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REGULATORY CONTROL OF NATURAL GAS PROCUREMENT PRACTICES IN ILLINOIS: PERMISSIBLE REGULATION OR PREEMPTED ACTIVITY?

*Roger D. Colton and
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INTRODUCTION

Current natural gas rates severely hurt consumers and their respective states.¹ The magnitude of energy payments that leave state economies² is financially draining and burdensome to area residents.³ This burden in-

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The views expressed herein are solely those of the authors and do not necessarily reflect the views of the National Consumer Law Center or the Illinois Governor's Office of Consumer Services.

1. U.S. GENERAL ACCOUNTING OFFICE, CHANGES IN NATURAL GAS PRICES AND SUPPLIES SINCE PASSAGE OF THE NATURAL GAS POLICY ACT OF 1978, at 5 (June 4, 1981) [hereinafter cited as GAO REPORT]. The report states:

Natural gas prices have increased substantially since enactment of the Natural Gas Policy Act of 1978. During the first quarter of 1980, the surveyed natural gas distributors charged consumers an average of \$2.92 per 1,000 cubic feet (MCF). This is 72 cents per MCF (or about 33 percent) more than average 1978 prices Producer prices increased about 45 percent, or about 24 percent more than general prices as measured by the Consumer Price Index.

However, one commentator has argued that "[n]atural gas decontrol cannot raise the price level. To raise prices of goods and services, decontrol would have to raise the relative price of energy resources and, thereby, reduce real output. The relative price of energy is determined in world markets and is based on the scarcity of energy resources. Since decontrol cannot reduce the energy supply, it cannot raise energy prices or the price level." See Ott & Tatom, *A Perspective on the Economics of Natural Gas Decontrol*, FEDERAL RESERVE BANK OF ST. LOUIS 30 (1982).

2. U.S. DEPARTMENT OF ENERGY AND NEBRASKA ENERGY OFFICE, FINAL REPORT, ENERGY: REGIONAL ECONOMIC INDICATORS ANALYSIS 82-103 (1985). This Department of Energy report found that a national average of only 3.6 natural gas utility jobs were supported by one million dollars of natural gas revenues in 1982. *Id.* at 102.

3. See, e.g., NATIONAL CONSUMER LAW CENTER, HOMES WITHOUT HEAT: A NATIONWIDE STUDY OF DISCONNECTED NATURAL GAS USERS 1 (October 31, 1984) [hereinafter cited as HOMES WITHOUT HEAT]. The study states, "In 1983 alone, 4.7 million people in over 1.6 million households using natural gas had utility service disconnected nationwide. In 1984, if current trends hold, over 1.8 million households will lose their utility service." See also U.S. GENERAL ACCOUNTING OFFICE, DISCONNECTION OF NATURAL GAS SERVICE TO RESIDENTIAL CUSTOMERS (November 13, 1983).

creases each year that energy payments leaving a state remain unregulated.⁴

Under the current federal regulatory scheme, relatively unreviewed producer or pipeline price increases are passed on to consumers. Cost-of-service ratemaking of producer/pipeline gas sales has been abrogated at the federal level.⁵ Additionally, the Natural Gas Policy Act of 1978 now requires state rate regulators to accept, *as per se* "just and reasonable", rates that are determined "just and reasonable" under the act.⁶ Under the federal Purchased Gas Adjustment (PGA) clause,⁷ rate increases by producers to pipelines can be quickly passed through to distribution companies. Distribution companies may then pass the increases on to their consumers. The result is a system in which natural gas rate increases are not seriously reviewed.

Unreviewed rate increases are not the only factors likely to contribute to the imposition of unreasonable costs on consumers. Market imperfections, pervasive monopoly control—both vertical and horizontal by region—and proliferating conflicts of interest at the pipeline/producer level all artificially inflate the price of natural gas to retail customers.⁸ Affiliated enterprises, in which the pipeline and producer or the pipeline and distributor represent the same interests, create situations in which transactions are not conducted at arms length,⁹ and genuine bargaining does

4. "Since 1981, the amount of money owed gas utilities by consumers experiencing a shutoff of service has risen more than 200%. Currently households owe, on average, \$368 at the time of shutoff." HOMES WITHOUT HEAT, *supra* note 3, at 1. In the past four years, the number of disconnections has risen over nine percent annually. *Id.* at 6. If current trends continue, low incomes and high gas bills will combine to cause the disconnection of 1,819,000 households in 1984, 1,995,000 in 1985, 2,188,000 in 1986, 2,400,000 in 1987, and 2,633,000 in 1988. *Id.* at 7.

5. Martin, *Brambles in the Gas Patch: Problems of Natural Gas Decontrol*, 33 MERCER L. REV. 751 (1982). "Several criticisms can be made of the [Natural Gas Policy Act of 1978]'s basic approach . . . The categories of gas are not really cost-based and actually bear little relation to the cost of finding and producing gas." *Id.* at 763. In contrast, prior to the act, "[i]n order to comply with the Supreme Court's decision in [Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954)], the Commission established maximum wellhead prices on a company-by-company, individual case, cost-of-service basis." *Id.* at 753-54. *Cf.* American Pub. Gas Ass'n v. F.P.C., 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978); Shell Oil Co. v. F.P.C., 520 F.2d 1061 (5th Cir. 1975), *cert. denied sub nom.* California Co. v. F.P.C., 426 U.S. 941 (1976).

6. 18 C.F.R. § 154.38(d)(9) (1986); 15 U.S.C. § 3431(c)(2) (1982).

7. "The pipelines and distributors passed the increases of purchased gas along to their customers through general rate increases and purchased gas adjustments . . . Purchased gas adjustments provided for in the pipelines' and distributors' published tariffs allow automatic increases in prices to reflect changes in the cost of gas." GAO REPORT, *supra* note 1, at 6.

8. See generally CONGRESSIONAL RESEARCH SERVICE AND NATIONAL REGULATORY RESEARCH INSTITUTE, NATURAL GAS REGULATION STUDY (July 1982) [hereinafter cited as NATURAL GAS REGULATION STUDY].

9. *Id.* The study notes:

There is some vertical integration among the three industry tiers. That is, most of the pipelines own or control substantial portions of their supply. Columbia Gas

not occur.¹⁰ Furthermore, lower demand for natural gas,¹¹ when coupled with "take-or-pay" contracts at the producer/pipeline level,¹² creates incentives for pipelines to reduce their "takes" of cheaper gas and increase their "takes" of more expensive gas in order to minimize "take-or-pay" penalties.¹³

Many consumer advocates assert that state regulation is the only effective protection from this type of price escalation. In order to regulate natural gas distribution successfully, state regulators must first determine the role they will play in attempting to correct or counterbalance market imperfections in the natural gas industry at the producer/pipeline level. The Federal Energy Regulatory Commission (FERC) possesses sole authority to determine the reasonableness of rates for particular blocks of natural gas in sales from producers to pipelines and from pipelines to distributors.¹⁴ However, some state governments, both legislatively¹⁵ and administratively,¹⁶ have demanded that distribution utilities justify more rigorously their natural gas purchases.¹⁷ The basis for state regulation is that while the FERC's regulations require states to accept the price of the purchased gas, they are not required to accept the distribution utility's choice of the particular block of gas to procure.¹⁸ Although gas prices

System is the only completely vertically integrated company since it is a major producer, transmission company, and distribution company. However, there does exist an increasing number of affiliations among the three sectors of the industry. Major pipeline companies are increasingly interrelated with corporations that engage in exploration and drilling for natural gas in order to supplement their supplies.

Id. at 18-19. Moreover, "the shortages of natural gas and the accompanying curtailments during the 1970's prompted natural gas distributors to form joint ventures to explore and develop natural gas fields." *Id.* at 247.

10. *Id.* at 247-48.

11. *Id.* at 114-15.

12. In a take-or-pay contract, the purchaser agrees to pay for a minimum amount of the product, whether or not that minimum amount is utilized.

13. NATURAL GAS REGULATION STUDY, *supra* note 8, at 203. The study referred to take-or-pay contracts as being one of "a number of paradoxical responses to demand fluctuations, responses that are counter to classical market behavior in anything but the very long term, and which result in strong measure because of the strong incentives for pipeline companies to minimize changes in their connections to gas producing fields." *Id.*

14. The Natural Gas Act of 1938 is the source of the FERC's authority to regulate such transactions. 15 U.S.C. § 717 (Supp. 1976 & Supp. IV 1980).

15. See *infra* notes 81-110.

16. See *infra* notes 111-33.

17. In its 1985 annual review of the state's natural gas utilities' procurement practices, the Iowa State Commerce Commission found that each company's "procurement plan and five-year forecast are generally adequate given the state of mind of the distribution industry, but hardly adequate given the challenges which face this industry in Iowa." See, e.g., *In re Interstate Power Co.*, ISCC Docket No. ARG-84-150, Decision and Order at 12 (May 28, 1985).

18. *In re Columbia Gas of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392 (June 28, 1982). In *Columbia Gas*, the Commission noted that:

may be reasonable in light of production costs, the purchase of gas at a particular price may be unreasonable.

In 1985, the State of Illinois joined several other states in directing their public utility commissions to conduct periodic reviews of natural gas distribution utility planning and procurement practices. In a comprehensive rewrite of the state public utility act,¹⁹ the Illinois legislature mandated that state regulators biannually review utility "energy plans" from both the demand-side²⁰ and the supply-side.²¹

Controversy exists, however, over whether the FERC's power to establish "just and reasonable" natural gas rates for pipeline and producer sales preempts state regulation of supply-side decisions. State regulators who seek to limit retail costs assert that the FERC does not regulate the reasonableness of a distribution company's management and procurement decisions. Moreover, proponents of state regulation assert that, in light of the available alternatives, it is within the state commission's authority to evaluate the prudence of pipeline costs incurred by a distribution utility.

