

appropriate circumstances was recently and clearly affirmed in *Elizabethtown Gas Co. v. FERC*.<sup>6</sup> There, the court upheld the Commission's approval of a natural gas pipeline's proposal, as part of a pre-Order No. 636 restructuring settlement entered into with its customers, to sell gas for resale at market-based prices. Noting that the Supreme Court has held on numerous occasions that the just and reasonable standard does not dictate any single pricing methodology,<sup>7</sup> the court held that where there is a competitive market, the Commission "may rely upon market-based prices in lieu of cost-of-service regulation to assure a 'just and reasonable' result."<sup>8</sup> In sustaining the Commission's approval of market pricing in this case, the court alluded to the Commission's specific finding that the pipeline's markets were "sufficiently competitive to preclude [the pipeline] from exercising significant market power in its merchant function\* \* \*."<sup>9</sup> Specifically, the Commission had determined—and no record evidence to the contrary was cited on appeal—that adequate divertible supplies of gas existed to give customers options to buy from sellers other than the pipeline, thus assuring that the pipeline would have to sell its own gas at competitive prices. This finding, the court reasoned, justified the Commission's conclusion that the pipeline would be able to charge only a price that was just and reasonable within the meaning of section 4 of the NGA.

In reaching this result, the court of appeals in *Elizabethtown* distinguished the Supreme Court's decision in *FPC v. Texaco, Inc. (Texaco)*,<sup>10</sup> in which the Supreme Court had remanded an FPC order exempting small gas producers from direct regulation of their prices. The Commission order under challenge in *Texaco* provided that small producers' prices would be subject to scrutiny only as a part of the rates of pipelines and large producers to whom they sold their gas, and then only through review of the pipeline and large producer rates. This indirect review procedure was found by the Court to be permissible under the NGA.<sup>11</sup> However,

the order was remanded because the Commission had not clearly shown how, or even whether, the just and reasonable standard would be applied to the small producers' prices in this process.<sup>12</sup> The Court admonished that on remand the Commission must adhere to the principle that "the prevailing price in the market cannot be the final measure of 'just and reasonable' rates mandated by the Act."<sup>13</sup>

The court in *Elizabethtown* reasoned that the point of *Texaco* was only that if Congress has subjected an industry to regulation because of anticompetitive conditions in the industry, the market cannot be the "final" arbiter of the reasonableness of a price.<sup>14</sup> Further, the court in *Elizabethtown* stated, in the *Texaco* proceeding the Commission had not even mentioned the "just and reasonable" standard, but rather appeared to apply only the marketplace standard in determining the reasonableness of small producers' rates. In contrast, in the order challenged in *Elizabethtown*, the Commission had made it clear that it would exercise its section 5 authority if necessary to assure that a market rate is just and reasonable.

A hybrid cost/market-based pricing scheme under the FPA was approved by the court in *Environmental Action v. FERC*.<sup>15</sup> There the Commission had approved the application of certain regulated and non-regulated electric utilities to operate a power pool in which transactions would be priced according to the market, subject to a uniform ceiling price based upon a hypothetical average utility's costs. The court, in rejecting challenges to the pricing mechanism, emphasized the speed and administrative efficiency benefits of market-based pricing. In addition, the court also cited the Commission's expressed intention to monitor transactions and invoke its investigatory powers under section 206 (either sua sponte or upon complaint) to redress abuses. Thus, the court concluded that "[i]n sum, FERC sought to preserve the Pool's efficiencies even as it guarded against price gouging. On the facts in evidence, we find no basis

for concluding it acted unreasonably."<sup>16</sup>

The court's treatment of market-based pricing policies implemented by other agencies offers little guidance to the Commission since much of the focus on increasing competition and reducing federal regulations has been through statutory reform, rather than through agency interpretation of existing statutory authorities. The bounds of agency authority to interpret existing statutory procedural requirements in a manner to facilitate a move to market-based pricing was addressed by the Supreme Court in *MCI Telecommunications Corporation v. American Telephone and Telegraph Company (MCI II)*,<sup>17</sup> and by the court of appeals in *Southwestern Bell Corporation v. FCC (Southwestern Bell)*.<sup>18</sup> However, *MCI II* and *Southwestern Bell* do not speak to the substantive validity of market-based regulation under a just and reasonable statutory standard. Judicial precedents, as explained above, uphold the use of market-based ratemaking, or some variation thereon, if the agency finds that clearly delineated non-cost factors (including the Commission's oversight and remedial authorities) are sufficient to protect the interests of consumers.

## II. The Commission's Prior Experience With Market-Based Rates

### A. The Gas Inventory Charge Cases

#### 1. The Analysis Used

In 1988, the Commission began its movement towards light-handed regulation of some aspects of natural gas markets. The light-handed regulation first appeared with the implementation of market-based gas inventory charges (GIC) for pipeline sales service. In determining whether a pipeline could implement a GIC mechanism, the Commission looked at three key factors: Market definition, the availability of divertible gas supplies and measures of market power. Additionally, the Commission considered whether the transportation of alternative supplies would be on a comparable basis to the terms and conditions of transportation service provided for gas purchased under the GIC. If the supply markets were found to be competitive and transportation terms and conditions

<sup>6</sup> 10 F.3d 866, 870 (D.C. Cir. 1993) (*Elizabethtown*).

<sup>7</sup> The court cited *Mobil Oil Exploration v. U.S.*, 111 S. Ct. 615, 624 (1991): "\* \* \* the just and reasonable standard does not compel the Commission to use any single pricing formula \* \* \*." 10 F.3d at 870.

<sup>8</sup> *Id.* (quoting *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1104 (D.C. Cir. 1990)).

<sup>9</sup> 10 F.3d at 870-71 (quoting *Transcontinental Gas Pipe Line Corp.*, 55 FERC ¶ 61,446 at 62,234).

<sup>10</sup> *FPC v. Texaco, Inc.*, 417 U.S. 380, 397 (1974).

<sup>11</sup> 417 U.S. at 387-91.

<sup>12</sup> The Commission stated that the just and reasonable standard would be applied, and enumerated various factors, in addition to prevailing market prices, that would be taken into account. The Court observed that these representations were relevant to the validity of the order, but ruled that because they were not made in the order itself—only on appeal—they were unavailing. 417 U.S. at 397.

<sup>13</sup> 417 U.S. at 397.

<sup>14</sup> *Elizabethtown*, 10 F.3d at 870.

<sup>15</sup> 996 F.2d 401 (D.C. Cir. 1993).

<sup>16</sup> *Id.* at 410. See also *National Rural Telecom Assoc. v. FCC*, 988 F.2d 174 (D.C. Cir. 1993) (approving flexible pricing for local exchange companies, subject to a ceiling rate).

<sup>17</sup> 114 S. Ct. 2223 (1994).

<sup>18</sup> Nos. 93-1562, 93-1568, 93-1590, and 93-1624 (D.C. Cir. Jan. 20, 1995).