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HIGHLIGHT

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Senate Energy Committee Considers Two New Proposals for Natural Gas Reform

On 5/18/83 the Senate Energy Committee continued markup sessions on proposed natural gas legislation. The Committee proceeded to discuss aspects of Chairman James McClure's three-part proposal to modify S. 615 as introduced last week, but not before Committee members complained about a perceived lack of direction or goal in Committee deliberations on natural gas reform so far. Senator J. Bennett Johnston (D-La.) also introduced what he described as a natural gas compromise substitute for S. 615, which, following some discussion over administration of Committee rules, was relegated to future consideration only after a vote on McClure's proposal.

The lethargic progress of the markup of S. 615 to date elicited remarks from Senator Howard Metzenbaum (D-Ohio) that he "was beginning to wonder where we are going." Neither Johnston nor McClure had enough votes to win approval for their plans, he said, and in fact "no one has the votes for anything." He suggested that since no consensus would develop for an overall bill, it should be possible to "fragment" the legislation so some provisions at least could be presented to the Senate floor this year. Senator Wendell Ford (D-Ky.), who charged last week that DOE was holding up an unfavorable report on consumer effects under the Administration's bill, asked the Chairman to postpone further markup until after Memorial Day because the projected release date of the report on 5/25/83 makes it impossible for the Committee to do anything but "sit here and speculate." (The report is an EIA response to a request from Rep. Phil Sharp, Chairman of the House Subcommittee on Fossil and Synthetic Fuels.)

McClure rejected both requests, though he said Metzenbaum's suggestion that the bill be fragmented was "worthwhile" and he would not reject it out of hand. However, he is still convinced "if we cannot develop unanimous agreement (on the bill), we can get at least majority agreement." McClure added that he also did not know where the Committee was going, but he had proceeded cautiously to allow members an opportunity to establish their positions on the issues. Referring to Ford's request for postponement, McClure reiterated that time to act was diminishing for the Committee, so it should continue to discuss the two specific proposals currently before it regardless of the results of the EIA report.

In the ensuing discussion of the McClure amendment, the greatest enthusiasm for the proposal came from Senator Don Nickles (R-Okla.) who congratulated the chairman for addressing many of his own concerns. Senator Ford objected to McClure's proposal because he fears it would create a dual market giving unfair advantages to intrastate pipelines.

McClure described his amendment as a modification of the Administration's bill that assures a more orderly and phased transition to a deregulated market while leaving the market-out provisions relatively intact. Basically, it would extend market adjustments over a different timeframe, reducing the immediate impact of deregulated prices on consumers during the peak winter heating season. It would also maintain the availability of volumes of gas supplies in the marketplace during the transition period to full deregulation. At the same time, the proposal would address producer concerns by giving them a predictable cash flow on which to base their financial planning.

The Chairman's proposal would do the following:

(1) Move dates for market-out to 4/15/85-4/15/86 (from the current 1/1/85-12/31/85) and increase the notice period to 60 days.

(2) Give pipelines the option to compel a producer to continue deliveries under the contract after market-out is invoked until a new purchaser can take deliveries.

(3) Give the producer an option to compel the purchaser to continue takes under a contract at the lower of the applicable price or gas cap price until either the new purchaser can take deliveries or until 4/15/86, whichever is earlier.

As submitted to the Senate Energy Committee, Johnston's natural gas compromise substitute for S. 615 would do the following:

(1) Deregulate upon enactment "new new gas," defined as gas sold under contracts entered into after the date of enactment, as well as "renegotiated gas" sold under contracts expiring or renegotiated after the date of enactment.

(2) Establish a "free market price indicator," to be determined four months after the date of enactment and monthly thereafter, based on the weighted average price of "new new gas" contracts entered into during the three months prior to the month in which the determination is made.

(3) Where the price of gas under first sale contracts in effect on the date of enactment is above the free market price indicator, the contract price would be adjusted downward beginning four months after enactment, when the free market price indicator is first computed. The price adjustment mechanism would operate in 12 monthly increments to adjust the contract price to equal the free market price indicator 16 months after enactment. All contract price limitations would be removed 16 months after enactment, but the free market price indicator would be an upward limit on the operation of automatic contract escalator clauses for an additional 12-month period.

(4) Where the price of gas under first sale contracts in effect on the date of enactment is below the free market price indicator, the contract price will be adjusted upward beginning four months after enactment. The price adjustment mechanism would operate in 24 monthly increments to adjust the contract price so that the maximum lawful price would equal the free market price indicator 28 months after enactment. All contract price limitations would be removed 28 months after enactment, but the free market price indicator would operate as a permanent reference for area rate clauses.

(5) Allow reduction of minimum take-or-pay percentages under existing gas purchase contracts, at the option of the purchaser, to 65% of deliverability for the first year after enactment, and 70% for the second year. If this option were exercised, the volumes of gas not taken during the two-year period would no longer be dedicated under the Natural Gas Act, and could be sold to any other purchaser without an abandonment proceeding. A pipeline could not receive gas under a contract post-enactment if take-or-pay percentages for pre-enactment gas purchase contracts had been reduced as provided above. A pipeline may not reduce takes unless it has reduced takes from affiliated entities commensurately.

(6) Amend the guaranteed cost passthrough provisions of the NGPA to add a "prudency" test and to require a dollar for dollar passthrough for savings in gas purchase costs as a result of take-or-pay reductions, and maximum lawful price reductions due to the price adjustment mechanism.

(7) Amend the contract carriage provision already cleared by the Committee with respect to dates, and add a provision to disallow the 5¢ incentive allowance for transportation of gas owned by a pipeline's or local distribution company's affiliate.

The Johnston proposal would also include the following provisions of S. 615: (1) repeal of Natural Gas Act jurisdiction over first sales of committed or dedicated natural gas from S. 615; (2) repeal of provisions allowing reimposition of price controls and report to Congress; (3) authorization of certain interstate sales, transportation and assignments; (4) access to interstate supply sources; (5) repeal of certain sections of FUA; (6) incremental pricing repeal; and (7) technical and conforming amendments.

Continued debate and a possible vote on Chairman McClure's three-point proposal was placed on the Senate Committee's agenda for the next scheduled markup of S. 615 on 5/24/83. In the House, Philip Sharp's Subcommittee on Fossil and Synthetic Fuels has set a tentative date of 5/25/83 to begin markup of its own version of natural gas legislation. The House Subcommittee, however, has not set a specific time or place for the first session and has not decided on a vehicle, whether a committee print or bill, to develop its legislation.

Capitol Hill Club Seminar Features Panel on Contract Carriage and Competition for Natural Gas

A Congressional seminar on 5/17/83, sponsored by Congressman Berkeley Bedell (D-Iowa) and moderated by FERC Commissioner Oliver G. Richard, III, addressed the potential effect of contract carriage provisions on competition for natural gas if such provisions are included in reform legislation now before both houses of Congress. Eleven panelists presented a diversity of opinion ranging from outright disapproval of carriage to qualified or total support. Participants in the discussion represented consumer, Congressional and industrial interests. Few participants praised the recent markup of the Bradley contract carriage amendment in the Senate Energy Committee under Chairman James McClure. Several cited the lengthy Senate debate over potential load loss to local distributors as overdone. All members of the panel, regardless of special interest, agreed that contract carriage by itself would not have the desired effect of freeing up the natural gas market unless other contractual and regulatory problems are also addressed. Supporters of contract carriage regard the competition of alternative fuels as the greatest threat to the industry and contract carriage as the best assurance that gas consumers, and especially large industrial users, will have access to the cheapest supplies. Opponents predicted that the current gas surplus will be short-lived and that, as competition for reduced supplies increases, the larger and more powerful buyers will outmaneuver smaller concerns and cause disproportionate consumer price increases.

The panelists participating in the program included Kenneth Lay, President of Transco Energy Co.; Arthur Seder, Chairman of Michigan Wisconsin Pipe Line Co.; Jerry Keenan, staff member of the Illinois Commerce Commission; David Wilson, President of Natural Gas Equal Access; Cathy Hurwit of Citizen/Labor Energy Coalition; Gene Kimmelman, Staff Attorney for Congress Watch; Richard Storat, Energy Affairs Manager of Bethlehem Steel Corp.; Augustine A. Mazzei, Jr., Vice President and General Counsel of Equitable Gas Co.; Joseph Hydok, Senior Vice President of Consolidated Edison Co. of New York; William Johnson, Washington Representative of Michigan Consolidated Gas Co.; and Joseph Paul of Yankee Resources.