This article examines the authority of the Illinois Commerce Commission to regulate the supply-side planning decisions of natural gas distribution utilities. The new Illinois statute will be compared with recently enacted legislation in Michigan²² and Iowa,²³ as well as a recent administrative decision in West Virginia.²⁴ Like the new Illinois law, these states have provided their utility commissions with regulatory authority to review natural gas planning decisions. This article also examines the extent to which the FERC's ratemaking authority preempts state natural gas regulation.²⁵ First, however, an historical overview of the growth of the natural gas industry and the development of price regulation is provided to illustrate the problems that states are seeking to address through the enactment of new rate-making legislation.

[E]ven though we have determined that this commission does not have the authority to pass upon the reasonableness of the rate charged to Columbia by [the pipeline], this commission is of the opinion that we have the authority and obligation to investigate the reasonableness of Columbia's purchasing practices with regard to the volumes of natural gas which it buys and its management practices with regard to the operation of the company.

Id. at 425.

19. See *infra* notes 81-93 and accompanying text.

20. ILL. REV. STAT. ch. 111 2/3, § 8-402(d)(i) (1983).

21. ILL. REV. STAT. ch. 111 2/3, § 8-402(d)(ii) (1983).

22. MICH. COMP. LAWS § 460.6a-460.6n (1980).

23. IOWA CODE § 476.6(15) (1985).

24. *In re Columbia Gas of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392 (June 28, 1982).

25. This article only examines the question of whether state review of local retail distribution utilities' procurement practices is preempted by federal regulation. It does not examine other federal/state areas of conflict such as rate design (incremental pricing) and the prescription of curtailment policies.

I. NATURAL GAS: THE PROTOTYPICAL MONOPOLY

Natural gas has been utilized as an energy source in America since the early nineteenth century.²⁶ Natural gas consumption in the early nineteenth century was restricted to cities within one hundred miles of either the Appalachian fields or southern California.²⁷ A national market developed in the 1920's with technology that implemented long-distance, interregional high pressure pipelines.²⁸ By the early 1930's, pipelines reached from northern Texas and Appalachia to the major markets of the Midwest and the South.²⁹

Laying a major pipeline was a capital-intensive venture. Investors therefore sought to assure the availability of long-term supplies of gas prior to construction.³⁰ One historian recounts:

To assure their sources of supply and satisfy investors of the feasibility of the project, the pipeline companies bought up huge tracts of prospective or producing land. In the early 1930s, then, most gas fields had only one pipeline outlet, leaving independent producers in each area at the mercy of a single buyer.³¹

Along with industry control over the supply of natural gas, pipeline companies sought to integrate the production, transportation and distribution of natural gas. Pipeline ventures frequently involved competition among gas companies engaged in other activities.³² Before long, most natural gas distributors became components of integrated utility systems that involved production, pipeline transportation, and ultimate delivery to households and

26. Dorner, *Beginnings of the Gas Industry*, in REGULATION OF THE GAS INDUSTRY 1-6 to 1-10 (American Gas Ass'n 1984).

27. M.E. SANDERS, THE REGULATION OF NATURAL GAS: POLICY AND POLITICS, 1938-1978, at 44 (1981). The Natural Gas Regulation Study reports:

From the earliest uses of natural gas for home, commercial, and industrial purposes until the 1930s—and perhaps the 1940s—natural gas was a commodity in need of a market for lack of transportation. In most cases, gas was discovered by chance in connection with attempts to find oil . . . Until the mid-1920s, when long distance pressurized lines became technically feasible there was no way for gas to reach the potential major markets of the North and East. As a result, natural gas was generally only available in proximity to natural gas wells—say a few hundred miles at most.

NATURAL GAS REGULATION STUDY, *supra* note 8, at 108.

28. *Id.* See also Richard, *Appeal From Jarndyce v. Jarndyce: The State Role Under the Natural Gas Policy Act of 1978*, 41 LA. L. REV. 147, 147-48 (1980) (noting technological developments of 1920's that fostered development of long-distance pipelines).

29. M.E. SANDERS, *supra* note 27, at 25. By 1931, high pressure pipelines had been laid from fields in northern Texas to "Denver, Omaha, Minneapolis, Kansas City and Chicago. By the end of the next year, a pipeline through central Illinois and Indiana connected the Appalachian pipeline system with the Amarillo and Hugoton fields. Another pipeline system sent highly pressurized gas from Louisiana (the Monroe field) to the Saint Louis area, and east through Birmingham and Atlanta, terminating in central Georgia." *Id.*

30. NATURAL GAS REGULATION STUDY, *supra* note 8, at 105-11.

31. M.E. SANDERS, *supra* note 27, at 25.

32. *Id.*

businesses. By 1934, "there were only 25 separately owned gas utility systems in the entire United States."³³

The nature of this economic environment created antitrust problems and monopoly abuses. Large holding companies divided markets, eliminated competitors,³⁴ and erected artificial barriers to entry into the industry.³⁵ In 1934, the Federal Trade Commission (FTC) was asked to investigate the industry with a view toward remedial legislation. The final FTC report included ninety-six volumes. Some remarkable statistics highlighted the concentrated nature of the industry:

The report revealed that more than half the gas produced in the United States, and over three-fourths of the fifty thousand miles of interstate natural gas pipelines, were controlled by eleven holding companies. The four largest holding companies . . . controlled 58% of the total mileage. The same group of holding companies dominated the manufacture and distribution of synthetic gas and electricity and often had extensive coal and petroleum properties, as well.³⁶

The final FTC report also listed a myriad of abuses that resulted from monopoly dominance of the industry. These abuses ranged from the waste of resources to predatory pricing policies and unfair trade practices.³⁷

Even during the 1980's, monopoly power (frequently called market power, i.e., the power to raise prices and exclude competition) remains the dominant force within the natural gas industry. These monopolistic tendencies are largely a result of the geographic separation of natural gas pipelines.³⁸ This geographic separation is a product of both technological and legal developments.

Technologically, the natural gas industry has demonstrated natural monopolistic tendencies at the pipeline level.³⁹ Capital requirements to enter the

33. *Public Utility Compendium* 7, 1 PUB. UTIL. FORT. 25 (April 1934).

34. See D. HAWES, *UTILITY HOLDING COMPANIES* 2-29 (1984).

35. NATURAL GAS REGULATION STUDY, *supra* note 8, at 109-10. See also Miller, *Competition and the Public Interest in the Interstate Gas and Electric Industries*, 55 IOWA L. REV. 570, 570-72 (1970) (barriers created by wholesale agreements between power companies and municipalities restricting amounts that municipalities could resell to consumers).

36. M.E. SANDERS, *supra* note 27, at 28.

37. Dorner, *Initial Phases of Regulation of the Gas Industry*, in REGULATION OF THE GAS INDUSTRY 2-12 to 2-14 (American Gas Ass'n 1984).

38. On a regional basis, the monopolistic tendencies of the natural gas industry are even more pronounced. See, e.g., Douglas, *The Case for the Consumer of Natural Gas*, 44 GEO. L.J. 566, 577 (1956) (noting how a few pipeline companies dominate interstate transmission of natural gas, creating in effect a monopolistic situation).

39. "A natural monopoly exists when a single firm can provide the least-cost service over the entire range of demand for the product. Because of this attribute, competition does not work to allocate resources efficiently. The entry of a competitor into a natural monopolist's market would split demand between two producers, thus lowering the output for the existing firm. Since, by definition, the demand would be served most cheaply by one company, costs will necessarily increase both absolutely and on an average cost basis." Colton, *Conservation*,

market are staggering. Consequently, the results of head-to-head competition between different pipelines that serve one geographic area would be economically destructive.⁴⁰ Legally, the enactment of the Natural Gas Act of 1938 institutionalized this geographic monopoly status. Section 7c of the Natural Gas Act proscribed new pipelines from entering into any area already served by an existing pipeline without first obtaining a certificate from the Federal Power Commission (FPC).⁴¹ The FPC could issue a certificate only if it found that the public convenience and necessity required an additional pipeline.⁴²

Natural gas producers also benefit from the nature of their market. Pipelines are costly ventures that, once constructed, become fixed targets for price exploitation by producers.⁴³ Natural gas consumers, particularly residential and commercial consumers, are also tied to natural gas by the magnitude of their fixed investment. As Senator Paul Douglas, a noted economist, explained in 1956:

The 26.5 million residential customers in 1955 have a total investment in major gas appliances of \$14,396 million or an average of \$542. This is a large sum to a typical family, being 13% of the average family income (\$4170), or the entire paycheck for the average family for almost seven weeks. When the price of gas goes up, all the householder and his wife

Cost-containment and Full Energy Service Companies: Iowa's New Definition of "Reasonably Adequate Utility Service", 34 DRAKE L. REV. 1, 5 (1984-85). Congress has also recognized that the natural gas industry has demonstrated natural monopoly tendencies. NATURAL GAS REGULATION STUDY, *supra* note 8, at 27.

40. This situation is frequently referred to as being characterized by "indivisibilities" of investment. See generally F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 519-20 (1970).

41. See 15 U.S.C. § 717f(c)(1)(A) (1982). See generally, Wheat, *Administration by the Federal Power Commission of the Certificate Provisions of the Natural Gas Act*, 14 GEO. WASH. L. REV. 194 (1945-46).

42. 15 U.S.C. § 717(f)(e) (1982). See also *In re Transcontinental Gas Pipe Line Corp.*, 25 Pub. Util. Rep. 3d 157 (F.P.C. 1958) (granting certificate and applying a flexible interpretation of public convenience and necessity); *Kansas Pipe Line & Gas Co.*, 2 F.P.C. 29 (1939) (denying certificate where inadequate proof of public convenience and necessity had been demonstrated).

