EB-2009-0242

ONTARIO ENERGY BOARD

ASSOCIATION OF MAJOR POWER CONSUMERS IN ONTARIO

APPLICATION TO REVIEW AMENDMENTS TO THE MARKET RULES MADE BY THE INDEPENDENT ELECTRICITY SYSTEM OPERATOR (“IESO”)

IESO BOOK OF AUTHORITIES

December 11, 2019

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ELECTRICITY ACT, 1998, SO 1998, C 15, SCH A

PART I
GENERAL

Purposes

1 The purposes of this Act include the following:

(a) to ensure the adequacy, safety, sustainability and reliability of electricity supply in Ontario through responsible planning and management of electricity resources, supply and demand;

(a.1) to establish a mechanism for energy planning;

(b) to encourage electricity conservation and the efficient use of electricity in a manner consistent with the policies of the Government of Ontario;

(c) to facilitate load management in a manner consistent with the policies of the Government of Ontario;

(d) to promote the use of cleaner energy sources and technologies, including alternative energy sources and renewable energy sources, in a manner consistent with the policies of the Government of Ontario;

(e) to provide generators, retailers, market participants and consumers with non-discriminatory access to transmission and distribution systems in Ontario;

(f) to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service;

(g) to promote economic efficiency and sustainability in the generation, transmission, distribution and sale of electricity;

(g.1) to facilitate the alteration of ownership structures of publicly-owned corporations that transmit, distribute or retail electricity;

(g.2) to facilitate the disposition, in whole or in part, of the Crown’s interest in corporations that transmit, distribute or retail electricity, and to make the proceeds of any such disposition available to be appropriated for any Government of Ontario purpose;

(h) to ensure that Ontario Hydro’s debt is repaid in a prudent manner and that the burden of debt repayment is fairly distributed;

(i) to facilitate the maintenance of a financially viable electricity industry; and

(j) to protect corridor land so that it remains available for uses that benefit the public, while recognizing the primacy of transmission uses. 2004, c. 23, Sched. A, s. 1; 2014, c. 7, Sched. 7, s. 1; 2015, c. 20, Sched. 9, s. 1; 2016, c. 10, Sched. 2, s. 1.

[…]

PART II
INDEPENDENT ELECTRICITY SYSTEM OPERATOR

[…]

Objects

6 (1) The objects of the IESO are,

(a) to exercise the powers and perform the duties assigned to it under this Act, the regulations, directions, the market rules and its licence;

(b) to enter into agreements with transmitters to give it authority to direct the operation of their transmission systems;

(c) to direct the operation and maintain the reliability of the IESO-controlled grid to promote the purposes of this Act;

(d) to participate in the development by any standards authority of criteria and standards relating to the reliability of the integrated power system;

(e) to establish and enforce criteria and standards relating to the reliability of the integrated power system;

(f) to work with the responsible authorities outside of Ontario to co-ordinate the IESO's activities with the activities of those authorities;

(g) to operate the IESO-administered markets to promote the purposes of this Act;

(h) to engage in activities related to contracting for the procurement of electricity supply, electricity capacity, electricity storage, transmission systems or any part of such systems and conservation resources;

(i) to engage in activities related to settlements, payments under a contract entered into under the authority of this Act and payments provided for under this Act or the *Ontario Energy Board Act, 1998*;

(j) to engage in activities in support of the goal of ensuring adequate, reliable and secure electricity supply and resources in Ontario;

(k) to forecast electricity demand and the adequacy and reliability of electricity resources for Ontario for the short term, medium term and long term;

(l) to conduct independent planning for electricity generation, demand management, conservation and transmission;

(m) to engage in activities to facilitate the diversification of sources of electricity supply by promoting the use of cleaner energy sources and technologies, including alternative energy sources and renewable energy sources;

(n) to engage in activities in support of system-wide goals for the amount of electricity to be produced from different energy sources;

(o) to engage in activities that facilitate load management;

(p) to engage in activities that promote electricity conservation and the efficient use of electricity;

(q) to assist the Board by facilitating stability in rates for certain types of consumers;

(q.1) to exercise the powers and rights and to perform the duties and obligations assigned to it under the *Ontario Fair Hydro Plan Act, 2017* and to engage in activities to facilitate the implementation of the *Ontario Fair Hydro Plan Act, 2017*, including,

(i) entering into agreements or arrangements with any person for the purposes of the *Ontario Fair Hydro Plan Act, 2017*,

(ii) engaging in activities related to making payments to and receiving payments as contemplated under the *Ontario Fair Hydro Plan Act, 2017* and related settlement activities;

(iii) REPEALED: 2019, c. 6, Sched. 3, s. 11 (1).

(r) to collect and make public information relating to the short term, medium term and long term electricity needs of Ontario and the adequacy and reliability of the integrated power system to meet those needs; and

(s) to engage in such other objects as may be prescribed by the regulations. 2014, c. 7, Sched. 7, s. 3 (1); 2016, c. 10, Sched. 2, s. 3; 2017, c. 16, Sched. 1, s. 43 (1); 2019, c. 6, Sched. 3, s. 11 (1).

[…]

MARKET RULES

Market rules

32 (1) The IESO may make rules,

(a) governing the IESO-controlled grid;

(b) establishing and governing markets related to electricity and ancillary services; and

(c) establishing and enforcing standards and criteria relating to the reliability of electricity service or the IESO-controlled grid, including standards and criteria relating to electricity supply generated from sources connected to a distribution system that alone or in aggregate could impact the reliability of electricity service or the IESO-controlled grid. 1998, c. 15, Sched. A, s. 32 (1); 2004, c. 23, Sched. A, s. 41 (1, 2); 2009, c. 12, Sched. B, s. 11 (1).

Examples

(2) Without limiting the generality of subsection (1), the market rules may include provisions,

(a) governing the making and publication of market rules;

(b) governing the conveying of electricity into, through or out of the IESO-controlled grid and the provision of ancillary services;

(c) governing standards and procedures to be observed in system emergencies;

(d) authorizing and governing the giving of directions by the IESO, including,

(i) for the purpose of maintaining the reliability of electricity service or the IESO-controlled grid, directions requiring persons, including persons providing electricity supply generated from sources connected to a distribution system, within such time as may be specified in the direction, to synchronize, desynchronize, increase, decrease or maintain electrical output, to take such other action as may be specified in the direction or to refrain from such action as may be specified in the direction, and

(ii) other directions requiring market participants, within such time as may be specified in the direction, to take such action or refrain from such action as may be specified in the direction, including action related to a system emergency; and

(e) authorizing and governing the making of orders by the IESO, including orders,

(i) imposing financial penalties on market participants,

(ii) authorizing a person to participate in the IESO-administered markets or to cause or permit electricity to be conveyed into, through or out of the IESO-controlled grid, or

(iii) terminating, suspending or restricting a person's rights to participate in the IESO-administered markets or to cause or permit electricity to be conveyed into, through or out of the IESO-controlled grid. 1998, c. 15, Sched. A, s. 32 (2); 2004, c. 23, Sched. A, s. 41 (2-6); 2009, c. 12, Sched. B, s. 11 (2).

General or particular

(3) A market rule may be general or particular in its application. 1998, c. 15, Sched. A, s. 32 (3).

Legislation Act, 2006*, Part III*

(4) Part III (Regulations) of the *Legislation Act, 2006* does not apply to the market rules or to any directions or orders made under the market rules. 1998, c. 15, Sched. A, s. 32 (4); 2006, c. 21, Sched. F, s. 136 (1).

Publication and inspection of market rules

(5) The IESO shall publish the market rules in accordance with the market rules and shall make the market rules available for public inspection during normal business hours

at the offices of the IESO. 1998, c. 15, Sched. A, s. 32 (5); 2004, c. 23, Sched. A, s. 41 (7).

Notice to Board

(6) The IESO shall not make a rule under this section unless it first gives the Board an assessment of the impact of the rule on the interests of consumers with respect to prices and the reliability and quality of electricity service. 2004, c. 23, Sched. A, s. 41 (8).

Transition

(7) All rules made before subsection 4 (1) of Schedule A to the *Electricity Restructuring Act, 2004* comes into force remain in effect until amended or revoked in accordance with this Act. 2004, c. 23, Sched. A, s. 41 (8).

(8), (9) REPEALED: 2004, c. 23, Sched. A, s. 41 (8).

Section Amendments with date in force (d/m/y)

Amendment of market rules

33 (1) The IESO shall, in accordance with the market rules, publish any amendment to the market rules at least 22 days before the amendment comes into force. 2004, c. 23, Sched. A, s. 42.

Notice to the Board

(2) The IESO shall give the Board a copy of the amendment and such other information as is prescribed by the regulations on or before the date the IESO publishes the amendment under subsection (1). 2004, c. 23, Sched. A, s. 42.

Board's power to revoke

(3) Despite section 4.1 of the *Statutory Powers Procedure Act* and section 35.1 of this Act, the Board may, not later than 15 days after the amendment is published under subsection (1) and without holding a hearing, revoke the amendment on a date specified by the Board and refer the amendment back to the IESO for further consideration. 2004, c. 23, Sched. A, s. 42.

Application for review

(4) Any person may apply to the Board for review of an amendment to the market rules by filing an application with the Board within 21 days after the amendment is published under subsection (1). 2004, c. 23, Sched. A, s. 42.

***Application of* Ontario Energy Board Act, 1998**

(5) Subsection 19 (4) of the *Ontario Energy Board Act, 1998* applies to an application under subsection (4). 2004, c. 23, Sched. A, s. 42.

Review by Board

(6) The Board shall issue an order that embodies its final decision within 120 days after receiving an application for review of an amendment. 2004, c. 23, Sched. A, s. 42; 2017, c. 2, Sched. 10, s. 1.

Stay of amendment

(7) No application for review of an amendment under this section shall stay the operation of the amendment pending the completion of the Board's review of the amendment unless the Board orders otherwise. 2004, c. 23, Sched. A, s. 42.

Same

(8) In determining whether to stay the operation of an amendment, the Board shall consider,

(a) the public interest;

(b) the merits of the application;

(c) the possibility of irreparable harm to any person;

(d) the impact on consumers; and

(e) the balance of convenience. 2004, c. 23, Sched. A, s. 42.

Order

(9) If, on completion of its review, the Board finds that the amendment is inconsistent with the purposes of this Act or unjustly discriminates against or in favour of a market participant or class of market participants, the Board shall make an order,

(a) revoking the amendment on a date specified by the Board; and

(b) referring the amendment back to the IESO for further consideration. 2004, c. 23, Sched. A, s. 42.

Section Amendments with date in force (d/m/y)

Urgent amendments

34 (1) Section 33 does not apply if the IESO files a statement with the Board indicating that, in its opinion, an amendment to the market rules is urgently required for one or more of the following reasons:

1. To avoid, reduce the risk of or mitigate the effects of conditions that affect the ability of the integrated power system to function normally.
2. To avoid, reduce the risk of or mitigate the effects of the abuse of market power.
3. To implement standards or criteria of a standards authority.
4. To avoid, reduce the risk of or mitigate the effects of an unintended adverse effect of a market rule.
5. A reason prescribed by the regulations. 1998, c. 15, Sched. A, s. 34 (1); 2002, c. 23, s. 3 (14); 2004, c. 23, Sched. A, s. 43 (1).

Publication of urgent amendment

(2) The IESO shall publish the amendment in accordance with the market rules at the same time or as soon as reasonably possible after the statement referred to in subsection (1) is filed. 1998, c. 15, Sched. A, s. 34 (2); 2004, c. 23, Sched. A, s. 43 (2).

Notice to the Board

(2.1) The IESO shall give the Board a copy of the amendment and such other information as may be prescribed by the regulations on or before the date the IESO publishes the amendment under subsection (2). 2004, c. 23, Sched. A, s. 43 (3).

Board's power to revoke

(2.2) Despite section 4.1 of the *Statutory Powers Procedure Act* and section 35.1 of this Act, the Board may, not later than 15 days after the amendment is published under subsection (2) and without holding a hearing, revoke the amendment on a date specified by the Board and refer the amendment back to the IESO for further consideration. 2004, c. 23, Sched. A, s. 43 (3).

Review by Board

(3) On application by a person who is directly affected by the amendment, the Board shall review the amendment. 1998, c. 15, Sched. A, s. 34 (3); 2002, c. 23, s. 3 (17).

Time for application

(4) The application must be filed within 21 days after the amendment is published under subsection (2). 1998, c. 15, Sched. A, s. 34 (4).

Effect of revocation by Board

(4.1) If the Board revokes the amendment under subsection (2.2),

(a) subsection (3) ceases to apply to the amendment; and

(b) the Board shall not proceed with any review that arises from an application that was made under subsection (3) before it revoked the amendment. 2009, c. 33, Sched. 14, s. 2 (5).

Note: On a day to be named by proclamation of the Lieutenant Governor, subsection (4.1) is repealed. See: 2009, c. 33, Sched. 14, s. 2 (6), 4 (2).

Stay of amendment

(5) An application under this section does not stay the operation of the amendment pending the completion of the review. 1998, c. 15, Sched. A, s. 34 (5).

Referral back to IMO

(6) If, on completion of its review, the Board finds that the amendment is inconsistent with the purposes of this Act or unjustly discriminates against or in favour of a market participant or class of market participants, the Board,

(a) shall make an order referring the amendment back to the IESO for further consideration; and

(b) may make an order revoking the amendment on a date specified by the Board. 1998, c. 15, Sched. A, s. 34 (6); 2004, c. 23, Sched. A, s. 43 (4).

Section Amendments with date in force (d/m/y)

Other reviews of market rules

35 (1) On application by a person who is directly affected by a provision of the market rules, the Board may review the provision. 2002, c. 23, s. 3 (20).

Exception

(2) Subsection (1) does not apply to a provision of the market rules that was reviewed by the Board under section 33 or 34 within the 24 months before the application. 1998, c. 15, Sched. A, s. 35 (2).

Review of market rule made by the Minister

(3) Subsection (1) does not apply to a provision of the market rules that was made by the Minister before May 1, 2002 unless the application is made before May 1, 2005. 2004, c. 23, Sched. A, s. 44 (1).

Restriction

(4) An application shall not be made under this section by a market participant unless the applicant has made use of the provisions of the market rules relating to the review of market rules. 1998, c. 15, Sched. A, s. 35 (4).

Stay of provision

(5) An application under this section does not stay the operation of the provision pending the completion of the review. 1998, c. 15, Sched. A, s. 35 (5).

Referral back to IMO

(6) If, on completion of a review under this section, the Board finds that the provision is inconsistent with the purposes of this Act or unjustly discriminates against or in favour of a market participant or class of market participants, the Board shall make an order directing the IESO to amend the market rules in a manner and within the time specified by the Board. 1998, c. 15, Sched. A, s. 35 (6); 2004, c. 23, Sched. A, s. 44 (2).

Publication

(7) The IESO shall, in accordance with the market rules, publish any amendment made pursuant to an order under subsection (6). 1998, c. 15, Sched. A, s. 35 (7); 2004, c. 23, Sched. A, s. 44 (2).

Further reviews

(8) Sections 33 and 34 do not apply to an amendment made in accordance with an order under subsection (6). 1998, c. 15, Sched. A, s. 35 (8).

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TAB 2

Ontario Energy Board

Commission de l'énergie de l'Ontario

EB-2007-0040

IN THE MATTER OF the *Electricity Act, 1998*, S.O.1998, c.15 (Schedule B);

AND IN THE MATTER OF an Application by the Association of Major Power Consumers in Ontario under section 33 of the *Electricity Act, 1998* for an Order revoking an amendment to the market rules and referring the amendment back to the Independent Electricity System Operator for further consideration, and for an Order staying the operation of the amendment to the market rules pending completion of the Board's review.

DECISION AND ORDER
(Issued April 10, 2007 and as corrected on April 12, 2007)

BEFORE: Gordon Kaiser
Presiding Member and Vice Chair

Pamela Nowina
Member and Vice Chair

Bill Rupert
Member

The Application

On February 9, 2007, the Association of Major Power Consumers in Ontario ("AMPCO") filed with the Ontario Energy Board (the "Board") an Application under section 33(4) of the *Electricity Act, 1998* (the "Act") seeking the review of an amendment to the market rules approved by the Independent Electricity System Operator (the "IESO") on January 17, 2007. The Board has assigned file number EB-2007-0040 to the Application.

The amendment that is the subject matter of the Application is identified as MR-00331-R00: "Specify the Facility Ramping Capability in the Market Schedule" and relates to the ramp rate assumption used in the market pricing algorithm within the IESO-administered markets (the "Amendment").

The specific relief sought in the Application is the following:

- an order under section 33(7) of the Act staying the operation of the Amendment pending completion of the Board's review of the Amendment;

- an order under section 33(9) of the Act revoking the Amendment and referring the amendment back to the IESO for further consideration; and

- an award of costs, such costs to be payable by the IESO.

On February 9, 2007, the Board issued its Notice of Application and Oral Hearing in relation to the Application.

Under section 33(6) of the Act, the Board is required to issue an order that embodies its final decision in this proceeding within 60 days after receiving AMPCO's application.

This is the first application of its kind to proceed to a hearing before, and a decision by, the Board. An earlier application by a different applicant and in relation to a different amendment to the market rules was subsequently withdrawn.

Although the Board has considered the entirety of the record in this proceeding, the Board has summarized the record only to the extent necessary to provide context for those findings.

The Amendment

The Amendment relates to the calculation of the energy price (the market clearing price or "MCP" that is calculated in five-minute intervals) in the real-time energy market administered by the IESO and, more specifically, to a change (from 12x to 3x) in the assumption that is made about the ramping capabilities of generation facilities when determining market prices.

The algorithm that is used to compute MCP – known as the “market schedule” and sometimes referred to as the unconstrained schedule – contains a parameter (the “TradingPeriodLength”) that specifies the ramp rate multiplier to be used in determining energy market prices. Ramp rate, which is usually expressed in MW per minute, indicates how quickly the output of a generation facility can be increased or decreased.

Prior to the Amendment, the market rules authorized the IESO (then known as the Independent Electricity Market Operator or IMO)[1] to establish the “TradingPeriodLength” parameter for the pricing algorithm but did not define its value. Prior to market opening, the value of the parameter was set at 60 minutes, which is the equivalent of a 12x ramp rate. Most generation facilities, and in particular those that typically set market prices, can change their output from minimum levels to full output in roughly one hour. The result of the 12x ramp rate multiplier is that the market schedule has since market opening assumed that generation facilities are able to ramp output up or down 12 times faster than is, in fact, the case. It is widely acknowledged that use of the 12x ramp rate multiplier was implemented as a temporary solution to address extreme price excursions that were experienced during testing prior to opening of the wholesale market.

Further examination of the ramp rate multiplier issue was initiated by the IESO in December, 2005. Stakeholder consultations ensued, principally through the Market Pricing Working Group as well as through the IESO’s Stakeholder Advisory Committee.

At the end of this examination, the IESO proposed to amend the market rules by setting the value of the “TradingPeriodLength” parameter at 15 minutes, which is the equivalent of a 3x ramp rate. To that end, on December 27, 2006, the IESO published the Amendment for comment. Five submissions were received in response; one from AMPCO opposing the Amendment and four from generators supporting the Amendment as a move in the right direction albeit not as the preferred solution. The Board of Directors of the IESO approved the Amendment on January 17, 2007, and it was published on January 19, 2007. The Amendment was scheduled to go into effect on February 10, 2007, the earliest date permitted by section 33(1) of the Act.

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[1] For convenience, this Decision and Order will refer throughout to the IESO even though, at the time relevant to the point under discussion, it may have been called the IMO.

Once implemented, the Amendment would result in the market schedule assuming that generation facilities are able to ramp output up or down 3 times faster than is, in fact, the case.

It is to be noted that the 3x ramp rate multiplier relates solely to the calculation of energy prices. The physical dispatch algorithm (known as the "real-time schedule" and sometimes referred to as the constrained schedule), which is used by the IESO to dispatch facilities to meet market demand in any given interval, reflects the actual ramping capabilities of generation facilities (in other words, the value of the "TradingPeriodLength" parameter is set at 5 minutes, equivalent to a 1x ramp rate).

The role played by, and the impact of, the ramp rate multiplier in the determination of real-time energy prices is discussed further below under the heading "Pricing and Dispatch in the Real-time Energy Market".

The Proceeding

A brief description of the issues and the orders issued by the Board is summarized below.

1. *Stay of Operation of the Amendment*

The Amendment had an effective date of February 10, 2007. AMPCO's arguments in support of its application for an order under section 33(7) of the Act staying the operation of the Amendment pending completion of the Board's review of the Amendment were that: (i) it is in the public interest to order the stay; (ii) there are legitimate concerns with respect to the Amendment that should be considered by the Board; and (iii) the balance of convenience favours a stay.

On February 9, 2007, the IESO filed a letter with the Board indicating that it consented to the stay of the operation of the Amendment, such consent being without prejudice to any arguments that the IESO might make in relation to the Board's review of the Amendment. The IESO noted that it had given due consideration to the balance of convenience and the short duration of the stay given the Board's statutory deadline for completion of its review of the Amendment.

By Order dated February 9, 2007, the Board stayed the operation of the Amendment pending completion of the Board's review of the Amendment and issuance by the Board of its order embodying its final decision on AMPCO's application for review of the Amendment. The Board noted in particular that the balance of convenience favoured a stay of the operation of the Amendment, particularly given the long history of the ramp rate issue in the IESO-administered markets.

2. Intervenors

The following parties requested and were granted intervenor status in this proceeding: the Association of Power Producers of Ontario ("APPrO"); Coral Energy Canada Inc. ("Coral Energy"); the Electricity Market Investment Group ("EMIG"); Hydro One Networks Inc. ("Hydro One"); the IESO; Ontario Power Generation Inc. ("OPG"); TransAlta Energy Corp. and TransAlta Cogeneration L.P. (collectively "TransAlta"); TransCanada Energy Ltd. ("TransCanada"); and the Vulnerable Energy Consumers Coalition ("VECC").

In addition, the Board received on March 30, 2007 a letter of comment filed by Constellation Energy.

3. *Procedural Order No. 1*

On February 16, 2007, the Board issued its Procedural Order No. 1. In addition to establishing the process and timelines for this proceeding, Procedural Order No. 1 also:

- indicated that cost awards would be made available in this proceeding to eligible intervenors, and solicited written submissions on the issue of the party from whom cost awards should be recovered;

- directed the IESO to file materials associated with the development and adoption of the Amendment; and

- identified the following as the issues to be considered in this proceeding:

  (i) is the Amendment inconsistent with the purposes of the Act?

  (ii) does the Amendment unjustly discriminate against or in favour of a market participant or a class of market participants?

4. *Cost Awards*

Requests for eligibility for an award of costs were made by AMPCO, VECC and APPrO. TransAlta reserved its right to apply for an award of costs should special circumstances arise in the proceeding. In its letter of intervention, the IESO also indicated that it would seek an award of costs.

In response to Procedural Order No. 1, four parties made submissions in relation to the issue of the party from whom cost awards should be recovered. The submissions are summarized in the Board's Procedural Order No. 2 issued on March 9, 2007.
The Board determined that cost awards in this proceeding should be recovered from the IESO, for the reasons stated in Procedural Order No. 2. The Board also determined that VECC, APPrO and AMPCO are eligible for an award of costs in this proceeding, subject to any objections that the IESO might wish to make for consideration by the Board. By letter dated March 16, 2007, the IESO indicated that while it accepts and respects the Board's decision regarding cost eligibility, it reserved the right to ask the Board to limit the amount of costs recoverable by parties objecting to the Amendment in the event that it appears, at the end of the proceeding, that some or all of the grounds for the objection ought not to have been advanced.

5. *Production of Materials by the IESO*

As noted above, among other things Procedural Order No. 1 directed the IESO to file materials associated with the development and adoption of the Amendment. By letter dated March 2, 2007, AMPCO alleged that the IESO's filing in response to Procedural Order No. 1 was deficient in a number of respects. By letter also dated March 2, 2007, the IESO replied to the allegations contained in AMPCO's letter, stating that there is no merit to AMPCO's allegations and that the IESO had produced all of the materials required by Procedural Order No. 1.

In its Procedural Order No. 2, the Board among other things ordered the IESO to produce certain materials, including material prepared by the IESO in the context of the Day Ahead Commitment Process and/or the Day Ahead Market initiative that directly relates to ramp rate (the "DAM/DACP Materials"). In ordering the IESO to produce the DAM/DACP Materials, the Board expressly recognized that the relevance of those Materials to the criteria set out in section 33(9) of the Act, which form the basis of the issues list set out in Procedural Order No. 1, is not clear. Procedural Order No. 2 thus also invited parties to make submissions on the issue of the relevance to this proceeding of the DAM/DACP Materials, and more specifically to the criteria set out in section 33(9) of the Act and the issues list set out in Procedural Order No. 1.

On March 12, 2007, the IESO filed a letter with the Board in response to Procedural Order No. 2. In that letter, the IESO stated that the nature and extent of the task involved in satisfying the document production requirements of Procedural Order No. 2 makes completion of the task within anything remotely close to the specified timeframe completely impractical. Without waiving any of its rights or accepting the relevance to this proceeding of the materials identified in Procedural Order No. 2, the IESO put forward a proposed plan to meet the Board's information requirements within the requisite timeframes. On March 14, 2007, AMPCO filed a letter with the Board expressing its concerns regarding the IESO's proposed plan. The concerns related principally to the scope of the IESO's production in respect of the subject matter and time period to be covered.

On March 14, 2007, the Board issued its Procedural Order No. 3. The effect of Procedural Order No. 3 was to revise the nature of the production required of the IESO under Procedural Order No. 2, generally in line with the proposed plan submitted by the IESO in its letter of March 12, 2007 but with the exception that the production should cover a longer period than that proposed by the IESO.

6. *Technical Conference*

Procedural Order No. 1 made provision for a technical conference to be held in this proceeding. On March 20, 2007, and in response to inquiries received by certain parties, Board staff communicated with the parties to confirm whether they wished to proceed with the technical conference. Based on the responses received to that communication, the Board decided to cancel the technical conference and the parties were so advised by Board staff on March 21, 2007.

7. *Submissions on the "Relevance Issue"*

On March 21, 2007, AMPCO filed with the Board a letter setting out a proposal for submissions on the issue of the relevance of certain materials to this proceeding. As noted above, in its Procedural Order No. 2 the Board invited parties to make submissions on the relevance of the DAM/DACP Materials. AMPCO's proposal, made with the consent of the IESO, was to the effect that AMPCO would provide the Board and all parties with a "comprehensive submission on the relevance of materials produced by the IESO in relation to a central theme contained in AMPCO's application: "that the Amendment violates fundamental principles of procedural fairness". The proposal also suggested that, rather than filing submissions in accordance with Procedural Order No. 2, parties should await production of AMPCO's comprehensive submission and respond to that document.

