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Federal Regulation of Independent Natural Gas Producers—An Adventure in Pragmatism

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In describing and evaluating area rate-making, Mr. Foy concentrates on its historical context. His discussion shows how conventional utility and railroad regulatory methods grew to fit the economic characteristics of the regulated industries. He traces the fluctuating standards of the federal "fair value" era and the modern "end-result" era, with emphasis on the Hope *case, and analyzes the use of typical or representative costs in various types of group proceedings. Concluding that natural gas producers occupy a unique factual position, he warns that the FPC must continue to devise ingenious, pragmatic methodology, untrammelled by conventional regulatory concepts, if its regulation is to avoid crippling the industry and impairing the nation's future gas supplies.*

The "first and last question as to the law is what is the fact."
—Holmes[1]

All price regulation is essentially unnatural in a capitalistic economy. Natural gas field price regulation as developed by the Federal Power Commission is decidedly unique, occupying a segregated niche of its own within the general regulatory framework. Even before the days of federal producer regulation, an eminent jurist advocated singularly flexible ingenuity in the regulation of natural gas, observing that, "in no other field of public service regulation is the controlling body confronted with factors so baffling as in the natural gas industry, and in none is continuous supervision and control required in so high a degree."[2] One should resist the temptation to approve virtually any natural gas regulatory measure proposed by the Commission merely because it is difficult to imagine a more suitable one. Nevertheless,

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1. 8 GREAT AMERICAN LAWYERS 126 (W. Lewis ed. 1909).

2. Pennsylvania v. West Virginia, 262 U.S. 553, 621 (1923) (Brandeis, J., dissenting).

perhaps no other branch of the law more strikingly illustrates the tendency and the ability of legal principles to conform to peculiar economic facts, industrial circumstances, and the demands of administrative practicability.

With *Opinion No. 468, Area Rate Proceeding for Permian Basin,*[3] the first final order fixing area-wide field prices of independent producers, and *Skelly Oil Co. v. FPC,*[4] affirming in part but remanding the order for additional evidence and findings, the Commission and the Tenth Circuit have brought into focus vexatious problems that have plagued the industry, the regulators and the courts for over thirteen years. These decisions culminate a series of pragmatic adjustments of regulatory policy to fit the peculiar economic facts of the industry, under expanding judicial mandates.

There is good reason to suspect that independent producer price jurisdiction is court-made, rather than statutory, law. Certainly it did not germinate from any seed in the legislative history of the Natural Gas Act.[5] However, in 1954 the Supreme Court held, in *Phillips Petroleum Co. v. Wisconsin (Phillips I),*[6] that producer sales to interstate pipelines were sales for resale in interstate commerce, and that the vague exemption afforded producing and gathering operations by the Natural Gas Act did not apply, reasoning that production ceases before the sales are made and the gas is delivered to the pipelines.[7] Some have contended that the Court based its decision more on its assumption of a practical need for regulation than on customary principles of statutory construction.[8] They contended that the Act was not "well-designed,"[9] in fact, not at all designed to supply statutory standards for the administrative task;[10] and that, having thrust an unsolicited duty upon the Commission, the courts have been

3. 34 F.P.C. 159, *rehearing denied,* 34 F.P.C. 1068 (1965). There are companion orders issuing certificates, 34 F.P.C. 418 (1965); ordering producers who were not parties to show cause why the area ceilings should not apply to them, 34 F.P.C. 424 (1965), and denying rehearing in the certificate proceedings, 34 F.P.C. 1082 (1965).

4. 375 F.2d 6 (10th Cir.), *cert. granted, sub. nom.* Continental Oil Co. v. FPC, 388 U.S. 906 (1967). No consumer, distributor or pipeline purchaser interest appealed from the Commission's orders.

5. 15 U.S.C. § 717 (1964). *See* Flittie & Armour, *The Natural Gas Experience—A Study in Regulatory Aggression and Congressional Failure To Control the Legislative Process,* 19 Sw. L.J. 448, 469-71 (1965); Comment, *Extension of Federal Regulation of Natural Gas Production,* 40 CORNELL L.Q. 328 (1955); Comment, *Natural Gas Act Construed To Encompass Sale by Independent Producers,* 1954 U. ILL. L.F. 509.

6. 347 U.S. 672 (1954).

7. *Id.* at 677-79.

8. Comment, *Extension of Federal Regulation of Natural Gas Production,* 40 CORNELL L.Q. 328 (1955).

9. *See* Sunray DX Oil Co. v. FPC, 370 F.2d 181, 190 (10th Cir. 1966).

10. Comment, *Are "Conventional Methods" Necessary in Natural Gas Rate Regulation?,* 41 CORNELL L.Q. 438, 456 (1956).

subsequently honoring an implied commitment to read the statute broadly enough to enable the Commission to achieve practical regulatory control.[11]

In the wake of this historic decision, the Commission and the courts may have achieved an ultimate in accommodating a statute to economic and practical realities. Critics have found in the *CATCO*,[12] *Texaco*,[13] *Hunt*[14] and *Callery*[15] cases concepts which they could not justify or approve on the basis of the Natural Gas Act. Now the *Permian Basin Order* and the *Skelly* case offer additional opportunities for the extension of administrative flexibility on pragmatic grounds.

During the first six years after *Phillips I*, the Commission floundered in fruitless efforts to apply traditional regulatory standards to independent producer rates. By 1960, it was convinced that it had neither the time nor the manpower to make any substantial reduction in its workload by traditional methods. *Opinion No. 338*,[16] dismissing an investigation of the rates of Phillips Petroleum Company, announced the Commission's abandonment of the attempt to regulate independent producer rates on an individual basis and its intention to initiate a series of area proceedings in which it would seek to establish fair prices for all gas produced in each area. With the tentative approval of its project by the Supreme Court in *Wisconsin v. FPC (Phillips II)*,[17] the Commission pursued to completion the *Permian Basin* proceeding. Meanwhile, other proceedings have been initiated in other areas.[18]

By interim orders in the *Permian* proceeding, the Commission prohibited the introduction of evidence of the individual costs of each

11. *See* Flittie & Armour, *supra* note 5, at 492 n.200.

12. Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378 (1959); *cf.* Scott, *Federal Certificate Regulation of Producer Gas Sales: Initial Rates and Related Problems*, 18 Sw. L.J. 570, 589-93 (1964); Searls, *Decision of FPC in Phillips Petroleum Company Case and Effect on Producers of Commission's Statement of General Policy No. 61-1, As Amended*, 12th OIL & GAS INST. 1, 20, 21 (Sw. Legal Fdn. 1961).

13. FPC v. Texaco, Inc., 377 U.S. 33 (1964); *see* Fitzgerald, *Adoption of FPC Price-Changing Rules Without Evidentiary Hearing; Statutory Collision*, 18 Sw. L.J. 236 (1964).

14. FPC v. Hunt, 376 U.S. 515 (1964), *noted in* 7 S. TEX. L.J. 307 (1964).

15. United Gas Improvement Co. v. Callery, 382 U.S. 223 (1965); *cf.* Attwell, *Present Status of FPC Regulation of Natural Gas Producers*, 17th OIL & GAS INST. 1, 13-15 (Sw. Legal Fdn. 1966).

16. 24 F.P.C. 537 (1960).

17. 373 U.S. 294 (1963).

18. 24 F.P.C. 1121 (1960) (Permian Basin); 25 F.P.C. 942 (1961) (South Louisiana); 30 F.P.C. 1354 (1963) (Hugoton-Anadarko and Texas Gulf Coast). These four proceedings involve about 75% of the gas flowing in interstate commerce. Area Rate Proceeding (Permian Basin), 34 F.P.C. 159, 176 (1965). A fifth proceeding, encompassing another 14%, was initiated on February 28, 1967. Area Rate Proceeding (Other Southwest Area), 32 Fed. Reg. 3792 (1967).

producer.[19] It circulated questionnaires among the parties to develop composite cost information, to which many of the producers made no answers.[20] Evidence of broad scope, covering a multitude of economic, financial and technical topics, was introduced. There were 251 days of hearings, in which the record grew to 30,839 pages; 337 main exhibits with numerous supplemental exhibits were received in evidence.[21]

Opinion No. 468[22] finally emerged on August 5, 1965. The Commission held that area pricing through group proceedings is lawful under both the Constitution and the Natural Gas Act. It deemed average contract price levels resulting from arm's-length bargaining to be inappropriate as a standard for the area price; it rejected a proposal that contract prices be undisturbed so long as the ratio between reserves and production is not excessive; and it held that composite costs should be the foundation of its price determinations.

Adopting the examiner's finding that the industry had developed the ability to drill "directionally" for gas,[23] as distinguished from oil, and finding January 1, 1961 as a date when that ability had been developed, the Commission established ceiling prices for "new, gas-well gas" (gas-well gas reserves committed to interstate commerce by contract after January 1, 1961), and "flowing gas" (including both old, gas-well gas and gas produced from oil wells). As a basis for the new gas-well gas price, the Commission used national data to develop a composite current cost of exploration and production; for flowing gas, it used composite historical costs incurred in the Permian Basin. The tabulation[24] on the next page shows the construction of the two prices in cents per thousand cubic feet (Mcf).

These costs were rounded to 16.5 cents per Mcf and 14.5 cents per Mcf respectively to establish the area prices in Texas, including production taxes. Since New Mexico production taxes vary by counties, the ceiling prices were reduced by one cent per Mcf for New Mexico production, with the stipulation that actual New Mexico taxes could be added to them.

These ceiling prices apply to gas of pipeline pressure and quality. They are to be reduced by the cost of bringing the gas up to the standards prescribed in the order.[25] Furthermore, new gas-well gas

19. 27 F.P.C. 943 (1962).

20. Area Rate Proceeding (Permian Basin), 34 F.P.C. 159, 213-14 (1965). Orders promulgating the questionnaires are published in 26 F.P.C. 247, 514, 531 (1961) and 27 F.P.C. 20 (1962).

21. FPC Press Release No. 13964, Aug. 5, 1965.

22. Area Rate Proceeding (Permian Basin), 34 F.P.C. 159 (1965).

23. *Id.* at 185-89.

24. *Id.* at 189-220.

25. *Id.* at 221-25. These standards include the maximum amounts of carbon dioxide, hydrogen sulfide and water that pipeline quality gas may contain, and the minimum

	New Gas-Well Gas	*Flowing Gas*
Exploration and Development Costs		
Dry Holes	1.42	1.42
Other Exploratory Costs	1.59	1.59
Adjustment for Exploration in Excess of Production	1.11	1.11
Production Operating Expense	2.70	2.70
Net Liquid Credit	(3.10)	(3.10)
Regulatory Expense	.14	.14
Depletion, Depreciation and Amortization of Production Investment Costs		
Successful Well Costs	2.88	2.42
Lease Acquisition Costs	.76	.64
Cost of Other Production Facilities	.31	.26
Return on Production Investment (at 12 Percent)	5.21	4.38
Return on Working Capital	.35	.35
Subtotals	13.37	11.91
Royalty at 12-1/2 Percent	2.05	1.83
Production Taxes	1.01	.90
Totals	16.43	14.64

which has a heat content of less than 1000 Btu per Mcf is subject to a proportionate price reduction, while new gas-well gas which has a heat content of more than 1050 Btu per Mcf commands a proportionate price increase.[26] Since much of the gas is subject to sales contracts at prices lower than the applicable ceilings, the Commission also fixed a minimum price of 9 cents per Mcf, subject to quality and pressure adjustments, thereby allowing the contracts to determine the actual prices paid between the floor and the ceiling established in the order. In addition, the Commission exempted small producers from the quality adjustments and certain filing requirements; and it imposed a moratorium forbidding all producers to file for increases above the area ceilings before January 1, 1968.

On appeal in the *Skelly* case, the producers attacked both the foundation and the structure of the Commission's order. In an

pressure at which it may be delivered. *See also*, on application for rehearing, Area Rate Proceeding (Permian Basin), 34 F.P.C. 1068, 1071 (1965).

26. Area Rate Proceeding (Permian Basin), 34 F.P.C. 159, 223, 224 (1965).

27. Skelly Oil Co. v. FPC, 375 F.2d 6 (10th Cir. 1967).

exhaustive opinion,[27] the Court of Appeals sustained the basic area-approach against constitutional and statutory arguments. Although area-pricing necessarily implies that low cost producers may prosper greatly, while others may suffer inadequate returns, administrative feasibility justifies the diverse results. In sections 5 and 16 of the Act,[28] the court found authority for the moratorium on future rate increase filings. Respectfully, the court declined to examine "the turmoil of numbers" in the record underlying the Commission's findings, confining its review to questions of law. It found the two-price system to be within the legitimate discretion of the Commission.

However, the court deemed the Commission's findings inadequate to permit effective review. It held that the Commission must find the dollar amount of group revenues and equate those with group costs. Because the overall effect of the quality deductions on revenues had not been established in the record, additional evidence would be necessary on that point. There are intimations in the opinion that the court is unsatisfied concerning the gap between 1000 and 1050 BTU's in the BTU adjustment; and that it would be better pleased if the ceiling prices had been applied across the board, regardless of contract limitations. But overall, the court conceived that its duty under *FPC v. Hope Natural Gas Co.*[29] was to determine whether the end result of the order was fair to the group under regulation. This task it believed to be impossible on the basis of the Commission's finding that the area prices would result in a "fair relationship" between the aggregate prices to be paid by consumers and the aggregate costs incurred by the producers. "Fair relationship," it said, is only part of the end result standard; that standard is "not satisfied by a reliance on unknowns."[30] Hence, it remanded the case for additional evidence and findings on the effect of the quality deductions, the amount of group revenues, and the precise relationship between aggregate revenues and aggregate costs.

