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AREA PRICE REGULATION OF GAS PRODUCER RATES BY THE FEDERAL POWER COMMISSION

BY CHARLES I. FRANCIS*

Federal Power Commission regulation of independent producers[1] of natural gas under the Natural Gas Act[2] currently grows into one of the country's more controversial areas of legal concern. During the last decade a majority of the Commission's opinions in contested producer rate and certificate cases have been appealed by either the producers, the gas distributing companies, or the public service commissions of the consuming states. In many instances the appellate courts have reversed and remanded the Commission's opinions with only the vaguest instructions as to how the Commission should proceed in the performance of its gargantuan task of regulating the thousands of producers scattered throughout the gas-producing states.

The embittered legal struggle between the producers and representatives of the consumers of natural gas resulted in a staggering backlog of cases on the Commission's dockets.[3] The Commission, steadily falling further behind in its work-load, was attacked as the outstanding example in the federal government of the breakdown of the administrative process.[4]

In an imaginative effort to extricate itself from this chaos of legal con-

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The author acknowledges the contributions in researching this Article of Jack D. Head, General Counsel of Texas Eastern, and his assistant, Bolivar C. Andrews, both of Houston, Texas.

1. The Commission defines "independent producer" to mean any person "who is engaged in the production or gathering of natural gas and who sells natural gas in interstate commerce for resale, but who is not engaged in the transportation of natural gas . . . by pipeline in interstate commerce." 18 C.F.R. § 154.91 (Supp. 1963).
2. 52 Stat. 821 (1938), as amended, 15 U.S.C. §§ 717-717w (1958).
3. As of the date of the decision in Phillips Petroleum Co., 24 F.P.C. 537 (1960), there were 3,372 independent producers who had 11,091 rate schedules on file and 33,231 supplements to those rate schedules. With regard to rate filings alone, there were 570 producers involved in 3,278 rate increase filings that were awaiting hearings and decisions. The Commission predicted that if its staff were tripled, producer rate work would achieve a current status by 2043 A.D. *Id.* at 545-46.
4. LANDIS, REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT, submitted by the Chairman of the Subcommittee on Administrative Practice and Procedure to the Committee on the Judiciary of the United States Senate (Dec. 1960).

flict, the Commission on September 28, 1960, promulgated a Statement of General Policy[5] inaugurating a unique concept—regulating prices paid producers on the basis of area rates. In this Statement of Policy, since amended several times, the Commission designated twenty-three different natural-gas-producing areas and established ceiling-price levels for initial and increased rate filings by producers in each producing area. The Commission announced it would institute a series of hearings to determine fair prices for gas "based on reasonable financial requirements of the industry"[6] for each of the producing areas of the country.

The general concept of regulation through area pricing has received approval from the courts; but it is certain that the practical application of this new type of regulation will be challenged from many quarters. Before discussing the knotty problems which courts must ultimately unravel, a review of the maelstrom of events leading to the adoption of area pricing may be helpful for those not previously exposed to the intricacies of producer regulation.[7]

HISTORY OF COST-OF-SERVICE REGULATION OF INDEPENDENT PRODUCERS

The Natural Gas Act, passed in 1938, culminated a congressionally authorized investigation of the interstate gas-pipeline industry by the Federal Trade Commission. In view of the purpose of the investigation,[8] the report of the Federal Trade Commission, and the ultimate design of the act itself, it was the almost universal view that only interstate gas pipeline companies were to be regulated. Support for the belief that field sales of natural gas escaped control under the legislation came from the stipulation of section 1(b)[9] that "the provisions of this Act . . . shall not apply . . . to the production or gathering of natural gas." Shortly after the passage of the act in *Matter of Columbian Fuel Corp.*,[10] and on several subsequent occasions, the Commission held field sales of natural gas by producers to be outside the agency's jurisdiction. Doubts as to this exclusion first became apparent in 1946 as the result of a court decision holding within Commission jurisdiction a pipeline company's field sales to nonaffiliated purchasers.[11] This decision brought prompt action by the Commission to assure producers that it

5. 24 F.P.C. 818 (1960).
6. Phillips Petroleum Co., 24 F.P.C. 537, 547 (1960).
7. See generally Mosburg, *Regulation of the Independent Producer by the Federal Power Commission*, 16 OKLA. L. REV. 249 (1963).
8. S. Doc. No. 92, 74th Cong., 2d Sess. (1935).
9. 52 Stat. 821 (1938), 15 U.S.C. § 717(b) (1958).
10. 2 F.P.C. 200 (1940).
11. Interstate Natural Gas Co. v. FPC, 156 F.2d 949 (5th Cir. 1946), *aff'd*, 331 U.S. 682 (1947).

would not exercise jurisdiction over their sales;[12] and in 1950 Congress passed the Kerr-Harris Bill[13] expressly placing this situation outside Commission jurisdiction, but this bill was vetoed by President Truman.[14]

Immediately following veto of the bill the Commission announced that investigations of producer sales would be made where the price appeared excessive. An investigation of the prices charged pipeline companies by Phillips Petroleum Company was instituted. After completing its review of Phillips' prices the Commission held in *Phillips Petroleum Co.*,[15] for what proved to be the last time, that jurisdiction was absent, because Phillips' sales were made as a part of the gathering and production of gas. The United States Court of Appeals for the District of Columbia Circuit reversed. The Supreme Court, first denying certiorari but then persuaded to reconsider, affirmed the decision of the court of appeals. Divided five-to-three the Supreme Court held that Congress had expressed in the act an intent to regulate sales by independent producers of natural gas which would be resold in interstate commerce.

