted a clear congressional finding that:

> [g]as producers do not have "natural" monopoly power; that is, the industry does not possess the inherent technical characteristics that prevent its efficient[] and economical operation unless operated as a monopoly. Therefore, the theory that a regulatory agency is necessary to represent consumers when they bargain on rates with a natural monopolist like a utility no longer applies to gas production.

Id. at 378-79.

With regard to specific regulatory controls, FERC saw its obligation as two-fold. It would keep, but significantly modify, public utility-model regulation over the interstate transportation portion of the natural gas industry. Its countervailing obligation was to promote competition in that sector of the natural gas industry in which gas is traded essentially as a commodity.[60] Accordingly, Order 436 could permissibly be sweeping in its outlook and breadth. What follows is a short exposition of some of the specific terms of the regulation.

Transportation

As FERC recognized, the principle of non-discriminatory access to pipelines is the centerpiece of Order 436. There are two specific mechanisms adopted to ensure non-discrimination. First, FERC has modified pipeline rate structures to permit the pipelines to recover their cost of service (including a permitted rate of return) when they transport non-owner natural gas; but prohibits them from insisting on transportation fees which generate revenue out of line with the specific services provided.[61] For anyone not familiar with natural gas pipeline practices this probably sounds so simple and matter-of-fact that it is unremarkable.

Recall, however, that historically natural gas pipelines virtually never shipped gas belonging to others. A company that manufactures widgets and buys a truck to haul the widgets to the final purchaser is likely to build the entire cost of owning and maintaining that truck (however frequently or infrequently it is used) into the sales price of the widget. By contrast, when all a regulated company does is transport widgets for others, those shippers cannot be expected to pay a transportation fee which also includes a component for those times when the truck is not used. The so-called "downtime" for the truck is something that the trucking company ordinarily bears; it is rare that such costs of doing business can be passed on to the consumer. This is essentially the new principle built into Order 436. Pipelines may charge non-owner shippers for transporting their natural gas and that charge may include what non-regulated industries call a "profit." But that profit will be closely examined by FERC to insure that the pipeline is not charging substantially more than the cost of transportation plus a reasonable rate of return.

The second device for insuring non-discrimination is simply a clear statement that discrimination on virtually any basis between the pipeline's own natural gas and gas owned by others is forbidden. The basic rule is almost deceptively simple and is stated in three different portions of the Order. One example, in the context of firm service,[62] reads:

60. Order 436, *supra* note 57, at 42413. FERC believes that Congress' failure to completely repeal the NGA constitutes a finding that the pipeline sector of the industry is still not sufficiently competitive to dispense with public utility-style regulation. *Id.*

61. 18 C.F.R. §§ 284.7, 284.8 (1987).

62. Service on a firm basis is defined as "the service is not subject to a prior claim by another customer or another class of service and receives the same priority as any other class of firm service." *Id.* at § 284.8(a)(1)(3).

> An interstate pipeline or intrastate pipeline that offers [normal] transportation service on a firm basis . . . must provide such service without undue discrimination, or preference, including undue discrimination or preference in the quality of service provided, the duration of the service, the categories, prices, or volumes of natural gas to be transported, customer classification, or undue discrimination or preference of any kind.[63]

In other words, a pipeline may no longer deny access to non-owner shippers and must treat non-owner natural gas virtually the same as it treats gas that it owns. The functional effect of these provisions is to transmute natural gas pipelines from private carriers to common carriers, much like the difference between manufacturers who own their own trucks (private carriers) and interstate trucking companies who must transport on a non-discriminatory basis any freight proffered to them.

This is a profound alteration of the natural gas industry's basic regulatory structure, and one that would normally be preceded by major legislation expressly ordering the change in status. Since there was no such new legislation, these actions raised a major issue when some entities participating in the rulemaking suggested that FERC might not have the authority to impose a principle of non-discrimination. The suggestion was grounded on the lack of any parallel provision in the NGA which requires pipelines to transport natural gas belonging to others. The NGA contains a prohibition against undue discrimination in rates, charges and practices, but this language has never been extended to the question of *access* to a pipeline's transportation services.[64] When the Natural Gas Act was passed, pipelines carried only gas that they owned.

FERC was relatively sanguine about its authority in its commentary to Order 436. It cited the language of the NGA and a number of court decisions[65] which arguably permitted FERC broad discretion in imposing conditions in the operating certificates of pipelines, and the fundamental notion of voluntariness built into Order 436—i.e., no pipeline will be *compelled* to abide by these requirements.

One of the principal devices FERC chose to carry out the open access program is the blanket transportation program. This is an attractive carrot by which a pipeline is simply authorized, under FERC's authority conferred by section 7 of the NGA, to transport natural gas on a generic basis and need not return to FERC time and again when it desires to alter some of its services. However, if a pipeline chooses to avail itself of this generic, or "blanket" permission to provide transportation services, it must agree to establish itself as an open access carrier.

63. *Id.* at § 284.8(b). The one major caveat is that no pipeline is required to provide the requested transportation service if it lacks sufficient capacity or if the service would require the construction or acquisition of new transmission facilities. *Id.* at § 283.7(e).

64. 15 U.S.C. §§ 4(b), 5(a) (1982).

65. Order 436, *supra* note 56, 50 Fed. Reg. at 42427. FERC cited section 7 of the NGA and, among others, Gulf Oil Corp. v. FPC, 563 F.2d 588, 596-97 (3d Cir. 1977). *Id.* A close reading of *Gulf Oil* makes one wonder whether that case can bear all that weight on what was a tangential comment in the court's opinion. *Gulf Oil*, 563 F.2d at 596-97.

The blanket certificates are authorized after application and hearing. Once granted they permit a pipeline novel discretion. It may abandon any service without further need for authorization when the underlying contract expires (the so-called "pre-grant of abandonment" provision). It may begin or discontinue, or raise or decrease supplies of natural gas at any particular receipt point or delivery point. It may receive automatic authorization for any one period not exceeding 120 days to transport any natural gas for any shipper to any end-user without prior notice to FERC.[66]

There were a number of other issues, such as the provision of exchanges,[67] storage facilities,[68] and the applicability of the non-discrimination provisions to backhauls[69] that FERC disposed of quickly and matter-of-factly. A tougher question of priority of access was raised even though throughout the rulemaking process virtually all pipelines were functioning at something less than full-capacity. When a pipeline is operating at peak capacity, how must it treat shippers who request access? There are two possibilities: a first-come-first-served principle or a pro-rata principle. Under the latter, the pipeline parcels out access on some kind of percentage basis based on total volumes requested by the various shippers. While a "pure" principal of non-discrimination might favor the pro-rata basis, FERC instead opted for first-come, first-served.

On this point, it is clear that FERC did not want to totally disrupt existing industrial arrangements. It recognized that many pipelines contract with their customers on a *firm* basis (by which the pipeline agrees to hold a certain amount of transportation capacity available for that customer).[70] Thus, the focus of non-discrimination rests on a determina-

66. 18 C.F.R. §§ 284.221, 284.223 (1987).