Furthermore, although the Commission's order had provided a saving clause, by which individual producers might exempt their operations from the general order, the saving clause did not provide, in the court's opinion, sufficiently precise and detailed guidelines to be effective. Holding that it was not adequate merely to provide that "confiscation" would be prevented, the court instructed the Commission to prepare a saving clause containing guidelines that will permit an aggrieved and conforming producer "to be heard promptly and to have a stay of the general rate order until its claim for exemp-

28. *Id.* at 26.

29. 320 U.S. 591 (1944).

30. Skelly Oil Co. v. FPC, 375 F.2d 6, 34 (10th Cir. 1967).

tion is decided."[31] On motion for rehearing, the court also held that the Commission may order refunds of rates previously collected under bond only for those periods during which group revenues exceeded group costs.[32]

Skelly is now pending before the Supreme Court on certiorari.[33] The final decision will involve intriguing and baffling questions of regulatory law and procedure. The constitutionality and legality of the group approach, the rights of individuals in such a proceeding, the standards by which a group order is to be tested, and the role of costs in regulating prices, all must be considered in a setting dominated by the Supreme Court's prior decision in *FPC v. Hope Natural Gas Co.*[34] and other related cases.

The following discussion develops the factual and legal background of natural gas producer regulation, with reference to the statutory framework, the distinctive regulatory problems encountered in applying the Natural Gas Act to producers, and the policies which have apparently shaped the decisions of the Supreme Court in certificate, as well as rate cases. It attempts to show how the Court has answered related questions in the regulation of public utilities, railroads and other industries in the context of their own peculiar factual circumstances. Special attention is devoted to the *Hope* case, since both producer and consumer interests have cited it as controlling in the current *Permian* litigation. The final two sections draw certain conclusions with regard to the legal and practical future of area regulation.

I. The Statutory Framework and the Filing Problem

Proceedings before the Commission arise principally under sections 4, 5 and 7 of the Natural Gas Act.[35] Basic to the Commission's rate regulation is the declaration of section 4(a) that all rates and charges must be "just and reasonable," and that any rate which is not just and reasonable is unlawful.[36] Under section 4(c) all rate schedules of every natural gas company covering jurisdictional sales must be filed with the Commission.[37] Unless otherwise ordered by the Commission, such rates may not be changed, except after 30 days' notice to the Com-

31. *Id.* at 30.
32. *Id.* at 36. The court further held that refunds may only be ordered on an "equitable" basis.
33. Continental Oil Co. v. FPC, 388 U.S. 906 (1967). A number of petitions are involved. Some of the producers argue in support of the Tenth Circuit judgment; some oppose both FPC order and appellate judgment. All consumer and distributor interests, as well as the Commission, support the Commission's order and urge reversal of the *Skelly* judgment.
34. 320 U.S. 591 (1944).
35. 15 U.S.C. §§ 717c, 717d & 717f (1964).
36. 15 U.S.C. § 717c(a) (1964).
37. 15 U.S.C. § 717c (1964).

mission and the public, which is accomplished by filing new schedules.[38] Upon the filing of a new schedule, the Commission may enter upon a hearing and decision, and it may suspend the new schedule for a period not to exceed five months from the date on which it would otherwise go into effect. After this period the new rates may go into effect, subject to the Commission's power to require a bond and order a refund of the portion of the increased rates or charges ultimately found to be unjustified.[39] Under section 5, the Commission may at any time enter into a hearing to determine whether an existing rate is unjust or unreasonable;[40] however, in a section 5 proceeding, the Commission may act only prospectively.[41]

Each natural gas company is required by section 7 of the Act to obtain a certificate of public convenience and necessity authorizing its sales and the construction, extension, acquisition or operation of its facilities.[42] A hearing on each certificate application is required by section 7(c)[43] to ascertain whether the applicant is able and willing to perform and whether the proposal is required by present or future public convenience and necessity.[44] The Commission has authority to attach to the grant of the certificate "such reasonable terms and conditions as the public convenience and necessity may require." A temporary certificate may issue pending determination of the application for a permanent certificate.[45] Once a certificate has issued, and has been accepted by the applicant, neither the facilities nor the service rendered thereby may be abandoned without the approval of the Commission.[46]

Because of the number and diversity of independent producers, and of their jurisdictional sales, tremendous difficulties have been encountered in the Commission's efforts to apply the Act to them.[47] Filing requirements under section 4 were simplified by an order permitting the producers to file their gas sales contracts as rate schedules.[48] However, the contracts of independent producers have distinctive delivery, service and pricing provisions which have caused novel regulatory problems.

39. 15 U.S.C. § 717c(d) (1964).
39. 15 U.S.C. § 717c(e) (1964).
40. 15 U.S.C. § 717d (1964).
41. *See* Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378, 389 (1959).
42. 15 U.S.C. § 717f (1964).
43. 15 U.S.C. § 717f(c) (1964).
44. 15 U.S.C. § 717f(e) (1964).
45. 15 U.S.C. § 717f(c) (1964).
46. 15 U.S.C. § 717f(b) (1964). *Compare* Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137 (1960), *with* United Gas Pipe Line Co. v. FPG, 385 U.S. 83 (1966).
47. Tarver, *The Natural Gas Regulatory Problem—A Middle Way*, ABA Mineral & Natural Resources Section 15, 16 (1961); Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 Harv. L. Rev. 549 (1962).
48. Order 242, 27 Fed. Reg. 1356 (1962); *see* 18 C.F.R. §§ 154.92, 154.93 (1967).

In meeting their own requirements for certification, the pipelines have usually had to show that they had acquired at least a twenty-year gas supply.[49] Therefore, the producer contracts generally provide terms of at least twenty years. To induce the execution of such long-term contracts, the pipelines have agreed to various forms of price escalation. Clauses increasing prices in proportion to increased taxes and other expenses are one type; regular escalation by fixed increments at stated intervals is another; and, in some instances, the contracts require price redetermination, with or without a specified pricing formula, after certain periods.[50] So-called "favored nations" clauses were designed to give the contracting producer the benefit of any better price paid by its purchaser in the field or area,[51] or of any better price paid by any other purchaser in the field or area.[52] "Spiral escalation" clauses provide that when the pipeline obtains increases in its resale rates, it must pay proportionately higher prices to the producer. For several years, the Commission permitted the filing of contracts containing these variegated escalation clauses because proceedings under section 4 would be necessary to place in effect any price increases occasioned thereby.[53]

Pressure, quality and heat content are generally regulated by detailed contract provisions. These often incorporate pricing adjustments, particularly in relation to heat content, for which the price goes up or down in proportion to variations above or below a specified level of Btu's per Mcf of gas, usually 1000.[54] Take-or-pay clauses regulate deliveries by providing that the purchaser must pay for gas, whether or not taken during the contract year, up to certain minimum average daily, monthly or annual quantities, designed to afford fairly regular depletion of the contract reserves over their estimated life; the purchaser generally has the right to "make up" deficient quantities in a limited period of years by taking gas in excess of contract minimums without additional payment, except where intervening escalation has occurred.[55] Many of these provisions have an obvious effect on the pipeline's costs, and therefore upon the ultimate prices paid by consumers.

49. *Hearings on H.R. 4560 Before the House Comm. on Interstate and Foreign Commerce*, 84th Cong., 1st Sess. 26 (1955); Atkinson, *Federal Regulation of Natural Gas—The Independent Producers' Status*, 13 Sw. L.J. 425, 463-64 (1959); Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 HARV. L. REV. 549, 550 (1962).

50. *See* Richardson, *Producer Contracts for Sale of Natural Gas in Interstate Commerce*, 11th OIL & GAS INST. 201, 224-27 (Sw. Legal Fdn. 1960).

51. So-called "two-party" favored nations clause.

52. So-called "three-party" favored nations clause.

53. Tamborello, 14 F.P.C. 123 (1955).

54. *See* Trunkline Gas Co., 33 F.P.C. 122 (1965).

55. *See* Order No. 334, January 18, 1967.

Phillips I[56] suggested no distinctive methodology for producer rate regulation; neither does the Natural Gas Act. Soon after the first *Phillips* decision, the Commission invited producers to suggest pricing techniques which it might use in regulation. The result was inconclusive.[57] In a case involving gas produced by a pipeline utility, the Commission had tentatively adopted the standard of a "fair field price," based upon average prices established by negotiation between sellers and buyers.[58] The standard encountered judicial disapproval in *City of Detroit v. FPC*.[59] While the court said that the "conventional rate base method" is not the only one available to the Commission, "it is essential in a case such as this that it be used as a basis of comparison. . . . Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning."[60] After the decision in *Phillips I*,[61] producers attempted in a series of cases to justify price increases by evidence of arm's-length bargaining, competitive market conditions, and other generalized economic considerations, without proof of their individual costs of service. A dutiful Commission dismissed a number of applications for want of sufficient evidence; but on appeal, the cases were generally remanded for reconsideration upon a proper showing of relevant costs.[62]

By 1959, the Commission had not processed any producer rate case to a final rate-making order upon any definitive standard. There was utter confusion in the effort to prescribe pricing standards for the industry.[63] Demand for gas continued to multiply, and producers continued to file contracts at increasing price levels. Although aware of its conditioning powers under section 7, the Commission was yield-

56. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

57. Consideration of Principles and Methods, 14 F.P.C. 1128 (1955).

58. Panhandle E. Pipe Line Co., 13 F.P.C. 53 (1954).

59. 230 F.2d 810 (D.C. Cir. 1955). A former FPC General Counsel has described the history of the case in Gatchell, *Some Basic Factors and Trends in Public Utility Regulation*, 12th Oil & Gas Inst. 23, 47-50 (Sw. Legal Fdn. 1961).

60. 230 F.2d 810, 818-19 (D.C. Cir. 1955). The Commission has pending before it a proceeding to determine whether area price ceilings fixed for independent producers should apply to gas produced by pipeline utilities. The pipelines are advocating use of the area ceilings.

61. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

62. *See, e.g.*, Forest Oil Corp. v. FPC, 263 F.2d 622 (5th Cir. 1959); Sears & Herrmann Corp. v. FPC, 263 F.2d 626 (5th Cir. 1959); Bel Oil Corp. v. FPC, 255 F.2d 548 (5th Cir. 1958); Associated Oil & Gas Co. v. FPC, 255 F.2d 555 (5th Cir. 1958); Gulf Oil Corp. v. FPC, 255 F.2d 556 (5th Cir. 1958); Sun Oil Co. v. FPC, 255 F.2d 557 (5th Cir. 1958).

63. For detailed history of producer rate cases prior to 1960, see May, *Preparation for Gas Rate Hearing Before the Federal Power Commission*, 11th Oil & Gas Inst. 123 (Sw. Legal Fdn. 1960); McGee, *Independent Producers—After Six Years of FPC*, ABA Mineral & Natural Resources Section 219 (1960).

ing to producer price stipulations in order to assure the dedication of gas to the interstate service.[64] The situation came before the Supreme Court in the *CATCO*[65] case, and the Court firmly issued marching orders.

CATCO's rationale rested squarely on the purpose of the Natural Gas Act to "underwrite" just and reasonable rates. "The Act was so framed," Justice Clark said for the Court, "as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." Since an initial price is subject to reduction only through section 5 proceedings, "the initial certificating of a proposal under section 7(c) of the Act as being required by the public convenience and necessity becomes crucial." Acknowledging that the Act does not require a "just and reasonable rate" to be determined in a section 7 proceeding, the Court nevertheless thought the "inordinate delay" experienced in section 5 investigations "requires a most careful scrutiny and responsible reaction to initial price proposals of producers under section 7." Among the situations requiring or justifying Commission action would be initial prices which were "*out of line*," or prices which would "trigger" general price rises or increases in the applicant's own rates because of "favored nations" clauses or otherwise. "Section 7 procedures . . . thus act to *hold the line* awaiting adjudication of a just and reasonable rate." (Emphasis supplied.)

The *CATCO* opinion reflected a growing impatience with the lead-footed pace of the Commission, observing that although *Phillips I* was decided in 1954, section 5 proceedings were still in the investigative stage. The delay was apparently "interminable." "This long delay, without the protection of refund, as is possible in a section 4 proceeding, would provide a windfall for the natural gas company with a consequent squall to the consumers." Hence, the practical situation required the Commission to shift the burden of price adjustments to the producer by carefully examining initial price proposals and imposing such price conditions in certificates as would keep initial prices in line.

No "in line" price standard is prescribed in the Natural Gas Act, much less a procedure or formula for determining one. There is a discernible policy, however, in the *CATCO* opinion and its progeny to hasten the grasping of control over producer prices; a sense of urgency has electrified the judicial oversight. A period followed *CATCO*, during which the Commission, under close judicial supervision, struggled with "in line" standards under section 7 while it was wallowing in the "just and reasonable" bog of the section 4 and section 5

64. Scott, *Federal Certificate Regulation of Producer Gas Sales: Initial Rates and Related Problems*, 18 Sw. L.J. 570, 576-88 (1964).

65. Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378 (1959).

cases. Judge John R. Brown's dissenting opinion in a 1961 Fifth Circuit decision[66] graphically portrayed the Commission's plight. Reliance on market prices involved the risk of reversal under the "suspect price" doctrine;[67] justification on the basis of individual producer costs intensified an already ponderous administrative burden.