On March 22, 2007, the Board issued its Procedural Order No. 4 setting out the timeframe for the filing of AMPCO's submissions on relevance. The Board encouraged intervenors to make written submissions in response to those of AMPCO but, given the imminence of the commencement of the oral hearing, indicated that it would allow all intervenors to make oral submissions on the relevance issue at the beginning of the oral hearing.

Written submissions on relevance were filed by AMPCO, the IESO, APPrO and Coral Energy. The positions of the parties are summarized below under the heading "The Board's Mandate".

8. *The Oral Hearing and Final Written Argument*

The Board held an oral hearing in this proceeding, commencing on March 29, 2007 and concluding on March 30, 2007. The first day of the hearing was devoted almost exclusively to submissions by the parties on the "relevance issue", as described in greater detail below under the heading "The Board's Mandate". On the second day of the hearing, witnesses gave evidence on behalf of AMPCO, the IESO, APPrO and TransCanada, principally in relation to the nature and impact or effect of the Amendment. The position of the parties in this regard is discussed in greater detail below under the heading "The Impact of the Amendment".

During the hearing, proposals were also made by certain of the parties in relation to the filing of final written argument, and these were accepted by the Board. AMPCO filed its final written argument on April 2, 2007. VECC filed its final written argument on April 3, 2007. The following parties filed their final written argument on April 4, 2007: the IESO; APPrO; and TransCanada. OPG filed a letter with the Board indicating its support for the final argument filed by APPrO. Coral Energy did not file final written argument, but did indicate during the oral hearing that it would address the substantive issues associated with the Amendment through APPrO. AMPCO filed its written reply argument on April 5, 2007.

The Board's Mandate

The "relevance issue", as it has been referred to in this proceeding, arose initially in relation to the DAM/DACP Materials. As stated in Procedural Order No. 4, the issue is relevance of materials – and hence of the position or argument that the materials support – relative to the criteria set out in section 33(9) of the Act. This issue, of necessity, requires consideration of the scope of the Board's mandate on applications to review amendments to the market rules under section 33 of the Act.

As the proceeding progressed, it became clearer that AMPCO's views as to the scope of the Board's mandate differs markedly from the views of other parties. A number of the concerns raised by AMPCO regarding the Amendment relate not to the impact or effect of the Amendment, but rather to the process by which the Amendment was made by the IESO. Many of the materials filed by the IESO in response to the Board's Procedural Orders are relevant to those concerns, but have little or no relevance to the issue of the impact or effect of the Amendment.

The position of the parties in relation to the scope of the Board's mandate, as expressed in the written submissions filed in response to Procedural Order No. 4 and/or in oral submissions made at the commencement of the oral hearing, may be summarized as follows.

AMPCO's position is that the Board's mandate is not limited to the grounds set out in section 33(9) of the Act. Rather, the Board has a "plenary review jurisdiction" that would allow the Board to address what AMPCO alleges as significant failures of procedural fairness by the IESO. In support of its position, AMPCO referred to and relied on sections 33(4), 33(5) and 33(6) of the Act, on section 19(4) of the *Ontario Energy Board Act, 1998*, on the Board's authority to determine all questions of law and fact in all matters within the Board's jurisdiction, and on the Board's public interest role. On that basis, in AMPCO's view the criteria expressed in section 33(9) of the Act are better understood as the two instances in which the legislature has directed the Board on how it must exercise its review discretion, leaving the Board otherwise able to exercise its review discretion as the Board sees fit.

By contrast, the position of the IESO, APPrO, Coral, OPG and TransCanada is that the Board's mandate is limited by section 33(9) of the Act to a determination of whether (a) the amendment is inconsistent with the purposes of the Act; or (b) the amendment unjustly discriminates against or in favour of a market participant or a class of market participants. On that basis, whether the IESO has, and breached, a common law duty of procedural fairness or acted in a manner giving rise to a reasonable apprehension of bias (both of which allegations were denied by the IESO), are not matters for consideration by the Board on a market rule amendment review application under section 33 of the Act. Materials produced by the IESO that are relevant only to the IESO's processes in making the Amendment should therefore be disregarded. The IESO also specifically requested that the Board strike AMPCO's March 26, 2007 submission from the record.

On March 29, 2007, the Board rendered an oral decision on this issue. Specifically, the Board determined that its mandate under section 33 of the Act is limited to an examination of the market rule amendment against the criteria set out in section 33(9) the Act. The Board also ordered that any evidence relating to the IESO's stakeholdering process, including AMPCO's March 26, 2007 submission, be struck from the record. An excerpt from the transcript of the oral hearing that contains the Board's decision and order in this regard is set out in Appendix A to this Decision and Order.

The parties agreed to, and filed with the Board, a list of the materials affected by the Board's decision (i.e., those to be struck from the record and those to remain on the record).

The Impact of the Amendment

It remains for the Board to determine whether the Amendment is inconsistent with the purposes of the Act or unjustly discriminates against or in favour of a market participant or a class of market participants.

A brief summary of the position of the parties is set out below, followed by the Board's findings.

In order to better understand the position of the parties, however, it is necessary to provide some further context around the setting of prices in the IESO-administered energy market and the role that the ramp rate multiplier plays, if only at a high and simplified level.

1. *Pricing and Dispatch in the Real-time Energy Market*

The MCP, which is calculated in five-minute intervals, is determined using a market schedule (pricing algorithm) that calculates the price based on the most economical offers submitted by generators that would satisfy the demand for energy in a particular five-minute interval. Dispatchable generators receive the MCP for their output, and dispatchable loads pay MCP for the energy they consume. All other generators and loads receive or pay, respectively, the Hourly Ontario Energy Price ("HOEP"). HOEP is a simple average of the 12 MCPs determined for the hour. Ontario currently has a uniform pricing system and MCP (and thus HOEP) are the same everywhere in the province. The introduction of locational marginal pricing for the province, which has long been the subject of discussion, is not expected to occur at least in the short term. However, the IESO does calculate what the prices would be in different locations were locational marginal pricing to be in place. These are referred to as "shadow prices".

Three aspects of the market schedule are of particular relevance to this proceeding:

- the market schedule is "myopic", in that it ignores expected demand in future intervals and sets the MCP based solely on demand conditions in each five-minute interval;

- the market schedule ignores transmission constraints, and assumes for pricing purposes that the cheapest available generation facility anywhere in Ontario is available to satisfy demand in any interval when, in fact, it may be unavailable due to transmission constraints; and

- the market schedule assumes for pricing purposes that generation facilities are able to ramp output up or down faster than they might actually be able to do so (by a factor of 12 currently or by a factor of 3 under the Amendment).

By contrast, the algorithm used by the IESO to dispatch facilities has the following characteristics:

- the dispatch algorithm has, since 2004, incorporated multi-interval optimization ("MIO"), which "looks ahead" to expected demand in future five-minute intervals;

- the dispatch algorithm takes account of all physical constraints on the system; and

- the dispatch algorithm respects the actual ramping capabilities of generation facilities.

The result is that MCP does not necessarily reflect what the prices would have been had the prices been determined on the basis of the offers submitted by generation facilities that are actually dispatched to provide energy to meet demand in a given five-minute interval. The ramp rate multiplier allows the market schedule to set prices on the basis of generation facilities that are cheaper but unavailable due to actual ramping restrictions, and as a result reduces both price volatility and the average level of prices. The same can be said for the market schedule assumption that the system is unconstrained.

A consequence of the lack of complete alignment between the pricing algorithm and the dispatch algorithm is that generation facilities that were assumed by the market schedule to be supplying energy in a five-minute interval might not in fact be dispatched due to the presence of transmission or ramping constraints. A generation facility may have to be dispatched even though it had offered to supply electricity at a price that is higher than HOEP. These generation facilities will be “constrained on”, and under the market rules are entitled to an additional payment referred to as a Congestion Management Settlement Credit (“CMSC”) payment. Similarly, when a cheaper generation facility is not dispatched due to the presence of transmission constraints or because it can ramp down more quickly than a more expensive generation facility, the cheaper facility will be “constrained off” and also entitled to a CMSC payment. In both cases, the CMSC payment reflects the difference between HOEP and the offer made by the generation facility that has been constrained on or constrained off, as the case may be. CMSC payments are not reflected in the energy price, but are recovered through uplift charges from wholesale market participants on a pro-rata basis based on their energy consumption at the time at which the CMSC payments were incurred.

2. *Position of the Parties on the Impact of the Amendment*

The following summary is based principally on the final arguments filed by the parties. For the most part, these largely reflect the tenor of each party’s participation in this proceeding.

The position of the parties to this proceeding fall into two distinct camps: AMPCO and VECC oppose the Amendment while the IESO, APPrO, Coral Energy (through APPrO), OPG and TransCanada support it. The letter of comment received from Constellation Energy also supports the Amendment. TransAlta was not an active participant in this proceeding, but is one of the generators that indicated its support for the Amendment as an interim solution in response to the IESO's request for submissions referred to above. EMIG (of which Coral Energy and Constellation Energy Group Inc. are members) was also not an active participant in this proceeding, but noted in its letter of intervention its belief that "in order to support new private investment in generation, Ontario must transition towards a competitive market where prices reflect the true cost of power". Hydro One did not take a position in this proceeding.

A number of the arguments made by AMPCO and VECC challenge the validity or reliability of the IESO's assessment of the costs and benefits associated with the Amendment, and are therefore better understood if the position of the parties supporting the Amendment is presented first.

<u>Parties Supporting the Amendment</u>

Active participants in this proceeding that support the Amendment assert that the Amendment is consistent with the purposes of the Act and does not unjustly discriminate against or in favour of a market participant or a class of market participants. Certain parties have added that the evidence in this proceeding is overwhelmingly to that effect.

The IESO's position is that the Amendment is consistent with, and will promote, a number of the purposes of the Act. Specifically, the IESO submits that the Amendment will: enhance overall reliability, better protecting the interests of consumers in that regard (sections 1(a) and 1(f) of the Act); encourage conservation and demand management (sections 1(b) and 1(c) of the Act); promote economic efficiency (section 1(g) of the Act); and cultivate a financially viable electricity industry (section 1(i) of the Act). According to the IESO, the Amendment will contribute to the achievement of these objectives by: more closely aligning the dispatch and pricing algorithms; resulting in more accurate price signals for consumers and producers; reducing uneconomic exports out of Ontario with resulting efficiency gains realized through the mechanism of export arbitrage; providing immediate efficiency gains for the Province; reducing fossil fuel generation; and achieving a significant improvement in efficiency for the Ontario market.

The IESO further submits that the Amendment, a superior solution to the available alternatives (including incorporation of MIO in the pricing algorithm), will be simple and inexpensive to implement and will achieve the noted benefits with minimal, if any, impact on average prices for consumers. The IESO has estimated that the impact of the Amendment on HOEP will be an average 2.6 percent increase. However, the IESO has also estimated that the impact on consumer bills will be mitigated by: the export arbitrage response that is expected to follow implementation of the Amendment; the global adjustment; the rebate that is currently paid out on revenues earned by OPG on its non-prescribed assets (the “OPG Rebate”); savings in CMSC payments; and savings in Intertie Offer Guarantee payments (these being payments made to importers to reduce price risks for imports that result from the fact that they are scheduled based on pre-dispatch prices but settled on the basis of real-time prices).   After accounting for such mitigation, and based on 2006 market prices, the impact of the Amendment would, according to the IESO, vary from a net cost of $6.68 million or 0.004 cents/kWh (assuming an export arbitrage response of 50%, which the IESO considers conservative) to a net saving of approximately $13 million or 0.008 cents/kWh (assuming an export arbitrage response of 100%). As a supplementary mitigation measure, the IESO intends to disburse surplus funds from the transmission rights clearing account (the “TR Clearing Account”) over 12 consecutive months to begin in conjunction with implementation of the Amendment.

With respect to the issue of unjust discrimination, the IESO argues that discrimination, in the context of a market for electricity, refers to economic discrimination. As such, more must be involved than an economic advantage accruing to one party rather than the other. The IESO further states that, by lessening subsidies and better aligning prices and dispatch costs, the Amendment plainly lessens inappropriate economic treatment of market participants.

Similar to the IESO, APPrO submits that improvements resulting from implementation of the Amendment are consistent with the purposes set out in sections 1(b), 1(c), 1(f), 1(g) and 1(i) of the Act. According to APPrO, the Amendment addresses many of the challenges and inefficiencies resulting from the use of the 12x ramp rate multiplier by creating just price signals for generators and loads, and does so with minimal, if any, customer cost impacts. APPrO also argues that the effects resulting from the 12x ramp rate multiplier are prejudicial to, and discriminate against, consumers and suppliers. APPrO states that, by more closely aligning the pricing algorithm with the dispatch algorithm, the Amendment would mitigate those prejudicial and discriminatory effects (such effects including that consumers are not paying the true cost of the electricity they consume and are paying for inefficiencies through uplift charges).

TransCanada's position is that the Amendment will improve the operation of Ontario's competitive electricity market and, since many of the purposes of the Act have as their object the promotion of a competitive market, improvements to the market support the purposes of the Act. According to TransCanada, by moving the market closer to real prices, the Amendment will also specifically encourage conservation (section 1(b) of the Act) and promote the use of cleaner energy sources (section 1(d) of the Act). TransCanada also submits that market efficiency will be promoted by: more closely aligning the pricing and dispatch algorithms; increasing the internal consistency of the market rules; improving price signals and inducing more efficient investment; and improving price transparency and reducing less transparent uplift payments (by reducing CMSC payments). While not a perfect solution, in TransCanada's view the Amendment represents an important step in the right direction.

On the issue of unjust discrimination, TransCanada agrees with the view expressed by Coral Energy in submissions made before and during the oral hearing to the effect that "unjust" discrimination equates with "inefficient" discrimination.

Parties Opposing the Amendment

AMPCO and VECC take the position that the Amendment fails when considered in light of the criteria set out in section 33(9) of the Act, and should therefore be revoked and referred back to the IESO for further consideration.

AMPCO's position is that the Amendment is inconsistent with certain of the purposes of the Act. The purposes of the Act that underlie this position are: (i) ensuring the adequacy, safety, sustainability and reliability of electricity supply in Ontario through responsible planning and management of electricity resources, supply and demand (section 1(a) of the Act); and (ii) protecting the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service (section 1(f) of the Act). AMPCO also submits that the Amendment unjustly discriminates against consumers (by increasing prices) and in favour of generators (by providing "windfall profits" to generators – such as nuclear generators – that are unable to respond quickly to changing demand conditions).

In support of its position, AMPCO submits that the IESO is not at liberty to pick and choose the purposes of the Act that it will further while ignoring others in favour of perceived improvements in efficiency. The Act does not assign differing weights or priorities to the various purposes of the Act and, if anything, the protection of the interests of consumers has been given priority.

AMPCO also submits that the IESO's estimates of the costs and benefits of moving to a 3x ramp rate multiplier in terms of determining the wealth transfer implied by the Amendment are unreliable. According to AMPCO, the efficiency gains flowing from the Amendment, as articulated by the IESO and other parties, are: (i) not supported by economic theory having regard to the "Theory of the Second Best"; (ii) based on the mistaken view that uneconomic exports are principally the result of the 12x ramp rate multiplier rather than being largely attributable to Ontario's uniform pricing structure; and (iii) overstated. AMPCO states that, by contrast, the impact of the Amendment on consumers – a price impact variously estimated by the IESO at approximately $225 million, $197 million, $112 million and $100 million depending on whether the effect of arbitrage is taken into account – has been understated. AMPCO notes that a number of the price mitigation mechanisms identified by the IESO are of short (the OPG Rebate and the disbursement of funds from the TR Clearing Account) or uncertain (the global adjustment) duration or are speculative (export arbitrage), and a longer term price mitigation strategy is required. AMPCO also notes that the 3x ramp rate multiplier solution is inferior to incorporation of MIO in the pricing algorithm, which is a superior solution that could be implemented at a modest cost, and is not the preferred option identified by any market participant.

In its reply argument, AMPCO submits that the evidence in this proceeding does not, contrary to the position expressed by APPrO, answer the question of whether the Amendment will result in a HOEP that more closely approximates the price that would result were the pricing and dispatch algorithms perfectly aligned. AMPCO also submits that the evidence does not address what the "true cost" of electricity might be, nor how such notion compares based on the current HOEP versus HOEP calculated on the basis of the Amendment. Moreover, given the hybrid nature of the market, prices are not in AMPCO's view expected to have more than a marginal impact on investment decisions. AMPCO also notes that, contrary to the view articulated by TransCanada, the Act does not have as one of its objectives the promotion of a competitive market.

VECC's position is that the Amendment unjustly discriminates against consumers because it results in a pricing algorithm that moves away from, rather than towards, the prices generated by the IESO's dispatch algorithm, resulting in overall inefficiency in the setting of HOEP by unjustifiably increasing the prices consumers pay on a province-wide basis. While agreeing that the Board's role is not to "remake" the IESO's decision in relation to the Amendment, VECC submits that the Board must determine whether the decision-making process was sound and led to a reasonable result in that: the issue was clearly defined; the criteria used by the IESO were comprehensive and consistent with the purposes of the Act; and the criteria were applied on a consistent and balanced basis throughout the decision-making process. VECC argues that the IESO's characterization of the issue changed over time from a focus on the differences between the pricing algorithm and the dispatch algorithm to a focus on inefficient exports. According to VECC, there is no confidence that the Amendment is the best way to address the newly framed issue without unjustly discriminating against consumers. In VECC's view, the IESO should therefore be directed to reconsider alternative solutions to the inefficient export issue that do not unjustly discriminate against consumers by inexplicably raising domestic prices.

VECC also expressed concern regarding use of the IESO's cost/benefit analysis as the measure of economic efficiency for changes in rules dealing with the market schedule and the determination of energy prices, noting that: uneconomic exports are largely the result of the fact that Ontario has uniform pricing; the IESO has narrowly redefined the issue of economic efficiency as reducing exports to New York; certain of the benefits that the IESO has identified in relation to the Amendment are unsubstantiated; and any amendment to the market rules that increased market prices would be judged as economically efficient when based on the IESO's analytical framework.

3. *Position of the Parties on the Burden of Proof*

An issue that arose most squarely in the exchange of final written argument is the question of which party bears the burden of proof in an application under section 33 of the Act.

Certain references in the IESO's final written argument make it clear that, in the IESO's view, in an application under section 33 of the Act the burden of proof is on the applicant to demonstrate that the market rule amendment is inconsistent with the purposes of the Act or is unjustly discriminatory.

AMPCO takes a different view, and submits that the burden of proof is ultimately on the IESO to show that the market rule amendment at issue in fact satisfies the test to be applied by the Board as set out in section 33(9) of the Act. In support of that view, AMPCO notes that a market rule amendment review is fundamentally different from a more typical proceeding before the Board in that, among other things, applicants have no ability to pursue the relief of their choice by seeking an alternative or different amendment to the one adopted by the Board of Directors of the IESO. AMPCO also notes that the 60-day timeline within which the Board must issue its order on an application under section 33 of the Act supports AMPCO's position on the burden of proof issue. It would be patently unreasonable to expect that any applicant could develop a traditional applicant's filing complete with a full array of econometric and other analyses in the time allowed.

4. *Board Findings*

a. The Burden of Proof

In applications before the Board, the burden of proof is typically on the applicant to satisfy the Board that the requested relief should be granted. The Board certainly expects that the IESO will participate fully in proceedings relating to applications under section 33 of the Act in support of the amendment that is under review. However, the Board has heard no compelling reason that would cause it to take a different approach and place the burden of proof on the IESO in the circumstances of this case.

b. The Merit of Addressing the 12x Ramp Rate Multiplier Issue

Before turning to an examination of the impact or effect of the Amendment, the Board considers it useful to provide further context regarding the history and impact of the 12x ramp rate multiplier in the marketplace. Several parties noted that, as the wholesale market was designed for implementation at market opening, inputs to both the pricing algorithm and the dispatch algorithm were aligned in relation to the value to be used to reflect the ramping capabilities of generation facilities (in both algorithms, the value of the "TradingPeriodLength" was set at 5 minutes). To this day, that remains the case for the dispatch algorithm. As noted above, however, prior to market opening the market rules were amended to allow the IESO to set a different value for the "TradingPeriodLength" parameter in the pricing algorithm as a temporary measure to address extreme real-time price excursions that occurred during market testing. This is reflected in the "Explanation for Amendment" contained in market rule amendment proposal MR-00189-R00, dated April 16, 2002, which proposed the amendment to the market rules that would allow the IMO the discretion to set the value of the TradingPeriodLength parameter in the pricing algorithm:

> The proposed amendment would permit the IMO to establish a longer Trading Period Length in the market schedule (unconstrained) to overcome the [price excursion] problems identified above. With a longer Trading Period Length within the market schedule (unconstrained), generation facilities will have large ramping capability and there will be less need to select additional higher cost resources to meet the increasing demand. As a result, less extreme price excursions will occur.
>
> The real-time schedule (constrained) will continue to use the 5 minute Trading Period Length. Therefore, discrepancies will increase between the real-time schedule and the market schedule (unconstrained). As a consequence, congestion management settlement credit (CMSC) payments will increase. However, the decreases in energy prices, resulting from the change in the ramp time in the market schedule, are expected to offset increases in CMSC payments.
>
> It should be noted that using a longer Trading Period Length in the determination of the market schedule is judged to be a transitional provision. It is expected that a longer term solution will need to be considered which could include a day-ahead market with unit commitment, increased generator self-scheduling, contracted ramp capability, or multi-period optimization.

The Board has not heard any evidence in this proceeding that would point to the introduction of the 12x ramp rate multiplier as having a basis rooted in market economics. To the contrary, the evidence in this proceeding is that the 12x ramp rate multiplier distorts wholesale market prices downwards and engenders adverse consequences for the marketplace in the form of generation and demand side inefficiencies. For example, dampened wholesale prices diminish incentives for conservation, load management and demand side management. The evidence in this proceeding is also that the 12x ramp rate multiplier contributes to inefficient exports. Inefficient exports, in turn, can increase the need for coal-fired generation to meet Ontario demand and thereby contribute to increased emissions. These adverse consequences were identified and discussed at some length in the evidence filed by, and the testimony given on behalf of, the IESO and APPrO, and are also discussed in the evidence filed by TransCanada. That adverse consequences flow from the 12x ramp rate multiplier was not seriously contested by evidence to the contrary filed by

AMPCO, although AMPCO did challenge the strength of any causal connection between the 12x ramp rate multiplier and inefficient exports.

The Board also notes that the 12x ramp rate multiplier issue has been the subject of comment by the Market Surveillance Panel. Specifically, the potential adverse market impact of the 12x ramp rate multiplier has been referred to or discussed in the following Market Surveillance Panel semi-annual monitoring reports, which were referred to by a number of parties to this proceeding: December 13, 2003 (covering May 2002 to October 2003); December 13, 2004 (covering the period May to October 2004); June 9, 2005 (covering the period November 2004 to April 2005); June 14, 2006 (covering the period November 2005 to April 2006); and December 13, 2006 (covering the period May to October 2006).

For example, after concluding that a significant portion of the difference between the constrained and unconstrained real-time prices, and of the remaining difference between HOEP and the unconstrained pre-dispatch price, is due to the 12x ramp rate assumption, the Market Surveillance Panel stated as follows in its December 13, 2004 report (at page 66):

> The Panel is of the view that the continued understatement of the HOEP leads to inefficient decisions by both loads and generators in both the short-term and the long-term. This takes the form of an inefficient load profile and of under-investment in both conservation and generation.
>
> With respect to the argument that the assumption that ramp rates are 12-times their true value results in a more stable HOEP, the Panel recognizes that price stability can be beneficial to market participants. The Panel observes, however, that it is open to market participants to insulate themselves contractually from price variation. Moreover, price volatility presents a profit opportunity for more price responsive generation and loads. To the extent that it is efficient to do so, volatility can be reduced by the actions of market participants. This is much better, in the Panel's view, than suppressing price variation by artificial means, especially when this has the side effect of understating the average price. The Panel strongly recommends that actual ramp rates be used to determine the HOEP.

Eighteen months later, the Market Surveillance Panel further commented on the issue in its June 14, 2006 report (at page 79) as follows:

> For these and possibly other reasons, arbitrage between Ontario and New York is focused on the HOEP. The result is inefficient exports and the effective extension of the cross-subsidy inherent in Ontario's uniform price regime to New York loads. This problem has been exacerbated by market rules that, other things being equal, would have reduced the HOEP relative to prices in the constrained schedule. For example, the 12 times ramp rate assumption, which has the appearance of systematically lowering the HOEP (i.e., because it removes ramp effects in price), may simply lead to more exports than would otherwise occur.

In its most recent report, dated December 13, 2006, the Market Surveillance Panel stated as follows on page 106:

> There are two major causes of socially inefficient exports from Ontario to New York. First, like privately inefficient exports, the lack of accurate price signals or information can lead to "guessing wrong" and hence socially inefficient exports ex post. Improvements in price signals should result in a higher frequency of socially efficient exports. Socially inefficient exports can also occur, however, if there are defects in the market design. Ontario's uniform pricing regime is poorly designed in the sense that it admits to the possibility that the prices that exporters pay do not reflect the incremental cost of supply. Other aspects of the unconstrained pricing algorithm such as the 12 times ramp rate assumption can further misalign the HOEP and the relevant nodal prices thereby contributing to the potential for ex post socially inefficient exports… (footnote omitted)

And again at pages 147 and 148:

> Moreover, with the Global Adjustment dampening the redistributive effects of changes in HOEP and mitigating any harm that might be said to be visited upon consumers from potentially higher HOEP, the Panel contends that there may be no better time than now to address the remaining sources of inefficiency in the design of the Ontario spot market. Artificially reducing the HOEP, as is the outcome under the current market design, simply means that consumers pay more (or receive a smaller rebate) through the Global Adjustment, all the while inducing market inefficiencies from which all Ontarians lose.

> The real-time price signals generated by an efficient wholesale market are central to the economic success of the new hybrid market for several reasons:
>
> - First, the real time production and consumption decisions of many wholesale market participants will continue to be guided by real-time prices. If these price signals continue to ignore certain system realities such as transmission constraints or the actual ramping capabilities of generation facilities, they will at times induce these participants to make decisions that reduce the short-term dispatch efficiency. As we have indicated in Chapter 3, factors such as the uniform pricing system and the 12 times ramp rate assumption create a wedge between the HOEP and local shadow prices. This can result in inefficient production and consumption decisions such as the inefficient exports from Ontario to New York that we began documenting in our last report….(footnote omitted)
>
> - Second, even though long-term investment will be guided through central planning in the near term, price signals from an efficient wholesale market can and should play an important role in guiding this planning process…Furthermore, as we have argued above, attempts to subsidize consumers by suppressing real-time prices leads to over-consumption and could ultimately lead to over-investment by the planners at [the Ontario Power Authority].