Several participants noted that very little background study or detailed analysis of the effect of contract carriage on each segment of the industry had yet been conducted in Congress. However, some panelists predicted future benefits from opening the gas markets to a greater number of purchasers. Storat of Bethlehem Steel, a large industrial user, saw little likelihood that large users historically dependent on local distribution companies (LDCs) would seek to circumvent their

accustomed suppliers in order to gain transportation from outside pipelines. It has always been difficult for industrial users purchasing supplies directly to obtain transportation from pipelines and local distribution companies, he noted. "We don't think we will be negotiating for gas by ourselves and we don't want to go into the gas utility business." However, while most industrial users will naturally want to retain their supplies from the LDC, contract carriage would give them a "club under the table," he said. The load loss problem for LDCs is overstated. The real issue centers on a choice, faced by LDCs today, between having no industrial gas load at all because of competition from No. 6 fuel oil or obtaining revenues from contract transportation of gas. The real load loss problem is related to alternative fuels not to competition between gas suppliers at the local level. Storat concluded that no one legislative provision will assuage the much larger gas marketing problem, however, and that contract carriage could only work in the context of deregulation of all natural gas prices and through contract corrections recommended by the Administration.

A supporter of Illinois' proposed Consumer Access Plan (entailing immediate conversion of interstate pipelines to common carrier status), 1/ Jerry Keenan also contended that Senate Energy Committee concern over the ability of industrial customers to go directly to the pipeline was of no consequence. First, such a direct linkage would be faced with the hurdle of obtaining certification under Section 7 of the Natural Gas Act for transportation involved in interstate commerce. Second, local rates are under the jurisdiction of state public utility commissions which make determinations on a cost basis. Such rate-setting provides little incentive for an industrial user to undertake the expense of hooking up with alternatives to its local supplier. Third, industrial customers do not have the power of eminent domain to facilitate direct hook ups to a pipeline. The expense, legal obstacles and overall inconvenience make such transactions unlikely, Keenan said. As the Bethlehem Steel representative, he viewed the real problem as fuel switching and the growing possibility that gas suppliers face a permanent loss of load as a result. In Illinois, for example, if gas prices are not brought into line with alternatives, there is potential for major industrial conversion to coal as well as No. 6 fuel oil. Conversion to coal would mean the gas is lost permanently. Keenan also said capacity problems are minor in character and occur primarily on peak load days in the winter. Some bottlenecks need to be reconciled, but most serious curtailment emergencies in the past resulted from supply shortages not lack of capacity, he noted.

William Johnson of Michigan Consolidated supported a form of mandatory contract carriage because an element of competition would benefit the market. Furthermore, such a restructuring would provide distribution companies with other business opportunities, such as gas brokering, which are not available to them now. In a practical sense, he added, unless something is done soon to protect industrial load, the distributors are going to lose the gas anyway. Michigan Consolidated lost half of its industrial load during the past year. Even if some load loss to distributors should result from direct purchases by industrial gas users from sellers other than the local distributor, the revenue gained by the distributor from transporting gas would reduce the impact of the loss, Johnson commented. The Bradley contract carriage proposal is worth considering as reasonable protection for the various parties involved in carriage, Johnson added, but he fears that an excessive amount of attention to this issue might cause everyone to forget about take or pay and other contract problems that must be addressed.

1/ The Illinois Consumer Access Plan has been introduced as H.R. 2565 by Rep. Corcoran and as S. 1119 by Senators Percy and Dixon. (See REPORT NO. 1411, pp5-6.)

Joseph Hydok of ConEd agreed with Hohnson's statement earlier that no one knows the long range implications of contract carriage. He concluded, however, that it was unwise to consider a quick fix. Overall reform is preferable to any restructuring based on a single issue such as contract carriage.

The Bradley contract carriage amendments are "onerous and essentially unworkable," Kenneth Lay of Transco stated. Lay contended that the Senate version of contract carriage had been expanded in scope enough to create another layer of regulation on the natural gas industry. Some form of carriage could work, however. Producers want a higher price for gas while the consumer wants a lower price. How that can be worked out is not clear, but at least both parties should be allowed the opportunity, he commented. Contract carriage could be the answer but only in the form of a reasonably simple bill that provides for voluntary, rather than mandatory, participation from the pipelines. Service obligations must also be protected so that existing customers are not hurt in the process.

Yankee Resources, Inc., a subsidiary of Yankee Oil & Gas Co., is engaged in arranging for the sale and transportation of natural gas to a variety of local users. As an experienced natural gas broker, Joseph Paul argued that it does not matter whether a pipeline transports gas or purchases gas so long as it can make its marginal profits. Furthermore, local distribution companies are not faced with a "doomsday scenario" under contract carriage, as some have characterized it. The distinction between load loss and revenue loss was not clearly made during consideration of the Bradley amendment, Paul said. The loss of load does not necessarily mean a distributor cannot recoup through providing transportation services. A brokered arrangement as provided by Yankee, however, would be the first to be curtailed by pipelines in the event of a shortage under current conditions, Paul noted.

Support for contract carriage was also expressed by David Wilson of the Natural Gas Equal Access Committee and, with qualifications, by CLEC's Cathy Hurwit. Wilson argued that natural gas needs to be moved more equitably on a national basis. Regional diversity in prices and access is too great under the current regulatory scheme. The only way to bring about a national market is to free the industry from its contracts, establish mandatory carriage for pipelines, and allow all users the opportunity to buy gas directly from the producers. No total solution will work without contract carriage. The restructuring of the industry must also include consumer protections by keeping the monopoly powers of all segments of the industry to a minimum. (Wilson's testimony before the Senate Energy Committee in early March is summarized in REPORT NO. 1406, App. pp11-12.)

Consumers are particularly concerned about industrial users who seek to avoid bearing their fair share of the costs, Hurwit stated. Co-ops and residential users also must get involved in the purchasing process and protect their interests, she said. Further, protection must be afforded to high priority users during supply shortages. Finally, she said, the Federal Government should not interfere with the jurisdiction of the local commissions because they tend to have a better handle on the issues with respect to local ratepayers.

Opposing contract carriage, Arthur Seder of Michigan Wisconsin stated that the Senate Energy Committee had only scratched the surface of the contract carriage problem, and the extent of the controversy there only confirmed his opinion that there is little basis for agreement. He warned that the current glut of "cheap" gas supplies was only the first surplus in 20-plus years. Eventually, there will be strong competition for supplies as prices moderate, he said, but gas shortages are impending and the cheap sources of supply will no longer be there. According

to Seder, three problems evolve from contract carriage. First, as illustrated by the Senate Energy Committee markup deliberations, the question arises as to what happens to the local distributor if the industrial customer signs up for alternative sources of gas supply. Secondly, contract carriage makes no reduction in the overall costs to gas users but, instead, shifts the costs to small industrial users and small distributors. The strong and powerful will eventually use their advantage to obtain the cheapest gas. Third, as a practical matter, the Bradley amendment does not account for the tremendously complex system of pipes and gas movements that take place in any pipeline system. "When you start assigning costs for transportation, there are going to be some very complex problems," Seder commented. As the systems operate now, there is a great deal more flexibility than would be provided under Bradley's carrier proposal or others, he said.

Equitable's Vice President echoed Seder's concerns and warned that supply management problems loom on the horizon under contract carriage. The whole new layer of regulation being considered is putting the distribution companies in the position of not being able to manage their supplies, he said.

Gene Kimmelman strongly urged that the free market should guide any undertaking to stimulate competition for natural gas, premised on ultimate deregulation of all gas prices. He asserted that Congress Watch gives qualified support to contract carrier ideas only to the extent that increased room is provided for competition. Kimmelman's greatest fear is that the industrial user may engage in "cream skimming" and will dump the largest share of the costs on the consumer public. If industrial users can be kept in line, and competition could be enhanced by providing equal treatment to interstate and intrastate pipelines while eliminating minimum bill requirements for distribution companies, Congress Watch would support a contract carriage provision. However, such legislation cannot be drawn up with a narrow view of the market. The consumer must be protected in either glut or shortage circumstances, Kimmelman argued. He noted that the Bradley amendment contained provisions addressing some of his concerns but, as others observed, it seems to be a package that is too complex to be fully understood.

Bills Introduced in Senate to Promote Select Use of Natural Gas in Large Industrial Boilers, and to Provide Subsistence Utility Rates for Elderly and Poor

On 5/4/83 Senator Ernest Hollings (D-S.C.) introduced a bill to repeal restrictions on the use of natural gas and oil in new or existing powerplants in order to reduce emissions that allegedly cause acid rain. The bill, entitled "Select Gas Use for Environmental Purposes Act of 1983" (S. 1211), would repeal sections of the Powerplant and Industrial Fuel Use Act which ban the use of either gas or oil in large industrial boilers, and would allow the concurrent burning of gas and other less "clean" fuels, such as oil and coal, in the same or separate boiler units. Hollings stated that this practice would obtain "the maximum benefit from the cleanest fossil fuel -- natural gas -- which emits virtually no sulfur or particulate matter when burned." Though enactment of the provision could cause shifts in fuel use patterns including the substitution of gas for coal, "in the short term increased use of gas should not prove to be problematical," he stated. Hollings agreed that using gas alone as a fuel source for the utility companies would not be the most energy-efficient practice, nor good conservation policy, but use in combination with other fuels is good environmental policy.

