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Daniel Watkiss

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DEREGULATORY MYOPIA: SACRIFICING THE FILED RATE DOCTRINE AND RULE AGAINST RETROACTIVE RATEMAKING TO PROMOTE COMPETITION IN GAS MARKETS

by

Daniel Watkiss*

PROMOTING competition in the sales market for natural gas has been the premier goal of the Federal Energy Regulatory Commission (FERC)¹ since Congress partially deregulated the wellhead market for gas in the Natural Gas Policy Act of 1978 (NGPA).² A large cost obstructing transition from a pervasively regulated to a competitive wellhead market is the nearly \$8 billion in unpaid liabilities³ that most of the twenty-six major interstate natural gas pipelines currently owe gas producers pursuant to take-or-pay terms in long-term gas sales contracts.⁴ The success and

* A.B., Stanford University; J.D., University of Utah. Attorney, Powell, Goldstein, Frazer & Murphy, Washington, D.C.

1. The FERC is successor to the Federal Power Commission (FPC), 42 U.S.C. § 7172(a) (1982). The FPC's functions were transferred to the FERC on October 1, 1977, pursuant to § 401 of the Department of Energy Organization Act, 42 U.S.C. § 717(a) (1982 & Supp. 1988). See Exec. Order No. 12,009, 3 C.F.R. 142 (1977), reprinted in 42 U.S.C. § 7341 note (1982), revoked Exec. Order No. 12,553, 3 C.F.R. 204 (1986) (resetting effective date). The FERC is the regulatory agency with jurisdiction to set rates for interstate natural gas pipelines, electric utilities, and oil pipelines, and certify or license natural gas facilities and hydro-electric projects. 42 U.S.C. § 7172 (1982).

2. Pub. L. No. 95-621, 92 Stat. 3350 (codified at 15 U.S.C. §§ 3301-3432 (1982 & Supp. 1985)). See generally Pierce, *Natural Gas Policy Act of 1978—Change, Complexity, and a Major New Role for the KCC*, 47 J. KAN. B.A. 259, 261-62 (1978) (discussing federal regulation under NGPA); Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 TEX. L. REV. 101, 107 (1980) (guiding purpose of NGPA was protection of natural gas consumers). For an overview of the FERC deregulatory initiatives since passage of the NGPA, see Pierce, *Reconstituting the Natural Gas Industry from Wellhead to Burnertip*, 9 ENERGY L.J. 1, 22-51 (1988) [hereinafter Pierce, *Wellhead to Burnertip*]; S. WILLIAMS, *THE NATURAL GAS REVOLUTION OF 1985*, at 15-17 (1985). The effects of those initiatives on natural gas pipelines is reviewed in *Wagner & Brown v. ANR Pipeline Co.*, 837 F.2d 199, 204-06 (5th Cir. 1988); *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 995 (D.C. Cir. 1987), cert. denied, 108 S. Ct. 1468-69, 99 L. Ed. 2d 698-99 (1988); *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1151 (D.C. Cir. 1985), cert. denied, 476 U.S. 1114 (1986).

3. INGAA, *The Unrelenting Take-or-Pay Problem: Year-End 1987 Exposure and Costs* (April 1988) (reporting exposure of \$7.4 billion at year-end 1987; \$10 billion in 1986; \$6.1 billion in 1985; and \$4.7 billion in 1984); cf. *Pipelines' Take or Pay Costs Continue to Mount*, Oil & Gas J., Aug. 10, 1987, at 20 (forecasting \$11.7 billion in liabilities by end of 1987).

4. See H. WILLIAMS & C. MYERS, *MANUAL OF OIL AND GAS TERMS* 976-79 (7th ed.

timing of the FERC's program to promote gas sales competition now turns largely on how and if the FERC and the courts permit the pipelines to recover take-or-pay liabilities. That question has pitted each segment of the gas industry against the others, all hoping that the take-or-pay burden falls elsewhere.

The FERC's solution, set forth in its recent Order No. 500,⁵ is an unlawful retroactive rate that squarely contravenes two foundations of utility ratemaking: the filed rate doctrine and the rule against retroactive ratemaking.⁶ Order No. 500 and its initial applications by the FERC also put the

1987) (defining take-or-pay terms). Producers and purchasers commonly enter long-term contracts with take-or-pay provisions because of the substantial investment that both gas producers and natural gas pipelines make in production and transmission plant, and because of the long-term service requirements of the pipelines. See Pierce, *Natural Gas Regulation, Deregulation and Contracts*, 68 VA. L. REV. 63, 77-82 (1982). Typically, the amount of gas that the purchaser, usually a pipeline, must take from a producer or pay for is a percentage of either a fixed volume or the rate of deliverable production at the wellhead. The following clause illustrates the deliverability based take-or-pay clause that predominated since the early 1970s.

Buyer agrees to purchase and receive from Seller or to pay for if available but not taken, a quantity of gas equal to the sum of the Daily Contract Quantities herein specified. . . . The Daily Contract Quantity shall be the daily rate of production equal to seventy-five percent (75%) of the Delivery Capacity of each well.

Medina, McKenzie & Daniel, *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185, 187 (1986). "[T]he true effect of the take-or-pay clause is to assign the risk of a deteriorating natural gas market to the pipeline." *Id.* at 188; see also *International Minerals & Chem. Corp. v. Llano, Inc.*, 770 F.2d 879, 882 (10th Cir. 1985) (take-or-pay reduces producer investment risk), *cert. denied*, 475 U.S. 1015 (1986). In December 1982, the FERC announced that it would prospectively deem take-or-pay prepayments under requirements exceeding 75% of annual deliverability unjust and unreasonable and would not allow those prepayments into the rate base. Take-or-Pay Provisions in Gas Purchase Contracts; Statement of Policy, 47 Fed. Reg. 57,268 (Dec. 23, 1982) (codified at 18 C.F.R. § 2.103 (1988)), reprinted in [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,409; see Doane, *Take-or-Pay: FERC's Regulatory Dilemma*, 2 NAT. RESOURCES & ENV'T, Spring 1987, at 20. Producers and purchasers executed the majority of existing take-or-pay contracts during a severe shortage of deliverable gas in the 1970s. See *Maryland People's Counsel v. FERC*, 761 F.2d 768, 771 (D.C. Cir. 1985).

5. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Interim Rule and Statement of Policy, Order No. 500, 52 Fed. Reg. 30,334 (1987) [hereinafter Order No. 500] (to be codified at 18 C.F.R. pts. 2, 84) reprinted in [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. ¶ 30,761, modified, Order No. 500-B, 52 Fed. Reg. 39,630 (1987), reprinted in [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. ¶ 30,772, modified, Order No. 500-C, 52 Fed. Reg. 48,986 (1987) reprinted in [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. ¶ 30,786, *reh'g denied*, Order No. 500-E, 53 Fed. Reg. 16,859 (1988), 43 F.E.R.C. ¶ 61,234 (1988), *petition for review docketed sub nom. Associated Gas Distribs. v. FERC*, No. 87-1588 (D.C. Cir.). Order No. 500 is the FERC's response to the court's decision, also styled in *Associated Gas Distribs. v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), in which the court vacated and remanded the FERC's Order No. 436. *Id.* at 1044. See Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 Fed. Reg. 42,408 (1985) [hereinafter Order No. 436] (to be codified at 18 C.F.R. pts. 2, 157, 250, 284, 375, 381), reprinted in [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,665, modified, Order No. 436-A, 50 Fed. Reg. 52,217 (1985) (to be codified at 18 C.F.R. pts. 2, 157, 284, 375), reprinted in [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,675, modified further, Order No. 436-B, 51 Fed. Reg. 6398 (1986) (to be codified at 18 C.F.R. pt. 284), reprinted in [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. ¶ 30,688, *reh'g denied*, Order No. 436-C, 34 F.E.R.C. ¶ 61,404, *applications for reh'g denied*, Order No. 436-D, 34 F.E.R.C. ¶ 61,405, *reconsideration denied*, Order No. 436-E, 34 F.E.R.C. ¶ 61,403 (1986).

6. For definitions and analysis of the doctrine and rule, see *infra* text accompanying notes 39-41, 59-92.

FERC and its deregulatory programs onto a collision course with the United States Court of Appeals for the District of Columbia Circuit. Earlier this year, in *Columbia Gas Transmission Corp. v. FERC (Columbia)*,⁷ the D.C. Circuit struck and remanded a FERC decision that, like Order No. 500, would have permitted pipelines to bill customers directly for certain gas production costs in proportion to purchases those customers made during a past period even though nothing in the pipelines' then-filed tariff informed gas customers of the upcoming retroactive charge.⁸ Order No. 500 and its application in several FERC decisions are currently pending appeal to the D.C. Circuit.

This Article explains that the conflict in *Columbia* grew out of the FERC's delay in promulgating certain regulations needed to implement the phased wellhead deregulation program that Congress enacted in the NGPA.⁹ A second and more consequential conflict grows out of the FERC's current effort in Order No. 500 to reinterpret and limit the prohibition on retroactive ratemaking, not only to save Order No. 500, but also to redeem the FERC's efforts to promote competitive gas pricing and its "open-access" transportation rule. The D.C. Circuit vacated and remanded the open-access rule, embodied in the FERC's Order No. 436, precisely because of the FERC's failure to address the multi-billion dollar take-or-pay liabilities that natural gas pipelines owe to gas producers.¹⁰

In a larger context, one can view the FERC's resort to retroactive ratemaking as the result of the FERC's piecemeal efforts to restructure and partially deregulate the natural gas sales market at the pipeline level only, without regard for the consequences of that restructuring upstream at the gas wellhead or downstream in local distribution and end-use markets.¹¹ If the FERC persists, it will invite yet another judicial reversal, prolonging the take-or-pay problem, and further delaying realization of competitive well-head gas markets. This Article concludes with a discussion of ratemaking

7. 831 F.2d 1135 (D.C. Cir. 1987), *modified on reh'g*, 844 F.2d 879 (1988).

8. 831 F.2d at 1142.

9. *See id.* at 1137-38.

10. *See Associated Gas Distribs.*, 824 F.2d at 1044.

11. The natural gas industry has three primary segments: (1) producers explore for, locate, and extract gas from gas fields; (2) natural gas pipelines purchase gas from producers, process the gas, and transport the gas to local distribution companies or directly to industrial end users and residential gas consumers; and (3) local gas distribution companies purchase gas from the natural gas pipelines, or occasionally from producers directly, for resale to residential, commercial, or industrial consumers within their local market areas. *See generally* McDONALD, *NATURAL GAS: THE NECESSITY OF DEREGULATION* 5-6 (1982). Ordinarily, ownership of gas passes from producer to natural gas pipeline to local distributor or end user at each transfer. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 348 (1983). The FERC's jurisdiction to promote competitive gas sales market is limited and cannot directly reach local markets. Many local regulators insist that their local distributors receive open access to pipeline facilities at the same time that the regulators erect barriers preventing pipelines from competing with their local distributor for sales. *See National Steel Corp. v. Long*, 689 F. Supp. 729, 737 (W.D. Mich. 1988) (holding that federal jurisdiction under the NGA preempted the Michigan Legislature's enactment intended to regulate locally the access of Michigan direct purchasers to interstate pipeline sellers).

alternatives that could lawfully achieve the same goals that motivated the FERC to implement unlawful retroactive rates in Order No. 500.

I. PRELUDE TO THE PROBLEM

The current take-or-pay debacle grows out of the period immediately preceding and following enactment of the NGPA. During that period the interstate pipelines, as the nation's predominant merchants of gas and gas transportation to residential, commercial, and other end-use markets, aggressively purchased gas deliverability at the wellhead to replenish deliverability stocks that had fallen to historical lows during the mid-to-late 1970s.¹² Curtailment of services to many gas markets caused by the low deliverability stocks exposed pipelines to suits for breach of contract¹³ and to the indignation of politicians and local regulators.¹⁴ Pipelines reacted by purchasing too much gas deliverability.¹⁵ At the same time, wellhead sellers answered the bullish demand for gas with excessive prices and unreasonably high minimum-take contract requirements.¹⁶

Soon after enactment of the NGPA, this seller's market collapsed in economic recessions,¹⁷ the collapse of oil prices, restricted gas demand,¹⁸ and

12. *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1149-52 (D.C. Cir. 1985); *Subcommittee on Intergovernmental Relations of the Comm. on Governmental Affairs, the Status of the Nation's Preparedness for the Winter of 1977-78*, 95th Cong., 1st Sess. 3-4 (1977); S. BREYER, *REGULATION AND ITS REFORM* 244-53 (1982); see also *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621, 626 n.2 (1972) (quoting an FPC Statement that reported 10.3% drop in proven reserves of gas in lower 48 states between 1967 and 1970); Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 965-67 (1973) (analyzing gas shortages in 1971 and 1972 and predicting future shortages). In fact, the shortfall of deliverability that tormented natural gas markets in the winter of 1976-77 ended by 1978 when the NGPA was enacted. See *Existing Plants Using Natural Gas Freed of Near-Term Fuel Switching Mandate*, 1978 ENERGY USERS REPORT (BNA) 6 (Nov. 16, 1978) (recognizing gas surplus of one trillion cubic feet).

13. See *United Gas Pipe Line Co. v. FERC*, 824 F.2d 417, 425-30 (5th Cir. 1987) (certificate or tariff no bar to fault-based liability); Note, *Contractual Liability of Pipelines for Damages Caused by Gas Supply Curtailments: Texasgulf, Inc. v. United Gas Pipeline Co.*, 6 ENERGY L.J. 281, 287-89, 290-95 (1985) (discussing pipeline's duty of care); cf. *Tennessee Gas Pipeline Co., Opinion No. 249*, 36 F.E.R.C. ¶ 61,071, at 61,174 (1986) (rejecting defense of fixed cost minimum commodity based on certificate since pipeline "faces no penalty for failure to meet its customer's [sic] contract requirements"); cf. *Rossin v. Southern Union Gas Co.*, 472 F.2d 707, 711 (10th Cir. 1973) (rejecting absolute liability for utility's failure to provide service).

14. *Associated Gas Distribs.*, 824 F.2d at 1027 (Pipelines "caught in an unusual transition. They entered into now uneconomic contracts in an era when government officials berated pipeline management for failures of supply and constantly predicted energy price escalations.").

15. See Doane, *supra* note 4, at 18; Pierce, *Wellhead to Burnertip*, *supra* note 2, at 14.

16. See Threadgill, *Anticompetitive Abuse by Producers Under the Natural Gas Policy Act*, PUB. UTIL. FORT., Mar. 3, 1988, at 15, 16-18 (alleging producer abuses and anticompetitive provisions in wellhead sales contracts entered between 1979 and 1982).

17. See generally *Maryland People's Counsel v FERC (MPC-I)*, 761 F.2d 768, 771 (D.C. Cir. 1985); Doane, *supra* note 4, at 14; Pierce, *supra* note 11, at 352. The Energy Information Administration (EIA) recently concluded that existing take-or-pay liabilities present a problem "so widespread that it is likely to be more related to universal factors affecting the industry than to any choices made by the [pipeline] companies." EIA, *NATURAL GAS MONTHLY*, Apr. 1, 1988, at 14 [hereinafter EIA].

18. A companion statute to the NGPA, the Power Plant and Industrial Fuel Use Act of 1978, Pub. L. No. 95-620, 92 Stat. 3289 (1979) (codified in scattered sections of 15, 42, 45, 49

take-or-pay liability began to climb inexorably as pipelines were unable to market gas up to their minimum wellhead take obligations. Gas prices, however, did not follow the downward path of demand.¹⁹ The incongruence of price and demand demonstrated that wellhead gas markets had become price-insensitive due to the rigid gas pricing categories of the NGPA²⁰ and other regulatory barriers to competitive gas purchasing, including the monopoly or monopsony control pipelines exerted over gas transmission.²¹

The FERC responded to this changing market by promoting special gas marketing programs that, until stricken by the courts, allowed limited competitive pricing and sales of over-abundant pipeline supplies to the pipelines' noncaptive markets.²² At the same time, the FERC focused on changing the relationships between pipelines and their purchasers, predominantly local distributors. First, it promulgated Order No. 380,²³ in which it used its authority under sections 42²⁴ and 52²⁵ of the Natural Gas Act (NGA) to strike from pipeline tariffs variable-cost minimum commodity bills, which in a manner similar to take-or-pay requirements forced purchasers to pay a portion of gas supply charges even for gas not actually taken.²⁶ The intended

U.S.C.) restricted permissible uses of natural gas. See *Pierce, Wellhead to Burnertip*, *supra* note 2, at 11.

19. See ASSISTANT SECRETARY FOR POLICY, SAFETY & ENVIRONMENT, U.S. DEP'T OF ENERGY, INCREASING COMPETITION IN THE NATURAL GAS MARKET: THE SECOND REPORT REQUIRED BY SECTION 123 OF THE NATURAL GAS POLICY ACT OF 1978, at 8, table 1-3, 17 (DOE/PE-0069 Jan. 1985).

20. See *Wagner & Brown v. ANR Pipeline Co.*, 837 F.2d 199, 205 (5th Cir. 1988) (cases cited therein); *Maryland People's Counsel v. FERC (MPC-II)*, 761 F.2d 780, 781 (D.C. Cir. 1985).

21. See *Wagner & Brown*, 837 F.2d at 205; *Pierce, Wellhead to Burnertip*, *supra* note 2, at 15-16, 22-24.

22. These programs, which came to be known as special marketing programs or SMPs, created dual pipeline sales markets in which the pipelines could selectively discount gas sales or transportation to price-sensitive and fuel-switchable customers while continuing to bill fully allocated rates to captive customers. See *Nowak & Leitch, Maryland People's Counsel: Will It Spur Changes in FERC's Regulation of the Natural Gas Industry?*, 6 ENERGY L.J. 265, 267-72 (1985); *Pierce, Wellhead to Burnertip*, *supra* note 2, at 24. In companion cases, two panels of the court held that, by creating two classes of customers with substantially different access to regulated gas supply, the SMPs violated the NGA's prohibition on undue discrimination. *MPC-I*, 761 F.2d at 772; *MPC-II*, *id.* at 781-82.

23. Elimination of Variable Costs from Certain Natural Gas Minimum Commodity Bill Provisions, Order No. 380, 49 Fed. Reg. 22,778 (1984) [hereinafter Order No. 380] (codified at 18 C.F.R. pt. 154), reprinted in [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,571, *aff'd sub nom. Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1168 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986). See generally Note, *Elimination of Variable Costs from Natural Gas Minimum Bills: Wisconsin Gas Co. v. FERC*, 7 ENERGY L.J. 131 (1986).

24. 15 U.S.C. § 717c (1982).

25. *Id.* § 717d.

26. A minimum commodity bill requires a pipeline customer to pay a commodity charge, either variable or fixed components, irrespective of whether the customer actually purchases and takes delivery of any gas. *E.g., Wisconsin Gas Co.*, 770 F.2d at 1150; *Mississippi River Trans. Corp. v. FERC*, 759 F.2d 945, 948-49 (D.C. Cir. 1985). It is "a type of contractual take-or-pay arrangement between a pipeline and its customer, whereby the customer is obligated to take a minimum amount of gas or else pay for the variable [or fixed] cost of the gas not taken." Doane, *supra* note 4, at 20. Distinct from a minimum bill is a minimum take requirement, which obliges a customer actually to take delivery and pay. Like the take-or-pay clause in upstream wellhead contracts, the minimum bill shifts the risk of a deteriorating natural gas market downstream. *Cf. Medina, McKenzie & Daniel*, *supra* note 4, at 188 (discussing

and actual result of Order No. 380 was to increase the flexibility of downstream gas consumers, enabling them to purchase from gas suppliers other than their traditional pipeline gas merchants.²⁷ The unintended, although foreseeable, result of Order No. 380 was to decrease demand for the pipelines' gas, which exacerbated their take-or-pay exposure at the wellhead.

Order No. 380 represented only part of the FERC's deregulatory equation. Because the pipelines are contract carriers²⁸ under the NGA, and not common carriers, which are accessible to all customers at nondiscriminatory tariff rates, the pipelines remained largely free to refuse to transport for customers who had used their new flexibility under Order No. 380 to buy gas from competing gas sellers. The FERC responded in 1985 with its "open-access transportation" proposal in Order No. 436,²⁹ which cajoles but does not force pipelines to assume "open-access" carriage, allowing all gas sellers to compete head on with the pipelines and then use the pipelines' transportation system to get their gas to markets. The pipelines' acquiescence to Order No. 436 could only further reduce traditional pipeline sales,³⁰ exacerbating take-or-pay liabilities that had already soared into the billions of dollars. Accordingly, the pipelines only grudgingly acceded to Order No. 436.³¹

Many local distribution companies and their state regulators did not help this situation. Notwithstanding declining real demand for gas in their markets, the local distribution customers of the pipelines, often under pressure from local regulators, have required the pipelines to hold unrealistically high

risk shift under take-or-pay clause). Order No. 380 invalidated only the variable cost component of minimum commodity bills; in later individual rate hearings the FERC eliminated the fixed component of most pipeline minimum bills. *E.g.*, Trunkline Gas Co., Opinion No. 297, 42 F.E.R.C. ¶ 61,201, at 61,699 (1988); East Tennessee Natural Gas Co., 41 F.E.R.C. ¶ 61,165, at 61,421 (1987); KN Energy, 40 F.E.R.C. ¶ 61,263, at 61,873 (1987); Transcontinental Gas Pipe Line Corp., Opinion No. 260-A, 40 F.E.R.C. ¶ 61,188, at 61,592 (1987). At least one federal district court has found that, under a specific contract, Order No. 380 was an unforeseeable event, constituting *force majeure* and excusing the pipeline purchaser from the take-or-pay liability. *Burkhart Petroleum Corp. v. ANR Pipeline Co.*, No. 87-C-257-C (N.D. Okla. June 30, 1988).

27. *See Wisconsin Gas Co.*, 770 F.2d at 1151; Order No. 380, *supra* note 23, 49 Fed. Reg. 22,782-83, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,961-63; Doane, *supra* note 4, at 21.

28. Congress rejected proposals that would have made the gas pipelines into common carriers, like oil pipelines. Instead, it adopted in the NGA a public utility regulatory scheme under which pipelines retained control over customers they would contract with, subject to restrictions prohibiting undue discrimination or preference between those customers to the extent the customers were similarly situated. *See Associated Gas Distribs.*, 824 F.2d at 997.

29. FERC found in Order No. 436 that pipelines were discriminatorily denying to transport gas in competition with their own gas sales. Since pipelines control an essential facility, these denials were unduly discriminatory and preferential under the NGA. Based on that finding, Order No. 436 makes available procedures for obtaining transportation service certificates on condition that a pipeline make its capacity available to anyone who requests transportation, including competitors in the sales market and their customers. Order No. 436, *supra* note 5, 50 Fed. Reg. 42,408, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,495.

30. *See Pierce, Wellhead to Burnertip*, *supra* note 2, at 35-36.