These comments reinforce the evidence in this proceeding as to the inefficiencies to which the 12x ramp rate multiplier contributes.

The observations of the Market Surveillance Panel in its most recent (December 13, 2006) report also support the assertion made by the IESO and others that addressing efficiency of the market remains a relevant objective even in the context of the hybrid framework under which Ontario's electricity sector operates at this time. Even AMPCO's expert witness, Dr. Murphy, who questioned the relevance or merits of the Amendment in light of the evolution of the market to a hybrid structure, conceded on cross-examination that improvements in wholesale market efficiency and accurate price signals are important even in a hybrid market.

The Board accepts that the 12x ramp rate multiplier, introduced as a temporary measure, has price distorting effects that can and do engender inefficiencies. The Board therefore also accepts that, in principle, there is merit in addressing the 12x ramp rate multiplier issue if and to the extent that efficiency improvements can be expected to result, and that this is so even in the context of the hybrid market.

c. Evaluation of the Amendment as a Solution

The IESO has put forward credible evidence that the Amendment will result in greater efficiency in the IESO's real-time market as compared to the status quo. The benefits from this improved efficiency include, but are not limited to, reduced uneconomic exports to New York. The impact of this latter benefit is quantifiable, and has been quantified by the IESO. The other benefits are less easily quantified, but bear consideration nonetheless.

The Board does not agree with AMPCO's argument that the Amendment is inconsistent with the purposes of the Act and that the IESO has selectively chosen the purposes of the Act it will further while ignoring others. AMPCO asserts that the Amendment is contrary to section 1(a) of the Act ("responsible planning and management of electricity resources, supply and demand"). The Board concurs with the IESO's view that greater economic efficiency will further that objective. AMPCO also argues that the Amendment is inconsistent with section 1(f) of the Act ("protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service"). As discussed more fully below, the Board finds that the IESO has carefully considered the impact of the Amendment on consumers' average bills and determined that the impact is likely to be relatively modest. It may even be positive. The IESO has also noted that, while there may be a modest impact on consumers' bills, the Amendment is consistent with the purpose of protecting the interests of consumers with respect to the adequacy and reliability of supply.

There is no evidence before the Board in this proceeding that would lead the Board to take issue with the assertion made by the IESO and others that improvements in the economic efficiency of the electricity system in Ontario will promote adequacy and reliability of supply by providing more accurate price signals and triggering more appropriate price responsive behaviour. The same can be said for the assertions that the Amendment will encourage conservation, load management and demand side management and will, by reducing inefficient exports, also reduce the need for coal-fired generation to meet Ontario demand and thereby contribute to a lessening of emissions.

AMPCO and VECC both assert that the "3x myopic" Amendment is, by the IESO's own submission, inferior to a "1x MIO" solution. They support this view by reference to documents that were prepared by the IESO at various times in the Amendment development process. They submit that this is a valid basis on which the Board should revoke the Amendment.

The Board does not accept that view. Although it is obvious that the IESO reviewed several alternatives in the course of developing the Amendment, it has consistently taken the position in this proceeding that a “3x myopic” rule is superior to a “1x MIO” option. This conclusion appears in the document issued by the Board of Directors of the IESO when the Amendment was approved, and it is supported by the IESO’s and APPrO’s experts. Other than referring to earlier assessments that the IESO does not currently support, AMPCO and VECC provided no evidence that “1x MIO” is a superior solution.

d. The Anticipated Impact on Consumer Bills

The Board has also considered the possible impact of the Amendment on consumers’ electricity bills.

As noted above, the IESO has calculated that the net annual cost to consumers of adopting the 3x ramp rate assumption in the pricing algorithm is $6.68 million, or 0.004 cents/kWh. That calculation is based on the following assumptions and estimates:

- an average annual HOEP of $49 per MWh (the average price in 2006);
- an increase of 2.6% in the average HOEP as a result of the Amendment, before consideration of mitigating factors;
- mitigation of 50% of the estimate increase in HOEP due to “export arbitrage”;
- mitigation of 80% of the net price increase (that is, after the export arbitrage effect) due to the global adjustment and the OPG Rebate; and
- reductions in CMSC payments and Intertie Offer Guarantees that are paid through uplift charges.

In its calculation of the net consumer impact, the IESO also takes into account a planned distribution to consumers of approximately $54 million from the IESO’s TR Clearing Account. The Board does not believe that this particular distribution is appropriately considered as a mitigation measure in relation to the Amendment. Elimination of this particular mitigation measure does not affect the Board's overall assessment of the Amendment.

Dr. Rivard of the IESO testified that, on the basis of additional analysis on the elasticity of export response, the export arbitrage effect on HOEP would likely be higher than 50%, which would reduce further the net cost of the Amendment to consumers. He noted that were the export arbitrage effect to reach approximately 65%, and keeping the other assumptions the same, the impact of the Amendment would be a net reduction in consumers' bills.

AMPCO disputes most of the assumptions and estimates that underlie the IESO's calculations. It claims that the IESO's estimates are unreliable, although it provided little evidence about the estimates it believes should be used.

Predicting the net effect of the Amendment on consumer's bills is a complex exercise and is not something the Board believes can be done with precision. The Board does, however, view the IESO's calculation as an indicator of the order of magnitude of the net effect of the Amendment. The Board agrees with AMPCO that the base price of $49 per MWh, which is the starting point of the IESO's calculation, is low by historical standards. The Board notes, however, that the IESO provided additional information on a range of net consumer costs using higher average HOEPs. The Board also acknowledges AMPCO's comment that the OPG Rebate is scheduled to expire in two years. Even if the OPG Rebate is discontinued at that time, the IESO has estimated that the global adjustment would still provide significant price mitigation, approximately 60% compared to the current 80% from the combined global adjustment and OPG Rebate.

The Board finds that the expected impact on consumers' bills is relatively modest. The IESO's published calculation shows a very minor impact – just 0.004 cents/kWh – based on estimates that the IESO considers to be conservative. Even if a higher base price were used (an average annual HOEP of $70 per MWh based on 2005 prices), and assuming no replacement for or extension of the OPG Rebate in two years, the estimated net impact would be larger but still relatively small. The difference resulting from the use of a higher base price relative to use of the lower one would be much less than 1/10th of a cent/kWh.

e. Conclusions

The Board concludes that the efficiency benefits that are anticipated to arise as a result of the Amendment are consistent with the purpose of the Act that speaks to promoting economic efficiency in the generation, transmission, distribution and sale of electricity. The Amendment also supports the purposes that relate to encouraging electricity conservation, demand management and demand response; ensuring the adequacy, safety, sustainability and reliability of electricity supply in Ontario; and protecting the interests of consumers in relation to the adequacy and reliability of electricity service. While the Board acknowledges that the Amendment may result in an increase in average consumer bills, that increase is anticipated to be modest.

The Board is also of the view that, in the context of its mandate under section 33 of the Act, unjust discrimination means unjust economic discrimination.

Based on the record of this proceeding, the Board finds that the Amendment is consistent with the purposes of the Act. The Board also finds that the Amendment does not unjustly discriminate for or against a market participant or a class of market participants.

Other Matters

1. *Stay of the Amendment Pending Appeal*

By the terms of the Board’s February 9, 2007 Order, the stay of the operation of the Amendment applies pending completion of the Board’s review of the Amendment. Issuance of this Decision and Order completes the Board’s review, and has by the terms of the Order the effect of lifting the stay. For greater certainty, however, the Board will include an order to that effect in this Decision and Order.

In its final written argument, AMPCO requested that, in the event that the Board does not revoke the Amendment, the Board order a stay of the Amendment pursuant to section 33(6) of the *Ontario Energy Board Act, 1998* pending appeal to the Divisional Court.

In the letter accompanying its final written argument, the IESO noted that this request for relief was not included in the Application and is out of time. While the IESO therefore did not address this request in its final written argument, the IESO did in its letter express the view that the Board does not have jurisdiction to grant such relief, and that if AMPCO wants a stay it must apply to the Divisional Court. APPrO's position is to the same effect.

In the circumstances of this case, the Board has decided not to extend its February 9, 2007 order staying the operation of the Amendment.

The Board understands that the IESO may wish to proceed with implementation of the Amendment on a timely basis, and that parties that are supportive of the Amendment would be equally supportive of prompt implementation. However, the Board does not believe that it is in the best interests of the wholesale electricity marketplace to face the prospect of the Amendment being implemented one day and suspended shortly thereafter further to the invocation of a judicial process. The Amendment is not urgently required for reasons such as reliability and the ramp rate issue is one that has been outstanding for several years. In the circumstances, the Board expects that the IESO will act responsibly by allowing AMPCO a reasonable opportunity to request judicial recourse prior to taking whatever steps may be required to implement the Amendment. The Board similarly expects that AMPCO will act responsibly by ensuring that any request for a stay of the operation of the Amendment that it may wish to make to the Divisional Court is made without undue delay.

2. *New Obligations for IESO under its Licence*

In its final written argument, AMPCO requested that the Board require the following, either under an existing condition of the IESO's licence or by way of a new licence condition:

- that the IESO prepare and submit to the Board, for every proposed market rule and market rule amendment, a report supported by appropriate analysis and available to the public, that explains how the proposed rule or amendment is consistent with the objects of the IESO and promotes the purposes of the Act; and

- that, in relation to the Amendment and such other market rules or market rule amendments as the Board considers appropriate, the IESO report publicly on an annual basis with respect to whether and the extent to which the amendments have met the IESO's objectives and provided the benefits anticipated by the IESO at the time each of the amendments were made.

In the letter accompanying its final written argument, the IESO noted that this request for relief was not included in the Application, is out of time, was not dealt with in any way in this proceeding and is entirely inappropriate.

Whatever the Board may think of AMPCO's request on the merits, the Board does not consider it appropriate to address the request at this stage in the proceeding. The issue of new reporting requirements for the IESO in relation to amendments to the market rules was not raised by AMPCO on a timely basis, and the other parties to this proceeding will not have had a fair opportunity to consider and respond to the request. AMPCO may, if it so wishes, pursue this matter further outside the context of this proceeding.

3. *Cost Awards*

Parties eligible for an award of costs, as identified in Procedural Order No. 2, shall submit their cost claims by April 24, 2007. A copy of the cost claim must be filed with the Board and one copy is to be served on the IESO. The cost claims must comply with section 10 of the Board's *Practice Direction on Cost Awards*.

The IESO will have until May 8, 2007 to object to any aspect of the costs claimed. A copy of the objection must be filed with the Board and one copy must be served on the party against whose claim the objection is being made.

A party whose cost claim was objected to will have until May 15, 2007 to make a reply submission as to why its cost claim should be allowed. Again, a copy of the submission must be filed with the Board and one copy is to be served on the IESO.

The Board will issue its decision on cost awards at a later date once the above process has been completed.

THE BOARD ORDERS THAT:

1. The Application by the Association of Major Power Consumers in Ontario for an order under section 33(9) of the *Electricity Act, 1998* revoking the market rule amendment identified as MR-00331-R00: "Specify the Facility Ramping Capability in the Market Schedule" and referring the amendment back to the IESO for further consideration is denied.

2. The stay of the operation of the market rule amendment identified as MR-00331-R00: “Specify the Facility Ramping Capability in the Market Schedule”, as ordered by the Order of the Board dated February 9, 2007, is lifted.

DATED at Toronto, April 10, 2007.

ONTARIO ENERGY BOARD

Original signed by

Kirsten Walli
Board Secretary

APPENDIX A

to

Decision and Order
April 10, 2007

Association of Major Power Consumers in Ontario
Review of Market Rule Amendment
EB-2007-0040

<u>Excerpt from Transcript of Oral Hearing Held March 29, 2007</u>

(see attached document)

our binder. I apologize, it might just be me, but the record, the decision does not bear out the quote that that included.

MR. RUPERT: Mr. Rodger, I was going to mention, I think the page 5 reference, at least as I read it here, didn't refer to the page that was doing what you thought it did. Maybe there is a cross-reference issue in your submissions.

MR. RODGER: I'll certainly check that. Sorry, Mr. Rupert.

MR. KAISER: Why don't you have a look now, and see if you can help us.

MR. RODGER: Mr. Chair, we'll endeavour to get copies during the lunch break.

MR. KAISER: All right. We'll take the lunch break now. We'll come back at 2 o'clock.

--- Recess taken at 12:34 p.m.

--- On resuming at 2:11 p.m.

DECISION:

MR. KAISER: Please be seated.

The Board has decided to issue a decision now on the matter of the relevance of the evidence with respect to the process, rather than deferring it, as Mr. Rodger suggested, in order that we can proceed with the case in a more orderly manner.

We are dealing with an application by AMPCO under section 33(4) of the *Electricity Act* for review of the three times ramp rate market rule amendment. In that context there has been a discussion and a concern about the scope of the case, and particularly whether evidence regarding the process by which the IESO reached this rule is relevant.

AMPCO submits that the three times ramp rate market rule amendment should be revoked by this Board and referred back to the IESO for stakeholder consultation, based on the following grounds: First, that the process followed by the IESO in the three times ramp rate stakeholder consultation process violated IESO's common-law duty of procedural fairness, by breaching AMPCO's legitimate expectation that the IESO would follow its published stakeholder engagement process and apply its stakeholder engagement principles, and raising a reasonable apprehension of bias that the IESO favoured the interests of generators; secondly, that the integrity of the statutorily-mandated consultation process has been undermined. They say this is inconsistent with the purposes of the *Electricity Act* and unjustly discriminates against Ontario consumers in favour of Ontario generators.

They also allege certain substantive failures, as well, which are not at issue in the proceeding this morning.

Accordingly, AMPCO argues that the materials produced by IESO relating to procedural matters are relevant both to the issue of procedural fairness and also the substantive issues.

The starting point in this discussion is section 33(9) of the *Electricity Act*. It has been referred to by virtually everyone this morning. It provides that:

> "If, on completion of its review, the Board finds that the amendment is inconsistent with the purposes of this *Act*, or unjustly discriminates against or in favour of a market participant or a class of market participants, then the Board shall make an order revoking the amendment on the date specified by the Board and referring the amendment back to the IESO for further consideration."

AMPCO argues that all of the IESO materials are relevant because they demonstrate that the IESO failed to follow procedural fairness in developing the amendment. According to AMPCO, the lack of procedural fairness demonstrates that the amendment unjustly discriminates against its members in favour of generators.

In other words, AMPCO argues that it has rights of natural justice in IESO rule-making and that those rights should be enforced by the Board in the market review amendment process.

All of the other parties appearing before us this morning state that this is an incorrect interpretation of section 33(9), because it equates the term "unjustly discriminates" with a violation of the rules of natural justice and it equates the Board's review process with a judicial review application.

They argue that the purpose of the Board's review in a market review amendment should be aimed at economic efficiency and not natural justice.

They say that the OEB should be reviewing an amendment to the IESO rules and not the IESO stakeholdering process; that the scope of the Board's review should be aimed at the rule itself, and the impact of that rule, not the process by which the amendment was made.

In other words, it's argued before us that the issue is whether the rule is unjustly discriminatory. The Board agrees with that position.

Sections 19(1) and 20 of the *OEB Act*, read together, provide that the Board has general authority to determine any question of law or fact arising in any matter before it except where that authority is limited by statutory provision to the contrary.

In the case of a market rule amendment, another statutory provision does limit the Board's jurisdiction. Section 33(9) of the *Electricity Act* specifically sets out certain grounds on which the Board may make an order.

Accordingly, we find that section 33(9) of the *Electricity Act* is a jurisdiction-limiting provision, not another jurisdiction-granting provision. That is, with respect to a market rule amendment, the Board's jurisdiction is not as broad as suggested by section 20 of the *OEB Act*, but limited by section 33(9) of the *Electricity Act*.

In this regard, the Board has also considered the submissions of various parties, and agrees, that the 60-day time limit for disposing of this review is consistent with the conclusion that the Board's scope of review is limited to the criteria set out in section 33(9).

The legislature can be taken as having known that an exhaustive review of the process would render it impossible to meet these timelines.

We then come to what can be seen as a second and distinct issue. That is whether there is a common-law principle of administrative law that the IESO has violated in the course of this market rule amendment process which yields a separate and distinct remedy.

The IESO says the common-law principles of administrative law do not assist AMPCO in extending the jurisdiction of the Board to review the details of the stakeholdering process. They say that the IESO is a statutory corporation whose affairs are managed and supervised by an independent board of directors, and the functions carried out by the IESO under the review at issue in this proceeding is a rule-making function and is essentially a legislative function.

They rely upon the Supreme Court of Canada's 1980 decision in the Inuit Tapirisat as support for the proposition that in legislative functions these rules do not apply.

AMPCO takes a different view and it relies upon the Supreme Court of Canada 1990 decision in Baker, as well as the Divisional Court decision in Bezaire.

The aspects of the decision that AMPCO relies upon can be found at pages 15 and 14, where the Court stated that one of the criteria that must be looked at in determining whether the rules of natural justice apply to a process is whether the parties had a legitimate expectation that those rules would be followed. The Court states, in part:

> "Fourth, the legitimate expectations of the person challenging the decision may also determine what procedures the duty of fairness requires in given circumstance."

They go on to say:

> "This doctrine as applied in Canada is based on the principle that the circumstances affecting procedural fairness take into account the promises or regular practices of administrative decision-makers and it would generally be unfair for them to act in contravention of representations as to procedure or to backtrack on substantive promises without according significant procedural rights."

The Court also noted that another factor to be considered in determining the nature and extent of the duty of fairness that's owed to the parties is the importance of the decision to individuals involved.

As has been pointed out, there's no question that there's a significant amount of money involved in this decision; it's an important decision. With respect to the expectations of the parties, there is a provision in section 13.2 of the *Electricity Act* requiring the IESO to establish processes by which consumers, distributors and generators may provide advice. AMPCO makes the point that a framework was established to govern the process by which these rules would be amended and implemented. They say that this procedure, despite the expectation they were entitled to, has not been followed.

That may or may not be the case, but this Panel is of the view that that is not a matter for our consideration. Mr. Vegh in his submissions questioned whether the Board should be a parallel Divisional Court. We don't think it should be.

IESO may or may not have followed the rules of natural justice. And they may or may not have been required to do so based upon the different authorities that have been cited by the different parties. But that, we believe, is a matter to be determined by the Divisional Court, not the Ontario Energy Board.

Mr. Rodger did refer us to a decision of this Board on September 20th, 2005. That appears at tab 11 of Ms. DeMarco's brief. I'm reading in part:

> "The Board concludes that stakeholder concerns have been substantially met. The true test will, however, be the experience of stakeholders in the new process. Stakeholders and the Board will have opportunities to review how well the process works over time as they are implemented. The Board therefore approves the IESO proposals on its stakeholdering process. It should be noted,

however, that this approval relates to the processes that the IESO has proposed. It does not change the Board's obligation to review IESO programs that have implications for IESO fees, expenses and revenue requirements, even when these programs have been subjected to the IESO stakeholdering process."

Mr. Rodger's submission was that having approved the stakeholdering process it was incumbent upon the Board to follow through and police, if you will, the rule-making process.

We differ on that. The two are distinct functions. The review at question is a judicial review and best reserved for the courts.

That leads us to the Order requested. Pursuant to this decision, the Board will order that any evidence relating to the stakeholdering process be struck. That would include Mr. Rodger's submission of March 26th. If the parties are unable to agree on what evidence is to be excluded or not excluded, the Board may be spoken to.

That completes the Board's ruling in this matter.

PROCEDURAL MATTERS:

Mr. Rodger and Mr. Mark, we were going to suggest, subject to your convenience, that you may want to adjourn for the rest of the day and regroup in light of that.

MR. MARK: It probably makes sense.

MR. KAISER: Unless there be some debate and discussion as to what evidence is to be struck and what

TAB 3

Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27

Supreme Court Reports

Supreme Court of Canada

Present: Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

1997: October 16 / 1998: January 22.

File No.: 24711.

[1998] 1 S.C.R. 27 | [1998] 1 R.C.S. 27 | [1998] S.C.J. No. 2 | [1998] A.C.S. no 2

Philippe Adrien, Emilia Berardi, Paul Creador, Lorenzo Abel Vasquez and Lindy Wagner on their own behalf and on behalf of the other former employees of Rizzo & Rizzo Shoes Limited, appellants; v. Zittrer, Siblin & Associates, Inc., Trustees in Bankruptcy of the Estate of Rizzo & Rizzo Shoes Limited, respondent, and The Ministry of Labour for the Province of Ontario, Employment Standards Branch, party.

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO

Case Summary

Employment law — Bankruptcy — Termination pay and severance available when employment terminated by the employer — Whether bankruptcy can be said to be termination by the employer — Employment Standards Act, R.S.O. 1980, c. 137, ss. 7(5), 40(1), (7), 40a — Employment Standards Amendment Act, 1981, S.O. 1981, c. 22, s. 2(3) — Bankruptcy Act, R.S.C., 1985, c. B-3, s. 121(1) — Interpretation Act, R.S.O. 1990, c. I.11, ss. 10, 17.

A bankrupt firm's employees lost their jobs when a receiving order was made with respect to the firm's property. All wages, salaries, commissions and vacation pay were paid to the date of the receiving order. The province's Ministry of Labour audited the firm's records to determine if any outstanding termination or severance pay was owing to former employees under the Employment Standards Act ("ESA") and delivered a proof of claim to the Trustee. The Trustee disallowed the claims on the ground that the bankruptcy of an employer does not constitute dismissal from employment and accordingly creates no entitlement to severance, termination or vacation pay under the ESA. The Ministry successfully appealed to the Ontario Court (General Division) but the Ontario Court of Appeal overturned that court's ruling and restored the Trustee's decision. The Ministry sought leave to appeal from the Court of Appeal judgment but discontinued its application. Following the discontinuance of the appeal, the Trustee paid a dividend to Rizzo's creditors, thereby leaving significantly less funds in the estate. Subsequently, the appellants, five former employees of Rizzo, moved to set aside the discontinuance, add themselves as parties to the proceedings, and requested and were granted an order granting them leave to appeal. At issue here is whether the termination of employment caused by the bankruptcy of an employer give rise to a claim provable in bankruptcy for termination pay and severance pay in accordance with the provisions of the ESA.

Held: The appeal should be allowed.

At the heart of this conflict is an issue of statutory interpretation. Although the plain language of ss. 40 and 40a of the ESA suggests that termination pay and severance pay are payable only when the employer terminates the employment, statutory interpretation cannot be founded on the wording of the legislation alone. The words of an

Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. Moreover, s. 10 of Ontario's Interpretation Act provides that every Act "shall be deemed to be remedial" and directs that every Act shall "receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act according to its true intent, meaning and spirit".

The objects of the ESA and of the termination and severance pay provisions themselves are broadly premised upon the need to protect employees. Finding ss. 40 and 40a to be inapplicable in bankruptcy situations is incompatible with both the object of the ESA and the termination and severance pay provisions. The legislature does not intend to produce absurd consequences and such a consequence would result if employees dismissed before the bankruptcy were to be entitled to these benefits while those dismissed after a bankruptcy would not be so entitled. A distinction would be made between employees merely on the basis of the timing of their dismissal and such a result would arbitrarily deprive some of a means to cope with economic dislocation.

The use of legislative history as a tool for determining the intention of the legislature is an entirely appropriate exercise. Section 2(3) of the Employment Standards Amendment Act, 1981 exempted from severance pay obligations employers who became bankrupt and lost control of their assets between the coming into force of the amendment and its receipt of royal assent. Section 2(3) necessarily implies that the severance pay obligation does in fact extend to bankrupt employers. If this were not the case, no readily apparent purpose would be served by this transitional provision. Further, since the ESA is benefits-conferring legislation, it ought to be interpreted in a broad and generous manner. Any doubt arising from difficulties of language should be resolved in favour of the claimant.

When the express words of ss. 40 and 40a are examined in their entire context, the words "terminated by an employer" must be interpreted to include termination resulting from the bankruptcy of the employer. The impetus behind the termination of employment has no bearing upon the ability of the dismissed employee to cope with the sudden economic dislocation caused by unemployment. As all dismissed employees are equally in need of the protections provided by the ESA, any distinction between employees whose termination resulted from the bankruptcy of their employer and those who have been terminated for some other reason would be arbitrary and inequitable. Such an interpretation would defeat the true meaning, intent and spirit of the ESA. Termination as a result of an employer's bankruptcy therefore does give rise to an unsecured claim provable in bankruptcy pursuant to s. 121 of the Bankruptcy Act for termination and severance pay in accordance with ss. 40 and 40a of the ESA. It was not necessary to address the applicability of s. 7(5) of the ESA.

Cases Cited

Distinguished: Re Malone Lynch Securities Ltd., [1972] 3 O.R. 725; Re Kemp Products Ltd. (1978), 27 C.B.R. (N.S.) 1; Mills-Hughes v. Raynor (1988), 63 O.R. (2d) 343; referred to: U.F.C.W., Loc. 617P v. Royal Dressed Meats Inc. (Trustee of) (1989), 76 C.B.R. (N.S.) 86; R. v. Hydro-Québec, [1997] 1 S.C.R. 213; Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411; Verdun v. Toronto-Dominion Bank, [1996] 3 S.C.R. 550; Friesen v. Canada, [1995] 3 S.C.R. 103; Machtinger v. HOJ Industries Ltd., [1992] 1 S.C.R. 986; Wallace v. United Grain Growers Ltd., [1997] 3 S.C.R. 701; R. v. TNT Canada Inc. (1996), 27 O.R. (3d) 546; Re Telegram Publishing Co. v. Zwelling (1972), 1 L.A.C. (2d) 1; R. v. Vasil, [1981] 1 S.C.R. 469; Paul v. The Queen, [1982] 1 S.C.R. 621; R. v. Morgentaler, [1993] 3 S.C.R. 463; Abrahams v. Attorney General of Canada, [1983] 1 S.C.R. 2; Hills v. Canada (Attorney General), [1988] 1 S.C.R. 513; British Columbia (Director of Employment Standards) v. Eland Distributors Ltd. (Trustee of) (1996), 40 C.B.R. (3d) 25; R. v. Z. (D.A.), [1992] 2 S.C.R. 1025.

Statutes and Regulations Cited

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Employment Standards Act, R.S.O. 1970, c. 147, s. 13(2).
Employment Standards Act, R.S.O. 1980, c. 137, ss. 7(5) [rep. & sub. 1986, c. 51, s. 2], 40(1) [rep. & sub. 1987, c. 30, s. 4(1)], (7), 40a(1) [rep. & sub. ibid., s. 5(1)].
Employment Standards Act, 1974, S.O. 1974, c. 112, s. 40(7).
Employment Standards Amendment Act, 1981, S.O. 1981, c. 22, s. 2.
Interpretation Act, R.S.O. 1980, c. 219 [now R.S.O. 1990, c. I.11], ss. 10, 17.
Labour Relations and Employment Statute Law Amendment Act, 1995, S.O. 1995, c. 1, ss. 74(1), 75(1).