67. An exchange is a very common transaction in both the natural gas and oil industries. Assume that pipeline A has agreed to deliver a quantity of natural gas to customer 1 and pipeline B has agreed to deliver a similar quantity of natural gas to customer 2. If it becomes difficult for either pipeline to make the actual delivery, the pipelines may simply "exchange" their delivery obligations—i.e., pipeline B will deliver to customer 1 and pipeline A will deliver to customer 2. In the Order 436 proceeding, the pipelines argued that exchanges were not really transporation operations but were really purchase and sale transactions which should not be subject to the non-discrimination provisions. Noting that "[t]his issue presents an excellent example of the implementation problems that would arise were the Commission to attempt to impose the non-discriminatory access condition without restructuring transportation rates," FERC determined that while exchanges are not exempt from the non-discrimination provision, a proper rate restructuring should prompt all pipelines to want to move natural gas in the least costly, most efficient manner possible. Order 436, *supra* note 56, 50 Fed. Reg. at 42431. Exchanges promote this type of cost-saving and efficiency. To the extent that special cases exist, FERC wishes to address those in the process of reviewing individual pipeline tariffs. *Id.*

68. Storing natural gas can be difficult and costly. Frequently, it is reinjected into gas-bearing rock formations nearer the end-user market. Pipelines have a substantial investment in storage facilities, but a question was raised in the rulemaking as to whether these facilities were actually transportation and thus subject to the non-discrimination principle. FERC determined that storage was integral to the overall transportation process and thus would not be exempt from the non-discriminatory access provision. *Id.* at 42431-32.

69. A natural gas backhaul occurs when a pipeline delivers gas to a customer in a direction opposite that of the pipeline's direction of flow. For purposes of its non-discrimination analysis, FERC saw no difference between conventional transportation and backhauls. *Id.* at 42432.

70. Customers who require only intermittent access to a pipeline's services are classified as *interruptible* service. 18 C.F.R. § 284.9(3) (1987).

tion of a pipeline's initial decisions to do business with various shippers. Once a proper contract for firm service has been executed, the pipeline has in essence guaranteed a particular level of service to the customer and will be permitted to serve that customer on a priority basis even if late-comers demand access.[71]

Rate Conditions

One problem traditionally associated with industries which are regulated as public utilities is that the individual businesses often lose a sense of themselves as competitors and entrepreneurs. Indeed, one of the reasons for public utility-style regulation is to ensure more stability and continuity than might be the case in non-regulated industries. Business failures among utility companies are not happy events because so many of their customers are essentially captives of that particular utility.

However, utilities can become excessively sanguine on many of the business propositions that other companies take for granted, such as soliciting the lowest cost goods and making their operation as cost-efficient as possible. FERC ratemaking in the natural gas pipeline industry has certainly contributed its share to these problems. In Order 436, FERC attempted to develop far more flexible rate principles than had been approved in the past. In essence, the new tariffs filed under Order 436 were to contain a range of charges from the highest rate to the lowest rate (often referred to as ceiling and floor rates). FERC would then approve this range of rates rather than approving individual rates. Under Order 436 a pipeline may charge rates anywhere within the approved range.[72] The pipeline's highest or maximum rate would reflect that pipeline's "fully allocated cost" for performing the transportation. In other words, the highest rate is to be calculated so that a pipeline recovers all of its costs plus a reasonable return on investment for shipping that particular gas over the stated distance.

A complicating factor, however, is the question of how a pipeline subject to the open access requirement serves its firm customers. These customers contract for pre-established volumes of transportation service even if their actual needs do not necessarily require that volume at a given time. In the past, a pipeline was simply free to contract with its firm customers up to the level of its maximum capacity and then charge those customers whether or not they used the service. Under Order 436, pipelines are permitted only to charge a reservation fee for firm service.[73]

71. Order 436, *supra* note 56, 50 Fed. Reg. at 42436-38. Interestingly, FERC chose not to put the first-come, first-served concept in the rule itself but set it out in some extensive commentary in the preamble. *Id.* There is a debate among federal administrative lawyers as to the ultimate legal effect of language in a rule's preamble. Not stating the first-come, first-served principle in the substantive rule may cause FERC problems in the future.

72. 18 C.F.R. §§ 284.7, 284.8(d), 284.9(d) (1987).

73. *Id.* at § 284.7.

Contract Demand (CD) Adjustments

As noted above, typically customers contract for a specified level of service and a pipeline must be ready to provide that level of service, normally referred to as the customer's "contract demand" (CD) at all times or risk both breach of contract and possible FERC sanctions. This concept of firm sales underlies virtually the whole relationship between a pipeline and its customers. In Order 436, FERC had to cope with this business practice in the context of its new open access theory. It did not want pipeline customers charged for services that they did not use, but also it did not want the pipelines to get stuck with the losses incurred by standing ready to serve a customer who chooses to deal (after open access) with another pipeline.

Order 436 devised two options. Customers of pipelines were given a unilateral right to modify their existing contracts. They could convert specified percentages of the customer's CD from a gas purchase obligation to a mere gas transportation obligation, and thereby avoiding the costs associated with the firm service obligation. Alternatively, customers could simply reduce their CD by similar percentages.[74] FERC saw its CD provisions as central to the success of the open access doctrine since a customer who could not get out of its firm obligations with one pipeline would not be free to contract with the lowest-charging available carrier.

Take-or-pay

The take-or-pay phenomenon was one of the primary instigating forces for FERC's launching the investigation which ultimately resulted in Order 436. Large numbers of pipelines were faced with huge financial consequences stemming from their execution of long-term contracts that obligated them to pay even for gas not actually shipped and re-sold.[75] Indeed, by late 1984 many problems so exacerbated take-or-pay liabilities that FERC decided it had to deal with it through a statement of policy and interpretative rule even before announcing the proposals that ultimately became Order 436.

FERC proposed what it described as a "safe-harbor" approach to take-or-pay. Under this approach it would almost automatically deem "prudent" (and thus virtually exempt from sanction) any one-time payments made by pipelines to extricate themselves from take-or-pay obligations. Unfortunately, virtually no one outside the FERC agreed with this move and FERC decided merely to retain its earlier statement of policy.[76]

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74. *Id.* at § 284.10. The specific percentages are: 15 percent in years one and two of the contract, 20 percent in the third year, and 25 percent in years four and five. *Id.* at § 284.10(e). Customers could both convert and reduce simultaneously, but only to the extent of their total firm obligations. *Id.*

75. The take-or-pay issues are provocatively addressed, in Comment, *Take-Or-Pay; The D.C. Circuit Forces FERC's Hand*, 23 LAND & WATER L. REV. 149 (1987) (authored by Nathaniel K. Adams).

76. Order 436, *supra* note 56, 50 Fed. Reg. at 42464. As FERC put it: "[T]he imposition of a generic rule to handle take-or-pay buyouts at this time will *not improve* the take-or-pay problem and *may actually aggravate* the situation. In particular, we have no wish to upset current renegotiations." *Id.* (emphasis supplied).