Commission regulation of producers remained in effect suspended for a time following the *Phillips Petroleum* case; the Commission and the industry renewed their efforts to secure remedial legislation. Congress responded by passing the Harris-Fulbright Bill in 1955,[16] which would have freed the producer from utility-type regulation, but preserved for the Commission the right to regulate producer contract prices. President Eisenhower, while cognizant of a need for legislation of this type, vetoed the bill for reasons apart from its merits.[17] Efforts to pass similar legislation persist, but without success.[18]

Veto of the Harris-Fulbright Bill left the Commission faced again with the problem of independent producer regulation, an almost impossible undertaking within the framework of the Natural Gas Act which was designed to regulate an entirely different business—the transportation and sale of gas by interstate pipeline companies. The broad directive of the act did not make the

12. The Superior Oil Co., 7 F.P.C. 627 (1948); General Crude Oil Co., 7 F.P.C. 1024 (1948); La Gloria Corp., 7 F.P.C. 349 (1948); R. J. & D. E. Whelan, 6 F.P.C. 672 (1947); Hassie Hunt Trust, 6 F.P.C. 835 (1947); Kansas-Nebraska Natural Gas Co., 6 F.P.C. 664 (1947); The Chicago Corp., 6 F.P.C. 98 (1947); Fin-Ker Oil & Gas Production Co., 6 F.P.C. 92 (1947); 18 C.F.R. § 2.54 (1947).

13. H.R. 1758, 81st Cong., 2nd Sess. (1950).

14. H.R. Doc. No. 555, 81st Cong., 2nd Sess. 1-3 (1950).

15. Phillips Petroleum Co., 10 F.P.C. 246 (1951), *rev'd sub. nom.* Wisconsin v. FPC, 205 F.2d 706 (D.C. Cir. 1953), *cert. denied*, 346 U.S. 896 (1953), *cert. granted*, 346 U.S. 934 (1954), *aff'd sub nom.* Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

16. H.R. 6645, 84th Cong., 1st Sess. (1955).

17. H.R. Rep. No. 837, 85th Cong., 1st Sess. 3 (1957).

18. Heard, *Pending Legislation to Amend the Natural Gas Act*, in Oil and Gas Operations 406-34 (Slovenko ed. 1963).

Commission's task easier: sections 4[19] and 5[20] provide only that the rates of natural gas companies shall be "just and reasonable," prescribing no formula or method for arriving at the determination.[21]

In previous rate regulation of pipeline companies, including regulation of gas production activities conducted by the pipelines, the Commission had adopted the so-called cost-of-service method, employing rates designed to permit a pipeline to recover its outlays plus a return on a rate base computed by totaling the depreciated original costs of properties devoted to jurisdictional service.[22] Approving the Commission's use of this method the Supreme Court in the now famous case of *FPC v. Hope Natural Gas Co.*[23] stated:

> Under the statutory standard of "just and reasonable" it 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 then important.[24]

Mr. Justice Jackson dissented insofar as the *Hope* decision sustained the cost-of-service-method—

> Is it necessary to a "reasonable" price for gas that it be anchored to a rate base of any kind? . . . Gas is what Hope sells and it can be directly priced more reasonably and easily and accurately than the components of a rate base can be valued. Hence the reason for resort to a roundabout way of rate base price fixing does not exist in the case of gas in the field.[25]

The Colorado Interstate Gas Company also challenged utilization of a rate-base calculation for production and gathering facilities.[26] Colorado Interstate was a "natural gas company" as defined by the act, and the majority did not believe the production and gathering exemption of section

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19. 52 Stat. 822 (1938), as amended, 15 U.S.C. § 717c (1958).
20. 52 Stat. 823 (1938), 15 U.S.C. § 717d (1958).
21. FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942).
22. See the author's *Federal Regulation of Interstate Shipment and Sale of Gas*, in FOURTH ANNUAL INSTITUTE ON OIL & GAS LAW & TAXATION 103 (1953); *Rate Regulation of Natural Gas Companies by the Federal Power Commission*, 19 LAW & CONTEMP. PROB. 413 (1954).
23. 320 U.S. 591 (1944).
24. 320 U.S. at 602. The Commission's continued adherence to the depreciated original cost method, approved in this case, as opposed to the fair present value method, has received a great deal of criticism, because the former approach fails to recognize the continuing inflationary spiral, resulting in rates that may be confiscatory. *Supra* note 22; see Iowa-Illinois Gas & Elec. Co. v. City of Fort Dodge, 248 Iowa 1201, 85 N.W.2d 28 (1957).
25. 320 U.S. at 647-48.
26. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945).

1(b) precluded the Commission in its rate computations from considering all the gas properties employed in gas production by a company subject to the act. Congress might have excluded producing or gathering facilities from the base and made an allowance in operating expenses for the fair field price of gas as a commodity. Observing that some thought that to be the wiser course, the Court failed to find any mandate to that effect in the act. Rather, the provisions of the act suggested Congress had thought in terms of ingredients of the customary rate base; referring to the "end result" test of *Hope*, the Court noted that if the Commission abandoned rate-base valuation, the act did not say gas would have to be valued at the fair field price.[27] Thus, in a somewhat defensive manner, application of the rate-base method to gas production was justified. In view of more recent developments the dictum qualifying the Court's holding is of extreme interest. "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 . . . ."[28]

Not until 1954, just a few weeks before the Supreme Court handed down its epochal *Phillips* decision, did the Commission decide to price a pipeline company's gas directly by adopting a "fair field price" formula in *Panhandle Eastern Pipeline Co.*[29] Among the considerations leading to the new approach was the Commission's determination that gas production by pipelines should be encouraged in order to reduce their dependency upon independent producers for gas. The *Panhandle* decision was reversed by the Court of Appeals for the District of Columbia Circuit in what is known as the *City of Detroit*[30] case. Although refusing to interpret prior decisions to mean that use of the field price was prohibited, making the rate-base method mandatory for *all properties in all circumstances,* the court failed to find abandonment of the treatment historically accorded pipeline-produced gas in rate-making justified on this record. The rate-base method was not the only one available under the statute, but the court believed it "essential in such a case as this that it be used as a basis of comparison."[31] Because of the method's repeated use by the Commission and approval by the courts, the court said, "Unless it is continued to be used at least as a point of depar-

27. *Id.* at 601-03.

28. *Id.* at 601.

29. 13 F.P.C. 53 (1954).