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APPEAL from a judgment of the Ontario Court of Appeal (1995), 22 O.R. (3d) 385, 80 O.A.C. 201, 30 C.B.R. (3d) 1, 9 C.C.E.L. (2d) 264, 95 C.L.L.C. par. 210-020, [1995] O.J. No. 586 (QL), reversing a judgment of the Ontario Court (General Division) (1991), 6 O.R. (3d) 441, 11 C.B.R. (3d) 246, 92 C.L.L.C. par. 14,013, ruling that the Ministry of Labour could prove claims on behalf of employees of the bankrupt. Appeal allowed.

Steven M. Barrett and Kathleen Martin, for the appellants. Raymond M. Slattery, for the respondent. David Vickers, for the Ministry of Labour for the Province of Ontario, Employment Standards Branch.

Solicitors for the appellants: Sack, Goldblatt, Mitchell, Toronto. Solicitors for the respondent: Minden, Gross, Grafstein & Greenstein, Toronto. Solicitor for the Ministry of Labour for the Province of Ontario, Employment Standards Branch: The Attorney General for Ontario, Toronto.

The judgment of the Court was delivered by

IACOBUCCI J.

1 This is an appeal by the former employees of a now bankrupt employer from an order disallowing their claims for termination pay (including vacation pay thereon) and severance pay. The case turns on an issue of statutory interpretation. Specifically, the appeal decides whether, under the relevant legislation in effect at the time of the bankruptcy, employees are entitled to claim termination and severance payments where their employment has been terminated by reason of their employer's bankruptcy.

1. Facts

2 Prior to its bankruptcy, Rizzo & Rizzo Shoes Limited ("Rizzo") owned and operated a chain of retail shoe stores across Canada. Approximately 65 percent of those stores were located in Ontario. On April 13, 1989, a petition in bankruptcy was filed against the chain. The following day, a receiving order was made on consent in respect of Rizzo's property. Upon the making of that order, the employment of Rizzo's employees came to an end.

3 Pursuant to the receiving order, the respondent, Zittrer, Siblin & Associates, Inc. (the "Trustee") was appointed as trustee in bankruptcy of Rizzo's estate. The Bank of Nova Scotia privately appointed Peat Marwick Limited ("PML") as receiver and manager. By the end of July 1989, PML had liquidated Rizzo's property and assets and closed the stores. PML paid all wages, salaries, commissions and vacation pay that had been earned by Rizzo's employees up to the date on which the receiving order was made.

4 In November 1989, the Ministry of Labour for the Province of Ontario, Employment Standards Branch (the "Ministry") audited Rizzo's records to determine if there was any outstanding termination or severance pay owing to former employees under the Employment Standards Act, R.S.O. 1980, c. 137, as amended (the "ESA"). On August 23, 1990, the Ministry delivered a proof of claim to the respondent Trustee on behalf of the former employees of Rizzo for termination pay and vacation pay thereon in the amount of approximately $2.6 million and for severance pay totalling $14,215. The Trustee disallowed the claims, issuing a Notice of Disallowance on January 28, 1991. For the purposes of this appeal, the relevant ground for disallowing the claim was the Trustee's opinion that the bankruptcy of an employer does not constitute a dismissal from employment and thus, no entitlement to severance, termination or vacation pay is created under the ESA.

5 The Ministry appealed the Trustee's decision to the Ontario Court (General Division) which reversed the Trustee's disallowance and allowed the claims as unsecured claims provable in bankruptcy. On appeal, the Ontario Court of Appeal overturned the trial court's ruling and restored the decision of the Trustee. The Ministry sought leave to appeal from the Court of Appeal judgment, but discontinued its application on August 30, 1993. Following the discontinuance of the appeal, the Trustee paid a dividend to Rizzo's creditors, thereby leaving significantly less funds in the estate. Subsequently, the appellants, five former employees of Rizzo, moved to set aside the discontinuance, add themselves as parties to the proceedings, and requested an order granting them leave to appeal. This Court's order granting those applications was issued on December 5, 1996.

2. Relevant Statutory Provisions

6 The relevant versions of the Bankruptcy Act (now the Bankruptcy and Insolvency Act) and the Employment Standards Act for the purposes of this appeal are R.S.C., 1985, c. B-3 (the "BA"), and R.S.O. 1980, c. 137, as amended to April 14, 1989 (the "ESA") respectively.

Employment Standards Act, R.S.O. 1980, c. 137, as amended:

7. --

(5) Every contract of employment shall be deemed to include the following provision:

> All severance pay and termination pay become payable and shall be paid by the employer to the employee in two weekly instalments beginning with the first full week following termination of employment and shall be allocated to such weeks accordingly. This provision does not apply to severance pay if the employee has elected to maintain a right of recall as provided in subsection 40a (7) of the Employment Standards Act.

40. -- (1) No employer shall terminate the employment of an employee who has been employed for three months or more unless the employee gives,

(a) one weeks notice in writing to the employee if his or her period of employment is less than one year;

(b) two weeks notice in writing to the employee if his or her period of employment is one year or more but less than three years;

(c) three weeks notice in writing to the employee if his or her period of employment is three years or more but less than four years;

(d) four weeks notice in writing to the employee if his or her period of employment is four years or more but less than five years;

(e) five weeks notice in writing to the employee if his or her period of employment is five years or more but less than six years;

(f) six weeks notice in writing to the employee if his or her period of employment is six years or more but less than seven years;

(g) seven weeks notice in writing to the employee if his or her period of employment is seven years or more but less than eight years;

(h) eight weeks notice in writing to the employee if his or her period of employment is eight years or more,

and such notice has expired.

. . .

(7) Where the employment of an employee is terminated contrary to this section,

(a) the employer shall pay termination pay in an amount equal to the wages that the employee would have been entitled to receive at his regular rate for a regular non-overtime work week for the period of notice prescribed by subsection (1) or (2), and any wages to which he is entitled;

. . .

40a . . .

(1a) Where,

(a) fifty or more employees have their employment terminated by an employer in a period of six months or less and the terminations are caused by the permanent discontinuance of all or part of the business of the employer at an establishment; or

(b) one or more employees have their employment terminated by an employer with a payroll of $2.5 million or more,

the employer shall pay severance pay to each employee whose employment has been terminated and who has been employed by the employer for five or more years.

Employment Standards Amendment Act, 1981, S.O. 1981, c. 22

2.--(1) Part XII of the said Act is amended by adding thereto the following section:

. . .

(3) Section 40a of the said Act does not apply to an employer who became a bankrupt or an insolvent person within the meaning of the Bankruptcy Act (Canada) and whose assets have been distributed among his creditors or to an employer whose proposal within the meaning of the Bankruptcy Act (Canada) has been accepted by his creditors in the period from and

including the 1st day of January, 1981, to and including the day immediately before the day this Act receives Royal Assent.

Bankruptcy Act, R.S.C., 1985, c. B-3

121. (1) All debts and liabilities, present or future, to which the bankrupt is subject at the date of the bankruptcy or to which he may become subject before his discharge by reason of any obligation incurred before the date of the bankruptcy shall be deemed to be claims provable in proceedings under this Act.

Interpretation Act, R.S.O. 1990, c. I.11

10. Every Act shall be deemed to be remedial, whether its immediate purport is to direct the doing of anything that the Legislature deems to be for the public good or to prevent or punish the doing of any thing that it deems to be contrary to the public good, and shall accordingly receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act according to its true intent, meaning and spirit.

. . .

17. The repeal or amendment of an Act shall be deemed not to be or to involve any declaration as to the previous state of the law.

3. Judicial History

A. Ontario Court (General Division) (1991), 6 O.R. (3d) 441

7 Having disposed of several issues which do not arise on this appeal, Farley J. turned to the question of whether termination pay and severance pay are provable claims under the BA. Relying on U.F.C.W., Loc. 617P v. Royal Dressed Meats Inc. (Trustee of) (1989), 76 C.B.R. (N.S.) 86 (Ont. S.C. in Bankruptcy), he found that it is clear that claims for termination and severance pay are provable in bankruptcy where the statutory obligation to provide such payments arose prior to the bankruptcy. Accordingly, he reasoned that the essential matter to be resolved in the case at bar was whether bankruptcy acted as a termination of employment thereby triggering the termination and severance pay provisions of the ESA such that liability for such payments would arise on bankruptcy as well.

8 In addressing this question, Farley J. began by noting that the object and intent of the ESA is to provide minimum employment standards and to benefit and protect the interests of employees. Thus, he concluded that the ESA is remedial legislation and as such it should be interpreted in a fair, large and liberal manner to ensure that its object is attained according to its true meaning, spirit and intent.

9 Farley J. then held that denying employees in this case the right to claim termination and severance pay would lead to the arbitrary and unfair result that an employee whose employment is terminated just prior to a bankruptcy would be entitled to termination and severance pay, whereas one whose employment is terminated by the bankruptcy itself would not have that right. This result, he stated, would defeat the intended working of the ESA.

10 Farley J. saw no reason why the claims of the employees in the present case would not generally be contemplated as wages or other claims under the BA. He emphasized that the former employees in the case at bar had not alleged that termination pay and severance pay should receive a priority in the distribution of the estate, but merely that they are provable (unsecured and unpreferred) claims in a bankruptcy. For this reason, he found it inappropriate to make reference to authorities whose focus was the interpretation of priority provisions in the BA.

11 Even if bankruptcy does not terminate the employment relationship so as to trigger the ESA termination and severance pay provisions, Farley J. was of the view that the employees in the instant case would nevertheless be entitled to such payments as these were liabilities incurred prior to the date of the bankruptcy by virtue of s. 7(5) of the ESA. He found that s. 7(5) deems every employment contract to include a provision to provide termination and severance pay following the termination of employment and concluded that a contingent obligation is thereby created for a bankrupt employer to make such payments from the outset of the relationship, long before the bankruptcy.

12 Farley J. also considered s. 2(3) of the Employment Standards Amendment Act, 1981, S.O. 1981, c. 22 (the "ESAA"), which is a transitional provision that exempted certain bankrupt employers from the newly introduced severance pay obligations until the amendments received royal assent. He was of the view that this provision would not have been necessary if the obligations of employers upon termination of employment had not been intended to apply to bankrupt employers under the ESA. Farley J. concluded that the claim by Rizzo's former employees for termination pay and severance pay could be provided as unsecured and unpreferred debts in a bankruptcy. Accordingly, he allowed the appeal from the decision of the Trustee.

B. Ontario Court of Appeal (1995), 22 O.R. (3d) 385

13 Austin J.A., writing for a unanimous court, began his analysis of the principal issue in this appeal by focussing upon the language of the termination pay and severance pay provisions of the ESA. He noted, at p. 390, that the termination pay provisions use phrases such as "[n]o employer shall terminate the employment of an employee" (s. 40(1)), "the notice required by an employer to terminate the employment" (s. 40(2)), and "[a]n employer who has terminated or who proposes to terminate the employment of employees" (s. 40(5)). Turning to severance pay, he quoted s. 40a(1)(a) (at p. 391) which includes the phrase "employees have their employment terminated by an employer". Austin J.A. concluded that this language limits the obligation to provide termination and severance pay to situations in which the employer terminates the employment. The operation of the ESA, he stated, is not triggered by the termination of employment resulting from an act of law such as bankruptcy.

14 In support of his conclusion, Austin J.A. reviewed the leading cases in this area of law. He cited Re Malone Lynch Securities Ltd., [1972] 3 O.R. 725 (S.C. in bankruptcy), wherein Houlden J. (as he then was) concluded that the ESA termination pay provisions were not designed to apply to a bankrupt employer. He also relied upon Re Kemp Products Ltd. (1978), 27 C.B.R. (N.S.) 1 (Ont. S.C. in bankruptcy), for the proposition that the bankruptcy of a company at the instance of a creditor does not constitute dismissal. He concluded as follows at p. 395:

> The plain language of ss. 40 and 40a does not give rise to any liability to pay termination or severance pay except where the employment is terminated by the employer. In our case, the employment was terminated, not by the employer, but by the making of a receiving order against Rizzo on April 14, 1989, following a petition by one of its creditors. No entitlement to either termination or severance pay ever arose.

15 Regarding s. 7(5) of the ESA, Austin J.A. rejected the trial judge's interpretation and found that the section does not create a liability. Rather, in his opinion, it merely states when a liability otherwise created is to be paid and therefore it was not considered relevant to the issue before the court. Similarly, Austin J.A. did not accept the lower court's view of s. 2(3), the transitional provision in the ESAA. He found that that section had no effect upon the intention of the Legislature as evidenced by the terminology used in ss. 40 and 40a.

16 Austin J.A. concluded that, because the employment of Rizzo's former employees was terminated by the order of bankruptcy and not by the act of the employer, no liability arose with respect to termination, severance or vacation pay. The order of the trial judge was set aside and the Trustee's disallowance of the claims was restored.

4. Issues

17 This appeal raises one issue: does the termination of employment caused by the bankruptcy of an employer give rise to a claim provable in bankruptcy for termination pay and severance pay in accordance with the provisions of the ESA?

5. Analysis

18 The statutory obligation upon employers to provide both termination pay and severance pay is governed by ss. 40 and 40a of the ESA, respectively. The Court of Appeal noted that the plain language of those provisions suggests that termination pay and severance pay are payable only when the employer terminates the employment. For example, the opening words of s. 40(1) are: "No employer shall terminate the employment of an employee. . . ." Similarly, s. 40a(1a) begins with the words, "Where . . . fifty or more employees have their employment terminated by an employer. . . ." Therefore, the question on which this appeal turns is whether, when bankruptcy occurs, the employment can be said to be terminated "by an employer".

19 The Court of Appeal answered this question in the negative, holding that, where an employer is petitioned into bankruptcy by a creditor, the employment of its employees is not terminated "by an employer", but rather by operation of law. Thus, the Court of Appeal reasoned that, in the circumstances of the present case, the ESA termination pay and severance pay provisions were not applicable and no obligations arose. In answer, the appellants submit that the phrase "terminated by an employer" is best interpreted as reflecting a distinction between involuntary and voluntary termination of employment. It is their position that this language was intended to relieve employers of their obligation to pay termination and severance pay when employees leave their jobs voluntarily. However, the appellants maintain that where an employee's employment is involuntarily terminated by reason of their employer's bankruptcy, this constitutes termination "by an employer" for the purpose of triggering entitlement to termination and severance pay under the ESA.

20 At the heart of this conflict is an issue of statutory interpretation. Consistent with the findings of the Court of Appeal, the plain meaning of the words of the provisions here in question appears to restrict the obligation to pay termination and severance pay to those employers who have actively terminated the employment of their employees. At first blush, bankruptcy does not fit comfortably into this interpretation. However, with respect, I believe this analysis is incomplete.

21 Although much has been written about the interpretation of legislation (see, e.g., Ruth Sullivan, Statutory Interpretation (1997); Ruth Sullivan, Driedger on the Construction of Statutes (3rd ed. 1994) (hereinafter "Construction of Statutes"); Pierre-André Côté, The Interpretation of Legislation in Canada (2nd ed. 1991)), Elmer Driedger in Construction of Statutes (2nd ed. 1983) best encapsulates the approach upon which I prefer to rely. He recognizes that statutory interpretation cannot be founded on the wording of the legislation alone. At p. 87 he states:

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament.

Recent cases which have cited the above passage with approval include: R. v. Hydro-Québec, [1997] 1 S.C.R. 213; Royal Bank of Canada v. Sparrow Electric Corp., [1997] 1 S.C.R. 411; Verdun v. Toronto-Dominion Bank, [1996] 3 S.C.R. 550; Friesen v. Canada, [1995] 3 S.C.R. 103.

22 I also rely upon s. 10 of the Interpretation Act, R.S.O. 1980, c. 219, which provides that every Act "shall be deemed to be remedial" and directs that every Act shall "receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act according to its true intent, meaning and spirit".

23 Although the Court of Appeal looked to the plain meaning of the specific provisions in question in the present case, with respect, I believe that the court did not pay sufficient attention to the scheme of the ESA, its object or the intention of the legislature; nor was the context of the words in issue appropriately recognized. I now turn to a discussion of these issues.

24 In Machtinger v. HOJ Industries Ltd., [1992] 1 S.C.R. 986, at p. 1002, the majority of this Court recognized the importance that our society accords to employment and the fundamental role that it has assumed in the life of the individual. The manner in which employment can be terminated was said to be equally important (see also Wallace v. United Grain Growers Ltd., [1997] 3 S.C.R. 701). It was in this context that the majority in Machtinger described, at p. 1003, the object of the ESA as being the protection of ". . . the interests of employees by requiring employers to comply with certain minimum standards, including minimum periods of notice of termination". Accordingly, the majority concluded, at p. 1003, that, ". . . an interpretation of the Act which encourages employers to comply with the minimum requirements of the Act, and so extends its protections to as many employees as possible, is to be favoured over one that does not".

25 The objects of the termination and severance pay provisions themselves are also broadly premised upon the need to protect employees. Section 40 of the ESA requires employers to give their employees reasonable notice of termination based upon length of service. One of the primary purposes of this notice period is to provide employees with an opportunity to take preparatory measures and seek alternative employment. It follows that s. 40(7)(a), which provides for termination pay in lieu of notice when an employer has failed to give the required statutory notice, is intended to "cushion" employees against the adverse effects of economic dislocation likely to follow from the absence of an opportunity to search for alternative employment. (Innis Christie, Geoffrey England and Brent Cotter, Employment Law in Canada (2nd ed. 1993), at pp. 572-81.)

26 Similarly, s. 40a, which provides for severance pay, acts to compensate long-serving employees for their years of service and investment in the employer's business and for the special losses they suffer when their employment terminates. In R. v. TNT Canada Inc. (1996), 27 O.R. (3d) 546, Robins J.A. quoted with approval at pp. 556-57 from the words of D. D. Carter in the course of an employment standards determination in Re Telegram Publishing Co. v. Zwelling (1972), 1 L.A.C. (2d) 1 (Ont.), at p. 19, wherein he described the role of severance pay as follows:

> Severance pay recognizes that an employee does make an investment in his employer's business -- the extent of this investment being directly related to the length of the employee's service. This investment is the seniority that the employee builds up during his years of service. . . . Upon termination of the employment relationship, this investment of years of service is lost, and the employee must start to rebuild seniority at another place of work. The severance pay, based on length of service, is some compensation for this loss of investment.

27 In my opinion, the consequences or effects which result from the Court of Appeal's interpretation of ss. 40 and 40a of the ESA are incompatible with both the object of the Act and with the object of the termination and severance pay provisions themselves. It is a well established principle of statutory interpretation that the legislature does not intend to produce absurd consequences. According to Côté, supra, an interpretation can be considered absurd if it leads to ridiculous or frivolous consequences, if it is extremely unreasonable or inequitable, if it is illogical or incoherent, or if it is incompatible with other provisions or with the object of the legislative enactment (at pp. 378-80). Sullivan echoes these comments noting that a label of absurdity can be attached to interpretations which defeat the purpose of a statute or render some aspect of it pointless or futile (Sullivan, Construction of Statutes, supra, at p. 88).

28 The trial judge properly noted that, if the ESA termination and severance pay provisions do not apply in circumstances of bankruptcy, those employees "fortunate" enough to have been dismissed the day before a bankruptcy would be entitled to such payments, but those terminated on the day the bankruptcy becomes final would not be so entitled. In my view, the absurdity of this consequence is particularly evident in a unionized workplace where seniority is a factor in determining the order of lay-off. The more senior the employee, the larger the investment he or she has made in the employer and the greater the entitlement to termination and severance pay. However, it is the more senior personnel who are likely to be employed up until the time of the bankruptcy and who would thereby lose their entitlements to these payments.

29 If the Court of Appeal's interpretation of the termination and severance pay provisions is correct, it would be acceptable to distinguish between employees merely on the basis of the timing of their dismissal. It seems to me that such a result would arbitrarily deprive some employees of a means to cope with the economic dislocation caused by unemployment. In this way the protections of the ESA would be limited rather than extended, thereby defeating the intended working of the legislation. In my opinion, this is an unreasonable result.

30 In addition to the termination and severance pay provisions, both the appellants and the respondent relied upon various other sections of the ESA to advance their arguments regarding the intention of the legislature. In my view, although the majority of these sections offer little interpretive assistance, one transitional provision is particularly instructive. In 1981, s. 2(1) of the ESAA introduced s. 40a, the severance pay provision, to the ESA. Section 2(2) deemed that provision to come into force on January 1, 1981. Section 2(3), the transitional provision in question provided as follows:

> 2. . . .
>
> (3) Section 40a of the said Act does not apply to an employer who became a bankrupt or an insolvent person within the meaning of the Bankruptcy Act (Canada) and whose assets have been distributed among his creditors or to an employer whose proposal within the meaning of the Bankruptcy Act (Canada) has been accepted by his creditors in the period from and including the 1st day of January, 1981, to and including the day immediately before the day this Act receives Royal Assent.

31 The Court of Appeal found that it was neither necessary nor appropriate to determine the intention of the legislature in enacting this provisional subsection. Nevertheless, the court took the position that the intention of the legislature as evidenced by the introductory words of ss. 40 and 40a was clear, namely, that termination by reason of a bankruptcy will not trigger the severance and termination pay obligations of the ESA. The court held that this intention remained unchanged by the introduction of the transitional provision. With respect, I do not agree with either of these findings. Firstly, in my opinion, the use of legislative history as a tool for determining the intention of the legislature is an entirely appropriate exercise and one which has often been employed by this Court (see, e.g., R. v. Vasil, [1981] 1 S.C.R. 469, at p. 487; Paul v. The Queen, [1982] 1 S.C.R. 621, at pp. 635, 653 and 660). Secondly, I believe that the transitional provision indicates that the Legislature intended that termination and severance pay obligations should arise upon an employers' bankruptcy.

32 In my view, by extending an exemption to employers who became bankrupt and lost control of their assets between the coming into force of the amendment and its receipt of royal assent, s. 2(3) necessarily implies that the severance pay obligation does in fact extend to bankrupt employers. It seems to me that, if this were not the case, no readily apparent purpose would be served by this transitional provision.

33 I find support for my conclusion in the decision of Saunders J. in Royal Dressed Meats Inc., supra. Having reviewed s. 2(3) of the ESAA, he commented as follows (at p. 89):

> . . . any doubt about the intention of the Ontario Legislature has been put to rest, in my opinion, by the transitional provision which introduced severance payments into the E.S.A. . . . it seems to me an inescapable inference that the legislature intended liability for severance payments to arise on a bankruptcy. That intention would, in my opinion, extend to termination payments which are similar in character.

34 This interpretation is also consistent with statements made by the Minister of Labour at the time he introduced the 1981 amendments to the ESA. With regard to the new severance pay provision he stated:

> The circumstances surrounding a closure will govern the applicability of the severance pay legislation in some defined situations. For example, a bankrupt or insolvent firm will still be required to pay severance pay to employees to the extent that assets are available to satisfy their claims.

. . .

> . . . the proposed severance pay measures will, as I indicated earlier, be retroactive to January 1 of this year. That retroactive provision, however, will not apply in those cases of bankruptcy and insolvency where the assets have already been distributed or where an agreement on a proposal to creditors has already been reached.
>
> (Legislature of Ontario Debates, 1st sess., 32nd Parl., June 4, 1981, at pp. 1236-37.)

Moreover, in the legislative debates regarding the proposed amendments the Minister stated:

> For purposes of retroactivity, severance pay will not apply to bankruptcies under the Bankruptcy Act where assets have been distributed. However, once this act receives royal assent, employees in bankruptcy closures will be covered by the severance pay provisions.
>
> (Legislature of Ontario Debates, 1st sess., 32nd Parl., June 16, 1981, at p. 1699.)

35 Although the frailties of Hansard evidence are many, this Court has recognized that it can play a limited role in the interpretation of legislation. Writing for the Court in R. v. Morgentaler, [1993] 3 S.C.R. 463, at p. 484, Sopinka J. stated:

> . . . until recently the courts have balked at admitting evidence of legislative debates and speeches. . . . The main criticism of such evidence has been that it cannot represent the "intent" of the legislature, an incorporeal body, but that is equally true of other forms of legislative history. Provided that the court remains mindful of the limited reliability and weight of Hansard evidence, it should be admitted as relevant to both the background and the purpose of legislation.

36 Finally, with regard to the scheme of the legislation, since the ESA is a mechanism for providing minimum benefits and standards to protect the interests of employees, it can be characterized as benefits-conferring legislation. As such, according to several decisions of this Court, it ought to be interpreted in a broad and generous manner. Any doubt arising from difficulties of language should be resolved in favour of the claimant (see, e.g., Abrahams v. Attorney General of Canada, [1983] 1 S.C.R. 2, at p. 10; Hills v. Canada (Attorney General), [1988] 1 S.C.R. 513, at p. 537). It seems to me that, by limiting its analysis to the plain meaning of ss. 40 and 40a of the ESA, the Court of Appeal adopted an overly restrictive approach that is inconsistent with the scheme of the Act.

37 The Court of Appeal's reasons relied heavily upon the decision in Malone Lynch, supra. In Malone Lynch, Houlden J. held that s. 13, the group termination provision of the former ESA, R.S.O. 1970, c. 147, and the predecessor to s. 40 at issue in the present case, was not applicable where termination resulted from the bankruptcy of the employer. Section 13(2) of the ESA then in force provided that, if an employer wishes to terminate the employment of 50 or more employees, the employer must give notice of termination for the period prescribed in the regulations, "and until the expiry of such notice the terminations shall not take effect". Houlden J. reasoned that termination of employment through bankruptcy could not trigger the termination payment provision, as employees in this situation had not received the written notice required by the statute, and therefore could not be said to have been terminated in accordance with the Act.

38 Two years after Malone Lynch was decided, the 1970 ESA termination pay provisions were amended by The Employment Standards Act, 1974, S.O. 1974, c. 112. As amended, s. 40(7) of the 1974 ESA eliminated the requirement that notice be given before termination can take effect. This provision makes it clear that termination pay is owing where an employer fails to give notice of termination and that employment terminates irrespective of whether or not proper notice has been given. Therefore, in my opinion it is clear that the Malone Lynch decision turned on statutory provisions which are materially different from those applicable in the instant case. It seems to me that Houlden J.'s holding goes no further than to say that the provisions of the 1970 ESA have no application to a bankrupt employer. For this reason, I do not accept the Malone Lynch decision as persuasive authority for the Court of Appeal's findings. I note that the courts in Royal Dressed Meats, supra, and British Columbia (Director of Employment Standards) v. Eland Distributors Ltd. (Trustee of) (1996), 40 C.B.R. (3d) 25 (B.C.S.C.), declined to rely upon Malone Lynch based upon similar reasoning.