Order 436 did push take-or-pay implementation a little further, however, by setting out an expedited process by which producers could apply for and receive permission to abandon unsuitable take-or-pay relationships. Expeditious treatment of an abandonment obligation is warranted, under the rule, in either of two cases: (1) cases in which a natural gas producer has been subjected to reduced "takes" without payment by the pipeline; and (2) cases in which the producer and pipeline have executed a take-or-pay buyout.[77] By normal FERC standards, the procedures are truly expeditious. Persons who intend to oppose or intervene in an abandonment application have 15 days from the date of filing the application in which to seek intervention or to submit comments in opposition. When an abandonment application is filed because of an agreed-upon buyout between pipeline and producer, FERC deems the producer to have waived any opposition to the abandonment. In cases of opposed application, the proceeding must be set for expedited hearing.[78]

The Optional Certificate Procedure

Under the NGA, pipelines must obtain FERC approval to construct new facilities or to substantially alter existing facilities through the traditional process of obtaining a certificate of public convenience and necessity. This has always been a long, drawn-out, extraordinarily cumbersome process that many commentators viewed as an impediment to true competitiveness in the industry.[79] Worse, any artificial barriers placed in the way of pipelines' improving their services, or in being able to compete with other pipelines for the same business, would devastate the entire Order 436 program—a program premised on greatly heightened competition for business. However, one of the problems inherent in uncontrolled construction of new facilities is the phenomenon of *bypass.* This is a phenomenon in which large consumers of natural gas avoid the necessity and the expense of hooking up with their local distribution companies and construct direct transportation links with interstate pipelines. This is an understandable concern and one currently faced by the telephone industry as well as the natural gas industry. To the extent that large end-users may bypass the local distribution companies, the LDC's are stuck with serving only those end-users, such as small businesses and residences, that cannot do business directly with a pipeline and for whom the costs of service—and thus the profit margins—are smaller.

On this point, FERC was somewhat cold-blooded, pronouncing flatly:

> The Commission will not insulate the LDC markets from the competitive incentives that are the foundation of the final rule. In order to promote economic efficiency—a necessary factor in providing gas to consumers at the lowest reasonable rates—the rule must

77. *See* 18 C.F.R. § 2.77(a) (1987).
78. *Id.* at § 2.77(b).
79. *See, e.g.,* Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry,* 97 HARV. L. REV. 345 (1983); S. BREYER & P. MACAVOY, ENERGY REGULATION BY THE FEDERAL POWER COMMISSION (1974).

> provide sufficient competitive incentives to all elements of the market. This means making all market participants, including LDC's, accountable for the success or failure of their market participation.[80]

But FERC was quick to acknowledge that any specifically articulated grievances could be addressed by way of a protest filed in any new service or abandonment application.[81] Any new or amended certificates would, of course, have to comply with the conditions on unbundling of services set by FERC in the transportation portion of Order 436.[82]

Having announced Order 436 and having set an effective date of November 1, 1985 (approximately three weeks after the Order was issued) for most of the Order's provisions, FERC sat back, caught its breath and waited for the inevitable outcry. It came quickly. Many pointed comments were made and FERC was forced to issue two follow-up orders, 436-A,[83] and 436-B,[84] in order to accommodate some of the divergent points of view and to clarify a number of points first raised in the original Order 436. Summarized briefly, both Orders 436-A and 436-B restated virtually all of FERC's assertions as to its basic jurisdiction to take action, reaffirmed its belief that changes in the natural gas markets warranted drastic action and made some relatively technical changes in a number of provisions in the original order. The sum and substance of initial Order 436 remained intact, however.

THE COMPANION RULEMAKING - FERC ORDER 451

Around the same time that FERC was coping with the details of Order 436, it received and entertained a proposal from the Secretary of Energy.[85] This proposal was specifically described as a companion rulemaking to Order 436, and urged FERC to set a single new ceiling price for natural gas. This gas has been referred to variously as "old, flowing gas," or labelled in terms of its NGPA price category as "section 104 gas," (gas committed and dedicated to interstate commerce prior to the enactment of the NGPA) or "section 106 gas" (intrastate natural gas subject

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80. Order 436, *supra* note 56, 50 Fed. Reg. at 42469.

81. *Id.*

82. 18 C.F.R. §§ 157.02, 157.03, 157.04 (1987). Stated a bit more precisely, FERC presumes, subject to rebuttal by any protesters, that the new certificate is required in the public convenience and necessity. Order 436, *supra* note 56, 50 Fed. Reg. at 42474.

83. 18 C.F.R. §§ 2.77, 157.102, 284.7, 284.10, 284.13, 284.106, 284.123, 284.223, 375.307 (1987) (FERC Order 436-A, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Final Rule, Order Granting in Part and Denying in Part Applications for Rehearing, Denying Petition for Stay, and Granting Clarification, 50 Fed. Reg. 52217 (1985) [hereinafter Order 436-A].

84. 18 C.F.R. §§ 284. 10 (1987) (FERC Order 436-B, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order Granting in Part Petitions for Rehearing and Reconsideration, 51 Fed. Reg. 6398 (1986) [hereinafter Order 436-B].

85. FERC is an independent regulatory agency which exists as a component of the Department of Energy. 42 U.S.C. §§ 7134, 7151, 7171, 7172 (1982). Under section 403 of the Department of Energy Act, 42 U.S.C. § 7173, both FERC itself and the Secretary of Energy have the statutory power to propose rules on regulatory matters within FERC's jurisdiction. However, only FERC may issue the final rules. *Id.*

to a rollover contract). This gas, as noted above, continues to be subject to some form of FERC price control so long as the NGA remains in effect. At the time the Secretary of Energy made this proposal, prices of this gas were set in terms of the date or vintage of its production.

The existence of price controls on what amounts to a substantial amount of natural gas produces market distortions. In the view of the Secretary of Energy:

> Price controls create an incentive for pipeline companies to purchase a mix of low-cost and high-cost gas. Consumers pay an average of these prices. Price controls on low-cost, old gas allow high-cost domestic and imported gas to receive prices above the average price. . . . Thus, the major beneficiaries of price controls on old gas are high-cost domestic producers and gas importers, *not* consumers.[86]

This conclusion and FERC's resulting rulemaking prompted FERC to promulgate Order 451 to do away with market distortions caused by the existence of low-cost, NGA price-controlled natural gas.[87]

The underlying assumptions of Order 451 mesh squarely with those of Order 436 in FERC's view:

> gas should be priced to bring about efficiency in both its production and its consumption and to reflect the resource cost of bringing the commodity to market. In other words, prices should ensure that the consumer's willingness to pay for a unit of gas corresponds to the cost of producing a unit of gas at that time. Prices should also allow the market to clear; that is, gas supplied should equal gas demanded.[88]

FERC eventually adopted most of what the Secretary of Energy proposed. Order 451 first sets out an alternative maximum lawful price for section 104 and 106 gas. This price may be used by producers in lieu of the applicable prices under the vintaging system, so long as the new price is established under either a new purchase and sale contract or an agreed-to modification of an existing contract.[89]

But FERC recognized that this is a somewhat hollow authorization if there are no incentives to work out these new pricing schemes. One

86. U.S. DEP'T OF ENERGY, INCREASING COMPETITION IN THE NATURAL GAS MARKET: SECOND REPORT REQUIRED BY SECTION 123 OF THE NATURAL GAS POLICY ACT OF 1978, 137 (1985), *quoted in* 51 Fed. Reg. 22168, 22170 (1986) (emphasis in the original).