43. Some commentators, however, argue that this monopolistic ability works in reverse. See, e.g., Lambert & Gilfoyle, *Reforming Natural Gas Markets: The Antitrust Alternative*, PUB. UTIL. FORT. 15 (May 12, 1983). The authors note that:

Prior to enactment of the [Natural Gas Policy Act of 1978], the law defined the purchasing relationship between the interstate pipeline and producers as exclusive from the date of initial production. While producers and pipelines had nominal authority to define their relationship by contract, the NGA was so constituted that, once gas was sold from the wellhead to a pipeline, the associated reserves were deemed to be dedicated to the purchaser until no longer commercially producible, even if the governing gas purchase was limited to a defined term. Absent a successful petition to FERC to obtain authority to abandon service . . . , a producer could not sell his gas to a willing third party buyer, even if the purchasing pipeline declined to take the gas.

Id. at 16.

can do is wince and bear it. He is not going to scrap his investment in a gas furnace, hot water heater or gas range.⁴⁴

Horizontal integration is another means by which the energy industry exercises pervasive monopoly control over the natural gas market. This control extends to other energy sources. By 1985, it was anticipated that at least sixty-two percent of the national coal output would be accounted for by oil, utility, steel and other non-coal companies, as compared to only a twenty-five percent share in 1966. As a group, oil and gas companies control more than fifty-five billion tons of coal, or about forty-one percent of all non-governmental reserves.⁴⁵ Large American oil companies control over seventy percent of the United States' high quality retrievable uranium ores, and they mine sixty percent of the nation's uranium.⁴⁶

The United States has traditionally faced the problems associated with monopolization of crucial resources. The government has historically established regulatory controls over powerful private and regional interests.⁴⁷ Likewise, the natural gas industry has been regulated.

II. EARLY FEDERAL REGULATION

The FTC report of 1934 provided an important impetus for Congressional enactment of substantial reform legislation regarding natural gas industry regulation.⁴⁸ Additionally, between 1924 and 1934 several important Supreme Court cases held that the states lacked the authority to regulate the interstate sale of gas between unaffiliated producers and pipelines.⁴⁹ These Supreme Court decisions produced a "gap" that could only be closed by federal regulation.⁵⁰

44. See Douglas, *supra* note 38, at 575. Update the numbers and the same argument applies in 1986. "[Consumers] have made their heavy investments because of the present [relatively low] rates and have given their appliances as hostages. Their marriage with natural gas . . . is virtually indissoluble." *Id.* at 576. See also NATURAL GAS REGULATION STUDY, *supra* note 8, at 117-18.

45. This is more than three times the twelve percent share of reserves controlled by independent coal companies. See Petzinger, *Major Oil Companies Increase Their Share of U.S. Coal Output: As Independents Lose Out, Questions Start to Arise About Future of Prices*, Wall St. J., Dec. 22, 1980, at 1, col. 6. See also W. ROGERS, *ENERGY AND NATURAL RESOURCES LAW* 751-52 (1979).

46. M. MOSKOWITZ, M. KATZ & R. LEVERING, *EVERYBODY'S BUSINESS* 496 (1980). Even in terms of solar energy, oil company subsidiaries have bought controlling interests in companies comprising roughly eighty percent of the market in photovoltaics. See Wilcox, *Oil Companies and Photovoltaics: A Potential Monopoly?* 3 SOLAR L. REP. 703 (1981).

47. See generally W. SHEPARD, *THE TREATMENT OF MARKET POWER: ANTITRUST, REGULATION, AND PUBLIC ENTERPRISE* (1975).

48. See *supra* notes 36-38 and accompanying text.

49. *Public Util. Comm'n v. Attleboro Steam & Elec. Co.*, 273 U.S. 83 (1927); *Missouri v. Kansas Natural Gas Co.*, 265 U.S. 298 (1924).

50. This "gap" was created by both state efforts to regulate interstate wholesale sales and Congress's failure to exercise regulatory power over such sales until 1938. The gap in control over interstate wholesale sales was cited regularly in the reports and debates leading to the adoption of the Natural Gas Act of 1938. See Douglas, *supra* note 38, at 569.

The Natural Gas Act of 1938 (the NGA) closed the regulatory gap by bringing wholesale sales under the FPC's control.⁵¹ The NGA also controlled the entry of gas companies into new markets,⁵² and empowered the FPC to regulate extensions and abandonments of service.⁵³

The NGA defined the extent of the Federal Power Commission's jurisdiction to include:

the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.⁵⁴

This language excludes from federal regulation direct sales by pipelines to industrial users because direct sales are not sales for "resale." Also, FPC jurisdiction does not extend to the local distribution of gas.

The NGA left one important question unanswered. Did the new statute allow the FPC to regulate sales by producers to pipelines? The answer to this question was critical to the creation of effective price regulation. Because of the structural complexity of both horizontal and vertical integration at all supply levels, failing to regulate prices early in the production chain could lead to tremendous monopoly profits. Without price controls, the FPC would be required to use the prices charged in producer/pipeline sales as data for determining just and reasonable rates in subsequent pipeline/distributor transactions.

Integrated systems would significantly benefit from the deregulation of producer sales. This is especially true when the wholesale prices charged at the producer/pipeline level must be taken as per se "just and reasonable" in regulating pipeline/distributor sales. Mandatory acceptance of producer prices would ensure that the producer's gain in an integrated system would be preserved at both the pipeline and distribution level. Additionally, in cases involving independent pipelines or distributors, intra-group dissent over a producer's wholesale prices would not arise because the additional costs would simply pass automatically through to the next level of purchaser.

51. See 15 U.S.C. § 717 (1982). The NGA was described as a "substantial and effective harness . . . for the natural gas pipeline industry." See Miller, *supra* note 35, at 574. Miller stated that "the interstate pipelines which had been exploiting the regulatory gap were subjected to quite complete regulation." *Id.*

52. 15 U.S.C. § 717f(c)-(e) (1982). See also *Kansas Pipe Line & Gas Co.*, 2 F.P.C. 29 (1939) (discussing the conditions and requirements necessary to obtain FPC certificate of convenience and necessity).

53. See generally *J.M. Huber Corp. v. F.P.C.*, 236 F.2d 550 (3d Cir. 1956) (denial of petition to abandon contracts for sale and delivery within FPC jurisdiction), *cert. denied*, 352 U.S. 971 (1957).

54. 15 U.S.C. § 717(b) (1982).

Natural gas producers and pipeline subsidiaries did not extract Congressional concessions of this magnitude in 1938. Soon thereafter, however, they did obtain, with certain exceptions, the FPC's adoption of a general policy declining to exercise its statutory authority over producer sales.⁵⁵ As a result, the regulatory "gap" that Congress had intended the NGA to close had been shifted to the FPC.

In a series of decisions, the United States Supreme Court found that the FPC's non-regulation policy violated the terms of the NGA. In *Interstate Natural Gas Co. v. Federal Power Commission*,⁵⁶ a unanimous Supreme Court held that the NGA's exemption for "production or gathering" was not intended to prohibit the FPC from regulating producer sales.⁵⁷

After the *Interstate* decision, the FPC acknowledged that it had jurisdiction to regulate producer sales. However, it continued to refuse to exercise that jurisdiction. In 1951, the FPC refused to exercise jurisdiction over producer sales in a case involving Michigan, Wisconsin, Iowa, Missouri and several cities served by the Michigan-Wisconsin pipeline.⁵⁸ The Wisconsin Public Service Commission appealed the FPC's refusal to exercise jurisdiction to the District of Columbia Circuit Court of Appeals,⁵⁹ which reversed the FPC's order. Phillips then appealed to the United States Supreme Court. In the 1954 landmark decision of *Phillips Petroleum Co. v. Wisconsin*,⁶⁰ the Supreme Court held that the FPC both had jurisdiction over producer sales pursuant to the NGA and was required to exercise that jurisdiction to set rates for all producer sales destined for further resale in interstate commerce.⁶¹ *Phillips*, however, laid the foundation for a natural gas market divided along interstate and intrastate lines.

III. RECENT FEDERAL REGULATORY DEVELOPMENTS

Congress commenced a new age of federal natural gas regulation with the enactment of the Natural Gas Policy Act of 1978 (NGPA). For years producers argued to Congress the necessity of deregulating natural gas prices.⁶² First, producers contended that the supply shortfalls of the mid-

55. See *infra* notes 56-61 and accompanying text.

56. 331 U.S. 682 (1947).

57. *Id.* at 690-91.

58. *Phillips Petroleum Co.*, 7 F.P.C. 983 (Order Instituting Investigation) (1948); *Phillips Petroleum Co.*, 10 F.P.C. 246 (1951). The Michigan-Wisconsin Pipeline purchased the majority of its gas supplies from Phillips Petroleum.

59. 205 F.2d 706 (D.C. Cir. 1953).

60. 347 U.S. 672 (1954).

61. *Id.* at 682-85.

62. For an overview of the history of legislation leading up to enactment of the NGPA, see Richard, *supra* note 28, at 150, 152-53, & 156.

1970's⁶³ resulted directly from the shortage of capital available to develop future gas reserves.⁶⁴ Gas production had declined yearly since 1973, while additions to natural gas reserves failed to exceed production.⁶⁵ Second, *Phillips* created a disparity between the regulation of interstate and intrastate gas markets. Because the FPC did not regulate intrastate transactions, intrastate gas prices were substantially higher than interstate rates.⁶⁶ Consequently, in the 1970's, available supplies were drawn away from national markets and made available only for intrastate sales.⁶⁷ Despite these supply-side problems, Congress ignored the deregulation issue through the middle 1970's.