39 The Court of Appeal also relied upon Re Kemp Products Ltd., supra, for the proposition that although the employment relationship will terminate upon an employer's bankruptcy, this does not constitute a "dismissal". I note that this case did not arise under the provisions of the ESA. Rather, it turned on the interpretation of the term "dismissal" in what the complainant alleged to be an employment contract. As such, I do not accept it as authoritative jurisprudence in the circumstances of this case. For the reasons discussed above, I also disagree with the Court of Appeal's reliance on Mills-Hughes v. Raynor (1988), 63 O.R. (2d) 343 (C.A.), which cited the decision in Malone Lynch, supra, with approval.

40 As I see the matter, when the express words of ss. 40 and 40a of the ESA are examined in their entire context, there is ample support for the conclusion that the words "terminated by the employer" must be interpreted to include termination resulting from the bankruptcy of the employer. Using the broad and generous approach to interpretation appropriate for benefits-conferring legislation, I believe that these words can reasonably bear that construction (see R. v. Z. (D.A.), [1992] 2 S.C.R. 1025). I also note that the intention of the Legislature as evidenced in s. 2(3) of the ESAA, clearly favours this interpretation. Further, in my opinion, to deny employees the right to claim ESA termination and severance pay where their termination has resulted from their employer's bankruptcy, would be inconsistent with the purpose of the termination and severance pay provisions and would undermine the object of the ESA, namely, to protect the interests of as many employees as possible.

41 In my view, the impetus behind the termination of employment has no bearing upon the ability of the dismissed employee to cope with the sudden economic dislocation caused by unemployment. As all dismissed employees are equally in need of the protections provided by the ESA, any distinction between employees whose termination resulted from the bankruptcy of their employer and those who have been terminated for some other reason would be arbitrary and inequitable. Further, I believe that such an interpretation would defeat the true meaning, intent and spirit of the ESA. Therefore, I conclude that termination as a result of an employer's bankruptcy does give rise to an unsecured claim provable in bankruptcy pursuant to s. 121 of the BA for termination and severance pay in accordance with ss. 40 and 40a of the ESA. Because of this conclusion, I do not find it necessary to address the alternative finding of the trial judge as to the applicability of s. 7(5) of the ESA.

42 I note that subsequent to the Rizzo bankruptcy, the termination and severance pay provisions of the ESA underwent another amendment. Sections 74(1) and 75(1) of the Labour Relations and Employment Statute Law Amendment Act, 1995, S.O. 1995, c. 1, amend those provisions so that they now expressly provide that where employment is terminated by operation of law as a result of the bankruptcy of the employer, the employer will be deemed to have terminated the employment. However, s. 17 of the Interpretation Act directs that, "[t]he repeal or amendment of an Act shall be deemed not to be or to involve any declaration as to the previous state of the law". As a result, I note that the subsequent change in the legislation has played no role in determining the present appeal.

6. Disposition and Costs

43 I would allow the appeal and set aside paragraph 1 of the order of the Court of Appeal. In lieu thereof, I would substitute an order declaring that Rizzo's former employees are entitled to make claims for termination pay (including vacation pay due thereon) and severance pay as unsecured creditors. As to costs, the Ministry of Labour led no evidence regarding what effort it made in notifying or securing the consent of the Rizzo employees before it discontinued its application for leave to appeal to this Court on their behalf. In light of these circumstances, I would order that the costs in this Court be paid to the appellant by the Ministry on a party-and-party basis. I would not disturb the orders of the courts below with respect to costs.

TAB 4

"Complex" Consol. Edison Co. v. FERC

United States Court of Appeals for the District of Columbia Circuit

November 23, 1998, Argued ; February 12, 1999, Decided

No. 97-1554, Consolidated with Nos. 97-1560, 97-1580, 97-1590

Reporter

165 F.3d 992 *; 1999 U.S. App. LEXIS 2088 **; 334 U.S. App. D.C. 205

"COMPLEX" CONSOLIDATED EDISON COMPANY OF NEW YORK, INC., ET AL., PETITIONERS v. FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT; NORTHERN ILLINOIS GAS COMPANY, ET AL., INTERVENORS

Prior History: [**1] On Petition for Review of Orders of the Federal Energy Regulatory Commission.

Disposition: JMC Power's petition for review denied. Affirmed the Commission's rulings in Opinions 406 and 406-A and its denial of Equitable's request for rehearing. Denied the petitions for review filed by JMC Power, Equitable, and Con Ed.

Core Terms

customers, facilities, rolled-in, pipeline, incremental, pricing, benefits, costs, rates, flexibility, hourly, Equitable, unjust, meter, undue discrimination, natural gas, decisions, quantitative, shippers, looping, gas pipeline, petition for review, discriminatory, integrated, mainline, Zone, system-wide, grounds, similarly situated, transportation

Case Summary

Procedural Posture

Petitioners sought review of several Federal Energy Regulatory Commission (FERC) rulings, in which FERC approved a Tennessee proposal to continue recovering the cost of a series of facility expansions on an incremental basis. Petitioners claimed that, in accepting the proposed incremental rate treatment, FERC unjustifiably departed from both its own precedent and prior decision of the district court.

Overview

Tennessee Gas Pipeline (TGP) made a general rate filing pursuant to 15 U.S.C.S. § 717c. Petitioners sought review of the Federal Energy Regulatory Commission (FERC) determinations in Opinion 406 and 406-A regarding rolled-in or incremental rate treatment for four different sets of facilities involved in the TGP rate proceeding. The petition for review was denied. The court found that FERC had provided reasoned explanations for rejecting petitioners' requests that TGP be required to shift from incremental to rolled-in pricing for TGP's NET/T-180 facilities; for approving continuation of rolled-in pricing for TGP's FSST/T-149 facilities and boundary facilities; and for rejecting a new incremental surcharge for TGP's Niagara Spur. The court noted that FERC's decision provides a reasonable reconciliation of the tension between Battle Creek and the evidentiary constraints of the Natural Gas Act § 5, 15 U.S.C.S. § 717d(a). The court also affirmed FERC's conclusion that TGP's practice of allowing greater hourly flexibility in takes for New England customers than for certain New York customers was not unduly discriminatory because of operational differences between the two groups.

Outcome

The petition for review was denied. The court concluded that Opinion 406 and 406-A clearly clarified FERC's historic test for determining the propriety of rolled-in versus incremental pricing of expansion facilities' costs, and that FERC provided a reasoned explanation for a modest shift from its strictly two-tiered Battle Creek test towards a standard that examined additional relevant factors.

LexisNexis® Headnotes

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

HN1[] **Natural Gas Industry, Natural Gas Act**

Under the Battle Creek test, the costs affiliated with expansion facilities can properly be rolled into the general system rates whenever such facilities are integrated with the pipeline system and provide system-wide benefits.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

HN2[] **Natural Gas Industry, Natural Gas Act**

See 15 U.S.C.S. § 717d(a).

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

HN3[] **Natural Gas Industry, Natural Gas Act**

The mere fact that rolled-in treatment may be just and reasonable under Battle Creek, does not establish that incremental treatment is necessarily unjust and unreasonable. There is not a single magic point on the continuum between incremental and rolled-in rates such that at that single point an incremental rate becomes unjust and unreasonable while a rolled-in rate simultaneously becomes just and reasonable.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN4[] **Natural Gas Industry, Natural Gas Act**

Under the Battle Creek test, the Federal Energy Regulatory Commission asks: (i) whether the expansion facilities form part of an integrated system that functions as a single unit in serving pre-existing and expansion customers alike; and (ii) whether the expansion facilities provide system benefits that accrue generally to all those who utilize the pipeline. Rolled-in pricing is only appropriate in those instances where expansion facilities are integrated and provide system-wide benefits.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > Certificates of Need

Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > ... > US Federal Energy Regulatory Commission > Hearings & Orders > Judicial Review

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

HN5[] **Natural Gas Act, Certificates of Need**

The district court reviews rate-setting deferentially; the court's scrutiny is limited to ensuring that the Federal Energy Regulatory Commission has made a principled and reasoned decision supported by the evidentiary record. Nevertheless, the court has strictly policed the statutory line that separates action taken under the Natural Gas Act (NGA) section 4 from that taken under NGA section 5. 15 U.S.C.S. §§ 717c(e) and 717d(a).

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN6[] **Natural Gas Industry, Natural Gas Act**

Under 15 U.S.C.S. § 717d(a), the Federal Energy Regulatory Commission (FERC) must first establish that the proposed or existing rate is unjust and unreasonable. It is only after this antecedent showing has been made that FERC properly can illustrate that its alternative rate proposal is both just and reasonable.

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview

HN7[] **Regulators, US Federal Energy Regulatory Commission**

The district court will not approve a rate formulated by the Federal Energy Regulatory Commission (FERC) unless FERC has shown (i) that the proposed and rejected rate is unjust and unreasonable and (ii) that its alternative formulation is just and reasonable.

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > Authorities & Powers

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

HN8[] **US Federal Energy Regulatory Commission, Authorities & Powers**

It is only when the proposed rate crosses the boundary separating the just from the unjust that the Federal Energy Regulatory Commission can act under its section 5 authority to order a rate of its own formulation. 15 U.S.C.S. § 717d(a).

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN9[] **Regulators, US Federal Energy Regulatory Commission**

The mere fact that the court has not required the explicit quantification of benefits does not carry a concomitant prohibition on the use of quantitative measures. Where the parties expend the necessary resources to allow for quantitative projections, the Federal Energy Regulatory Commission is not forbidden from looking at those estimations.

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > Authorities & Powers

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN10[] **US Federal Energy Regulatory Commission, Authorities & Powers**

When an expansion is both integrated and to the benefit of existing users, the Federal Energy Regulatory Commission is not bound to study the quantitative effect of rolling in construction costs.

Administrative Law > Judicial Review > Reviewability > Factual Determinations

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Administrative Proceedings > Rehearings

***HN11*[] Reviewability, Factual Determinations**

Factual differences serve to distinguish cases when some legislative policy makes the differences relevant to determining the proper scope of the prior rule.

Energy & Utilities Law > Natural Gas Industry > General Overview

Evidence > Burdens of Proof > General Overview

Energy & Utilities Law > Electric Power Industry > Federal Power Act > General Overview

Business & Corporate Compliance > ... > Electric Power Industry > Federal Power Act > Federal Rate Regulation

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > Certificates of Need

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

***HN12*[] Energy & Utilities Law, Natural Gas Industry**

Section 205 of the Federal Power Act and section 4 of the Natural Gas Act are identical in form and have been treated as identical in substance. Compare 16 U.S.C.S. §§ 824d(e) & 824e(a) with 15 U.S.C.S. §§ 717c(e) & 717d(a). There is no reason to adopt one set of evidentiary rules for rate proposals from utilities but a different set for rate proposals from pipelines. Therefore, in a proceeding supporting a rate change pursuant to section 4 of the Natural Gas Act, a pipeline may rely on any submitted evidence, regardless of its source, to satisfy its burden of proof.

Civil Procedure > Appeals > Rehearings in Appellate Courts

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > Authorities & Powers

Energy & Utilities Law > ... > US Federal Energy Regulatory Commission > Hearings & Orders > Judicial Review

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

***HN13*[] Appeals, Rehearings in Appellate Courts**

The Federal Energy Regulatory Commission (FERC) has broad discretion in exercising its authority under the Natural Gas Act and the court may not substitute its judgment for that of the agency. The court's review is limited to assuring that FERC's orders are reasoned, principled, and based upon the record.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

***HN14*[] Natural Gas Industry, Natural Gas Act**

Under the Natural Gas Act, see 15 U.S.C.S. §§ 717c, 717d, differences in the rates paid by two sets of customers are not always unduly discriminatory. Rather, to show undue discrimination, petitioner must demonstrate that the two classes of customers are similarly situated for purposes of the rate.

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

***HN15*[] Regulators, US Federal Energy Regulatory Commission**

Differences based on relevant, significant facts that are explained are not contrary to the Natural Gas Act.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

HN16[] **Natural Gas Industry, Natural Gas Act**

Although 15 U.S.C.S. § 717c(b)(2) forbids any unreasonable difference in service, the difference in service is not unreasonable because of operational constraints.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Pipelines & Transportation > Pipelines > Rates

HN17[] **Natural Gas Industry, Natural Gas Act**

The critical factor in the claim of undue discrimination is a disparity in the costs of service.

Counsel: Lee A. Alexander argued the cause for petitioners JMC Power Projects and New England Power Company. With him on the briefs were Stefan M. Krantz and Mitchell F. Hertz. Yoav K. Gery entered an appearance.

Gary E. Guy argued the cause and filed the briefs for petitioner Equitable Gas Company.

Harvey L. Reiter argued the cause for petitioners Consolidated Edison Company of New York, Inc., et al. With him on the briefs was Kenneth T. Maloney. Marc Richter entered an appearance.

Timm L. Abendroth, Attorney, Federal Energy Regulatory Commission, argued the cause for respondent. With him on the brief were Jay L. Witkin, Solicitor, and Susan J. Court, Special Counsel.

Jonathan D. Schneider argued the cause for intervenor New York State Electric and Gas Corporation.

Kevin J. McKeon argued the cause for intervenor Connecticut Natural Gas Corporation. With them [**2] on the brief were Richard M. Lorenzo, Gary E. Guy, David I. Bloom, Scott P. Klurfeld, David D'Alessandro, Tom Rattray, Barbara K. Heffernan, Roy R. Robertson, Jr., Nancy A. White, Elizabeth Ward Whittle and Kevin M. Sweeney. Lillian S. Harris and Bruce A. Connell entered appearances.

Jeffrey D. Komarow argued the cause for intervenors Tennessee Gas Pipeline Company and Bay State Gas Company, et al. With him on the brief were Robert H. Benna, Barbara K. Heffernan and Tom Rattray. Michael J. Fremuth entered an appearance.

Judges: Before: WALD, RANDOLPH and ROGERS, Circuit Judges.

Opinion

[*995] *PER CURIAM*: Tennessee Gas Pipeline Company ("Tennessee") owns and operates a "long-line" interstate natural gas pipeline system running from the Texas gulf coast to New Hampshire. In 1991, Tennessee made a general rate filing pursuant to section 4 of the Natural Gas Act. 15 U.S.C. § 717c (1994). A number of Tennessee's customers brought challenges. Most issues were resolved at various points in the ensuing rate proceedings, with the exception of those raised by the petitioners here. Petitioners now seek review of several rulings issued by the Federal Energy Regulatory Commission ("FERC" or the [**3] "Commission"). *See Tennessee Gas Pipeline Co.*, 76 F.E.R.C. P61,022 (1996) ("Opinion 406") ("*Tennessee II*"), *reh'g denied*, *Tennessee Gas Pipeline Co.*, 80 F.E.R.C. P61,389 (1997) ("Opinion 406-A") ("*Tennessee III*"). For the reasons set forth in Parts I, II, and III, we deny each of the petitions for review. [1]

[1] Part I, written by Judge Wald, discusses the NET/T-180 facilities. Part II, written by Judge Randolph, discusses the FSST/ T-149 and Boundary facilities, as well as the Niagara Spur Charge. Part III, written by Judge Rogers, discusses the Uniform Hourly Take Tariff. The factual background and procedural history relevant to each of the petitioners'

PART I: THE NET/T-180 FACILITIES

JMC Power Projects and the New England Power Company (jointly "JMC Power") petition for review of several FERC rulings, in the relevant portions of which the Commission approved a Tennessee proposal to continue recovering the costs of a series [**4] of facility expansions, collectively referred to as the NET/T-180 facilities, on an incremental basis. [2] [**5] Petitioners claim that, in accepting the proposed incremental rate treatment, FERC unjustifiably departed from both its own precedent and prior decisions of this court, and unlawfully utilized quantitative measures in assessing the potential costs and benefits of the expansion facilities to pre-existing customers. We conclude that Opinions 406 and 406-A clearly clarified the Commission's historic test for determining the propriety of rolled-in versus incremental pricing of expansion facilities' costs, and that FERC provided a reasoned explanation for a modest shift from its strictly two-tiered *Battle Creek* test [3] towards a standard that examines additional relevant factors. Because [*996] FERC supplied a sufficient explication for this clarification which, as intended, brought FERC policy into accord with this court's Natural Gas Act jurisprudence, we deny JMC Power's petition for review.

A. *Background*

Between 1988 and 1992, FERC approved the construction of seven separate projects (collectively the "NET/T-180 facilities") [4] [**7] by Tennessee, whose costs were initially to be recovered through incremental pricing. [5] In its 1991 general rate filing pursuant to section 4 of the Natural Gas Act ("NGA"), 15 U.S.C. § 717c, [6] Tennessee proposed to continue the existing incremental pricing of the NET/T-180 facilities. [7] FERC accepted the rate filing subject to refund, and set the matter for evidentiary hearing [**6] before an Administrative Law Judge ("ALJ"). Tennessee and its customers later reached an agreement settling most of the contested issues, which FERC then approved on October 29, 1993. *See Tennessee Gas Pipeline Co.*, 65 F.E.R.C. P61,142. The remaining issues were assigned to the ALJ.

In the ensuing series of evidentiary hearings, JMC Power sought rolled-in treatment for the NET/T-180 facilities by arguing that the facilities were fully integrated into the Tennessee [**8] pipeline system and provided various operational and financial benefits to

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challenges are discussed within the respective parts.

[2] "Incremental" pricing refers to a cost-recovery method in which the constructing pipeline develops a separate cost of service for the expansion facilities, recapturing the construction cost solely from the particular customers who utilize them. *See TransCanada Pipelines Ltd. v. FERC*, 306 U.S. App. D.C. 299, 24 F.3d 305, 307 n.1 (D.C. Cir. 1994). Under "rolled-in" pricing, the primary alternative to incremental treatment, the pipeline adds the costs of the expansion facilities to its total rate base, recovering its expenditures by increasing the general rate that all customers pay in proportion to their reservation of capacity or direct usage. *See Algonquin Gas Transmission Co. v. FERC*, 292 U.S. App. D.C. 197, 948 F.2d 1305, 1308 & n.1 (D.C. Cir. 1991).

[3] In *Battle Creek Co. v. FPC*, 108 U.S. App. D.C. 209, 281 F.2d 42 (D.C. Cir. 1960), this court first gave its approval to the prevailing Federal Power Commission ("FPC") policy with respect to the pricing of expansion facilities. *See Southeastern Michigan Gas Co. v. FERC*, 328 U.S. App. D.C. 171, 133 F.3d 34, 37 (D.C. Cir. 1998). ***HN1***[] Under the so-called *Battle Creek* test, the costs affiliated with expansion facilities can properly be rolled into the general system rates whenever such facilities are integrated with the pipeline system and provide system-wide benefits.

[4] Serving various customers in Zones 5 and 6 of the Tennessee pipeline, the NET/T-180 facilities are as follows. (1) The Ocean State Power Project, which provides service to a new electric generation facility, consists of roughly 14.3 miles of 30-inch mainline looping, 10.7 miles of 20-inch pipeline extension, and three new compressors. Its rate schedule was designated T-180. (2) The Niagara Import project phase II, which provides transportation service to four new customers, includes approximately 30.3 miles of 30-inch pipeline looping, 31.4 miles of 30-inch looping along the Niagara Spur, and two new compressors in New York and Massachusetts. (3) The Niagara Import project phase III, which provides transportation service to three additional customers, includes a percentage of a half mile 30-inch loop crossing the Niagara River, a percentage of 17.3 miles of mainline looping and two new compressors along the Niagara Spur, and roughly 24.4 miles of mainline looping in New York and Massachusetts. (4) The NET-Northeast project encompasses a part of both the Iroquois Gas Transmission System ("Iroquois") Phase I and Phase II expansions. (5) Iroquois Phase I provides service to twelve customers located in Massachusetts, Rhode Island, Connecticut, and New Hampshire. It includes approximately 62.8 miles of mainline looping and pipeline replacement. (6) Iroquois Phase II provides service to three customers, along with 27.13 miles of mainline looping and replacement laterals in Massachusetts, and an additional 9350 horsepower of compression at three stations situated in Massachusetts and New York. (7) The NET-Elgin project serves four customers through 29.33 miles

Tennessee and its pre-expansion customers. In particular, its primary witness testified that, in his estimation, the NET/T-180 facilities produced between $ 28.85 and $ 79.45 million in total levelized annual benefits [8] to pre-existing Tennessee customers, with a mid-case value of $ 46.53 million. He also asserted that the annual levelized costs of rolled-in treatment would amount to $ 22.73 million. [*997] *See Tennessee Gas Pipeline Co.*, 72 F.E.R.C. P63,005, at 65,077 (1995) ("*Tennessee I*"). A number of Tennessee's preexisting customers challenged these claims, questioning the existence of each alleged benefit, as well as the statistical models upon which JMC Power had assessed their value. According to the ALJ's initial decision, the weight of the evidence favored the conclusion that the NET/T-180 facilities provided neither operational benefits nor additional reliability to Tennessee's system customers. In addition, the ALJ found that rolling-in the costs of the NET/T-180 facilities to Tennessee's general rate base would cause a rate increase for pre-expansion customers in excess of 5%. *See id.* at [**9] 65,084-86. On the basis of these findings, he concluded that both the *Battle Creek* test and FERC's Pricing Policy Statement [9] mandated incremental pricing. Accordingly, he approved the Tennessee proposal to continue the existing incremental treatment. *See id.* at 65,086.

[**10] JMC Power filed exceptions to the ALJ's initial decision with the Commission, alleging that the judge had misinterpreted both FERC and D.C. Circuit precedent, and had misapplied the *Battle Creek* test in assessing the proper pricing scheme for the NET/T-180 facilities. JMC Power further contended that the ALJ had misconstrued the evidence before him, as the testimony presented (in JMC Power's view) fully established that the NET/T-180 facilities were both integrated into the Tennessee pipeline and provided significant benefits to pre-existing customers. These alleged benefits included: increased interruptible service; increased peak capacity due to both nonsynchronous demand and the fuel switching capabilities of the primary NET/T-180 customers; avoided facilities costs for future expansions; the encouragement of price competition through increased access to Canadian gas suppliers; fuel savings stemming from the greater efficiency of the new compressors; contribution to Tennessee's take-or-pay costs through the payment of the volumetric

of 30-inch and 36-inch mainline looping and 3100 additional horsepower of compression at two New York stations. *See Tennessee II*, 76 F.E.R.C. at 61,108-09.

[5] Although the projects were priced individually at the time of their respective certification, in 1992 FERC accepted a partial settlement through which Tennessee's different NET rate schedules were consolidated into a single incremental rate schedule. *See Tennessee Gas Pipeline Co.*, 63 F.E.R.C. P61,095 (1992).

[6] Section 4(e) of the NGA provides that "at any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate is just and reasonable shall be upon the natural-gas company…." 15 U.S.C. § 717c(e).

[7] Tennessee had made a limited section 4 filing in Docket No. RP92-132-000, solely addressing its NET-EU and T-180 Rate Schedules. FERC consolidated this docket with Tennessee's general section 4 rate filing in Docket No. RP91-203-000, the filing which gave rise to this case. *See Tennessee Gas Pipeline Co.*, 58 F.E.R.C. P61,343 (1992).

[8] Levelization refers to a process in which the costs of a one-time capital expenditure or a lump-sum benefit are converted into a constant annual cash flow so as to provide a consistent basis from which to compare average annual costs and benefits. The annual levelized cost refers to that amount which, if collected for each year of the project's life, would yield the same present value of revenue requirements as is yielded under traditional rate-making. The JMC Power witness utilized levelized estimates so as to avoid the distorting effects caused by straight-line depreciation, which does not differentiate between present and future value.

[9] In 1995, FERC issued a Pricing Policy for New and Existing Facilities Constructed by Interstate Natural Gas Pipeline, 71 F.E.R.C. P61,241 (1995), *reh'g denied*, 75 F.E.R.C. P61,105 (1996) ("Pricing Policy Statement"), which clarified its policy with respect to the pricing of expansion facilities. The Commission solicited comments on that subject in Docket No. PL94-4-000, receiving written submissions from seventy-five companies and groups and hearing oral comments from others through a public hearing. Concerned that the use of rolled-in pricing could force existing customers to pay substantially higher prices without receiving proportionate system-wide benefits, and that the lack of price certainty negatively impacted customers with long-term service contracts, FERC announced a new policy designed to

surcharge established by the Cosmic Settlement; [10] potential contributions to stranded investment and new facilities costs; potential contributions [**11] to gas supply realignment ("GSR") costs; and general environmental and national security benefits. Finally, JMC Power claimed that the ALJ had miscalculated the rate impact of rolling-in the contested facilities; according to JMC Power's calculations, rolled-in treatment would only result in a 4.9% rate increase, below the 5% presumption established in the Pricing Policy Statement. The parties who had presented contrary evidence before the ALJ filed briefs opposing JMC Power's exceptions.

[*998] In Opinion 406, the Commission agreed with the ALJ's decision to order incremental pricing for the NET/T-180 facilities. The Commission found the alleged system benefits postulated by JMC Power to be insubstantial; in each case, the purported benefits flowed [**12] almost entirely to the shippers for whom the NET/T-180 facilities were constructed. Because of the high load factor [11] of these shippers--roughly 85-90%--FERC concluded that they likely made substantial purchases of Canadian gas, thereby leaving little capacity available for other pre-existing shippers and limiting the availability of interruptible transportation. [12] *See Tennessee II*, 76 F.E.R.C. at 61,112. Moreover, FERC reasoned, a capacity bottleneck at Station 219 prevented upstream shippers from utilizing the NET/T-180 facilities, calling into question any additional access to Canadian gas supplies. *See id.* at 61,112-13. The alleged benefits of cheaper future expansions and declining fuel costs were deemed purely speculative, as were the payment of GSR costs in the event of future conversions to open-access transportation, and the alleged environmental and national security benefits. [13] *See id.* at 61,113-14. Finally, the Commission noted that JMC Power had manipulated its estimation of the rate increase that would accompany rolled-in treatment by illegitimately adding the costs of the FSST, Niagara Spur, and the Boundary facilities into the figure it used for the [**13] pre-expansion rate base. *See id.* at 61,114 n.144.