31. *See Griggs, Restructuring the Natural Gas Industry: Order No. 436 and Other Regulatory Initiatives*, 7 ENERGY L.J. 71, 97 (1986) (few major pipelines are operating as "open-access" transporters under permanent tariffs today); *see also* Doane, *supra* note 4, at 21; Pierce, *supra* note 2, at 35.

levels of gas deliverability subject to take-or-pay obligations.³² At the same time, the distribution companies and their regulators have often led the charge to free the local companies to buy gas from sellers rather than the traditional pipeline suppliers.³³ This local perspective illustrates that the players in local markets want to retain the traditional security of a pipeline gas supplier, which assuages the politically understandable fear of a recurrence of the gas shortages of the 1970s, while at the same time they insist that the traditional pipeline supplier's sales market be exposed to increasing competition and, *ipso facto*, less security.

In *Associated Gas Distributors v. FERC*³⁴ the United States Court of Appeals for the District of Columbia Circuit largely affirmed the coercive, but not mandatory, open-access carriage scheme of Order No. 436.³⁵ The court nevertheless vacated and remanded that order with instructions that the FERC either act or explain its inaction regarding the burgeoning take-or-pay liabilities that Orders No. 380 and No. 436 had exacerbated.³⁶ The FERC's response, on which the success of its deregulatory initiatives may now depend, has been to continue to ignore the core of the problem: the pipelines' post-curtailed gas purchases and the resulting wellhead contracts between the pipelines and wellhead sellers. Instead, the FERC offered Order No. 500, which permits the pipelines to charge a fixed direct bill of up to one-half of their take-or-pay costs to downstream customers.³⁷ The pipe-

32. Illustrative of the conflicting interests of local distributors and their pipeline suppliers is the recent decision in *National Steel Corp. v. Long*, 689 F. Supp. 729 (W.D. Mich. 1988). The Michigan distribution companies, which had litigated and lobbied extensively to compel their pipeline suppliers to become open-access transporters of gas that the distribution companies would buy themselves, had obtained protective state legislation that allowed the state of Michigan to prohibit those pipeline suppliers from bypassing the local distributors and competing for the industrial direct-sales market. The district court, however, invalidated the legislation on the grounds that the state's authority was federally preempted in the NGA. *Id.* at 737; *cf.* Order No. 436, *supra* note 6, 50 Fed. Reg. 42,468-69, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,571-72 (discussing local opposition to bypass). Traditionally, the FERC has favored direct sales by local distributors only. *See* *Panhandle E. Pipe Line Co. v. Michigan Pub. Serv. Comm'n*, 341 U.S. 329, 336 (1951). That policy began to change around 1986. *See* IV NATURAL GAS CONTRACTS, *Contract Rept.* at 2-4 (May 1988).

33. For example, in 1984, the Pennsylvania legislature directed its public utility commission to deny local gas distributors' rate increase applications unless the commission finds that the "utility is pursuing a least cost fuel procurement policy" including taking all steps "necessary . . . to [obtain] relief[] from existing [gas supplier] contract terms which are or may be adverse to the interests of the utility's ratepayers." 66 PA. CONS. STAT. ANN. § 1318(a) (Purdon Supp. 1988); *see* *Kentucky W. Va. Gas Co. v. Pennsylvania Pub. Util. Comm'n*, 837 F.2d 600 (3d Cir. 1988) (upholding constitutionality of Act 74), *petition for cert. filed* July 15, 1988.

34. 824 F.2d 981 (D.C. Cir. 1987).

35. *Id.* at 1024 (analogizing pipeline's "choice" under Order No. 436 to that of condemned man choosing between hangman and firing squad).

36. *Id.* at 1030; *see also* *Consolidated Edison Co. v. FERC*, 823 F.2d 630, 640 (D.C. Cir. 1987); EIA, *supra* note 17, at 4 ("asymmetry of Order No. 380 . . . resulted in the pipeline companies having an increasingly difficult time selling gas that they were obligated to purchase").

37. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784-87. In order to qualify for an Order No. 500 direct bill a pipeline must become an "open-access" transporter under Order No. 436 and agree to absorb from 25 to 50% of its take-or-pay settlement costs. *Id.*, 52 Fed. Reg. 30,341-43, [Regs. Preambles 1986-1987], F.E.R.C. Stats. & Regs. at 30,784-87. "[T]hen it will be permitted to recover an equal amount from its customers through a fixed take-or-pay charge." *Id.*, 52 Fed. Reg.

lines are permitted to charge the downstream customers, not in relation to current services to those customers, but rather in relation to how much those customers reduced their pipeline gas purchases during periods up to seven years earlier.³⁸

II. RATE CERTAINTY AND ENFORCEMENT OF THE FILED RATE DOCTRINE

The filed rate doctrine is the statutory requirement that "forbids a regulated entity to charge rates for its services other than those properly filed with [and approved by] the appropriate federal regulatory authority."³⁹ The rule against retroactive ratemaking enforces the filed rate doctrine by ensuring that the FERC change filed rates only prospectively and by "bar[ring] . . . the [FERC's] retroactive substitution of an unreasonably high or low [filed] rate with a [new] just and reasonable rate."⁴⁰

The FERC has traditionally applied the filed rate doctrine and the rule against retroactive ratemaking in the same manner as the courts, but in *Columbia*⁴¹ and Order No. 500 the FERC abandoned the traditional definition of retroactive ratemaking. The traditional definition focuses on the need of both regulated sellers and their purchasers to be sure at the time they decide to sell or buy what price they will actually receive or pay and recognizes the regulators' need to control monopoly pricing of utility services. These objectives are justified under the rubric of rate certainty. By contrast, the rule as now viewed by the FERC simply requires that rates only recover "current" costs. The FERC's view, in effect, simply requires that rates recover costs that, on a cash accounting basis, can be characterized as current.⁴²

A. *The Emerging Conflict Between the FERC and the Court*

In *Columbia* the D.C. Circuit struck and remanded five FERC orders issued in 1985 and 1986.⁴³ The orders authorized five gas pipelines to bill

30,338, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,779. The balance between 25 and 50% "may be billed," to the extent marketable, "through a commodity surcharge, or a volumetric surcharge on pipeline throughput." *Id.*

38. *Id.*, 52 Fed. Reg. 30,341-42, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. 30,785 (adopting Recovery of Take-or-Pay Buy-Out and Buy-Down Costs by Interstate Natural Gas Pipelines, Proposed Policy Statement, 38 F.E.R.C. ¶ 61,230 [hereinafter Proposed Policy Statement]).

39. *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 (1981); accord *Montana-Dakota Utils. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251 (1951). In *Arkansas La. Gas Co.* the Court recognized a possible exception where the misconduct of a party to a tariff transaction resulted in a failure to change a filed rate when the change otherwise would have been permissible. 453 U.S. at 583 n.13. A lower federal court recently concluded that a mere negligent misrepresentation was insufficient to invoke that possible exception. *Southern Union Co. v. FERC*, No. 87-1232, slip op. at 12 (D.C. Cir. Sept. 23, 1988).

40. *City of Piqua, Ohio v. FERC*, 610 F.2d 950, 954 (D.C. Cir. 1979); accord *Arkansas La. Gas Co.*, 453 U.S. at 578.

41. 831 F.2d at 1135.

42. See Order No. 500, *supra* note 5, 52 Fed. Reg. 30,347, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,793. The FERC's current definition of retroactive ratemaking as an accounting rule is analyzed *infra* text accompanying notes 93-111.

43. 831 F.2d at 1142.

their customers for the pipelines' payments to gas producers for certain production-related costs⁴⁴ in proportion to the amounts of gas purchased by those customers during periods up to six years earlier.⁴⁵ According to the court, the orders unlawfully imposed rates retroactively in violation of the filed rate doctrine.⁴⁶

The court rejected both of the FERC's defenses: that the orders promoted equity and that, in any event, the orders did not constitute retroactive ratemaking because FERC orders issued in 1980 and 1983 had allegedly given the pipeline customers notice at the time they purchased the gas that they would later be liable for the production-related costs at issue. The court did not directly address the FERC's assertion of equity,⁴⁷ implying simply that retroactive rates are inherently inequitable.⁴⁸ The court rejected the FERC's contention that the targeted customers were on notice that past purchases would later give rise to additional charges for production-related costs, and held that notice must be actual and cannot be imputed.⁴⁹

In stark contrast with the court's analysis in *Columbia*, the FERC re-

44. "Production-related" is a term of art that describes activities and costs associated with the extraction of gas at the wellhead as opposed to activities and costs associated with the transmission, storage, or distribution of gas after it is pumped from underground gas reservoirs. The first step in formulating rates for utility service, functionalization, focuses on this distinction based on the phase of gas marketing from wellhead to burnertip. For a discussion of functionalization, see *infra* text accompanying notes 197, 269-74. Production-related costs are of regulatory significance under the NGPA because sellers can recover production-related costs in first sales of gas as an add-on to the otherwise applicable maximum lawful price governing that gas under the NGPA. See 15 U.S.C. § 3319 (1982). As defined in the NGPA, production-related costs are "any costs of compressing, gathering, processing, treating, liquefying, or transporting such natural gas, or other similar costs, borne by the seller and allowed for, by rule or order, by the Commission." *Id.* § 3320(a)(2). At issue in *Columbia* were compression costs, for which the FERC did not provide a mechanism for recovery until late 1985, seven years after the NGPA was enacted.

45. The FERC orders provided for billing in proportion to customers' purchases during the period of 1980 through 1983. The first FERC order that authorized the billing scheme became a final order in late 1985. Transcontinental Gas Pipe Line Corp., 32 F.E.R.C. ¶ 61,230, *reh'g and clarification denied*, 33 F.E.R.C. ¶ 61,213 (1985). The FERC soon issued additional orders authorizing the billing scheme. *E.g.*, Texas E. Trans. Corp., 32 F.E.R.C. ¶ 61,493, *reh'g denied*, 33 F.E.R.C. ¶ 61,257 (1985); Texas Gas Trans. Corp., 33 F.E.R.C. ¶ 61,032, *reh'g denied*, 33 F.E.R.C. ¶ 61,359 (1985); Panhandle E. Pipe Line Co., 33 F.E.R.C. ¶ 61,218 (1985), *reh'g denied*, 34 F.E.R.C. ¶ 61,231 (1986); Trunkline Gas Co., 33 F.E.R.C. ¶ 61,217 (1985), *reh'g denied*, 34 F.E.R.C. ¶ 61,021 (1986).

46. 831 F.2d at 1141.

47. The FERC's first line of defense was that the direct bill produced an equitable result: The Commission . . . determined that allocating these costs to the pipelines' customers on the basis of volumes purchased at the time the costs were incurred "will equitably bill customers for the higher amounts they should have paid based on actual purchases during the past billing periods." This is a sound reason for adopting the direct billing method; thus the Commission's choice of that method is rationally based.

Id. at 1140 (quoting Brief for FERC at 13). The direct bill, in other words, simply made those customers who bought gas in the past pay for the compression of that gas just as if compression costs had been billed when the purchases were made.

48. The court passed this argument and went right to the law of the filed rate doctrine. "[T]he effect of the orders is quite clear: downstream customers are expected to pay a surcharge, over and above the rates on file at the time of the sale, for gas they had already purchased." 831 F.2d at 1140.

49. *Id.*

cently proposed in its Order No. 500 to allow gas pipelines to bill customers directly, based on purchasing decisions made by those customers up to seven years ago, for the costs of settling producer take-or-pay obligations.⁵⁰ Even though Order No. 500 was simply a statement of FERC policy, the FERC has imposed the take-or-pay direct bill whenever pipelines have sought to recover their take-or-pay payments outside of their current commodity charge.⁵¹ Gas pipelines have argued that conventional commodity classification of the take-or-pay payments would render their gas supplies unmarketable.⁵² Without endorsing the pipelines' marketability contention,⁵³ the FERC nevertheless continued to authorize the direct bill and has repeatedly denied objections that the direct bill is retroactive.⁵⁴

The FERC's response to the claims of retroactive ratemaking has been fourfold. First, the FERC contends that it is the date on which a regulated entity incurs a cost, and not the use of past activities such as purchase decisions as the basis for allocating a direct bill among customers, that determines whether a rate recovering that cost is retroactive.⁵⁵ Second, the FERC has asserted that, even if its take-or-pay direct bill is retroactive, the billing mechanism is nevertheless justified because the customers targeted by the direct bill, unlike those customers in *Columbia*, had actual notice that a later charge would follow when they made their past purchase decisions.⁵⁶ Third, the FERC has intermittently argued that customer purchasing decisions in the past created the pipelines' take-or-pay obligations and, therefore, past purchases provide the only equitable basis for recovering those costs from customers.⁵⁷ Fourth, and most recently, the FERC argued in *Colum-*

50. See *infra* text accompanying notes 93-101.

51. *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 (D.C. Cir. 1974) ("When the agency applies [a general statement of] the policy in a particular situation, it must be prepared to support the policy just as if the policy statement had never been issued."). The FERC's exclusive reliance on the Order No. 500 policy statement to decide pending rate cases is currently being challenged as an improper use of general statements of policy. See Appellant Texas Gas Transmission Corp.'s Motion for Summary Disposition, *Texas Gas Trans. Corp. v. FERC*, No. 88-1167 (D.C. Cir. filed April 14, 1988).

52. *E.g.*, *Transwestern Pipeline Co.*, 40 F.E.R.C. ¶ 61,324, at 61,992-94 (1987).

53. See *id.* at 61,994 ("We find that . . . an opportunity [to recover take-or-pay costs] is provided in our current policy which allows pipelines to include in their commodity rates all prudently incurred take-or-pay costs."); accord *Order No. 500*, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,785.

54. *E.g.*, *Order No. 500*, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,785; *United Gas Pipeline Co.*, 42 F.E.R.C. ¶ 61,197, at 61,681 (1988), *petition for review docketed sub nom.* *Baltimore Gas & Elec. Co. v. FERC*, No. 88-1161 (D.C. Cir. Feb. 29, 1988).

55. *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. ¶ 61,175, at 61,630 (1980) (proposal to bill now based on purchase reductions from 1981 to 1984 "does not constitute retroactive ratemaking because it does not seek to recover costs incurred in a prior period"), *petition for review docketed sub nom.* *Associated Gas Distribs. v. FERC*, No. 88-1388 (D.C. Cir. May 27, 1988); see also *Order No. 500*, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787 (direct bill is not a retroactive rate because it "would enable pipelines to recover in their future rates costs which they have actually incurred but have not recouped").

56. See, *e.g.*, *United Gas Pipeline Co.*, 42 F.E.R.C. at 61,681 (1988); *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. at 61,630 (1988).

57. The FERC has advanced this argument only by implication. For example, in defending the past-purchase-deficiency billing mechanism, the FERC asserted:

bia, but not in Order No. 500, that section 4(d) of the NGA empowers the FERC to waive the filed rate doctrine.⁵⁸

B. Defining the Issue

To understand why the D.C. Circuit condemned, while the FERC embraced, a rate mechanism that currently bills utility customers based on past purchasing decisions, the reader must understand the difference between how the court and the current FERC have defined the rule against retroactive ratemaking. Both the court and the FERC have defined the filed rate doctrine as a requirement that utilities charge only final rates that the utility has filed with the regulator and the regulator has approved. The area of the law in which the court and the current FERC have fundamentally differed lies in the court's traditional view that the rule against retroactive ratemaking enforces rate certainty by insuring that a purchaser will pay and a utility seller will collect only the rate on file when the purchase and sale decisions are made. By requiring that rates be implemented only prospectively, the rule against retroactive ratemaking preserves the regulator's ability to influence sale and purchase decisions. Retroactive changes in the design of a rate, on the other hand, come after the fact and thus cannot influence sales or purchases. The FERC, by contrast, now defines the rule as an accounting protocol limiting rate recovery to current utility payments, irrespective of whether the sellers and purchasers knew who would ultimately pay when they made the sale and purchase decisions.

1. The Regulator's Primary Jurisdiction to Prescribe Rates for Regulated Services

The filed rate doctrine, which is based on "straightforward principles, . . . forbids a regulated entity to charge rates for its services other than those properly filed with the appropriate federal regulatory authority."⁵⁹ In one of

[T]he Commission [does not] believe the [direct billing] proposal unfairly prejudices parties who followed a least-cost gas purchasing strategy. Commission actions that enabled pipeline customers to purchase gas from alternative sources at lower prices *may have* resulted in an increase in pipeline take-or-pay obligations. . . . [I]t is reasonable that the beneficiaries of Commission initiatives to increase competition in the natural gas industry should share in the transition costs [of] . . . the industry's restructuring.

Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787 (emphasis added). The FERC has implied that this purported cause-and-effect relationship is the basis for past-purchase-deficiency billing. *Id.*, 52 Fed. Reg. 30,345, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,791 ("allocation of take-or-pay costs [should] reflect the causation of the . . . costs"). At the same time, the FERC has conceded that it had not and *could not* show specific and quantifiable cause-and-effect relations. *See id.*, 52 Fed. Reg. 30,337, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,778-79; El Paso Natural Gas Co., 42 F.E.R.C. ¶ 61,024, at 61,148 (1988); Tennessee Gas Pipeline Co., 40 F.E.R.C. ¶ 63,008, at 65,082 (1987) ("difficult, if not impossible, to trace directly a particular take-or-pay obligation to a particular customer").

58. *Columbia Gas Trans. Corp. v. FERC*, 844 F.2d 879, 880 (D.C. Cir. 1988) (allowing FERC to pursue waiver defense on remand). The waiver defense is analyzed *infra* in text accompanying notes 174-94.

59. *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 (1981).

its earliest decisions on the filed rate doctrine as applied under the Interstate Commerce Act (ICA), the Supreme Court instructed a rail carrier that it must "abide absolutely by the [filed] tariff . . . [and] so long as it [is] of force In this respect, [the tariff is] to be treated as though it [were] a statute, binding as such upon [r]ailroad and shipper alike."⁶⁰

This definition of the filed rate doctrine underscores the statutory primacy of the regulator's primary jurisdiction to police just and reasonable utility rates under applicable enabling legislation.

[T]he filed rate doctrine . . . assure[s] effective . . . oversight of the rates at which power [or any other regulated service] is sold. "The considerations underlying the [filed rate] doctrine . . . are preservation of the agency's *primary jurisdiction* over reasonableness of rates and the need to insure that regulated companies charge only those rates of which the agency has been made cognizant."⁶¹

The statutory basis of the filed rate doctrine is twofold. First, pipelines, electric utilities, and other carriers must publicly file their rates.⁶² Second, they must thereafter charge only final filed rates that the regulator has determined to be just and reasonable.⁶³ The doctrine is applied most prominently in ratemaking under either the Federal Power Act [FPA] or the NGA.⁶⁴

Sections 4(c) and 4(d) of the [NGA] require sellers of natural gas in interstate commerce to file their rates with the Commission. Under § 4(a) of the Act, . . . rates . . . for sale and transportation of natural gas are lawful only if they are "just and reasonable." No court may substitute its own judgment . . . for the judgment of the Commission. The authority to decide whether the rates are reasonable is vested by § 4 of the Act solely in the Commission, see *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944), and "the right to a reasonable rate is the right to the rate which the Commission files or fixes," *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951). Except when the Commission permits a waiver, no regulated seller of natural gas may collect a rate other than the one filed with the Commission.⁶⁵

Statutory parallels govern not only the largely identical federal regulation of electric utilities under the FPA,⁶⁶ but also railroads,⁶⁷ motor carriers,⁶⁸

60. *Pennsylvania R.R. v. International Coal Mining Co.*, 230 U.S. 184, 197 (1913); see *Northwestern Pub. Serv. Co. v. Montana-Dakota Utils. Co.*, 181 F.2d 19, 22 (8th Cir. 1950) (rates filed and approved are lawful until changed in a way that is provided for by statute), *aff'd*, 341 U.S. 246 (1951).

61. *City of Girard, Kan. v. FERC*, 790 F.2d 919, 922 (D.C. Cir. 1986) (emphasis added) (citing *City of Cleveland v. FPC*, 525 F.2d 845, 854 (D.C. Cir. 1976)).

62. NGA, 15 U.S.C. § 717c(d) (1982); FPA, 16 U.S.C. § 824d(d) (1982).

63. See *supra* notes 39-40 and accompanying text.

64. *Public Serv. Co. v. FERC*, 600 F.2d 944, 957 (D.C. Cir.), *cert. denied*, 444 U.S. 90 (1979).

65. 453 U.S. at 576-77 (footnote omitted). The FERC also held that the filed rate doctrine and the rule against retroactive ratemaking limit the effective date of wellhead contract rates under the NGPA. *Transcontinental Gas Pipe Line Corp.*, 17 F.E.R.C. ¶ 61,232, at 61,453 (1981).

66. See, e.g., *Southern Cal Edison Co. v. FERC*, 805 F.2d 1068, 1070 n.2 (D.C. Cir. 1986); *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 492-93 (D.C. Cir. 1985); *Anaheim v.*

and oil pipelines⁶⁹ under the Interstate Commerce Act. Courts have also used the filed rate doctrine and the rule against retroactive ratemaking to bar retroactive telephone rates⁷⁰ and bus fares.⁷¹

Under each of these statutory schemes the regulator alone possesses exclusive jurisdiction to decide whether *proposed* rates are just and reasonable.⁷² In turn, only just and reasonable rates are allowed to become final, filed rates.⁷³ When a customer challenges *existing* final, filed rates, the regulator decides the sufficiency of the challenge;⁷⁴ the regulator then has exclusive jurisdiction to set new just and reasonable rates for the utility to file and thereafter observe if the regulator deems the existing rates unlawful.⁷⁵ In *Electrical District No. 1 v. FERC*,⁷⁶ the D.C. Circuit emphasized the overriding significance of the filed rate doctrine in the context of changing *existing* rates that the regulator found no longer just and reasonable. The court confronted a claim that when a customer successfully challenged existing rates and the regulator found the rates to be unjust and unreasonable, the regulator must *immediately* prescribe and implement lawful rates. Based on the filed rate doctrine, the court rejected this contention and held that the old rates remain in force, *until the utility files and the regulator accepts a compli-*

FERC, 669 F.2d 799, 807-08 (D.C. Cir. 1981); *Public Serv. Co.*, 600 F.2d at 957-58 (cases apply filed rate doctrine and rule against retroactive ratemaking to electric utilities).

67. See *Lowden v. Simond-Shields-Lonsdale Grain Co.*, 306 U.S. 516, 520 (1939) ("Under § 6 of the Interstate Commerce Act the carrier cannot deviate from the rate specified in the tariff") (citing Act of Feb. 4, 1887, ch. 104, 24 Stat. 379, 389 (codified as amended at 49 U.S.C. § 6(7) (1920)); *Pennsylvania R.R.*, 230 U.S. at 197. Part I of the ICA, governing rail tariffs, does permit retroactive refunds called reparations. See *infra* note 80.

68. See *T.I.M.E. Inc. v. United States*, 359 U.S. 464, 468-71 (1959) (construing the Motor Carrier Act of 1935).

69. See *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631, 642 (1978) (discussing § 15 of ICA as augmented by Hepburn and Mann Elkins Act). As with all rates regulated under Part I of the ICA, retroactive refunds, called reparations, may be available. See *infra* note 80.

70. *Nader v. FCC*, 520 F.2d 182, 202 (D.C. Cir. 1975).

71. See *Payne v. Washington Metro Area Transit Comm'n*, 415 F.2d 901, 910-11 (D.C. Cir. 1968).

72. E.g., *Arkansas La. Gas Co.*, 453 U.S. at 452-53 (natural gas pipelines under NGA); *T.I.M.E.*, 359 U.S. at 475 (motor carriers under ICA); *City of Cleveland v. FPC*, 525 F.2d 845, 854 (D.C. Cir. 1976) (electric utilities under FPA).