The FPC finally moved to a national pricing system in 1975. In order to attain a price approximating the market value of gas, the FPC abandoned cost-of-service pricing in favor of a system that provided for adding in "non-cost" factors created by market forces.⁶⁸ However, the price of natural gas substitutes rapidly escalated. By 1976 the FPC had increased the ceiling price of new gas nearly three hundred percent over the 1974 price. This dramatic price increase indicated that the FPC either believed that the nation's natural gas shortage was genuine or that it was necessary to consider it genuine.⁶⁹

In 1977, President Jimmy Carter addressed the burgeoning natural gas problem by introducing a natural gas bill as part of the administration's comprehensive National Energy Plan.⁷⁰ The Administration proposed price

63. Due to the shortage of interstate natural gas supplies, real or created, the Federal Power Commission initiated a rationing program through its "curtailments" policies. Martin, *supra* note 5, at 755 (citing 45 F.P.C. 570 (1971); 49 F.P.C. 85 (1973)). Pipeline curtailments, which had reached one trillion cubic feet in 1970-71, had reached 3.4 trillion cubic feet by 1976-77. See M.E. SANDERS, *supra* note 27, at 127.

64. Some industry analysts disputed the reality of the purported natural gas supply shortages. See, e.g., W. ROGERS, *supra* note 45, at 754-55 (1979). See also *Hearings on "Behind-the-Pipe" Natural Gas Reserves Before the House Subcomm. on Oversight and Investigations, 95th Cong., 1st Sess. 47 (1977); Hearings on Competition in the Natural Gas Industry Before the Senate Subcomm. on Antitrust and Monopoly, 93d Cong., 1st Sess. 456 (1973).*

65. GAO REPORT, *supra* note 1, at 14-17. See also *F.P.C. v. Louisiana Power & Light Co.*, 406 U.S. 621, 626-29 (1972) (noting how gas shortages prompted many pipelines to petition FPC for curtailment plans). See generally Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 965 (1973) (noting inability of pipelines to deliver on contracts because of lack of supplies).

66. For a discussion of the elimination of the distinction between the intrastate and interstate markets in natural gas, see Richard, *supra* note 28.

67. See Martin, *supra* note 5, at 754-55. Martin states that "certain standard operating agreements among working interest owners for production prohibited the operator from selling in the interstate market." *Id.* at 755 n.16.

68. The Federal Power Commission's ratemaking scheme was known as "commodity pricing." See Opinion No. 770, 10 FED. POWER SERV. 5-293 (Matthew Bender 1976).

69. See generally Manning, *Federal Regulation of Pricing Provisions in Natural Gas Sales Contracts—From the Phillips Decision to the Natural Gas Policy Act of 1978*, 16 Hous. L. REV. 1081, 1092-93 (1979).

70. See generally Richard, *supra* note 28.

ceilings based on cost-of-service ratemaking.⁷¹ The Senate, however, defeated the Administration's proposal. Finally, in 1978, after nearly a year of negotiation, Congress approved a compromise bill. The agreement required producers to increase supplies and consumers to pay market prices after 1985, with a phased-in program of rapid price increases in the interim.⁷²

When the NGPA emerged from conference committee, it embodied compromises in virtually all of its major provisions. With respect to consumer concerns over the regulation/deregulation issue, Congress extended federal regulatory authority to cover prices in intrastate natural gas markets, thereby eliminating the troublesome dual market.⁷³ The *quid pro quo*, however, was accession to the staged deregulation of approximately fifty-five to sixty-five percent of all gas by 1985. Consumers emerged victorious on the pricing issue as Congress, rather than the Federal Energy Regulatory Commission (FERC),⁷⁴ would set base prices. Their victory was soured, however, by the fact that the FERC would set the actual level of those prices. Consumers also lost on the issue of how the FERC should set rates. The FERC would set rates based on a "commodity pricing" scheme,⁷⁵ rather than on cost-of-service principles.

The NGPA created a variety of widespread problems for consumers that ostensibly had been resolved by the NGA's enactment in 1938 and by the *Phillips* decision in 1954. Perhaps the most significant problem was the re-creation of the "gap" that the NGA and *Phillips* had sought to eliminate.⁷⁶

IV. CONTEMPORARY STATE REGULATION

Because of the federal deemphasis on natural gas regulation, several state legislatures have sought to restrain rising natural gas rates by establishing local regulatory review over retail distribution utilities' natural gas procurement and contracting practices.⁷⁷ State review focuses upon various aspects

71. The Administration's proposal was approved by a large majority of the House of Representatives. For a comprehensive overview of the legislative debate leading up to Congressional approval of the NGPA, see Richard, *supra* note 28, at 152-56.

72. For a description of NGPA price categories, see Martin, *supra* note 5, at 756-58.

73. See generally *Oklahoma v. FERC*, 494 F. Supp. 636 (D. Okla. 1980) (FERC has power to impose price controls on intrastate gas), *aff'd*, 661 F.2d 832 (10th Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982).

74. The FERC superseded the Federal Power Commission in 1977.

75. See *supra* note 68 and accompanying text. See also *Pennzoil Co. v. FERC*, 645 F.2d 360, 378-79 (5th Cir. 1981) (Congress intended to allow price escalator clauses in interstate contracts to maximum lawful price under NGPA).

76. See *supra* notes 48-50 and accompanying text.

77. State regulation was foreseen by Congress in its 1982 study of the natural gas industry. The study noted that:

[t]he monopolistic geographic franchises accorded local gas distribution companies is the fundamental reason for state retail distribution and rate regulation. Irrespective

of local utility management practices,⁷⁸ a traditional area of local regulatory concern.⁷⁹ In each instance, the state public utility commission has either been granted, or has asserted, authority to review public utilities' plans to provide natural gas service to their customers. The purpose of state review is to ensure that natural gas customers are provided adequate service at the lowest cost.⁸⁰

A. The Legislative Initiatives

The Illinois legislature conducted a comprehensive rewrite of the state's public utility act in 1985.⁸¹ The new statute requires the state commerce commission to review the natural gas procurement practices of its public utilities.⁸² In providing for the review process, the Illinois legislature sought, among other things, to "ensure the provision of adequate, efficient, reliable and environmentally safe energy services at the lowest possible cost to all Illinois energy consumers and users."⁸³

The new statute requires Illinois' gas utilities⁸⁴ to file an "energy plan" every two years with both the Illinois Commerce Commission and the Illinois Department of Energy and Natural Resources.⁸⁵ Each utility's energy plan

of the nature of wellhead regulation, it seems unlikely that the need for this local regulation will be found now to have lessened. However, the question of whether stricter scrutiny of purchase transactions by distribution companies is desirable in a new regulatory environment of Federal wellhead decontrol may be raised over concern about the vacuum left by decontrol.

NATURAL GAS REGULATION STUDY, *supra* note 8, at 92.

78. See, e.g., *In re Columbia Gas Co. of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392, 425, 427 (W. Va. PSC 1982) (reasonableness of management practices and gas procurement policies).

79. For cases holding that states have a right to enact laws prohibiting the waste of natural gas, see *Cities Serv. Gas Co. v. Peerless Oil & Gas Co.*, 340 U.S. 179 (1950) (upholding state regulation of natural gas prices to conserve local resources); *Bandini Petroleum Co. v. Superior Court*, 284 U.S. 8 (1931) (statute prohibiting "the unreasonable waste of natural gas" is constitutional); *Lindsley v. Natural Carbonic Gas Co.*, 220 U.S. 61 (1911) (state may regulate the correlative rights of surface owners with respect to a common source of supply of water, gas and oil); *Ohio Oil Co. v. Indiana*, 177 U.S. 190 (1900) (statute regulating the manner in which gas and oil may be appropriated does not constitute a taking of private property without adequate compensation).

80. For a discussion of the application of the "prudent investment" theory within the context of natural gas regulation, see Bonbright, *Contributions of the Federal Power Commission to the Establishment of the Prudent Investment Doctrine of Rate-Making*, 14 GEO. WASH. L. REV. 136 (1945-46).

81. Illinois has enacted what is popularly known as a "sunset" statute. See ILL. REV. STAT. ch. 127, § 1904 (1985). Among its provisions is the automatic repeal of the state's Public Utilities Act unless that act is periodically readopted by the legislature. *Id.* § 1904.3(8).

82. ILL. REV. STAT. ch. 111 2/3, § 8-402 (1985).

83. *Id.* § 8-402(a).

84. The planning requirements also apply to the state's electric utilities. *Id.* § 8-402(c).

85. Pursuant to this statute, the state Department of Energy and Natural Resources (DENR) is to prepare a "comprehensive utility energy plan for the State of Illinois consistent with the

must contain a ten-year projection of customer service demand and an estimate of the number of customers by major service classifications.⁸⁶ The utility must also include a year-by-year projection of "all available sources of supply for each of the subsequent ten years."⁸⁷ Further, each utility must demonstrate that "the proposed plan represents the least-cost means of satisfying energy service needs."⁸⁸ Finally, the statute directs each utility to include in its energy plan statistical and forecasting data for assessing both short and long-term supply and demand, as well as demographic and economic information that may influence either the supply or demand for utility gas service.⁸⁹

The statute expressly states that gas utilities should pursue alternative energy measures.⁹⁰ The statutory review process, however, is not limited to an assessment of the adequacy of these strategies. Each utility must also justify its planned provision of natural gas service from a least-cost perspective.

The new Illinois statute requires the Illinois Commerce Commission to hold evidentiary hearings to determine the adequacy of each utility's energy plan.⁹¹ At the conclusion of these hearings, "the Commission shall issue an order adopting an energy plan for the State and for each utility."⁹² In each case, the Commission shall select the plan that has the greatest potential for providing "adequate, efficient, reliable and environmentally safe energy services at the least cost to consumers."⁹³

Michigan and Iowa have also enacted statutes that direct their respective utility commissions to examine the practices of retail distribution gas utility

planning objectives and requirements" of the statute. *Id.* § 8-402(b). The Department is required to review the plan every two years and to provide the plan to the Illinois Commerce Commission as part of the Commission's review of the energy plans of the individual utilities. The Commerce Commission has final authority to approve or modify the state energy plan and to direct individual utilities to file plans consistent with the final state plan. *Id.* § 8-402(f). If the Commission finds that the proposed plans submitted by the individual utilities "inhibit or do not fully ensure the economical utilization of conservation, renewable resources, cogeneration or improvements in energy efficiency," it may, in conjunction with the DENR, devise its own plans and direct the utilities to implement such revisions. *Id.* § 8-402(g).