II. Practical Expedients Pending Establishment of Price Control

Examining its general powers, the Commission began to attack its problems at their source. It commenced an investigation of escalation clauses, under which it was being inundated with section 4 filings for increases. Acting under section 16 of the Natural Gas Act,[68] which authorizes it to make "such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this Act," it proscribed "favored nations,"[69] and "spiral"[70] escalation clauses in contracts executed after April 2, 1962, by prospectively limiting contract escalation clauses to three narrow categories.[71]

Producers felt this was a violation of the filing privileges of section 4; and that the Commission could make such a ruling only after adversary hearings on individual contracts. On separate appeals, the Tenth Circuit agreed with the producers;[72] the Ninth Circuit disagreed.[73] However, the Supreme Court settled the question in favor of the Commission on broad practical grounds:

> It must be remembered that under the Act rate increases are initiated by the natural gas company, the Commission having the burden by reason of §4(c) of the Act to initiate a hearing on their legality with only a limited power to suspend new rates. . . . Natural gas companies that seek to enter

66. United Gas Improvement Co. v. FPC, 290 F.2d 133, 138 (5th Cir. 1961). *See* Foster, *Certificate Regulation of Independent Producers—After Six Years of FPC*, ABA Mineral & Natural Resources Section 195, 203-16 (1960).

67. Morris, *Recent Independent Producer Certificate Cases: 'The Suspect Price' Rule*, 32 Geo. Wash. L. Rev. 489 (1964).

68. 15 U.S.C. § 717(o) (1964).

69. *See* notes 51 & 52 *supra* and accompanying text.

70. *See* text accompanying notes 52 & 53 *supra*.

71. 18 C.F.R. § 154.93 (1967), defines the permissible types as follows:

"(a) Provisions that change a price in order to reimburse the seller for all or any part of the changes in production, severance, or gathering taxes levied upon the seller;

"(b) Provisions that change a price to a specific amount at a definite date; and

"(c) Provisions that, once in five-year contract periods duriug which there is no provision for a change in price to a specific amount (paragraph (b) of this section), change a price at a definite date by a price-redetermination based upon and not higher than a producer rate or producer rates which are subject to the jurisdiction of the Commission, are not in issue in suspension or certificate proceedings and, are in the area of the price in question. . . ."

72. Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir. 1963).

73. Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963).

> the field with prearranged escalator clauses and the like have a built-in device for ready manipulation of rates upward. Protection of the consumers against that device may be best achieved if it is done at the very threshold of the enterprise. . . .
>
> To require the Commission to proceed only on a case-by-case base would require it, so long as its policy outlawed indefinite price-changing provisions, to repeat in hearing after hearing its conclusions that condemn all of them. . . . We see no reason why under this statutory scheme the processes of regulation need be so prolonged and so crippled.[74]

The anticipated practical effect was to diminish the number of section 4 filings, since under the *Mobile*[75] case a natural gas company has no right to file a changed "schedule" which is contractually unauthorized. However, section 4 proceedings would continue to increase under contracts which had been executed prior to April 2, 1962. In order further to curtail section 4 filings, the Commission essayed to condition a temporary certificate by requiring the applicant not to file for increases pending permanent certification. Again the Supreme Court responded to producer challenge by sustaining the Commission's authority.[76]

Finally, the Commission consolidated its section 7 pricing powers in the *Callery*[77] case. It refused to admit in evidence "a tremendous mass of cost-type, economic and financial evidence" tendered by the producer on the "in line" price issue. Fixing an in-line price of 18.5 cents per Mcf, plus tax reimbursement, it prohibited the producer from thereafter filing any increased rate schedule above 23.55 cents per Mcf until a "just and reasonable" rate should have been established for the area, or until July 1, 1967, whichever was earlier, because any higher filing would "trigger" contract escalation clauses of other producers. It further ordered the producer to refund all amounts theretofore collected in excess of the in-line price, although no refund condition had been imposed in the certificate under which the sales had been initiated.

The Fifth Circuit disagreed with the Commission on all points.[78] Price, it said, is "not the whole thing" in determining public convenience and necessity. Demand, potential supply, increases in the costs of meeting the demand, all should be considered. It was error to exclude evidence bearing on these factors. Furthermore, the moratorium exceeded the reasonable limits of administrative power. In this case, nearly ten years had passed since the original certification, almost half the contract period. To sustain the moratorium would

74. FPC v. Texaco, Inc., 377 U.S. 33, 42-44 (1964).
75. United Cas Pipe Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1956).
76. FPC v. Hunt, 376 U.S. 515 (1964).
77. Callery Properties, Inc., 30 F.P.C. 283 (1963).
78. Callery Properties, Inc. v. FPC, 335 F.2d 1004 (5th Cir. 1964).

allow the Commission to obtain "an irrevocable dedication of the gas to interstate sale and an effectual denial of any opportunity for the producer to exercise the legislative right to file, subject to suspension and refund, contractual rate increases. If the Commission may do it for half of the period, there is no reason why it may not do so for all."[79] Granting that the power to require refunds existed in these circumstances, they should be based, not on the in-line price but on the just and reasonable rate to be established in the pending and applicable area rate proceeding.

However, the Supreme Court held that the Commission had acted "lawfully and responsibly" in line with the *CATCO* decision.[80] Experience had convinced the Commission that "the minimal utility derived from cost and economic trend evidence was outweighed by the administrative burdens and delays its consideration inevitably produced."[81] The Court agreed with this practical conclusion. Moreover, it found that the moratorium was within the conditioning powers of section 7 and that the prohibitory price level reflected the Commission's expertise; and it approved the refund of all amounts in excess of the in-line price.

Not all of the fallout of *CATCO* has been noted here—just enough to indicate the power of the Supreme Court's urgent thrust toward the initial establishment of regulatory control. In a case like *Callery*, the Court was openly permitting the risk that a producer would be trapped into exhausting the reserves under a given lease without ever having an opportunity to be heard on costs and without a just and reasonable rate ever having been established. Unless a sixth sense enabled the highest Court to ascertain that the in-line price was compensatory, the result can only be justified on the ground that the public need overrode the private right to due process, procedural as well as substantive. Although its record in the courts of appeal was spotty, the Commission could claim a perfect batting average in the supreme tribunal, so long as its orders were tending to bring prices under control, forestall increases, and promote the payment of refunds to consumers. Unless these decisions are to be regarded as temporary expedients justified by a spiralling-price emergency, their plain implication relegates common conceptions of fair play and due process to dismal seats in a distant corner of the courtroom; but the Court made no attempt to support its conclusions by precedents which turned on the temporary character of the administrative action.[82]

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79. *Id.* at 1017.
80. United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223 (1965).
81. *Id.* at 228 n.3.
82. *See, e.g.*, Block v. Hirsh, 256 U.S. 135, 157 (1921) ("A limit in time, to tide

III. Conventional Cost Methodology Discarded

As a result of the remand in *Phillips I*, the Commission reinstituted its section 5 investigation of the field prices of Phillips Petroleum Company, consolidating in the proceeding a number of section 4 applications by Phillips for increased field prices. After approximately six years, on September 28, 1960, the Commission rendered its decision in this case, the first really definitive opinion to be issued in a contested independent producer rate case.[83] It found that Phillips' cost of service exceeded its contract prices during 1954 and prior years, and therefore dismissed the proceedings, even as to later years.

At the same time, the Commission declared its independence of individual cost of service methodology in producer rate cases. Experience had convinced the Commission that "the traditional original cost, prudent investment rate base method of regulating utilities is not a sensible or even a workable method of fixing the rates of independent producers of natural gas."[84] Producers could not be treated like public utilities. In contrast to the utility, which is reasonably assured of the financial feasibility of a project before any funds are expended, "the producer must invest his funds prior to ascertaining whether he will have anything to sell or whether, if he does, he will have an adequate market."[85]

Furthermore, the individual cost of the producer is not related to the amount of natural gas which it ultimately has to sell. The Commission recalled a statement from the dissenting opinion of Justice Jackson in the *Hope* case:

> [T]he service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the result than in a game of poker.[86]

As a matter of fact, the Commission said, "under the cost rate base method, the producer who first takes the risk in an area and proves it productive will get the least return, for he will undoubtedly pay less for his rights than those who came in later after the area is proved."[87]

Administratively, the individual cost of service method was completely impractical. Since much natural gas is produced along with

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over a passing trouble, may well justify a law that could not be upheld as a permanent change").

83. Phillips Petroleum Co., 24 F.P.C. 537 (1960).

84. *Id.* at 542.

85. *Id.* at 543.

86. FPC v. Hope Natural Gas Co., 320 U.S. 591, 649 (1944).

87. 24 F.P.C. 537, 543 (1960).

oil, the cost method would require an allocation of the respective costs of producing the oil and the gas. "A producer actually could become bankrupt, or could make enormous profits, depending merely on the methods of allocation used."[88] In part, the development of unit costs would necessarily be based upon estimates of reserves in place underground, "which can never be precise and have been shown to be highly inaccurate in many cases."[89] For this reason, as well as the practical impossibility of dividing costs between the unregulated commodity, oil, and the regulated commodity, gas, "the calculation of the unit cost of gas is, and will be, an inexact, complex, unsatisfactory, and time consuming process, fraught with controversy."[90]

Furthermore, at that time the Commission had accumulated filings by 3,372 independent producers, to whom should be added 15,435 non-filing co-owners under any rate base theory. At the date of the decision, 11,091 rate schedules and 33,231 supplements were on file. Awaiting hearings and decisions were 3,278 producer rate increase filings, involving 570 of the producers. If the existing staff of the Commission were tripled, it nevertheless thought that it could not reach a current status in its independent producer rate work until 2043 A.D.[91] Acknowledging the implications of *City of Detroit v. FPC*,[92] that in every case it must calculate a rate base and determine a rate of return at least as a point of departure, the Commission drew the issue plainly: if that decision prohibited its new approach, then "adequate regulation of producers appears to be impossible under existing law."[93]

Therefore, the Commission announced that it would attempt to find "fair prices for gas, based on reasonable financial requirements of the industry and not on the particular rate base and expense of each natural gas company."[94] It would consider the need for a price adequate to maintain the gas supplies needed by the consumers of the nation, would make use of cost data which it had obtained in the past and would acquire in the future, and would use all information of an economic nature acquired in the past and in the future. But the Commission was aware that "costs incurred in the past are only a part of the body of information pertaining to the economics of the gas producing industry which is necessary for intelligent regulation of that industry."[95] However, it could foresee that "a representative

88. *Id.* at 544.
89. *Id.*
90. *Id.*
91. *Id.* at 545, 546.
92. 230 F.2d 810 (D.C. Cir. 1955).
93. 24 F.P.C. 537, 547 (1960).
94. *Id.*
95. *Id.*

sampling of the industry in any one area must be accepted as part of the basis for fixing rates for all producers in the area."[96]

On the same day, the Commission promulgated *Policy Statement 61-1*,[97] delineating areas of the country in which it would later institute area-wide rate determinations, and specifying guideline rates to be considered in certification proceedings pending the establishment of just and reasonable area rates. No disclosure was made of either the basis for the guideline rates or the effect which they would have in future proceedings as either a ceiling or floor for initial prices. In summary, the two orders presaged a complete departure from the traditional method of rate regulation developed in pipeline cases by the Commission.

Consumer interests took the case for review to the Court of Appeals for the District of Columbia.[98] That court found ample justification for the new departure, although it was inconsistent with the Court's own decision in the *City of Detroit*[99] case. Calling attention to "the differences between a public utility, such as a pipeline rendering a service by means of a fixed plant and operation, and a producer, who discovers or buys a product where, when and under such terms as he may, and sells that product under contracts negotiated on the open market,"[100] the court could discern ample statutory authority for innovation. The court distinguished the regulation of the rates at which a public utility service is performed, and the regulation of the prices at which a commodity, like natural gas, may be sold:

> Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of [a natural gas merchandiser] limited to fair returns on his own investment and prices paid by him (and, if so, what investment and what prices), or are those prices reasonably measured by the fair prices for the product as measured by the open competitive market for the product, evaluated by Commission expertise and data on the whole of the market operation? Either criterion is a method of regulation. It seems to us that the choice must lie with the Commission.[101]

While the Commission had by no means indicated in its order that it would confine itself in future cases to an examination of market prices, the court seems to have felt that would be a permissible method of regulation. As to the argument that the new method would present insoluble constitutional problems of confiscation, the court said those

96. *Id.*
97. 24 F.P.C. 818 (1960).
98. Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1961).
99. 230 F.2d 810 (D.C. Cir. 1955).
100. 303 F.2d 380, 388 (D.C. Cir. 1961).
101. *Id.*

questions would have to await "proof presented by a producer in respect to a particular rate in a particular area."[102]

A bare majority of the Supreme Court affirmed the lower tribunals in a cautiously worded opinion.[103] While the area price method was not directly involved, the Court indicated its awareness that the decision would at least imply its validity or invalidity.[104] The majority could find no reason to believe that the area pricing method would be unworkable, illegal or unconstitutional. It found the opinion of the court of appeals to be "thorough and informative," but placed no reliance on that court's suggestion that cost data might be subordinated to evidence of "fair prices for the product as measured by the open, competitive market." To the contrary, the Court relied on the assurance of the Commission that "composite cost of service data will be considered in the area rate proceeding."[105] It felt that "to whatever extent the matter of costs may be a requisite element in rate regulation, [there was] no indication that the area method will fall short of statutory constitutional standards."[106] With particular reference to the *Hope*[107] case and its contemporaries,[108] the Court saw no precedent which could properly limit the Commission in its choice of regulatory method.