73. In keeping with the rule against retroactive ratemaking, final rates are not subject to refund. Final rates contrast with filed rates, which, pending a determination as to justness and reasonableness, are allowed to go into effect expressly subject to refund. See, e.g., *FPC v. Sunray DX Oil Co.*, 391 U.S. 9, 23-25 (1968) (last final rate sets floor under NGA and cannot be reduced via refunds); cf. *Public Serv. Co.*, 6 F.E.R.C. ¶ 61,299, at 61,710 (1979) (addressing analogous concept applied to formula rates or rate trackers on gas or fuel costs that go into effect as a mathematical formula, without the regulator determining that any specific rate level is just and reasonable).

74. This jurisdiction to determine the lawfulness of a rate under NGA § 4 and FPA § 204 is exclusive. *Arkansas La. Gas Co.*, 453 U.S. at 577 (NGA); *Montana-Dakota*, 341 U.S. at 250 (FPA). Jurisdiction to decide challenges to existing rates is primary, but not exclusive.

75. See, e.g., *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986) (no court may substitute its judgment as to what rate is reasonable (quoting *FPC v. Southern Cal. Edison Co.*, 376 U.S. 205, 215-16 (1964))); *Arkansas La. Gas Co.*, 453 U.S. at 578 (FERC shall determine just and reasonable rate to be observed); *Montana-Dakota*, 341 U.S. at 251-52 ("right to a reasonable rate is the right to the rate which the Commission files or fixes").

76. 774 F.2d 490 (D.C. Cir. 1985).

ance tariff setting forth the new rates.⁷⁷

2. Efficiency and Fairness through Rate Certainty and Rate Design

The next step in understanding how the courts have defined the rule against retroactive ratemaking is to determine why the rule is essential to the enforcement of the filed rate doctrine and to the regulator's primary jurisdiction to fix final rates. Three interrelated prohibitions within the rule against retroactive ratemaking enforce the filed rate doctrine. The first two focus on *rate certainty*. Court and agency decisions have affirmed, on the one hand, the regulated utilities' right to rely on, and collect, filed rates without threat of refund, so long as the utilities actually charge the filed rate.⁷⁸ On the other hand, court and agency decisions have protected purchasers of utility services by forbidding surcharges after the purchasers made their purchase decisions based on filed rates that, for whatever reason, later prove to have been too low.

Both lines of cases bar retroactive ratemaking,⁷⁹ although courts sometimes refer to the prohibition against requiring utilities to make refunds below filed rates as a bar on reparations.⁸⁰ The cases enforce the regulated

77. *Id.* at 494. The result in *Electric Dist. No. 1* should be distinguished from cases in which the courts lowered rates pursuant to NGA § 5 or FPA § 206 as of the date they were determined to be unlawful and *should have been* changed absent "legal error" by the regulator in failing to impose a timely remedy. *E.g.*, *Office of Consumers' Counsel, Ohio v. FERC*, 826 F.2d 1136, 1139 (D.C. Cir. 1987) ("when [regulator] has committed legal error in a section 5 case the proper remedy is one that puts the parties in the position they would have been in had the error not been made"); *Tennessee Valley Mun. Gas Ass'n v. FPC*, 470 F.2d 446, 452-53 (D.C. Cir. 1972) (implementing § 5 rate reduction to cure regulator's legal error, with remedy extending back 112 days to date when regulator erroneously dismissed complaint). Absent a finding of legal error by the regulator, however, NGA § 5 and FPA § 206 remedies do not include retroactive refunds. *See, e.g.*, *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 184, 189 n.7 (D.C. Cir. 1986) (cases cited therein).

78. *See, e.g.*, *FPC v. Tennessee Gas Trans. Corp.*, 371 U.S. 145, 153 (1962) ("The [utility] having initially filed [its] rates . . . must, under the theory of the [NGA], shoulder the hazards incident to its action including not only the refund of any illegal gain but also its losses where its filed rate is found to be inadequate."); *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956) (if utility's filed or contract rate proves too low it can be remedied prospectively only).

79. *See Montana-Dakota Utils. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 258 (1951) (Frankfurter, J., dissenting on other grounds). Justice Frankfurter clearly summarized the working of the filed rate doctrine as enforced by the rule against retroactive ratemaking: "Despite the unqualified statutory declaration that unreasonable rates are unlawful, we think it clear that Congress did not intend either court or Commission to have the power to award reparations on the ground that a properly filed rate or charge has in fact been *unreasonably high or low.*" *Id.* (emphasis added); *accord Lowden v. Simonds-Shields-Lonsdale Grain Co.*, 306 U.S. 516, 50-21 (1939).

80. *See, e.g.*, *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 578 n.8 (1981) (FPC "may not impose a retroactive rate alteration and, in particular, may not order reparations" (emphasis in original)); *FPC v. Sunray DX Oil Co.*, 391 U.S. 9, 24 (1968); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 618 (1944) ("under the [NGA] the [FPC] has no power to make reparation orders"). In *Public Serv. Co. v. FERC*, 600 F.2d 944 (D.C. Cir. 1979), the court suggested that the rule against reparations is even stronger under the FPA than under the NGA. *Id.* at 957 n.51; *cf. Middle S. Energy, Inc. v. FERC*, 747 F.2d 763, 776 n.5 (D.C. Cir. 1984) (Ginsburg, J., concurring in part and dissenting in part) (distinguishing right to reparations under ICA regulation of oil pipelines from absence of reparation authority under FPA), *cert. dismissed*, 473 U.S. 930 (1985); *see also Alabama Power Co. v. ICC*, No. 86-1052, slip op. at 20-25 (D.C. Cir. Aug. 2, 1988) (affirming ICC's partial denial of retroactive refunds or ground of

seller's and the purchaser's expectations of, and their reliance on, the known status quo.⁸¹ In this respect, there are several parallels to the filed rate doctrine in commercial transactions, in which the law seeks primarily to satisfy the reasonable price expectations of the parties to an agreement.⁸²

The right to expect and rely on the filed rate is often discussed in terms of advance notice. Indeed, the *raison d'être* of the rule against retroactive ratemaking and its parent, the filed rate doctrine, is to provide advance notice of a transaction's economics. Section 4 of the NGA and section 5 of the FPA require that the regulated company publicly file rates and charges and not change the rates and charges thereafter without "notice . . . given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes . . ."⁸³ The *Columbia* court emphasized that notice, in order to have any meaning, must permit those who receive it to respond rationally by reducing their purchases from suppliers with the highest prices.⁸⁴ In order to support the direct bill that the court struck in *Columbia*, the utility should have given direct notice to the customers through filed tariff provisions informing the customers of the *type* and *amount* of the charge to be added later.⁸⁵

The third prohibitory aspect of the rule against retroactive ratemaking focuses on the role of the regulator. Cases in this group address the ability of the regulator to police statutory rate requirements and implement regulatory policy by designing rates that stimulate, retard, or maintain levels of supply

shippers' notice and reliance); *T.I.M.E. Inc. v. United States*, 359 U.S. 464, 470-71 (1959) (distinguishing motor carrier regulation under Part II of the ICA (Motor Carrier Act), which does not permit reparations, from Part I (rail and oil pipeline) and Part III (water carriers), which do permit limited common law right to reparation); *Arizona Grocery Co. v. Atchison, T. & S.F. Ry.*, 284 U.S. 370, 390 (1932) (limiting ICC discretionary authority to order retroactive refunds); *Pennsylvania R.R. v. International Coal Mining Co.*, 230 U.S. 184, 197 (1913) (recognizing limited right to award reparations on application of a rail shipper under the different statutory scheme of original ICA).

81. *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 493 (D.C. Cir. 1985) (wholesale purchasers who must set resale rates need to know cost of what they are receiving before they can set resale rates). The need of downstream distribution companies to rely on an electric utility's filed rate is an "equitable factor" underlying the rule against retroactive ratemaking. *Indiana & Mich. Elec. Co.*, 502 F.2d at 344.

82. For example, in the law of contracts, courts prefer damages measurable in terms of a contractually prescribed price term to extracontractual remedies such as restitution of benefits conferred. See *United States v. Western Casualty & Sur. Co.*, 498 F.2d 335, 339 (9th Cir. 1974); 5 A. CORBIN, *CORBON ON CONTRACTS* § 1110, at 585-86 (1964) (At "common law . . . , if the defendant alleged and proved the terms of the contract [or, by analogy, the tariff] . . . the amount for which the plaintiff got judgment was the contract price; he could not recover more than that."); E. FARNSWORTH, *CONTRACTS* § 12.19 (1982); In modern commercial transactions a principal policy basis for avoiding a contract obligation is the doctrine of unconscionability, which implements a policy of preventing oppression and unfair surprise. See U.C.C. § 2-302 comment 1 (1982). Parties cannot ordinarily circumvent price terms under the doctrine, however, since "rarely can a party [to a commercial transaction] claim surprise as to price." E. FARNSWORTH, *supra*, § 4.28, at 311; see also *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449-50 (D.C. Cir. 1965) (courts can find nonprice terms unconscionable).

83. 15 U.S.C. § 717c(d) (1982) (NGA); 16 U.S.C. § 824d(d) (1982) (FPA).

84. 831 F.2d at 1141; accord Proposed Policy Statement, *supra* note 37, at 61,732 (Stalon, Comm'r, alternative policy statement) ("No market can be expected to function efficiently if prices in the market are not known to the contracting parties").

85. See *id.* (notice may not be imputed).

and consumption of a regulated service. Under almost all rate regulatory statutes the statute directs the regulator to prevent undue discrimination in rates charged to similarly situated customers.⁸⁶ By imposing the filed rate doctrine, the regulator can insure against unduly discriminatory deviations from the filed rate by, for example, granting selective rebates, which are a form of retroactive rates.⁸⁷

The regulator further implements policies, in significant part, through its consistent enforcement of the filed rate design. Rate design for wholesale service ordinarily classifies utility or carrier billings between fixed and variable charges. The regulator then designs rates for customers or customer classes by determining the percentages or types of fixed and variable costs that the utility or carrier recovers in its demand charge and commodity charge.⁸⁸ The regulators can realize the objectives of specific design formulas⁸⁹ only if both the seller and the purchaser know and can rely on a specific design when they decide to sell or buy. Objectives traditionally pursued via rate design include (1) equitable allocation of costs between customers and customer classes, recognizing that the demand profile of each imposes different costs on the utility or carrier; (2) proper allocation of risk through open communication of price signals; (3) allocational efficiency to discourage wasteful uses of the regulated products and services; and (4) marketing flexibility.⁹⁰

Seminal to achieving rate-design objectives is "stability or continuity of rate structures . . . in order that price and market signals can be communicated and then acted upon . . ." ⁹¹ Regulatory orders that retroactively

86. See 15 U.S.C. §§ 717c(b), 717d(a) (1982) (NGA); 16 U.S.C. §§ 824d(b), 824e(a) (1982) (FPA); 49 U.S.C. § 316(d) (1982) (motor vehicles under ICA); 49 U.S.C. § 905(c) (1982) (water carriers under ICA); 47 U.S.C. § 202(a) (1982) (communications carriers under Federal Communications Act); see also *Atchison, T. & S.F. Ry. v. United States*, 549 F.2d 1186 (8th Cir.) (rail carriers under ICA), *cert. denied*, 434 U.S. 874 (1977).

87. See *Pennsylvania R.R. v. International Mining Co.*, 230 U.S. 184, 196-97 (1913) (affirming award of damages to shipper denied rebates that regulator had selectively granted to shipper's competitors in violation of filed rate under ICA).

88. See *Northern Ind. Pub. Serv. Co. v. FERC*, 782 F.2d 730, 734-35 (7th Cir. 1986); *Columbia Gas Trans. Corp. v. FERC*, 628 F.2d 578, 582-83 n.12 (D.C. Cir. 1979) (defining demand and commodity components); Pierce, *Natural Gas Rate Design: A Neglected Issue*, 31 VAND. L. REV. 1089, 1094 (1978).

89. Common examples of rate design formulas from the regulation of natural gas pipelines are: (1) the fixed-variable formula, under which the pipeline recovers fixed costs in the demand charge and variable costs in the commodity charge; (2) the modified fixed-variable formula (currently used for most natural gas pipelines), which deviates from fixed-variable by assigning equity return and taxes to the commodity charge; (3) the *Seaboard* formula under which the regulator assigns 50% of nonproduction variable costs to the demand charge, *In re Atlantic Seaboard Corp.*, 11 F.P.C. 43 (1952), *aff'd sub nom. State Corp. Comm'n v. FPC*, 206 F.2d 690 (8th Cir. 1953), *cert. denied*, 346 U.S. 922 (1954); and (4) the *United* formula used during the gas deliverability shortages of the 1970s under which 25% of nonproduction variable costs are assigned to the demand charge. *United Gas Pipe Line Co.*, 50 F.P.C. 1348 (1973), *aff'd sub nom. Consolidated Gas Supply Corp. v. FPC*, 520 F.2d 1176 (D.C. Cir. 1975); see *Texas E. Trans. Corp.*, 30 F.E.R.C. ¶ 61,144, at 61,260-62 (1985).

90. *Texas E. Trans. Corp.*, 2 F.E.R.C. at 61,259; see also *Northern Ind. Pub. Serv. Co.*, 782 F.2d at 734 n.8 (rate design supposed to maximize system utilization, assure stable revenue flow, transmit current market signals, assess consistent rates, and motivate pipelines to use long-term planning).

91. *Texas E. Trans. Corp.*, 30 F.E.R.C. at 61,259.

burden past purchase decisions with costs that were not contained in the tariff on file when the purchase decisions were made destroy stability and continuity. Simply stated, “[o]nly current customers are *now* in a position to modify their purchasing decisions.”⁹²

*C. Redefining the Rule Against Retroactive Ratemaking
as an Accounting Rule*

The direct bill stricken in *Columbia* and the take-or-pay direct bill in Order No. 500 squarely contravene rate certainty and notice and would undermine the regulator’s flexibility to police and pursue regulatory policy through rate design. In both instances, during the period upon which the billing schemes are based no filed tariffs contained or gave notice of the subject direct bills. Undaunted, the FERC jettisoned the substantive objectives of the filed rate doctrine and rule against retroactive ratemaking and, in their stead, imposed a formalistic accounting rule that would allow the supplier to bill customers for any expense characterized as current, based upon their past purchases of the regulated services.

1. The FERC’s New Rule Against Retroactive Ratemaking

In response to the D.C. Circuit’s concerns about the FERC’s open-access transportation initiatives in the Order No. 436 rulemaking, specifically the court’s concern regarding the FERC’s failure to recognize and address growing pipeline take-or-pay liability in connection with the imposition of open-access transmission,⁹³ the FERC promulgated in Order No. 500 a statement of policy authorizing deficiency-based direct billing of pipeline payments to gas producers to settle potentially billions of dollars in take-or-pay liabilities.⁹⁴ The FERC presented this direct bill as a rate recovery alternative to the FERC’s traditional and “current policy . . . that take-or-pay [settlement] costs are expenses related to the acquisition of gas supplies and should therefore be classified as production related and recovered through the pipeline’s [variable] commodity rates.”⁹⁵

The new take-or-pay recovery mechanism would permit pipelines to continue to bill take-or-pay payments as a portion of the charge for gas currently sold in their variable commodity charge. Alternatively,

[P]ipelines that transport [as open-access transporters] under this rule and volunteer to assume an equitable share of their take-or-pay costs may request alternative rate treatment for the remaining costs. Under

92. *Kentucky W. Va. Gas Co.*, 37 F.E.R.C. ¶ 61,310, at 61,912 (1986) (emphasis added).

93. *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1023 (D.C. Cir. 1987).

94. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,338, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,779.

95. *Id.*, 52 Fed. Reg. 30,342, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,786; *accord* *Tennessee Gas Pipeline Co.*, 43 F.E.R.C. ¶ 61,329, at 61,928 (1988) (“commodity recovery is the principal method approved by the Commission for the recovery of [take-or-pay] costs”); *Transwestern Pipeline Co.*, 40 F.E.R.C. ¶ 61,134, at 61,994 (1987) (affirming that “current policy” of commodity classification provides “a reasonable opportunity to recover . . . prudently incurred costs”); *Tennessee Gas Pipeline Co.*, 36 F.E.R.C. ¶ 61,032, at 61,074 (1986) (commodity classification is “traditional” practice).

this provision, pipelines may elect to absorb from 25 to 50 percent of their take-or-pay costs and may apply to recover an equal share of costs through a fixed charge . . . [with the] remaining amounts [to be] billed through a commodity surcharge or volumetric surcharge on total pipeline throughput. . . .

. . . [E]ach customer's demand surcharge should be based on [that purchaser's] *cumulative deficiency of purchases in recent years measured in relation to that customer's purchases during a representative base period prior to the accrual of take-or-pay liabilities.*⁹⁶

What this means can be illustrated by some of the specific proposals that the FERC has approved under Order No. 500. The FERC approved a proposal by Tennessee Gas Pipeline Company to bill its customers \$650 million in 1988 and 1989 based on how much less each customer purchased in 1983 to 1986 than in 1981-1982.⁹⁷ More recently the FERC allowed an Order No. 500 take-or-pay direct bill tariff filed by United Gas Pipe Line Company to take immediate effect without suspension and before hearing.⁹⁸ Under the United Gas Pipe Line Company direct bill, the pipeline's customers immediately start to pay the pipeline up to nearly \$250 million, allocated among the customers in proportion to how much less gas they purchased in 1983-1986 than in 1980-1982.⁹⁹ In both cases, the pipelines will recover their take-or-pay settlement costs even when those costs are offset by reductions in other costs of providing utility service.¹⁰⁰ Moreover, the Order No. 500 policy requires that natural gas pipelines downstream of the direct billing pipeline also bill their customers the upstream pipeline costs on the same retroactive deficiency basis.¹⁰¹

96. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784-85 (emphasis added).

97. Tennessee Gas Pipeline Co., 43 F.E.R.C. at 61,931-32.

98. Allowing a major change, such as the Order No. 500 direct bill, to take effect without suspension and before holding a hearing on contested issues was, in itself, a radical departure from the FERC's general practice of not permitting automatically adjusted or tracked changes in a single specific cost component of rates. The general practice, codified in 18 C.F.R. § 154.38(d)(3) (1988), requires that "any change . . . be considered with other [cost] changes in the context of a [NGA] section 4 rate case." Texas E. Gas Trans. Corp., 37 F.E.R.C. ¶ 61,260, at 61,676 (1986); *accord* United Gas Pipeline Co., 20 F.E.R.C. ¶ 61,005, at 61,007 (1982) (rejecting proposal to track transportation costs separately), *aff'd*, 707 F.2d 1507 (D.C. Cir. 1983); Sea Robin Gas Pipeline Co., 18 F.E.R.C. ¶ 61,277, at 61,575 (1982) (rejecting proposal to track transportation costs separately).

99. United Gas Pipe Line Co., 42 F.E.R.C. ¶ 61,197, at 61,682-83 (1988).

100. *See id.* at 61,683; Tennessee Gas Pipe Line Co., 42 F.E.R.C. ¶ 61,175, at 61,629 (1988); *cf. supra* note 98 (FERC regulations and precedent prohibit nearly all rate trackers of single cost items).

101. *See* Order No. 500, *supra* note 5, 52 Fed. Reg. 30,345, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,791; *see also* Mississippi River Trans. Corp., 42 F.E.R.C. ¶ 61,244, at 61,788 (1988) (requiring downstream pipeline to implement upstream billing scheme in accordance with Order No. 500); United Gas Pipe Line Co., 42 F.E.R.C. at 61,684. Most states are beginning to approach the issue of downstream pass-through on a case-by-case basis. *See States Have Plans to Deal with Take-or-Pay Passed to Distributors*, INSIDE F.E.R.C., Aug. 22, 1988, at 1.

2. *Mischaracterizing the Result Under a Redefined Rule*

In Order No. 500 the FERC defended billing schemes of this type against charges of retroactive ratemaking.

The Commission rejects assertions that the cumulative deficiency method of allocation based on historical sales data constitutes retroactive ratemaking. There is nothing in the Commission's proposal which would retroactively change the rates pipelines have charged their customers in the past *or which would involve imposing a rate increase for gas already sold*. Rather, the proposed allocation method would enable pipelines to recover in their future rates costs which they have actually incurred but have not recouped.¹⁰²

In this response, the FERC both mischaracterizes the effect of its take-or-pay direct bill and effectively redefines retroactive ratemaking.

As to the effect of the deficiency-based direct bill, Order No. 500 not only permits, but *requires* a "rate increase for gas already sold."¹⁰³ A purchaser's current direct-bill liability for take-or-pay costs will either decrease or increase depending upon whether the purchaser bought more or less gas in a recent period than in an earlier base period. It is not necessary that the supplier file any tariff during either the recent or base period that would have given notice of the direct bill to come. More importantly, the purchaser can do nothing today to change its liability under the direct bill. In short, the direct bill determines a customer's current liability entirely on the basis of gas already sold or not sold.

That the deficiency-based direct bill changes the price for gas already sold is apparent from the FERC's directives in Order No. 500 that specify periods over which the supplier will recover take-or-pay costs. For pipeline customers who continue to purchase the direct-billing pipeline's gas, the FERC contemplates a standard amortization period of four to five years.¹⁰⁴ The pipeline, however, is permitted to accelerate, through an exit fee, the total deficiency-based take-or-pay obligation of customers who cease to purchase services from the direct-billing pipeline.¹⁰⁵ If the purchaser's liability for take-or-pay costs were in any way a function of current or future purchases, acceleration would plainly be illogical. If the take-or-pay costs were a function of current or future purchases, then there would be *no* charges to accelerate when the customer ceased current or future purchasing.¹⁰⁶ By allowing pipelines to accelerate the take-or-pay direct bill the FERC has

102. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787 (emphasis added).

103. *Id.*

104. *Id.*, 52 Fed. Reg. 30,345, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,792.

105. United Gas Pipeline Co., 42 F.E.R.C. at 61,682-83.

106. *Contra id.* In response to an objection to United Gas Pipe Line's exit fee alleging retroactive ratemaking, the FERC simply resorted to its irrelevant characterization of the accelerated charges as "current expenses." *Id.* at 61,683. Nowhere does the FERC explain how "current" pipeline costs can be billed to noncurrent customers without resorting to retroactive ratemaking.

made it clear that an Order No. 500 direct bill is a charge for gas already sold or not sold and is therefore wholly retroactive.

The FERC's defense also misconstrues the filed rate doctrine and rule against retroactive ratemaking. Specifically, the FERC's statement that the deficiency-based direct bill "would enable pipelines to recover in their future rates costs which they have actually incurred but have not recouped"¹⁰⁷ has no bearing on the filed rate doctrine or the rule against retroactive ratemaking. The FERC has only stated a tautological proposition: A pipeline's obligation to pay when gas is not taken by a specific date is accompanied by a make-up right permitting the pipeline to recoup prepaid gas up to five years later;¹⁰⁸ it is thus necessarily true that the pipeline incurs liability but cannot recoup its prepayment until later, if at all. When a cost is deemed accrued or incurred is simply irrelevant to whether it is billed on an unlawful, retroactive basis.