Hollings believes that concurrent use of gas in industrial boilers would reduce the nation's dependence on imported oil while increasing consumption of domestic coal and gas; would maintain or improve air quality; and would enhance the employment outlook for eastern and midwestern coal miners. The energy consumer would

benefit from cuts in overall fuel costs; reduction of fuel supply disruptions; increased flexibility in siting new facilities; and a less expensive pollution control option than purchasing pollution abatement equipment. The gains exceed the costs, Hollings asserted.

Besides repealing the automatic ban in FUA on the use of gas and oil in large boiler facilities, the Hollings' bill would also: (1) repeal the DOE's discretionary authority to ban gas or oil use by large existing industrial facilities; (2) retain the ban on gas and oil use in large new and existing powerplants except for the select use of gas to achieve environmental compliance by reducing emissions associated with direct coal combustion; (3) maintain the right of electric utilities to volunteer for mandatory conversion of powerplants from oil and gas to coal; and (4) repeal incremental pricing provisions.

An AGA report, cited by Hollings, concludes that a policy for gas use in conjunction with other fuels would be successful depending on a variety of site-specific variables, including emission limitations, fuel cost differences, oil dependence and equipment types. The best results are likely in the South Atlantic region; most of the Middle Atlantic region; East South Central and East North Central regions; and parts of the Pacific and Mountain regions.

* * * * *

Another utility-related bill was introduced in the Senate on 5/4/83 to provide lower utility rates for subsistence amounts of natural gas and electricity supplied to elderly and low income residential consumers. Senator Gary Hart (D-Colo.) introduced the "Utility Lifeline Rate Act of 1983" (S. 1204), requiring that all utilities, within two years of enactment, provide a special "lifeline" rate for their poor and elderly customers. The rate would be set either at the lowest rate the utility charges any of its other classes of consumers, or at 75% of the average cost of services to all customers, whichever is lower. Eligibility for such subsistence rates is granted to any head or principal wage earner of a household who is at least 65 years of age, or to anyone eligible for assistance under the Low Income Home Energy Assistance Act of 1981.

Within two years of enactment, a state public utility commission and each nonregulated electric or gas utility must provide public notice and conduct hearings to determine the rate level for the amount of electricity or gas necessary to meet essential needs -- including heating, lighting, cooking, food refrigeration, medical and other essential needs as defined by the PUC and the utility. Any natural gas or electricity consumed beyond the subsistence level would be billed at the normal residential rate.

Hart said his proposal was nearly the same as a bill he introduced in the Senate in 1977. The Senate approved the measure as an amendment to utility reform legislation. During subsequent conference proceedings, however, the amendment was deleted in favor of a provision requiring the DOE to file a report with Congress on possible lifeline rates.

Hart denounced the recent increases in home energy costs, suggesting that the dramatic increases in natural gas prices have had the most pervasive effect. Over 60% of the elderly and low income population heat with natural gas. During the winter, over 70% of the low income elderly spent more than 20% of their income to keep warm, he said. This year, the Citizen/Labor Energy Council testified before Congress that about 300,000 households will lose utility service, up 30% from last year.

"Current utility rate structures are not only inequitable, they are also wasteful," Hart declared. His bill would reverse the declining block rate structure in which industrial and large energy users get a quantity discount and therefore pay the lowest rates. Residential customers pay the highest rates, Hart said; and because large energy users enjoy lower rates, they have less incentive to conserve energy while residential users bear the greatest burden.

House Subcommittee Staff Calculates Incremental Unit Cost Close to $7.50 per Mcf for Added "Old Gas" Reserves Estimated by Shell Oil Under Total Deregulation

On 5/6/83 the staff of Rep. Philip Sharp's (D-Ind.) House Subcommittee on Fossil and Synthetic Fuels issued an analysis of the extra cost to consumers of producing 52 Tcf of added "old gas" reserves estimated by a recent Shell Oil Co. study to result if "forever controlled" natural gas reserves are deregulated. Assuming a $3.50/Mcf price for all old gas in the event of deregulation, the incremental cost of the added 52 Tcf was calculated at about $389 billion, or about $7.48/Mcf of added production. Furthermore, as the incremental production resulting from decontrol becomes smaller, the effective price per Mcf of that increment becomes higher, the staff noted. Consequently, under a recent ARCO study which projected 38 Tcf of additional old gas reserves from old gas decontrol, the marginal price of production would be about $8.94/Mcf. An even higher marginal price would result if DOE Secretary Hodel's estimate of 2.5 to 11 Tcf of extra "old gas" production were correct.

Shell released a study during testimony on 4/14/83 before Sharp's Subcommittee estimating that nearly 115 Tcf of "forever controlled" gas reserves would be produced if the NGPA continued to operate. Under total deregulation, however, Shell predicted a total of 167 Tcf could be produced from the same fields if sold for about $3.50/Mcf. (See REPORT NO. 1410, p8.)

The staff compared the cost of producing 115 Tcf of old gas reserves under current controls (at $1.70/Mcf) and 167 Tcf under Shell's estimated price for deregulated gas ($3.50/Mcf), arriving at a consumer cost of $195.5 billion and $584.5 billion, respectively. 1/ The staff also cautioned that if oil prices increased sharply in the future, Shell's projected marketclearing price would be too low, requiring an upward adjustment in that price and a corresponding increase in the incremental price of the added reserves. Conversely, a lower marketclearing price would lower the incremental price. "The calculations are in no sense a 'refutation' of the Shell study, or its methodology or conclusions," the staff memorandum said. "Instead, the analysis accepts all of Shell's conclusions and simply calculates the added cost of producing added reserves." However, since Congress should seek to receive the biggest supply "bang for the buck," the memorandum questioned whether "52 Tcf of additional production [would] be achieved at a lower price per Mcf, or more than 52 Tcf at the $7.48/Mcf price, if the $389 billion were directed to exploration and production of new gas?"

The Natural Gas Supply Association attacked the Subcommittee staff memorandum, charging that the calculations inflate the true cost of producing additional supplies by failing to include a factor for the reduction of the price of high cost gas supplies in a totally deregulated environment.

1/ The 3.50/Mcf deregulated price is in real 1983 dollars. The selected average price of $1.70/Mcf is a weighted average reflecting prices for a number of NGPA categories, plus 7¢/Mcf allowance for production-related costs and another 10¢ to account for "pattern" or "mix" changes over time.

Amoco and Superior File Suits in Louisiana State Court Challenging Price and Volume Reductions Adopted by Tennessee Under Emergency Gas Purchase Policy

During the past week, Amoco Production Co. and Superior Oil Co. filed suits in a Louisiana Court (15th Judicial District Court, Lafayette Parish) challenging price and volume reductions unilaterally adopted by Tennessee Gas Pipeline Co. under a new "emergency gas purchase policy" announced 5/1/83.

Tennessee adopted the emergency policy to reduce its weighted average cost of purchased gas and to stem further market loss. Under the policy, Tennessee will (1) reduce its annual minimum take-or-pay obligations to 50% of the seller's delivery capacity for Sections 102, 103 and 107 gas, and to 70% for Sections 104, 105, 106 and 109 gas; (2) nominate daily takes under each contract based on a formula reflecting the above take-or-pay percentages insofar as reasonably practicable; (3) reject deliveries by any producer in excess of nominated volumes or, alternatively, pay for such excess volumes at the minimum rate published monthly by the FERC; (4) reduce prices under currently exercisable market-out clauses to the applicable NGPA maximum lawful rates or $3.40/MMBtu (inclusive of all severance taxes, gathering charges and other similar fees and charges) ~~(5)~~ pay no more than the applicable lawful maximum price or, if none is applicable, 110% of the No. 2 fuel oil index published monthly by the FERC pursuant to NGPA Section 203 for purchases under contracts containing no currently exercisable market-out clauses; (6) refuse to recognize claims for take-or-pay payments unless the contract has been amended consistent with the emergency gas purchase policy, and unless the producer-supplier assures either delivery of makeup gas paid for but not taken, or refund of payments therefor; and (7) cease takes of Section 107 gas (deep gas, tight sands gas, or other incentive-priced gas) on 6/1/83 under contracts which contain no currently exercisable market-out, economic-out or similar clause, unless the producer has agreed in writing by 5/26/83 to amend the applicable contract consistent with Tennessee's emergency gas purchase policy. On 5/4/83 Tennessee filed an out-of-cycle PGA decrease of 40.84¢/dth, with a proposed effective date of 5/1/83, implementing the emergency gas purchase policy. (See REPORT NO. 1414, pp5-6.)