87. The regulatory history of Order 451 is voluminous. 18 C.F.R. §§ 154.94, 157.40, 157.301, 270.201, 271.402, 271.602, 284.225 (1987) (FERC Order 451, Ceiling Prices; Old Gas Pricing Structure, Final Rule, 51 Fed. Reg. 22168 (1986)) [hereinafter Order 451], *as modified by* 18 C.F.R. §§ 270.201, 284.225, 284.226 (1987) (FERC Order 451-A, Ceiling Prices; Old Gas Pricing Structure, 51 Fed. Reg. 46762 (Dec. 24, 1986)) [hereinafter Order 451-A], *as modified by* 18 C.F.R. §§ 270.201, 284.225, 284.226 (1987) (Order 451-B, 52 Fed. Reg. 21669 (1987)) [hereinafter Order 451-B], *rehearing denied*, Order 451-C, 52 Fed. Reg. 29659 (1987) (Orders 451 and 451-A are currently on appeal before the United States Court of Appeals for the Fifth Circuit in Mobil Oil Exploration Co. v. FERC, No. 86-4940 (1986)).

88. Order 451, *supra* note 86, 51 Fed. Reg. at 22169.

89. 18 C.F.R. § 271.402(c) (1987).

device established by Order 451 is a requirement of good faith negotiation. Under this requirement a producer will be granted abandonment permission by FERC if (1) the producer wishes to sell at the higher price, (2) cannot get the buyer under the current contract to agree to the higher price and (3) is able to find another buyer at the higher price.[90] Moreover, producers are to be granted blanket certificates of public convenience and necessity authorizing the sale of any natural gas which is deemed abandoned under Order 451. Interstate pipelines which are not Order 436 open-access transporters will nonetheless be given blanket transportation certificates to ship any gas released under the terms of Order 451.[91]

These last two elements tie Order 451 directly into the overall scheme of Order 436 and would appear to stand or fall on judicial scrutiny along with the parallel provisions in 436. However, the good faith negotiation rule may run afoul of one of the fundamental principles in FERC natural gas ratemaking known as the Mobile-Sierra doctrine.[92] This doctrine generally forbids any kind of unilateral modifications of natural gas contracts, holding that parties which are no longer satisfied with their present contracts may seek relief only through a FERC proceeding (the so-called section 5 hearing).[93] In the NGA section 5 hearing, FERC formally determines whether the rates are just and reasonable under its NGA statutory authority.[94]

It is arguable, however, that the doctrine itself began to evaporate when the old Federal Power Commission began its national natural gas rate structure. That structure permitted contract prices to rise to the lawful maximum prices automatically, through indefinite price escalation clauses that the FPC permitted in each natural gas pipeline's tariff. FERC takes the position that the good faith negotiation process applies only when a buyer and seller are already functioning under a contract with an indefinite price escalation clause. Thus, there can be no Mobile-Sierra violation.[95]

90. *Id.* at § 270.201. The process of good faith negotiation is carefully prescribed by FERC rule. After October 31, 1986 a producer may request in writing that the existing buyer of the producer's natural gas state a *price* which the buyer is willing to pay for the producer's gas. This constitutes a formal offer by the producer to cancel the existing price and to renegotiate a new price. However, in normal circumstances it is only the price of the natural gas which is subject to this renegotiation. All the other terms of the contract including volumes purchased remain the same. If the purchaser does not respond to the producer's offer within sixty days, the producer is free to find another buyer although certain firm sales customers of a non-open access transporter under Order 436 have first refusal. Once this new deal is worked out, the producer may give the existing buyer 30 days notice and abandon the existing contract unless the buyer then offers the highest price up to the alternative maximum lawful price. If the existing buyer is willing to pay that price, the producer must accept and continue to sell to the existing buyer. *Id.*

91. *Id.* at § 284.225.

92. The Mobile-Sierra doctrine grows out of two Supreme Court cases decided on the same day, one a natural gas case; United Gas Pipe Line Co. v. Mobile Gas Svc. Corp., 350 U.S. 332 (1956); the other an electric power supplier case; FPC v. Sierra Pacific Power Co., 350 U.S. 348 (1956).

93. *United Gas Pipe Line Co.,* 350 U.S. at 332; *Sierra Pacific Power Co.,* 350 U.S. at 348.

94. 15 U.S.C. § 717c(a), (e) (1982).

95. Order 451, *supra* note 86, 51 Fed. Reg. at 22206.

In Orders 451-A and 451-B, FERC has tinkered somewhat with these basic principles without altering their basic character. Whether the Orders survive judicial review, however, is an as-yet unanswered question. Even so, it would seem that Order 451 is well-reasoned and so closely tied to Order 436 in both concept and language that most if not all of the policy will survive the Fifth Circuit's scrutiny. There is no question that Order 436 is a far weaker and less-compelling policy statement without the contributions of Order 451. Logically, they should stand or fall together.

THE NEW POLICIES ON JUDICIAL REVIEW - HEREIN OF *ASSOCIATED GAS DISTRIBUTORS* AND *CONSOLIDATED EDISON*

The Associated Gas Distributors Decision

Order 436 survived judicial review nearly intact. On July 23, 1987, the United States Court of Appeals for the District of Columbia Circuit issued its opinion in *Associated Gas Distributors v. FERC.*[96] In a lengthy opinion, the court reviewed the legislative and regulatory history underlying Order 436 and suggested that the Order itself "may well come to rank with the three great regulatory milestones of the industry:" the enactment of the NGA, the *Phillips* decision and the enactment of the NGPA.[97]

Described briefly, the court identified six important aspects of Order 436 for close scrutiny. First, the new blanket certificate program, which converted pipelines into open-access carriers. Second, the first-come, first-served principle introduced in the Order. Third, the new, and far looser, rate regulation for open access pipelines. Fourth, the opportunity for local distribution companies to convert contract demand from a purchase obligation to an obligation for transportation services. Fifth, the take-or-pay issue, and sixth, the optional, expedited certificate program for new facilities.

FERC's initiatives were largely upheld by the court. FERC can be justifiably proud of promulgating such a revolutionary order which has survived such thorough scrutiny both at the agency level and in court. However, Order 436 was remanded by the D.C. Circuit because the court viewed the order, and rightfully so, as an "interdependent" mechanism and because it detected certain flaws in a number of the components of Order 436 which require corrective action on the agency's part.