The FERC's own accounting rules prescribe accrual, rather than cash, accounting.¹⁰⁹ Under accrual accounting, the pipeline may have incurred an obligation to take or pay either when it obligated itself to a gas supply contract, when it did not take the minimum contract quantity within the time specified, or when the prepayment recoupment period expired.¹¹⁰ Under cash accounting, by contrast, the pipeline incurs its take-or-pay cost when the pipeline actually pays the gas producer-seller. Each of these accounting

107. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,342-43, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787.

108. Since 1967, the FERC's regulations have required contracts for transportation or sale of natural gas to contain provisions that allow purchasers to make up prepaid take-or-pay volumes at any time during the shorter of five years following the prepayment or the remaining contract term. Non-Acceptability of Contracts between Independent Producers and Interstate Natural Gas Companies Containing Certain Provisions in Daily-Contract-Quantity and Take-or-Pay-For Clauses, Order No. 334, 32 Fed. Reg. 865 (Jan. 25, 1967) (codified at 18 C.F.R. §§ 154.103, 154.110 (1988)), *reprinted in* 37 F.P.C. 110 (1967). The purchaser's right to make up is available in the future period, however, only to the extent that its purchases exceed the minimum contract quantities, below which take-or-pay liability is incurred. Consequently, a purchaser has little or no opportunity to exercise its make-up rights and recoup prepaid volumes in a depressed sales market. By a recent notice of proposed rulemaking, the FERC has proposed to eliminate the five-year make-up period entirely. Five-Year Take-or-Pay Make-up Provisions in Natural Gas Producer-Pipeline Contracts, 53 Fed. Reg. 27,704 (July 22, 1988) (to be codified at 18 C.F.R. pt. 154), *reprinted in* [Regs. Preambles 1988] F.E.R.C. Proposed Regs. ¶ 32,464. For some unarticulated reason, the FERC's proposed rulemaking asserts that take-or-pay settlements will be promoted by depriving pipelines and their customers of this remaining bargaining chip in their negotiations with gas producers. *Id.*, 53 Fed. Reg. 27,704, [1988] FERC Proposed Regs. at 32,283-84. If approved, this change will further exacerbate the unequal bargaining strengths of the segments of the gas industry that have resulted from the FERC's piecemeal deregulation.

109. Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act, Order No. 219, 25 Fed. Reg. 5616 (June 21, 1960) (codified at 18 C.F.R. 201 general instruction 11 (1988)); Uniform System of Accounts for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act, Order No. 218, 25 Fed. Reg. 5014 (June 7, 1960) (codified at 18 C.F.R. 101 general instruction 11 (1988)); Uniform System of Accounts Prescribed for Oil Pipeline Companies Subject to Provisions of the Interstate Commerce Act, Order No. 119, 46 Fed. Reg. 9044 (Jan. 28, 1981) (codified at 18 C.F.R. 352 general instruction 1-4 (1988)).

110. Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events, and circum-

perspectives, however, is irrelevant to the application and purposes of the filed rate doctrine and rule against retroactive ratemaking. Whether a gas pipeline recognizes its take-or-pay liability for ratemaking purposes pursuant to accrual or cash accounting does not determine whether the pipeline's recovery of that liability in rates is permissible or unlawfully retroactive. What is forbidden, and what the FERC did in *Columbia* and Order No. 500, is to design a rate to recover accrued or actually paid costs based on past purchase decisions that the customers made under final filed tariffs that did not, at the time the customers made the purchase decisions, contain or otherwise give advance notice of the later charge.¹¹¹

3. *Abandoning Purposes of the Filed Rate Doctrine and Rule Against Retroactive Ratemaking*

As a simple accounting requirement, the FERC's redefined rule against retroactive ratemaking undermines the traditional purposes of the filed rate doctrine and rule against retroactive ratemaking: rate certainty, notice, and the ability of regulators to police regulatory requirements and enforce regulatory policies by influencing sale and purchase decisions. This is particularly true when the costs subject to a direct bill were classified as variable for rate design purposes during the past period used to assign cost responsibility retroactively. In *Columbia* and Order No. 500 the subject costs, gas production and commodity-classified gas supply costs, respectively, were variable charges. In the context of take-or-pay costs, Order No. 500 took variable costs classified to commodity charges¹¹² of gas pipelines' rates and made them de facto fixed, unavoidable charges. As a result, a purchaser who rationally minimized variable costs by maximizing its purchases from gas pipeline sellers that offered the lowest variable costs realizes only later that its strategy did not produce the lowest unit costs among the available alternatives when it made its purchasing decisions.

The FERC's Order No. 500 actually most burdens those pipeline customers that followed the FERC's advice to purchase least-cost gas from tradi-

stances occur rather than only in the periods in which cash is received or paid by the entity

Thus, accrual accounting is based not only on cash transactions but also on credit transactions, barter exchanges, nonreciprocal transfers of goods or services, changes in prices, changes in form of assets or liabilities, and other transactions . . . that have cash consequences for an entity but involve no concurrent cash movement.

FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6, ELEMENTS OF FINANCIAL STATEMENTS ¶ 139-40 (1985).

111. Rejecting challenges to the Order No. 500 direct bill, the FERC has argued: "If pipeline recovery of take-or-pay costs at the time they are paid were retroactive ratemaking merely because the costs relate back to some past event, a pipeline could never lawfully recover these costs under *any* rate treatment." *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. ¶ 61,175, at 61,630 (1988) (emphasis in original). This argument is an obvious strawman; Order No. 500 is not even under fire for allowing recovery of costs that "relate back to some past event," but rather because it would bill customers, without advance notice, on the basis of past events.

112. See Order No. 500, *supra* note 5, 52 Fed. Reg. 30,342, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,786 (affirming that commodity classification was current and longstanding practice before Order No. 500); see also *supra* note 95.

tional or nontraditional suppliers.¹¹³ Assume, for example, that Purchaser (*P*) traditionally purchased from Seller One (*S-1*) during a "base" period¹¹⁴ all of its 100 gas units of demand at a variable commodity charge of \$1.00 per unit. During a later period—the "recent" period in Order No. 500's parlance¹¹⁵—*P* reduced its *S-1* purchases to 50 gas units in order to purchase the balance of 50 gas units at the lower price of \$.80 per unit from Seller Two (*S-2*). *P* thereby reduces its variable cost by \$.10 per unit. For simplicity, further assume that *P* was the only purchaser to reduce its purchases from *S-1* between the "base" and the "recent" periods.¹¹⁶ Under Order No. 500, the FERC authorized *S-1* to change, retroactively, the effect of *P*'s decision into a loss simply by proving that *S-1* paid, or will pay, \$21.00 to settle its take-or-pay obligations. Under Order No. 500 *S-1* can bill \$10.50¹¹⁷ of the \$21.00 directly to *P* as a fixed charge. After the direct bill, *P*'s economically rational purchase decision saved \$10.00 in variable costs but added \$10.50 in an unforeseen and unavoidable fixed charge.

If *P* had possessed all of this price information, *P* would never have reduced its purchases from *S-1* in the first place. Under Order No. 500, and all other retroactive rates, however, the purchaser does not have full price knowledge when the purchaser makes the decision to buy or not buy. Only after *P* makes the economic decision to purchase from *S-2* does *P* learn that its economically rational choice produced irrational results.

Variations on this example are numerous. *P* may have reduced its purchases from *S-1* after determining that an investment in conservation would produce savings in relation to continued purchases of regulated service from *S-1* at the existing filed tariff rate. Alternatively, *P* may have made a long-term investment in fuel-switching capability, which would be amortized in part by the lower variable cost of the alternative fuel over several years. In each variation Order No. 500's use of past purchasing decisions to impose later extra-tariff fixed charges alters the economics of these decisions after the fact.

The purchaser is not the only loser. Competition in general loses since the retroactive charge lessens the cost to *S-1* of fewer or smaller sales, which results in *S-1* being shielded, in part, from the competitive pricing pressure exerted by *S-2*.¹¹⁸ Moreover, once utility or carrier purchasers come to ex-

113. The FERC has not disputed the fact that pipeline customers who most effectively used the purchasing flexibility created by Orders No. 380 and No. 436 are hit hardest by Order No. 500's direct bill; rather, the FERC has simply opined that the beneficiaries of the FERC's deregulatory initiatives should retroactively share in the "transition costs." Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787; *see also supra* note 57.

114. *See supra* notes 97-99 and accompanying text.

115. *Id.*

116. While there are many customers and customer classes on most pipelines, this assumption merely focuses the impact of Order No. 500's direct bill, but does not unrealistically distort how it affects customers.

117. *See supra* note 37 and accompanying text.

118. In this respect, Order No. 500 guarantees a certain level of recovery of costs associated with gas sales service, similar to minimum commodity bills before they were stricken by Order No. 380 and its progeny. *See supra* notes 23-27 and accompanying text.

pect that current purchase decisions may later result in unquantifiable retroactive liabilities, they too may become less price sensitive. In turn, reduced price sensitivity would harm those, like *S-2*, who would otherwise compete with *S-1* for gas sales. In sum, retroactive ratemaking undermines the potential for gas sales competition that Orders No. 380 and No. 436 created.

Further, the traditional regulatory objectives of rate design become less effective when the authorities permit, and market participants begin to expect, retroactive rates. As noted above, rates ordinarily are not a simple one-part charge from services rendered, but are designed to contain fixed and variable charges.¹¹⁹ Regulators change rate designs prospectively from time to time to promote different regulatory objectives. For example, when the supply of the regulated service is abundant, regulators often respond by shifting fixed utility costs from the variable commodity charge to the demand charge to reduce avoidable costs and thereby induce higher levels of consumption.¹²⁰ Conversely, during the shortages of deliverable gas in the mid-1970s, the FERC's predecessor shifted costs from the demand charge to the commodity charge in an effort to increase avoidable cost and thereby induce conservation.¹²¹ In order for these and other regulatory strategies to remain viable, the market participants must not perceive rate design as a moving target.

III. REWRITING THE FAILURES OF PIECEMEAL REGULATION WITH RETROACTIVE RATES

Since the FERC's novel accounting interpretation of the rule against retroactive ratemaking undermines the traditional goals of the filed rate doctrine and rule against retroactive ratemaking, why has the FERC so tenaciously embraced retroactive direct bills in both *Columbia* and Order No. 500? The ostensible need for direct billing in *Columbia* resulted from a three-year delay in promulgating rules needed to implement a key pricing provision of the NGPA. Direct billing was chosen purportedly as a means of putting all parties in the same position they would have been in absent the delay.

The perceived need for a direct bill in Order No. 500 was to respond to a court order vacating and remanding the FERC's Order No. 436 and, at the same time, prod gas pipelines to become "open-access" transporters, rather than simple contract carriers,¹²² under the terms of that Order.¹²³ Less clear in Order No. 500 than in *Columbia* is why the FERC selected direct billing rather than some less objectionable form of rule recovery. The FERC's explanations of its reasoning in Order No. 500 have been

119. See *supra* note 89.

120. See *Texas E. Trans. Corp.*, 30 F.E.R.C. ¶ 61,144, at 61,260-61 (1985); *supra* note 89.

121. See *Texas E. Trans. Corp.*, 30 F.E.R.C. at 61,260-61.

122. See *supra* note 28.

123. The take-or-pay relief provided by Order No. 500's retroactive direct bill is available only to pipelines that become "open-access" transporters under Order No. 436. See *supra* note 37.

inconsistent.¹²⁴

A. *The Columbia Direct Bill of Production-Related Costs*

The direct bill stricken in *Columbia* grew out of section 110 of the NGPA,¹²⁵ which permits natural gas producers to charge for certain costs related to gas production¹²⁶ in excess of the otherwise applicable maximum lawful price (MLP) in a first sale.¹²⁷ Not until 1980 in Order No. 94¹²⁸ did the FERC adopt regulations for quantifying and allowing gas producers to bill these production-related costs. The FERC excluded the cost incurred by producer-sellers for compressing gas from the 1980 regulations because it presented "the single most complex cost category" and therefore required further consideration.¹²⁹ The FERC nevertheless assured producers and put the pipelines on notice in 1980 that "a retroactive collection procedure [would] be provided" once the necessary regulations were promulgated.¹³⁰ Those regulations were not adopted until March 7, 1983, in Orders No. 94-A and No. 94-B.¹³¹ After the Fifth Circuit upheld those orders on appeal,¹³² producers began to bill purchasing pipelines for previous compression costs that the producers had incurred between July 1980 and March 1983.¹³³

When the purchasing pipelines began to pass the retroactive charges downstream to their resale purchasers, the FERC approved the charges.¹³⁴ Specifically, the FERC found that continuing the retroactive charge downstream was fair and appropriate in that it enforced the NGPA as if there had been no delay in promulgating the regulations for billing compression costs. According to the FERC, the compression charge "match[ed] . . . [compres-

124. See *infra* notes 167-78 and accompanying text.

125. 15 U.S.C. § 3320 (1982).

126. See *supra* note 44.

127. 15 U.S.C. § 3320(a)(2). The NGPA introduced phased wellhead deregulation under which the FERC set price ceilings, called maximum lawful prices (MLPs), for the first sales of gas based on either vintage of the gas or the characteristics of its production (*e.g.*, deep gas or stripper-well gas). On all new and some old gas, the FERC has or will phase out MLPs and a deregulated price will govern first sales. See generally *Danden Petroleum, Inc. v. Northern Natural Gas Co.*, 615 F. Supp. 1093, 1099-1100 (N.D. Tex. 1985) (explaining NGPA pricing system). Section 110 allows producers to recover the costs of production in excess of the applicable MLP, without violating § 504(a), 15 U.S.C. § 3414(a) (1982), which makes it unlawful to sell gas at a price exceeding the MLP.

128. Order Amending Interim Regulations Under the Natural Gas Policy Act of 1978 and Establishing Policy Under the Natural Gas Act, Order No. 94, 45 Fed. Reg. 53,099 (Aug. 11, 1980) (codified at 18 C.F.R. pts. 2, 270, 271 (1987)), reprinted in [Regs. Preambles 1977-1981] F.E.R.C. Stats. & Regs. ¶ 30,178 [hereinafter Order No. 94], *aff'd sub nom. Texas E. Trans. Corp. v. FERC*, 769 F.2d 1053 (5th Cir. 1985).

129. See *Columbia*, 831 F.2d at 1138 (quoting Order No. 94, 45 Fed. Reg. at 53,107, [Regs. Preambles 1977-1981] F.E.R.C. Stats. & Regs. at 31,218).

130. *Id.*

131. Order No. 94-A, 48 Fed. Reg. 5,152 (Jan. 24, 1983), reprinted in [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,420; Order No. 94-B, 48 Fed. Reg. 5,190 (Jan. 24, 1983) (codified at 18 C.F.R. pts. 270, 271 (1983)), reprinted in [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,421.

132. See *supra* note 128.

133. *Columbia*, 831 F.2d at 1138-39.

134. See *supra* note 128.

sion] costs with those who benefitted from the costs . . . with precision by allocating the cost liabilities based only on the amount of gas each customer [actually] purchased during the retroactive period."¹³⁵

The pipelines began to bill the compression charges downstream in proportion to their customers' gas purchase during the 1980 to 1983 period. Downstream purchasers, led by Columbia Gas Transmission Corporation, objected on the ground of retroactive ratemaking. The FERC rejected this argument, contending that both the 1980 and 1983 orders in Orders No. 94 and No. 94-A had put all downstream purchasers on notice of the charge that would later be assessed,¹³⁶ and therefore, the downstream purchasers knew of their future liability when they made purchase decisions in the 1980 to 1983 period.

A unanimous panel of the court disagreed, holding that the direct bill was a retroactive rate increase in violation of the NGA.¹³⁷ In the court's opinion, the rule against retroactive ratemaking "might have been overridden by adequate notice."¹³⁸ Although the court did not define what type of notice would have been adequate, the court concluded that the 1980 and 1983 orders were not adequate. "Because they were addressed exclusively to *first sales* . . . , they cannot be deemed to have placed downstream purchasers on notice that they in turn would be expected to absorb those costs through a system of surcharges collected after the fact."¹³⁹

In its petition for rehearing, the FERC retreated substantially from its former contention that Orders No. 94 and No. 94-A constituted adequate downstream notice. The FERC simply argued that during the 1980 to 1983 period, "Columbia and other pipelines [could] be held to the *knowledge that . . . they were not paying the full cost* of the gas volumes they . . . purchased from the pipelines [upstream]."¹⁴⁰ Repeating its earlier matching argument, the FERC contended that intergenerational equity¹⁴¹ required a waiver in order to match compression costs from 1980 to 1983 with the customers that

135. Tennessee Gas Pipeline Co., 36 F.E.R.C. ¶ 61,032, at 61,075 (1986) (interpreting order approving downstream application of Order No. 94 direct bill in Transcontinental Gas Pipe Line Corp., 32 F.E.R.C. ¶ 61,230, at 61,543-45 (1985)).

136. *Columbia*, 831 F.2d at 1140 (citing Brief for FERC at 14).

137. *Id.* at 1139-40.

138. *Id.* at 1140.

139. *Id.* (emphasis in original).

140. Petition of FERC for Rehearing and Suggestion for Rehearing *en Banc* at 13, Columbia Gas Trans. Corp. v. FERC, 844 F.2d 879, 880 (D.C. Cir. 1988) (order denying rehearing).

141. See *supra* text accompanying notes 47-48. Matching and intergenerational equity are simply different perspectives on the ratemaking principle that regulated rates to a utility customer should recover only those costs incurred in connection with the services provided to that customer. In other words, regulated rates should match cost responsibility with cost incurrence, not only as between different regulated services but also as to different or intergenerational time periods. Often these concepts are invoked to structure rate refunds that result when the regulated entity charges a rate higher than the rate allowed or when the regulated entity charged a nonfinal rate that becomes effective subject to refund. In connection with a refund, "matching" or "intergenerational equity" . . . [requires] that the benefits of revenues received by a public utility should . . . flow to those customers who have borne the financial burdens of the [regulated] operations that produced the revenues, and *vice versa*." Northwest Pipeline Corp. v. Colorado Interstate Gas Co., 33 F.E.R.C. ¶ 63,076, at 65,293 (1985) (emphasis added), *aff'd*, 35 F.E.R.C. ¶ 61,284 (1986). In both *Columbia* and Order No. 500, by

purchased gas during that period.¹⁴² The FERC also argued for the first time that the court failed to recognize that the FERC has authority under section 4 of the NGA to waive the filed rate doctrine.¹⁴³

The court reaffirmed its earlier finding of impermissible retroactive ratemaking, but instructed that, on remand, the FERC could try to develop a justification based on the new waiver argument. Specifically, "the magnitude of the costs at issue" persuaded the court that it should not foreclose the FERC from considering the waiver issue in a manner consistent with the court's previous holding that the retroactive direct bill could not be redeemed by the allegation of adequate notice.¹⁴⁴

B. *The Take-or-Pay Direct Bill of Order No. 500*

Order No. 500 articulated an interim rule and general statement of policy in response to the D.C. Circuit's decision in *Associated Gas Distributors v. FERC*.¹⁴⁵ In that case, the court upheld most elements of the FERC's Order No. 436, which the court characterized as a "complete restructuring of the natural gas industry [that] may well come to rank [among] the . . . great regulatory milestones of the industry."¹⁴⁶ The court approved of Order No. 436's primary innovation, which required gas pipelines subject to the FERC's jurisdiction to provide open-access to their transmission facilities¹⁴⁷ as a prerequisite to their participation in a new and streamlined regulatory program, called blanket certificates, for the services they provide.¹⁴⁸ To free up pipeline capacity for open-access transmission, Order No. 436 also requires open-access pipelines to allow their firm sales service customers either to convert, over a period of years, their entitlement to sales to a reservation of transmission capacity or to back out of their sales entitlement altogether.¹⁴⁹ The court affirmed the conversion option, but reversed the out-

contrast, the FERC invoked matching and intergenerational equity to *increase*, not *decrease*, a regulated rate.

142. Petition of FERC for Rehearing and Suggestion for Rehearing *En Banc* at 8, 12, *Columbia*, 844 F.2d at 879.

143. *Id.* at 12.

144. *Columbia*, 844 F.2d at 880. The FERC later did so in *Panhandle E. Pipe Line Co.*, 44 F.E.R.C. ¶ 61,183 at 61,573 (1988). For an analysis of the waiver granted in *Panhandle*, see *infra* notes 181-94 and accompanying text.

145. 824 F.2d 981 (D.C. Cir. 1987).

146. *Id.* at 993.

147. "Open access" is not common carriage in which all would-be shippers receive a pro rata share of existing capacity. See Pierce, *Wellhead to Burnertip*, *supra* note 2, at 24-25. "Open access" simply requires that transmission capacity be made available on a first-come-first-served basis to the extent there is capacity available. *Associated Gas Distribs.*, 824 F.2d at 996. An "open-access" natural gas can neither discriminate in favor of its sales customers nor deny transmission capacity to shippers of third-party gas. The *Associated Gas Distributors* court upheld Order No. 436's "open-access" requirement expressly because the FERC had found that the pre-existing practice of favoring the pipeline sales customers was unduly discriminatory. *Id.* at 993, 998-1001. One commentator correctly observed that the FERC's analysis "represents application . . . of the 'essential facility' doctrine developed by the courts under the Sherman Act . . ." Pierce, *Wellhead to Burnertip*, *supra* note 2, at 24.

148. See 824 F.2d at 996 (describing blanket certification as "authorizing transportation services generically and thus obviating the need for unwieldy individual certification").

149. *Id.* at 1013-21.

right reduction because it was unsupported by the record underlying Order No. 436.¹⁵⁰

Because the FERC lacks statutory authority to compel common carriage by gas pipelines,¹⁵¹ the FERC styled open-access transmission as a nonmandatory program to be selected or rejected by the pipelines.¹⁵² Experience under Order No. 436, however, has proved that the choice is largely illusory. Despite justified fears that open-access transportation would reduce sales and exacerbate their take-or-pay exposure to gas producers,¹⁵³ the pipelines have, in fact, acquiesced to Order No. 436 because they otherwise would potentially suffer even greater competitive injury if they were unable to compete for sales of transmission under Order No. 436.¹⁵⁴

The *Associated Gas Distributors* court vacated and remanded Order No. 436 despite its approval of open-access because the order failed to address concerns that the combined effect of open-access transportation for nonsales customers and customer rights to convert contract demand for gas sales to transportation capacity would exacerbate the already large take-or-pay liabilities that the pipelines owe gas producers.¹⁵⁵ The court characterized the FERC's arguments diminishing the magnitude of the take-or-pay problems and its excuses for taking no remedial action as "utterly Panglossian."¹⁵⁶ The FERC responded by issuing the general statement of policy authorizing pipelines to bill directly take-or-pay costs via deficiency-based fixed charges.

150. *Id.* at 1018-20. The court found that the FERC's rulemaking record and findings demonstrated a nationwide pattern of pipeline discrimination in refusing to transport gas in competition with their own captive sales, which was effectively remedied by conversion. *Id.* at 996, 1017. By contrast, the reduction option permitted purchasers to go beyond regional markets to procure gas, in which event they would need to sever most, if not all, of their contractual demand for both sales and transportation of gas from the traditional pipeline. The court found no evidence demonstrating that customers either needed or wanted that flexibility; nor was the court convinced that affording customers complete rights to abrogate contracts was necessary to remedy the evidence of preexisting discrimination against would-be transportation customers. *Id.* at 1019-20. Absent such findings and a decision to remedy those findings under § 5 of the NGA, the court could not justify FERC's reduction option. *Id.*

151. *See supra* note 28.