30. City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955), *cert. denied,* 352 U.S. 829 (1956). For a discussion of this and other cases concluding that they do not require a rate-base approach for the independent producer, see Orn, *FPC Excursion Into New Regulatory Fields,* in FOURTEENTH ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 71 (1963).

31. 230 F.2d at 818.

ture, 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."[32]

The Solicitor General refused to sign the Commission's petition for a writ of certiorari in *City of Detroit,* and, ultimately the Supreme Court denied the writ. Consequently, the first attempt by the Commission to depart from the rate-base method in fixing rates for gas production in the field was thwarted.[33] In view of the advent of producer regulation during the *City of Detroit* litigation it is perhaps unfortunate that the Supreme Court did not choose to hear that case.

The Commission cited *City of Detroit* as controlling in its first significant producer decision holding that cost of service evidence must be considered at least as a basis of comparison; reliance solely on field-price evidence was inadequate.[34] On appeal the Fifth Circuit in *Bel Oil Corp. v. FPC,*[35] followed in a series of Fifth Circuit and District of Columbia Circuit decisions,[36] appeared to view as nonessential the traditional utility approach to producer rate regulation; the choice of methods rested with the Commission. *Episcopal Theological Seminary v. FPC,*[37] decided by the same court, did hold that a fair balance between the producer and consumer interest could not be achieved without any evidence respecting investment or costs, but the court decisions uniformly disclose at least permissive indulgence for a retreat from traditional cost-of-service methods, a trend recently demonstrated by the District of Columbia Circuit in *Minneapolis Gas Co. v. FPC.*[38] There, the court read its *City of Detroit* opinion as meaning "there may be situations in which rate-base proof constitutes the only 'anchor' "; it was for the Commission to decide in the first instance whether rate-base proof was necessary in a particular case.[39] The court approved of the attitude taken by the Fifth Circuit in *Bel Oil v. FPC*[40] and *Forest Oil Corp. v. FPC.*[41] A significant excerpt from *Forest Oil* reads—

32. *Id.* at 818-19.
33. For a comprehensive treatment of cases construing the act to require a rate-base approach, see Kaye, *Are "Conventional Methods" Necessary In Natural Gas Rate Regulation,* 41 CORNELL L.Q. 438 (1956).
34. Union Oil Co., 16 F.P.C. 100 (1956).
35. 255 F.2d 548 (5th Cir.), *cert. denied,* 358 U.S. 804 (1958).
36. Minneapolis Gas Co. v. FPC, 294 F.2d 212 (D.C. Cir. 1961); Episcopal Theological Seminary v. FPC, 269 F.2d 228 (D.C. Cir.), *cert. denied,* 361 U.S. 895 (1959); Forest Oil Corp. v. FPC, 263 F.2d 622 (5th Cir. 1959); Associated Oil & Gas Co. v. FPC, 255 F.2d 555 (5th Cir. 1958); Bel Oil Corp. v. FPC, 255 F.2d 548 (5th Cir.), *cert. denied,* 358 U.S. 804 (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).
37. *Supra* note 36.
38. 294 F.2d 212 (D.C. Cir. 1961).
39. *Id.* at 216.
40. 255 F.2d 548 (5th Cir.), *cert. denied,* 358 U.S. 804 (1958).
41. 263 F.2d 622 (5th Cir. 1959).

> We do not think that either the Commission or the petitioner should be baffled or handicapped in this new field of regulation by any formulas by whatever name they are known. Specifically, if there is an accounting or rate-making formula known to the public utilities industry as a "conventional rate-base method of rate-making" which the Commission in its order of dismissal in this case said must be used at least as a basis of comparison or point of departure, we say the Commission need not require it unless such method is the only way by which the Commission can make its required determination.[42]

Earlier, in its *Bel Oil* decision the court thought it to be quite clear that "the Commission might adopt some pragmatic standard to apply to these cases."[43]

Struggling, along with the courts, for a solution to the producer rate problem, the Commission found itself confronted with rate schedule filings numbering in the thousands submitted by several thousand producer "natural gas companies." Although cases indicated some leeway was available, none of them specified the kind of evidence required for a proper determination of the "justness and reasonableness" of producer rates. Not sure how to proceed, the Commission considered evidence relating to every possible theory of regulation; confusion reigned.

History of Certificate Regulation of Independent Producers

Seeking a workable means of regulating the rates of existing producer sales to interstate pipeline companies, the Commission paid scant attention to the prices received by producers for the new sales of gas that occurred after the *Phillips* decision. Although a producer is required to obtain a certificate of public convenience and necessity from the Commission under section 7[44] of the Natural Gas Act before commencing a new sale of gas, the Commission announced that it did not deem "it prudent to expend the time required to resolve rate issues at this stage nor has . . . [the Commission] found it practical to inquire into the reasonableness of producer rates in all producer certificate proceedings."[45] Despite vigorous consumer protests, the Commis-

42. *Id.* at 626.
43. 255 F.2d at 554.
44. 52 Stat. 824 (1938), as amended, 15 U.S.C. § 717(f) (1958). See Mosburg, *supra* note 7, at 260-76 for a thorough discussion of producer certificate regulation.
45. Anthony J. Tamborello, 14 F.P.C. 123, 126 (1955). Actually, American La. Pipe Line Co., 13 F.P.C. 380 (1954) was the first producer certificate decision after the 1954 *Phillips* decision subjected producers to regulation under the act, and the Commission there refused to impose a price condition. Subsequent decisions following the policy reflected in *Tamborello* include: Trunkline Gas Co., 21 F.P.C. 704 (1959); Seaboard Oil Co., 19 F.P.C. 416 (1958); Southern Natural Gas Co., 18 F.P.C. 38 (1957); Houston Texas Gas & Oil Corp., 16 F.P.C. 118 (1956), *aff'd sub nom.* Florida Economic Advisory Council v. FPC, 251 F.2d 643 (D.C. Cir. 1957), *cert. denied,* 356 U.S. 959 (1958); The Atlantic Refining Co., 14 F.P.C. 480 (1955).

sion believed that it could defer a determination as to the reasonableness of prices until subsequent rate proceedings under section 4 or 5 of the act.[46] The attempt by the Commission to postpone consideration of producer rates in certificate cases came to an abrupt halt with the Supreme Court's decision in *Atlantic Refining Co. v. Public Serv. Comm'n*,[47] the so-called "Catco" case.