Associated Gas Distributors was a victory for FERC, but it was a mixed victory at best. From FERC's standpoint, the court fight was likely well worth the struggle. The D.C. Circuit confirmed FERC's basic statutory authority to proceed with the drastic shift in policy represented by Order 436's basic open access premise. On this point, the court launched

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96. 824 F.2d 981 (D.C. Cir. 1987). The court's opinion was authored by Judge Steven Williams, who was a law professor at the University of Colorado immediately prior to taking a seat on the D.C. Circuit. As a law professor, Judge Williams was noted for some important law review articles on natural gas regulation. *See, e.g.*, Williams, *The Proposed Sea-Change in Natural Gas Regulation*, 6 ENERGY L.J. 233 (1985). The other two circuit panel members were Judges Mikva and Bork.
97. *Associated Gas Distrib.*, 824 F.2d at 993.

a straightforward inquiry into the premises and express language of both the NGA and the NGPA to conclude, in the court's words, that the NGA "fairly bristles with concern for undue discrimination."[98]

The court declined to get into the largely semantic battle of whether FERC was, by rule, imposing on the pipelines the status of common carrier. It instead chose to focus on what the court regarded as three unchallenged factual findings made by FERC in the Order 436 proceeding. First, the pipelines have substantial market power. Second, they have used this market power to deny both to their own customers and to other persons who lack the capability to switch among various fuels the benefits of competitive natural gas prices. Third, the consumers ultimately bear the brunt of these anti-competitive practices.[99] Similarly, the court could find no barriers in the NGPA[100] to FERC's open access doctrine, holding essentially that its interpretation of the statute was reasonable. The court gave similarly short shrift to arguments that the Order 436 rate conditions were arbitrary and capricious or a violation of statute.[101]

However, those points on which the court faulted FERC and which triggered the remand are substantial and will continue to be troublesome. For example, the court was clearly unhappy with FERC's refusal to address expressly the first-come, first-served principle in the substantive portion of Order 436.[102] Nonetheless, on this point the court's hands were probably tied. FERC intends to deal with the first-come, first-served problems on a case-by-case basis. The United States Supreme Court has long since held that agencies have the discretion to make policy by either rule (as in Order 436) or by deciding individual cases (by "order" in the parlance of the Administrative Procedure Act).[103] That principle, first enunciated just after the enactment of the APA in 1947 has never been seriously questioned. While the *Associated Gas Distributors* court raised an eyebrow here ("the Commission may [not] endlessly postpone the necessary decisions"[104]), it did not command a different result.

There are three components of Order 436 with which the court took issue. First, the contract demand adjustment, which grew out of the tradi-

98. *Id.* at 998.
99. *Id.* at 999.
100. *Id.* at 1001-03. The parties attacking open access invoked section 602(b) of the NGPA, which provides that no pipeline may be regulated as a common carrier simply because it provides certain types of natural gas transportation, and section 601(a)(2)(A) of the NGPA, which states that providing transportation under a Presidential emergency order does not constitute transporting natural gas in interstate commerce. 15 U.S.C. §§ 3422(b), 3431(a)(2)(A) (1982).
101. *Associated Gas Distrib.,* 824 F.2d at 1007-12.
102. In one of the neater literary efforts in *Associated Gas Distrib.,* Judge Williams notes: " 'First-come, first-served' is an easy principle to apply in a bakery where each customer pulls a numbered ticket on entering and is served in that order. But in an industry such as natural gas transportation it may often be difficult to say who 'comes first.' " *Id.* at 1005.
103. *See* W. FOX, UNDERSTANDING ADMINISTRATIVE LAW 114-122 §§ 33-35 (1986). The 1947 case is SEC v. Chenery Corp., 332 U.S. 194 (1947). The Court's most recent exposition of the "informed discretion" doctrine came in NLRB v. Bell Aerospace, 416 U.S. 267 (1974). The Supreme Court has never reversed an agency for making policy on a case-by-case basis.
104. *Associated Gas Distrib.,* 824 F.2d at 1006.

tional natural gas provisions by which a pipeline agrees to stand ready to deliver a stated quantity of natural gas per day. Second, the take-or-pay issue, which FERC ducked in Order 436. Third, certain of FERC's decisions to grandfather certain existing practices, such as previously issued blanket certificates.

Here, it is important to note that the court did not necessarily disagree with the terms of Order 436 and clearly did not want to dictate any particular result. It has merely held that FERC did not provide adequate reasoning or explanation for its new policies. While the court cites a number of specific decisions to bolster its conclusions on inadequate reasoning and explanation, the most important precedent supporting the court's action is the Supreme Court decision, *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[105] The Court there squarely held that an administrative agency may change policy so long as it provides an adequate explanation for doing so.[106]

The D.C. Circuit was not satisfied by some of the justifications advanced in Order 436. For example, on the issue of whether the imposition of new conditions in certificates was purely voluntary, the court concluded that FERC simply had not explained why it has authority to do so under section 7 of the NGA without addressing why it need not make a specific determination of unreasonableness under section 5 (which requires an individualized hearing). However, "[o]n remand, the Commission can proceed under such grants of power as it believes are relevant . . . . In so doing, of course, it may employ rulemaking."[107] Further, the court was not happy with FERC's constant combining of the two concepts of CD reduction and CD conversion. It noted that many of FERC's arguments in favor of their power to order CD reduction are "peripheral" to the main point of trying to set up a market in which consumers have access to competitively priced gas.[108]

On certain of the grandfathering decisions, the court simply found FERC's explanations inadequate.[109] But most of the heat in the decision was reserved for FERC's hesitation and obfuscation on the take-or-pay issue.[110] The court found weaknesses in FERC's decision to stand on its pre-436 policy statement. It similarly faulted FERC's failure "to condition producer access on cooperation in solving take-or-pay issues," as well

105. 467 U.S. 837 (1984).

106. *Id.* at 864. Notably, in *Chevron* the Court reversed the D.C. Circuit in what the Court viewed as an overzealous attempt to upset policies made by the Environmental Protection Agency. *Id.* Compare *Chevron* with Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins., 463 U.S. 29 (1983) (The Court overturned a new seat belt regulation promulgated by the Department of Transportation because the only explanation for the change in policy appeared to be the change in political administrations from President Carter to President Reagan.).

107. *Associated Gas Distrib.*, 824 F.2d at 1015.

108. *Id.* at 1019.

109. *Id.* at 1040-42.

110. On this point the court wisely noted that take-or-pay is a true problem in the natural gas industry only when combined with the extraordinarily high prices of the "take-or-pay" gas. *Id.* at 1021. This one point is a good example of a judge writing a decision on an issue that he deeply understands.

as other alternatives that might help mitigate the worst aspects of the take-or-pay question.[111] But its harshest language came in its summation on the take-or-pay failures:

> Recognizing that the Commission is expert in this area [and thus that it might properly decide on inaction], we nevertheless find its stated legal premises questionable and its factual assessments utterly Panglossian. . . . We do not require that FERC reach any particular conclusion; we merely mandate that it reach its conclusion by reasoned decisionmaking.[112]

Consolidated Edison

The second note of impatience with FERC's seeming reluctance to come firmly to grips with the take-or-pay problems was sounded in *Consolidated Edison of New York, Inc. v. FERC,*[113] a case involving review of FERC's 1985 producer abandonment policy. *Consolidated Edison* is a classic natural gas case. In 1959 the producers agreed to sell natural gas from a well offshore Louisiana to Transcontinental Gas Pipe Line Corporation (Transco), one of the largest natural gas pipelines in the United States. That contract expired in 1981, but upon expiration, the parties continued to do business on a series of one-month and then day-to-day contracts. This arrangement could be cancelled by written notice.[114] In October, 1983 the producers notified Transco of their cancellation of the contract and simultaneously filed an abandonment petition with FERC. At the time of cancellation, in a situation then typical of a large part of the natural gas industry, Transco was taking only about 20 percent of the total amount of gas that the producers could have delivered. The producers sought cancellation and abandonment so that they could seek out a higher-volume buyer.