86. *Id.* § 8-402(d)(i).

87. *Id.* § 8-402(d)(ii).

88. *Id.* § 8-402(d)(iii).

89. *Id.* § 8-402(b).

90. These alternative measures include conservation and renewable resource strategies. *Id.* § 8-402(d)(ii).

91. *Id.* § 8-402(e).

92. *Id.* § 8-402(f). The statute also expressly adopts a "non-proliferation policy" for new power production. The statute requires the state energy plan, and the plan for each utility, to utilize "to the fullest extent practicable, all economical sources of conservation, renewable resources, cogeneration and improvements in energy efficiencies as the primary sources of new energy supply." *Id.* § 8-402(f). For a discussion of the concept of a "non-proliferation policy" for new power plants, see Colton, *The Role of Power Plant Certification Statutes in Promoting Utility Investments in Energy Management*, 16 ENVTL. L. 175 (1985).

93. ILL. REV. STAT. ch. 111 2/3, § 8-402(a) (1985).

companies in providing natural gas supplies.⁹⁴ The express purpose of these statutes is to establish a review process through which state regulators can determine whether gas costs are "incurred under reasonable and prudent policies and practices."⁹⁵ Each of these statutes is far more detailed than its Illinois counterpart.

The Michigan and Iowa statutes differ over when regulatory review of natural gas procurement practices is proper. Iowa's legislation directs the state's commerce commission to conduct its review "periodically but not less than annually."⁹⁶ In contrast, Michigan's review is undertaken neither automatically nor necessarily at regular intervals. The Michigan statute allows local utilities to incorporate into their rate schedules a "gas cost recovery clause."⁹⁷ The Michigan statute, however, does not require a utility to incorporate such a clause into its tariffs. If a utility decides to do so, its natural gas cost procurement practices will be subject to regulatory review.⁹⁸

In both Iowa and Michigan, the primary goal of the gas review proceedings is to determine whether a utility should be allowed to recover its purchase gas costs from retail customers.⁹⁹ The Iowa statute provides:

If a utility is not taking all reasonable actions to minimize its purchase gas costs, consistent with assuring an adequate long-term supply of natural gas, the commission shall not allow the utility to recover from its customers purchase gas costs in excess of those costs that would be incurred under reasonable and prudent policies and practices.¹⁰⁰

Although the Michigan process differs, it effectively yields the same result. The Michigan commission is to set a "gas cost recovery factor," defined as "that element of the rates to be charged to reflect gas costs incurred by a gas utility."¹⁰¹ As a prerequisite to seeking the commission's approval of a "recovery clause," a utility must file a twelve-month gas procurement plan requesting a specific gas cost recovery factor each month.¹⁰² The public service commission, after reviewing the utility's procurement practices and policies, is then authorized to "approve, reject or amend the 12 monthly

94. See IOWA CODE § 476.6(15) (1985); MICH. COMP. LAWS § 460.6a-460.6n (1980).

95. See IOWA CODE § 476.6(15) (1985); MICH. COMP. LAWS § 460.6h(1)(b) (1982).

96. IOWA CODE § 476.6(15) (1985).

97. Michigan state regulators are permitted, but not required, to approve a request for a gas cost recovery factor. MICH. COMP. LAWS § 460.6(h)(2) (1980). Such a "recovery factor" is to be approved in lieu of an automatic purchase gas adjustment clause. The gas recovery clause "permits the monthly adjustment of rates for gas in order to allow the utility to recover the booked costs of gas sold by the utility . . ." *Id.* § 460.6h(1)(b).

98. *Id.* § 460.6h(2)-(3).

99. This legislative goal, however, is not always achieved. See *infra* note 127 and accompanying text.

100. IOWA CODE § 476.6(15) (1985).

101. MICH. COMP. LAWS § 460.6h(1)(c) (1980).

102. *Id.* § 460.6h(3).

gas cost recovery factors," describing the factors ultimately set "in fixed dollar amounts per unit of gas."¹⁰³

In both Michigan and Iowa, the gas utility must furnish the commission with two comprehensive sets of data in order to initiate the review process. First, the utility must submit a gas procurement plan.¹⁰⁴ Second, each utility is required to submit a five-year forecast of gas requirements, sources of supply and projected gas costs.¹⁰⁵ In both states, the utility is required to describe in its procurement plan "the expected sources and volumes of its gas supply and changes in the cost of gas anticipated over a future twelve month period"¹⁰⁶ Additionally, each utility must describe all of its "major contracts and gas supply arrangements . . . for obtaining gas during the specified twelve-month period."¹⁰⁷ This description must include "the price of gas, the duration of the contract or arrangement, and an explanation or description of any other term or provision as required by the commission."¹⁰⁸

Iowa and Michigan differ somewhat in their common requirement that the utility include in its annual plan an "evaluation of the reasonableness and prudence of its decisions to obtain gas in the manner described in the plan."¹⁰⁹ Michigan's statute, like its Illinois counterpart, specifically mandates that the evaluation be undertaken "in light of the major alternative gas supplies available to the utility."¹¹⁰ Iowa's statute contains no such requirement.

B. Administrative Initiatives

In 1982, the West Virginia Public Utility Commission decided that Columbia Gas of West Virginia could not automatically recover its purchased natural gas costs from retail consumers.¹¹¹ The West Virginia Commission conceded its lack of authority to "pass upon the reasonableness of the rate charged" by Columbia Gas Transportation Corporation (CGTC) to the local distribution company.¹¹² The Commission held, however, that it *did* have "the authority and obligation to investigate the reasonableness of Columbia's purchasing practices with regard to the volumes of natural gas which it buys and its management practices with regard to the operation of the Company."¹¹³ The Commission observed that because Columbia Gas was an

103. *Id.* § 460.6h(6).

104. IOWA CODE § 476.6(15) (1985); MICH. COMP. LAWS § 460.6h(3) (1980).

105. IOWA CODE § 476.6(15) (1985); MICH. COMP. LAWS § 460.6h(4) (1980).

106. IOWA CODE § 476.6(15) (1985); MICH. COMP. LAWS § 460.6h(3) (1980).

107. *Id.*

108. *Id.*

109. *Id.*

110. MICH. COMP. LAWS § 460.6h(3).

111. *In re Columbia Gas of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392 (W. Va. PSC 1982).

112. *Id.* at 425. CGTC was the interstate pipeline company.

113. *Id.*

intrastate natural gas distribution utility, it was subject to the Commission's authority.¹¹⁴

The West Virginia Commission undertook its review of natural gas practices in an atmosphere of economic crisis and industrial rebellion.¹¹⁵ Rising utility rates contributed to the crisis atmosphere. The West Virginia Commission defined its regulatory goal as protecting the state's public interest. Because further natural gas cost increases would have a detrimental effect on West Virginia's industrial companies, the Commission held that it bore "a strong obligation to analyze and investigate as fully as possible Columbia's purchasing practices in order to insure [sic] that Columbia is doing everything it can to purchase the cheapest supplies of natural gas available to it."¹¹⁶

The West Virginia Commission found that Columbia Gas's management and procurement practices had not been conducted in its ratepayers' interest.¹¹⁷ The Commission noted that Columbia Gas had not aggressively sought gas supplies other than CGTC gas, despite the potential availability of cheaper supplies.¹¹⁸ In short, the Commission stated, "we are convinced that Columbia Gas of West Virginia, Inc. has engaged in purchasing practices and management practices which are designed to further the interests of and benefit the Columbia Gas System as a whole, rather than Columbia's West Virginia jurisdictional customers."¹¹⁹

The West Virginia Commission directed Columbia Gas to "alter its procurement and management practices in order to efficiently and adequately serve its customers and fulfill its public service obligations in this State."¹²⁰ The Commission noted that its regulatory concern "is not the well-being of the overall Columbia Gas System or the consolidated operation of the

114. *Id.* Because the Commission's statutory authority extended to "regulations, practices, acts or services" that it found "unjust, unreasonable, insufficient, or unjustly discriminatory," the Commission concluded that it was authorized to determine and fix "reasonable regulations, practices, acts and services to be followed in the state." *Id.*

115. *Id.* at 426. The commission noted that, "[t]he industrial climate in West Virginia has deteriorated precipitously in the past few years as a result of the continuing economic problems at the Federal level and unremitting cost increases for these industrial companies at the local level." *Id.*

116. *Id.* at 427. The West Virginia Commission ultimately concluded that Columbia Gas had not been "engaging in management practices or purchasing practices which redound to the benefit of West Virginia customers." *Id.*

117. The Commission found that Columbia Gas had not inquired into or contested the mix of gas supplied to it by CGTC. *Id.* In addition, Columbia Gas had not objected to or inquired about CGTC's procurement practices. *Id.* Nor had it actively participated in cases before the FERC that might have resulted in lowering the prices charged to Columbia by CGTC. *Id.* Columbia Gas also had not performed any price elasticity studies to determine the impact on Columbia's market if gas costs reached a certain level. *Id.* at 427, 429-30. Finally, the Commission found that Columbia Gas had not considered adjusting natural gas prices in order to maximize its industrial use. *Id.* at 428-30.

118. *Id.*

119. *Id.* at 439.

120. *Id.* at 430.