The Court recognized that section 7 of the act imposed no requirement on the Commission to determine the justness and reasonableness of rates in certificate proceedings; however, the Court recognized also that proposed initial prices were a consideration of prime importance in view of the fact that gas prices had vaulted from one plateau to another. Increasing the consideration's importance was the lack of power in the Commission to suspend initial rates under section 7 and the delay before the section 5 proceeding, under which initial certificated rates are reviewable without any refund protection.

Observing the Commission's authorization under section 7(e)[48] to impose such conditions on certificates as the public convenience and necessity required, the Court remarked—

> Where the proposed price is not in keeping with the public interest because it is out of line or because its approval might result in a triggering of general price rises or an increase in the applicant's existing rates by reason of "favored nation" clauses or otherwise, the Commission in the exercise of its discretion might attach such conditions as it believes necessary.[49]

The Court thought conditions could protect the consuming public until the justness and reasonableness of the price fixed by the parties had been determined under other sections of the act. Exercise of this power by the Commission would not constitute an infringement on the Court's landmark *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*[50] decision holding that the act preserves the integrity of individual contracts, which initially determine the prices.

That the Commission did not interpret *Catco* as a strict requirement to "hold the line" in certificating initial prices became evident in the agency's first post-*Catco* decision concerning initial prices.[51] This limited reading of

46. There was one significant instance during this period in which the Commission chose to condition a producer's initial price. Cities Serv. Gas Co., 14 F.P.C. 134 (1955), *aff'd sub nom.* Signal Oil & Gas Co. v. FPC, 238 F.2d 771 (3rd Cir. 1956), *cert. denied*, 353 U.S. 923 (1957). In this case the price was conditioned on evidence that the proposed price would constitute a new high, and stimulate favored nation clauses in a particular region of Oklahoma.

47. 360 U.S. 378 (1959).

48. 56 Stat. 84 (1942), 15 U.S.C. § 717f(e) (1958).

49. 360 U.S. at 391.

50. 350 U.S. 332 (1956).

51. South Ga. Natural Gas Co., 22 F.P.C. 211 (1959). In this decision prices in

the case became more apparent when five separate decisions, all issued on August 10, 1959, authorized a series of producer sales without conditioning the contract prices.[52] The subsequent reversal of these five decisions made it clear that *Catco* had sharply diminished the freedom exercised by the Commission in certificating initial prices.[53] The courts would require the agency to actively utilize its conditioning powers with respect to the price at which new gas enters the interstate market.

In terms of workload alone the reversals increased substantially the burdens of Commission and producer alike; in addition, the general language employed in the opinions left unanswered many questions as to the nature and quantum of evidence required in certificate cases. With this background of uncertainty and confusion the Commission's Statement of General Policy No. 61-1[54] and the *Phillips* decision on remand[55] came down simultaneously on September 28, 1960, heralding a new era of producer regulation.

REGULATION UNDER THE STATEMENT OF GENERAL POLICY

The Supreme Court's *Phillips* decision in 1954 forced the Commission into the task of producer regulation. It was perhaps fitting that the agency utilized the opinion in the remanded *Phillips* case as a vehicle for announcement in 1960 of the new concept of regulating producer rates through area prices.

Following remand of the case, the Commission consolidated the section 5 investigation of Phillips' rates with several section 4 rate increases filed by Phillips.[56] After the almost interminable hearings considering primarily cost-

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the same range as those struck down in *Catco* were certificated. The Commission believed this to be within its discretion in considering all facets of the "public convenience and necessity." The principal support for this conclusion came from a decision of the Third Circuit Court of Appeals, which was handed down shortly after the Supreme Court's *Catco* decision and which interpreted it in a limited manner. United Gas Improvement Co. v. FPC, 269 F.2d 865 (3d Cir. 1959). The Supreme Court subsequently vacated the Third Circuit's judgment, and directed that court to remand the case to the Commission for redetermination in the light of *Catco*. Public Serv. Comm'n v. FPC, 361 U.S. 195 (1959).

52. These decisions relied heavily on the decision of the court of appeals in the *United Gas Improvement* case, *supra* note 51.

53. United Gas Improvement Co. v. FPC, 290 F.2d 133 (5th Cir.), *cert. denied*, 368 U.S. 823 (1961); United Gas Improvement Co. v. FPC, 290 F.2d 147 (5th Cir.), *cert. denied*, 366 U.S. 965 (1961); United Gas Improvement Co. v. FPC, 287 F.2d 159 (10th Cir. 1961); Public Serv. Comm'n v. FPC, 287 F.2d 146 (D.C. Cir. 1960), *cert. denied*, 365 U.S. 880, 882 (1961); United Gas Improvement Co. v. FPC, 283 F.2d 817 (9th Cir. 1960), *cert. denied*, 365 U.S. 879, 881 (1961).

54. 24 F.P.C. 818 (1960).