A vigorous dissenting opinion by Justice Clark, in which the Chief Justice and Justices Black and Brennan concurred, described the area rate experiment as a "new, untried, untested, inchoate program which, in addition, is of doubtful legality."[109] The dissenting Justices thought that an area price would have to be a floor, rather than a ceiling, and "to be constitutionally sound must include a showing that the individual producer at the area rate fixed will recover his costs; otherwise it would be confiscatory and illegal."[110] They disagreed sharply with the cost of service findings of the Commission, strongly asserted a conviction that Phillips' prices were too high by applicable standards, and would have required the Commission to reconsider its

102. *Id.* at 389.

103. Wisconsin v. FPC, 373 U.S. 294 (1963).

104. "If we believed that such a departure from present concepts had little, if any, chance of being sustained, we would be hard pressed to say that the Commission had not abused its discretion in terminating this § 5(a) proceeding while undertaking the area experiment. For if area regulation were almost sure to fail, and if the individual company cost-of-service method had been abandoned, then there would be virtually no foreseeable prospect of effective regulation. Difficult as the problems of cost-of-service regulation may be, they would not warrant a breakdown of the administrative process." *Id.* at 308.

105. *Id.* at 310.

106. *Id.* at 309.

107. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

108. Colorado Interstate Natural Gas Co. v. FPC, 324 U.S. 581 (1945); FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942).

109. Wisconsin v. FPC, 373 U.S. 294, 317 (1963).

110. *Id.* at 327.

dismissal. Moreover, the dissenting Justices were unconvinced by the Commission's protestations of administrative impossibility, feeling that it could develop exemption regulations eliminating the great preponderance of the cases, and thus free itself to proceed on a cost basis with those which remained.[111] At this point, the dialogue between the majority and the minority could be regarded by the Commission as an assurance that the questions of constitutionality and statutory authority, in the light of the Commission's findings of the economic and practical characteristics of the industry and administrative feasibility, had been thoroughly debated within the Court, and that the tentative step away from individual cost methodology had a good chance of ultimate approval.

Nevertheless, the authority of *Phillips II* is murky, because the facts did not require the Court to illuminate directly the issues of the precise role of individual costs, necessary procedural safeguards and indispensable findings.[112] Consumers pressed the appeal, arguing that the dismissal was wrong because it left them to the protection of a method which could not work, since regulation must allow each producer the recovery of his costs. Although that argument sounds hollow coming from consumers, it remains to be seen how the majority will respond to specific producer equities, and how the minority will react when the confiscation argument, which impressed them so in consumer briefs, is urged upon them by the victims of an allegedly confiscatory order.

IV. DEVELOPMENT OF THE CONVENTIONAL STANDARDS: THE FAIR VALUE RULE

Since both producer and consumer interests have resorted to the assertion of principles purportedly established in judicial review of public utility and carrier rate regulation, it should be useful to examine the historical background of price regulation as reflected in the Supreme Court's decisions. Although the authorities in the public utility and railroad fields are not directly applicable, some understanding of what those authorities teach is essential in order to avoid mistaken analogies. Furthermore, the reflection of varying judicial reconciliations between public and private interests, as well as between the legislative and judicial power, may shed some light upon the precise issues involved in the current litigation.

Rate making is, of course, an exercise of legislative, not judicial power, whether the legislative branch acts directly through a statute, or indirectly through delegation of authority to a commission or

111. *Id.* at 329.
112. *Id.* at 308.

agency.[113] Perhaps the most difficult decision for the Court is to what extent it may or must regulate the regulator, since the Court itself has no power to fix rates. Some early decisions tended to leave legislative rate-making excesses to correction solely at the polls;[114] however, the Court evolved a standard of review requiring no less than reasonableness, judicially ascertained,[115] as the level below which it would enjoin the enforcement of a statute or order. Most of the cases have involved the constitutionality of state regulation; consequently the processes as well as the ultimate standards of review have most often been shaped by judicial precedent rather than statutory specifications. Furthermore, economic and factual analysis have often influenced the Court more than pure legal theory; the Court has long recognized that "the extent to which regulation may reasonably go varies with different kinds of business."[116]

Railroads and public utilities began to be regarded as potential predators by the legislatures of the late nineteenth century. Entry into the field is limited by the large capital investments which characterize these businesses.[117] The nature of the enterprises limits the degree and effectiveness of competition, ordinarily the best protector of the public against extortionate charges for necessary commodities or services.[118] Price regulation originated as a substitute for the control ordinarily expected from free competitive forces.[119] At the same time, there has been early and consistent agreement that unlimited competition is unnecessary and even undesirable in these fields.[120] Dupli-

113. "A judicial inquiry investigates, declares, and enforces liabilities as they stand on present or past facts and under laws supposed already to exist. That is its purpose and end. Legislation, on the other hand, looks to the future and changes existing conditions by making a new rule, to be applied thereafter to all or some part of those subject to its power. The establishment of a rate is the making of a rule for the future, and therefore is an act legislative, not judicial, in kind. . . ." Prentis v. Atlantic Coast Line Co., 211 U.S. 210 (1908) (Holmes, J.).

114. Peik v. Chicago & N.W. R.R., 94 U.S. 164 (1877); *cf.* Munn v. Illinois, 94 U.S. 13 (1877).

115. Chicago, M. & St. P. Ry. v. Minnesota, 134 U.S. 418 (1890). *Compare* Ohio Valley Water Co. v. Ben Avon Borough, 253 U.S. 287 (1920), *with* St. Joseph Stock Yards Co. v. United States, 298 U.S. 38 (1936), particularly Mr. Justice Brandeis' dissenting opinion in the former, 253 U.S. at 292, and his concurring opinion in the latter, 298 U.S. at 73. *See* Comment, *The Scope of Judicial Review of Rate Regulation*, 39 ILL. L. REV. 160 (1944). An interesting sidelight in the *Hope* case is the dialogue between Justices Black and Murphy, concurring, and Mr. Justice Frankfurter, dissenting, over whether "congressional acquiescence" in *Chicago, M. & St. P. Ry. v. Minnesota* might "fairly be claimed." FPC v. Hope Natural Gas Co., 320 U.S. 591, 619, 620, 625 (1944).

116. Wolff Packing Co. v. Court of Indus. Relations, 262 U.S. 522, 538-39 (1923).

117. P. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS 22-24 (1964).

118. *Id.* at 16-18.

119. Leventhal, *Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy*, 74 YALE L. J. 989, 990 n.5 (1965).

120. J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 11 (1961); P. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS 16-18 (1964).

cation of the large capital outlays typically involved is an economic waste of resources. Therefore, through franchise and certificate regulation, direct competition has been largely eliminated in traditional utility fields.[121] Just as entry into the business is limited, the abandonment of a facility or service is often prohibited or regulated on public interest grounds. Hence, dedication of large and extensive aggregations of facilities to public service subjects private property to public use under governmental restriction and protection in a sense which comes as close to public ownership as anything in the private sector of the economy. Justice Brandeis reasoned of a fictional bargain which the utility investor makes with the community:

> The investor agrees, by embarking capital in a utility, that its charges to the public shall be reasonable. His company is the substitute for the State in the performance of the public service; thus becoming a public servant.[122]

These economic considerations led the Court to concentrate on the extensive property interests of the investor in cases attacking state regulation of rates. By analogy to principles involved in eminent domain, the Court developed a concept of confiscation of the value of the property wherever inadequate rates were imposed.[123] The landmark case of *Smyth v. Ames*[124] rejected a railroad's argument that a regulatory statute was unconstitutional unless it permitted the company to earn a sufficient amount of revenues to cover its operating expenses, the interest on its debt, and dividends for its stockholders.[125] To the contrary, it held that "what the company is entitled to ask [as profit] is a fair return on the value of that which it employs for the public convenience."[126] On the other hand, it would be a wrong to the public for the company to exact rates "without reference to the

121. P. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS, 28-32 (1964).

122. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 290-91 (1923) (concurring opinion).

123. "When the property itself is taken by the exertion of the power of eminent domain, just compensation is its value at the time of taking. So, when by legislation prescribing rates or charges the use of the property is taken, just compensation assured by these constitutional provisions is a reasonable rate of return upon the value." West v. Chespeake & Potomac Tel. Co., 295 U.S. 662, 671 (1935); Reagan v. Farmer's Loan & Trust Co., 154 U.S. 362, 410, 412 (1894); Chicago, M. & St. P. Ry. v. Minnesota, 134 U.S. 418, 458 (1890); Railroad Comm'n Cases, 116 U.S. 307 (1886).

124. 169 U.S. 466 (1898).

125. *Id.* at 543-44.

126. *Id.* at 546-47. "And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case."

fair value of the property used for the public, or the fair value of the service rendered."[127]

It followed that the returns constitutionally protected would fluctuate with economic cycles. "It is well established," said the Court in *McCardle v. Indianapolis Water Co.*, "that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase."[128] There were also other consequences. Where utility management had made "mistakes of construction, even though honest,"[129] where plants were overbuilt,[130] where extended drouth depressed values,[131] where the management engaged in unsuccessful speculation,[132] where facilities became obsolete,[133] the investor must bear the economic brunt. Actual interest and dividend requirements of the regulated company itself were not the judicial standard employed for review: the Court said in *Covington & L. Turnpike Co. v. Sandford* that "the public cannot properly be subject to unreasonable rates in order simply that stockholders may earn dividends."[134] On the other hand the Court provided that value increases during upswings of the econonric cycle should inure to the benefit of the investor:

> [W]e are not limited to the consideration of the actual investment. If that has been reckless or improvident, losses may be sustained which the community does not underwrite. As the company may not be protected in its actual investment, if the value of its property be plainly less, so the making of a just return for the use of the property involves the recognition of its fair value if it be more than its cost.[135]

Evaluation of the rate of return involved ultimately an analysis of the position of the regulated enterprise in the economic structure. *Willcox v. Consolidated Gas Co.*,[136] for instance, noted the relative safety of the gas utility's securities. Justice Butler articulated the classic test of utility rate of return in the famous *Bluefield Water Works*[137] case:

127. *Id.* at 544.

128. 272 U.S. 400, 410 (1926).

129. *See, e.g.*, Stanislaus County v. San Joaquin Canal & Irrigation Co., 192 U.S. 201, 214 (1904).

130. *Cf.* Galveston Elec. Co. v. City of Galveston, 258 U.S. 388, 395 (1922) (Brandeis, J.: "Past losses obviously do not tend to prove present values").

131. *See, e.g.*, San Diego Land & Town Co. v. Jasper, 189 U.S. 439, 444-45 (1903).

132. *Id.* at 447 (Holmes, J.: "If the original company embarked upon a great speculation which has not turned out as expected, more modest valuations are a result to which it must make up its mind"); *cf.* Dow v. Beidelman, 125 U.S. 680 (1888).

133. *See, e.g.*, Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287 (1933).

134. 164 U.S. 578, 596 (1896). *See* Smyth v. Ames, 169 U.S. 466 (1898).

135. Minnesota Rate Cases, 230 U.S. 352, 454 (1913).

136. 212 U.S. 19 (1909).

137. 262 U.S. 679 (1923).

> A public utility is entitled to such rate as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on other investments which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.[138]

Fairness to the utility investor, consistent with legitimate public interest, reflected his practical expectations to a greater extent than any a priori concept of entitlement. If the utility return were comparable to that which might be expected through the normal exercise of economic forces, in the absence of regulation, it could not be branded as unreasonable.

Lacking criteria adequate to measure directly the "fair value of the service rendered,"[139] or the amount which "the services were reasonably worth,"[140] the Court had to concentrate on the effect which the rates would inflict upon the individually regulated enterprise. This was a kind of "end-result" test in the pre-*Hope* days. Often disregarding the method by which the rates had been devised, the Court tested their results on each complaining company by its own findings of rate of return on the fair value rate base.[141] The test was fashioned to fit the most salient economic characteristics of the industry. Thus, the focus on a fair value rate base resulted from the industry's relatively large investment in property, plant and facilities; and the standards of rate of return took into account the typically protected market area, stability of demand, and comparatively safe and secure yields from operations.

In those cases where a statute or regulatory order prescribed the rates for an entire group no effort was made to measure the overall effect of the rates on a group of companies. In the *Minnesota Rate Cases*,[142] rates applicable to a group of railroads were enjoined as to one railroad, but sustained as to two others. The tests of confiscation or reasonableness were fashioned to measure the impact of the regula-

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138. 262 U.S. at 692-93. The opinion continued: "The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally." *Id.* at 693.

139. Smyth v. Ames, 169 U.S. 466, 544 (1898).

140. *Id.* at 547.

141. Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287 (1933); *cf.* Ohio Valley Water Co. v. Ben Avon Borough, 253 U.S. 287 (1919).

142. 230 U.S. 352 (1913). *See also* Dayton-Goose Creek Ry. v. United States, 263 U.S. 456, 481-82 (1924), and cases cited therein at 482.

tion on individual enterprises. *Aetna Insurance Co. v. Hyde,*[143] a case involving state-wide insurance rates, articulated the rule which is illustrated by the holdings in utility and railroad cases: that while "rates sufficient to yield adequate returns to some may be confiscatory when applied to the business of others," nevertheless, "the latter have no constitutional right to prevent their enforcement against the former."