Columbia Distribution Companies," but rather "the interests of the State and Columbia's jurisdictional customers."¹²¹ The Commission then directed the Columbia Gas distribution company to undertake a variety of prescribed changes in its practices.¹²²

This is precisely the type of regulatory review that the Illinois, Iowa and Michigan statutes are designed to encompass. These statutory review procedures can be extremely effective in revealing the weaknesses in a natural gas utility's planning processes. In 1985, the Iowa Commerce Commission completed its second series of annual reviews of the state's gas distribution utilities.¹²³ The Commission criticized the gas utilities' "business as usual" attitude concerning the state's gas distribution industry.¹²⁴ The Commission further noted that the state's gas distribution companies had failed to maintain current data for forecasting future needs.¹²⁵ The Commission rejected the contention that Iowa's gas utilities could improve their needs forecasting by relying more heavily on econometric models. The Commission noted that "[t]he distribution utilities do not know their market. Until they get some idea of that market, more computer runs of more studies will not give them anything except more useless information."¹²⁶

The Iowa Commerce Commission recommended a number of changes in the state's gas distribution utilities' procurement practices.¹²⁷ The Commission

121. *Id.*

122. *Id.* at 430-31, 440. The Commission directed Columbia to 1) let out bids for the purchase of some significant quantity of gas to fulfill its customers' requirements, 2) make a substantial effort to purchase West Virginia-produced gas, 3) prove that dependable lower-priced supplies of natural gas are not otherwise available, and 4) be prepared to demonstrate at the next rate hearing its efforts to represent more adequately the interests of Columbia's customers. *Id.*

123. *In re Interstate Power Co.*, ISCC Docket No. ARG-84-150, Decision and Order at 3 (May 28, 1985). The Commission found that the proceeding's record "highlights the deficiencies rather than the lofty accomplishments of the gas distribution companies in this state."

124. *Id.* at 3.

125. *Id.* at 4. The Commission noted that:

The previously accepted conditions for natural gas distribution companies in the 1970's simply have no relevance today. For the distribution companies to be looking at those 1970's conditions as benchmarks and guidelines for the 1980's and 1990's is a denial of the reality of the current situation.

Id.

126. *Id.*

127. *Id.* Notwithstanding the recommended procurement improvements, the Iowa Commerce Commission fell short of its statutorily mandated review function. In the event that a utility "is not taking all reasonable actions to minimize its purchase gas costs, consistent with assuring an adequate long-term supply of natural gas," the Iowa statute directs its commission to prohibit distribution utilities from charging customers for "gas costs in excess of those costs that would be incurred under reasonable and prudent policies and practices." The Commerce Commission concluded its annual review by making express findings of fact that each Iowa distribution utility: (1) had failed to take advantage of opportunities regarding spot market purchases; (2) had not adequately attempted to obtain contract demand reductions from their respective pipeline suppliers; and (3) had been "less than diligent" in participating in proceedings

indicated that the "top priority" for the companies was to "identify their market."¹²⁸ The Commission noted that it was particularly important for distribution companies to maintain frequent communication with their largest customers.¹²⁹ The Commission then indicated that the utilities must move toward short-term supply and flexible volume contracts, while maintaining a continuing awareness of the existing constraints in the availability of supply.¹³⁰ Moreover, the Commission told the distribution companies that when their existing contracts expired they must aggressively pursue renegotiation and changes in contract terms.¹³¹ Finally, the Commission criticized the utilities for "focusing on supply side planning using 1970's criteria."¹³² Instead, the Commerce Commission directed the utilities to focus more attention on demand side planning.¹³³

V. FEDERAL PREEMPTION OF STATE REGULATION

Opponents of strict state regulation of natural gas procurement practices assert that the FERC's jurisdiction preempts state action in this area.¹³⁴ Opponents further argue that when the FERC approves retail rates, states may not exclude from these rates costs that the FERC determines a particular utility has "imprudently incurred." Opponents contend that state regulation "hinder[s] the goals expected of a federal regulatory scheme."¹³⁵

before the FERC. *Id.* Moreover, for each company, the Commerce Commission held that "the record is replete with instances of missed opportunities or miscalculations based on faulty assumptions which could have been eliminated based upon basic communication between the large industrial customers and the distribution companies." *Id.* Notwithstanding these express findings of fact, and despite the pointed critical verbiage of the order, the Commerce Commission ultimately refused to make the revenue adjustment contemplated by the statute.

128. *Id.* at 4.

129. *Id.* The Commission's insistence on requiring distribution companies to communicate with their largest customers was clear from the Commission's comment that "[a] computer model cannot tell when a large industrial customer is going to buy gas in Oklahoma and hook up directly to the interstate pipeline." *Id.*

130. *Id.* at 5. In finding that many possibilities existed for spot market purchases and transportation arrangements during the current period of surplus, the Iowa Commerce Commission noted that "[t]hese constitute missed opportunities . . ." *Id.*

131. *Id.* at 6. The Commission found that there was a need "to use creativity and innovation rather than merely changing the dates of the old contract and replacing it with another long-term contract." *Id.*

132. *Id.*

133. *Id.* at 9.

134. One industry journal posits that "the rule" regarding electricity is as follows:

[T]he state commission, in setting retail rates, must accept as reasonable operating expenses those wholesale rates for electric power approved by the FERC through the authority of the Federal Power Act which gives the FERC exclusive jurisdiction to pass on the rates charged for electric power for wholesale in interstate commerce.

Pietrantonio, *The Preemptory Effect of a FERC Rate Approval*, PUB. UTIL. FORT. 54, 57-58 (Aug. 16, 1984).

135. *Id.* at 58.

A. A Preemption Primer

State regulation of utilities' natural gas procurement practices is based upon the state's inherent police powers to protect the public health, safety and welfare.¹³⁶ In certain situations, however, federal regulation preempts state regulation. The intent to preempt is not presumed.¹³⁷ Preemption is only found when Congressional intent to supersede state regulation is "clear and manifest."¹³⁸

Congressional intent, however, is rarely "clear and manifest." The courts, therefore, have developed a number of indicators to determine Congress's intent when faced with a claim of implied preemption.¹³⁹ First, courts have found a Congressional intent to preempt state regulation when the federal government adopts an elaborate and detailed statutory scheme of regulation, so pervasive that it "takes possession of the field."¹⁴⁰ Where such a federal scheme exists, the state can neither supplement nor forego federal requirements. Second, preemption occurs when state statutory provisions directly conflict with federal statutes.¹⁴¹ Preemption in this instance, however, occurs infrequently. Third, a state statute will be preempted when it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."¹⁴²

136. See *Washington Gas Light Co. v. District of Columbia Pub. Serv. Comm'n*, 452 A.2d 375 (D.C. 1982); *Public Serv. Co. of Colo. v. Colorado Pub. Util. Comm'n*, 644 P.2d 933 (Colo. 1982); *Eastern Edison Co. v. Massachusetts Dep't of Pub. Util.*, 388 Mass. 292, 446 N.E.2d 684 (1983); *Northern States Power Co. v. Hagen*, 314 N.W.2d 32 (N.D. 1981); *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 465 A.2d 735 (Pa. Commw. Ct. 1983); *Narragansett Elec. Co. v. Burke*, 119 R.I. 559, 381 A.2d 1358 (1977).

137. See generally Engdahl, *Preemptive Capability of Federal Power*, 45 U. COLO. L. REV. 51, 52 (1973) (Congressional intent to preempt and preemptive capability is primarily ascertained judicially); Hirsch, *Toward a New View of Federal Preemption*, 1972 U. ILL. L.F. 515, 552 (proposing analytical framework to determine whether or not federal law preempts state law); Note, *The Preemption Doctrine: Shifting Perspectives on Federalism and the Burger Court*, 75 COLUM. L. REV. 623 (1975) (canvassing recent U.S. Supreme Court decisions that indicate a willingness to uphold state legislation where Congressional intent to preempt is unclear, or the conflict between state and federal law is indirect).

138. See *New York State Dep't of Social Serv. v. Dublino*, 413 U.S. 405, 413 (1973) (clear manifestation of Congressional intent required before the court will void a state statutory program); *Schwartz v. Texas*, 344 U.S. 199, 202-03 (1952) (no presumption that federal statute is intended to supersede state statute).

139. See generally *Northern States Power Co. v. State of Minn.*, 447 F.2d 1143, 1146-47 (8th Cir. 1971) (factors include aim and intent of Congress, pervasiveness of regulatory scheme, nature of subject matter, and whether state law is an obstacle to the accomplishment of Congressional objective).

140. See *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 163, 178 (1978); *Napier v. Atlantic Coast Line R.R.*, 272 U.S. 605 (1926).

141. *Florida Lime & Avocado Growers v. Paul*, 373 U.S. 132, 142-43 (1963); *Northern States Power Co. v. State of Minn.*, 447 F.2d 1143, 1146 (8th Cir. 1971).

142. *Ray v. Atlantic Richfield*, 435 U.S. 151, 164 (1978); *Huron Portland Cement Co. v. Detroit*, 362 U.S. 400, 446 (1960). See also *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (federal alien registration law preempts state law).

Application of these three tests to natural gas regulation reveals that Congress did not intend federal preemption of states' efforts to regulate the prudence of intrastate natural gas distribution utilities' management and procurement practices.