Amoco sued Tennessee for breach of contract obligation under some 26 contracts. A company vice president said Amoco could not "stand idly by" and allow one party to unilaterally impose new contract terms just because it no longer likes the terms to which it previously agreed. Specifically, the Amoco suit seeks a declaratory judgment that its 26 contracts with Tennessee remain valid and enforceable, that performance of contractual obligations by Tennessee is not excused or suspended by reasons of force majeure or any other reason, and that Tennessee cannot unilaterally amend or modify the contracts. Amoco also contested Tennessee's reduction of the price paid for an offshore Louisiana purchase to $3.40/MMBtu because of failure to comply with notice requirements that exercise of market-out rights "be accompanied by data or references to data relied upon by Buyer in its nomination of such new price."

Superior ~~also seeks~~ similarly asks for a declaratory judgment that all provisions of its five contracts with Tennessee remain in effect and that Tennessee continues to be obligated to take or pay for the minimum annual quantities stated in the contracts at the agreed price. In addition, Superior requested a preliminary injunction directed to one particular contract covering deregulated purchases ~~by Tennessee~~ from two deep wells in the Kaplan Field~~, Vermilion Parish, Louisiana~~ at a current contract price of $8.366/MMBtu. Superior said the two wells produce from a common reservoir along with a third well from which the production is sold intrastate at a current price of $3.39/MMBtu. If the two deep wells are shut in or production substantially

reduced, Superior noted the possibility of diversion of gas to the third well in the same reservoir, or irreparable loss of reserves due to the ~~circumstance of a~~ characteristics of the water drive reservoir. Superior further contended that operations at its Kaplan gas processing plant would become physically impossible without production from the two Section 107 wells. Accordingly, Superior asked the Court to enjoin Tennessee from ceasing purchases of gas from the two deep wells, from nominating less than its ratable share of total withdrawals from the reservoir involved, and from failing to take monthly minimum quantities. Finally, Superior claimed $6.9 million in damages due to Tennessee's failure to pay for deficiencies in annual takes under the Kaplan Field contract during the year ending 6/30/82, based on the prevailing contract price of $8.366/MMBtu, and failure to take 406,073 Mcf for the months of March and April 1983.

Other producers, including Texaco Inc. and Shell Oil Co., are reported also to be considering court action against Tennessee.

In the FERC, several producers petitioned to intervene with respect to Tennessee's PGA filing submitted 5/4/83. (A few producers also filed late petitions to intervene in Tennessee's onging rate proceeding, RP82-125-000, because of the impact of Tennessee's new policy on issues regarding the prudency of the company's gas purchasing practices.) For the most part, the producers noted their disagreement with Tennessee's emergency gas purchase policy and urged the Commission to avoid any endorsement thereof. Texaco, for example, said it would be improper for the Commission "to sanction, or appear to sanction, even indirectly, a policy which is predicated largely upon the abrogation of contracts (including certificated sales), before the legality of such unilateral action has at least been tested in an appropriate forum."

The New York PSC, by contrast, filed a notice of intervention in general support of Tennessee's PGA filing proposal to become effective 5/1/83. At the same time, however, New York protested Tennessee's continued payment of prices pegged to 110% of No. 2 fuel oil for deregulated gas under contracts where Tennessee failed to include market-out clauses exercisable before 1985. This lack of protective market-out provisions, New York stated, is only one aspect of an "abusive purchasing practice" resulting in excessive prices which should be denied passthrough under NGPA Section 601(c). New York claimed such prices were excessive due to "abuse or similar grounds."

Southern Natural Files Substantial Interim Rate Reduction in Advance of Expected Rate Settlement; Reduced Rates Reflect 21 Cent Drop in Average Gas Cost and Decrease in Requested Rate of Return from 17 to 13 Percent

On 5/18/83 Southern Natural Gas Co. (RP82-116-005 and TA83-2-7-003) filed interim rate reductions, proposed to be effective 6/1/83, amounting to 28¢, 37¢ and 45¢/Mcf in the company's three rate zones. 1/ The interim reductions, intended to stem a continuing loss of gas sales on the Southern System, were submitted in anticipation of a rate settlement expected to be filed on 5/24/83.

Southern's interim rate reductions primarily reflect (1) a decrease of 21.4¢/Mcf in the average cost of purchased gas to 294.55¢/Mcf, (2) a decrease from 17% to 13% in the rate of return on equity requested in RP82-116, ~~and (3)~~ a decrease in

1/ Pursuant to the interim reductions, Southern's commodity rates effective 6/1/83 under its principal two-part OCD rate schedule will be $3.23/Mcf in Zone 1, $3.31/Mcf in Zone 2 and $3.38/Mcf in Zone 3. These compare with commodity rates effective 4/1/83 of $3.51, $3.69 and $3.83 in the three zones, respectively.

(with equity representing 61.6% of capital structure)

the company's mainline depreciation rate to 3.0%. The reduced rates would remain in effect for a four-month period, 6/1/83-9/30/83. Southern added that its cost reduction program also entails an incentive systemwide sales target of 120 Bcf during the four-month period. Under this incentive plan, Southern will assume the risk, through a lower actual rate of return on equity, if the targeted system sales level is not achieved by its customers. Details of the plan, together with post-audit procedures, will be described in the settlement agreement to be filed in RP82-116.

The 21.4¢ decrease in Southern's purchased gas costs, amounting to about $107 million on an annual basis, will be implemented as an amendment to ~~the company's~~ most recent PGA filing (TA83-2-7), effective 4/1/83. ~~The decrease results from~~ (1) elimination of gas purchases originally projected from United Gas Pipe Line Co. through 9/30/83 and replacement of such volumes with lower cost gas supply; (2) a reduction in projected purchases of Mexican gas from Border Gas, Inc., ~~and replacement with lower cost gas supply; (3)~~ a reduction in the ~~price of remaining purchases from Border Gas based on the recent~~ Mexican border price ~~decrease~~ from $4.94 to $4.40/MMBtu; and (3) a reduction in the prices of projected deregulated gas purchases to reflect "the operation of contract price limitations." In this connection, Southern's amended filing shows virtually all of the company's deregulated gas purchases in the Oklahoma-Anadarko area at a price of $7.55 compared with prices reported mostly in the range of $8.82-$9.37 in its prior filing.

D.C. Circuit Affirms FERC Denial of AGD Request for Production of Gas Purchase Contracts Underlying Texas Eastern PGA Filing

On 5/13/83 the U.S. Court of Appeals for the D.C. Circuit affirmed an FERC order issued 9/8/81 (and 5/19/82 order denying rehearing) which denied a request by the Associated Gas Distributors for production of gas purchase contracts underlying a Texas Eastern Transmission Corp. PGA increase (TA81-2-17). AGD sought to examine the contractual basis for Texas Eastern's PGA filing. The Commission ruled that, absent specific allegations of fraud or abuse, a PGA proceeding is not the appropriate forum for inspection and review of gas purchase contracts. The Court affirmed the Commission because of AGD's right to challenge the rates involved and to obtain refunds in another proceeding. (Associated Gas Distributors v. FERC, No. 82-1758.)

The above PGA proceeding was one of several wherein AGD requested the Commission to require the pipeline to furnish copies of "new" gas purchase contracts, and to identify previously filed "old" gas contracts under which it claimed authorization to pay prices established in Sections 102, 103 or 107 of the NGPA. AGD claimed a right to inspect the contracts on which the pipeline relied to support the purchased gas costs shown in its PGA filing. The FERC held that the requested contractual information was not relevant to any issue in this proceeding. Further, the Commission stated, the concern expressed by AGD over the contractual authority of Texas Eastern's producer-suppliers to charge the rates shown in the pipeline's PGA filing "is very general and does not rise to the level of a specific protest . . . ." (See REPORT NO. 1365, pp16-17.)

The D.C. Circuit found AGD's reasoning "quite appealing" at first glance. Specifically, pipeline customers appear to be placed in a "Catch 22" situation: they must look at the underlying contracts to determine whether purchased gas costs are excessive, yet the Commission will allow them to review the contracts only if they have some evidence of excessive costs. However, the Court noted, AGD's argument ignores the fact that pipelines must agree to a full Section 4 review at least once every three years as a condition to using the PGA procedure. During this

full Section 4 review, the Court stated, "it is quite likely that if the question of contractual authority is raised, the Commission will require that the underlying contracts be produced." Indeed, in the currently pending full Section 4 review involving Texas Eastern, "AGD has intervened and the underlying contracts at issue in this case have been made available subject to a protective order." Furthermore, if an examination of the contracts between the producers and Texas Eastern during the full Section 4 review reveals that Texas Eastern has paid and passed through more than is required by contract, "Texas Eastern's customers, including AGD, have an adequate remedy. They may request that the Commission use its powers under Section 154.38(d)(4)(vi)(c) [of the Regulations] to order Texas Eastern to lower its rates and to refund all excess amounts collected since the last full Section 4 review. If for some reason the Commission is not itself empowered to order a refund, it is empowered to sue in district court to force compliance with the NGPA."

Hence, the Court observed, the situation here involves the following elements: "(1) a pipeline cannot use the PGA procedure without subjecting all of its costs and revenues to full review at least once every three years, (2) that full review encompasses all of the PGA proceedings during the relevant time period, (3) any legal or factual question relevant to those PGA proceedings is not mooted if it remains unanswered until the full review takes place, and (4) adequate relief remains available."