There are instances in which the Court has approved or required injunctions against rate orders because of defects in the method or procedure employed, but those cases may be distinguishable on the ground that the error was so fundamental that the Court believed the result was necessarily unjust.[144] In the two *West Ohio Gas Co.*[145] cases of 1935, Justice Cardozo wrote opinions condemning the rate orders because of the wholesale arbitrary disallowance of operating expenses and because of the willful refusal to consider operating experience acquired after the close of the test year. At the same time, he acknowledged the validity of a general rule which would leave procedure and method to the administrative discretion.[146] There were even cases in which the probable result of operations under a new set of rates was uncertain, and the Court would refuse an injunction in order to allow a fair test of the rates in their practical operation, without prejudice to the complainants' right to make another application for relief if the rates should prove inadequate.[147] One of the last cases of the federal "fair-value" era emphasized that the question for the Court "is not as to the mere correctness of the method and reasoning adopted but whether the rates it fixes will result in confiscation."[148] In *Lindheimer v. Illinois Bell Telephone Co.,*[149] the Court found that because of the protracted litigation involved, there had been a substantial period of operations after the issuance of the Commission's

143. 275 U.S. 440 (1928). The Commission in *Permian* cites this case to the proposition that an individual has no constitutional right to the full recovery of costs under rates fixed in a group proceeding. 34 F.P.C. 159, 180 (1965). Because of the posture of the case before the Supreme Court, its support for that proposition is dubious, although its language admittedly tends to support the Commision's use of it.

144. McCart v. Indianapolis Water Co., 302 U.S. 419 (1938); West v. Chesapeake & Potomac Tel. Co., 295 U.S. 662 (1935); Smith v. Illinois Bell Tel. Co., 282 U.S. 133 (1930); St. Louis & O'Fallon Ry. v. United States, 279 U.S. 461 (1929); Northern Pacific Ry. v. Department of Pub. Works, 268 U.S. 39 (1925).

145. West Ohio Gas Co. v. Public Util. Comm'n, 294 U.S. 63 (1935); West Ohio Gas Co. v. Public Util. Comm'n, 294 U.S. 79 (1935).

146. West Ohio Gas Co. v. Public Util. Comm'n, 294 U.S. 63, 70 (1935).

147. New York v. United States, 331 U.S. 284, 340 (1947); Clark's Ferry Bridge Co. v. Public Serv. Comm'n, 291 U.S. 227 (1934); Brush Elec. Co. v. City of Galveston, 262 U.S. 443 (1923); Darnell v. Edwards, 244 U.S. 564 (1917); Willcox v. Consolidated Gas Co., 212 U.S. 19 (1909); and Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909).

148. Railroad Comm'n v. Pacific Gas & Elec. Co., 302 U.S. 388 (1938).

149. 292 U.S. 151 (1934).

order. The prosperity enjoyed by the company during that period was so inconsistent with the apparently low rate of return on the fair value rate base that the Court discarded its usual standard and refused an injunction, declaring that "elaborate calculations which are at war with realities are of no avail."[150] By that holding, the Court showed a remarkable inclination to subordinate theoretical consistency to economic practicality.

V. Hope Natural Gas and Its Contemporaries

During the later years of the "fair value" era, growing ferment developed among regulators, scholars and judges, who were becoming impatient with the conjectural nature of some of the fair value estimates, the speculative increments of "going concern value," and the burdensome length and complications of a fair value trial.[151] In a notable concurring opinion, Justices Brandeis and Holmes vainly attempted to direct the Court's attention toward concepts of invested capital rather than property values:

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes, not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor, the allowance for risk incurred, and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined.[152]

The rate base, they thought, should be the amount of money prudently invested in plant and facilities.[153] The opinion is replete with tren-

150. *Id.* at 164.

151. Dobie, *Judicial Review of Administrative Action in Virginia*, 8 Va. L. Rev. 477, 504 (1922); Edgerton, *Value of the Service as a Factor in Rate-Making*, 32 Harv. L. Rev. 516 (1919); Gooddard, *Public Utility Valuation*, 15 Mich. L. Rev. 205 (1917); Hale, *The 'Physical Value' Fallacy in Rate Cases*, 30 Yale L. J. 710 (1921); Henderson, *Railway Valuation and the Courts*, 33 Harv. L. Rev. 902 (1920); Richberg, *A Permanent Basis for Rate Regulation*, 31 Yale L. J. 263 (1922); Whitten, *Fair Value for Rate Purposes*, 27 Harv. L. Rev. 419 (1914).

152. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 292 U.S. 276, 291 (1923).

153. *Id.* at 289 n.1. "Prudent investment," as Mr. Justice Brandeis used it, meant the amount honestly and prudently spent on plant and property, less the reserve for depreciation. Such a rate base elminates some of the disadvantages of fair value, as expounded in the opinion, but it has its own disadvantages, especially in an extended period of progressive inflation. It not only ignores the unreality of recorded costs when the value of the dollar is declining, but it also creates the risk that a "disappearing" rate base, as the amount of depreciation reserve approaches the book cost of the property, will deprive the investor of any opportunity to earn revenues related to property actually in service. Modern techniques of trended cost and price level adjustments have eliminated, furthermore, much of the administrative delay and inconvenience attendant upon the fair value determinations of the former era. The practical objections to fair value have little validity under modern conditions.

chant criticism of the fair value practice of that day and its practical consequences.

By 1942, the Court was apparently ready to move a step away from strict application of the whole fair value theory. In an investigation of the rates of Natural Gas Pipeline Company, the FPC disallowed 8,500,000 dollars of "going concern value" claimed by the company, although otherwise it accepted the estimates of value provided by company witnesses; it calculated depreciation expense on an actual cost base, rather than on present value or reproduction cost; and it ordered a reduction of the company's rates. The Supreme Court sustained the order in *FPC v. Natural Gas Pipeline Co.*[154] Chief Justice Stone's majority opinion overruled none of the fair value decisions; instead, it borrowed and enlarged earlier doctrine which had been developing as a limitation upon judicial review:

> The Constitution does not bind rate making bodies to the service of any single formula or combination of formulas. Agencies to whom the legislative power has been delegated are free, within the ambit of their statutory authority to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end.[155]

On the facts, the decision held no more than that the specific objections to the Commission's findings were not sufficiently serious to justify a reversal. Justices Black, Douglas and Murphy concurred in the result, but protested the rationale of the decision.[156] They thought the occasion was appropriate "to lay to rest the ghost of *Smyth v. Ames*,"[157] by establishing prudent investment or actual cost as the minimum constitutional level of the rate base. Furthermore, they advanced the proposition that even a rate barely sufficient to enable the company to earn the actual cost of rendering service might be unjust and unreasonable to the public, therefore causing a "collision" between investor and consumer interests. It followed, in their opinion, that the majority had not conceded the full appropriate breadth of administrative discretion:

> The possibility of that collision reinforces the view that the problem of rate-making is for the administrative experts not the courts and that the ex post facto function previously performed by the courts should be reduced

154. 315 U.S. 575 (1942).

155. *Id.* at 586.

156. *Id.* at 599.

157. 169 U.S. 466 (1898); *cf.* Hale, *Does the Ghost of Smyth v. Ames Still Walk?* 55 Harv. L. Rev. 1116 (1942).

to the barest minimum which is consistent with the statutory mandate for judicial review. . . .[158]

In its subsequent investigation of the rates of Hope Natural Gas Company, the Commission rejected the company's fair value evidence and based the rates on "actual, legitimate cost."[159] Moreover, it eliminated more than seventeen million dollars of well drilling costs, which the company had charged off on its books as operating expenses in earlier years, but now sought to restore to its property accounts. It ordered Hope to reduce its rates. A sharply divided Supreme Court sustained the Commission's order in *FPC v. Hope Natural Gas Co.*[160]

Since it recognized that rate regulation involves a "balancing of consumer and investor interests," Justice Douglas' majority opinion set out to define the legitimate concern of the investor interest:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard, the return to the equity owner should be commensurate with the returns on other investments having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[161]

Applying this standard, Justice Douglas concluded that the financial history of the company, its notable success and prosperity, and the amounts available for the benefit of its common stockholders under the new rates were adequate to show that the rates were reasonable. Therefore, he said the Court need not consider "the conditions under which more or less might be allowed" than his standard seemed to require. Furthermore, it was not important to the decision,

> to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.[162]

Both *Natural Gas Pipeline*[163] and *Hope*[164] rejected the notion that review by separate constitutional standards is appropriate in a case involving the Natural Gas Act. "Since there are no constitutional

158. FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 608 (1942).
159. Hope Natural Gas Co., 3 F.P.C. 150 (1942).
160. 320 U.S. 591 (1944). For additional background matter, see Gatchell, *Some Basic Factors and Trends in Public Utility Regulation*, 12th OIL & GAS INST. 23, 41-47 (Sw. Legal Fdn. 1961).
161. 320 U.S. at 603.
162. *Id.*
163. FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942).
164. FPC v. Hope Natural Gas Co., 320 U.S. 591, 607 (1944).

requirements more exacting than the standards of the Act," Justice Douglas said, "a rate order which conforms to the latter does not run afoul of the former."[165] Where prior decisions had been willing to concede legislative discretion as to method, testing the result by the Court's findings of fair value and fair rate of return, the Court would now accept more generalized financial criteria in lieu of theoretically correct rate base or rate of return findings. Emphasis lay on the result of the order, however determined:

> [I]t is the result reached not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the act is at an end. The fact that the method employed to reach that result may contain infirmities is not important.[166]

Therefore, it is worth observing that the *Hope* and *Natural Gas Pipeline* cases did not adopt the Brandeis theory of prudent investment as a standard of either constitutional or statutory review; neither did they condemn the fair value theory as a standard for administrative guidance.[167] The rationale of the cases has as little concern for prudent investment methodology as it has for fair value methodology. Dissenting opinions by Justices Frankfurter and Reed in the *Hope* case fortify that conclusion: the former disapproved the majority opinion because he felt it abandoned objective criteria of review;[168] the latter professed to find consistency between the majority's approach and the fair value rule and dissented only because the Commission had eliminated the seventeen million dollars worth of well drilling costs from the rate base.[169]

The approach of the *Hope* case is peculiarly limited to consideration of the impact of a rate order upon an individual utility. Defending his standard in a later opinion, Justice Douglas denied that it was "so vague and devoid of meaning as to render judicial review a perfunctory process;" it was, he insisted, "a standard of finance resting on stubborn facts."[170] If so, it was individual company finance, since the heart of his analysis was a review of the Hope company's history and prospects. Furthermore, the Court supported the Commission's

165. *Id.*

166. *Id.* at 602.

167. *Id.* at 628, 629 (Jackson, J., dissenting opinion).

168. *Id.* at 627: "It will little advance the public interest to substitute for the hodge-podge of the rule in Smyth v. Ames . . . an encouragement of conscious obscurity or confusion in reaching a result, on the assumption that so long as the result appears harmless its basis is irrelevant."

169. *Id.* at 620, 624.

170. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 605 (1945); *cf.* Colorado-Wyoming Gas Co. v. FPC, 324 U.S. 626 (1945).

order by financial analysis of overall company operations but refused to consider the impact on separate functional divisions.

It was this last aspect that impelled Justice Jackson to dissent, in a brilliant and eloquent opinion which may have more influence in producer regulation than any majority opinion in any decided case.[171] Instead of devising a field price approach to the expense of company-produced gas, the Commission had simply lumped the cost of producing properties along with other assets in the rate base. This approach profoundly disturbed Justice Jackson. He suspected that previous decisions of the Court might have "constrained the Commission to accept the rate base method for producing properties," and he would have reversed the case so as to make it clear that the Commission is free to regulate the producing segment of the business on a basis more compatible with economic reality.[172] The heart of the problem, as he saw it, is "the elusive, exhaustible and irreplaceable nature of natural gas itself." Facilities relating to other kinds of utility business can be replaced, given sufficient time and money, but "the wealth of Midas and the wit of man cannot produce or reproduce a natural gas field."[173]

Hence, he advocated advising the Commission that it is "free to face up realistically to the nature and peculiarity of the resources in its control, to foster their duration in fixing price, and to consider future interests in addition to those of investors and present consumers." He thought that the Commission should "boldly make sound economic considerations, instead of legal and accounting theories, the foundation of federal policy."[174] Considering, among other things, that the yields from production are not proportionate to the amount invested,[175] that the prudent investment method would result in absurdly varying field prices,[176] and that a fair overall price is essential to induce producers to drill,[177] he would have allowed the Commission "to fix the price of gas in the field as one would fix maximum prices of oil or milk or coal, or any other commodity." Rate base and rate of return would not be relevant:

> The emphasis would shift from the producer to the product, which would be regulated with an eye to average or typical producing conditions in the field.[178]

The purport of the dialogue between Justice Jackson and the major-

171. 320 U.S. 591, 628 (1944).
172. *Id.* at 660.
173. *Id.* at 629.
174. *Id.* at 660.
175. *Id.* at 649.
176. *Id.* at 649.
177. *Id.* at 654, 655.
178. *Id.* at 652.

ity is clouded by two factors: West Virginia was in the case contending for higher field prices so as to maintain its production tax revenues at a desirable level; and the Jackson opinion also contended for a rate design which would increase the share of costs borne by industrial customers in order to discourage industrial consumption and conserve more gas for domestic use. While the majority opinion rejected "novel" doctrines, and expressed the view that sections 4(a) and 5(a) of the Act "contain only the conventional standards of rate-making,"[179] these comments apparently were directed at the extraneous policy concepts implicit in the production tax and industrial revenue arguments rather than Jackson's contention that sensible field price regulation requires repudiation of the rate base approach. Probably, Justice Jackson's proposal was rejected because of the majority's preoccupation with the overall relaxation of judicial review, rather than because of any fundamental disagreement with his economic and legal arguments.