[**14] Departing from the ALJ's reasoning to some extent, FERC based its final determination on the grounds that JMC Power had failed to provide sufficient evidence for the Commission to find, under section 5 of the NGA, [14] [**16] not only that rolled-in treatment itself

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minimize significant rate shocks and to provide greater cost certainty prior to the construction of new facilities. The Pricing Policy Statement sought to achieve these goals by making a determination as to the appropriate rate design at the certificate stage, at which time FERC would assess the system-wide benefits of a project as well as its rate impact on existing customers. To the extent that rolled-in pricing would increase the rates of existing customers by 5% or less, and its proponents had made a showing of system benefits with "reasonable particularity," *see* 71 F.E.R.C. at 61,916, FERC would presume that the expansion costs should be rolled-in. Opponents of rolled-in pricing could rebut this presumption by establishing that the benefits of the expansion facilities were so insignificant that rolled-in pricing would be unreasonable. *See id*. at 61,916-17. To the extent that rolled-in pricing would cause a rate increase of more than 5%, the Pricing Policy Statement created a rebuttable presumption in favor of incremental treatment. Opponents could overcome this presumption through showing that the resulting system benefits were sufficient to support rolled-in treatment. *See id.*

[10] The "Cosmic Settlement" refers to an agreement that resolved a significant number of Tennessee cases pending before FERC. *See Tennessee Gas Pipeline Co.*, 57 F.E.R.C. P61,360 (1991), *order on reh'g approving settlement as modified*, 59 F.E.R.C. P61,045 (1992).

[11] The term "load factor" refers to the ratio of a shipper's average hourly use over its maximum hourly use. Customers who need a constant supply of natural gas--*e.g.*, industrial customers--will have high load factors, while those whose needs vary throughout the day--*e.g.*, residential suppliers--will generally have lower load factors.

[12] Interruptible service "provides gas on a 'when available' basis and may be interrupted after notice to the subscriber." *Algonquin*, 948 F.2d at 1309 n.5.

[13] FERC reasoned that the environmental and national security benefits proffered by JMC Power raised the type of general social benefits which the Pricing Policy Statement had deemed improper for consideration because they "are difficult to substantiate and quantify." *Id.* at 61,114 n.143 (quoting Pricing Policy Statement, 71 F.E.R.C. at 61,196). FERC also noted the ALJ's finding, based upon the record before him, that such benefits were merely speculative, and that they were unrelated to the operation of a gas pipeline. Finally, the Commission stated that it was not "aware of any cases decided under *Battle Creek* in which such general social benefits were relied on to support rolled-in rates." *Id.*

[14] ***HN2***[] Section 5(a) of the NGA provides that:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge or classification demanded, observed, charged, or collected by a natural-gas

would be just and reasonable, but also that the pipeline's proposed continuation of the existing incremental treatment would be unjust and unreasonable. Since the NGA delegates the primary initiative to propose transportation rates to the pipelines, *see United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 100 L. Ed. 373, 76 S. Ct. 373 (1956); *ANR Pipeline Co. v. FERC*, 248 U.S. App. D.C. 315, 771 F.2d 507, 513 (D.C. Cir. 1985), FERC distinguished its treatment of the FSST/T-149 and Boundary facilities, *see* discussion *infra* Part II, on the grounds that Tennessee had proposed to roll-in their facilities costs. *See Tennessee II*, 76 F.E.R.C. at 61,115. By contrast, as Tennessee had proposed to continue the existing incremental treatment of the NET/T-180 facilities in this section 4 proceeding, FERC could only have ordered rolled-in treatment by acting under section 5 of the NGA. *See Algonquin Gas* [**15] *Transmission Co. v. FERC*, 292 U.S. App. D.C. 197, 948 F.2d 1305, 1311 (D.C. Cir. 1991). Accordingly, it reviewed JMC Power's exceptions by asking [*999] whether, as the proponent of rolled-in treatment, JMC Power had offered evidence sufficient to justify the statutory burden FERC would face were it to act under section 5 to order rolled-in treatment. [15] The Commission analogized the present case to the *Algonquin* proceedings, in which this court had remanded the Commission's decision to set aside the proposed incremental treatment, and to order rolled-in rates, on the grounds that it had failed to produce substantial evidence to satisfy its section 5 burden. On the record before it, FERC held that JMC Power had similarly failed to establish that the proposed incremental treatment would be unjust or unreasonable.

In Opinion 406-A, FERC denied JMC Power's request for rehearing and further elaborated its decision denying rolled-in treatment for the NET/T-180 facilities cost. [16] Focusing upon JMC Power's assertion that it had provided substantial evidence to [**17] support its contention that rolled-in pricing would be just and reasonable, FERC ruled that, even if true, JMC Power had nevertheless failed to make the necessary prior showing that the proposed incremental rates were unjust and unreasonable. The Commission acknowledged that it had previously considered the satisfaction of *Battle Creek*--a showing of integration and system-wide benefits--sufficient to support a finding both that rolled-in treatment is just and reasonable *and* that incremental pricing is unjust and unreasonable. However, FERC went on to note, this court's *Algonquin* and *TransCanada Pipelines Ltd. v. FERC*, 306 U.S. App. D.C. 299, 24 F.3d 305 (D.C. Cir. 1994), decisions had overturned its previous two rate-setting actions under NGA section 5. In its view, "a contributing factor"

> company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule regulation, practice or contract to be thereafter observed and in force, and shall fix the same by order….

15 U.S.C. § 717d(a).

[15] In order to act under section 5, FERC would have been required to show that the existing incremental pricing was unjust and unreasonable. Implicitly, then, FERC asked whether JMC Power had satisfied the standard that FERC itself would have had to meet were it to reject the proposed incremental pricing and to order rolled-in pricing. Since FERC supported the incremental treatment proposed by Tennessee in its section 4 rate filing, and found it to be just and reasonable, it shifted the statutory burden of section 5 onto the shoulders of JMC Power when assessing the argument for rolling-in the NET/T-180 facilities cost. Although this burden would have been FERC's had it formulated and ordered its own rate, FERC discussed the matter in terms of whether JMC Power had provided sufficient evidence to satisfy the section 5 burden. We shall do the same.

[16] The Commission first rejected an offer by 68% of the NET/T-180 shippers to convert to open-access transportation service under Part 284 of the Commission's regulations, conditional upon FERC's acceptance of rolled-in treatment. Since the conversion offer constituted a new proposal, and one opposed by Tennessee, FERC could only accept the offer if it had satisfied section 5 of the NGA. As superceding settlements in Docket No. RP93-151-024, *et al.*, *Tennessee Gas Pipeline Co.*, 79 F.E.R.C. P61,031 (1997), had fixed Tennessee's GSR surcharge for existing customers, the proposed shift to Part 284 service by some of the NET/T-180 shippers would not have reduced the GSR costs borne by the pre-expansion customers in the near future. *See Tennessee III*, 80 F.E.R.C. at 61,219-21. Morever, FERC noted that conversion to Part 284 service would have shifted the rate at which the NET/T-180 facilities were depreciated from the existing 5% level to the standard system rate of 2.5%. Such a shift would have reduced the return on equity associated with the NET/T-180 facilities, decreasing the level of revenues collected by Tennessee without providing any opportunity for it to offset these losses. *See id*. at 61,221-22 & n.97. After taking the altered depreciation rate into account, FERC found that the rate impact of rolled-in treatment would still exceed the 5% threshold utilized in the Pricing Policy Statement. *See supra* n.9.

to these decisions reversing the agency's price setting action "has been an improper blurring of the distinction between NGA sections 4 and 5." *Tennessee II*, 76 F.E.R.C. at 61,223.

[**18] In what it described as a refinement of the Commission's past practices under section 5 of the NGA, taken in light of this court's repeated admonitions to respect the boundaries that separate section 4 from section 5 rate-settings, FERC reiterated its premise that there is no single just and reasonable rate. *See id.* at 61,223-24 & n.106 (citing *Western Resources, Inc. v. FERC*, 304 U.S. App. D.C. 9, 9 F.3d 1568, 1578 (D.C. Cir. 1993); *Northwest Pipeline Corp.*, 71 F.E.R.C. P61,012 at 61,042 (1995)). ***HN3***[] The mere fact that rolled-in treatment may be just and reasonable under *Battle Creek*, FERC continued, does not establish that incremental treatment is necessarily unjust and unreasonable. "There is not a single magic point on the continuum between incremental and rolled-in rates such that at [*1000] that single point an incremental rate becomes unjust and unreasonable while a rolled-in rate simultaneously becomes just and reasonable." *Tennessee III*, 80 F.E.R.C. at 61,224.

The Commission then went on to explain that its references in Opinion 406 to the fact that the benefits of the NET/T-180 facilities primarily inure to the NET/T-180 shippers served to illustrate that the [**19] proposed incremental pricing was not unjust and unreasonable. Because the facilities provided a greater and more direct benefit to the expansion shippers than to Tennessee's pre-existing customers, the postulated system benefits of increased reliability, improved flexibility, and reduction of costs were insufficiently material. This determination, coupled with the fact that rolled-in treatment would entail a substantial cost-shifting to pre-expansion customers, led the Commission to reaffirm its earlier conclusion that incremental treatment was neither unjust nor unreasonable. Accordingly, the Commission had properly approved the proposed section 4 rate filing in Opinion 406.

In this petition for review, JMC Power challenges the Commission's decisions on three separate but interrelated grounds. First, it alleges that FERC unjustifiably departed from *Battle Creek*, and that it did so in contravention of-rather than, as FERC maintains, in accordance with--this court's *Algonquin* and *TransCanada* decisions. Second, JMC Power contends that FERC unlawfully applied a "strict quantitative" standard in assessing the costs and benefits of rolled-in treatment, and that it fully satisfied [**20] the qualitative *Battle Creek* standard that should have been utilized. Finally, JMC Power asserts that the Commission improperly departed from its own *Great Lakes Gas Transmission, L.P.*, 72 F.E.R.C. P61,081 (1995) ("*Great Lakes I*") precedent, wherein it ordered rolled-in pricing on the grounds that Great Lakes Gas Transmission, L.P. ("Great Lakes") had legitimately relied upon the continued application of *Battle Creek* at the time its expansion facilities were certificated and then constructed. JMC Power maintains that it too relied upon the future application of *Battle Creek*, and that the pricing of the NET/T-180 facilities should be determined solely on the basis of that standard. We disagree with all three of JMC Power's contentions, and hold that FERC provided sufficient explication for its refinement of the *Battle Creek* test, and that the multi-factored elaboration accords with both our supervening jurisprudence and common sense.

B. *Discussion*

1. *NGA Section 5 and Rolled-in Versus Incremental Pricing*

In *Battle Creek Gas Company v. Federal Power Commission*, 108 U.S. App. D.C. 209, 281 F.2d 42 (D.C. Cir. 1960), this court distilled from [**21] FPC precedents a two-prong test for determining whether the costs of expansion facilities were properly recovered through incremental or rolled-in pricing. Under what has become known as the ***HN4***[] *Battle Creek* test, the Commission asks: (i) whether the expansion facilities form part of an integrated system that functions as a single unit in serving pre-existing and expansion customers alike; and (ii) whether the expansion facilities provide system benefits that accrue generally to all those who utilize the pipeline. *See* 281 F.2d at 47. Rolled-in pricing is only appropriate in those instances where expansion facilities are integrated and provide system-wide benefits.

The *Battle Creek* test has proven more contentious in its application than this seemingly straightforward articulation might imply. In particular, when the question of its proper application has intersected with the disparate burdens that distinguish agency action under section 4 from that under section 5 of the NGA, as it does in this case, both the Commission and the courts have had a difficult time reconciling countervailing impulses. In Opinions 406 and 406-A, the Commission sought to impose a degree of conceptual [**22] order upon rate-setting at this point of overlap. Taken together, they offer a reasoned reconciliation of the pipeline's role as the primary initiator of price setting with FERC's statutory duty to ensure that proposed rates are just, reasonable, and nondiscriminatory.

a. *Section 5 in Court*

HN5[] This court reviews rate-setting deferentially; our scrutiny is limited to ensuring [*1001] that the Commission has made a principled and reasoned decision supported by the evidentiary record. *See Columbia Gas Transmission Corp. v. FERC*, 202 U.S. App. D.C. 291, 628 F.2d 578, 593 (D.C. Cir. 1979). Nevertheless, this court has strictly policed the statutory line that separates action taken under NGA section 4 from that taken under NGA section 5. In *Algonquin*, we described this distinction as follows:

> The Commission may act under two different sections of the Natural Gas Act (NGA or the Act) to effect a change in a gas company's rates. When the Commission reviews rate increases that a gas company has proposed, it is subject to the requirements of section 4(e) of the Act, 15 U.S.C. § 717c(e). Under section 4(e), the gas company bears the burden of proving that its proposed rates are reasonable. [**23] On the other hand, when the Commission seeks to impose its own rate determinations, rather than accepting or rejecting a change proposed by the gas company, it must do so in compliance with section 5(a) of the NGA.

948 F.2d at 1311. ***HN6***[] Under section 5, the Commission must first establish that the proposed or existing rate is unjust and unreasonable. It is only after this antecedent showing has been made that the Commission properly can illustrate that its alternative rate proposal is both just and reasonable. *See id.* at 1314.

In recent years, we have rejected a series of rate orders on the grounds that the Commission had failed to adhere to this statutory distinction. Our *Western Resources* decision typifies the reaction that past FERC rate-setting ignoring that distinction has evoked. *Western Resources*, 304 U.S. App. D.C. 9, 9 F.3d 1568. There, the Commission had rejected a proposed rate increase by Panhandle Eastern Pipeline Company, substituting in its place an alternative rate formulated by the Commission staff. Defending this rate in a petition for review before this court, FERC maintained that its formulation needed only to satisfy the section 4 just and reasonable [**24] standard. In its view, the proposed rate had met this standard by half; accordingly, it ordered a rate that amounted to exactly 50% of the pipeline's proposal. In rejecting this reasoning, as well as the rate it sought to justify, this court noted that it

> has consistently disallowed attempts to blur the line between §§ 4 and 5. As we complained four years ago, 'on four occasions in the last three years this court has reviewed Commission efforts to compromise § 5's limits on the power to revise rates. On each the court has repelled the Commission's gambit. This is number five.' We now make it an even six.

9 F.3d at 1568 (internal citations omitted).

FERC decisions specifically addressing the appropriate recovery method for the cost of expansion facilities--*i.e.*, incremental versus rolled-in pricing--have faced similar repudiation. In *Algonquin*, 292 U.S. App. D.C. 197, 948 F.2d 1305, for example, this court rejected a modification of proposed incremental rates on the grounds that the Commission had failed to establish that the proposed continuation of incremental treatment would be unjust and unreasonable. In support of its order to roll-in their cost, FERC [**25] had asserted generally that the new facilities both increased the overall reliability of the pipeline and made any future expansion easier and cheaper. *See id.* at 1312. Rejecting these conclusions as unsubstantiated, the court directed the Commission to undertake an analysis of the benefits allegedly associated with the expansion facilities, and to outline "with reasonable particularity the system-wide benefits which each new facility produces" before it could order rolled-in treatment under NGA section 5. *Id.* at 1313. In *TransCanada*, 306 U.S. App. D.C. 299, 24 F.3d 305, FERC ordered the incremental pricing of expansion facilities where the pipeline had proposed to roll-in the costs. In its *TransCanada* proceedings, FERC had articulated a new standard for determining the propriety of rolled-in versus incremental pricing, which this court styled the "commensurate benefits" test. 24 F.3d at 308. Under this standard, FERC weighed the system-wide benefits that the expansion facilities provided existing customers against the costs to those same customers of rolled-in treatment; on the record before it, the Commission found those benefits insufficient to support the proposed [**26] roll-in. After comparing it with *Battle Creek*, we concluded that the "commensurate benefits" [*1002] test constituted a departure from pre-existing Commission policy. As it had not been dictated by any supervening decision of this court, and FERC had failed to provide a reasoned explanation for this policy shift, we rejected FERC's rate order and remanded for further consideration and elaboration. *See id.* at 310.

b. *The NET/T-180 Facilities*

The parties before us disagree as to the proper reading of these decisions. According to JMC Power, *Algonquin* and *TransCanada*, together with *Southeastern Michigan Gas Co. v. FERC*, 328 U.S. App. D.C. 171, 133 F.3d 34 (D.C. Cir. 1998) (affirming the rolled-in treatment of expansion facilities' cost adopted by FERC on remand from *TransCanada*), collectively require application of *Battle Creek* to the NET/T-180 facilities. In its view, *Battle Creek* controls irrespective of the particular cost-recovery method proposed by the pipeline. Having demonstrated that the expansion facilities are integrated with Tennessee's mainline pipeline and having articulated qualitative system benefits, JMC Power claims to have satisfied [**27] *Battle Creek's* requirements for rolled-in pricing, whether assessed under section 4 or section 5. By contrast, FERC asserts that JMC Power has failed to satisfy the section 5 burden imposed by our NGA jurisprudence, as the pipeline had proposed incremental pricing for the NET/T-180 facilities. In its view, a determination that rolled-in pricing would satisfy *Battle Creek* if such rates had been proposed by the pipeline does not carry with it a concomitant determination that incremental pricing would necessarily be unjust and unreasonable. Rather, these two inquiries must be kept separate from one another; to collapse them would violate the settled doctrine that there is no single just and reasonable rate. *See Tennessee III*, 80 F.E.R.C. at 61,223-24 & n.107 (citing *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 20 L. Ed. 2d 312, 88 S. Ct. 1344 (1968); *Hope Natural Gas Co.*, 320 U.S. 591, 602, 88 L. Ed. 333, 64 S. Ct. 281 (1944)). In order to satisfy the NGA's grant of primary initiative for rate-setting to the pipeline, as well as this court's derivative and repeated assertion that section 5 of the NGA imposes a more rigorous evidentiary burden than section 4, FERC [**28] contends that the two prongs of *Battle Creek* cannot any longer constitute the sole measure for determining the propriety of incremental versus rolled-in pricing. Mindful of the Commission's broad discretion over the proper allocation of costs among a pipeline's customers, *see Algonquin*, 948 F.2d at 1313; *Consolidated Gas Supply Corp. v. FPC*, 172 U.S. App. D.C. 162, 520 F.2d 1176, 1185 (D.C. Cir. 1975), we endorse FERC's reading.

An avowed refinement of the *Battle Creek* standard in light of supervening decisions by this court, the minor policy shift that FERC articulated in Opinions 406 and 406-A is reasoned and justified. As FERC explicitly acknowledged in Opinion 406-A, our *Algonquin* and *TransCanada* decisions reveal that "the Commission's past practices with respect to rolled-in [versus] incremental pricing did not give sufficient weight to this statutory scheme." *Tennessee III*, 80 F.E.R.C. at 61,224. By separating the inquiry into whether a proposed rate is unjust and unreasonable from that into whether FERC's alternative formulation is just and reasonable, FERC tailored its policy to our jurisprudence. This clarification accords with our repeated emphasis [**29] of the necessary distinction between section 4 and section 5 rate-making proceedings, and accordingly with the text and structure of the NGA. *Cf. Clark-Cowlitz Joint Operating Agency v. FERC*, 264 U.S. App. D.C. 58, 826 F.2d 1074 (D.C. Cir. 1987) (in banc) (reinterpretation of FERC policy more compelling when animated by belief that earlier policy thwarted congressional intent).

Unlike the "commensurate benefits" test that this court remanded in *TransCanada*, the refinement of *Battle Creek* currently before us has been fully explicated below. In Opinions 406 and 406-A, the Commission announced its attempt to reconcile the tension between *Battle Creek* and the evidentiary constraints of NGA section 5. It went on to provide an elaborate and reasoned justification for what we consider a reasonable reconciliation. *See Tennessee II*, 76 F.E.R.C. at 61,115-16; *Tennessee III*, 80 F.E.R.C. at 61,223-25. Although FERC did not explicitly rely upon its 1995 Pricing Policy Statement, *see* discussion *supra* note 9, [*1003] the emphasis on the 5% cost impact figure that is present in the filings of the parties, the ALJ's decision, and the Commission's discussion, evidences a keen [**30] awareness of its background presence. FERC clearly referenced and reiterated the justifications underlying the Pricing Policy Statement in its *Tennessee II* and *Tennessee III* decisions, and its desire to prevent unwarranted rate shocks lends further support for its refinement of *Battle Creek*.

We agree with FERC that the alternative reading proffered by JMC Power improperly collapses the section 5 analysis into a single determination that rolled-in pricing would be reasonable under *Battle Creek*. On this theory, it makes no difference whether the pipeline proposed incremental or rolled-in rates, as the inquiry under either section 4 or section 5 would be the same. So long as the proponent of rolled-in treatment could show that the expansion facilities are integrated with the pipeline and provide some qualitative benefits, rolled-in treatment would be necessitated. This reading falters on at least two grounds. First, it ignores the statutory distinction between section 4 and section 5 ratesetting.

[17] As this court has repeatedly emphasized, and we reiterate, section 5 contains two separate and distinct components. ***HN7***[] We will not approve a rate formulated by FERC unless the [**31] Commission has shown (i) that the proposed and rejected rate is unjust and unreasonable and (ii) that its alternative formulation is just and reasonable.

[**32] Second, despite its pretension to the contrary, the reading articulated by JMC Power is not in any way dictated by any prior decision of this court. Nothing we have said can be reasonably read to limit FERC's freedom to modify its previous policies in the manner here chosen. In *TransCanada*, we remanded FERC's orders on the grounds that the Commission had failed to supply a sufficient explanation for the new "commensurate benefits" test it had utilized below. Nevertheless, we invited FERC to provide the sort of reasoned explanation contained in Opinions 406 and 406-A. This court's most recent decision in this area, *Southeastern Michigan*, 328 U.S. App. D.C. 171, 133 F.3d 34, lends further support to the refinement of *Battle Creek* that FERC has here undertaken. There, in upholding FERC's *Great Lakes I*, 72 F.E.R.C. P61,081, *reh'g denied*, 75 F.E.R.C. P61,089 (1996) ("*Great Lakes II*"), decision on remand from *TransCanada*, where FERC had approved the proposed rolled-in pricing, this court acknowledged that "on both a theoretical and practical basis, it is perfectly possible for both cross-subsidization [18] [**34] and systemwide benefits to exist on the same facts." [**33] 133 F.3d at 41. Although the court did not make the logical connection between this possibility and the potential existence of multiple just and reasonable rates, its assertion implicitly acknowledges one of the core ideas underlying FERC's refinement of *Battle Creek*. It is because cross-subsidization and systemwide benefits can coexist that there is no single "magic point" at which incremental or rolled-in pricing becomes unjust. *Tennessee III*, 80 F.E.R.C. at 61,224. While incremental [*1004] treatment may be required at one end of the rate-setting continuum, and rolled-in pricing required at the other, in between the two extremes lie a series of intermediate points in which both cost-recovery methods would satisfy section 4's just and reasonable test. [19] At each of these places along the continuum, the pricing mechanism will essentially lie in the hands of the initiating pipeline. ***HN8***[] It is only when the proposed rate crosses the boundary separating the just from the unjust that FERC can act under its section 5 authority to order a rate of its own formulation.

c. *FERC's Use of Quantitative Measures*

JMC Power also makes much of the fact that FERC allegedly assessed both the costs as well as the postulated system benefits of the NET/T-180 expansion on a quantitative basis, alleging that the use of any quantitative standard was unlawful. While JMC Power attaches many of its previous arguments to this claim, it also makes an independent assertion that the use of a quantitative standard is in and of itself arbitrary, capricious, or contrary to law. We reject this contention, as it rests upon a misreading of this court's caselaw and defies both logic and common sense.

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[17] FERC properly accorded different treatment to the FSST/ T-149 facilities, for which Tennessee Gas had proposed rolled-in pricing. Since Tennessee Gas proposed incremental treatment for the NET/T-180 facilities, and since JMC Power failed to carry its initial burden of establishing that such treatment would be unjust and unreasonable, FERC properly approved the rate filing. Due to the distinction between section 4 and section 5 proceedings, we reject JMC Power's additional assertion of discriminatory treatment as meritless.

JMC Power makes a separate claim of discrimination which emerges directly out of this court's *TransCanada* decision. Therein, we had concluded that FERC failed to assess whether incremental pricing of integrated facilities is necessarily discriminatory. *See TransCanada*, 24 F.3d at 311. In the proceedings below, the Commission explicitly responded to this challenge, going to great lengths to establish why, given the particular facts of this case, incremental treatment was just and reasonable. Since differential rates founded upon differences of fact do not constitute discrimination, FERC clearly responded to the concerns we had articulated in *TransCanada*. *See generally Tennessee II*, 76 F.E.R.C. at 61,113-15; *Tennessee III*, 80 F.E.R.C. at 61,223-27.

[18] Cross-subsidization occurs when expansion facilities that provide limited benefits to an integrated pipeline system receive rolled-in treatment. Where pre-expansion customers bear a portion of the construction costs that is not equivalent to the benefits they receive, they essentially subsidize the investment undertaken on behalf of the expansion customers.

[19] Although formulated in different terms, the *Battle Creek* court recognized this variability in its statement that

> whether the cost of a particular facility is more properly treated as a systemic cost and rolled-in to the rate base of all of the customers, or as a segregated cost to a particular customer, which should be treated on an incremental basis, is frequently a difficult issue of fact presented to the Commission.

281 F.2d at 47.

JMC Power's argument is [**35] difficult to reconstruct, but it seems to begin from this court's statement in *Battle Creek* that the rolled-in treatment of new facilities is just and reasonable when they are integrated with the pipeline and provide system-wide benefits. Although the Trunkline Gas Company had not quantified the benefits that would likely accrue from the expansion facilities, in the form of increased capacity and a reduction in the costs of planned future expansions designed to meet the supply needs of all customers, the *Battle Creek* court held that the existence of the benefits had been sufficiently established to support rolled-in treatment. 281 F.2d at 47-48. In *Algonquin*, this court rejected an assertion of system-wide benefits that failed to establish the existence of any such benefits with "reasonable particularity," but rested instead upon conclusory assertions of fact. 948 F.2d at 1313. *Algonquin* thereby called into question excessive reliance upon unsubstantiated qualitative benefits. In *TransCanada*, by contrast, the court cut off any shift towards requiring quantitative elaboration, emphasizing that the *Algonquin* decision "was careful not to require a balancing of [**36] costs and benefits (much less a quantification thereof)." 24 F.3d at 308. From this statement, JMC Power seemingly reads a ban on the use of quantitative analysis into this court's decisions.

However, ***HN9***[] the mere fact that the court has not *required* the explicit quantification of benefits which, as this case well illustrates, are difficult to forecast with precision, does not carry a concomitant *prohibition* on the use of quantitative measures. Where the parties expend the necessary resources to allow for quantitative projections, FERC is not forbidden from looking at those estimations. *Cf. Southeastern Michigan*, 133 F.3d at 41 ("***HN10***[] when an expansion is both integrated and to the benefit of existing users, FERC *is not bound* to study the quantitative effect of rolling in construction costs") (emphasis added). While JMC Power goes to great lengths to establish that FERC utilized a "strict quantitative standard," the evidence does not bear out its contention. Once it is understood that FERC simply attempted to assess whether JMC Power had made out a claim that incremental pricing would be unjust and unreasonable, all of its allegedly damning statements become innocuous. They [**37] amount to nothing more than a determination that the alleged benefits proffered by JMC Power, which FERC found to be either speculative or to the primary benefit of the NET/T-180 customers, did not establish that incremental pricing would be unjust. For the same reason, FERC did not err in referencing its finding that rolling-in the expansion [*1005] facilities would have a rate impact of greater than 6%. That finding merely supports its conclusion that the section 5 burden had not been satisfied.