Because AGD's statutory right to complain is fully effectuated in the full Section 4 review, the D.C. Circuit concluded that the FERC had permissibly read the Natural Gas Act and NGPA to require production of the underlying contracts only if there were some evidence of fraud or abuse. However, the Court added, it would be forced to a different interpretation "if access to the contracts and the right to obtain a refund were unavailable in another proceeding."

The Court's decision was handed down by Judge Mikva for a panel also including Judges Edwards and Swygert (the latter sitting by designation from the Seventh Circuit).

D.C. Circuit, in 2-1 Decision, Affirms FERC Rejection of Transportation "Tracker" Proposed by United Gas Pipe Line

On 5/17/83 the U.S. Court of Appeals for the D.C. Circuit, in a 2-1 opinion, affirmed an FERC order issued 4/30/82 (and 7/1/82 order denying rehearing) which rejected an all-inclusive transportation "tracker" included in a United Gas Pipe Line Co. rate filing (RP82-57-000), but without prejudice to a demonstration by United during the scheduled rate hearing that the tracker should be adopted prospectively. The Commission cited its general prohibition against "trackers," albeit with exceptions, but found no reason to allow an exception here. A Majority of the Court (Judges Ginsburg and Friedman) held that the Commission exercised its discretion in a permissible and rational manner. Judge Wilkey, dissenting, would remand the case to the Commission for "meaningful consideration" of the tracker proposal. United Gas Pipe Line Co. v. FERC, No. 82-1833.

In requesting the Commission to waive applicable regulations and accept the proposed automatic transportation "tracker," United explained that its costs of transportation performed by others had quadrupled over the period 1977-1981 and had become an increasingly significant portion of total cost of service. United's rate filing submitted 3/31/82 showed a transportation cost component accounting for approximately 71% of all operating and maintenance expenses, exclusive of gas purchase costs. The proposed tracking mechanism, United asserted, would assure that it neither overrecovered nor underrecovered these "significant system costs."

By order dated 4/30/82, the FERC summarily rejected the requested tracker because of United's failure to demonstrate "good cause" for waiver of the Commission's anti-tracking regulations. However, as noted, this rejection was without prejudice to United attempting to justify the tracking mechanism during hearings on the justness and reasonableness of the company's filed rates. At the same time, the Commission accepted United's alternative proposal for a tracker limited to the costs of transportation by Northern Border Pipeline Co. United requested rehearing, contending that rejection of the overall transportation tracker was arbitrary and capricious, especially in view of the Commission's acceptance of similar tracking provisions in settlement agreements of various other pipelines, and would unreasonably subject it to nonrecovery of costs. In a 7/1/82 order denying rehearing, the Commission acknowledged that certain items of cost (purchased gas costs, R&D costs, and costs associated with the Louisiana First Use Tax) had been excepted from the general prohibition against trackers, but pointed out that permanent tracking provisions for these items had been implemented through rulemaking procedures, not individual tariff filings. The FERC also conceded that transportation trackers had been approved in rate settlement agreements, applicable for the life of the agreements, but it distinguished these limited duration arrangements from trackers which are permanent features of a pipeline's tariffs. In short, the FERC found that United's contentions "provide no basis to deviate from the Commission's regulations."

The D.C. Circuit identified the major question as whether the FERC arbitrarily denied United's request for a broad and immediate waiver of the Commission's regulation prohibiting cost trackers in rate schedules. Under controlling judicial precedent, the Court noted, those challenging an agency's denial of a waiver application must show that the agency acted arbitrarily by failing to give "meaningful consideration" to the application. ~~And,~~ As elaborated in WAIT Radio v. FCC (418, F.2d 1153), "'the agency is not required to author an essay for the disposition of each application'" but, in the usual case, need only provide enough for the reviewing court to discern the "why and wherefore." In this case, a Majority of the Court held that the explanation provided for rejection of the tracker in the Commission's rehearing order, "while it might have been more expansive," was nonetheless sufficient to discern the "why and wherefore" of the Commission's reasoning. Accordingly, in view of the Commission's long-held policy, the Majority concluded that the FERC denial of the requested waiver in advance of the Section 4 hearing was not based on grounds "so insubstantial as to render [the] denial an abuse of discretion."

The Majority also dismissed United's claim that the FERC's rejection of the proposed tracker, without prejudice to development of an evidentiary record during the Section 4 hearing, had the effect of suspending a portion of its rate filing for an indefinite period, hence violating the five-month suspension limit. Since the FERC could have rejected the tracker unconditionally, thereby denying United any immediate opportunity for further airing of the matter, the Majority found that the Commission, far from "truncating" United's rights under the Natural Gas Act, had accorded United "more than the minimum required by law."

Judge Wilkey, dissenting, contended that the explanation advanced in the Commission's rehearing order failed to give "meaningful consideration" to United's request. The order merely described the Commission's present policy and certain departures therefrom, but "completely failed to address United's main arguments." These arguments, in Judge Wilkey's view, were "compelling." First, United argued that the policy behind the Commission's general rule prohibiting trackers -- the desirability of considering all of a company's costs in determining whether rates

are just and reasonable -- would not be advanced by denying the tracker proposed here, especially since all of the transportation costs sought to be tracked were rates paid to other pipelines already subject to Commission review and approval as just and reasonable under Section 4 of the Natural Gas Act. 1/ Second, United contended that automatic adjustments to track changes in transportation costs would serve the interests of the company and its customers both by enabling flow-through of any short-term cost reductions, and by enabling United to develop newer reserves remote from its mainline system. Meaningful consideration of these arguments might have revealed some flaws, Judge Wilkey declared, "but the Commission did not address them at all . . . . When logical arguments like those advanced by United are rejected without any discussion of their merits, it is difficult to see how they could have been meaningfully considered."

In addition, Judge Wilkey was "disturbed" by the Commission's summary rejection of the requested tracker, while offering United an opportunity to support the tracker at a later hearing. "If United's waiver request was so meritless as to deserve the summary rejection it received, why consider it again in the Section 4 hearing?" Delaying consideration of the issue until later merely reinforces the "arbitrariness" of the Commission's initial decision to reject, Judge Wilkey declared. He further criticized the Commission's disregard of the five-month suspension procedures established by Congress for matters deemed to merit a Section 4 hearing. By indefinitely postponing deliberation of the tracker proposal, the Commission deprived United of "any assurance that it will be able to collect rates which may ultimately be found just and reasonable."

Accordingly, Judge Wilkey would remand the case to the Commission with instructions immediately to consider the tracker proposal and either reject it on the basis of legitimate reasons or accept it for filing. If a hearing is necessary, the Commission should accept the filing and, if appropriate, suspend its effective date, but not for more than five months.

1/ Judge Wilkey noted that transportation rates paid by United to intrastate pipelines are governed by NGPA Section 311(a)(2) which requires the Commission to determine that the rates are "fair and equitable." However, Judge Wilkey continued, the difference between "fair and equitable" rates and "just and reasonable" rates is rendered academic by NGPA Section 601(b)(2) which provides that, for purposes of Sections 4 and 5 of the Natural Gas Act, "any amount paid by an interstate pipeline for any transportation authorized by the Commission under Section [311(a)] shall be deemed to be just and reasonable if such amount does not exceed that approved by the Commission under such section." Hence, Judge Wilkey asserted, transportation rates approved as "fair and equitable" under Section 311(a)(2) are automatically considered "just and reasonable" costs under Section 4 of the Natural Gas Act.

Third Circuit Affirms FERC Method for Valuing Storage Gas Inventory in North Penn Rate Case

On 5/13/83 the U.S. Court of Appeals for the Third Circuit affirmed an FERC order issued 1/16/81 (and 3/29/82 order denying rehearing) which rejected the method employed by North Penn Gas Co. (RP79-68) to value storage gas inventory for purposes of determining a working capital allowance to be included in rate base. The Commission adopted a different method of calculation, yielding an allowance $5.4 million lower than the figure derived by the company, and ordered North Penn to make refunds attributable to its overvaluation of gas inventory. The Court held that the Commission's actions were within its statutory authority. North Penn Gas Co. v. FERC, No. 82-3212.

The amount of working capital allowance for gas storage inventory is a last remaining issue in a North Penn rate case which otherwise was resolved by settlement. The dispute essentially involves whether the beginning gas inventory should be valued at the higher, current price as North Penn contends, or at the lower, original cost as the FERC decided.

The component of the working capital allowance attributable to stored gas is defined in an FERC regulation as "the average of 13 monthly balances of . . . gas for current delivery from underground storage." A beginning balance and the balance in each of the succeeding 12 months provide the 13 monthly balances used in the formulation.