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

56. Section 5 of the act, 52 Stat. 823 (1938), as amended, 15 U.S.C. § 717d (1958) permits the Commission to hold a hearing to establish "just and reasonable" rates "to be thereafter observed." The provision operates prospectively only. A decrease may be ordered if existing rates "are not the lowest reasonable rates."

of-service evidence, the record in *Phillips* provided ample justification for the adoption of a more workable substitute for the individual, cost-of-service approach to producer regulation. In enumerating some of the many shortcomings of that approach, the Commission mentioned the difficult problem of allocating costs between a producer's unregulated oil and regulated gas operations, the lack of preciseness in estimating oil and gas reserves, the absence of utility characteristics in the producing business, and the intolerable administrative burden of establishing the cost of service for each of thousands of producers. The Commission also pointed out that the cost-of-service approach would penalize the efficient or fortunate producer while rewarding the inefficient or unfortunate producer. Finally, it was noted that the cost-of-service approach resulted in widely varying prices for different producers in the same area or field and many times for different ownerships in gas produced from the same well.[57]

The Commission held cost-of-service evidence for the 1954 test year to be stale for the purpose of judging Phillips' revenue requirements for 1960 and future years, and dismissed the section 5 aspect of the case; however, the agency utilized the cost-of-service evidence to allow section 4 increases filed by Phillips for prior years. It was pointed out that utilization of a unit-cost, calculated by making numerous arbitrary allocations and estimates, did not satisfactorily solve the problem of fixing prices:

> Experience of the Commission in this case, as well as in many other producer rate cases during the last five years, has shown, beyond any doubt, 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.[58]

Finding calculation of the unit cost of gas entirely unsatisfactory, the Commission stated its intention to continue to make use of cost data, but only as a part of the body of information pertaining to the economics of the gas-producing industry in an effort to establish fair prices for gas "based on reasonable financial requirements of the industry"[59] rather than on the rate base and expenses of each producer. The Commission announced in its opinion the concurrent issuance of the Policy Statement setting forth for each of the various producing areas of the country: "(1) a price applicable

Section 4, 52 Stat. 822 (1938), as amended, 15 U.S.C. § 717c (1958) provides that a company may file for an increase in its rates, and for collection of the increased rate subject to refund of any amounts found after a hearing to be in excess of the "just and reasonable" rate. Then, the "just and reasonable" test is applied under both sections with the burden of proof on the Commission under § 5 and on the company under § 4.

57. 24 F.P.C. at 542-45.

58. *Id.* at 542.

59. *Id.* at 547.

to new contracts above which we will not certificate new sales without justification of the price; (2) a price pertaining to existing contracts, above which we shall suspend price escalations."[60]

In the Statement the Commission announced it would institute area rate proceedings wherein interested parties could challenge the price levels or geographical makeup of the areas of production established. The interim price levels reflected six years' experience regulating producers under the act, and were based upon a consideration of cost information from the following significant sources: all decided and pending cases,[61] existing and historical price structures, volumes of production and the markets available for the gas, and trends in production, prices, demand, and exploration and development.[62] The Policy Statement emphasized that the price levels did not represent an adjudication of "just and reasonable" rates; "guideline" prices would be employed to determine whether initial prices were "in line" and whether proposed increases under existing contracts should be allowed without suspension.

The initial prices established by the statement for *new* sales ranged from a high of 26.8 cents per thousand cubic feet for gas produced in the West Virginia area to a low of 12.7 cents per thousand cubic feet for gas produced in the San Juan Basin area of New Mexico; the range for increases under existing contracts rose to a high of 23.9 cents for the West Virginia area, and fell to a low, applicable to several areas, of 11 cents. Eight amendments followed the Policy Statement principally in order to make *ex parte* reductions in the initial guideline prices established for southern Louisiana and areas along the Texas Gulf Coast. The Commission has also authorized small increases above guideline prices pertaining to existing contracts in situations where the producers agreed to eliminate all or specified price-escalation clauses.

In accordance with its statement the Commission has permitted rate increases to become effective where new rates did not exceed guideline prices; the agency has granted also temporary certificates for new sales without re-

60. *Ibid.*

61. In what has been described as a confession of error, the Commission has for administrative reasons continued to decide those producer cases which were pending before it, prior to the commencement of area rate proceedings, on the basis of cost-of-service evidence. The Commission has believed it should salvage what it could in these proceedings, but in none of them has the § 5 aspect been decided. See, *e.g.*, Continental Oil Co., Opinion No. 405 (1963); Slade, Inc., 29 F.P.C. 11 (1963); H. L. Hunt, 28 F.P.C. 897 (1962); Hunt Oil Co., 28 F.P.C. 623 (1962); Shamrock Oil & Gas Corp., 26 F.P.C. 943 (1961); Alfred Glassel, 25 F.P.C. 1071 (1961). It should be noted that a number of these proceedings have been terminated by settlement agreements.

62. The Commission has never disclosed the information and evidence which formed the basis for its establishment of the interim price levels, and producer efforts to subpoena the Commission's files for the production of such evidence have thus far failed. Texaco v. FPC, 32 U.S.L. WEEK 2194 (D.C. Cir. Oct. 17, 1963), *cert. denied*, 32 U.S.L. WEEK 3211 (U.S. Dec. 9, 1963).

quiring price justification when the initial prices were at or below guideline levels, and issued permanent certificates conditioned on the maintenance of guideline prices.[63]

That the "in line" price determined after the statutory hearing for a permanent certificate might be lower than the "guideline" price became apparent in a Commission decision recently affirmed by the District of Columbia Court of Appeals:[64] The court held that a guideline price of 18 cents established by the Commission's Policy Statement for Texas Railroad Commission District 4 was not necessarily the "in line" price required by the *Catco* decision, and affirmed the Commission's conditioning the issuance of permanent certificates on price reductions of as much as 3 cents below the guideline prices previously authorized under temporary certificates. The decision held also that the Commission's authority to condition a permanent certificate under section 7(c) of the act included the power to require refunds of amounts collected under a temporary certificate in excess of the permanently certificated price. Power to impose this condition does not depend upon the existence of an explicit refund provision in the temporary certificate. This decision appears in conflict with an earlier decision[65] of the Court of Appeals for the Tenth Circuit, holding that even in attaching a refund condition to a temporary certificate the Commission must set a price at or below which the producer can sell without risk of a subsequent refund order on the theory that without such a refund floor the producer could not intelligently decide whether to accept the conditional grant and commit his gas reserves to the interstate market.