B. *The Federal Rate Statute*

The FERC's authority to regulate natural gas rates derives from the NGA.¹⁴³ The statute's language and legislative history indicate that Congress did not intend to expressly preempt state regulatory power. The United States Supreme Court has held that section 1(b) of the NGA places the following activities within the federal government's regulatory purview: "(1) the transportation of natural gas in interstate commerce; (2) its sale in interstate commerce for resale; and (3) natural gas companies engaged in such transportation or sale."¹⁴⁴ Section 1(b) expressly exempts from the FERC's authority "any other transportation or sale of natural gas" and "the local distribution of natural gas."¹⁴⁵ Thus, in *Federal Power Commission v. Panhandle Eastern Pipeline Co.*,¹⁴⁶ the Court explained that:

[T]he Natural Gas Act did not envisage federal regulation of the entire natural gas field to the limit of constitutional power. Rather, it contemplated the exercise of federal power as specified in the Act, particularly in that interstate segment which the states were powerless to regulate because of the Commerce Clause of the Federal Constitution.¹⁴⁷

The Supreme Court has repeatedly stated that the NGA took "no authority from state commissions."¹⁴⁸ The NGA's purpose was only to fill the regulatory "gap" in areas where the states could not act.¹⁴⁹

In the House Report on the NGA, Congress explicitly indicated its intent to fill the regulatory "gap" without usurping state regulatory powers:

The States have also been able to regulate sales to consumers even though such sales are in interstate commerce, such sales being considered local in character and in the absence of Congressional prohibition subject to State regulation There is no intention in enacting the present legislation to disturb the states in their exercise of such jurisdiction The basic

143. 15 U.S.C. § 717 (1982).

144. *Panhandle E. Pipeline Co. v. Public Serv. Comm'n of Indiana*, 332 U.S. 507, 516 (1947).

145. 15 U.S.C. § 717(b) (1982).

146. 337 U.S. 498 (1949).

147. *Id.* at 502-03.

148. *See, e.g., Federal Power Comm'n v. Panhandle E. Pipeline Co.*, 337 U.S. 498, 517 (1949) (regulation of transfer of gas leases outside scope of FPC's regulatory powers); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944) (validity of FPC rate order challenged).

149. *See supra* notes 50-54 and accompanying text.

purpose of the present legislation is to occupy [the] field in which the Supreme Court has held that the states may not act.¹⁵⁰

The statute's language and legislative history, therefore, indicate that Congress did not intend federal preemption of the entire field of natural gas ratemaking.¹⁵¹ Instead, Congress contemplated a dual system of federal/state regulation. Where no express preemption exists, however, it is necessary to determine whether state regulation of natural gas procurement practices conflicts with any federal statute, or whether such legislation impedes the accomplishment of some federal objective. Federal law does not preempt state review of natural gas distribution utilities' management and procurement practices when the state regulation addresses different problems and does not hinder the purposes of federal regulation.¹⁵² The FERC is vested with the exclusive authority to determine "just and reasonable" wholesale natural gas rates, and that authority is limited only by the constraints of the NGPA regarding price deregulation.¹⁵³

1. *The Policy of Preemption*

State review of local distribution utility companies' natural gas procurement decisions is designed to oversee a variety of contracting practices. State regulation does not review the reasonableness of federally approved wholesale rates. Nor do state regulators consider the costs underlying wholesale rates. Instead, the processes established in Illinois, Iowa, Michigan and West Virginia seek to ensure that local utilities' management practices are designed to procure least-cost gas supplies for retail customers.

a. *Affiliated Transactions*

Affiliated transactions¹⁵⁴ in the procurement of natural gas supplies pose special problems for state regulators. Affiliated transactions may arise when

150. H.R. REP. NO. 709, 75th Cong., 1st Sess. 1, 1-2 (1978). The House Report further states that "[t]he bill takes no authority from State commissions, and is so drawn as to complement and in no manner usurp State regulatory authority and contains provisions for cooperative action with State regulatory bodies." *Id.* See also *Federal Power Comm'n v. Transcontinental Gas Pipeline Co.*, 365 U.S. 1 (1961) (FPC did not exceed its authority in denying certificate of convenience); *Public Util. Comm'n of Ohio v. United Fuel Gas Co.*, 317 U.S. 456, 467 (1943) (local matters left to state regulatory bodies). This approach to the NGA is consistent with the Court's construction of other federal utility ratemaking legislation. See, e.g., *Consolidated Edison Co. v. Public Serv. Comm'n of the State of New York*, 63 N.Y.2d 424, 472 N.E.2d 981 (1984) (Public Utility Regulators Policies Act of 1978 does not preempt New York from requiring electric utilities to offer to buy energy from alternate producers), *cert. denied*, 105 U.S. 1831 (1985).

151. H.R. REP. NO. 709, 75th Cong., 1st Sess. 1, 2 (1978).

152. *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 465 A.2d 735 (Pa. Commw. Ct. 1983).

153. For a general discussion of NGPA price ceilings, see Martin, *supra* note 5, at 756-58.

154. See, e.g., *In re Columbia Gas Co. of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392 (W. Va. PSC 1982). Cf. *supra* notes 31-36 and accompanying text (problems associated with monopoly abuses).

a parent/subsidiary relationship¹⁵⁵ exists between a distributor and its supplier or when a distributor is intimately involved with its supplier in a joint venture.¹⁵⁶ When the distributor and its supplier are involved in an affiliated transaction, automatic pass-through schemes may be established that permit price inflation without regulatory oversight.¹⁵⁷

This is precisely the issue that the West Virginia Commission sought to address in *Columbia Gas*. The West Virginia Commission was ultimately "convinced that Columbia Gas of West Virginia, Inc. has engaged in purchasing practices and management practices which are designed to further the interests of and benefit the Columbia Gas System as a whole, rather than Columbia's West Virginia jurisdictional customers."¹⁵⁸

b. Needs Forecasting

Inadequate supply forecasting affects retail rates both directly and indirectly. To the extent that distribution utilities fail to account for the price elasticity associated with increased rates,¹⁵⁹ or the cross-elasticity of gas and alternate fuels,¹⁶⁰ minimum pipeline/distribution demand charges will be spread over fewer units of consumption with a resulting increase in retail rates.¹⁶¹ The Iowa Commerce Commission addressed this issue in criticizing Iowa utilities' lack of knowledge about their market.¹⁶²

Moreover, with large retail demand forecasts, pipelines have an incentive to enter into large take-or-pay contracts with producers.¹⁶³ If the retail

155. See *supra* notes 31-36 and accompanying text.

156. See *supra* note 9.

157. See *supra* note 7 and accompanying text.

158. *In re Columbia Gas Co. of W. Va., Inc.*, 47 Pub. Util. Rep. 4th 392, 427 (W. Va. PSC 1982).

159. Natural gas usage is generally considered to be "price elastic." Elasticity measures the percent change in usage for every percent change in price. An elastic demand indicates that as price increases, demand will decrease. For an indication that residential gas usage in particular is not entirely price elastic, i.e., that consumers cannot abandon service altogether, see *supra* note 44 and accompanying text.

160. Cross-elasticity measures the substitutability between products. For industrial natural gas users, for example, there is a cross-elasticity between natural gas and fuel oil. Once natural gas reaches its market clearing price, these consumers will likely engage in fuel switching.

161. A very simple rate structure will be made up of two primary components: (1) a demand charge, and (2) a commodity charge. The commodity charge is levied on a per unit of consumption basis. For each cubic foot of gas which is consumed, therefore, a charge is collected. If the gas is not burned, there is no cost. In contrast, the demand charge is for the entitlement to use a particular level of gas. The utility essentially reserves a certain amount of gas that a company is allowed to use. Thus, the company must pay for the reservation regardless of whether it is actually used.

162. The Commission noted that "the distribution utilities do not know their market. Until they get some idea of that market, more computer runs of more studies will not give them anything except more useless information." *In re Interstate Power Co.*, ISCC Docket No. ARG-84-150, Decision and Order at 4 (May 28, 1985). See *supra* notes 123-33.

163. For a brief discussion of take-or-pay contracts, see *supra* notes 12-13 and accompanying text.

forecasts are too high, in addition to the obvious impact of a minimum bill spread over fewer units of consumption, pipelines will also have an incentive to reduce take-or-pay penalties by decreasing their takes of cheaper gas in favor of maintaining their takes of more expensive gas. This result has been well-chronicled in recent years.¹⁶⁴

c. Contract Provisions

During the natural gas shortages from 1973 to 1976, pipelines frantically sought to assure long-term supplies in order to avoid the threat of curtailment. This placed producers in a superior bargaining position with pipelines.¹⁶⁵ Producers often required that contracts with pipelines include take-or-pay¹⁶⁶ and most-favored-nation¹⁶⁷ clauses. Unfortunately, with deregulation of some gas categories, and substantial ceiling price increases in others, the most-favored-nation clauses raised all prices to the highest price paid anywhere in the region.¹⁶⁸ Industrial users responded to these price hikes by switching to alternate fuels. Additionally, consumers reduced their consumption by increasing the efficiency of their gas usage. Pipelines and producers, however, perceiving a drop in sales, invoked their contracts' take-or-pay provisions. This forced consumers to pay the high price that gas had reached by operation of the most-favored-nation clauses, whether or not consumers had actually used the gas covered by the contracts.¹⁶⁹

Considerable controversy exists over whether most-favored-nation and take-or-pay contract provisions are unconscionable and, therefore, unenforceable.¹⁷⁰ The NGPA's legislative history indicates that Congress intended to preserve state regulatory authority in making this determination.¹⁷¹

164. NATURAL GAS REGULATION STUDY, *supra* note 8, at 203. The study noted that Congressional committees had been informed that:

[t]he rapid rise in retail gas rates is, in part, due to the use of take-or-pay provisions; new gas is more costly and has more rapid price increases, but when demand for gas drops the lower cost "old" gas under a 75% provision is curtailed ahead of higher cost "new" gas under a 95% provision.

Id.

165. See Manning, *supra* note 69.

166. See *supra* note 12 and accompanying text.

167. "Examples of indefinite escalation clauses include: (a) Two-party favored nation clauses, which are activated by higher prices paid to any other supplier by the same purchaser; (b) Three-party favored nation clauses, which are activated by higher prices paid to any other supplier by any purchaser." Note, *Contract Law—Indefinite Price Escalation Clauses in Natural Gas Sales Contract: Unconscionable and Contrary to Public Policy*, 17 LAND & WATER L. REV. 257, 259 (1982) [hereinafter cited as Note, *Indefinite Price Escalation*].