As the beginning balance, North Penn used current prices to value gas in storage as of December 31. The balance for each of the other months was determined by taking the amount of gas in storage at the end of the previous month, adjusting it by the net amount of injections and withdrawals for the current month, and then multiplying the resulting volume by the current weighted average cost of gas. North Penn contended that this methodology was consistent with the company's past practice and had been accepted by the Commission on prior occasions. The Commission concluded, however, that increasing the value of storage gas to current prices was improper and that the resultant rates were excessive. Instead of the company's approach, the Commission used the original cost of the volume of gas in storage as of December 31 as the beginning value balance. For each month during the ensuing year, the amount of injections into and withdrawals from storage was valued at the average LIFO cost of gas for the test year. As noted, the Commission's methodology yielded a working capital allowance $5.4 million lower than the allowance calculated by the company.

The Third Circuit rejected North Penn's contention that the Commission erred in not applying prior precedents. The Court noted that the company's methodology had previously been approved in a settlement where the pricing of stored gas was not challenged. In addition, because of the escalation of gas prices, the increase sought for stored gas in the present case was significantly higher than that sought in the earlier filing. Thus, "economic circumstances were not the same in both cases." Furthermore, the Court noted, "institution of the purchased gas adjustment, a practice not followed for any significant time in the past, has undermined the argument for increasing rates by raising inventory valuations. Because higher gas costs are now recovered quickly through the adjustment mechanism, the necessity of financing these gas purchases over a lengthy period of time has been eliminated." Thus, the Court concluded, North Penn's charge of unfairness because of the Commission's departure from prior orders is without merit. "The Commission is not bound to apply precedents rooted in grounds no longer germane."

The Court also rejected North Penn's claim that the Commission's calculation, by excluding some $5.4 million from its rate base, was confiscatory. The Court said the Commission is required to look at "the bottom line," namely, the reasonableness of the rate to be charged to the company's customers. "The inventory valuation is but one of the factors that must be examined to arrive at a rate fair to the company and customers alike."

Finally, the Court upheld the FERC's requirement of refunds. North Penn claimed that the Commission lacked the power to order refunds because the company followed the same methodology for determining the stored gas allowance as in previous cases, with the result that the Commission could change the methodology only prospectively under Section 5. In support, North Penn cited a 1980 decision of the D.C. Circuit (PSC of New York v. FERC, 642 F.2d 1335) which overturned the Commission's adoption of a new zone allocation method for Transcontinental Gas Pipe Line Corp. in a Section 4 rate proceeding because the pipeline had proposed no change from the status quo as to that portion of its rate filing. The Third Circuit said the D.C. Circuit's ruling in the Transco case was relatively narrow, as confirmed by two subsequent decisions holding that the Commission is not precluded "from reviewing a revised rate completely to assure that all its parts -- old and new -- operate in tandem to insure a 'just and reasonable' result and from ordering refunds if the previously approved [aspect] operates with new provisions to produce an overrecovery." Because the working capital allowance for gas in storage was an integral part of the rate increase North Penn requested in its Section 4 filing, the Third Circuit concluded that the Commission was authorized to direct refunds under Section 4(e) in this case.

The Court's decision was handed down by Judge Weis for a panel also including Judges Seitz and Becker.

Supreme Court Upholds FERC's "Full Avoided Cost" and Interconnection Rules to Encourage Cogeneration and Small Power Production

On 5/16/83 the U.S. Supreme Court, in an 8-0 opinion, reversed a D.C. Circuit decision which vacated two FERC rules, issued under Section 210 of the Public Utility Regulatory Policies Act, to encourage cogeneration and small power production. 1/ American Paper Institute, Inc. v. American Electric Power Service Corp., No. 82-34, and FERC v. American Electric Power Service Corp., No. 82-226.

1/ Section 210 of PURPA removed certain institutional obstacles to the development of small power production and cogeneration. These problems included the reluctance of traditional electric utilities to purchase power from -- and sell power to -- nontraditional generating facilities, and the financial burdens imposed by regulation of alternative energy sources by state and federal authorities. To overcome the first problem, Section 210 directed that the FERC prescribe rules requiring that electric utilities purchase electricity from, and sell electricity to, qualifying cogeneration and small power production facilities. The Commission was further directed to provide that utility purchases of electricity from a qualifying cogeneration and small power production facility be made at rates that are "just and reasonable" to the utility's customers and "in the public interest," nondiscriminatory with respect to the qualifying facility, and not in excess of the "incremental cost to the electric utility of alternative electric energy." To remove the second barrier inhibiting the development of nontraditional energy sources, Congress authorized the Commission to exempt qualifying facilities from federal and state regulation as public utilities if it determined that such exemption were necessary to encourage cogeneration and small power production.

(Footnote continued on next page.)

The two rules (1) required electric utilities to purchase electric energy from qualifying cogenerators and small power producers at a rate equal to each utility's "full avoided cost" (i.e., the cost the utility would incur if required itself to generate or purchase the electricity produced by the cogenerator); and (2) required electric utilities to make the physical interconnections necessary to accomplish sale and purchase transactions with qualifying facilities. The Commission concluded that evidentiary hearings were not required prior to making such interconnections.

The D.C. Circuit vacated both rules in a decision issued 1/22/82. First, the "full avoided cost" rule was remanded because of inadequate justification. The Court explained that the Commission failed to consider criteria other than "incremental cost" set forth in PURPA Section 210, particularly the requirement that rates for purchases by electric utilities from qualifying small power production and cogeneration facilities shall be "just and reasonable" to utility consumers and "in the public interest." By ignoring these statutory standards, the Court found that the FERC did not meet its obligation to provide the public with reasoned decisionmaking. Among other things, the D.C. Circuit suggested that the Commission should take a closer look at an approach based on a percentage of avoided cost. The Court stressed that the Commission "should allocate the benefits more evenly between the cogenerators and the utilities if the utilities can demonstrate that, under a percentage of avoided cost approach, an allocation less heavily favoring the cogenerators is in the public interest and the interest of the utilities' electric consumers, and will not disproportionately discourage cogeneration."

Second, the D.C. Circuit vacated the interconnection rule on the ground that it exceeded the Commission's authority. The Court of Appeals construed Section 210(e)(3) of PURPA as prohibiting the FERC from requiring utilities to interconnect with qualifying facilities without affording an opportunity for an evidentiary hearing under Sections 210 and 212 of the Federal Power Act in the case of each purchase and sale. (See REPORT NOS. 1351, pp34-35; 1387, pp37-39.)

The Supreme Court concluded that the FERC did not act arbitrarily or capriciously in promulgating the full avoided cost rule, which is the maximum rate permissible under Section 210(b). Such rule, the Court stated, plainly satisfies the statutory requirement that the rate not discriminate against qualifying cogeneration and small power production facilities. FERC also adequately explained why the rate is "just and reasonable to the electric consumers of the electric utility and in the public interest," the Supreme Court stated. Both the statutory language and the legislative history confirmed that Congress "did not intend to impose traditional ratemaking concepts on sales by qualifying facilities to utilities." And although

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(Footnote continued from previous page.)

In addition, Section 210(e)(3) of PURPA provided that "no qualifying small power production or cogeneration facility may be exempted from the provisions of Section 210 or 212 of the Federal Power Act . . . ." Sections 210 and 212 of the Federal Power Act empower the FERC, upon application, to order physical connection of any cogeneration or small power production facility, or the transmission facilities of any electric utility, with the facilities of the applicant. Upon receiving an application to connect facilities, the Commission must issue notice, afford an opportunity for an evidentiary hearing, and determine that the connection is in the public interest and will encourage overall conservation of energy or capital, optimize the efficient use of facilities and resources, and improve the reliability of any electric utility system.

FERC recognized that the rule would not directly provide any rate savings to consumers, the Commission reasonably deemed it more important at this time that the rule provide a significant incentive for the development of cogeneration and small power production, especially since "ratepayers and the nation as a whole will benefit from the decreased reliance on scarce fossil fuels, such as oil and gas, and the more efficient use of energy."

Nor did FERC exceed its authority in promulgating the interconnection rule, the Supreme Court declared. While the D.C. Circuit's "literal" reading of Section 210(e)(3) of PURPA is permissible, namely, that the FERC must afford an opportunity for evidentiary hearings before requiring utilities to interconnect with qualifying facilities, the Supreme Court concluded that the Commission's contrary reading is supported by the purposes of PURPA. "Providing an opportunity for evidentiary hearings before the Commission for every interconnection necessary to complete a purchase or sale under PURPA would seriously impede the very development of cogeneration and small power production that Congress sought to facilitate." There would be little incentive for many owners of qualifying facilities to purchase or sell electric energy if it were necessary to undergo an evidentiary hearing before FERC in Washington, D.C. every time they needed to hook up with a utility to consummate a purchase or sale, the Court observed. In short, the Supreme Court concluded, the FERC interconnection rule represented a "reasonable" interpretation of the relevant statutory provisions.

The Supreme Court's opinion was delivered by Justice Marshall. There were no dissents. Justice Powell took no part in the decision.