After setting up interim, guideline-area prices, on December 23, 1960, the Commission instituted the first proceeding to determine just and reasonable rates for a producing area, [66] the Permian Basin Area of Texas and New Mexico. A second proceeding instituted on May 10, 1961, contemplated just and reasonable rates for the South Louisiana Area,[67] and on November 27, 1963, two new area rate proceedings were issued for the Hugoton-Anadarko Area including Kansas and parts of Oklahoma and Texas and the Texas Gulf Coast Area consisting of three Texas Railroad Commission Districts.[68]

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63. Atlantic Refining Co. v. FPC, 316 F.2d 677 (D.C. Cir. 1963). While some of the earlier court decisions contained statements favorable to the Policy Statement, this recent decision of the District of Columbia Circuit for the first time approved a conditional rate as in conformance with the *Catco* requirements where the Commission had used the area pricing approach.

64. Skelly Oil Co., 28 F.P.C. 401 (1962), *aff'd sub nom.* Public Serv. Comm'n v. FPC, No. 17582, D.C. Cir., Jan. 23, 1964.

65. Sunray Mid-Continent Oil Co. v. FPC, 270 F.2d 404 (10th Cir. 1959).

66. Area Rate Proceeding, 24 F.P.C. 1121 (1960).

67. Area Rate Proceeding, 25 F.P.C. 942 (1961).

68. Area Rate Proceeding, 28 Fed. Reg. 12645 (1963).

The Permian Basin hearing, completed with a record of over 30,000 pages, represents a pilot proceeding, determining the factors and evidence to be considered in establishing just and reasonable area rates. During the hearing the Commission ruled upon a motion certified to it by the examiner that individual cost-of-service evidence could not be introduced "regardless of whether such studies relate to the operations of an individual producer or to any group or groups of the producers here involved."[69] The agency later modified that ruling, permitting parties to "introduce in evidence composite rate base cost of service studies relating to a significant segment of industry operations in this area."[70] Curiously, the order added that "such composite rate base cost of service studies may not suffer from the deficiencies which exist in individual company studies of this type." Except for the exclusion of individual cost-of-service studies, the record in the Permian Basin proceeding reflects almost every conceivable evidentiary approach for arriving at "fair prices for gas based on reasonable financial requirements of the industry"; the record achieved resulted from a uniquely cooperative effort. Intense disagreement arose, however, over the proper resolution of the issues:[71] Aside from the contention advanced by some that the proceeding should be dismissed outright, the recommendations as to the order which should be adopted range far and wide. Considerable controversy exists concerning the type of area rate determination the Commission should make, as well as over the scope and effect to be given to the determination.

In view of the divergent approaches and contentions the writer will not be so bold as to attempt to predict the course or rationale which the Commission might follow in arriving at its determination of just and reasonable rates for this area. However, it appears litigation will inevitably flow from any course the Commission chooses. A discussion of the legal problems the courts must eventually resolve follows.

Impact of the Supreme Court's 1963 Phillips Decision on Area Pricing and the Constitutional and Statutory Problems yet to be Resolved

During the evolutionary period of workable producer regulation under the Statement of General Policy, the *Phillips* case was again presented to the Supreme Court and decided on May 20, 1963.[72] One must remember

69. Order Ruling Upon Motion Relating to Evidence to be Considered in Area Rate Proceeding, 25 F.P.C. 614, 615 (1961). (Footnote omitted.)

70. Order denying motion and amending, in part, order relating to the type of evidence to be considered in area rate proceeding, No. AR61-1.

71. Most respondents have made an offer of proof as to their individual costs, and all have reserved their right to make such a showing later.

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

that while the Commission announced in its *Phillips* decision an intention to abandon the old cost-of-service approach and replace it with a system of pricing gas in group proceedings applicable to various sub-areas of the country, the agency, nevertheless, decided the justness and reasonableness of past rate increases, filed by Phillips under section 4 of the act, on a cost-of-service basis. At the same time, however, the Commission dismissed the investigation it had instituted under section 5 of the act to determine just and reasonable rates to be observed by Phillips *in the future* with the announcement that such rates would be determined later in the area rate proceedings to be initiated. Thus, although on appeal neither the validity of area pricing nor any area price was squarely before the Court, the unusual posture of the case made it virtually impossible for the Court to sustain the Commission without imputing some degree of validity to area pricing, because the question of whether the Commission abused its discretion in dismissing the section 5 investigation entailed an inquiry into the justifications for the area pricing concept. With both public and private interests of considerable magnitude hanging in the balance, the judiciary did not elect to be oblique.

In an opinion the Supreme Court later found to be "thorough and informative"[73] the Court of Appeals for the District of Columbia Circuit had sustained the Commission on November 30, 1961.[74] (Conspicuous in its absence was any reference by the court to its earlier *City of Detroit*[75] decision.) The court of appeals accepted the reasoning reflected in the early views of Mr. Justice Jackson, heavily relied upon by the Commission, on the implausibility of the rate-base method. "Mr. Justice Jackson once wrote that 'there is little more relation between the investment and the result than in a game of poker.' "[76] The court of appeals did approve the cost-of-service disposition relating to the section 4 proceedings and the finding that none of Phillips contracts were unduly discriminatory. As to the determination of future rates (section 5) the court of appeals noted the Commission's intention to accomplish this by the area price method, and stated that since Congress confided the regulation of the natural gas industry to the Commission, it would be foolish to hold the Commission bound "to apply to new conditions the methods and measurements designed and used for other and different regulatory purposes." "We think it is clear that the Commission had ample authority to embark upon an effort to design suitable new standards for use

73. *Id.* at 302.
74. Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1961).
75. Judge Fahy, the author of that opinion, dissented but had no quarrel with the Commission's right to undertake the area experiment; nor did he believe the Commission would be precluded from applying the area method in the future if required to decide the present case on cost of service.
76. 303 F.2d at 383.

in the regulation of producers when it found that the tools at hand were not suited to this purpose."[77]

The court carefully admonished that any new standard established would have to meet the test of the constitutional standard:[78]

> Of course, constitutional restrictions apply; rates fixed by governmental authority cannot be confiscatory; all procedures must be by due process, that term conveying meanings differing according to the basic nature of the proceeding but always including that which is fair and decent according to the standards of our social order and time.[79]

Language in the opinion suggests the advisability of permitting the Commission to select a method other than the traditional public-utility approach of measuring a "fair return"—

> Almost the whole of the economics of merchandising differs from the economics of public utility service. Are the just and reasonable prices of such a 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.[80]

Thus, earlier Supreme Court decisions were not read as commanding any single method of regulation under the broad terms of the act, but the court expressly left open the way to challenge the results of any area rate.