152. Order No. 436, *supra* note 5, 50 Fed. Reg. 42,430, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,504; *see Associated Gas Distribs.*, 824 F.2d at 996.

153. The *Associated Gas Distributor's* panel questioned whether "open-access" was really voluntary as structured, since "inability to provide blanket-certificate transportation for fuel-switchable users may in current market circumstance cause critical load loss" and spell bankruptcy for the non-"open-access" pipeline. 824 F.2d at 1024. The court aptly compared pipelines confronting Order No. 436's nonmandatory "open-access" option to a "condemned man . . . given the choice between the noose and the firing squad." *Id.*; *see also* Griggs, *supra* note 31, at 97 (reviewing pipeline's initial reluctance); Pierce, *Wellhead to Burnertip*, *supra* note 2, at 35-36 (explaining reasons for reluctance).

154. Most of the pipelines that initially asserted they would never become "open-access" transporters, *see* INSIDE F.E.R.C., Nov. 4, 1985, at 4-5, have subsequently filed and accepted open-access tariffs. *Compare id.* with Natural Gas Pipeline Co. of America, No. CP86-582; Panhandle E. Pipe Line Co., No. CP86-585; Southern Natural Gas Pipeline Co., No. CP88-316; Tennessee Gas Pipeline Co., No. CP87-115; Transcontinental Gas Pipe Line Co., No. CP88-328; Trunkline Gas Co., No. CP86-586; United Gas Pipe Line Co., No. CP88-6.

155. 824 F.2d at 1044.

156. *Id.* at 1030.

1. *Pipeline Customers Received No Advance Notice of the Retroactive Order No. 500 Direct Bill*

In orders and opinions issued since the *Columbia* decision, the FERC has taken pains to distinguish the rates found unlawfully retroactive in *Columbia* from those permitted by Order No. 500's take-or-pay direct bill. In addition to the current cost accounting defense, discussed earlier,¹⁵⁷ the FERC has argued that, even if the take-or-pay direct bill is retroactive in appearance, the bill is redeemed by adequate notice provided to all direct-bill targets, both direct and indirect downstream purchasers. In connection with the Tennessee Gas Pipeline direct bill that the FERC recently approved, for example, the FERC pointed to its 1984 Order No. 380 as containing notice to pipeline customers that their purchases in 1981 to 1982 and 1984 to 1986 would later be subject to the direct bill.¹⁵⁸ This argument, perhaps more than any other, illustrates the lengths to which the FERC will go to defend Order No. 500's direct bill and, in turn, Order No. 436's open-access program. In fact, there was even less notice in Order No. 380 than in the two orders involved in *Columbia*.

Order No. 380 grew out of a rulemaking finding that variable-cost minimum commodity bills contained in gas pipeline tariffs were unjust and unreasonable and needed to be eliminated.¹⁵⁹ By eliminating variable-cost minimum commodity bills, the FERC made pipeline customers responsible for fewer fixed or sunk costs.¹⁶⁰ As a result, customers attained greater flexibility to purchase lower-cost gas from nontraditional suppliers,¹⁶¹ making it more difficult for the traditional supplier to satisfy its take-or-pay commitments to gas producers at the wellhead.¹⁶² The FERC further exacerbated the pipelines' potential take-or-pay exposure, when it rejected pipeline requests that the FERC assure some form of recovery for take-or-pay prepayments¹⁶³ outside the variable-cost commodity charge so that their recovery would not be compromised by Order No. 380's elimination of the variable-cost minimum commodity bill.¹⁶⁴

Responding to these pipeline complaints, the FERC provided its purported advance notice of the direct bill to come over four years later in Or-

157. See *supra* notes 102-11 and accompanying text.

158. 42 F.E.R.C. at 61,630.

159. See *supra* notes 22-26 and accompanying text.

160. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,783-84, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,964-65; see also Pierce, *Wellhead to Burnertip*, *supra* note 2, at 23; Note, *supra* note 23, at 131-33.

161. See *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1158 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).

162. Despite this obvious interrelationship, the FERC rejected contentions that take-or-pay relief should accompany elimination of variable (and later, fixed) cost minimum commodity bills. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,788, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,971; see Note, *supra* note 23, at 136, 146. The court upheld the FERC on the ground that the FERC was acting within its reasonable discretion to deal with take-or-pay separately in a later proceeding. 770 F.2d at 1160.

163. See *supra* note 108.

164. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,787-88, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,970; Note, *supra* note 23, at 136.

der No. 500. The specific passage of Order No. 380 cited by the FERC reads:

Opponents of the rule argue that no customer should be forced to pay part of those carrying costs to the extent that they were caused by another customer's cutbacks.

The Commission is somewhat sympathetic to this line of reasoning. *There may be some justification for requiring prepayment carrying costs to be paid by certain customers if it can be demonstrated that their cutbacks caused the prepayments. No conclusion is reached on this point today; the matter requires further investigation.* Accordingly, the Commission encourages its Staff to consider in individual rate cases whether and under what circumstances take-or-pay carrying costs should be allocated separately from other costs.¹⁶⁵

This passage, written in May 1984, simply instructs the FERC's staff to investigate in future, individual pipeline rate cases whether carrying costs of take-or-pay prepayments should be allocated separately from other costs. That directive surely fails to satisfy the actual notice standard that the *Columbia* court required to redeem what would otherwise constitute an unlawful retroactive rate.¹⁶⁶

2. *Matching and Intergenerational Equity Are Rarely Achieved by Retroactive Rates*

In both *Columbia* and Order No. 500, the FERC argued that retroactive rates should be countenanced when they are necessary to insure that those who benefit from utility service pay for the costs incurred by the utility to provide that service. The FERC presents this argument as one of cost responsibility and intergenerational equity.¹⁶⁷ In *Columbia*, for example, the FERC argued that the downstream purchasers of gas during the period 1980 to 1983, when the regulations for recovering production-related compression costs were not yet in effect, should pay the costs of compressing that gas in

165. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,787-88, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,971 (emphasis added).

166. See *supra* notes 83-85 and accompanying text. Order No. 380's discussion of prepayment carrying costs *does not even address the same type of costs as are subject to the Order No. 500 direct bill*. Order No. 500 covers take-or-pay settlement costs defined as nonrecoupable payments to buy out of take-or-pay liability or to reform existing contracts. Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,728; see Order No. 500, *supra* note 5, 52 Fed. Reg. 30,342, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784 (adopting Proposed Policy Statement); Tennessee Gas Pipeline Co., 43 F.E.R.C. ¶ 61,329, at 61,928 (1988) (excluding prepayments from Order No. 500 direct bill). By contrast, the carrying costs on take-or-pay prepayments discussed in Order No. 380 were expressly and totally excluded from the fixed take-or-pay direct bill authorized in Order No. 500. Proposed 18 C.F.R. § 2.14(g) ("[t]his section does not . . . affect take-or-pay prepayments"). Additionally, even if it were construed as notice, Order No. 380 was issued in May 1984, more than three years after certain of the purchasing base periods used to compute take-or-pay liability under Order No. 500 direct bills. See *supra* text accompanying notes 97-99. Finally, conspicuously absent from Order No. 380 is any notice as to even approximate amounts of future take-or-pay liability or the basis of targeting customers based on past purchase levels. This information—vital to any intelligent gas purchasing strategy—is nowhere revealed in Order No. 380.

167. See *supra* note 141.

proportion to their actual 1980 through 1983 purchases.¹⁶⁸ If these customers do not pay the compression costs, the FERC correctly observed, a later generation of ratepayers will be forced to pay for services they may not have received. Based on this argument, the FERC sought to defend the *Columbia* direct bill on the ground that it perfectly "match[ed] . . . costs with those who benefitted from the costs" when they purchased gas during the same periods.¹⁶⁹ While this argument has superficial appeal, its logic founders on the rocks of application. Even perfect matching at one upstream level of a transaction does not and, given the myriad transactions between wellhead and end-use markets, cannot ensure that those who ultimately pay the retroactive charge downstream are the same end users that received utility service in the past.

Suppose, for example, that the FERC allowed pipelines who paid producer/sellers for compression charges to bill those costs downstream to their immediate purchasers in proportion to purchases during an earlier period. Such an approach provides no assurance that the direct bill would reach further downstream to the end use customers who actually received the gas in the earlier period. Inequity would almost certainly result because local distribution rates are ordinarily designed volumetrically;¹⁷⁰ without pervasive (and unlikely) change in local regulatory rules, local distribution customers would ultimately pay the upstream retroactive charges irrespective of whether they had bought gas or even were customers during the earlier period.¹⁷¹

Even if local rate designs permitted retroactive fixed charges, the task of segregating ultimate end users who were within the local rate jurisdiction and actually purchased gas during the past period from those end users who were not in the jurisdiction or did not purchase gas during that period would

168. 831 F.2d at 1138-39.

169. Tennessee Gas Pipe Line Co., 36 F.E.R.C. ¶ 61,032, at 61,075 (1986) (FERC interpreting Order No. 94 billing, before court's decision in *Columbia*, to support take-or-pay direct bill); see *supra* notes 47-48, 141 and accompanying text.

170. Unlike the multiple-part rate designs, discussed *supra* note 89, a volumetric rate is a one-part rate that recovers costs in a commodity charge per unit of service actually sold.

171. While most states are still deliberating on the issue of downstream billing, some have already rejected downstream adherence to FERC's retroactive purchase-deficiency methodology. For example, the Virginia State Corporation Commission found that the FERC's Order No. 500 "methodology would be impossible to administer given the diversity of respective LDC customer populations." *In re* Consideration of Adoption of Policy for Recovery of Costs Associated with Take-or-Pay Liability, No. PUE880028, slip op. at 14 (Va. St. Corp. Comm'n Sept. 27, 1988). Accordingly, the Virginia Commission prescribed for recovery of take-or-pay direct bills a fixed volumetric charge to all current and future firm sales and transportation customers. *Id.*, slip op. at 2. The Illinois Commerce Commission and the Indiana Utility Regulatory Commission similarly rejected the FERC's Order No. 500 methodology on the ground that all customers, and not merely customers that reduced past purchases, have benefitted from deregulatory restructuring of gas markets. See *In re* Investigation into the Appropriate Recovery by Illinois Gas Utilities of Costs Associated with Take-or-Pay Charges from Interstate Pipeline Companies, No. 88-0103, slip op. at 12-14 (Ill. Corp. Comm'n Nov. 22, 1988); INSIDE F.E.R.C., Oct. 17, 1988, at 4. Like Virginia, the Illinois and Indiana Commissions prescribed a fixed volumetric charge on current and future firm sales and transportation. *Id.* For a general understanding of the political resistance to any generic change in the design of locally regulated rates, see Pierce, *supra* note 88, at 1160-62 (proposing marginal rather than imbedded cost pricing).

be prohibitively expensive and very likely impossible. In a mobile society end-use profiles for gas, electric, and other utilities constantly change as residential customers move or switch fuel sources and industrial and commercial users start new businesses, close others, or switch fuel sources. Ratemakers have therefore traditionally had to reject superficially attractive efforts to achieve intergenerational equity via retroactive rates.¹⁷²

As in *Columbia*, the FERC has periodically touted intergenerational matching of costs and benefits as an equitable justification for the take-or-pay direct bill in Order No. 500.¹⁷³ This approach is surprising since the Order No. 500 direct bill, unlike that in *Columbia*, would bill customers *not* on the basis of identifiable past purchases, but on the basis of reductions in their purchases between one period and a more recent period. That is, Order No. 500 assigns cost responsibility on the basis of gas *not* purchased. The FERC has repeatedly and consistently concluded that it is not possible to match, even imperfectly, pipeline take-or-pay costs with downstream customer decisions *not* to purchase gas during past periods.¹⁷⁴ Moreover, the FERC has recognized that, in addition to customer purchasing patterns, pipeline take-or-pay liabilities are the product of numerous unquantifiable factors, including economic recession, fuel switching, conservation and excessive gas purchases by pipelines following the deliverability shortfalls and resulting curtailments of the late 1970s and early 1980.¹⁷⁵ In addition, the courts have found that the FERC exacerbated take-or-pay liabilities by failing to address take-or-pay in 1983, when it began to dismantle traditional pipeline sales markets in Order No. 380, and again in 1985, when it began to convert the pipelines from gas merchants into "open-access" carriers.¹⁷⁶

172. For example, in *Kentucky W. Va. Gas Co.*, 37 F.E.R.C. ¶ 61,310 (1986), a FERC order, which was later reversed on appeal, prevented the pipeline from charging a higher price for its gas sales during past periods. To recover the higher costs, the pipeline proposed a retroactive direct bill on the ground that it would "assure proper assignment of cost responsibility." *Id.* at 61,911. The FERC rejected the direct bill and, in its answer, described how a certain amount of cost shifting in regulated rates was inevitable. *Id.* at 61,912, 61,914 n.8. Ironically, the FERC earlier recognized in Order No. 436 the likelihood of shifts in cost responsibility between classes and generations of ratepayers. The FERC characterized the expected cost shifts as the "pinch of competition" and opined that "[n]either the pipeline [n]or its remaining customers should be immune from feeling the 'pinch of competition.'" Order No. 436, *supra* note 5, 50 Fed. Reg. 41,442, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,524.

173. See Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,726-27. The Proposed Policy was the FERC's first articulation of the retroactive direct bill and formed the basis for that portion of Order No. 500. See Order No. 500, *supra* note 5, 52 Fed. Reg. 30,350 [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,798-99.

174. See Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,727-28; *supra* note 57.

175. *Transwestern Pipeline Co.*, 42 F.E.R.C. ¶ 61,306, at 61,919 (1988) ("certain fundamental market changes during the 1980's" caused the take-or-pay problem); Order No. 500, *supra* note 5, 52 Fed. Reg. 30,336, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,777; Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,725; see also Order No. 380, *supra* note 23, 49 Fed. Reg. 22,787, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,970 (finding no direct relation between pipeline take-or-pay liability and elimination of variable-cost minimum bills, which created flexibility to reduce purchases from traditional pipeline supplies).

176. *E.g.*, *Consolidated Edison Co. v. FERC*, 823 F.2d 639, 640-42 (D.C. Cir. 1987); *Asso-*

Since even the superficial appeal of the intergenerational equity defense is premised on a showing that retroactive rates match cost incurrence with past benefits to identifiable past customers, the FERC's admitted inability to match take-or-pay costs with past decisions not to purchase gas deprives the FERC's equity defense in Order No. 500 of any persuasiveness whatsoever.¹⁷⁷ The FERC has nevertheless persisted, and has instructed downstream purchasers that it is not interested in receiving factual evidence that shows that matching falls apart downstream.¹⁷⁸

3. *The Filed Rate Doctrine Is Subject To Limited Waiver, But Not Total Elimination*

The FERC's most recent defense of the retroactive rate in *Columbia* is that the agency enjoys a limited authority to waive the filed rate doctrine.¹⁷⁹

In its rehearing order, the *Columbia* court instructed that the FERC remained free to develop this waiver argument on remand,¹⁸⁰ and the FERC did so in a recent decision waiving the filed rate doctrine to allow Panhandle Eastern Pipe Line Co. to bill compression costs on the same retroactive basis that the *Columbia* court found violated the rule against retroactive ratemaking.¹⁸¹ The reappearance in *Panhandle* of the waiver defense, however, is unlikely to save the billing in either *Columbia* and related cases or, by anal-

ciated Gas Distribs. v. FERC, 824 F.2d 981, 1022-24 (D.C. Cir. 1987); Order No. 500, *supra* note 5, 52 Fed. Reg. 30,336, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,777.

177. In *Tennessee Gas Pipeline Co.*, 36 F.E.R.C. ¶ 61,071 (1988) the FERC found that a pre-Order No. 500 take-or-pay direct bill, partially based on past-purchase deficiencies, "either ignore[d] or only partially incorporate[d] the matching principles that were key to the other [retroactive] direct billing proposals [that] were approved by the Commission" and later reversed by the court in *Columbia*. *Id.* at 61,075. Later, the FERC modified Tennessee's proposal to incorporate Order No. 500's direct bill, which is completely based on past-purchase deficiencies, and concluded that the modified version would successfully trace cost causation. *Tennessee Gas Pipeline Co.*, 43 F.E.R.C. ¶ 61,329, at 61,929-33 (1988). Any factual support for tracing, however, was conspicuously absent.

178. For example, in *Mississippi River Trans. Corp. (MRT)*, 42 F.E.R.C. ¶ 61,244 (1988), a downstream natural gas pipeline, MRT, requested that the FERC allow it to bill the take-or-pay settlement costs billed to it from its upstream pipeline on a basis other than Order No. 500's retroactive direct bill. MRT argued that the past-purchase-deficiency billing mechanism was not appropriate "because (1) [MRT] has . . . maintain[ed] its sales load . . . ; and (2) there is no nexus between [MRT's current] sales . . . and its reduced purchases of gas from [the upstream pipeline]" during past periods. *Id.* at 61,788. Ignoring MRT's "nexus" argument, the FERC ordered MRT to refile its tariff in accordance with Order No. 500. *Id.* The only finding FERC made was that MRT had lost part of its sales markets during the period that formed the basis of its upstream supplier's direct bill. *Id.* Further downstream at the local distribution level, state regulatory commissions are in the preliminary stages of determining how they will design local rates to respond to upstream take-or-pay direct bills. See *supra* note 171. Pennsylvania Public Utility Commission Chairman Shane characterized the state perspective as one of "watching the pig coming through the python." *INSIDE F.E.R.C.*, May 25, 1988, at 1.

179. See *supra* notes 58, 143-44 and accompanying text.

180. 831 F.2d at 1142.

181. *Panhandle E. Pipe Line Co.*, 44 F.E.R.C. ¶ 61,173 at 61,573 (1988). *Panhandle*, like *Columbia*, involved a pipeline's application to recover currently its NGPA § 110 compression costs from an earlier period. See *supra* notes 125-36 and accompanying text.

ogy, Order No. 500¹⁸² from findings of illegal retroactivity.

The FERC bases its assertion of waiver on parallel provisions of section 4(c) of the NGA and section 205(d) of the FPA. Sections 4(c) and 205(d) prescribe that "no change shall be made by any natural-gas company in any [filed] rates . . . except after thirty days' notice to the Commission and to the public,"¹⁸³ and that "no change shall be made by any public utility in any [filed] rate[s] . . . except after sixty days' notice to the Commission and to the public,"¹⁸⁴ respectively. Both statutes further provide that for good cause the FERC may allow rate changes without the thirty or sixty days' notice.¹⁸⁵ The FERC further points to the Supreme Court's decision in *Arkansas Louisiana Gas Co.*, which construes this statutory language. The Court instructed that while "the Commission may not *impose* a retroactive rate alteration . . . , it may 'for good cause shown' . . . waive the usual requirement of timely filing of an alteration in a rate."¹⁸⁶

The defect of the FERC's waiver argument lies in the FERC's own long-standing definition of good cause and in the duration of the waivers that would be necessary to support the *Columbia*, *Panhandle* and Order No. 500 retroactive bills. The FERC has explained and the courts have found that "[t]he Commission's long-standing general policy is to find 'good cause' *only* when the parties to the rate have *agreed* at some point in their negotiations on [a different] effective date and the waiver is in the public interest."¹⁸⁷ When the parties expressly agree and no party opposes an earlier effective date, "[d]eference to the parties' contractual arrangements . . . does not impair the regulatory powers of the [regulator]."¹⁸⁸ By requiring an agreement or consent, the good cause waiver, like the notice requirement of the filed rate doctrine,¹⁸⁹ "promotes equity among the parties to a ratemaking proceeding by giving each party the same power to control the effective date of a new rate."¹⁹⁰

This good cause exception cannot apply in *Columbia* and related cases, such as *Panhandle*, or in Order No. 500 because there were no expressions of mutual agreement or consent before the purchase billing period in *Columbia*

182. The FERC has not yet raised the waiver defense in connection with the Order No. 500 direct bill presumably because Order No. 500 was issued before the first *Columbia* remand.

183. 15 U.S.C. § 717c(d) (1982).

184. 16 U.S.C. § 824d(d) (1982).

185. 15 U.S.C. § 717c(c) (1982) (NGA); 16 U.S.C. § 824d(d) (1982) (FPA).

186. 453 U.S. at 578 n.8 (emphasis in original).

187. *City of Girard, Kan. v. FERC*, 790 F.2d 919, 925 (D.C. Cir. 1986) (emphasis added) (citing *City of Piqua, Ohio v. FERC*, 610 F.2d 950, 954 (D.C. Cir. 1979); *Pacific Power & Light Co.*, 27 F.E.R.C. ¶ 61,080, at 61,148 (1984); *Connecticut Light & Power Co.*, 20 F.E.R.C. ¶ 61,353, at 61,730-31 (1982); *Dayton Power & Light Co.*, 12 F.E.R.C. ¶ 61,296, at 61,678-79 (1980)); see generally Note, *FERC Waiver of the Filed Rate Doctrine: Some Suggested Principles*, 9 ENERGY L.J. 497 (1988) (reviewing waiver decisions and defining "good cause" under NGA as function of notice, contractual intent, reliance equity and public policy of NGA and NGPA).

188. *City of Piqua*, 610 F.2d at 954; see *City of Girard*, 790 F.2d at 925 ("requiring the waiver to be in the public interest fulfills the Commission's statutory mandate to regulate . . . with a view to the public interest").

189. See *supra* text accompanying notes 83-85.

190. *City of Girard*, 790 F.2d at 925.

and *Panhandle* or before the "base" or "deficiency" periods used to target take-or-pay costs in Order No. 500. The *Columbia*, *Panhandle* and Order No. 500 direct bills would have required hundreds of advance agreements between interstate pipelines and their purchasers in order to satisfy the good cause standard. Those agreements simply do not exist. Consequently, the FERC cannot now declare the existence of waivers by simply abandoning its own longstanding interpretation of good cause.¹⁹¹ Yet, that is precisely what the FERC did, without explanation, in *Panhandle*. In so doing, the FERC simply reated its earlier contention, rejected by the *Columbia* court, that intergenerational equity alone, without mutual intent, constituted good cause to abandon both the filed rate doctrine and rule against retroactive ratemaking.¹⁹²

In addition, even where evidence of mutual agreement has demonstrated good cause, the FERC has ordinarily waived the statutory thirty- or sixty-day advance filing requirements for only relatively short periods, five or six months at the greatest.¹⁹³ By contrast, the waivers needed to redeem the

191. The FERC "bears the burden of explaining the reasonableness of any departure from a long standing practice, and any facts underlying its explanation must be supported by substantial evidence." *Public Serv. Comm'n v. FERC*, 642 F.2d 1335, 1346 (D.C. Cir. 1980) (quoting *Columbia Gas Trans. Corp. v. FERC*, 628 F.2d 578, 586 n.31 (D.C. Cir. 1979)). Since FERC failed to argue waiver in Order No. 500, no reasoned explanation or evidence exists that would warrant changing the FERC's longstanding interpretation of "good cause" in connection with Order No. 500's retroactive direct bill. Even if the FERC asserts waiver in future attempts to justify the retroactivity of Order No. 500's direct bill, the necessarily radical redefinition of good cause is unlikely to satisfy the retroactivity doctrine, which limits retroactive applications of agency rules. See, e.g., *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972) (interpreting *SEC v. Chenery Corp.*, 332 U.S. 194, 203 (1947)). As a statement of policy, Order No. 500's direct bill is probably confined to prospective application as a matter of law. See *Pacific Gas & Elec. Co.*, 506 F.2d at 38 ("A policy statement announces the agency's tentative intentions for the future." (emphasis added)).