This type of abandonment proceeding is conducted by FERC on a case-by-case basis. In this instance, the administrative law judge refused abandonment on the basis that the producers had not identified by name any new customers who would take the gas if the petition were granted. On review by the full Commission, the ALJ's decision was reversed and a limited-term abandonment—i.e., an abandonment for three years with first refusal of the gas left in the hands of Transco—was granted. In the process of deciding this case, FERC announced a wholly new abandonment policy. It got rid of its long-standing "comparative need" abandonment policy,[115] by which FERC traditionally balanced or compared the interests of the producer, the competing pipelines, and the ultimate consumers of the natural gas.

111. *Associated Gas Distrib.,* 824 F.2d at 1028.

112. *Id.* at 1030.

113. 823 F.2d 630 (D.C. Cir. 1987). Despite its insertion in an earlier volume of the Federal Second series, *Consolidated Edison* was actually decided nearly one month after *Associated Gas Distrib.* Judge Bork was the only circuit judge to sit on both the panels.

114. *Id.* at 633-34.

115. The "comparative need" policy was formulated in the late 1950s and approved by the D.C. Circuit as early as 1960 in Mich. Consol. Gas Co. v. FPC, 283 F.2d 204 (D.C. Cir.), *cert denied,* 364 U.S. 913 (1960).

FERC's reasoning in getting rid of the comparative needs test was quite straightforward. Low-price natural gas was being shut-in, and only high price gas was moving in interstate commerce. This phenomenon was attributed to the incongruities fostered by the interaction of the NGA and the phased decontrol mandated by the NGPA. Producers faced with the stringent requirements of their take-or-pay contracts were taking and paying for only the high cost gas and thus passing on artificially high cost gas to consumers.[116]

In deciding the instant case, FERC announced its intention to permit abandonment in any case when the application can show "beneficial effects on the market overall, such as increasing competition and causing gas prices to respond to that competition."[117] When those benefits outweigh the possible injury to the current purchaser, abandonment will be granted. However, abandonment applications were still to be processed on a case-by-case basis and the other factors traditionally reviewed under the comparative need policy were to be considered.[118]

Much like the panel which decided *Associated Gas Distributors*, the *Consolidated Edison* panel invoked traditional judicial review of agency action case law including the *State Farm*[119] case. The court acknowledged that the agency needed a specific abandonment policy merely to flesh out the terribly ambiguous statutory standard of "public convenience and necessity" and could properly modify its policies to address the drastic changes then taking place in the natural gas industry as a whole.

However, FERC had articulated four reasons for the new policy. First, the new purchasers could lower their gas costs by taking this cheaper, abandoned gas. Second, the entry of the cheap gas in the marketplace would provoke other purchasers into seeking out similarly priced gas. Third, if a pipeline was faced with a possible producer abandonment of its long-term contract, the pipeline might be willing to take the cheap gas. Fourth, displacement of high-price gas by the cheaper gas may force producers and pipelines across-the-board to renegotiate their expensive, existing take-or-pay contracts.[120] As the court reviewed these justifications, it became more and more leery of FERC's explanations for the shift in policy. It expressed its greatest displeasure with the fourth reason, noting specifically:

> It seems counterintuitive to argue that pipelines will stop taking gas that they have to pay for anyway and that as a result producers will have an incentive to renegotiated contracts in which they are guaranteed high payments whether or not the customers take the gas. On the contrary, the whole purpose of take-or-pay

116. Felmont Oil Corp. 33 F.E.R.C. ¶ 61,333 (1985).
117. *Id., quoted in Consolidated Edison*, 823 F.2d at 635.
118. These factors include an evaluation of the environmental consequences of the abandonment and the express language of the current contract. *Consolidated Edison*, 823 F.2d at 635.
119. Motor Vehicles Mfrs Ass'n v. State Farm Mut., 463 U.S. 29 (1983).
120. *Consolidated Edison*, 823 F.2d at 637.

> contracts is to give the producers the same benefit whether or not the gas in question actually leaves the ground. (emphasis in the original; footnotes omitted).[121]

In the D.C. Circuit's view, FERC had neither explained nor satisfactorily addressed these contradictions and inconsistencies. It was, it seems, not so much what FERC said, as it was the absence of plausible explanations for the new policy that bothered the court. In this instance, the court went on to incorporate that portion of the *Associated Gas Distributors* decision in which that court expressed dismay with FERC's rather cavalier disregard of the entire take-or-pay issue.[122]

Nonetheless, just as *Associated Gas Distributors* remanded Order 436 for a better reasoned explanation for FERC's action, the *Consolidated Edison* court left the door wide open for FERC to simply reiterate its policy on remand:

> Following the lead of [*Associated Gas Distributors*] which remands an Order most elements of which [the court] would otherwise uphold, due to the unexplained take-or-pay rationale, we, likewise, remand this case for the same pervasive defect, although given proper bases we might well uphold it. Similarly, like the [*Associated Gas Distributors*] opinion, we acknowledge that the FERC may reach the same result if it explains adequately how it intends to deal with the take-or-pay problem. (emphasis supplied).[123]

FERC has now attempted that explanation in its brand-new Order 500.

FERC's Response to *Associated Gas Distributors*—FERC Order 500

On August 7, 1987 FERC tried again on the provisions of Order 436.[124] This product, Order 500,[125] has been issued as an interim order and statement of policy, effective upon publication and promulgated without the traditional notice and comment procedures afforded final substantive rules.[126] There is no doubt that the procedural issue as well as the substance of Order 500 will be closely reviewed by the D.C. Circuit on appeal.

The technique followed by FERC in Order 500 was simply to readopt Order 436, including those grandfathering provisions that caused the court

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121. *Id.* at 639-40.
122. *Id.* at 640.
123. *Id.* at 641.
124. The abandonment policy remanded for further explanation in *Consolidated Edison* will be the subject of a different FERC proceeding. As this article goes to press FERC has not taken final action on the *Consolidated Edison* issues.
125. FERC Order 500, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Interim Rule and Statement of Policy, 52 Fed. Reg. 30334 (1987) (to be codified at 18 C.F.R. pts. 2 and 284) [hereinafter Order 500].
126. Section 553(b)(B) of the Administrative Procedure Act permits FERC to dispense with notice and comment and to place a rule immediately into effect when it can show "good cause" for doing so. 5 U.S.C. § 553(b)(B) (1982). The APA nowhere expressly recognizes the device known as an "interim rule" but an earlier FERC interim rule involving electric rate making was approved by the D.C. Circuit. Mid-Tex Elec. Coop., Inc. v. FERC, 822 F.2d 1123 (D.C. Cir. 1987).

to raise an eyebrow, with only a few modifications to accommodate some of the court's specific criticisms. Those modifications are designed to do at least four things.

First, this would alleviate some of the hardships caused by the open access requirements of Order 436 to pipelines functioning under take-or-pay contracts. Producers are now required to credit against a pipeline's take-or-pay obligations any gas that is transported by the pipeline under contracts which were in effect before June 23, 1987.

Second, a new passthrough mechanism for the costs incurred by pipelines in buying out and settling existing take-or-pay contracts has been established. Under it there is relatively equitable sharing of the financial burdens as between pipelines and pipeline customers.