When Colorado Interstate Gas Company, in the next case to reach the Court on the issue,[180] contended that its company-produced gas should be priced at a "fair field price" based on the average contract prices paid to other producers in the field, the Court was more circumspect in its handling of the argument:

> We do not say that the Commission lacks the authority to depart from the rate base method. We only hold that the Commission is not precluded from using it. . . .
>
> [T]he Act does not say that the Commission would have to value [company-produced gas] at the fair field price if the Commission abandoned the rate-base method of regulation.[181]

Apparently satisfied with these concessions, Justice Jackson concurred in the result, but his concurring opinion re-emphasized the inescapable absurdities of the rate base approach to gas production.[182] Paradoxically, he could have carried the day for his views at this point, for the Chief Justice and three colleagues dissented[183] on the ground that including producing properties in the rate base violated the producing and gathering exemption in the Act. If he had concurred with them instead of with Justice Douglas, the case would have gone back to the Commission on a holding directly contrary to the position which the District of Columbia Circuit took, only ten years later, in the *City of Detroit*[184] case. Intriguing speculations are possible in the contemplation of what might have happened to the decision of *Phillips*

179. *Id.* at 616, 617.
180. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945).
181. *Id.* at 601, 603.
182. *Id.* at 608.
183. *Id.* at 615.
184. City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955).

I[185] (or, if jurisdiction over natural gas producers had been established anyway, what changes might have been wrought in the course of producer regulation) had Justice Jackson adhered to his principles in his vote as well as in his exposition of them.

In the same year, Justice Jackson, on behalf of a unified Court, interpreted the principles of the *Hope* case as they applied to the unique factual situation of *Market Street Railway v. Railroad Commission*.[186] The state commission had ordered a reduction in trolley rates, but the company had been permitted to collect its higher rates pending the proceedings, subject to impounding and potential refund. In the meantime, the company, nearing failure, had sold its facilities. The issue was whether the refund could be enforced. The opinion reiterated what Chief Justice Stone and Justice Douglas had already said, that regulation could not guarantee net profits. "All that was held [in *Hope*]," said Jackson, "was that a company could not complain if the return which was allowed made it possible for the company to operate successfully." He refused to infer the converse. The end result test is "inapplicable to a company whose financial integrity already is hopelessly undermined, which could not attract capital on any possible rate, and where investors recognize as lost a part of what they have put in." While *Hope* had carefully defined the investor's legitimate interest in net returns, "there was no suggestion that less might not be allowed when the amount allowed was all that the company could earn."[187] Although the company attacked the commission's implication that the company's fares exceeded the value of the service, and its prediction that lower fares might increase rather than decrease revenue, the Court found no impropriety in the commission's comparison of services rendered under the lower rate with that rendered under the new rate. Furthermore, "it is not forbidden by the Constitution that there be a pragmatic test of matters which even the most expert could not know in advance."[188]

Decisions from the utility sphere, including those which treated railroads like utilities, do not yield overwhelming support for the proposition that a rate order must allow every individual subject thereto the recovery of his costs. Cost was a subordinate principle in the era of constitutional "fair value." All that Brandeis and Holmes as lonely juristic advocates ever espoused was that the order should allow an *opportunity* to recover the cost of service.[189] In the era

185. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

186. 324 U.S. 548 (1945).

187. *Id.* at 566.

188. *Id.* at 569.

189. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 291 (1923).

where sustained inflation carried present values above cost, *Hope* held no more than to sustain rates which clearly permitted profitable operations. Indeed, by their disdain for fair value arguments, both *Hope* and *Natural Gas Pipeline Co.* drained the vitality out of the federal constitutional doctrine of confiscation. Furthermore, *Market Street Railway* recognized the definite economic limitation upon the power of rates to provide profitable operations.[190]

VI. Other Departures: Group Procedures and Representative Costs

Procedures and standards evolved in railroad regulation by the Interstate Commerce Commission are both interesting and instructive, although a comprehensive analysis is beyond the scope of this article. The original monopolistic advantage of the railroads has evaporated, as they have become increasingly vulnerable to competition by motor, air and water carriers. However, even before the influence of competition diminished the carriers' insistence on the recovery of all costs of service through rates, the Commission had devised special techniques to cope with the practical administrative problems created by the numerous and diverse companies within its jurisdiction.

Justice Brandeis' lucid and comprehensive opinion in the *New England Divisions Case*[191] described and approved the development of specialized procedures. Regulation of groups of railroads in a single proceeding had been specifically authorized in the Transportation Act of 1920;[192] however, the Act merely ratified a practice of long standing. "It was the actual necessities of procedure and administration which had led to the adoption of that method, in passing upon the reasonableness of proposed rate increases. The necessity of adopting a similar course when [there were] multitudes of divisions [of joint rates for transportation involving connecting carriers] was obvious. The method was equally appropriate in such enquiries; and

190. At least 22 of the states still adhere to some variety of the fair value or reproduction cost rule of rate-making because of local statutory or constitutional provisions. *See* Rose, *Confusion in Valuation for Public Utility Rate-Making*, 47 Minn. L. Rev. 1, 2 (1963). Professor Priest states persuasive economic, practical and legal bases for the fair value rule in his article, *Major Public Utility Decisions in Perspective*, 46 Va. L. Rev. 1327 (1960); *cf.* Smith, *The Reality of the Public Utility Rate Base*, 67 Dick. L. Rev. 83 (1963). Additional interest in fair value type standards is shown by the recent introduction in Congress of H.R. 12027, which would require the FPC to consider in its rate base determinations changes in the purchasing power of the dollar after December 31, 1966, as measured by the Consumer Price Index published by the Bureau of Labor Statistics. Despite the academic arguments to the contrary, the health of regulated utilities in the future may well depend on price-level adjustments to the rate base in all jurisdictions.

191. 261 U.S. 184 (1923).

192. 49 U.S.C. § 1 (1964).

we must assume that Congress intended to confer upon the Commission power to pursue it."[193]

As for the handling of costs in such a proceeding, the basic premise was that the Commission would base its order on evidence "typical in character, and ample in quantity, to justify the finding made in respect to each division of each rate of every character."[194] Obviously not every carrier would incur only typical or representative costs in performing its part of the service. Therefore, the Commission had provided a saving clause in its order, whereby an individual might obtain a special exception by showing that the order operated in an unjust or unduly harsh way in its individual circumstances. No constitutional question was created by this kind of procedure. Congress could have established a statutory presumption that the group rates were valid. Although Congress had not done this, the effect was the same, since "only in that way could the task be performed. . . ."[195] There could be no legitimate objection to this type of hearing procedure:

> A hearing may be a full one, although the evidence introduced does not enable the tribunal to dispose of the issues completely or permanently and although the tribunal is convinced, when entering the order thereon, that, upon further investigation, some changes in it will have to be made.[196]

Significant emphasis upon the *New England Divisions Case* came recently in the case of *Chicago & Northwestern Railway v. Atchison, Topeka & Santa Fe Railway*.[197] Since the petitions for certiorari relative to *Skelly* were pending at the time of the decision, the opinion takes on special significance.[198] The case involved rate divisions, and the Commission proceeded in its customary way. The district court reversed the Commission, holding that it was obliged to determine, in precise dollar amount, the revenue needs of each individual railroad, and also the revenue effect on each railroad of the new divisions established in its order. No appellee even defended the position of the district court when the case went up.[199] However, because it thought "the error in that position, which rejects over 40 years of administrative practice, requires comment," the Court fully expounded the basis for group regulation in its opinion.[200] The Commission had long since found "the complexity of the subject matter

193. 261 U.S. 184, 198-99 (1923) (the text is also supported by cases cited at 197).
194. *Id.* at 197.
195. *Id.* at 199.
196. *Id.* at 201.
197. 387 U.S. 326 (1967).
198. Mr. Justice Stewart delivered the opinion ou May 29, 1967. Certiorari was granted in the *Skelly* case on June 12, 1967. 388 U.S. 906 (1967).
199. 387 U.S. 326, 340 (1967).
200. *Id.* at 341.

and the multiplicity of carriers typically involved in divisions cases were such that a wooden requirement of individual findings would make effective regulation all but impossible." The Court saw that the considerations underlying the *New England Divisions Case* were amply illustrated by the case now before it:

> The pragmatic justifications for the Commission's group procedures are obvious. Even on a group basis, the Commission proceedings in this case require a voluminous record and were not completed until nearly 10 years after the complaints were filed. To demand individual evidence and findings for each of the 300 carriers in the Commission proceedings would so inflate the record and prolong administrative adjudication that the Commission's regulatory authority would be paralyzed.
>
> Nor do considerations of fairness require disregard of administrative necessities. The premise of group proceedings, as the New England Divisions Case explicitly recognized, is that evidence pertaining to a group is typical of its individual members. . . . It has always been accepted that an individual carrier may challenge this premise, and, on proper showing, receive independent consideration if its individual situation is so atypical that its inclusion in group consideration would be inappropriate. It is the Commission's practice to accord independent treatment to an individual carrier when a proper request for special consideration is made. . . . Departure from the practicalities of group procedure is justified only when there is a real need for separate treatment of a given carrier; the individual carriers themselves, which have the closest understanding of their own situation and interests, are normally the appropriate parties to show that such need exists.[201]

One slight shift of emphasis in the Court's discussion of the saving clause may have significance. Where Justice Brandeis had predicated special relief on harshness towards the individual carrier,[202] this most recent opinion attaches the greater importance to whether the carrier's "ability to provide service is jeopardized."[203] Furthermore, a footnote in the opinion quotes the Commission's own description of saving clause procedures, which it says enable it to "provide special individual treatment in order to maintain [the atypical] carrier as part of the nation's transportation system without regard to its cost of rendering the service."[204] The Court may be indicating that the applicable standard for individual exceptions is preservation of the ability of the carrier to render service rather than its ability to earn a fair return. If so, the portent of the decision for high-cost gas producers could be ominous.

Other cases have pointed up the requirement of typical or representative evidence. *United States v. Abilene & Southern Railway*[205]

201. *Id.* at 342-43.
202. 261 U.S. 184, 199 (1923).
203. 387 U.S. 326, 366 (1967).
204. *Id.* at 366 n.38.
205. 265 U.S. 274 (1924).

reversed the Commission partly because it had altered existing divisions on findings of mere aggregates of revenue and cost. Justice Brandeis stressed the principle that

> Evidence of individual rates or divisions, said to be typical of all, affords a basis for a finding as to any one. But averages are apt to be misleading.[206]

Although *Beaumont, San Lake & Western Railway v. United States*[207] criticized the Commission's report for failure to find clearly that the evidence justified reliance on average costs, the Court searched the record and concluded that "as to each carrier, operating and other conditions were shown and presumably considered by the Commission in deciding whether average or group conditions might appropriately be used."

A distinction in the handling of costs has been made between cases involving all of the rates of an individual or group and cases involving only individual rates. In *ICC v. Union Pacific Railroad*[208] the Court said:

> Where the rates as a whole are under consideration, there is a possibility of deciding, with more or less certainty, whether the total earnings afford a reasonable return. But whether the carrier earned dividends or not sheds little light on the question as to whether the rate on a particular article is reasonable. For, if the carrier's total income enables it to declare a dividend, that would not justify an order requiring it to have one class of goods for nothing, or for less than a reasonable rate. On the other hand, if the carrier earned no dividend, it would not have warranted an order fixing an unreasonably high rate on such article.

The principle explains the Court's statement in another case, that "[t]here is nothing in the [Interstate Commerce Act] requiring the use of the net return as evidence to fix a particular rate."[209]

Decisions by the Commission itself introduce the necessity for considering the following when individual rates are being set: the value of the commodity;[210] the value of the service, as well as its cost;[211] the volume of business and the conditions and force of competition;[212] and the ability of the shipper to reach a market and make

206. *Id.* at 290.
207. 282 U.S. 74 (1930).
208. 222 U.S. 541, 549 (1912).
209. Dayton-Goose Creek Ry. v. United States, 263 U.S. 456, 483 (1924).
210. General Commodity Rate Increases, 223 I.C.C. 657, 737-38 (1937); Mountain-Pacific Oil Cases, 192 I.C.C. 599, 636-37 (1933); Pacific Coast Fourth Section Applications, 190 I.C.C. 273, 281 (1932); Rice v. Louisville & N. R.R., 1 I.C.C. 722, 739 (1888).
211. Westbound Rates on Meats, 210 I.C.C. 13 (1935); Sand, Gravel, Slag, Stone and Chert, 165 I.C.C. 731, 766 (1930); Board of R.R. Comm'rs v. Atchinson, T. & S.F. Ry., 151 I.C.C. 431, 446 (1929); Frohman Chem. Co. v. Baltimore & O. R.R., 115 I.C.C. 322, 323 (1927); Boston Chamber of Commerce v. Lake Shore & M.S. Ry., 1 I.C.C. 754, 760-61 (1888).
212. Rubber Ass'n of America, Inc. v. Akron & B.B. Ry., 174 I.C.C. 79, 85, 86

his commodity a subject of commerce.[213] However, "most rates have within them an element of cost," and "[d]iscretion and flexibility of judgment within reasonable limits," must govern the weight accorded that element.[214] To make rates based "solely on the fully distributed costs would ignore value-of-service considerations. If rates were made in this manner, it would result in reducing the rates on much of the high-grade traffic transported . . . [and increasing] the rates on most of the low-grade, volume-moving traffic. Rates on the latter have been made in the past under a continuous interplay of economic forces to permit such traffic to move with reasonable freedom and thus to contribute as much as possible to the carriers' overhead or fixed costs."[215]

Thus, the Supreme Court's statement that "[b]oth the Commission and this Court have consistently rejected any thought that costs should be the controlling factor in rate-making,"[216] is justified as a generalization pertaining to the establishment or alteration of rate relationships. So many factors come into play in the field as to prompt the Court's description of the process of rate-making as essentially empiric:

> The stuff of the process is fluid and changing—the resultant of factors that must be valued as well as weighed. Congress has therefore delegated the enforcement of transportation policy to a permanent expert body and has charged it with the duty of being responsive to the dynamic character of transportation problems.[217]

When the Commission undertook to eliminate freight rate discriminations between the South and other sections, it concentrated on "out-of-pocket costs" as distinguished from depreciation, return and other fixed costs, to establish "a floor for all rates."[218] Its sectional rate reduction was sustained in *New York v. United States*.[219] The Court noted that operating results under the new rates were not yet ascertainable, since there had been an increase in the level of all rates in another proceeding. Since the entire problem was "in flux,"

(1931); Union Tanning Co. v. Southern Ry., 26 I.C.C. 159, 164 (1913); Penick & Ford v. Director General, 80 I.C.C. 152, 156 (1923); Boston Chamber of Commerce v. Lake Shore & M.S. Ry., 1 I.C.G. 754, 760-61 (1888).