JMC Power fails to recognize the import of such quantitative estimations because it seeks to collapse the two prongs of the section 5 analysis into a single assessment of whether rolled-in rates would be just and reasonable. Once it is recognized that NGA section 4 and section 5 have different requirements, however, it becomes clear that FERC can properly utilize quantitative measures of costs and benefits in making a section 5 assessment of whether a proposed cost-recovery method would be unjust and unreasonable.

2. *The* Great Lakes *Decisions and Reliance*

After this court's *TransCanada* decision, which invalidated FERC's application of its newly-crafted "commensurate benefits" test for [**38] failure to provide a reasoned explanation for its departure from *Battle Creek*, FERC ordered a roll-in of the expansion facilities' costs at issue. *See Great Lakes I*, 72 F.E.R.C. P61,081. Rather than articulating a sufficiently detailed justification for its policy shift, FERC decided that, on the facts of the case, it would be more equitable simply to apply *Battle Creek*. At the time that the Great Lakes expansion shippers had made substantial financial commitments for the planning and construction of the additional pipeline facilities, *Battle Creek* provided the prevailing backdrop. In its petition for review, JMC Power argues that it too relied upon the continued application of *Battle Creek* when making its own financial commitments. In its view, the same principles of equity and nondiscrimination that FERC relied upon in *Great Lakes I* dictate adherence to *Battle Creek* in this case as well. We do not agree.

Despite the alleged similarities stressed by JMC Power between its situation and that of the Great Lakes expansion shippers, material differences separate the respective business and regulatory environments that they confronted. First, and we think dispositive [**39] in light of our preceding discussion of the difference between section 4 and section 5 rate-settings, the pipeline company--Great Lakes Gas Transmission Limited Partnership--proposed rolling-in the costs of the expansion facilities at issue in the *Great Lakes* decisions. *See Atchison, Topeka & Santa Fe Ry. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 808, 37 L. Ed. 2d 350, 93 S. Ct. 2367 (1973) (plurality opinion) ***HN11***[] (factual differences serve to distinguish cases "when some legislative policy makes the differences relevant to determining the proper scope of the prior rule"). In the ensuing section 4 proceeding, FERC needed only to determine whether rolled-in pricing would be just and reasonable. Throughout its *Great Lakes II* opinion denying rehearing of its order approving the proposed rolled-in rates, 75 F.E.R.C. P61,089, FERC emphasized the procedural posture of the dispute and the resulting evidentiary burdens. Responding to objections made by a pre-expansion customer--Texas Eastern--FERC distinguished a series of its own previous decisions ordering incremental treatment on the grounds that, in each case, incremental rates had been proposed by the pipeline in a section [**40] 4 rate filing. "In all but one of the cases Texas Eastern cites, the Commission implemented incremental rates at the request of the pipeline. The other case … did not involve facilities-based incremental charges…." *Id.* at 61,272.

The assertion that the NET/T-180 shippers stand in the same position as the Great Lakes expansion shippers cannot survive the comparison. Since Tennessee Gas proposed to continue the existing incremental treatment of the NET/ T-180 facilities, this case presents the very scenario expressly distinguished in *Great Lakes II*. Moreover, FERC's opinion there went on to note that, where the pipeline proposes incremental treatment, "the Commission can only order rolled-in rates if it meets its burden under NGA section 5 to show that the existing non-rolled-in rates are unjust and unreasonable, and rolled-in rates are just and reasonable." *Id.* In the present case, FERC concluded that JMC Power had failed to satisfy its burden of establishing that the proposed incremental rates are unjust and unreasonable. We have not been directed to any evidence in [*1006] the record that points to a contrary direction, and see no reason to disrupt this conclusion.

Turning [**41] to the facts underlying the *Great Lakes* decisions, we note that the original certification of the Great Lakes expansion provided for rolled-in treatment of the facilities' cost. Given that Great Lakes Transmission L.P. is an affiliate of TransCanada Pipelines, its largest customer, TransCanada knew that the pipeline would seek to continue rolled-in treatment in its next rate filing. Accordingly, its assumption that *Battle Creek* would continue to apply in the resulting section 4 proceeding, and that the expansion facilities would continue to receive rolled-in treatment, was reasonable. In the present case, by contrast, the original certification process provided for incremental pricing of the NET/T-180 facilities, without any guarantee or firm commitment that the pipeline would necessarily seek rolled-in rates at the next section 4 proceeding. *See Tennessee II*, 76 F.E.R.C. at 61,115. The Commission held that JMC Power had no reasonable expectation of rolled-in treatment, and we agree. As JMC Power makes no other claim that the application of FERC's refinement of *Battle Creek* would entail a "manifest injustice," *Clark-Cowlitz*, 826 F.2d at 1081, we uphold its application [**42] to the NET/T-180 facilities.

C. *Conclusion*

For the reasons stated, JMC Power's petition for review is denied.

PART II: THE FSST/T-149 AND BOUNDARY FACILITIES AND THE NIAGARA SPUR CHARGE

Equitable Gas Company petitions for review of the Commission's orders in *Tennessee II*, *reh'g denied, Tennessee III*. In the relevant portions of these orders, the Commission approved Tennessee's proposal to recover the costs of a series of facility expansions, collectively referred to as the FSST/T-149 and Boundary facilities, on a "rolled-in" basis, and rejected Tennessee's proposed "Niagara Spur Charge," an incremental surcharge to Tennessee's open-access firm transportation rate (Rate Schedule FT-A) concerning Tennessee's Niagara Spur facilities. Equitable claims that the Commission wrongly reviewed Tennessee's roll-in proposal under section 4 instead of section 5 of the Natural Gas Act and that the Commission wrongly denied Equitable's request for a rehearing on the Niagara Spur Charge. We hold that Opinions 406 and 406-A properly followed the statutory framework set up by the Natural Gas Act and that the Commission acted well within its discretion in denying Equitable's [**43] request for a rehearing. We therefore deny Equitable's petition for review.

A. *Background*

Tennessee's pipeline system divides into seven zones. Zones 0 and 1 (the Texas and Southern Zones) comprise Tennessee's production area. The remaining zones (Central, Eastern, Northern, New York, and New England) comprise its market area. Between 1984 and 1993, Tennessee constructed four independent expansion projects in Zones 5 and 6, including the FSST/T-149, Boundary, and Niagara Spur facilities. [20]

[20] These projects primarily involved the addition of mainline looping and compression. The looping increased the carrying capacity of the entire pipeline. *See Algonquin*, 948 F.2d at 1308-09 n.4. Both the looping and the increased compression protect customers from outages.

Tennessee designed its FSST/T-149 facilities to provide service to nine customers in Zone 6 and one customer in eastern Zone 5. Constructed along scattered portions of Tennessee's mainline in Pennsylvania, New York, New Jersey, Connecticut, [**44] Massachusetts, and New Hampshire, the facilities include approximately 74 miles of looping and 17,300 horsepower of new and additional compression. The original estimated cost of the facilities was $ 99,043,000.

Tennessee's Boundary facilities were built to provide additional gas service to four eastern Zone 5 and nine Zone 6 customers to meet their peak period needs. These facilities consist of approximately ten mainline looping segments totaling 40 miles in various counties of Pennsylvania and Tennessee.

Pursuant to settlements the Commission approved in 1985 and 1987, Tennessee agreed to recover the costs of the FSST/T-149 and [*1007] Boundary facilities initially by incremental rates. Then, in its 1991 general rate filing pursuant to section 4 of the Natural Gas Act, 15 U.S.C. § 717c, Tennessee proposed to roll in the costs of the FSST/T-149 and Boundary facilities. *See Tennessee II*, 76 F.E.R.C. at 61,095-96.

The Commission suspended Tennessee's 1991 filing for five months and ordered an evidentiary hearing before an administrative law judge to resolve cost allocation and rate design issues. Two years later, in October 1993, the Commission approved a settlement among Tennessee [**45] and its customers resolving all questions concerning the allowable level of cost Tennessee could recover in its rates. The settling parties left for prospective resolution before an administrative law judge ("ALJ") the allocation of costs of the new facilities among Tennessee's customers, and the design of Tennessee's rates. *See id.* at 61,080.

In an initial decision issued after hearings, *Tennessee I*, 72 F.E.R.C. P63,005, the ALJ ruled that Tennessee--and its customers supporting the rolled-in pricing of the FSST/T-149 and Boundary facilities--had the burden under section 5 of the Act to show both that incremental pricing of those facilities was unjust and unreasonable, and that the proposed rolled-in pricing was just and reasonable. *See id*. at 65,068. Concluding that Tennessee and the other proponents of rolled-in pricing had not met that burden, *see id*. at 65,068-69, the ALJ held that Tennessee could not recover the costs of the FSST/T-149 and Boundary facilities on a rolled-in basis.

The ALJ also addressed Tennessee's proposal to modify the previous rolled-in rate treatment of the Niagara Spur by creating a new, incremental Niagara Spur Charge. Because the Niagara [**46] Spur is integrated into Tennessee's system and was intended to benefit the Tennessee system as a whole, the ALJ rejected Tennessee's proposal. *See id.* at 65,073.

On review, the Commission reversed the ALJ's ruling with respect to the FSST/T-149 and Boundary facilities. *See Tennessee II*, 76 F.E.R.C. at 61,097-104. The Commission held that because Tennessee had proposed the change to rolled-in pricing under section 4 of the Act, Tennessee needed to establish only that rolled-in pricing was just and reasonable without the additional burden of establishing that incremental rates were unjust and unreasonable under section 5. *See id.* at 61,097-104. Finding that Tennessee had met its section 4 burden of proof, the Commission approved Tennessee's proposal to roll in the costs of the FSST/T-149 and Boundary facilities. *See id.* at 61,098-104. The Commission also affirmed the ALJ's rejection of Tennessee's proposed incremental Niagara Spur Charge. *See id.* at 61,107-08.

Equitable, a distributor of natural gas in Pennsylvania, West Virginia and Kentucky, sought rehearing, which the Commission denied in Order 406-A. See *Tennessee III*, 80 F.E.R.C. at 61,070.

B. [**47] *Discussion*

The first issue Equitable raises is whether section 4 or section 5 of the Act governs Tennessee's proposal to roll in the costs of its FSST/T-149 and Boundary facilities. As discussed in Part I of this opinion, the approval or rejection of rates proposed by the pipeline is governed by section 4. *See* 15 U.S.C. § 717c. Under section 4, the pipeline must prove that its proposed rates are just and reasonable. *See* 15 U.S.C. § 717c; *see also Public Serv. Comm'n v. FERC*, 275 U.S. App. D.C. 286, 866 F.2d 487, 488 (D.C. Cir. 1989). Section 5 applies when the Commission or an intervenor seeks to impose on the pipeline rates different from either present rates or rates proposed by the pipeline. *See* 15 U.S.C. § 717d. Under section 5, the Commission or the intervenor must prove that the pipeline's present rates are not just and reasonable and that the new rates proposed by the Commission or the intervenor are just and reasonable. *See* 15 U.S.C. § 717d; *see also Public Serv. Comm'n*, 866 F.2d at 488.

It was Tennessee who proposed to roll in the costs of the FSST/T-149 and Boundary facilities. One would therefore suppose that section 4 governed the rate proceeding. [**48] Equitable nevertheless insists section 5, rather than section 4, applies. It claims that once Tennessee canceled its rate change request, [*1008] there was no longer any basis for using section 4. The trouble with Equitable's argument is that Tennessee did not, in fact, withdraw its proposal and did not abandon its stated desire for rolled-in pricing of its FSST/T-149 and Boundary facilities. Equitable has another line of argument based on the fact that Commission trial staff and other parties--but not Tennessee--presented the evidence in support of Tennessee's rate-change request concerning the FSST/T-149 facilities. [21] According to Equitable, whether section 4 or section 5 governs depends not on the identity of the party proposing the rate change, but on the identity of the party supporting the rate change with evidence at the hearing. Since the pipeline here did not mount the case in its favor, section 4 did not control. Nothing in the Act or this circuit's precedent suggests, let alone supports, this theory. When choosing between section 4 and section 5, the Act makes the source of the proposed rate change decisive. *See East Tenn. Natural Gas Co. v. FERC*, 274 U.S. App. D.C. 243, 863 [**49] F.2d 932, 937 (D.C. Cir. 1988). Because the pipeline (Tennessee) proposed the rate change concerning the FSST/T-149 and Boundary facilities, the Commission properly followed the framework set up by the Act and applied section 4. *See Sea Robin Pipeline Co. v. FERC*, 254 U.S. App. D.C. 137, 795 F.2d 182, 183-84 (D.C. Cir. 1986). [22]

This leads to Equitable's second challenge. Even if section 4 governs Tennessee's rate-change request, Equitable tells us that [**50] the Commission erred in another respect--namely, in holding that Tennessee proved that rolled-in rates were just and reasonable. Equitable argues that Tennessee could not have met its section 4 burden of proof because Tennessee itself did not present any evidence at the hearing to support its proposal.

City of Winnfield, La. v. FERC, 240 U.S. App. D.C. 247, 744 F.2d 871 (D.C. Cir. 1984), forecloses Equitable's line of reasoning, although no one saw fit to cite the decision to us. That case involved § 205 of the Federal Power Act, 16 U.S.C. § 824d, which requires utilities to prove that their rate-change proposals are just and reasonable. The precise question in *City of Winnfield* was whether an electric utility could meet its burden of proof under § 205 even though Commission staff--not the utility-presented key evidence in support of a rate change. *See* 744 F.2d at 876. The court held that "if evidence is introduced in the proceeding supporting a rate increase, the increase can lawfully be imposed, regardless of the source from which that evidence comes." *Id*. at 877. In reaching this conclusion, the court noted that the burden of proof requirement under § 205 relates to the burden of [**51] persuasion (or, more accurately, the risk of non-persuasion), not to the burden of production, and thus the identity of the party submitting evidence is not dispositive. *See* 744 F.2d at 877. [23] ***HN12***[] Section 205 of the Federal Power Act and section 4 of the Natural Gas Act are identical in form and have been treated as identical in substance. *See* 744 F.2d at 875; *compare* 16 U.S.C. §§ 824d(e) & 824e(a) *with* 15 U.S.C. §§ 717c(e) & 717d(a). There is no reason to adopt one set of evidentiary rules for rate proposals from utilities but a different set for rate proposals from pipelines. We therefore [*1009] hold that in a proceeding supporting a rate change pursuant to section 4 of the Natural Gas Act, a pipeline may rely on any submitted evidence--regardless of its source--to satisfy its burden of proof.

[**52] The two previous Commission decisions Equitable cites do not change our mind about this. According to Equitable, under *Equitrans, L.P.*, 80 F.E.R.C. P61,144 (1997), order on reh'g, 81 F.E.R.C. P61,030 (1997), and *El Paso Natural Gas Co.,* 48 F.E.R.C. P61,018 (1989), the Commission must reject

[21] Tennessee provided some of the evidentiary support for rolling in the costs of the Boundary facilities.

[22] This is not inconsistent, as Equitable claims, with the Commission's decision to apply section 5 to the New England Customer Group's proposal to eliminate the direct assignment of Tennessee's New England lateral facilities' costs. Because the New England Customer Group proposed rates different from those urged by the pipeline, the Commission properly applied section 5 to the New England Customer Group's proposal. *See* 15 U.S.C. § 717d.

[23] The procedural setting of *City of Winnfield* was unusual. The utility proposed incremental pricing to replace its average cost rates but indicated that if the Commission rejected this proposal, the utility would accept a staff proposal to increase the utility's average cost rates. *See* 744 F.2d at 873. In the § 205 proceeding, the Commission declined to permit the incremental pricing proposal but granted the average cost rate increase. *See id.* at 875. The court stated that "it would be wasteful to require, instead of the sensible procedure adopted here, that the Commission first deny [the utility's] requested increase and that the utility then commence a separate § 205 proceeding proposing the acceptable increase of rates under the existing scheme that the Commission staff had suggested." *See id.* at 876-77.

pipeline-initiated filings if the pipeline fails to support the filing with evidence. The facts in those cases differ from the facts in this case. As the Commission pointed out, in *El Paso*, no party furnished any evidence to support the filing. In *Equitrans*, the pipeline submitted some evidence to support its filing, but the Commission described it as "seriously deficient." [24] 81 F.E.R.C. at 61,157. In marked contrast, here no one disputes that intervenors and the Commission trial staff presented extensive evidence to support Tennessee's filing. Equitable does not challenge the adequacy of the evidence. The issue, according to Equitable, is whether the standard governing a pipeline's rate proposal turns on the identity of the party supporting the filing with evidence. As *City of Winnfield* makes clear, it does not.

[**53] One other detail about Tennessee's filing merits mention. Equitable contends that Tennessee failed to submit certain statements required by 18 C.F.R. §§ 154.301 & 154.312. Although the record is not clear in this regard, the Commission appeared to concede at oral argument that Tennessee may not have filed some documents required by Commission regulations. We will assume, arguendo, that Tennessee failed in this respect. But we will not assume that Tennessee's neglect obligated the Commission to reject its filing. The Commission has broad discretion to decide whether a filing substantially complies with its regulations. *See United Gas Pipe Line Co. v. FERC*, 228 U.S. App. D.C. 102, 707 F.2d 1507, 1512 (D.C. Cir. 1983). The Commission may even accept defective filings. *See id.* That seems to be the posture the Commission adopted with respect to Tennessee's filing. In any event, it does not appear that Equitable raised this issue in a timely manner before the Commission. Equitable thus cannot raise it--and this court will not address it--now. See 15 U.S.C. § 717r(b).

The third issue Equitable raises is whether the Commission abused its discretion by not rehearing a proposal to [**54] reinstate Tennessee's proposed Niagara Spur Charge. [25] The Commission held that rolled-in pricing of the Niagara Spur facilities was just and reasonable. Equitable argues that the Niagara Spur cost-allocation decision warranted a rehearing because the Commission allowed further hearings on a cost-allocation issue involving Tennessee's New England lateral facilities.

[**55] The Commission reasonably treated the two questions differently, ordering a rehearing in one but not the other. After a review of the record and allegations by the New England Customer Group regarding the treatment of non-New England lateral facilities, the Commission concluded that the existing cost-allocation of the New England laterals potentially violated the anti-discrimination provisions of section 5 of the Act. Although a hearing had already been held on the general issue of the justness and reasonableness [*1010] of that allocation methodology, the specific subsidiary issue whether the methodology is unduly discriminatory was not fully explored. In order to answer that question on the merits, the Commission believed it needed to develop the record further, and thus ordered a rehearing. The situation with the Niagara Spur cost-allocation issue was different. The record regarding this subject was adequate to decide on the merits whether rolled-in pricing of the Niagara Spur facilities was just and reasonable. In the Commission's considered view, further hearings were not needed. See Cajun Elec. Power Coop., Inc. v. FERC, 307 U.S. App. D.C. 306, 28 F.3d 173, 177 (D.C. Cir. 1994). We [**56] find no reason to question the Commission's judgment. For these reasons, and in deference to the Commission's expertise in deciding whether to conduct hearings in the first instance, *see Alabama Power Co. v. FERC*, 301 U.S. App. D.C. 253, 993 F.2d 1557, 1565 (D.C. Cir. 1993); *Southern Union Gas Co. v. FERC*, 268 U.S. App. D.C. 257, 840 F.2d 964, 970-71 (D.C. Cir. 1988), we hold that its refusal to rehear a proposal concerning the Niagara Spur Charge fell well within the Commission's discretion.

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[24] Equitable also cites *Pacific Gas Transmission Co.*, 66 F.E.R.C. P61,384 (1994). But that case does not address the issue here, namely, whether a pipeline's failure to support a section 4 filing with evidence requires the Commission to reject the pipeline's filing.

[25] Tennessee's Niagara Spur is located in Zone 5 and extends from an interconnection between the systems of Tennessee and a Canadian pipeline at the Niagara River to a connection with Tennessee's mainline at East Aurora, New York. The expansion of the Niagara Spur facilities involved the addition of odorization facilities and permanent compression facilities. The new facilities increased pressure on the Niagara Spur so that Tennessee could begin using the Niagara Spur to deliver gas to mainline customers. The Niagara Spur Charge recovers approximately half of the cost of the Niagara Spur facilities from those Rate Schedule FT-A shippers with primary receipt points on the Niagara Spur for delivery of transportation of Canadian gas supply into Tennessee's Zones 5 and 6. The remaining Niagara Spur costs are allocated to incremental Rate Schedule NET-Segment 1 shippers with firm transportation rights on the Niagara Spur.

C. *Conclusion*

No useful purpose would be served by setting forth Equitable's other arguments. We have considered and rejected them. We therefore affirm the Commission's rulings in Opinions 406 and 406-A and its denial of Equitable's request for rehearing.

PART III: THE UNIFORM HOURLY TAKE TARIFF

Consolidated Edison, Brooklyn Union, and the Long Island Lighting Companies (collectively "Con Ed") fare no better in contending that the Commission erred in concluding that Tennessee does not unduly discriminate in the implementation of a tariff provision governing the uniform hourly take of gas. The Commission reasonably found that while Tennessee routinely provides New England [**57] customers with greater hourly flexibility than New York area customers such as Con Ed, Tennessee was not unduly discriminatory because the two sets of customers were not similarly situated, due to the operational constraints of the system.

A. *Background*

A tariff provision affecting two of Tennessee's rate schedules requires customers to take "as nearly as practicable" uniform hourly quantities of their daily entitlements to gas. § 4.11 of Rate Schedule FT-A; *see also* § 4.4 of Rate Schedule IT. Con Ed complained to the Commission that Tennessee does not uniformly apply that provision; while a flow control valve at the White Plains meter limited Con Ed's hourly take of gas to strictly 1/24 (or 4.2%) of its daily contract, New England customers, with no flow control valves in place at their meters, routinely could take up to 6% of their daily entitlements during any given peak hour "under an informal, unwritten, and unfiled agreement." *Tennessee I*, 72 F.E.R.C. at 65,116. At the rates in effect during the administrative proceedings, Con Ed claimed that it could have contracted for 31% less gas, at an annual savings of approximately $ 4 million, had it been given the [**58] same hourly flexibility as the New England customers. Contending that Tennessee's practice constitutes undue discrimination in violation of sections 4 and 5 of the Natural Gas Act, *see* 15 U.S.C. §§ 717c-717d, Con Ed claimed that it should be allowed the same degree of hourly flexibility, or in the alternative, if Tennessee was able to demonstrate that it was operationally incapable of resetting the meters to provide the same flexibility, then Con Ed should be charged a lower rate to reflect the "inferior" quality of service. 72 F.E.R.C. at 65,116.

In his initial decision, the ALJ found that there was no evidence of undue preference; the uniform hourly take provision applied to all of Tennessee's customers, and any customer was entitled to flexibility if it was operationally feasible for Tennessee to allow that customer to take gas in excess of its scheduled hourly entitlement. *Id.* at 65,121. Given its evenhanded application of the provision, Tennessee explained that any difference in the hourly flexibility of New York and New England customers was due to the system's operational design, requiring flow control devices on all of Tennessee's meters [*1011] with maximum daily quantities [**59] ("MDQs") of 100,000 Dekatherm ("Dth") per day or greater, such as the White Plains meter used to service Con Ed. [26] *Id.* at 65,118, 65,121. The ALJ found that if Tennessee removed or even reset the flow control valve on the White Plains meter to allow for the same flexibility as in New England, the amount of gas that Con Ed could potentially draw from the system would deplete the pipeline's flow, rendering Tennessee incapable of meeting its obligations to other regional customers. *Id.* In New England, however, no set of customers on a single meter could draw enough gas to compromise the system. The ALJ concluded, therefore, that Con Ed had not met its burden to demonstrate that Tennessee implemented its uniform hourly take provision in an unduly discriminatory way by treating similarly situated customers differently. *Id.* at 65,121.

[**60] The Commission affirmed the ALJ's ruling, finding that the difference in hourly flexibility was the result of operational constraints rather than preferential treatment: the evidence showed that Tennessee (1) installed flow control devices on all meters with MDQs of 100,000 Dth per day or greater, (2) permitted all customers subject to the tariff to vary their hourly takes if operationally feasible, and (3) applied the same operational standard to all of its customers, granting every customer a provisional right to hourly flexibility. [27] *Tennessee II*, 76 F.E.R.C. at 61,137-38. The Commission also found that the ability of customers to

[26] As the Commission noted, the capacity of the White Plains meter is approximately 300,000 Dth per day; Consolidated Edison's MDQ alone is 165,000 Dth per day. *Tennessee II*, 76 F.E.R.C. at 61,135 n.258.

[27] The Commission noted that under the operational standard, Tennessee adjusted the flow control valve at the White Plains meter on several occasions in the winter to allow Con Ed to take gas in excess of 1/24 of its MDQ per hour; in the summer, the flow control valve could be shut off altogether. 76 F.E.R.C. at 61,137 n.274.

take in excess of their hourly schedule was not a firm entitlement; customers were still subject to the tariff restriction, and no customer had a firm right to hourly flexibility. *Id.* at 61,138.

[**61] To the extent that the consistent application of the operational standard resulted in differing degrees of hourly flexibility for New York and New England customers, the Commission agreed with the ALJ that it was due to the physical design of the system: given the size of the flow through the White Plains meter (300,000 Dth per day) and the proportion (50%) it comprised of the total pipeline capacity of the New York market, the Commission found that it was operationally not feasible for Tennessee to reset the White Plains meter to give Con Ed the same flexibility as Tennessee provided to New England customers, as none of their meters presented the same potential for endangering the service of others. *Id.* at 61,138-39. In addition, the Commission concluded that Con Ed failed to show "that a limitation upon hourly takes, in and of itself, apart from any considerations of undue discrimination, merits the reallocation of fixed costs and redesign of rates to reflect maximum hourly entitlements, instead of maximum daily quantities." *Id.* at 61,140.

In seeking rehearing, Con Ed asserted that the consistent application of the operational standard was irrelevant if the New England [**62] customers received, in effect, a firm right to hourly flexibility, and that the difference in flexibility did not constitute a reasonable variation in the nature of service received by the customers within a class. *Tennessee III*, 80 F.E.R.C. at 61,244-45. Furthermore, Con Ed maintained that the differences in flexibility resulted from Tennessee's intentional design of its system, making the resulting differences unduly discriminatory. Under the circumstances, Con Ed concluded, the proper remedy was to adjust rates to reflect that it received an inferior quality of service. *Id.* at 61,245.