192. 44 F.E.R.C. at 61,573 ("Equity demands . . . procedure which will allow Panhandle to collect production related costs from those customers who caused their incurrence.").

193. See, e.g., *Towns of Concord, Wellesley, Massachusetts v. FERC*, 844 F.2d 891, 896 (1st Cir. 1988) (waiving 60-day requirement); *City of Girard*, 790 F.2d at 925 (waiving three of 60 days notice); *City of Piqua*, 610 F.2d at 951-52 (rate effective three months before tariff filed); *Pacific Power & Light Co.*, 27 F.E.R.C. at 61,146 (1982) (one month before tariff filed); *Connecticut Light & Power Co.*, 20 F.E.R.C. at 61,730-31 (1982) (25 days before tariff filed). Only in *Hall v. FERC*, 691 F.2d 1184 (5th Cir. 1982), *cert. denied*, 464 U.S. 822 (1985), did a court grant a significantly longer waiver. After finding that an express agreement in a 1954 contract triggered an indefinite price escalator as of a date certain in 1961, the Fifth Circuit reversed the FERC and found good cause to waive the filing requirement and permit billing based on wellhead sales occurring up to 21 years earlier (1961 to 1972). *Id.* at 1187, 1195-96. However, *Hall* is distinguishable from both *Columbia* and Order No. 500. Gas purchasers did not agree in either *Columbia* or Order No. 500 to pay the gathering or take-or-pay costs retroactively from a certain date. See also *Towns of Concord, Wellesley*, 844 F.2d at 896 (emphasizing requirement of mutual agreement). *Hall* is also distinguishable on the face of the court's reasoning. Integral to the court's analysis in *Hall* was that the waiver only permitted the producer to bill the pipeline, while "[i]t [was] far from clear that [the pipeline] would be entitled to pass along to its customers an amount representing its delayed payment[s] for purchased gas . . ." 691 F.2d at 1193. In *Columbia* and Order No. 500, by contrast, the pipeline would bill its customers if the waiver were granted. This distinction was key to the *Hall* court's decision, which recognized that

[i]t is well settled that the Commission's duty under the NGA statutory scheme . . . is "to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." The clear import . . . is that the underlying-

direct bills in *Columbia*, *Panhandle*, and Order No. 500 are vastly longer: six years in *Columbia*, nine years in *Panhandle*, and up to seven years in some of the FERC decisions implementing Order No. 500.¹⁹⁴

IV. EFFECTIVE TAKE-OR-PAY RELIEF THROUGH PROSPECTIVE RATEMAKING AND REGULATION

It is ironic that the FERC ultimately looked to Order No. 380 as notice of Order No. 500's retroactive direct bill and that it imposed the direct bill order to salvage Order No. 436 on remand from the court. Orders No. 380 and No. 436 actually exacerbated the large take-or-pay liabilities that Order No. 500 purports to solve with unlawful retroactive ratemaking.

The irony increases when it is recognized that in comments on the rulemakings that produced Orders No. 380 and No. 436, various segments of the industry and one FERC commissioner repeatedly urged the FERC to taker prospective remedial action on take-or-pay in 1983 and 1985, respectively.¹⁹⁵ If the FERC had heeded those recommendations, it would have alleviated the magnitude of the pipelines' current take-or-pay exposure. The recommended actions included: (1) scrutinize how pipelines incurred their take-or-pay liabilities to determine whether the pipelines acted imprudently, and deny rate recovery to those liabilities found to be imprudent;¹⁹⁶ (2) limit

ing purpose of the NGA is protection of the consumer, "even though this may result in some injustice to the producers". . . . [I]t is [thus] far from clear whether [the pipeline] could justify [a waiver permitting] its requested rate increase.

Id. at 1193 (citations omitted) (quoting *Atlantic Ref. Co. v. Public Serv. Comm'n*, 360 U.S. 378, 388 (1959)). In addition, the court found evidence that matching and intergenerational equity would not be a significant problem, *id.* at 1193 ("little evidence in the record to suggest that . . . 1961-1972 customers are in fact different from its 1980 customers"), whereas customer profiles since 1980—the period covered by the Order No. 500 direct bills—have changed dramatically, creating significant intergenerational and matching problems.

194. See *supra* notes 97-99 and accompanying text; *Panhandle E. Pipeline Co.*, 44 FERC at 61,572..

195. See Order No. 436, *supra* note 5, 50 Fed. Reg. 42,462-63, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,560 (summarizing comments on 1985 rulemaking); Order No. 380, *supra* note 23, 49 Fed. Reg. 22,787 [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,970-71 (summarizing comments on 1982 rulemaking). Concurring in Order No. 380, Commissioner Sousa wrote in 1983:

Competition in the natural gas industry is hampered by many factors; minimum commodity bills are just one of those factors. Take-or-pay provisions are another. Therefore, although I agree with this rule, I believe that it addresses only one part of the problem, and the Commission should promulgate a rule on take-or-pay provisions in producer-pipeline contracts. Indeed the Commission should have done that concurrently with the issuance of this rule.

[1982-1985] F.E.R.C. Stats. & Regs. at 30,981 (Sousa, Comm'r, concurring). In his concurrence to Order No. 500, Commissioner Sousa again objected to the FERC's failure to act directly against non-competitive take-or-pay provisions. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,356-57, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,806.

196. When Tenneco, Inc. abruptly announced in 1988 that its pipe division, Tennessee Gas Pipeline Co., recognized a \$2 billion potential liability for take-or-pay, see Medina, McKenzie & Daniels, *supra* note 4, at 186, and filed to recover its settlement costs, many of Tennessee's customers challenged whether the liabilities had been prudently incurred. The FERC set the issue for what proved to be a two-month hearing, but then refused to decide the issue of prudence on appeal when Tennessee agreed to a billing mechanism similar to Order No. 500's.

or otherwise allow pipelines to escape take-or-pay requirements by inserting bilateral "economic out" provisions in gas supply contracts; (3) enjoin any rate recovery of nonrecoupable take-or-pay obligations; (4) refunctionalize¹⁹⁷ take-or-pay costs from exclusively production to both production and transmission to minimize cost shifts and potential for intergenerational inequity; and (5) reclassify some or all take-or-pay settlement costs to the demand charge for billing based on current contract demand levels rather than past purchase decisions.¹⁹⁸

Instead of pursuing these remedies to the take-or-pay problem, the FERC adopted, in connection with Order No. 500's retroactive direct bill, new regulations that permit open-access pipelines to refuse to transport a particular producer's gas if that producer declines to sign an affidavit in which the producer offers to credit on a unit-per-unit basis the amount of gas transported against gas not taken and therefore subject to take-or-pay liability under pre-June 1987 contracts.¹⁹⁹ In its *Associated Gas Distributors* remand, the D.C. Circuit suggested a similar remedy that would simply permit open-access transporters to deny access to producers who refused to renegotiate take-or-pay contracts.²⁰⁰

Instead, the FERC relied on Order No. 500's directive to deem presumptively prudent for purposes of direct billing an amount of take-or-pay settlement costs equal to the amount (25 to 50%) absorbed by the pipeline. *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. ¶ 61,174, at 61,626-27 (1988); *accord* Order No. 500, *supra* note 5, 52 Fed. Reg. 30,342-43, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787. This presumption that take-or-pay liabilities were incurred prudently if the pipeline later absorbs some of the cost of settling the liability is a non sequitur on its face. *See Tennessee Gas Pipeline Co.*, 42 F.E.R.C. at 61,636 (Sousa, Comm'r, concurring) ("50-50 sharing of take-or-pay costs is meaningless unless the Commission finds that the underlying transaction between the pipeline and the producer is itself reasonable"). Nevertheless, the FERC threatens customers who insist on an opportunity to rebut the presumption at an evidentiary hearing with a retroactive direct bill of not merely their deficiency-based allocation of up to 50% of the pipeline's take-or-pay settlement costs, but of all costs found prudent after hearing. *E.g.*, *Southern Natural Gas Co.*, 43 F.E.R.C. ¶ 61,186, at 61,477-79 (1988); *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. at 61,626; *United Gas Pipe Line Co.*, 42 F.E.R.C. ¶ 61,197, at 61,681 (1988); *Transcontinental Gas Pipe Line Corp.*, 42 F.E.R.C. ¶ 61,407, at 62,204 (1988). That threat is particularly potent since the FERC forces customers to choose before they are given an opportunity to pursue meaningful discovery of the factual issues on which prudence is decided. *See Transcontinental Gas Pipe Line Corp.*, 41 F.E.R.C. at 62,205; *United Gas Pipe Line Co.*, 41 F.E.R.C. at 62,059, 62,061 (Ordering ¶ F). The FERC has recognized that all of those facts are in the possession of the pipeline. *United Gas Pipe Line Co.*, 43 F.E.R.C. at 61,685.

197. Functionalization is ordinarily the first step in designing rates. Where a regulated entity provides more than one service, such as natural gas pipelines that provide sales, transmission and storage, costs are functionally associated with each of these services to be billed in the rate charged to customers in proportion to their demand for, or use of, that specific service.

198. *See supra* notes 163-64 and accompanying text.

199. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,339-40, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,781-84.

200. *Associated Gas Distribs.*, 824 F.2d at 1028-30. The FERC had rejected proposals to condition transmission access on take-or-pay relief on the ground that such a condition would be unduly discriminatory and therefore violative of the NGA. *See* Order No. 436, *supra* note 5, 50 Fed. Reg. 42,465, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,565. The court was unpersuaded.

Given that the Commission itself has identified the producer-pipeline contracts as a primary cause of the problem that Order No. 436 is intended to cure, . . . it eludes us why pipeline denial of access to producers that stand on the letter of their contract rights [to take-or-pay] should be viewed as unduly discriminatory.

While this approach, called "crediting," is an encouraging sign that the FERC is no longer totally ignoring the need to take action on take-or-pay, crediting is an indirect remedy that is proving to be cumbersome and thus far ineffectual.²⁰¹ As long as the FERC does not go to the heart of the problem, the take-or-pay contracts themselves, little reason exists to expect that crediting alone will provide sufficient take-or-pay relief. To the contrary, a rational producer would eschew the complexities of crediting and the mere potential of increased sales, and instead simply sue to enforce the high price and high take-or-pay requirements in their contracts.²⁰² Recent precedents suggest that producer suits will be successful and offer greater rewards²⁰³ than are possible from open-access transmission in the currently depressed gas sales market.²⁰⁴

A. Starting at the Beginning by Determining the Magnitude of Take-or-Pay Costs that Are Recoverable in Rates

The thrust of the FERC's Orders No. 380 and No. 436 was to enhance competition in natural gas markets. In Order No. 380 the FERC freed the pipeline customers to purchase gas more flexibly, on a least-cost basis from suppliers other than their traditional pipeline supplier.²⁰⁵ In Order No. 436 the FERC then provided pipeline customers with expanded access to the pipelines *qua* open-access transporters that stand ready to transport gas purchased from the nontraditional sources.²⁰⁶ While these objectives are copacetic in themselves, the FERC's myopic focus on changing the contractual obligations of downstream purchasers to their traditional interstate

824 F.2d at 1028-30; *see also* Doane, *supra* note 4, at 50.

201. *See, e.g.*, Transcontinental Gas Pipe Line Corp., 42 F.E.R.C. at 61,872-73 (1988) (discussing difficulties in implementing crediting).

202. The *Associated Gas Distributors'* panel recognized that a producer's incentive to credit is the ability to obtain transmission access and thereby pursue "entirely new market *opportunities*" to make sales directly to distribution and end-use markets. 824 F.2d at 1029 (emphasis added). It is far from certain whether a mere opportunity will override the apparently greater likelihood that the producer will succeed on a breach of contract claim while retaining its gas for future sales. Recognizing that producers may well resist for this reason, the court complained that the FERC "seems to confuse the pipelines' *incentive* to renegotiate contracts with their *ability* to do so." 824 F.2d at 1024 (emphasis in original); *cf. Consolidated Edison*, 823 F.2d at 640 ("whole purpose of take-or-pay contracts is to give producers the same benefit whether or not the gas in question actually leaves the ground"). The producer bar is buoyed by recent successes, including judgments for anticipatory repudiation when a pipeline's depressed sales market demonstrates that it will neither be able to take gas, nor be able to pay. *E.g.*, *El Paso Natural Gas Co. v. G.H.R. Energy Corp.*, No. 85-09329 (D. Ct. Harris County, Tex. 1988) (\$356.2 million jury verdict against pipeline for anticipatory repudiation). *See generally* Medina, McKenzie & Daniel, *supra* note 4, at 198-201, 256 (urging producers to litigate take-or-pay claims, including claims for anticipatory repudiation).

203. *See generally* D. JOHN, E. HENGERER & P. ESPOSITO, NATURAL GAS CONTRACTS §§ 12.003-.0012 (Thompson Pub. Group) (updating judgments in take-or-pay litigation).

204. *See id.* *See generally* Medina, McKenzie & Daniels, *supra* note 4.

205. *See* Order No. 380, *supra* note 23, 49 Fed. Reg. 22,779, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,958-59; Order No. 436, *supra* note 5, 50 Fed. Reg. 42,411, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,470; *see also supra* text accompanying notes 22-38.

206. Order No. 436, *supra* note 5, 50 Fed. Reg. 42,429, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,504; *see supra* notes 23-31 and accompanying text.

pipeline suppliers has caused the FERC to overlook entirely the interrelated contractual obligations of pipelines to both their downstream purchasers and upstream gas producers. The pipelines entered into these contractual commitments in reliance on the regulatory status quo existing before Orders No. 380 and No. 436. That status quo encompassed the pipelines' statutory and contractual obligation to satisfy the demands of downstream markets, not only for transportation services, but also for gas sales on demand.²⁰⁷ The status quo further encompassed the pipelines' corresponding need to keep enough gas supply under contract with gas producers at the wellhead or with other pipelines to fulfill the statutory certificate requirement to supply gas on demand to downstream purchasers. By reducing downstream purchasers' commitments to the pipelines as gas merchants while increasing the pipelines' obligations to serve as transporters independent of sales, the FERC undercut the longstanding contractual bases for existing wellhead contractual relations between the gas pipelines and their producer-suppliers.²⁰⁸ The first step in devising a lawful and nonretroactive solution to pipeline take-or-pay liability should therefore start with the wellhead contracts.

1. FERC's Jurisdiction to Modify or Invalidate Wellhead Contract Terms

Under conventional ratemaking principles, the FERC could address wellhead contracts from two angles. First, the FERC could examine whether the regulated gas pipelines were prudent in entering the gas supply commitments that have produced take-or-pay liabilities. Payments under imprudent contractual commitments are unjust and unreasonable, in violation of sections 4 and 5 of the NGA, and are therefore not eligible for recovery in rates.²⁰⁹ Second, the FERC can address whether contractual take-or-pay requirements exert an unjust and unreasonable effect on rates under section 5 of the NGA, or whether nonrecoupable take-or-pay payments violate max-

207. See *Associated Gas Distribs.*, 824 F.2d at 1016 n.18 ("In some cases [the pipelines'] commitments were not freely entered into, but are the product of Commission orders under NGA § 7(a) that the pipeline extend service to a particular customer"); *but cf. supra* note 13. Pre-Order No. 380 regulation under the NGA had actually strengthened the monopoly power of the pipelines as gas merchants. See *Associated Gas Distribs.*, 824 F.2d at 1017; Pierce, *Wellhead to Burnertip*, *supra* note 2, at 24.

208. See *Associated Gas Distribs.*, 824 F.2d at 1027 (citing Carpenter, Jacoby & Wright, *Adapting to Change in Natural Gas Markets*, in *ENERGY, MARKETS & REGULATION, ESSAYS IN HONOR OF M.A. ADELMAN 1* (1986) (discussing evolution of natural gas pipelines' exposure to risk)); see also Pierce, *Wellhead to Burnertip*, *supra* note 2, at 35-37.

209. 15 U.S.C. §§ 717c-717d (1982). "The Commission has the continuing responsibility under the Natural Gas Act to adjudicate the reasonableness of any rate or charge and to insure that all rates and charges are supported by *only* prudently incurred costs." *Metzenbaum v. Columbia Gas Trans. Corp.*, 2 F.E.R.C. ¶ 63,020, at 65,108 (1978) (emphasis added); *accord Atlantic Ref. Co. v. Public Serv. Comm'n*, 360 U.S. 378, 388 (1959). The NGA requirement that natural gas companies incur costs prudently comprises a pipeline's obligation "to consider the effect of its purchases [at the wellhead] on the marketability of its gas . . ." Office of Consumers' Counsel, *Ohio v. FERC*, 783 F.2d 206, 217 (D.C. Cir. 1986). Consequently, take-or-pay costs that are attributable to pipeline purchases of too much or too costly gas may not be eligible for rate recovery. On appeal of Order No. 436, the FERC assured the court that the pipelines would be allowed to bill only "prudently incurred" take-or-pay costs to customers downstream. *Associated Gas Distribs.*, 824 F.2d at 1027. Conversely, gas that is not marketable solely by reason of regulatory changes should not be similarly excluded from rate recovery.

imum lawful ceiling prices under section 504 of the NGPA.²¹⁰

No one, including the FERC itself, has questioned its statutory authority to pursue the first approach. In fact, the FERC recognized in Order No. 500 that it is "undoubtedly true that some pipelines imprudently entered into contracts incorporating both high prices and high take-or-pay levels."²¹¹ The FERC, nevertheless, has simply argued that prudence investigations are difficult and, for that reason, the FERC has effectively declined its statutory mandate to pursue them.²¹² In any event, few, if any, would argue that fact-specific prudence inquiries into the purchasing practices of individual pipelines present a meaningful regulatory vehicle for resolving the industry-wide take-or-pay problem.²¹³

By contrast, the FERC and others, predominantly gas producers, have challenged the FERC's authority to act directly against wellhead contracts, arguing that the NGPA deprived the FERC of its NGA section 5 jurisdiction over NGPA transactions.²¹⁴ The FERC has also asserted that it is not the province of the regulator to interfere in the contractual commitments between pipelines and producers.²¹⁵ These arguments, like the FERC's refusal to investigate prudence, are not supportable and cannot withstand judicial review. Particularly surprising is the sanctity that the FERC now purports to attach to contracts between producers and pipelines so soon after the FERC found no obstacle to rewriting minimum bills out of pipeline

210. See *supra* note 127. For a discussion of the NGPA's maximum lawful prices for various categories of gas, see generally Note, *supra* note 2.

211. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,336, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,778; see Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,726.

212. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787-88; Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,728 ("[t]he Commission seeks to avoid . . . lengthy hearings [on] . . . prudence"); see Tennessee Gas Pipeline Co., 42 F.E.R.C. ¶ 61,174, at 61,632 (1988) (ordering direct billing while indefinitely deferring § 5 relief). Indeed, the FERC has gone so far as to threaten to impose discriminatory rates on customers who are unwilling to forego their statutory protection against imprudently incurred rates and charges. See United Gas Pipe Line Co., 42 F.E.R.C. ¶ 61,195, at 61,685 (1988) ("litigating parties should be aware that they assume these risks when they raise the prudence issue").

213. Even where well-founded, prudence challenges are costly and difficult to prosecute. They have largely been pursued as a last resort by customers frustrated by the FERC's long inaction on the take-or-pay problem. See Doane, *supra* note 4, at 20.

214. Dicta in a footnote to the *Associated Gas Distributors* decision endorsed this proposition. 824 F.2d at 1027 n.30 (citing *Pennzoil v. FERC*, 645 F.2d 360, 380-83 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982)). Section 5 authority with respect to contracts for NGPA-priced gas was not at issue in *Associated Gas Distribs.*, 824 F.2d at 1022 n.25; see also Order No. 436-A, *supra* note 5, 50 Fed. Reg. 52,235 n.42, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 31,660 n.42 (the FERC did not address issue), nor was it decided in *Pennzoil*, in which the court simply determined that state contract law, and not FERC regulation, governed price escalation provisions up to the level of applicable MLPs. 645 F.2d at 383 ("[c]ourt affirms the use of general contract law in determining not to preclude area rate clause escalation generally as a matter of contract law").

215. E.g., *Associated Gas Distribs.*, 824 F.2d at 1026 (quoting FERC Brief at 130-31), 1027-30 (summarizing and rejecting the FERC's excuses for choosing not to address producer-pipeline contracts under NGA § 5). On remand, the FERC did not take § 5 action, but simply invoked its NGA and NGPA jurisdiction to order natural gas pipelines to submit more data on problem take-or-pay contracts.

supply contracts in Order No. 380. Nor is the FERC's veneration of well-head contracts consistent with its fiat in Order No. 436 converting pipelines into open-access carriers, thereby abrogating the pipelines' statutory and contractual status as contract carriers.²¹⁶

The FERC's jurisdiction to modify wellhead contracts arises primarily from section 5 of the NGA. If the FERC determines that a contract affecting rates is unjust and unreasonable under the Act, section 5 requires the FERC to "determine the just and reasonable . . . contract to be thereafter observed and in force, and shall fix the same by order."²¹⁷ With specific reference to take-or-pay terms in wellhead contracts, the FERC previously found that the effect of high percentage take-or-pay obligations on rates, even if the obligations were not unreasonable when entered into, but under present circumstances have become "unjust and unreasonable, unduly discriminatory and preferential."²¹⁸ That finding ultimately resulted in the FERC, with court approval, denying rate recovery of costs that a pipeline incurred to settle liabilities under unjust and unreasonable take-or-pay contract terms.²¹⁹

Section 5 authority over contracts affecting rates extends to both contracts covering price-regulated gas and contracts covering gas for which price has been deregulated under the pricing structure in the NGPA. The enactment of the NGPA in 1978 did not diminish that authority, which has been in force since Congress enacted the NGA in 1938. For example, in *Office of Consumers' Counsel v. FERC*,²²⁰ the D.C. Circuit affirmed the FERC's exercise of section 5 jurisdiction over contracts for NGPA section 107 gas, which is price deregulated under the NGPA, but then reversed the FERC's order below for failing to implement a mandatory remedy under section 5 for contracts covering section 107 gas that had been found unjust and unreasonable.²²¹ Any view to the contrary, including dictum in the *Associated Gas Distributors* decision,²²² is not supportable.²²³ The issue is only of secondary

216. Noting the inconsistency between the FERC's aggressive regulation and abrogation of pipeline-consumer contracts and its laissez-faire approach to the interdependent pipeline-producer contracts upstream, the *Associated Gas Distributors* court noted that "Order [No. 436] effectively reduces pipeline ability to face down recalcitrant producers." 824 F.2d at 1024. On remand, the court instructed the FERC that the most important restriction to be placed on its deregulatory inclinations was recognition that "producers' access to transportation . . . is itself dependent on government [regulatory] intervention." *Id.* at 1027.