Third, new principles for calculation of a pipeline's gas supply charges have been devised by FERC to avoid future take-or-pay problems.

Fourth, albeit with additional explanation and justification, FERC has reinstated Order 436's contract conversion option but has eliminated the order's contract reduction option.[127]

The Matter of Transportation Credits

Transportation credits are one of the dilemmas posed by Order 436. As both FERC and the *Associated Gas Distributors* court have recognized, pipelines need some leverage over producers to provoke changes in existing take-or-pay contracts. One form of leverage might be to permit pipelines to refuse to carry any natural gas for a particular producer if that producer refuses to renegotiate the existing contracts. In Order 436, FERC determined that an outright, categorical refusal of a pipeline to transport would be unduly discriminatory. The *Associated Gas Distributors* court essentially vetoed this option but recognized that the pipeline's enormous market power could be used inappropriately to overwhelm the average non-owner shipper.

FERC has now worked out an alternative in an attempt to balance the interests of producers and pipelines. Now pipelines are permitted to refuse to transport any natural gas produced by a non-owner shipper, unless the producer executes an affidavit agreeing to credit the gas actually transported against the pipeline's pre-existing take-or-pay obligations.[128] In other words, for each amount of gas transported in the future, a pipeline will be credited as if that gas had been shipped under a take-or-pay contract so long as that contract was in existence prior to June 23,

127. As noted above, FERC has continued to grapple with the take-or-pay problem since the announcement of its 1985 policy statement. Many of the pronouncements and mechanisms established in Order 500 were developed by FERC in a proposed take-or-pay policy statement published on March 11, 1987. Recovery of Take-or-Pay Buy-Out and Buy-Down Costs by Interstate Natural Gas Pipelines; Notice of Issuance of Proposed Policy Statement and Opportunity for Public Comment, 52 Fed. Reg. 7478 (1987).

128. 18 C.F.R. § 284.9(f) (1987).

1987 (the date of the *Associated Gas Distributors* decision).[129] If the appropriate affidavit is executed by the producer, the pipeline may not refuse transport. FERC was quick to note, however, that these are interim measures and will not likely continue indefinitely. It has invited additional comments on the effects of the crediting rule and on alternatives as part of its ongoing scrutiny of the take-or-pay phenomenon.[130]

The Passthrough Mechanism

One of the most important aspects of any reasonable take-or-pay policy is the establishment of some mechanism by which both pipelines and the pipelines' customers share some of the financial burdens of the artificially high take-or-pay contracts. Briefly stated, FERC has established two separate options. First, a pipeline will be permitted to pass through any buyout or buydown costs incurred in getting out of burdensome take-or-pay contracts if it can show that the costs were "prudently incurred."[131] In addition, FERC will now permit pipelines who agree to become open access carriers and who are faced with take-or-pay problems to elect to absorb between 25 to 50 percent of the pipeline's take-or-pay costs, and may ask FERC for permission to pass through an equal share of those costs by a fixed charge passed on to its customers.[132]

The New Principles For Gas Supply Charges

One of FERC's primary goals in this entire undertaking is to create a regulatory setting which minimizes the possibility of recurrence of the take-or-pay problem. In this light, FERC has promulgated five new ratemaking principles, applicable to a pipeline's gas supply charges.

First, pipelines may include a charge for merely being available to supply gas to its customers, so long as that charge does not relate to physical facilities.[133] FERC recognizes that under the new natural gas contracts, pipelines may be in a position of having to have the supplies necessary to satisfy customers' contract demands while the customers are not under a parallel obligation to take specified amounts. While pipelines have, in the past, inserted some kind of retroactive charge for

129. *Id.* The pipeline is given the discretion to select the contracts against which the take-or-pay credits will be entered. No credits need be given against a terminated take or pay contract or under a gas purchase contract that contains a so-called "market out" clause which gives the pipeline the right to terminate the contract at the pipeline's discretion. *Id.*

130. Order 500, *supra* note 120, 52 Fed. Reg. at 30341.

131. 18 C.F.R. § 2.104 (1987). The concept of prudence is one of long-standing at FERC and is a traditional construct in public utility ratemaking. It is used as a device to promote cost-effectiveness among regulated companies and the pipeline has the burden of proof in demonstrating prudence although FERC will indulge a presumption that a pipeline has been prudent if the pipeline agrees to assume an equitable share of the costs of getting out of the contract. Order 500, *supra* note 120, 52 Fed. Reg. at 30341.

132. 18 C.F.R. § 2.104 (1987). These are not self-effectuating provisions. Pipelines must make specific application for permission to use either of the mechanisms as part of the normal tariff approval process. *Id.*

133. 18 C.F.R. § 2.105 (1987).

their availability, these charges will now be calculated and inserted in tariffs prospectively.[134]

Second, no pipeline may recover take-or-pay charges from suppliers by any means other than the device set out above.[135]

Third, pipelines must always permit customers to nominate levels of service within the firm sales obligations contained in their contracts or must establish a mechanism for periodic renegotiation of those obligations.[136]

Fourth, pipelines must give their customers either firm prices or firm pricing formulas before the customers are required to make the service level nominations.[137]

Fifth, if a customer nominates a service level lower than the amounts of natural gas it is currently buying from a pipeline, the customer automatically consents to an abandonment of service proportional to the lowered service.

FERC makes clear that these are generic ratemaking principles which become effective and thus enforceable only when they are contained in tariffs filed by pipelines which are ultimately approved as reasonable by FERC. Nonetheless, the goal of the new principles is laudatory. In FERC's own words, the principles seek "to establish a rational, efficient pricing structure for the pipeline merchant function with emphasis on reciprocity and consideration of service obligations under the increased options available to a pipeline's sales customers."[138]

The Contract Demand (CD) Adjustments

Order 436 permitted a pipeline customer with a firm sales contract to convert specified percentages of the customer's CD requirements from a fixed obligation (which the customer must normally pay for whether or not it actually receives the gas—i.e., the now-outmoded notion of "bundled" service) to an "unbundled" or gas transportation service. In the alternative, a customer could simply reduce its CD by similar percentages. As noted above, the *Associated Gas Distributors* court had trouble with FERC's constant merging of the twin concepts of contract demand reductions and contract demand conversions, even though FERC believes that "the original objectives of the CD reduction option remain valid."[139] It has, however, kept the CD conversion mechanism in the new rule. While FERC recognizes that a CD conversion device may exacerbate a pipeline's take-or-pay problems, the new crediting mechanism set up in Order 500 should eliminate most of this bad effect while preserving the benefits to a pipeline's customers of the CD conversion option.[140]

134. Order 500, *supra* note 120, 52 Fed. Reg. at 30346.
135. 18 C.F.R. § 2.105 (1987).
136. *Id.*
137. *Id.*
138. Order 500, *supra* note 120, 52 Fed. Reg. at 30347.
139. *Id.*
140. *Id.* at 30348.