168. See, e.g., *Amoco Prod. Co. v. Stauffer Chem. Co. of Wyo.*, 612 P.2d 463, 464 (Wyo. 1980) (upholding clause calling for increased price if FPC prescribes higher price than contract price).

169. NATURAL GAS REGULATION STUDY, *supra* note 8, at 115-16.

170. See generally Note, *Indefinite Price Escalation*, *supra* note 167.

171. H.R. REP. NO. 95, 95th Cong., 2d Sess. 7, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 9000.

2. *The Law of Preemption*

State review of natural gas procurement and contracting practices does not interfere with the FERC's wholesale ratemaking jurisdiction. The Illinois planning review does not seek to redetermine federally-approved wholesale rates. Instead, Illinois' review focuses on local utilities' management and procurement practices.

In *Pike City Light & Power Co. v. Pennsylvania Public Utility Commission*,¹⁷² the Pennsylvania Supreme Court considered the preemption issue in the electricity rate-making context. In *Pike*, the Pennsylvania Public Utility Commission concluded that, in light of the availability of more economical supplies of electricity, a retail electric utility's purchase of power from its parent company, Orange & Rockland Utilities, Inc., constituted an abuse of management discretion.¹⁷³ Orange & Rockland was a wholesale supplier of electricity. The FERC approved as "just and reasonable" the wholesale rates Orange & Rockland charged to Pike. Nevertheless, the Pennsylvania Supreme Court held that the FERC's regulatory functions "do not overlap" with those of the state utility commission.¹⁷⁴ The court noted that while the FERC focused on "whether it is just and reasonable for that company [Orange & Rockland] to charge a particular rate," the FERC does not determine "whether it is just and reasonable for Pike to incur such a rate as an expense."¹⁷⁵

The Rhode Island Supreme Court's decision in *Narragansett Electric Co. v. Burke*¹⁷⁶ is consistent with *Pike*. In *Narragansett*, the Rhode Island Supreme Court held that Congress, in enacting the Federal Power Act,¹⁷⁷ "intended to vest exclusive jurisdiction in the [Federal Power Commission] to regulate interstate wholesale utility rates."¹⁷⁸ The court then indicated that with regard to a state electric distribution utility, a rate filed with the FPC by the wholesale supplier "constitutes an actual operating expense and must be so viewed by the PUC."¹⁷⁹

172. 77 Pa. Commw. 268, 465 A.2d 735 (Pa. Commw. Ct. 1983).

173. *Id.* at 271, 465 A.2d at 736.

174. *Id.* at 274, 465 A.2d at 738. The court stated that "while the FERC determines whether it is against the public interest for Orange & Rockland to charge a particular rate in light of its costs, the PUC determines whether it is against the public interest for Pike to pay a particular price in light of its alternatives." *Id.*

175. *Id. Accord In re Sinclair Mach. Prods.*, 126 N.H. 822, 498 A.2d 696 (1985) (state PSC may always inquire into reasonableness of utility's electric purchasing power under FERC-approved rates given other purchase options available to the utility). See also *Spence v. Smyth*, 686 P.2d 597 (Wyo. 1984).

176. 119 R.I. 559, 381 A.2d 1358 (1979).

177. 16 U.S.C. § 824 (1970).

178. 119 R.I. 559, 565, 381 A.2d 1358, 1361 (1979).

179. *Id.* at 566, 381 A.2d at 1362. The court then held that "for the purpose of fixing intrastate rates, the PUC must treat NEPCO's . . . interstate rate filed with the FPC as a reasonable operating expense." *Id.* at 567, 381 A.2d at 1363.

The issue presented in *Narragansett*, however, is substantively different from the management and procurement practice review of state natural gas distribution utilities. In *Narragansett*, the state utility commission acknowledged that it lacked jurisdiction to set wholesale electricity rates charged to state utilities.¹⁸⁰ The commission went on, however, to state that the local utilities could not pass on to retail consumers any portion of the wholesale costs that were "strikingly" or "glaringly" unreasonable.¹⁸¹ The commission noted that the reasonableness determination would be made after reviewing the costs underlying the *wholesale* rate.¹⁸² Thus, federal law only preempted the state's inquiry into the basis of the wholesale rate.¹⁸³

Narragansett has not been construed as holding that all FERC-approved costs must be passed on to local retail ratepayers. In *Natural Fuel Gas Distribution Corp. v. Public Service Commission of New York*,¹⁸⁴ the New York Supreme Court Appellate Division considered the lawfulness of the New York Utility Commission's decision to make a natural gas revenue adjustment that lowered the revenues collectible under FERC-approved wholesale rates.¹⁸⁵ The court rejected the local utility's argument that the FERC had preempted the area, and noted that the commission's order did not redetermine FERC-approved rates but "affected only intrastate retail New York rates"¹⁸⁶

The retention by state public utility commissions of exclusive control over intrastate ratemaking is supported by a line of cases that involves the proper treatment of Gas Research Institute (GRI) costs in retail ratemaking.¹⁸⁷ In *Washington Gas Light Co. v. Public Service Commission*,¹⁸⁸ the District of Columbia Court of Appeals considered whether the District of Columbia Public Service Commission could prevent Washington Gas Light Co. from including in its retail rates GRI costs that had been included in FERC-approved wholesale rates. While the court held that a state utility commission is not authorized to reexamine the reasonableness of costs underlying federally approved rates,¹⁸⁹ this proscription did not entirely eliminate state regulatory jurisdiction. The court held that the FERC's jurisdiction did not extend "to the issue of whether increased wholesale costs shall be passed

180. *Id.* at 565, 381 A.2d at 1361.

181. *Id.*

182. *Id.*

183. *Id.*

184. 90 A.D.2d 605, 456 N.Y.S.2d 178 (N.Y. App. Div. 1982).

185. *Id.* at 607, 456 N.Y.S.2d at 179. Even the FERC reached these same conclusions. *See, e.g., Consolidated Gas Co. of Fla. v. Florida Gas Transmission Co.*, 28 FERC 61,006, at 61,019 (1983); *In re Philadelphia Elec. Co.*, 15 FERC 61,264, at 61,019 (1981).

186. 90 A.D.2d 605, 607, 456 N.Y.S.2d 178, 181 (N.Y. App. Div. 1982).

187. *See, e.g., Public Serv. Co. of Colo. v. Public Util. Comm'n*, 644 P.2d 933, 940-42 (Colo. 1982) (PUC determines if GRI charges will be passed on to consumers).

188. 452 A.2d 375 (D.C. 1982).

189. *Id.* at 385.

through to retail customers by the local utility. The determination of the extent to which wholesale costs should be reflected in local utility rates lies exclusively with local utility commissions."¹⁹⁰

This is the type of review that state statutes direct their regulators to undertake regarding purchase gas costs. The Illinois statute requires utilities to provide year-by-year supply projections and justify their supply choices on a least-cost basis.¹⁹¹ Illinois' utilities are also required to report demographic and economic characteristics that might affect the accuracy of their sales forecasts.¹⁹² The utilities must report demand-side planning measures.¹⁹³ After receiving these reports and holding hearings on their adequacy, the Illinois Commerce Commission must adopt an "energy plan" for each individual utility and for the state as a whole.¹⁹⁴ The Illinois legislature did not intend for the Illinois Commerce Commission to inquire into the reasonableness of the costs underlying FERC-approved rates. On the contrary, the statutory scheme clearly concentrates on traditional state regulatory roles and the review of local utility management practices.

CONCLUSION

State public service commissions are increasingly asserting authority over local natural gas distribution utilities' procurement and contracting practices. Due to the federal government's recent deemphasis on producer/pipeline and pipeline/distributor rate regulation, local regulators must fill the regulatory gap to ensure that local utilities are providing energy services to consumers at the least cost.

In 1985, the Illinois state legislature rewrote the state Public Utility Act, joining Iowa, Michigan and West Virginia in requiring gas distribution utilities to justify their procurement practices in a regulatory proceeding. Utilities must present comprehensive "energy plans" which outline their projections of anticipated supply and demand. Utilities must then demonstrate to the state commerce commission's satisfaction that their plan to meet projected demand incorporates least-cost strategies including, but not limited to, energy management strategies.

190. *Id.* at 385 n.15. The Idaho Public Service Commission reached the same conclusion using the same analysis. See *In re* Washington Water Power Co., 27 Pub. Util. Rep. 4th 281 (Idaho PUC 1978). In refusing to allow Washington Water Power Co. to charge retail ratepayers for GRI costs, the Idaho Commission expressly addressed the issue of preemption:

We are not investigating and are not judging whether it is just and reasonable for Northwest to impose the GRI costs on Intermountain and Washington Water Power.

We are only deciding whether it is just and reasonable for Intermountain and Washington Water Power to impose that charge on their Idaho ratepayers.

Id. at 289.

191. ILL. REV. STAT. ch. 111 2/3, § 8-402(d)(ii) (1985).

192. *Id.* § 8-402(b).

193. *Id.* § 8-402(d)(ii).

194. *Id.* § 8-402(f).

Opponents of state regulation argue that the FERC's regulatory power preempts state rate regulation. Opponents further argue that state utility commissions must accept FERC-approved rates as legitimate operating expenses. Thus, opponents contend that state commissions may not disallow the inclusion of wholesale costs in rates to retail customers.

The gas procurement and contracting review undertaken in Illinois and elsewhere does not seek to redetermine whether wholesale gas rates are reasonable in light of the underlying costs. Instead, state review focuses on a number of local utility management practices that may result in unreasonable rates to retail customers. In light of the purpose underlying state review, it is clear that the FERC's regulatory authority does not preempt state regulation.