FERC Authorizes Midwestern to Abandon Sale of Canadian Gas to Tennessee

On 5/5/83 the FERC granted a request by Midwestern Gas Transmission Co. (CP77-459-002) for authority to abandon a sale to Tennessee Gas Pipeline Co. of up to 26,668 Mcf/d of Canadian gas purchased from TransCanada PipeLines Ltd. The primary term of the underlying import contract expired on 10/31/80, and the contract has continued on a year-to-year basis since that time. Tennessee requested cancellation of the sale. The Commission concluded that the proposed abandonment would have no significant impact on Midwestern or its customers and hence should be permitted. However, the Commission denied Midwestern's request to allow abandonment retroactive to 8/1/82. The company's application to abandon was filed after the requested effective date, the Commission noted, and no showing was made to justify retroactive relief.

In addition, the Commission noted Midwestern's desire to retain its existing import authorization for the subject gas in order to maintain greater flexibility to meet its customers' needs. Should Midwestern wish to transport or sell the imported gas for resale in interstate commerce, the Commission said it will have to file for appropriate authorization.

Importataion of the gas in question was authorized by ERA in March 1978. The following month, the FERC authorized transportation of the gas to Northern Natural Gas Co. in Minnesota, together with an exchange arrangement providing for redelivery of equivalent volumes by Northern to Tennessee in South Louisiana. (See REPORT NO. 1148, p4.)

FERC Adopts Final Rule Allowing Electric Utilities to Include Up to 50 Percent of CWIP in Rate Base

On 5/16/83 the FERC issued Order No. 298 (RM81-38) adopting new regulations to govern the inclusion of costs for construction work in progress (CWIP) in the rate base of public utilities. Under the new provisions, all electric utilities regulated by the FERC are allowed to file for wholesale rates based on inclusion in their jurisdictional rate base of up to 50% of investment in plant construction. However, during the first two years after the rule is enacted, a wholesale rate ceiling is set at 6% per year on the increase which can be attributed to CWIP. Nuclear fuel in process is included within the definition of CWIP. The new rule does not replace existing provisions that allow in the rate base all construction costs for pollution control and fuel conversion facilities. Finally, the rule requires cessation of the AFUDC capitalization on the amount of CWIP costs allowed in the rate base. 1/

In the process of considering a CWIP rate adjustment the Commission is now authorized to require the utility to submit information on construction plans and to examine the "prudence" of the programs before they are completed. The Commission stated that the new rule "will fundamentally reorient the Commission's assessment of the reasonableness of construction programs" by affording "an opportunity to review and judge the prudence of costs as those costs are incurred . . . rather than . . . when a project is completed or abandoned and a potentially unwise investment had already been made."

The Commission's objectives, based on lengthy hearings and consideration of many comments from interested parties, 2/ were threefold: (1) to reduce the bias which may discourage construction of new generating facilities; (2) to derive electric rates which more accurately reflect the costs of providing future service to existing customers and to allow the need for new capacity to be tested in the marketplace;

1/ Under FERC's previous policy, the allowance for funds used during construction (AFUDC) and the cost of construction are put in the rate base when the plant is placed in service. Until then, all costs of construction, including interest charged on amounts borrowed, are capitalized in a separate utility account and denied rate treatment. However, in a single exception, the FERC had previously allowed CWIP treatment for pollution control and fuel conversion facilities and in cases of financial hardship.

2/ For a period of six months ending on 1/15/82, the Commission received written initial and reply comments. Two days of oral presentations were also held. Comments were received from 33 federal and state government representatives, 11 firms serving the accounting and financial needs of the electric utility industry, 57 investor-owned utilities or groups, two natural gas utilities or industry representatives, 51 wholesale customers or groups of customers of utilities, 57 consumer representatives and consultants, and several hundred individuals who sent postcard comments. At hearings conducted by the FERC, 25 representatives of varied interests presented views.

Generally, investor-owned utilities and the financial community supported the inclusion of a significant portion or all CWIP in the rate case. The wholesale customers of primarily municipal and cooperative-owned utilities, retail consumer organizations, large industrial customers, and individual retail consumers and small businesses opposed inclusion of any CWIP in the rate base and instead favored continuation of AFUDC treatment. Government representatives, regulators and consultants were divided on the issue.

and (3) to establish greater rate stability and smoother increases in utility rates to consumers. The Commission hopes to give utilities greater flexibility to take advantage of favorable financial market conditions which, in turn, would lower capital costs flowed through to the consumer.

According to the Commission's analysis, the 6% cap per year on the wholesale rate increase attributable to CWIP would limit the average initial rate increase to wholesale customers to 3.57%. Less than 8% of all sales of electricity by privately owned utilities (measured by revenues) will be affected under the final rule. The consumer, as a consequence, will not be inordinately or adversely affected by the new policy. The Commission's rule allows utilities to recover from ratepayers only the financing costs on utility investment before the new plant is put in service, but will not allow recovery of principal invested in construction work before completion. Under the prior policy, the Commission noted that consumers were subjected to sudden sharp rate increases of as much as 30% when new generating units went into service. Consumer costs will now be spread out over a longer period of time. The new final rule brings an "equitable balance" that is needed between consumer and utility interests. The rule also modifies FERC's seven-year old policy which permitted utilities to earn a return on CWIP only when the utility could prove "severe financial difficulty," except for investment associated with pollution control and fuel conversion facilities. A utility no longer must show financial difficulty to qualify for CWIP.

The Commission defended the new rule as the intermediate position in a two-sided argument. On one side, wholesale power customers -- opposing the CWIP proceedings -- contended that the financial difficulties faced by the utility industry for many years had recently been greatly alleviated, especially as state regulatory commissions have increasingly recognized the need for higher rates. Furthermore, they argued, the extensive cancellations and deferrals of new capacity reflect a "belated recognition of sharply reduced growth in electricity demand, not the utilities' inability to obtain adequate financing." On the other hand, privately-owned utilities insisted that the industry remains in difficult financial straits, leaving companies uncertain of their ability to finance immediate capacity expansion needed to meet future needs. Because of inability to earn the allowed rate of return, current cash flow is reduced, thus increasing the need for additional external financing. In turn, this increases risk and increases the actual cost of capital, the utilities contended. "Financial concerns also have tended to bias the industry's investment in favor of smaller facilities which may require less construction capital but which are more costly to consumers in the long run because of higher fuel and maintenance costs," they maintained.

The Commission concluded that "while the financial picture (for utilities) has improved over the last year, difficulties remain."

The final rule applies to 206 electric utilities whose wholesale rates are regulated by the Commission. Of these 206 companies, 183 are Class A or B investor-owned facilities -- those having annual electric operating revenues of more than $2.5 million and $1.0 million, respectively. Other regulated companies include 16 investor-owned utilities, three industrially-owned, two cooperatives, one state agency and one nonprofit organization. All are now eligible to include CWIP costs in their rate base.

An Environmental Assessment of the final rule issued concurrently by the Commission estimated that the price effect of a 50% CWIP policy on wholesale customers would be highest in the early years of the policy change and then would diminish. An EIA

study of the CWIP rule -- using a Midterm Energy Forecasting System and National Utility Financial Statement model and done on a regional and national basis for 1982-1995 -- found that the average price increase to wholesale customers nationally would be 1.10%, 2.27%, 0.56% and 0.69% in 1983, 1985, 1990 and 1995. The FERC study, however -- relying on a computer model designed to estimate impacts on utilities and customers of allowing some or all CWIP in the rate base and calculating initial year impacts for individual utilities rather than the EIA's multi-year regional estimates -- found that the average initial impact would be about a 4.70% increase in wholesale prices, but with a wide variation among utilities. With the 6% "cap" ceiling, the average price increase under the FERC study would fall to 3.57%.

The Environmental Assessment further concluded that (1) only one in 13 retail utility customers would be affected by the Commission's rule, and that only one in 77 establishments would experience an initial rate increase at about the 6% ceiling level; (2) internal cash flow for utilities would improve by an average of 13.08% initially, although "the total company impacts would vary depending on the ratio of FERC jurisdictional sales to total sales and to the extent that state and local commissions follow the FERC's CWIP policy," (3) the magnitude of savings in financial costs to utilities under CWIP is uncertain, but savings would occur either through reductions in the costs of debt and equity capital or through increased flexibility in timing and choice of security issuances; (4) the final rule, on an industrywide basis, would have only minor impact on utility investment decisions and fuel choices; and (5) in terms of environmental impact, the CWIP rule would primarily cause a decrease in demand and cut back coal use in many regions.

FERC Chairman Butler Rejects Recusal Motion Against Him in CWIP Rulemaking

FERC's Chairman Charles Butler, III, in response to a motion of the American Public Power Association (APPA) that he recuse himself from participation in the CWIP rulemaking (RM81-38), issued a statement with the final rule on 5/16/83 that grounds did not exist to justify his disqualification from the decisionmaking process in this case. Arguing that "the law is clear that not all prejudgments subject quasi-legislative decisionmakers to disqualification," the Chairman charged that the credibility of the motion against him should be carefully scrutinized if the rule is brought for reconsideration before a court of appeals.