ANALYSIS AND CONCLUSION

Perhaps the best description of this entire problem was uttered by Judge Ginsburg in MPC II when he commented that the matter of natural gas regulation presented "baffling" difficulties for FERC. Indeed, this relatively short article cannot even begin to convey the complexity of both the industry, and the regulatory task faced by FERC. For readers not intimately familiar with the natural gas industry and FERC regulation of that industry, it may be enough to point out that the various FERC orders comprise hundreds of pages of small type in the Federal Register—which is to say nothing of the literally thousands of pages of decisional record accumulated by FERC and the thousands of hours of staff time that went into these several rulemakings. If mere industry, hard work, and, indeed, creativity were the only requirements for a successful agency rulemaking, FERC would have long since solved the country's natural gas problems.

FERC has not fully come to grips with all the difficulties, however, and may be a long way from doing so. There are three interrelated factors at work here which impede wise regulation. The rapidly changing industry itself, the sometimes hostile role of the D.C. Circuit, and congressional inaction. In the first instance, the industry is literally shifting beneath FERC's feet; trying to write rules governing the industry's conduct is much like trying to write on quicksand. The changes provoked both by the country's shifting domestic and international energy posture in general and by the NGPA's deregulation of wellhead prices in particular have substantially reconfigured the industry. As a result, FERC is trying to control, by rule, circumstances which are constantly being altered by things beyond its control. More hostile critics of the industry might also add that FERC is being asked to compensate for simply inept, sometimes downright appalling decision-making on the part of the various businesses involved. Unfortunately, this is too quick a response. Those same businesses were lulled into apathy and inaction by years of comfortable, almost riskless existence engendered by earlier models of regulation.

Second, FERC's work has been hampered by constant over-the-shoulder supervision of the D.C. Circuit which sometimes plays a larger role in agency policymaking than it might. Since FERC began its attempts to reconstruct its regulatory programs and to innovate in the area of natural gas regulation, there has been virtually no major FERC project which has not been taken to court, and there has been virtually no major project which has not been remanded by the court for reconsideration. As a consequence the policy making process at FERC has been almost Maoist—two steps forward, one step back—because of the constant "hard looks" taken by the court.

This is not to say that judicial review ought to be eliminated or that it plays only a spoiling role in agency policy making. Judicial review cannot be avoided. All major agency statutes provide for some type of review, and there are simply too many powerful and well-funded players in the natural gas controversy to avoid going to court. No one should forget that this is one of the basic industries of the country and one which generates billions of dollars a year in revenue. This is not the regulatory equivalent of the Consumer Product Safety Commission's prescribing safety standards for skateboards.

Viewed as a whole, the D.C. Circuit has been generally sympathetic to what FERC is trying to do, and FERC has almost always won on the truly fundamental questions—such as whether it has the basic power and authority to write an Order 436-style policy. It is equally clear that FERC has occasionally shot itself in the foot. For example, it is difficult if not impossible to explain FERC's various obfuscations on the take-or-pay issues when take-or-pay by anyone's analysis lies at the heart of current natural gas industry problems. Moreover, the D.C. Circuit has probably not been any more difficult or nitpicking on matters within FERC's jurisdiction than it has been with, say, regulation of the broadcast and telecommunications industry by the Federal Communications Commission.

Even so, FERC has to consider the court something of a burr under its saddle. FERC is virtually guaranteed that the court will hand back for some kind of further action nearly everything that goes up on review. While it appears to win most of the major issues, it is difficult to keep a policy in place when pieces of it keep flying back from the court. It is one thing for an agency to react after it has been told that it lacks a certain type of jurisdiction or that it violated a rulemaking procedure in promulgating a policy. It is entirely a different matter to decide how to react when a court says merely: "You didn't explain yourself sufficiently; go back and try again." This type of instruction on remand leaves something to be desired and almost guarantees piecemeal agency policymaking. Just as the D.C. Circuit frequently asks FERC to explain itself better, the court might well write more pointed and specific comments when it remands for further action.

Nonetheless, the third and most important impediment should be laid at the feet of the legislative branch. Congress has simply been derelict in carrying out its responsibilities. A quick look at the materials generated by the last several Congresses shows that the vast bulk of legislative effort and enthusiasm has been used up in developing a budget for the federal government as a whole and in reforming the tax code. There has been no significant new energy legislation since 1980, and the energy legislation which remains on the books could stand a lot of amending and refurbishing. For example, crude oil pipelines have been regulated under a model that has not changed since the breakup of Standard Oil in the early part of this century. The oil industry is radically different now, and yet Congress has not been able to get around to changing the structure of crude oil pipeline regulation. This leaves FERC the unenviable and probably impossible task of trying to perform economic regulation of the middle segment of the crude oil industry when there is virtually no price regulation at either the wellhead or the automobile gas tank.

From the standpoint of American administrative law, Congress's reluctance to amend the statutes under which natural gas is regulated severely impedes FERC's ability to cope with modern problems. At one time it might be enough to say to an agency: "This is the problem; go deal with it." It is probably not sufficient to do that these days. We live in an enormously complex and technologically sophisticated society. The problems are too complicated and the regulatory agencies are buffeted by too many powerful interest groups to be able to make wise policy in the absence of congressional guidance. The earlier understanding of the role of administrative agencies was that Congress would set broad policy and the agencies would do the day-to-day detail work necessary to carry out those policies. Through both its power to amend the enabling act and the exercise of its traditional oversight function, Congress would keep tabs on what the agencies were doing to insure that Congress's desires were being carried out.

This is simply not the case in natural gas regulation. Congress has left FERC with one fifty-year-old statute, the NGA, and one nine-year-old statute, the NGPA. The latter was passed to cope with an entirely different problem, merging the producer end of the inter- and intra state natural gas markets. Congress has thus let FERC flounder around trying to regulate natural gas pipelines. Congress owes the industry and the American public more than this.

Nor is it sufficient for Congress to point to the enormously elastic phrase "public convenience and necessity" in the NGA as an excuse for doing nothing. No one expects Congress to master or even to tackle the complicated details of industry regulation. The five hundred members of Congress, however competent, are not and never have been up to that task. But New Deal-style regulation probably no longer works in the energy industries. The regulated industries are changing too fast and it is no longer entirely clear what the "public" interest is.

Moreover, Congress changed its style of energy regulation in the late 1970's when it passed a number of highly specific energy regulation statutes. The NGPA, for example, contained extraordinarily detailed language for determining appropriate price categories for natural gas at the wellhead. Unfortunately, virtually all of that legislation was passed at a time when Congress was forced to deal with energy emergencies in the nature of severe *shortages*, rather than unanticipated surpluses. Thus, most if not all of the basic assumptions of the 1970's legislation are inappropriate to dealing with the problems that will be encountered between now and the turn of the century.

To make things even worse, Congress has not even taken steps to clean up some of the aberrations in the existing legislative structure. It is incomprehensible that the NGA remains in place to control wellhead natural gas prices of pre-NGPA natural gas when all of the so-called "new" gas is decontrolled. With total price decontrol at the wellhead, it might be easier for FERC to go about the job of regulating the pipelines. In sum, the picture is both simple and sobering: FERC will continue to have difficulty regulating natural gas until Congress lends a hand by amending or repealing applicable statutes. Conversely, action by Congress will instantly clean up many of the current problems. But until Congress acts, FERC is going to have to continue simply to limp along, trying the best it can under totally outmoded statutes construed by a sometimes less-than-sympathetic reviewing court. It is remarkable that the agency has been able to do as well as it has under the circumstances.