The Supreme Court affirmed,[81] five-to-four, giving the various issues much the same treatment they received in the court of appeals. The Court observed that the Commission's actions since the original *Phillips* case, the validity of the Policy Statement, and the *lawfulness of the area pricing method* were not before the Court for review, but "[t]o a limited extent these matters do bear upon the propriety of the Commission's decision to terminate this section 5(a) proceeding."[82] Within the issue of abuse of discretion the opinion discusses the area approach (likewise discussed in the briefs and at length during oral argument):

> If we believed that such a departure from present concepts had little, if any chance of being sustained, we would be hard pressed

77. *Id.* at 387.
78. See FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585-86 (1942).
79. 303 F.2d at 388.
80. *Ibid.*
81. Wisconsin v. FPC, 373 U.S. 294 (1963).
82. *Id.* at 308.

to say that the Commission had not abused its discretion in terminating this Section 5(a) proceeding while undertaking the area experiment. . . . But to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates.[83]

Citing its *Natural Gas Pipeline, Hope, and Colorado Interstate* decisions, the Court reiterated that no single method need be followed by the Commission in considering the justness and reasonableness of rates.

More specifically, the Court has never held that the individual company cost-of-service method is a sine qua non of natural gas rate regulation. . . . To whatever extent the matter of costs may be a requisite element in rate regulation, we have no indication that the area method will fall short of statutory or constitutional standards.[84]

Reference was made to the Commission's goal of rates based on "the reasonable financial requirements of the industry" in each area, and to statements made during oral argument to the effect that composite cost-of-service data would be considered in area rate proceedings. In a footnote the Court mentioned that it did not interpret the *City of Detroit* case to require the cost-of-service method in independent producer regulation.[85] In that case there was no question before the court relating to the area rate method. The Court cited Mr. Justice Jackson's opinions in the *Hope* and *Colorado Interstate* cases, demonstrating the difficulties inherent in regulating the price of a commodity such as natural gas, to support acceptance of the Commission's conclusion that the individual rate-base method is not feasible or suitable for producer rate regulation, and shared the Commission's hopes that the area approach would ultimately prove more satisfactory.[86]

The dissent agreed that the cost-of-service method is not the "sine qua non of natural gas rate regulation," but believed that abandonment of the old approach in summary fashion would leave producers without effective regulation for a number of years. Serious legal questions occurred to the dissent concerning the validity of area pricing, and the majority's strong implication of its validity struck the minority as premature. The contemplated averaging of costs to arrive at an area rate created the principal constitutional difficulty envisioned. The four dissenting Justices believed that any area rate order must include a showing that the individual producer will recover his

83. *Id.* at 308-09.
84. *Id.* at 309.
85. *Id.* at 310 n.16.
86. *Id.* at 310.

costs; otherwise the order would be confiscatory and illegal. In addition, the dissent pointed out that the individual producer could not be precluded from offering relevant proof of his costs to meet his burden of proving that his rates were just and reasonable.

Though one should not lose sight of the sharp division of the Supreme Court over the legality of the area approach, the majority found the new method of price regulation to be within the scope of the Commission's statutory power, in effect approving the adoption of a pragmatic standard in the regulation of producer rates.[87] The necessities of practicality explain the Court's approval: first, the administrative burden of regulating the individual rates of several thousand producers looms enormous; secondly, the business of producing natural gas simply does not lend itself to traditional rate-base calculations which produce any meaningful result. Although the Court found "no indication that the area method will fall short of statutory or constitutional standards," no just and reasonable area rate has as yet been determined. Any area rate promulgated must not be arbitrary; it must satisfy both statutory and constitutional requirements. Establishing the rates will be an extremely demanding task.

Many parties to the area proceeding continue to advance every possible argument against the area concept including the contention that the requirements of procedural due process are violated by group hearings. The second *Phillips* decision accepts, however, the adoption of a group procedure; and the Court on other occasions approved group rate-making under "just and reasonable" rate statutes.[88] Due process does include all "which is fair and decent according to the standards of our social order and time."[89] Of course the Commission must afford every opportunity for all to be heard.

Controversy over the area rate philosophy centers on the question ot whether any rate order which comports with the revenue requirements of the group as a whole must be struck down as not meeting the requirements of substantive due process if the mandate does not provide a "fair return" for each individual in the group. Assuming the validity of the order so far as it relates to those who receive just remuneration, would any producer who could recover his costs under the rate order be entitled to an increment above the ceiling to avoid a "taking of property" in violation of the fifth amendment of the United States Constitution.[90] Any discussion of this

87. For an excellent treatment of the question of price fixing vis-a-vis rate making, see Higgins, *The Legality of F.P.C. Regulation of Independent Gas Producers by Area Price Fixing*, 50 Geo. L.J. 250 (1961).

88. Taag Bros. & Moorhead v. United States, 280 U.S. 420 (1930); The New England Divisions Case, 261 U.S. 184 (1923).
184 (1923).

89. Wisconsin v. FPC, 303 F.2d 380, 388 (1961).

90. "[N]or shall private property be taken for public use, without just compensation." U.S. Const. amend. V.

question of confiscation should be divided on the basis of the validity and effect of an area rate order as to (1) new contracts entered into after the establishment by the Commission of the area price and (2) contracts which were in existence prior to the establishment of the area price.[91]

With regard to new contracts, the producers are under no obligation to commit their gas to jurisdictional sales in interstate commerce; a choice to seek nonjurisdictional intrastate markets is available.[92] Thus, the five Justices who constituted the majority in the Supreme Court's second *Phillips* decision should encounter little difficulty in sustaining the constitutionality of area price regulation of new sales.