217. 15 U.S.C. § 717d(a) (1982); see *American Smelting & Ref. Co. v. FPC*, 494 F.2d 925, 940-41 (D.C. Cir.), *cert. denied*, 419 U.S. 882 (1974).

218. *Office of Consumer's Counsel, Ohio v. FERC*, 783 F.2d 206, 218 (D.C. Cir. 1986) (quoting *Columbia Gas Trans. Corp.*, Opinion No. 204, 26 F.E.R.C. ¶ 61,034, at 61,120 (1984)).

219. *Id.* The court emphasized the need to remedy high-cost take-or-pay obligations: [T]he effect of these [high-cost take-or-pay] provisions under present conditions is . . . harmful to Columbia's customers who stand to lose markets because of fuel switching and unfair to consumers who must bear the cost. It is discriminatory to low-cost gas producers whose production is cut back. It is potentially harmful to Columbia itself.

Id. at 236 n.54 (quoting *Columbia Gas Trans. Corp.*, 26 F.E.R.C. at 61,120).

220. 783 F.2d 206 (D.C. Cir. 1986).

221. *Id.* at 233, 235-36.

222. See *supra* note 214 and accompanying text. Ironically, that dictum has eclipsed the

importance since available evidence, and the FERC's own findings indicate that most of the pipelines' current take-or-pay liabilities arise from contracts that are jurisdictional under the NGA.²²⁴

That many wellhead contracts currently require a section 5 remedy is apparent from the FERC's own findings underlying the Order No. 500 direct bill:

The take-or-pay problem currently affecting the natural gas industry appears to be the *vestige of an era of non-competitive conditions in well-head markets*. Many problem take-or-pay contracts were negotiated in the years immediately following enactment of the NGPA (roughly 1979 through Mid-1982), which were characterized by pervasive market dis-

contrary holding of *Office of Consumers' Council*, in the minds of certain commentators. *See, e.g., Pierce, Wellhead to Burnertip, supra* note 2, at 41. This is plainly contrary to the law: one panel of the court cannot overrule the recent holding of another panel. *United States v. Doe*, 730 F.2d 1529, 1531 n.2 (D.C. Cir. 1984); *Brewster v. Commissioner*, 607 F.2d 1369, 1373 (D.C. Cir.), *cert. denied*, 444 U.S. 991 (1979). Due to the "labyrinthine" breadth of the *Associated Gas Distributors* decision, one judge from the panel reiterated the narrow holding, which simply affirmed open access absent CD reductions, and refused to be bound by the rest of the opinion's "loose language and stray observations." 824 F.2d at 1044 (Mikva, J., concurring in the judgment in part and dissenting in part). Consistent with the *Office of Consumers' Council* decision, a second panel of the D.C. Circuit refused to be bound by the *Associated Gas Distributors* dictum: "The initial panel clearly assumed, without question or objection from any party, that in imposing remedies under Section 5 FERC had the power to modify . . . illegal take-or-pay provisions. The . . . footnote in *Associated Gas Distribs.* is clearly dictum and it in no way affects the law of this case." *Office of Consumers' Council, Ohio v. FERC (OCC II)*, 826 F.2d 1136, 1139 n.2 (D.C. Cir. 1988).

223. Section 601(a)(1) of the NGPA, 15 U.S.C. § 3431(a)(1), removed the FERC's NGA jurisdiction over first sales of "nonjurisdictional" gas and over the seller or purchaser that would otherwise attach "solely by reason of any first sale of such natural gas." *Id.* That diminution in jurisdiction over price in first sales did not otherwise diminish the FERC's § 5 authority over contracts affecting rates. Construing the parallel provision of the FPA, the Supreme Court held precisely this in *FPC v. Conway Corp.*, 426 U.S. 271, 281 (1976) ("The rules, practices or contracts 'affecting' the jurisdictional rate are not themselves limited to the jurisdictional context."). Indeed, the contrary, which would negate § 5 jurisdiction over "nonjurisdictional" first sales under the NGPA, would also negate Order No. 436's open-access transmission in connection with transmission of "nonjurisdictional gas." Order No. 436, however, was plainly not so circumscribed. It is well-settled that the FERC is empowered to exercise its jurisdiction even when to do so results in indirect regulation of subjects over which the FERC has no direct jurisdiction. *See, e.g., FPC v. Louisiana Power & Light Co.*, 406 U.S. 621 (1972) (FPC has power under NGA to regulate pipeline's curtailments of sales, including nonjurisdictional direct sales, even though such action has the effect of overriding private sales contracts for nonjurisdictional transactions); *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 25-26 (1961) (FPC has power under NGA to deny transportation certificate for a nonjurisdictional direct sale on the ground that the price is excessive, even though the effect of denying a certificate is to regulate indirectly the price for a direct sale, over which FPC has no jurisdiction); *Panhandle E. Pipe Line Co. v. FPC*, 324 U.S. 635, 646-47 (1945) (FPC has power under NGA to take into consideration a pipeline's rates for nonjurisdictional direct sales when computing rates for jurisdictional sales.). In *Mississippi Indus. v. FERC*, 808 F.2d 1525 (D.C. Cir.), *cert. denied*, 108 S. Ct. 501, 9 L. Ed. 2d 499 (1987), the D.C. Circuit recently held that the FERC acted within its authority when it modified a contract pursuant to § 206 of the FPA (the counterpart of NGA § 5), even though its action affected generating facilities, over which the FERC has no jurisdiction, 808 F.2d at 1543, and even though its action had some impact on state regulation, into which the FERC is not permitted to intrude. *Id.* at 1547.

224. *See* INGAA, *supra* note 3, at 1; *see also Associated Gas Distribs.*, 824 F.2d at 1027-28 ("bulk of high-cost 'problem' contracts without 'market-outs' may be those entered into prior to 1982 involving offshore gas," which is under continuous NGA jurisdiction); *Consolidated Edison Co. v. FERC*, 823 F.2d 630, 634 (D.C. Cir. 1987).

orders including high prices for new and unregulated gas reserves. . . . The large and growing take-or-pay liability of the pipelines is a source of continuing market disorder which is *at odds with the establishment of market-responsive prices and the unbundling of natural gas services that the Commission has endeavored to foster through Order Nos. 380, 436, and 451.*²²⁵

Recently, the courts have twice recognized that the noncompetitive effect of these problem wellhead contracts has been magnified by Orders No. 380 and No. 436, as well as other recent FERC initiatives to promote competition in gas sales markets. For example, in vacating and remanding the FERC's revised policy on when it will grant authority to abandon certified wellhead gas supply commitments between producers and pipelines, the court in *Consolidated Edison Co. v. FERC*²²⁶ observed that "the take-or-pay contracts problem will be exacerbated, not mitigated, by the various deregulatory maneuvers in which the [FERC] is engaged."²²⁷ Because of the FERC's failure to address the take-or-pay implications of its new abandonment policy, the court found that the new rule fell short of reasoned decisionmaking and remanded the case to the FERC for action on take-or-pay.²²⁸

These findings that high-percentage take-or-pay contracts are noncompetitive and against the public interest are virtually interchangeable with the FERC's findings that it successfully relied on in Order No. 380 to relieve pipeline customers from paying the variable-cost minimum commodity bills contained in pipeline tariffs. Indeed, most of the specific findings concerning the effects of variable-cost minimum commodity bills in Order No. 380 are equally true of high percentage take-or-pay terms in wellhead contracts. Just as the minimum bills immunized pipelines and their suppliers from market risk,²²⁹ take-or-pay protects producers by forcing pipelines and, under the retroactive direct bill, downstream purchasers to pay producers for gas at prices that are not marketable.²³⁰ Take-or-pay hinders the ability of pipelines to obtain gas supply on a least-cost basis,²³¹ just as the FERC

225. Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,726 (emphasis added); *see generally* Threadgill, *supra* note 16 (arguing that pipeline take-or-pay liability is result of producer abuses).

226. 823 F.2d 630 (D.C. Cir. 1987).

227. *Id.* at 642; *accord* Wagner & Brown v. ANR Pipeline Co., 837 F.2d 199, 205 (5th Cir. 1988) ("These orders [No. 380 and No. 436] essentially removed the gas consumers' obligation to take high-priced gas from pipelines but did not relieve the pipelines' take-or-pay obligations to producers."); *cf.* Order No. 500, *supra* note 5, 52 Fed. Reg. 30,336, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,777.

228. 823 F.2d at 641-43.

229. Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1150-51 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986); *see* Note, *supra* note 23, at 144-45.

230. *Associated Gas Distribs.*, 824 F.2d at 1021; *see* Medina, McKenzie & Daniel, *supra* note 4, at 188 ("take-or-pay . . . assign[s] the risk of a deteriorating natural gas market to the pipeline.").

231. In fact, take-or-pay in the current market has a more harmful effect on gas consumers than minimum commodity bills since it protects higher-than-market wellhead prices, *Associated Gas Distribs.*, 824 F.2d at 1021; *Consolidated Edison*, 823 F.2d at 641-42; Order No. 500, *supra* note 5, 52 Fed. Reg. 30,338, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,779. The evidence against minimum commodity bills, by contrast, simply demonstrated

found that pipeline minimum bills denied gas to downstream purchasers on a least-cost basis.²³² Further, like the variable-cost minimum commodity bill, take-or-pay requirements are not necessarily cost-based, since they permit producers to recover costs not incurred by them and potentially allow them to recover multiple times for the same gas.²³³

Because of these similarities, no reason exists why section 5 should require complete abrogation of the contractual minimum bill agreements between pipelines and their customers and yet not require a parallel modification in the interdependent gas supply contracts between pipelines and producers. The FERC has nevertheless refused or indefinitely deferred any direct section 5 remedy.²³⁴ In Order No. 500, the FERC simply committed itself to study the issue further by collecting new data.²³⁵ Further study is hardly warranted. Findings in Orders No. 380, No. 436 and No. 500, supported by ample data and other evidence, compel prompt section 5 relief, thereby diminishing the perceived need for less direct remedies, such as unlawful retroactive rates.

Perhaps the most effective regulatory remedy under section 5 would be the least intrusive. The FERC could simply order that all wellhead contracts containing minimum take requirements violative of section 5 be modified to include an economic-out clause. The economic-out or "market-out,"²³⁶ which has become common in gas supply contracts during the past four to five years, grants the purchaser a once-exercisable right to determine the price at which it could market a minimum take level, within the parameters of the post Orders No. 380 and No. 436, gas markets, without incurring

that they reduced pipeline risk by limiting customer flexibility or, in the case of variable cost minimum commodity bills, could allow pipelines to recover costs never actually paid by them. See Order No. 380, *supra* note 23, 49 Fed. Reg. 22,779, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,959. Judged against the primary purpose of the NGA to protect customers from exploitation at the hands of the natural gas companies, *Atlantic Ref. Co. v. Public Serv. Comm'n*, 360 U.S. 378, 388 (1958); *California Gas Producers Assoc. v. FPC*, 421 F.2d 422, 428 (9th Cir. 1970) ("primary duty . . . is the protection of the consumer"), high-cost take-or-pay contract terms are arguably more in need of a regulatory remedy than were minimum commodity bills.

232. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,783, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,964.

233. This is particularly true with respect to nonrecoupable take-or-pay prepayments, under which the producer-seller is paid, receives time value for the storage service it effectively provides, and is allowed to sell the gas again. Nonrecoupable prepayments are discussed *infra* text accompanying notes 240-70.

234. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784. Order No. 380, *supra* note 23, 49 Fed. Reg. 22,789, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,972.

235. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,341 [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784.

236. An *economic-out* provision in a gas contract "permits the purchaser to rescind contracts for deregulated natural gas if prices of competitive fuel drop to the extent that the distributors of the gas cannot compete." H. WILLIAMS & C. MEYERS, *supra* note 4, at 295. A *market-out* provision "permit[s] a pipeline purchaser to lower [the] price [it pays] if market conditions dictate" and allows the gas seller "to reject the lower price and have the pipeline transport the gas to another buyer." *Id.* at 547. See generally Johnson, *Natural Gas Sales Contracts*, 34 S.W. LEGAL FOUND. OIL & GAS INST. 83, 104 (1983); Smith & Billings, *Taxation and Financial Reporting Regarding the Economic-Out Clause*, 35 OIL & GAS TAX Q. 115 (1986).

take-or-pay liability. The pipeline would then offer that price to the wellhead seller as a contract amendment. The seller, in turn, could either accept the amendment or terminate the sales agreement, including the pipeline's take-or-pay obligation, and endeavor to sell the gas elsewhere.

The virtue of this approach is that it would *not* require the regulator to devise and impose specific new contract provisions. In response to exercise of an economic-out, the parties would be free either to conform their contract to new market conditions or terminate their relationship. Creation of this contractual mutuality in remedying the take-or-pay problem is essential to its success.²³⁷ Moreover, this approach conforms to the FERC's new Order No. 451²³⁸ policy, which creates a one-time right for parties to renegotiate wellhead prices that are still subject to price regulation.²³⁹

2. *Statutory Invalidation of Nonrecoupable Take-or-Pay*

The FERC could also diminish the magnitude of the pipelines' apparent take-or-pay exposure by strictly enforcing the maximum-lawful-price ceilings prescribed in title I of the NGPA and section 5 of the NGA to invalidate and enjoin nonrecoupable take-or-pay prepayments. With respect to price-regulated gas, section 504(a) of the NGPA makes it "unlawful for any person . . . to sell natural gas at a first sale price in excess of any applicable maximum lawful price under this Act."²⁴⁰ Section 2(20) defines a sale as any "transfer for value."²⁴¹ Prepaid take-or-pay obligations that become nonrecoupable²⁴² could, therefore, violate section 504(a).

237. See Pierce, *Wellhead to Burnertip*, *supra* note 2, at 21-22 (instructing that preserving mutuality is important to success of any program to remedy take-or-pay problem).

238. Ceiling Prices; Old Gas Pricing Structure, Order No. 451, 51 Fed. Reg. 22,168 (June 18, 1986), [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. ¶ 30,701, *petition for review docketed sub nom. Mobil Oil Exploration & Producing, S.E., Inc., v. FERC*, No. 86-4949 (5th Cir. Dec. 15, 1986).

239. This is the "good faith" renegotiation rule, which allows producers and pipelines to renegotiate the price terms of certain gas contracts, without regulatory imposition of prices up to an MLP. *Id.*, 51 Fed. Reg. 22,204-09, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,250-58. Order No. 451 revises the varying MLPs for so-called "old gas" under the NGPA—*viz.*, gas that remains subject to NGA price jurisdiction pursuant to NGPA §§ 104 and 106—and establishes an alternative ceiling price for those categories of gas. The good faith renegotiation rule pertains to §§ 104 and 106 producer contracts containing indefinite price escalation clauses. If the producer seeks escalation and is unable to nominate a price acceptable to the purchaser up to the MLP, the producer is granted abandonment and a right to terminate the contract. It can sell the gas elsewhere, subject to a first refusal right vested in the erstwhile purchaser's firm sales customers. See *id.*, 51 Fed. Reg. 22,204, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,210-12, 30,250-52. The purchaser is allowed to respond to a producer requested escalation by nominating a new price on all NGPA vintages of gas covered by a multi-vintage contract containing the escalation provision. *Id.*, 51 Fed. Reg. 22,204, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,250. The latter right of the purchaser, according to the FERC "balance[s] the negotiating rights among the parties." *Id.*

240. 15 U.S.C. § 3414(a) (1982).

241. *Id.* § 3301(20). A "first sale" subject to MLPs is, in turn, defined as "any sale of any volume of natural gas—(i) to any interstate pipeline or intrastate pipeline" which is the first such sale. *Id.* § 3301(21)(A).

242. See *supra* note 108. Under Order No. 500, prepayments themselves are not eligible for the retroactive direct bill. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,345, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,791; Tennessee Gas Pipeline Co., 42 F.E.R.C. ¶ 61,175, at 61,627 (1988); proposed 18 C.F.R. § 2.104(g) ("This section . . . is not intended to

Recently, three FERC Commissioners rejected this interpretation of title I of the NGPA in *ANR Pipeline Co. v. Wagner & Brown*,²⁴³ which had been pending before the FERC since 1983. The FERC's belated decision came in response to the Fifth Circuit's primary jurisdiction referral, in which the court gave the FERC six months to decide the issue, if it was going to decide at all.²⁴⁴ The FERC held that when the purchaser takes no prepaid gas, there is no sale for purposes of the NGPA's first sale definition.²⁴⁵ When the purchaser later takes part, but not all, of the prepaid gas, however, a first sale occurs, but the prepayment is "attributable solely to gas taken pursuant to the make-up provision of the contract" and "[c]onsequently . . . represent[s] a cost of gas only to the extent gas is made up."²⁴⁶ On the issue of whether a sale occurs, the FERC added that the prepayments are like free or discounted transportation services that a pipeline provides to a producer in connection with a sale, independent of the first-sale price. The FERC held in an earlier decision that, for purposes of the NGPA, free or discounted transportation does not constitute part of the transfer for value underlying a sale.²⁴⁷ More generally, the FERC explained in *Wagner & Brown* that it could not construe nonrecoupable prepayments as part of the first-sale price because of pre-NGPA practice under area-rate price ceilings and Congress's silence on the issue in the NGPA and its legislative history.²⁴⁸

None of these explanations is compelling. What is the nonrecouped prepayment when the pipeline takes no gas if it is not part of the first-sale price? Proponents of nonrecoupable prepayments had argued that the prepayments were reservation or storage fees, liquidated damages or consideration for an option.²⁴⁹ The FERC simply held that it was *not* a sale.²⁵⁰ Given the importance of the issue and the potential for ameliorating the take-or-pay problem, the FERC should have given a significantly more thoughtful answer.

The FERC cannot logically escape the illegality of nonrecoupable take-or-pay obligations on price-regulated gas simply by characterizing the prepayment obligations as a producer remedy in the form of inventory or storage

affect [take-or-pay] prepayments . . ."). Prepayments continue to be eligible for capitalization in rate base for recovery on (but not of) the prepaid amount. See *Tennessee Gas Pipeline Co.*, 42 F.E.R.C. at 61,627-28 ("[P]repayments are . . . a rate base item. These are amounts spent for which a service will be provided in the future."); 18 C.F.R. pt. 201 (1988) (Account No. 165). The threat that many existing and future prepayments will prove nonrecoupable in current market conditions underlies the need to renegotiate the take-or-pay contracts. Since settlement payments made in connection with renegotiation are eligible for direct billing, some pipelines have threatened to make settlement payments, which are recoverable under the direct bill, to extinguish prepayment liabilities even where recoupment is possible and would possibly prove more economical. See Request for Rehearing of *Tennessee Gas Pipeline Co.*, Tennessee Gas Pipeline Co., Nos. RP86-119-000, at 29-32 (filed March 9, 1988).

243. 44 F.E.R.C. ¶ 61,057 (1988) (3-1 decision), *petition for reh'g filed* Aug. 15, 1988.

244. 837 F.2d at 206.

245. 44 F.E.R.C. at 61,157.

246. *Id.*

247. *Id.* (citing *Indicated Producers*, 22 F.E.R.C. ¶ 61,013, at 61,021 (1983), *aff'd sub nom. Texas E. Trans. Corp. v. FERC*, 769 F.2d 1053 (5th Cir. 1985), *cert. denied*, 106 S. Ct. 1967 (1986)).

248. *Id.* at 61,157-58.

249. *Id.* at 61,156.

250. *Id.* at 61,157.

charges as opposed to first-sale payments. The producer has a complete remedy for inventory and storage costs caused by purchaser takes below minimum contract quantity without having to retain nonrecoupable prepayments. The available remedy is the producers' unchallenged right to retain the time value of any take-or-pay prepayment.²⁵¹ Moreover, once the prepaid gas becomes nonrecoupable, by definition the producer no longer holds any gas for which an inventory or storage fee should be charged.

The characterization of nonrecoupable prepayments as liquidated damages is subject to attack on at least two grounds. First, when a purchaser takes no gas at all, the producer can sell elsewhere whatever gas it has. The existence of any nonmitigable damage is therefore questionable. Second, a court could deem the prepayment, characterized as a liquidated damage award, to be an unlawful penalty,²⁵² particularly since the damage award has such an enormous impact on a regulated service invested with the public interest.

The characterization of nonrecoupable prepayments as consideration for an option is likewise untenable. To purchase an option is to buy the right to decide later whether to purchase and pay for the optioned item. Under take-or-pay, a pipeline may or may not take the gas in the future, but it must take or pay for the full purchase price of between sixty to 100 percent of the contracted gas reserves or deliverability. Options are priced according to the length of time they are open, the normal fluctuation in price of the optioned item, the prevailing interest rate, and other factors entirely independent of the value of the optioned item.²⁵³ Indeed, the cost of the option is generally

251. Take-or-pay prepayments resemble interest-free loans to producer-sellers. The producer-seller realizes the full time value of the contract price of the gas that he is holding in the ground until it is actually taken or "recouped." The retained interest or time value is, in effect, the inventory or storage charge collected by the seller. The *Associated Gas Distributors* majority apparently overlooked this time value when it opined in dictum that characterizing a prepayment as an NGPA first sale was "improbable" because

Congress must have been aware that producer and pipelines would incorporate these [NGPA price] ceilings into long-term contracts, and that the contracts would include remedies for producers. Obviously the remedial rights would constitute value. If any such value put into breach of the NGPA a contract nominally at the NGPA ceiling, the NGPA would provide a most uncertain guide.

824 F.2d at 1022 n.26.

252. "[I]n the light of the circumstances existing when [a] contract was [entered]," if the liquidated damage "amount agreed upon is 'unconscionable' or is disproportionate to the value of the performance promised and the consideration paid, the sum fixed will be called a penalty and the agreement to pay it will not be enforced." A. CORBIN, *CORBIN ON CONTRACTS* § 1063, at 362 (1963 & Kaufman Supp. 1984). For a court to enforce liquidated damages, it must find some relationship between foreseeable damages and the liquidated amount. *Id.* Similarly, the UCC provides that "[a] term fixing unreasonably large liquidated damages is void as a penalty." U.C.C. § 2-718(1) (1982); see *Bogatz v. Case Catering Corp.*, 86 Misc. 2d 1052, 383 N.Y.S.2d 535 (N.Y. Cir. Ct. 1976) (clause holding buyer liable for full contract price in event of cancellation held unconscionable). Nonrecoupable prepayments, therefore, may not be enforceable as liquidated damages clauses. The prepaid amounts do not attempt to provide contractually for reasonably foreseeable damages and may be perceived arguably "unreasonably large." *But see Medina, McKenzie & Daniel, supra* note 4, at 220-22 (rejecting penalty argument, but not addressing nonrecoupable prepayments specifically).

253. See *W.F. SHARPE, INVESTMENTS* 364-76 (1978) (explaining option valuation and setting out the Black-Scholes model, which uses such factors as interest rates, price fluctuation

not stated as part of the purchase price (although it can, depending on its size, *affect* the purchase price), but is stated instead as the value required by the seller for keeping the optioned item off the market for a period of time, and the amount the buyer is willing to risk to own the right to make a future decision to purchase. By contrast, take-or-pay prepayments are applied to the purchase price of any gas later taken within the recoupment period, are set by reference to the price of the gas, and reflect a current decision by a pipeline to commit itself to the purchase of gas it may never even take. An option holder only becomes similarly committed after it exercises the option. In short, the two are essentially dissimilar.