213. Imperial Coal Co. v. Pittsburgh & L.E. R.R., 2 I.C.C. 436 (1889).

214. *See* Boileau v. Pittsburgh & L.E. R.R., 22 I.C.C. 640, 652 (1912); *cf.* Class Rate Investigation, 262 I.C.C. 447, 692-93 (1945).

215. *See* United States Sugar Corp. v. Atlantic Coast Line R.R., 277 I.C.C. 193 (1950).

216. *See* Alabama-Great Southern R.R. v. United States, 340 U.S. 216, 223 n.4 (1951).

217. *See* Board of Trade v. United States, 314 U.S. 534, 546 (1942).

218. Class Rate Investigation, 262 I.C.C. 447, 692-93 (1945).

219. 331 U.S. 284 (1947).

involving "an interim order made necessary as a result of a comprehensive revision of entire rate structures," it held that the district court had properly protected the carriers "[w]hen it overruled their claim that the interim rates are confiscatory without prejudice to another suit to challenge the legality of those rates if, after a fair test, they prove to be below the lowest reaches of a reasonable minimum or if the permanent rates do not meet that standard."[220]

In connection with regulation of other types of businesses, fair value or other rate base problems have not caused serious problems for the Court. One example is in the regulation of livestock marketing agencies by the Secretary of Agriculture.[221] In *Acker v. United States*[222] the Court approved an order which fixed maximum fees in accordance with the Secretary's findings of reasonable expenses. The opinion noted that the agencies owned little fixed property, hence no substantial question of confiscation could be involved. Another example is the regulation of insurance rates, as in *Aetna Insurance Co. v. Hyde*.[223]

In air carrier cases, the CAB has employed an aggregate invested capital rate base for the entire regulated group, meanwhile recognizing that its method would result in unsatisfactory returns for individual members of the group.[224] Maritime carrier rates have been fixed by analyzing the cost of service of a "dominant carrier," and the resulting rates are imposed upon the entire group under regulation.[225] In motor carrier cases, the ICC uses a group operating ratio or profit margin approach, which hardly resembles conventional utility methodology.[226] A former commissioner has explained the inapplicability of individual rate base treatment in such cases:

> It is demonstrated by experience that a 'fair return on value' of motor carrier property, or other keenly competitive industries involving a relatively small fixed plant, but with high operational costs, is inadequate to enable them to provide adequate and efficient . . . transportation service. . . .

220. *Id.* at 340.

221. 7 U.S.C. §§ 181-231. (1964).

222. 298 U.S. 426 (1936); *cf.* Tagg Bros. & Morehead v. United States, 280 U.S. 420 (1930).

223. 275 U.S. 440 (1928).

224. *See* General Passenger Fare Investigation, 32 C.A.B. 291 (1960). Partially justifying its order, the Board called attention to the possibly beneficial effect of its fare design, and to the availability of subsidies to the weaker carriers.

225. *See* Rates of Aleutian Marine Transp. Co., 7 F.M.C. 592 (1963) (prudent investment); General Increase in Alaskan Rates and Charges, 5 F.M.C. 486 (1958) (fair value); Hawaii General Increase in Rates, 5 F.M.C. 347 (1957) (fair value).

226. *See, e.g.*, Increases, California, Arizona, Colorado, New Mexico and Texas, 51 M.C.C. 747, 760 (1950). Of some interest, also, is the "bellwether" regulation of telegraphic common carriers by the FCC. *See* The Western Union Telegraph Co., 25 F.C.C. 535, 577-80 (1958); Postal Telegraph-Cable Co., 5 F.C.C. 524, 527 (1938).

> [I]n a highly competitive situation, the fair-return theory is an exercise in metaphysics.[227]

Of course, the same reasoning applies with equal force to a fair return on cost method in the same circumstances.

These cases, therefore, allow the determination of rates based on either an average cost level, or a level of costs fixed by judgment between the highest and lowest costs incurred by individuals within the group and deemed to be representative. *Acker v. United States* sternly rejected the protests of the higher cost livestock market agencies:

> [R]egulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs.[228]

But the measure of extravagance was the representative level of costs determined by the Secretary: if costs exceeded those allowed in the Secretary's rates, they were ipso facto excessive.

No case involving group regulation seems to turn on whether the aggregate revenue permitted by the order equaled the aggregate costs of the group.[229] At least one case seems to deny consideration to the argument that the rates are confiscatory on an overall basis, *i.e.*, that some portion of the property owned by the group is being confiscated by rates which do not permit an overall fair rate of return on a group rate base.[230] There is even precedent for summary disposition of the confiscation question where it is administratively infeasible to consider it, particularly if an individual may escape the consequences of the order by changing the use of his property.[231]

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227. Aitchison, *Fair-Return-on-Value Theory in Rate Making Loses Force*, 25 ICC PRAC. J. 11, 17 (1957).

228. 298 U.S. 426, 431 (1936).

229. Although Aetna Ins. Co. v. Hyde, 275 U.S. 440 (1928), described a method which apparently equated group revenues and group costs, the decision did not rest on that factor, but on the necessity of showing individual confiscation. *But cf.* Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381 (1940); *see* United States v. Rock Royal Co-op, 307 U.S. 533 (1939); Nebbia v. New York, 291 U.S. 502 (1934). However, there is usually an effort to determine the overall import of the order on that segment of the group whose operations form the basis of the rate. *See* notes 224-26 *supra*.

230. *See* Beaumont, S.L. & W. Ry. v. United States, 282 U.S. 74 (1930). "There is no allegation in the complaint, or evidence in the record to show, that any division to any of the appellants will not yield operating expenses chargeable to the service covered by it plus a reasonable return on property value fairly attributable to that service." *Id.* at 89; *cf.* Baltimore & O. R.R. v. United States, 298 U.S. 349 (1936) (ICC would not be reversed merely because it refused to hear evidence on issue of confiscation).

231. Bowles v. Willingham, 321 U.S. 503 (1943). The case may be distinguishable because it is based on the war powers of Congress and involves temporary or emergency legislation. *See* Block v. Hirsh, 256 U.S. 135, 157 (1921).

VII. Skelly on Review: Policy and Legality

These pages have demonstrated that the principles and methods of rate and price regulation have grown to fit the salient characteristics of each regulated industry. Each of the landmark decisions was as controversial in its own time as the *Skelly* case is today. While individual costs are always a significant factor, at various times they have yielded to value concepts, to competitive realities, to supervening public needs and to expediency. Each so-called regulatory principle and method requires evaluation in the light of its own times; most of the authorities deserve to be distinguished rather than to be applied or followed. Area rate-making is more likely to stand or fall on the basis of factors intrinsic to the business of finding and producing natural gas than on the basis of theories applied in other regulatory fields in the past.

Skelly arrives before the Supreme Court in a factual setting which appears greatly to favor ultimate approval of the Commission's order. At last the Commission has formulated a pricing method which promises to achieve regulatory control, even though some of its details may be subject to criticism, and although the Tenth Circuit has argued plausibly that the underlying findings are deficient. Since 1954, the courts, the industry and the Commission have chafed at the "nigh interminable"[232] delay involved. There are strong practical reasons why the Court might strive to avoid compounding the delays already encountered. The Court is undoubtedly aware of the other area proceedings now in progress,[233] the multitude of individual-exception cases that will surely confront the Commission, the luxuriating jungle of certificate applications,[234] and the overriding need to replace anxieties with certainty. Strong policy considerations, therefore, combine to encourage a decision on grounds that will contribute to stability and strengthen the Commission's hand.[235]

At least two factual premises underlying area regulation seem to have been irrefutably established. The first is, of course, the utter impracticality of attempting to regulate multitudes of producer rates by individual rate base/rate of return criteria. If the twelve-year

232. Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378, 389 (1959).

233. *See* note 18 *supra*. Presiding Examiner Zwerdling issued his initial decision in the Southern Louisiana Area Rate Proceeding on Dec. 30, 1966. 32 Fed. Reg. 426 (1967). There is no indication that the Commission will issue an order at any time prior to final disposition of *Skelly*.

234. The importance of the area rates in certificate cases is noted in Area Rate Proceeding (Permian Basin), 34 F.P.C. 159, 226, 230-31, 237, 419, 424 (1965); 34 F.P.C. 1068, 1082 (1965), and illustrated by Phillips Petroleum Company v. FPC, 377 F.2d 278 (10th Cir. 1967) (certificate conditioned on initial price not exceeding Permian Area ceiling price: held, reversed because of reversal of *Permian* order).

235. *See* text accompanying notes 63-67 *supra*.

ordeal of the Commission has not established that premise, it is difficult to see how it could be established in any regulatory field. One can hardly predict with any assurance that the Court will withdraw the tentative acceptance of that conclusion by the majority which decided *Phillips II*.[236] Second, it is hardly debatable that utility-type regulation simply does not fit producer economics.[237] Judicial language such as Justice Butler's famous *Bluefield Water Works*[238] standard, Justice Brandeis' articulation of the investor's expectation in the *Southwestern Bell*[239] case, and Justice Douglas' analysis of legitimate investor concern in the *Hope*[240] case, is attuned to security of capital, safety of yield and waiver of speculative gain. Producers, in contrast, take gamblers' risks in the hope of winning gamblers' stakes. Regulation cannot furnish guaranties against their natural risks; nor should it frustrate their legitimate aspirations. Since many exploratory costs, as well as dry holes, are generally written off as expenses on the producers' books, their investment assets on the balance sheet are low, compared to utilities and railroads. Uniform area prices appear to be more consistent with these characteristics than tailor-made individual rates, designed to recover all of the individual's costs but straitening the permissible yield within a narrow, modest limit.

Once the nature of the proceeding is determined, however, there still remain the critical questions of administrative standards and judicial review. Apparently four possible approaches to the formulation of rates were before the Commission: (1) average contract prices established in free bargaining, (2) the level of prices that would preserve a desirable reserves-to-production ratio, (3) composite costs and (4) a so-called project method.[241]

Of these, the Commission rejected the first two out of hand.[242] Its attitude towards price levels established by bargaining reflects a

236. Wisconsin v. FPC, 373 U.S. 294, 310 (1963). *See generally* Francis, *Area Price Regulation of Gas Producer Rates by the Federal Power Commission*, 68 Dick. L. Rev. 237 (1964).

237. From FPC v. Hope Natural Gas Co., 320 U.S. 591, 628 (1944) (Jackson, J., dissenting), to Phillips Petroleum Co., 24 F.P.C. 818 (1960), to Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1961), to Skelly Oil Co. v. FPC, 375 F.2d 6 (10th Cir. 1967), the realization has grown. *See* Ross, *The Area Rate Proceedings: An Unsettled Experiment in Public Control of Natural Gas Prices*, 18 Sw. L.J. 165, 199-207 (1964); Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 Harv. L. Rev. 549, 551-53 (1962).

238. Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692-93 (1923).

239. Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 290-91 (1923).

240. FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

241. 34 F.P.C. 159, 180-85, 190-91, 192-93 (1965).

242. *Id.* at 180-85.

period of conditioning through judicial condemnation of market-price standards in section 7 cases.[243] Commissioner O'Connor developed at length, in his separate opinion, the proposition that contract price levels established by bargaining are reasonable in relation to costs, to the price trends in competitive sources of energy, and to the trends of other economic indicators.[244] Perhaps the Commission deprived itself of important independent verification of its rates by failing at least to agree with O'Connor's economic exposition.

Although indicating considerable interest in the "project method," the Commission thought it had insufficient evidentiary support.[245] Essentially, this method involves a hypothetical unit cost of finding and producing gas, which treats exploration costs as capital items rather than current expenses. It bears some resemblance to the hypothetical cost estimates typical of fair value studies. Future area price determinations may well establish its importance.[246]

The composite cost standards finally selected by the Commission are similar to the criteria used by the Secretary of Agriculture in *Acker v. United States*.[247] For new gas-well gas, the standard was current costs, developed on a national basis; for flowing gas, the standard was historical costs incurred in the Permian Basin, developed from the questionnaire data. One advocate of the fair value test has expressed interest in the Commission's statement that "historical costs do not necessarily reflect current realities."[248] Obviously, the use of two different sets of criteria is basic to the two-price system.