In *Bowles v. Willingham*,[93] the Supreme Court upheld the Emergency Price Control Act of 1942,[94] which authorized the fixing of maximum housing rentals under a "generally fair and equitable" standard on a class rather than an individual basis, even though some landlords would not be provided with fair rentals. A "taking" of property was not involved in this class regulation, because seciton 4(d) of the act specifically provided that "nothing in this Act shall be construed to require any person to sell any commodity or to offer any accommodations for rent."[95] By analogy, a producer's voluntary election to make a sale subject to area price regulation by the Federal Power Commission could not result in a confiscation or taking of his property.

Jurisdictional sales in existence prior to the Commission's determination of just and reasonable area prices present an entirely different question. Once a producer commences a jurisdictional sale of gas, he cannot abandon the transaction without approval of the Commission and a finding under section 7 (b)[96] of the act "that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment."[97] Producers are not afforded a choice of seeking a nonjurisdictional market.

91. It is recognized that there is disagreement over the scope of an area hearing as to whether rate filings made after the institution of the hearing and not consolidated therein should nevertheless be included in the order; however, it is believed that the answer to this question will turn on the validity of area rate-making itself.

92. This freedom of choice is clearly demonstrated by the *Catco* case, where the Supreme Court observed that the filing of a certificate application does not constitute a dedication to the interstate market, and that a producer is free, within the terms of his contract, to refuse a conditional certificate proposed by the Commission. 360 U.S. at 387, 388.

93. 321 U.S. 503 (1944). Since *Bowles* was decided on the basis of the war power, the case is of little precedential value in determining the constitutional limits of price-fixing.

94. Ch. 26, § 2(b), 56 Stat. 23.

95. 321 U.S. at 517.

96. 52 Stat. 824 (1938), 15 U.S.C. § 717f(b) (1958).

97. Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137 (1960); Sun Oil Co. v. FPC, 364 U.S. 170 (1960).

If reasonable area prices determined without regard to the needs or costs of an individual producer require him to reduce his contract price to a level which is confiscatory as to his production, an unconstitutional taking of his property has occurred.

The Commission may take the view that in instances where just and reasonable area prices would result in the confiscation of a producer's property, the constitutional issue can be avoided by permitting the producer to abandon service.[98] However, would this constitute a solution to the problem? Most producers commit their gas to the interstate pipeline companies under long-term contracts, usually for a period of twenty years or more. Although the Commission possesses the power to permit an abandonment of service, serious doubt exists as to the power that could be exercised in a manner contrary to existing contract rights between producers and the pipeline companies. In the landmark case, *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*,[99] the Supreme Court pointed out that the Natural Gas Act evidences no purpose to abrogate private rate contracts and except for the Commission's power to review the reasonableness of rates the contractual powers of the parties are no different than they would be in the absence of the act. The opinion comments upon the purpose of the act, "By preserving the integrity of contracts, it permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry."[100] Apparently, with respect to existing contracts, to avoid an unconstitutional taking of property through area price regulation the Commission must employ some escape device other than abandonment of service.

Supreme Court decisions relating to group regulation by the Interstate Commerce Commission mention that an individual carrier should be afforded the opportunity of showing that a group rate is not just and reasonable as to his operations. For example, in *The New England Divisions Case*[101] the Court attached to a group rate determination by the ICC a rebuttable presumption of reasonableness with regard to individual carriers, saying, "[S]erious injustice to any carrier could be avoided by availing of the saving clause which allows anyone to except itself from the order, in whole or in part, on proper showing."[102] The Supreme Court, in *North Carolina v. United States*[103] com-

98. See statements of the Commission's General Counsel made at oral argument before the Supreme Court in Wisconsin v. FPC, 373 U.S. 294 (1963). Record, p. 66. This suggestion has been implemented more specifically in the initial brief of the Commission's staff, pp. 34, 36 in the Permian Basin Area Rate Proceeding, 24 F.P.C. 1121 (1960).

99. 350 U.S. 332 (1956).

100. *Id.* at 344.

101. 261 U.S. 184 (1923).

102. *Id.* at 200.

103. 325 U.S. 507 (1945).

mented upon a similar rate determination by the ICC: the "very nature of such a broad general order requires that it contain a saving clause for future modification and adjustment of particular rates."[104] Whether the Federal Power Commission will include a saving clause in its determination of area rates remains to be seen.[105]

Other issues pertaining to area rates which will come before the Supreme Court include the question of whether the Commission, in granting a producer a temporary certificate to initiate a new sale, can impose a condition denying the producer the right to file under section 4 of the Natural Gas Act for contractually authorized price increases in excess of the Commission's interim, guideline area prices. The Supreme Court has granted a petition for writ of certiorari to a decision of the Court of Appeals for the Fifth Circuit striking down the imposition of this condition.[106] The Court of Appeals recognized that its decision would make it difficult for the Commission to hold the line on producers' prices in accordance with the instructions of the Supreme Court's *Catco* decision; however, "if the Commission may set aside section 4 and the rights, privileges and protections which it accords to a natural gas company subject to all of the obligations of the Act, then there is no end to the legislative tampering which the Commission may undertake."[107]

The foregoing material reflects some of the many problems encountered in area price regulation of producers. Other and more difficult problems will undoubtedly arise as the Commission continues its task of attempting to regulate the sale of a commodity by thousands of different producers with divergent interests and costs. It can be hoped that the best efforts of all interests will eventually devise an acceptable method of fixing gas prices on an area basis which can be functional within the framework of the Natural Gas Act and at the same time, satisfy the requirements of due process of law.

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104. *Id.* at 518.

105. In its Order Ruling Upon Motion Relating to Evidence to be Considered in Area Rate Proceeding the Commission held this question to be premature, but stated that it would not allow an individual cost-of-service presentation under any saving clause. 25 F.P.C. 614, 616-17 (1961).

106. H. L. Hunt v. FPC, 306 F.2d 334 (5th Cir. 1962), *cert. granted*, 32 U.S.L. WEEK 3126 (U.S. Oct. 14, 1963) (No. 273).

107. 306 F.2d at 344.