The FERC's own analogy in *Wagner & Brown*, comparing a take-or-pay prepayment to a "prepayment of a lease,"²⁵⁴ actually seems to belie the option characterization. A lease prepayment ordinarily is a prepayment of all or a portion of the total lease cost for the commodity, property, or service leased, with the lessor getting the time value of the prepayment. The prepayment on a lease is therefore not an option payment, but is instead a payment for the lease itself.²⁵⁵

Nor is the FERC's reasoning made more accessible by reference to its earlier finding that free or discounted transportation services are not part of a first-sale price.²⁵⁶ Transportation is an in-kind transfer of value that is not ordinarily related to the per-unit price of gas. By contrast, nonrecoupable prepayments are monetary transactions expressly valued as a percentage of the per-unit price of gas.²⁵⁷ In these respects, nonrecoupable prepayments are not equivalent to transportation service that is provided in connection with a sale of gas. The prepayments are instead fundamentally similar to prepayments that pipelines paid to producers in connection with the advance payments program.²⁵⁸ The advance payments program, which was an out-

and length of the option in order to arrive at a value); Corbin *supra* note 252, 259, at 459-60; see also *J.C. COX & M. RUBENSTEIN, OPTIONS MARKETS* 33-39 (1985).

254. 44 F.E.R.C. at 61,157.

255. The FERC's prepaid lease analogy actually seems to buttress the dissent of Commissioner Stalon in the FERC's *Wagner & Brown* decision. Commissioner Stalon rejected the majority's interpretation of NGPA § 101(b)(4), 15 U.S.C. § 3311(b)(4) (1982), as confining a first sale to situations in which the payment for and receipt of gas occur in the same month. Under that definition, prepayments that become nonrecoupable at the end of a five-year make-up period would never be part of the price paid. As Commissioner Stalon instructed, § 101(b)(4) relates to the price ceilings themselves, which can change from month to month. 44 F.E.R.C. at 61,158-59. Prepayments, however, like long-term lease prepayments, are not discrete monthly occurrences unrelated to the price of what is leased or purchased. Moreover, the FERC's earlier proposed rulemaking including gas advance payments in the first sale price for NGPA purposes squarely contradicts the FERC's current interpretation of the reference to "month" in NGPA § 101(b)(4). *Id.* at 61,159-3 to -4; see *infra* note 260 and accompanying text.

256. 44 F.E.R.C. at 61,157.

257. See *supra* note 4.

258. See Accounting and Rate Treatment of Advances Included in Account No. 166, Advances for Gas Exploration, Development and Production, Order No. 499, 50 F.P.C. 2111 (1973) (governing contracts executed between Jan. 1, 1974, and Dec. 31, 1975); Accounting and Rate Treatment of Advance Payments Included in Account 166, Advance Payments for Gas Development and Production, Order No. 465, 48 F.P.C. 1550 (1972) (extending advance payments program to Dec. 31, 1973); Accounting and Rate Treatment of Advance Payments to Suppliers for Exploration and Lease Acquisition of Gas Producing Properties, Order No.

growth of the gas deliverability shortages of the 1970s,²⁵⁹ authorized pipelines to fund development of gas reserves for later delivery. In 1980 the FERC concluded that, since pipelines could easily manipulate advance payments to evade price ceilings, the payments should be deemed part of the price paid in a first sale.²⁶⁰

Finally, the FERC's reference to area rates and congressional silence proves nothing. The legality of nonrecoupable take-or-pay prepayments apparently never arose in the context of area rates, and the negative pregnant that the FERC divined in Congress's silence regarding these prepayments in the NGPA²⁶¹ is unconvincing. The inability of pipelines to recoup prepayments did not become a significant problem until the gas markets changed in the early 1980s, well after Congress deliberated on and passed the NGPA in 1978.²⁶² FERC's interpretation of Congress's silence further runs afoul of statutory construction rules. In section 110 of the NGPA Congress expressly addressed two categories of gas supply-related costs that can be charged in excess of the MLP: state severance taxes and certain production-related costs.²⁶³ By contrast, take-or-pay as well as producer debt service costs, storage and inventory costs, options or liquidated damages are nowhere mentioned. Thus, under the rule of *expresio unius est exclusio alter-*

441, 46 F.P.C. 1178 (1971) (governing advance payments contracts executed between Nov. 10, 1971, and Dec. 31, 1972); Accounting and Rate Treatment of Advance Payments to Suppliers for Gas, and Amending F.P.C. Form No. 2, Order No. 410-A, 45 F.P.C. 135 (1971) (amending the treatment of advance payments governed by Order No. 410); Accounting and Rate Treatment of Advance Payments to Suppliers for Gas and Amending F.P.C. Form No. 2, Order No. 410, 44 F.P.C. 1142 (1970) (governing advances made pursuant to contracts entered after Oct. 2, 1970).

259. See *Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094, 1099 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980).

260. Advance Payments under the NGPA of 1970, Notice of Proposed Rulemaking, 45 Fed. Reg. 28,345, 28,346 (Apr. 29, 1980), *reprinted in* [1980] F.E.R.C. Proposed Regs. ¶ 32,063, at 32,702-03. In response to the court's remand in *Tennessee Gas Pipeline Co.*, the F.E.R.C. issued a notice of proposed rulemaking in which it concluded:

[T]he District of Columbia Court of Appeals indicated that advance payments "provide a 'bonus' to producers in the amount of the interest factor, an amount which is never refunded." The court found that this bonus effectively raised the price of natural gas "above the regulatory ceiling." The Commission agrees; without an appropriate adjustment, advance payments may allow producers to circumvent the maximum lawful prices established under the NGPA.

Id. (footnote omitted). The FERC later withdrew the proposed rulemaking as unnecessary because the subject of that docket—the advance payment program—no longer existed. Termination of Rulemaking Dockets, Order No. 354, 49 Fed. Reg. 1525 (Jan. 12, 1984), *reprinted in* [Proposed Regs. 1982-1987] F.E.R.C. Stats. & Regs. ¶ 32,364. The logic of the proposed rulemaking and the applicability of that logic to nonrecoupable take-or-pay prepayments, however, remain compelling.

261. 44 F.E.R.C. at 61,158.

262. See *Wagner & Brown v. ANR Pipeline Co.*, 837 F.2d 199, 204-05 (5th Cir. 1988); *Associated Gas Distribs.*, 824 F.2d at 995-96; *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144, 1151 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986); Doane, *supra* note 4, at 18 ("take-or-pay provisions . . . were not a source of controversy . . . [until] middle to late 1970's"); Medina, McKenzie & Daniel, *supra* note 4, at 189-92 ("During the 1980's, the take-or-pay clause began to become significant to the pipeline."); Moody, *The Natural Gas Industry After Partial Deregulation*, 36 INST. ON OIL & GAS L. & TAX'N §§ 6.01, 6.06[3] (1985).

263. 15 U.S.C. § 3320; see also *supra* note 44 (discussing production-related costs that NGPA expressly allows producers to recover in excess of price ceilings); see *supra* note 127.

ius,²⁶⁴ nonrecoupable prepayments should not be exempt from an otherwise applicable MLP. This is particularly appropriate if Congress did actually consider the issue, as the FERC suggests in *Wagner & Brown*.²⁶⁵

Even if the courts uphold the *Wagner & Brown* decision, nonrecoupable prepayments remain vulnerable under NGA section 5.²⁶⁶ Viewed as a liquidated damage award, the penalty imposed is hardly just and reasonable. As noted earlier, section 5 of the NGA, empowers the FERC to review and remedy "any rate, charge . . . or contract affecting such rate."²⁶⁷ This mandate to insure that all rates and contracts affecting rates are just and reasonable extends to contract provisions governing the sale of gas to interstate pipelines, whether the gas is price regulated or deregulated.²⁶⁸

A FERC finding that nonrecoupable prepayments violate section 5 would lessen the compulsion that pipelines feel to pay off take-or-pay obligations before they become nonrecoupable. Prepaid gas would then remain dedicated to the purchaser who made the prepayment and producers could not retain take-or-pay prepayments and sell the prepaid gas elsewhere, double-billing for the same volumes. In order to free prepaid take-or-pay volumes for another sale, the producer would in all likelihood have to remit the prepaid principal, thereby lessening the pipeline's take-or-pay burden. In sum, the FERC could significantly reduce the magnitude of pipeline take-or-pay liability without resorting to Order No. 500's retroactive direct bill if it invalidates nonrecoupable take-or-pay obligations.

B. Minimizing Cost Shifts and the Potential for Intergenerational Inequity Through Refunctionalization

Even though retroactive rates cannot effectively match past purchases with current take-or-pay liabilities, it is not necessary to abandon altogether the FERC's concern regarding pipelines shifting take-or-pay costs unfairly between classes or generations of ratepayers. One FERC Commissioner, in his policy alternative to Order No. 500's retroactive direct bill, recognized that cost shifting can lawfully be mitigated by refunctionalizing²⁶⁹ some portion of take-or-pay costs away from the conventional production function to the transmission function.²⁷⁰

264. See 2 A. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 47.23 (Sands 4th ed. 1984).

265. 44 F.E.R.C. at 61,158 n.5; see also *Associated Gas Distribs.*, 824 F.2d at 1022 n.26. The FERC's assumption, however, is not persuasive; the legislative history of the NGPA suggests "political turmoil and compromise" and not concentration on discrete or then unapparent historical details. Note, *Deregulation and Natural Gas Purchase Contracts: Examination Through Neoclassical and Relational Contract Theories*, 25 WASH. L.J. 43, 45 (1985) (citing Morgan & Paterson, *The Natural Gas Policy Act of 1978: Four Years of Practice and Two Years to Make Perfect*, 71 KY. L. J. 105 (1982)); see also Note, *supra* note 2, at 113-16 (discussing congressional debate on NGPA).

266. 44 F.E.R.C. at 61,156-57 (FERC expressly disclaimed any decision under NGA § 5).

267. 15 U.S.C. § 717d (emphasis added); see *supra* note 217.

268. See *supra* text accompanying notes 217-24.

269. For a definition of functionalization, see *supra* note 197.

270. Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,731-32 (Stalon, Comm'r, alternative policy statement).

The refunctionalization approach, which is permitted, but not required, by Order No. 500,²⁷¹ essentially starts with the same threshold premise as the Order No. 500 retroactive direct bill. The premise is that the past decisions of certain customers to reduce or cease gas purchases from their traditional pipeline in response to the competitive purchase options created by Orders No. 380 and No. 436 have contributed to the take-or-pay exposure that the pipelines now confront. Many, although not all, of those customers availed themselves of their enhanced flexibility under Order No. 380 to purchase from nontraditional suppliers—wellhead sellers, brokers, or other pipelines—and then used the traditional or some other pipeline as an Order No. 436 open access carrier, to transport the nontraditional gas supply.

The alternative policy recognized that, under the conventional practice, take-or-pay costs are recoverable only in the gas sales rates. Thus, customers who were most captive to the traditional pipeline supplier ended up paying.²⁷² By contrast, those customers who reduced or ceased purchases could successfully shift onto those captives and later generations of sale customers part or all of the take-or-pay costs to which their past purchasing decisions contributed, according to the threshold premise. This result is moderated by refunctionalizing some or all take-or-pay costs away from production to transmission. Purchasers from nontraditional suppliers would then have to contribute to take-or-pay costs whenever they contracted to have their nontraditional gas supplies transported by the traditional pipeline supplier or some other transporter whose take-or-pay costs would similarly be refunctionalized.

Refunctionalization has the added virtue of prodding gas producers to moderate their take-or-pay claims. Since most producer wellhead revenue for gas sold is net of transmission costs,²⁷³ any increase in transmission expense occasioned by functionalizing take-or-pay costs to that service will ordinarily be offset, at least in part, by a reduction in the producers' netback receipts for wellhead sales. The diminution in the netback receipt will gener-

271. See Order No. 500, *supra* note 5, 52 Fed. Reg. 30,341, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,784-85; see Transcontinental Gas Pipeline Corp., 42 F.E.R.C. ¶ 61,407, at 62,207-09 (1988) (discussing Order No. 500 proposal to recover 50% of pipeline's take-or-pay in volumetric surcharge on total throughput).

272. Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,731 (Stalon, Comm'r, alternative policy statement). The resulting misallocation under this scenario lies at the heart of the FERC's defense of past-purchase-deficiency billing. See *supra* text accompanying notes 167-78.

273. In Order No. 380-A, the FERC recognized the increasing orientation of gas markets to netback wellhead pricing:

[The industry pricing] system is changing to a "net-back" pricing system similar to the net-back system in oil markets. Under "net-back" pricing the wellhead price is governed by the burner-tip price and not vice versa. In a net-back system price formation begins in the final demand markets. The need to clear the final demand markets—that is, to equate available gas supply with gas demand, which depends on the prices of the other fuels that customers can buy—determines gas prices in end-use markets

Order No. 380-A, 49 Fed. Reg. 31,269 (Aug. 6, 1984), [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,584, at 31,047 (adopting Statement of George R. Hall).

ally be in proportion to the burden that producer take-or-pay demands impose on transporting pipelines.

Obviously, refunctionalization alone cannot reach all of the purchasers who, according to the threshold premise, may have contributed to take-or-pay liabilities. For example, erstwhile purchasers who have stopped gas purchases altogether will not pay gas transmission rates burdened by refunctionalized take-or-pay costs. Nevertheless, refunctionalization would lawfully address the cost-shifting rationales put forward in support of the retroactive direct bill in Order No. 500.

Since refunctionalization would mark a significant departure from longstanding FERC practice, its implementation would have to be accompanied by substantial evidence showing refunctionalization to be reasonable under the circumstances confronting the industry.²⁷⁴ This legal requirement, however, is equally applicable to Order No. 500's departure from the longstanding regulatory practice of classifying all take-or-pay costs to the commodity charge. To the extent the FERC now purports to have marshalled substantial evidence justifying Order No. 500, the FERC surely could rely on the same evidence to validate an otherwise lawful departure in the form of refunctionalization. Moreover, if the FERC were to impose a sunset provision limiting the duration of refunctionalization to a period long enough to reduce appreciably existing and anticipated take-or-pay liability, the justification for the departure would likely be strengthened.

C. Reclassifying Take-or-Pay for Recovery in Whole or in Part in a Fixed Demand Charge

Order No. 500 introduced two major departures from conventional rate treatment of take-or-pay costs. One is the unlawfully retroactive billing mechanism. The other, and potentially lawful, change is the reclassification of take-or-pay costs from the commodity charge, recoverable against current and future purchases, to a fixed charge, recoverable irrespective of gas sales.²⁷⁵ Reclassification itself does not require retroactive billing. The FERC could implement reclassification, for example, in relation to a customer's *current* or *future* demand for gas, however measured, as opposed to past purchases.²⁷⁶

Reclassification of take-or-pay costs would have two primary effects. First, once reclassified as fixed demand charges, take-or-pay costs could no longer be avoided by a customer pursuing a least-cost purchasing strategy, except to the extent the customer reduced its contractual demand entitlement to the pipelines' capacity. Second, the pipeline would attain greater assurance that its customers would pay its take-or-pay costs since recovery

274. See *supra* note 191.

275. See *supra* notes 93-101 and accompanying text.

276. The FERC embraced a partial reclassification mechanism, in addition to a retroactive past-purchase-deficiency mechanism, to bill part of Tennessee Gas Pipeline's take-or-pay settlement costs, but reversed itself on rehearing, holding that all take-or-pay direct bills must conform to the wholly retroactive billing scheme of Order No. 500. Compare 42 F.E.R.C. at 61,629-30 with 43 F.E.R.C. at 61,928-32.

would no longer be a function of the competitive marketability of the pipelines' gas cost.

Reclassification, with these results, is only *potentially* lawful, since, like refunctionalization, it would mark a material departure from the FERC's longstanding practice and would therefore have to be supported by substantial evidence that the departure was needed and reasonable.²⁷⁷ Even to the extent it could be supported, however, it should be embraced only to the extent that the other take-or-pay remedies, such as prudence reviews, section 5 relief, enjoining recovery of nonrecoupable take-or-pay prepayments and refunctionalization, are tried and proven ineffective. Reclassification is not a desirable remedy because it strikes at the heart of both Orders No. 380 and No. 436. By increasing the unavoidable fixed charges associated with obtaining gas supply, reclassification increases sunk costs while it lessens the variable costs associated with the traditional pipeline's gas supply. As a result, reclassification stymies customer flexibility to pursue least-cost purchasing under Order No. 380. The system would force a customer who is pursuing a rational strategy of minimizing *variable* costs to buy from the traditional supplier, even at a greater *total* unit cost. Further, and perhaps more harmful to Order No. 380's stated objective of creating a more competitive gas sales market, reclassification strengthens the monopsony power²⁷⁸ of the traditional pipeline gas supplier by protecting a greater proportion of its gas supply cost against price competition from other pipelines, gas marketers, or wellhead sellers.²⁷⁹

This result would, in turn, compromise the objectives of, and even the need for, Order No. 436's open-access transportation. If the FERC tilted the economic preference in favor of purchases from the traditional pipeline's gas supply, customers will commensurately reduce their demand for transmission access independent of gas sales. Customers will simply continue to purchase gas and its transmission as a single tied or "bundled" service from the traditional pipeline supplier.

The only possible competitive gain achieved by reclassifying take-or-pay costs to a demand charge lies in the potential for forcing downstream customers, especially distribution companies and their local regulators, to reassess realistically the level of firm demand that they require. As noted throughout this Article, a principal flaw in both Order No. 380 and No. 436 was the FERC's myopic focus on restructuring the contractual entitlements of the pipelines without forcing corresponding reductions in the obligations of pipelines to upstream producers and downstream distribution and end-use customers. Increasing downstream fixed charges through reclassification could indirectly force downstream purchasers to reevaluate how much contract demand they need and are willing to pay for. Achievement of even this

277. See *supra* note 191.

278. See Order No. 380, *supra* note 23, 49 Fed. Reg. 22,778, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,958.

279. See Proposed Policy Statement, *supra* note 38, 38 F.E.R.C. at 61,731-32 (Stalon, Comm'r, alternative policy statement).

limited benefit, however, would require the FERC to use current and future demand levels, and not past historical demand levels, as the basis for the billing of take-or-pay costs. Order No. 500, however, expressly rejects billing based on any current level of demand in lieu of the retroactive past-purchase-deficiency mechanism.²⁸⁰

The slight indirect benefit of reclassification is probably outweighed by the substantial competitive damage it would cause. In Order No. 500 the FERC has already laid the ground work for a more direct and arguably more effective, prospective restructuring of the relation between pipeline suppliers and their downstream customers. Pursuant to Order No. 500, the FERC is currently developing, in individual pipeline certificate proceedings, what is referred to as a gas inventory charge, or GIC.²⁸¹ Furthering the effort to untie or "unbundle" charges for the utility services that pipelines provide, the GIC would permit pipelines to charge downstream customers a separate cost-based rate for the pipeline's cost to maintain gas deliverability (subject to take-or-pay) in inventory ready to meet the downstream purchasers' peak demand for gas supply. Unlike the minimum bill, stricken in Order No. 380 and in individual pipeline rate proceedings, the GIC would be cost-supported,²⁸² and, unlike a reclassified take-or-pay charge that admittedly could not be matched directly with a customer's or class of customers' contract demand or past purchases,²⁸³ the GIC is intended to prorate and bill the costs that each firm-sales customer chooses to impose on the pipeline by reserving rights to differing levels of peak and nonpeak deliverability. As an intended result, the downstream purchaser is confronted directly and in advance with the cost, including take-or-pay costs, that its demand profile imposes on the pipeline.

Coupled with Order No. 436's option entitling customers to convert their

280. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,787; *see supra* note 276.

281. Order No. 500, *supra* note 5, 52 Fed. Reg. 30,343, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,792-94. As described by the FERC, the new GIC would be a separate or "unbundled" charge by which the pipelines could recover "currently for contracting for a gas supply to meet its customers' requirements." *Id.*, 52 Fed. Reg. 30,346-47, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,793. By authorizing the pipelines to charge currently (before gas is sold) for their cost of standing ready to satisfy firm sales demands, the FERC hopes to make "a pipeline's system supply customers more careful in nominating . . . demand." *Id.* However, because the GIC is designed to recover the pipelines' future "costs of contractually committ[ed] gas service," *see id.*, 52 Fed. Reg. 30,347, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,794, it cannot alone alleviate the massive take-or-pay liability already on the pipelines' books. *Id.* In its initial orders on GIC applications, the FERC has made it difficult for the pipelines to embrace GICs by requiring the pipelines to cease any Order No. 500 direct billing of past take-or-pay before the GIC can be implemented to recover future costs of maintaining gas supply, including take-or-pay costs. *See Transwestern Pipeline Co.*, 44 F.E.R.C. ¶ 61,164, at 61,536 (1988); *see* Order No. 500, 52 Fed. Reg. 30,346, [Regs. Preambles 1986-1987] F.E.R.C. Stats. & Regs. at 30,792 ("the pipeline may not recover take-or-pay or similar charges from suppliers by any other means" than the GIC once implemented).

282. *Compare* Order No. 380, 49 Fed. Reg. 22,780-81, 22,786, [Regs. Preambles 1982-1985] F.E.R.C. Stats. & Regs. at 30,960, 30,969 *with* *Transwestern Pipeline Co.*, 44 F.E.R.C. at 61,538 (distinguishing minimum commodity bills and minimum take requirements from GIC).

283. *See supra* note 57.

contract demand from sales to transportation service, the GIC promises to force downstream contract modifications that will reduce the downstream sales obligations of pipelines roughly in proportion to the contractual sales expectations and revenues that the pipelines lost under Orders No. 380 and No. 436. By contrast, reclassification would achieve similar downstream results, if at all, only through indirection and only if current and future, as opposed to historical, demand levels were used as the basis for billing. Consequently, little reason exists to recommend reclassification as a take-or-pay remedy.

V. CONCLUSION

The emerging conflict between the FERC and the courts was precipitated by the FERC's attempts since Congress enacted the NGPA to use unlawful retroactive rates to remedy errors and oversights that have characterized the FERC's piecemeal initiatives to promote competitive gas sales markets. The FERC's retroactive take-or-pay remedy in Order No. 500 is misguided and should be abandoned just as the court in *Columbia* rejected the retroactive rate. Not only are the filed rate doctrine and rule against retroactive ratemaking foundations of traditional ratemaking, they are also essential to realization of the more competitive, partially deregulated, gas market that the FERC hopes to achieve. In both highly regulated or competitive markets, parties to gas supply contracts, from wellhead to burnertip, must be able to rely on, and plan around, known filed rates. If the FERC allows filed rates to become retroactive moving targets, the markets will simply not be able to function.

To abandon the filed rate doctrine and the rule against retroactive ratemaking now in order to remedy the take-or-pay problems that were, in part, caused and surely exacerbated by the FERC's deregulatory initiatives is tantamount to throwing out the baby with the bath water. Resort to retroactive rates is all the more misguided since the FERC has authority to pursue the more effective take-or-pay remedies described here.