A two-price system was required, the Commission said, for two reasons. A price geared to current costs is necessary to encourage producers to continue drilling and developing the nation's gas supply; however, the same price applied to old gas-well gas and casinghead gas would allow the producers to reap a "windfall."[249] Furthermore, the new gas price can be adjusted in future proceedings without disturbing the flowing gas price, thus promoting expediency.[250]

243. *See, e.g.*, Public Serv. Comm'n v. FPC, 373 F.2d 816 (D.C. Cir. 1967) ("Congress created the FPC to protect the consumer from the market place, not simply to reflect it"); United Gas Improvement Co. v. FPC, 290 F.2d 133 (5th Cir. 1961).

244. 34 F.P.C. 159, 243, 252-63 (1965).

245. *Id.* at 192-93.

246. Note especially the interest of Commissioner Ross, concurring, *Id.* at 271-73.

247. 298 U.S. 426 (1936); *cf.* Tagg Bros. & Morehead v. United States, 280 U.S. 420 (1930).

248. 34 F.P.C. 159, 191 (1965); *see* Priest, *Factors Leading up to Permian Basin Decision*, PUB. UTIL. FORT., March 2, 1967, at 13, 17; *cf.* Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 HARV. L. REV. 549, 552 (1962) (discusses use of past years to predict future costs of production).

249. 34 F.P.C. 159, 186-87 (1965).

250. *Id.* at 227-28.

However, it seems questionable for the Commission to be so concerned about "windfalls," in view of the basic postulates of the area method.[251] So long as fair current costs are the basis of pricing, a uniform price for all gas of the same quality is more consistent with the economics of commodity merchandising.[252] The Commission may not have properly recognized the need for internally generated funds from past discoveries in order to finance future drilling. Two-price incentives may well be insufficient to encourage exploration. If the Commission felt the amounts allowed for exploratory costs and return would be excessive when applied to oil-well gas, it might have been fairer to break the prices as between oil-well gas and gas-well gas.[253] Although two-thirds of the gas produced in the Permian Basin is oil-well gas, there is no indication that the Commission found it evenly distributed between individual producers.

In the case of contracts providing prices below the area ceilings, the Commission again departed from a strictly uniform treatment. No correlation of costs with gas of varying contract price or vintage appears in the opinion; neither is there apparent evidentiary support for a 9-cent minimum price, as opposed to 6 or 12 cents or any other figure.[254] While giving the purchaser the benefit of the lower contract prices between the minimum price and the area ceiling, the Commission also refused to take the resulting loss of revenue into account as a factor in its price computations, saying

> It would be contrary to all regulatory principles to permit prices in excess of an otherwise just and reasonable rate for certain purchases merely because other sales had been voluntarily made at below full cost as herein determined.[255]

That is not a sufficient answer to the producers' objection. The regulatory principle established in the area proceedings is that uniform area prices provide a fair opportunity of profit for all producers fortunate enough to find marketable quantities of gas. To

251. The Commission acknowledged that "individual returns will vary greatly" and that "there is scope for greater or lesser reward as dictated by the results of exploratory efforts." *Id.* at 179.

252. *See* Wisconsin v. FPC, 303 F.2d 380, 388 (D.C. Cir. 1961); Forest Oil Corp. v. FPC, 263 F.2d 622, 625 (5th Cir. 1959). *But cf.* Comment, *Regulating Independent Gas Producers: The First Area Attempt,* 115 U. PA. L. REV. 84 (1966).

253. The examiner did so. 34 F.P.C. 159, 172, 337, 357-60 (1965).

254. *Id.* at 231-32.

255. 34 F.P.C. 1068, 1073 (1965). Presumably the "regulatory principles" involved are those established by FPC v. Tennessee Gas Transmission Co., 371 U.S. 145 (1962) (losses in one area do not justify an illegal gain in another), and FPC v. Sierra Pac. Power Co., 350 U.S. 348 (1956) (utility generally not entitled to be relieved of improvident bargain by regulation, unless rate so low as to affect public interest). However, those cases involve individual utility situations, not area-wide commodity price-fixing.

reduce the producers' higher negotiated prices, while holding them to their lower negotiated prices and refusing to make up the loss of revenue, is an unnecessary and inconsistent stricture.

Developing its overall justification that there is a "fair relationship between the aggregate price the consumer pays and the aggregate costs that the producers incur,"[256] the Commission emphasizes, on application for rehearing, factors tending to offset the harshness of some of its rulings.[257] While quality deductions are treated as a risk rather than a cost, the Commission finds their maximum impact in the range of 0.7 cent to 1.5 cents per Mcf.[258] The ceiling price computation includes a 4.08 cents allowance for exploration and development and a 12 per cent return on investment, which the Commission deemed excessive as applied to gas discovered in the search for oil and produced from an oil well. Even the utility cases have permitted offsetting errors to sustain the regulatory order.[259] The possible legality of the action, however, does not excuse the individual hardships likely to result from the inconsistencies of the order. These deficiencies are aggravated by the 50 Btu gap in the Btu adjustment, as Commissioner O'Connor demonstrated in dissent.[260]

Although the 12 per cent return on investment looks high in comparison to returns allowed by the Commission in pipeline cases, there are reasons why it may be barely adequate, if adequate at all. The computation bears little resemblance to the calculation of utility return; in effect, it is but a mathematical device employed to fix a profit margin in constructing the unit price. While two factors are involved in the computation, the investment factor involves the clearest demonstration yet that a depreciated cost-type rate base is a "disappearing" rate base. The Commission took an average twenty-year life, divided it into investment, and multiplied the dividend by eleven, comprising one-half of the life plus one year of lag time.[261] Perhaps the overall result is fair to the producer, since the earliest years of production generally are the flush years, and the producer may obtain his returns more rapidly than at the even rate which the calculation assumes. On the other hand, it is clear that the Commission has introduced factors which could reduce the yields to unsatisfactory levels. It might have reached a better result by focusing on

256. 34 F.P.C. 159, 179 (1965); 34 F.P.C. 1068, 1074 (1965).
257. 34 F.P.C. 1068, 1072-74 (1965).
258. *Id.* at 1073.
259. Dayton Power & Light Co. v. Public Util. Comm'n, 292 U.S. 290, 298-304 (1934); Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287, 309-11 (1933); Willcox v. Consolidated Gas Co., 212 U.S. 19, 55 (1909).
260. 34 F.P.C. 159, 267-68 (1965).
261. *Id.* at 199-200.

economic criteria related to the profit margins necessary to generate the funds and provide incentive for exploratory programs, rather than the inapposite return standards of its pipeline rate cases.

While acknowledging Justice Brandeis' dictum that "it is easier to reject formulas presented as being misleading than to find one apparently adequate,"[262] one might nevertheless indulge the hope that the Commission would in future proceedings be more consistent with the uniform commodity price predicate, and less intent on providing harsh details which afford minuscule benefits to individual consumers but serious hazards to individual producers.[263] Small changes in the well-head price are, as Commissioner O'Connor showed, scarcely discernible in the price the ultimate consumer pays for gas.[264] One might recall the words of Thomas Babington Macaulay:

> The Puritan hated bear-baiting, not because it gave pain to the bear, but because it gave pleasure to the spectators.[265]

VIII. The Possible Outcome

Nothing in the authorities really supports *Skelly's* equation of group revenues with group costs.[266] The *Hope* case did not provide affirmative requirements to which rate orders must conform; that case devised the "end-result" test only as a means of departure from the fair value authorities.[267] To require overall rate base/rate of return findings aggregates and therefore enlarges the ponderous impracticability of the individual rate base/rate of return approach.[268] What group is to be employed, those who answered the questionnaires,[269]

262. Groesbeck v. Duluth, S.S. & A. Ry., 250 U.S. 607, 614-15 (1919).

263. Judge Breitenstein has commented on the comparative amounts involved and their comparative importance in Sunray DX Oil Co. v. FPC, 370 F.2d 181 (10th Cir. 1966): "The distributors emphasize the importanee of refunds to the protection of the consumer interests. This may be conceded to the extent that refunds are passed down to the ultimate user. These benefits must be weighed against the desirability of the maintenance of an adequate supply of gas. A repricing of the gas, without warning, cannot help but have a severe impact on the operations of the producers. We will not speculate on the effect of such repricing on their exploration and development activities. The benefits derived from such costly activities may or may not be of greater value, from the public standpoint, than the few dollars recovered by the home consumer. Perhaps he would rather have an assured supply for his expensive appliances than a modest refund." *Id.* at 192-93.

264. 34 F.P.C. 159, 257-59 (1965).

265. 1 T. Macauley, History of England, 154 (1899).

266. 375 F.2d 6, 27, 35 (1967).

267. *Cf.* Bauer, *The Establishment and Administration of a Prudent Investment Rate Base*, 53 Yale L. J. 495 (1944).

268. Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 Harv. L. Rev. 549, 562 (1962). The number of independent producers far exceeds the number of air or maritime carriers involved in a typical CAB or FMB proceeding.

269. 34 F.P.C. 159, 213-14 (1965). If this is the group the court had in mind, its revenue-cost equation is at least feasible; otherwise, it would be very difficult to apply.

all those who are parties to the proceeding,[270] or all those who operate in the area and will be affected by the rate?[271]

Reasoning in prior cases offers the Supreme Court a number of avenues to avoid applying the *Skelly* test. Conceivably, it might hold such a test inapplicable because aggregated confiscation standards are inappropriate for determining prices in this industry.[272] On the other hand, it might hold the rate of return and revenue-cost tests inapplicable because the prices involved are "particular" rates, not company-wide rates.[273]

If the Court feels there has not been an adequate period of operation under the two-price system to test its built-in incentive features, it could borrow the "fair trial" device from a number of cases and hold that the present attack is premature.[274] Or it may well consider the questions of reasonableness and confiscation to be premature, since individual hardships have not yet been adequately developed in the record.[275] An individual producer may well be required to avail himself of the saving clause procedure before he is permitted to complain.[276]

Moreover, the factors suggested by the Commission, particularly on application for rehearing, could lead the Court to the conclusion that the overall end result, on the facts of this case, is fair.[277] Such a holding would not necessarily portend, however, that an identical rate design would be approved in other areas where there is not such a predominance of oil-well gas, where plant revenues are proportionately less, where higher cost factors are involved, or where the historical pricing pattern is different. It could be very useful for the Court to limit its holding to the peculiar facts of this case, thereby encouraging the Commission to exploit the full range of administrative flexibility in future proceedings.

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270. There were 336 respondents. FPC Press Release No. 13964, Aug. 5, 1965.

271. Approximately 1400 would be affected. *Id.*

272. *Cf.* Bowles v. Willingham, 321 U.S. 503 (1944).

273. *Cf.* Dayton-Goose Creek Ry. v. United States, 263 U.S. 456 (1924); ICC v. Union Pacific R.R., 222 U.S. 541 (1912).

274. *Cf.* New York v. United States, 331 U.S. 284, 340 (1947); Clark's Ferry Bridge Co. v. Public Serv. Comm'n, 291 U.S. 227 (1934); Brush Elec. Co. v. City of Galveston, 262 U.S. 443 (1923); Daruell v. Edwards, 244 U.S. 564 (1917); Willcox v. Consolidated Gas Co., 212 U.S. 19 (1909); Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909). The Commission expressly invoked a "practieal test" of its two-price system in 34 F.P.C. 159, 188 (1965).

275. *Cf.* Chicago & N.W. Ry. v. Atchison, T. & S.F. Ry., 387 U.S. 326, 343 (1967); Beaumont, S.L. & W. Ry. v. United States, 282 U.S. 74, 89 (1930).

276. *Cf.* Chicago & N.W. Ry. Co. v. Atchison, T. & S.F. Ry., 387 U.S. 326 (1967). The Court said: "If the Commission's new divisions . . . do have an impact on the Rio Grande [railroad] that is unfairly disproportionate . . . the Rio Grande may apply to the Commission for relief. There is no reason to suppose that relief will not be promptly forthcoming if the Rio Grande's claim is meritorious." *Id.* at 366-67.

277. 34 F.P.C. 1068, 1072-73 (1965).

Finally, while the Supreme Court is likely to provide by its judgment all of the latitude that the Commission needs to perform its regulatory duty, the wisdom of the Commission's policies will depend upon the continued availability of adequate gas reserves. Producers are arguing that the *Permian* rates are not sufficiently compensatory to enable them to explore for gas on a satisfactory scale. Debate will continue until the future course of the industry has been established. Undoubtedly, the practical effect of regulation will prove more important than the historical continuity or theoretical validity of the principles and methods involved.

Area pricing is a pragmatic approach, promising workable solutions to the problems created by the first *Phillips* decision. It would be unfortunate if irrelevant utility precedents, unnecessarily harsh methods, or an unreasonably stringent attitude should subvert and destroy the potential benefit of an area approach. If the Commission continues its efforts to develop adequate and precise factual data and to devise ingenious, pragmatic techniques for application to the unique problems it faces, it can make a substantial contribution in the development of an energy supply to meet the nation's growing needs. If its policies should cripple the industry or discourage growth, tomorrow's consumer is unlikely to applaud a transient bargain made available to his predecessors.