The request for his withdrawal from the rulemaking was initiated by the APPA after Butler expressed his opinion on the CWIP rule before "A Seminar on Utility Finances" sponsored by the World Energy Conference, U.S. National Committee, and Edison Electric Institute on 10/27/81. Focusing on a specific part of Butler's presentation, APPA complained, "it appears that Chairman Butler already has prejudged two of the fundamental issues in this case -- intergenerational inequities and the presumption against inclusion of CWIP (in the rate base)." His remarks, the Association charged, were evidence that Butler summarily dismissed other views, failed to recognize alternatives, and that he had "an unalterably closed mind."

Butler's decision not to recuse himself was supported by the FERC's General Counsel, Charles Moore. Butler admitted that there is much confusion in government over questions of what is at stake and how to analyze the facts when a motion for recusal and disqualification is filed against an administrative decisionmaker. However, a rulemaking requires the decisionmaker to choose between competing priorities in proposing rules and includes a general duty to acquire knowledge and perspective to the matter, he said. In other words, "ordinary rulemaking is impossible without some prejudgments by the rulemaker." He argued that the controversial remarks

which elicited the motion were clearly not reflective of an "unalterably closed mind" if read in the context in which they were presented. 1/

However, he added, it is necessary to address the question of what kinds of prejudgments necessitate recusal. In the strictest sense, "a decisionmaker must recuse himself if he has an irrevocably closed mind about an issue of adjudicative fact material in the decision in a matter pending before him." 2/ Furthermore, he continued, it is generally accepted that this standard applies more strongly to a quasi-judicial matter than to a quasi-legislative one. In the first case, open-mindedness and fairness is necessary to consider issues that are provable and subject to meaningful cross-examination. In the second case, matters of judgment are decided in the context of experience, general philosophy, and the like; "and it is virtually impossible for such facts to be decided with a complete tabula rasa."

Butler asserted that he, in a quasi-lawmaker position, subscribes to the view that agency commissioners should openly discuss policy issues pending before them in order to inform interested persons of those policy views. "To do so tends to maximize, if not optimize, the opportunity for debate of the issues and for feedback to the decisionmakers." In contrast, a liberal policy of disqualification "would have a chilling effect on the public's opportunity to learn the nature and extent of an agency's concerns about important issues of public policy, and would tend to discourage debate of the issues."

The Chairman also noted that, when confronted with the motion to recuse himself, he initially acted to put the matter before the other Commissioners for a vote in his absence. However, at least one Commissioner strongly objected to such a procedure, fearing that such a precedent could lead to divisions among the commissioners if future more difficult questions of recusal arise. Butler commented that he too, on reflection, agreed that "the prospect of such division among the Commissioners would probably outweigh the value of the procedure."

Issuing his own countercharges to the motion, Butler made three points: (1) the motion's discussion of the law is characterized by such an absence of legal scholarship as to be of concern; (2) mischaracterizations of his speech through omission of material parts are plausibly knowingly false, and raise questions under the Code of Professional Responsibility; (3) at least one of the allegations is "disingenuous on its face." He referred to the Association's claim that his rejection of the presumption against CWIP in the rate base is a forbidden prejudgment. "How is the rejection of a prejudgment itself a forbidden prejudgment," Butler asked. "In sum, I believe that the credibility of the motion itself is a matter for careful scrutiny." (See REPORT NO. 1347, pp23-26.)

1/ "I shall accept . . . that the electric utility industry is, indeed, in poor financial shape. I shall also disregard the claims . . . that the financial condition of the utilities is improving . . . . There seems to me to be little merit to arguments about intergeneration inequities. I disagree with the Staff position -- contained in our notice of proposed rulemaking -- that there should be a presumption against the inclusion of CWIP in rate base. There appears to be three reasons why . . . CWIP might be . . . desirable . . . ." Those reasons were: adequately compensating the company for lack of receipt of cash earnings, receiving revenues if a generating project fails or does not go on line, and meeting the capital market's preference for cash income.

2/ FTC v. Cement Institute, 333 U.S. 683 (1948).

FERC Staff Director Orders Pipelines to Submit Projected Gas Supply and Requirements Data for 1983-1984 Winter in Order to Assess Potential Impacts of Any Service Curtailments

On 5/13/83 the Director of FERC's Office of Pipeline and Producer Regulation (OPPR) ordered 24 interstate pipelines -- Algonquin Gas Transmission Co. et al. (TC83-8 et al.) -- to file information regarding their projected gas supply status during the 1983-1984 winter. The purpose is to provide the Commission with the best information available on gas supplies and any potential adverse curtailment impacts prior to the 1983-1984 winter in order that it may take any action necessary to ensure adequate natural gas service.

OPPR has directed the filing of similar data in each of the previous seven years to determine anticipated curtailment impacts in the upcoming winter periods. Based on the pipeline submissions, the Staff has concluded each year that, assuming normal weather conditions, the impact of projected gas curtailments during the winter months should be manageable, without any significant economic dislocations. Staff's last two reports assessing the situation for the 1981-1982 and 1982-1983 winters indicated no significant industrial or commercial dislocation or shutdowns from pipeline curtailments, even if the weather were colder than normal. (See REPORT NOS. 1104, pp14-15; 1123, pp16-18; 1129, pp21-31; 1159, p18; 1205, pp15-16; 1228, pp5-7; 1257, p21; 1281, pp10-11; 1315, pp21-22; 1335, pp9-10; 1385, p16.)

Specifically, the 24 pipelines were directed to file information by 8/1/83 on (1) total gas supply projections, including a detailed breakdown of deliveries from all supply sources by month, anticipated new supply by month, any projected surplus supply by month, projected emergency purchases and "self-implemented" purchases (together with a description of the pipeline's policy regarding such purchases), status of ongoing storage injections, and working gas inventory anticipated in storage at the beginning of the heating season; (2) scheduled storage withdrawals by month under normal and colder than normal weather conditions, storage operation plans governing gas iwthdrawals and injections, scheduled storage operations during each month, and contingency plans for meeting colder than normal winter weather later in the season; (3) derivation of estimated requirements shown in the Form 16 report (including an explanation of any changes from the previous year) and a statement of requirements for each winter month assuming colder than normal weather; and (4) any projected curtailments by month assuming both normal and colder than normal weather conditions.

The Director of OPPR further directed the 24 pipelines to request information from their distributor customers (and direct industrial customers) regarding any possible industrial shutdowns next winter due to lack of an alternate fuel supply or alternate fuel equipment to offset projected natural gas curtailments, assuming both normal and colder than normal weather conditions. The distributors are to report this information to their pipeline suppliers by 7/1/83.

The Staff was directed to analyze the pipeline submissions and file a report with the Commission by 9/26/83.

New EIA Study Expected to Cast Doubt on Administration's Price and Supply Projections Under Its Natural Gas Decontrol Plan

According to the Wall Street Journal dated 5/20/83 as well as other reports, an Energy Information Administration study due to be released on 5/23/83 will contradict earlier Administration claims that consumer prices under its natural gas decontrol bill (S. 615, H.R. 1760) would drop 7%-11% below prices under the NGPA within one year after enactment. Some officials say the new study concludes that the average wellhead price of gas could be as much as 20% above the $2.95/Mcf average price predicted by DOE Secretary Donald Hodel for the end of 1985 if natural gas is totally decontrolled. The report is also reported to question arguments that total decontrol would stimulate gas exploration and production for the rest of the decade.

According to an earlier analysis by DOE, average wellhead prices and retail prices would fall about 33¢/Mcf below NGPA levels in the first year after enactment of the bill. As current surplus deliverability is reduced and as low cost reserves are depleted, wellhead retail prices would eventually rise to NGPA levels and would remain comparable for the rest of the 1980's. The DOE also estimated that deregulation of old gas prices would add at least 5 to 10 Tcf to the nation's supply of old gas.

The new EIA report has been expected for some time, but recent delays in its release date (originally set for 5/6/83) led some opponents of the bill to suspect that its results were unfavorable to the Administration's arguments. Senator Wendell Ford (D-Ky.), during the past two markup sessions of the Senate Energy Committee, expressed concern that the Administration was trying to adjust the report's results. Committee Chairman McClure rejected Ford's request on 5/18/83 that markup of S. 615 be discontinued until the study is made available.

Secretary Hodel told members of the National Petroleum Council on 5/19/83 that the report may "cast doubt" on the price forecasts used in the past by the White House to justify its decontrol efforts. However, the differences are likely to be a result of various assumptions about future world oil prices and other economic factors.

Last month, the General accounting Office submitted a report to the Senate Energy Committee predicting that S. 615 would result in national average prices 27¢ and 40¢ below those estimated under the NGPA in 1983 and 1984, respectively. (See REPORT NO. 1411, pp9-10.)