The Commission denied rehearing. Although the New England customers received more hourly take flexibility than Con Ed, it was not undue discrimination, in the Commission's view, because the two were not similarly situated, and a rational basis existed for denying Con Ed the additional flexibility. *Id.* The record showed that the size and proportion of the White Plains meter required Tennessee to maintain flow control [*1012] over Con Ed, while "no meter in New England presented the same potential for endangerment of service that the White Plains meter presented." *Id.* at 61,246. Because the [**63] differing degrees of flexibility resulted from the evenhanded application of an operational standard, the Commission opined that the evidence in the record demonstrated that the difference was not arbitrary. *Id.* The Commission rejected Con Ed's complaint that it received allegedly "inferior" service, inasmuch as Con Ed had failed to show that the lesser amount of hourly flexibility made the quality of service it received "inferior" to merit a rate adjustment. *Id.* The mere fact that Con Ed had to contact Tennessee officials to request flexibility while the New England customers could take additional gas off the system without contacting Tennessee officials, the Commission found was a "difference without substance." *Id.* (internal brackets omitted). The Commission noted, moreover, that Con Ed's service may be superior in other respects, such as delivery pressure, to the service in New England. *Id.* at 61,246 & 61,246 n.183. In any event, regardless of whether the quality of service was inferior, the Commission concluded that Con Ed failed to justify its remedy of a downward rate adjustment because it had not shown that Tennessee incurred less costs in providing service [**64] with limited flexibility to New York customers "than it does in providing the more flexible service to the New England customers, or by showing that Tennessee incurs more costs to provide the New England customers with the extra flexibility." *Id.* at 61,247.

Con Ed contends in its petition for review that because the differing degree of hourly flexibility available to New York and New England customers constitutes undue discrimination, the Commission erred in denying an appropriate remedy--namely an adjustment of its rate to reflect the inferior quality of service. *See* 5 U.S.C. § 706(2)(A),(E). Intervenors, Tennessee and the Bay State Gas Company, contend as a preliminary matter that the court is barred from entertaining what in effect is a new claim of undue discrimination. *See* NGA § 19(b), 15 U.S.C. § 717r(b); *Louisiana Ass'n of Indep. Producers & Royalty Owners v. FERC*, 294 U.S. App. D.C. 243, 958 F.2d 1101, 1117 n.8 (D.C. Cir. 1992). We disagree. Intervenors maintain that throughout the administrative proceedings, Con Ed's claim of undue discrimination was consistently one of outright preference, in which Tennessee granted additional hourly flexibility to New [**65] England customers rather than New York. Con Ed's allegedly new position, that the undue discrimination arises from the fact that it pays the same rate while receiving inferior service, was thus never argued before the Commission. In fact, Con Ed's petition for rehearing articulated the theory of discrimination it raises now on appeal. We therefore address Con Ed's contention, and do so with the recognition that ***HN13***[] the Commission has broad discretion in exercising its authority under the NGA, *see Tennessee Gas Pipeline Co. v. FERC*, 860 F.2d 446, 452 (D.C. Cir. 1988), and that the court may not "substitute its judgment for that of the agency." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43, 77 L. Ed. 2d 443, 103 S. Ct. 2856 (1983). Our review is limited to assuring that the Commission's orders are reasoned, principled, and based upon the record. *See, e.g.*, *Pennsylvania Office of Consumer Advocate v. FERC*, 327 U.S. App. D.C. 332, 131 F.3d 182, 185-86 (D.C. Cir. 1997), *modified*, 328 U.S. App. D.C. 266, 134 F.3d 422 (D.C. Cir. 1998); *Western Resources*, 9 F.3d at 1572; *Columbia Gas Transmission Corp. v. FERC*, 202 U.S. App. D.C. 291, 628 F.2d 578, 593 (D.C. [**66] Cir. 1979).

B. *Discussion*

HN14[] Under the NGA, *see* 15 U.S.C. §§ 717c, 717d, differences in the rates paid by two sets of customers are not always unduly discriminatory. Rather, to show undue discrimination, the petitioner must demonstrate that the two classes of customers are similarly situated for purposes of the rate. *See, e.g.*, *Tennessee Gas*, 860 F.2d at 452 n.9; *City of Vernon v. FERC*, 269 U.S. App. D.C. 297, 845 F.2d 1042, 1046-47 (D.C. Cir. 1988); *Consolidated Edison Co. v. FERC*, 219 U.S. App. D.C. 165, 676 F.2d 763, 773 & 773 n.31 (D.C. Cir. 1982).

In its request for rehearing, Con Ed did not challenge the Commission's findings that the largest meters of 100,000 Dth per day or greater, such as the one in White Plains, New York, required flow control devices [*1013] while the smaller meters, such as many of those in the New England states, remained on pressure control. *See* 80 F.E.R.C. at 61,245. The Commission reasonably concluded that this operational distinction, which created the difference in hourly flexibility the two groups received, showed that the New York and New England customers were not "similarly situated," and that therefore there was no undue [**67] discrimination because Tennessee had a rational basis for treating the two differently. *See id.* at 61,245-46.

The capacity constraints also entered into the Commission's analysis. It found, and Con Ed did not contest, that the capacity of the White Plains meter comprised half of the New York area market, *see* 76 F.E.R.C. at 61,138-39; 80 F.E.R.C. at 61,245-46, and to the extent Con Ed could take gas off the system in excess of the uniform hourly requirement, that Con Ed could potentially deplete the availability of service in the area, adversely affecting other Tennessee customers. 80 F.E.R.C. at 61,246. "***HN15***[] Differences ... based on relevant, significant facts which are explained are not contrary to the NGA." *TransCanada Pipelines Ltd. v. FERC*, 278 U.S. App. D.C. 299, 878 F.2d 401, 413 (D.C. Cir. 1989); *see also Metropolitan Edison Co. v. FERC*, 194 U.S. App. D.C. 44, 595 F.2d 851, 857 (D.C. Cir. 1979); *St. Michaels Utils. Comm'n v. FPC*, 377 F.2d 912, 915 (4th Cir. 1967). The Commission noted the difference in operational circumstances but found that Tennessee applied the same feasibility standard to all customers in determining whether to grant additional flexibility. [**68] *See* 80 F.E.R.C. at 61,246. For these reasons we conclude that the Commission gave an adequate explanation of how it reached its conclusion that there was no undue discrimination; the record substantially supported the Commission's findings that the two customer groups were not similarly situated, and a rational, non-discriminatory basis existed for the difference in situation, namely operational constraints.

Contrary to Con Ed's contention, the Commission did not give inconsistent reasons in Opinion Nos. 406 and 406-A. The Commission, in Opinion 406, affirmed the ALJ's finding that although there was in fact a difference in the degree of hourly flexibility, it was not a "substantive difference in treatment between the New York customers and New England customers on the part of Tennessee" because no customer had a firm right to that flexibility and all customers were given the same opportunity to vary their hourly takes if operationally feasible. 76 F.E.R.C. at 61,140. In Opinion No. 406-A, the Commission again acknowledged that "although Tennessee assesses all customer requests to vary hourly takes under the same standard, in practice, there is a difference between the hourly [**69] take flexibility that the New England customers receive and the flexibility that the New York customers receive." 80 F.E.R.C. at 61,245. The Commission then explained that the difference in treatment was not unduly discriminatory; in other words, it was "not a substantive difference in treatment" because the customers were not similarly situated and Tennessee had a rational basis for treating them differently. *Id.*

Citing *Alabama Elec. Coop., Inc. v. FERC*, 221 U.S. App. D.C. 246, 684 F.2d 20 (D.C. Cir. 1982), Con Ed contends that the Commission's finding that the New York and New England customers were not similarly situated should have led to a finding of undue discrimination. "Just as charging similarly situated customers different rates is unduly discriminatory," Con Ed maintains, "so too is it discriminatory to charge customers the same rate if, as FERC has found here, they are *not* similarly situated." Yet *Alabama Electric* does not stand for the proposition that charging the same rates to differently situated customers always constitutes undue discrimination. Although *Alabama Electric* stated that in the "unusual case," 684 F.2d at 21, charging the same rate [**70] to differently situated customers could constitute a form of discrimination, the critical determination was whether that difference was unreasonable or undue. *Id*. at 28. Because the Commission provided a sufficient explanation for the operational limits placed upon Con Ed, the resulting differences were not unduly discriminatory.

Nor can *Alabama Electric* be read to recognize quality of service claims such as Con Ed's as necessarily constituting undue discrimination. ***HN16***[] Although 15 U.S.C. § 717c(b)(2) forbids "any unreasonable difference [*1014] in … service," the difference in service here was not unreasonable because of operational constraints. Furthermore, the court in *Alabama Electric* held that the application of the same rate to customers who were similar in many respects could still potentially constitute undue discrimination if the rate applied to the two classes of customers yielded disparate rates of return on the costs to the pipeline to service them. *Id*. at 27-28. Because "it has come to be well established that … rates should be based on the costs of providing service to the utility's customers," *id*., the court concluded ***HN17***[] the critical factor in the claim of [**71] undue discrimination was a disparity in the costs of service. *Id.* at 28 & 28 n.34; *see also Electricity Consumers Resource Council v. FERC*, 241 U.S. App. D.C. 397, 747 F.2d 1511, 1515-16 (D.C. Cir. 1984).

Here, the Commission could properly find that Con Ed failed to make an adequate showing regarding such costs to justify a downward rate adjustment. 80 F.E.R.C. at 61,247. A witness for Con Ed referred to testimony by Tennessee's expert that there were additional costs in monitoring pressure control and in maintaining the New England lateral pipelines, all of which operationally contribute to New England's greater flexibility; the Con Ed witness also testified that only 50% of those costs were directly incurred by New England customers, and the rest borne by others on the system, despite the benefit to New England customers. However, merely asserting that the direct assignment of 50% of the lateral costs to New England customers was insufficient to reflect the cost of additional flexibility is not the same as submitting evidence in support of such a claim. Under section 5 of the NGA, *see Sea Robin Pipeline*, 795 F.2d at 184, Con Ed had the burden to justify a change in [**72] rates, yet it submitted no cost allocation studies on providing hourly flexibility to New England customers in comparison to those in New York. The evidence in the record demonstrates neither "that Tennessee incurs less costs in providing to the New York customers a service with limited flexibility than it does in providing the more flexible service to the New England customers, … [nor] that Tennessee incurs more costs to provide the New England customers with the extra flexibility." 80 F.E.R.C. at 61,247; *cf*. *Alabama Elec.*, 684 F.2d at 28 & 28 n.34. Moreover, the Commission found that Con Ed had not sufficiently shown that the quality of service it received was necessarily inferior to the service received by New England customers to warrant an adjustment in rates. *See* 80 F.E.R.C. at 61,246. The New England customers' service was not firm, *see* 76 F.E.R.C. at 61,138, and the Commission noted that the record reflected that in some regards, the service to Con Ed may be better than that in New England. 80 F.E.R.C. at 61,246.

C. *Conclusion*

Because the Commission's refusal to order Tennessee to provide Con Ed with a rate adjustment on the grounds of undue [**73] discrimination was reasoned and supported by the record, we deny Con Ed's petition for review.

Accordingly, we deny the petitions for review filed by JMC Power, Equitable, and Con Ed.

So ordered.

End of Document

TAB 5

133 F.E.R.C. P61,029; 2010 FERC LEXIS 1827

Federal Energy Regulatory Commission - Commission

October 12, 2010

Docket No. EL10-19-001

Reporter
133 F.E.R.C. P61,029 *; 2010 FERC LEXIS 1827 **

Western Grid Development, LLC

Core Terms

Projects, transmission, energy, Grid, storage, declaratory order, transmission facilities, batteries, reliability, wholesale, generation, markets, ancillary services, electricity, capacitors, argues, pumped, rates, planning process, storage facility, bid, asserts, costs, request for a rehearing, market participant, circumstances, classified, contends, supplied, bundled

Action

[**1]

ORDER DENYING REHEARING

Panel: Before Commissioners: Jon Wellinghoff, Chairman; Marc Spitzer, Philip D. Moeller, John R. Norris, and Cheryl A. LaFleur

Opinion

[*61114]

1. In this order, we deny requests for rehearing of an order issued on January 21, 2010 that granted Western Grid Development, LLC's (Western Grid) petition for declaratory order, finding that operation of its proposed sodium sulfur battery storage projects (Projects) in the manner it proposed would make the Projects wholesale transmission facilities, and conditionally granting the requested transmission rate incentives, with the exception of the abandoned plant incentive. [1]

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[1] *Western Grid Dev., LLC*, 130 FERC P 61,056 (2010) (Declaratory Order).

I. Background

2. On November 20, 2009, Western Grid filed a petition for declaratory order (Petition), requesting a Commission finding that its Projects are wholesale transmission facilities. [2] In addition, Western Grid requested Commission approval of certain incentive rate [**2] treatments for the Projects pursuant to section 219 of the Federal Power Act (FPA) [3] and Order No. 679. [4] In the Declaratory Order, the Commission found that, based on the circumstances and characteristics of the Projects, the Projects are wholesale transmission facilities. Importantly, the Commission determined that, because the Projects would be operated by Western Grid under the direction of the California Independent System Operator Corporation (CAISO) in a manner similar to the way in which high-voltage wholesale transmission facilities are operated currently by participating transmission owners (PTO) under the direction of CAISO, the independence of CAISO would be maintained. [5] The Commission also found that, based on the proposal to use the Projects to provide voltage support and address thermal overload situations, the Projects shared some important characteristics with capacitors, which the Commission had previously found to be transmission equipment. [6] In addition, the Commission noted that the Projects would not be bid into the CAISO markets or be market participants in any way and would pass through any incidental market revenues to customers through a PTO tariff. [7] [**3] Based upon these facts, the Commission concluded that the Projects would be wholesale transmission facilities if built and operated in the manner proposed. The Commission emphasized that its findings applied only to the specific Projects already identified by Western Grid to CAISO in CAISO's transmission planning process as of the date Western Grid filed the Petition. The Commission stated that it did not intend to classify all energy storage projects as wholesale transmission facilities and did not rule out the possibility of a general rulemaking on the issue in the future. [8] [**4]

3. The Commission also conditionally granted Western Grid's request for the following incentives: (1) inclusion of 100 percent of the Projects' construction work in progress (CWIP) in rate base; (2) a combined return on equity (ROE) adder of 195 basis-points for the Projects; (3) deferred cost recovery through creation of a regulatory asset for pre-commercial costs that will be amortized over five years; and (4) a hypothetical capital structure of 50 percent equity and 50 percent debt until the Projects are placed into service. The Commission's grant of these incentives was conditioned upon, among other things, CAISO's approval of the Projects in its transmission planning process. The Commission denied Western Grid's request for recovery of 100 percent of prudently-incurred abandoned plant costs if the Projects were cancelled or abandoned for reasons beyond Western Grid's control.

4. Public Service Electric & Gas Company, PSEG Energy Resources & Trade LLC, and PSEG Power LLC (collectively, PSE&G) and the California Department of Water Resources State Water Project (SWP) [**5] filed timely requests for rehearing.

[*61115] **II. Discussion**

A. Rehearing Requests

5. In its request for rehearing, PSE&G argues that the Commission erred in finding that batteries could function as transmission assets. PSE&G asserts that, very much like pumped storage facilities that have long been classified

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[2] Western Grid November 20, 2009 Petition for Declaratory Order in Docket No. EL10-19-000 (Petition).

[3] 16 U.S.C. § 825s (2006).

[4] *Promoting Transmission Investment through Pricing Reform*, Order No. 679, FERC Stats. & Regs. P 31,222 (2006), *order on reh'g*, Order No. 679-A, FERC Stats. & Regs. P 31,236, *order on reh'g*, 119 FERC P 61,062 (2007).

[5] Declaratory Order, 130 FERC P 61,056 at P 45.

[6] *Id*. P 47.

[7] *Id*. P 46, 47, 50, 51.

[8] *Id*. P 56.

as generation, batteries store energy received and later release stored energy to provide ancillary services. PSE&G further contends that batteries are easily distinguished from capacitors, which have been classified as transmission, because, unlike capacitors, batteries are "active" in the sense that they can produce real energy and displace generation or other resources that are supplying energy and/or ancillary services in the competitive marketplace. [9]

6. Further, PSE&G asserts that the Commission failed to articulate a sound basis for departing from applicable precedent [**6] regarding the status of energy storage facilities. [10] PSE&G argues that this "substantial deviation from past established Commission policy and practices" clashes with the reasonable expectations of market participants and violates procedural due process requirements. [11] Finally, PSE&G contends that the Commission's determination in the Declaratory Order is not consistent with the definition of transmission facilities under the North American Electric Reliability Corporation (NERC) reliability standards [12] because batteries "are not associated equipment necessary for the movement of power over bulk power transmission lines." [13]

[**7]

7. Both PSE&G and SWP claim that the Commission's approval of the requested rate treatment for the Projects is inconsistent with existing open access and pro-competition policies and fails to articulate a basis for departing from such requirements. Specifically, according to SWP and PSE&G, the Projects would be providing ancillary services that cannot be rolled into transmission rates under Order No. 888. [14] PSE&G contends that the products that will be supplied by the Projects are part of the competitive ancillary services market and, as such, must be unbundled from transmission to ensure a competitive outcome. [15] SWP asserts that the Declaratory Order is at odds with the Commission's finding in *Nevada Hydro II* that the "purpose of the CAISO's transmission access charge is to recover the costs of transmission facilities under the control of the CAISO; the purpose is not to recover bundled services." [16] In addition, SWP argues that the Projects exhibit none of the natural monopoly characteristics of transmission facilities [**8] and asserts that Commission transmission ratemaking is not intended to use ratepayer funding as a way to shield a start-up competitor from market forces. Further, SWP claims that the Commission's decision to use a case-by-case approach to electricity storage devices not only eliminates the efficiencies of competition by selecting certain projects as "winners" in terms of rate and financing advantages, but also fosters undue discrimination against other providers of similar reliability services. [17] Finally, SWP argues that the Commission's

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[9] PSE&G February 22, 2010 Request for Rehearing in Docket No. EL10-19-001 at 5-6 (PSE&G Rehearing Request).

[10] *Id*. at 7-8 (citing *Norton Energy Storage, L.L.C*., 95 FERC P 61,476 (2001) (*Norton Energy Storage*) (granting petition for declaratory order to establish that energy exchange transactions facilitated by a compressed air energy storage facility were subject to the Commission's exclusive jurisdiction); *Nevada Hydro Co*., 122 FERC P 61,272, at P 83 (2008) (*Nevada Hydro II*) (rejecting request to recover costs of pumped storage facility in CAISO transmission access charge)).

[11] *Id*. at 15-16.

[12] *Id*. at 10.

[13] *Id*.

[14] *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities*, Order No. 888, FERC Stats. & Regs. P 31,036 (1996), *order on reh'g*, Order No. 888-A, FERC Stats. & Regs. P 31,048, *order on reh'g*, Order No. 888-B, 81 FERC P 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC P 61,046 (1998), *aff'd in relevant part sub nom. Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 343 U.S. App. D.C. 151 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 535 U.S. 1, 122 S. Ct. 1012, 152 L. Ed. 2d 47 (2002).

[15] PSE&G Rehearing Request at 10-11.

[16] SWP Request for Rehearing in Docket No. EL10-19-001 at 8-9 (SWP Rehearing Request) (citing *Nevada Hydro II*, 122 FERC P 61,272 at P 83 (internal quotes omitted)).

[17] *Id*. at 10-12.

failure to address what SWP considers the "anti-competitive effects" of Western Grid's proposal cannot be reconciled with the Commission's statutory duty under numerous sections of the FPA. [18]

[**9]

8. Similarly, PSE&G asserts that the Commission failed to adequately consider the impact of its finding on the CAISO markets and opines that any energy and ancillary services that would be provided by the Projects would displace energy that would otherwise be competitively procured. Thus, PSE&G argues that any energy released by the Projects would affect market prices. PSE&G contends that the record does not support the Commission's finding of no adverse market impact. [19] PSE&G argues that the Commission failed to adequately consider and respond to the concerns raised by the CAISO that the treatment of energy storage devices as transmission will result in discrimination and harm to the markets. [20]

[**10]

9. SWP claims that the Commission failed to consider the justness and reasonableness of the rate incentives approved in the Declaratory Order. SWP appears to argue that, by conditioning the grant of the rate incentives on approval of the Projects in the CAISO transmission planning process, [*61116] the Commission improperly delegated its ratemaking responsibilities to CAISO. [21] SWP challenges the Commission's determination that Western Grid's proposal to retain operational control of the Projects makes transmission rate treatment appropriate. SWP argues that this finding is contrary to both the CAISO tariff, which defines the transmission revenue requirement as "the total annual authorized revenue requirements associated with transmission facilities ... turned over to the operational control of the CAISO," [22] and prior Commission determinations that energy storage facilities must be under CAISO control to receive transmission rates. [23] According to SWP, the Projects would not be under CAISO's operational control. Thus, SWP asserts that the finding that CAISO will be responsible [**11] for directing the use of the Projects in the same manner as other transmission assets rests upon factual error and not substantial record evidence. [24]

10. PSE&G contends that the Commission should have set this matter for hearing or undertaken further investigation of the issues through a technical conference or rulemaking. PSE&G argues that, pursuant to the requirements of the Administrative Procedure Act, [25] the Commission cannot use this single issue proceeding to effect a major policy change regarding the treatment of energy storage. [26] SWP repeats its request that the Commission convene a proceeding to establish a national policy for the treatment of energy storage devices, instead of proceeding via a case-by-case [**12] approach. SWP states that cost allocation is one of the energy storage issues that needs to be addressed. Specifically, SWP questions whether the Projects would pay transmission costs when acting as a load, as other loads do. SWP expresses concern that the "load pays" approach to transmission cost allocation has been adopted by CAISO and other RTOs/ISOs without clear

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[18] *Id*. at 12 (citing *Gulf States Utils. Co. v. FPC*, 411 U.S. 747, 758-59, 93 S. Ct. 1870, 36 L. Ed. 2d 635 (1973)).

[19] PSE&G Rehearing Request at 11-13.

[20] *Id*. at 13-15.

[21] SWP Rehearing Request at 6-7.

[22] *Id*. at 13 (citing CAISO Tariff 4th Replacement Vol. II, 1st Rev. Sheet 960, *available* at http://www.caiso.com/2471/2471974a121c0.pdf).

[23] *Id*. (citing *Nevada Hydro II*, 122 FERC P 61,272 at P 83).

[24] *Id*. at 14.

[25] 5 U.S.C. §§ 501, *et seq*. (2006).

[26] PSE&G Rehearing Request at 17.

explanation or justification and has, as a practical matter, become increasingly difficult to apply and reconcile to demand response and energy storage. SWP suggests that this policy may unfairly discriminate against demand response and energy storage to the extent that they are allocated costs that other, generation-based, resources are not. [27]

B. Commission Determination

11. The Commission denies the rehearing requests of PSE&G and SWP. First, we reject PSE&G's contention that battery storage [**13] facilities cannot be considered transmission facilities. In the Declaratory Order, the Commission acknowledged that electricity storage devices, in a general sense, do not readily fit neatly into either of the traditional functions of generation, transmission or distribution. [28] Accordingly, rather than making a general pronouncement regarding the classification of battery storage, the Commission limited its findings to the specific facts and circumstances of this case. [29] Based on the proposed use of the Projects and the evidence submitted by the parties, the Commission concluded that the Projects share enough characteristics with capacitors to justify the analogy and afford similar treatment. [30] Therefore, we reject PSE&G's argument that, because batteries can produce real power and interact in the market, any comparison to capacitors is inapt. The mere fact that batteries, in general, have the potential to produce real power does not mean that the Projects cannot be considered transmission assets. As the Commission stated in the Declaratory Order, the Projects would "not be bid into the CAISO markets or be a market participant in any way;" instead, they would "only be operated [**14] at the CAISO's request when system reliability issues require them to provide voltage support to the grid." [31] This fundamental operational difference justifies a different cost recovery treatment. Indeed, the information supplied by Western Grid persuaded the Commission that the Projects will function in a manner that is comparable to capacitors in the sense that they will be operated to provide electricity to the transmission grid to maintain system reliability, rather than to act as an energy or capacity resource. [32] PSE&G has not supplied any additional evidence in its rehearing request to persuade us otherwise.

12. Moreover, the fact that batteries share some characteristics with pumped storage facilities, which have previously been classified as generation, [33] does not mandate a general finding that [**15] battery storage devices are generation. The rationale for denying incentive transmission rate treatment in prior cases involving pumped storage focused on the operation of the facilities at issue. [34] As the Commission explained in the Declaratory Order, the concerns that contributed to the Commission's denial in *Nevada Hydro II* were sufficiently addressed by Western Grid in its Petition. [35] *Nevada Hydro II* raised the question of whether the CAISO's operation of the Lake Elsinore Advanced Pump Storage (LEAPS) storage facility would render it an energy market participant. Nevada Hydro proposed that CAISO would decide when to charge and discharge the facility and would therefore have influence over the [*61117] prices paid and received during those operations. Nevada Hydro also did not propose any mechanism to deal with the potential costs and revenues from such market operations, which could have left CAISO in the position of being a profit-seeking operator of the LEAPS facility. Thus, the Commission concluded that

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[27] SWP Rehearing Request at 14-16.

[28] Declaratory Order, 130 FERC P 61,056 at P 44.

[29] *Id*.

[30] *Id*. P 47.

[31] *Id*. P 50.

[32] Petition, Exhibit AJP (Affidavit of Armando J. Perez) at para. 24.

[33] *See, e.g., Nevada Hydro II*, 122 FERC P 61,272.

[34] Declaratory Order, 130 FERC P 61,056 at P 48.

[35] *Id*. P 48-49.

it would be inappropriate for CAISO to assume operational control over the LEAPS facility. [36] In contrast, in the Declaratory Order, the Commission explained that Western [**16] Grid's proposal eliminated the concern raised in *Nevada Hydro II* by specifying that Western Grid, rather than CAISO, will be responsible for maintaining the state of charge of the Projects, thereby minimizing the risk that CAISO will become a profit-seeking market participant. [37] Additionally, the Commission found that Western Grid will further mitigate the concern presented by the LEAPS facility because Western Grid will credit any incidental net revenues from such transactions to its customers via the transmission access charge. [38] Therefore, there is little likelihood here that CAISO will become a profit-seeking energy market participant, and we disagree with PSE&G's contention that the Commission failed to meaningfully consider the evidence offered by CAISO on this issue. We therefore continue to find that the result in *Nevada Hydro II* is not controlling in this case.

[**17]

13. PSE&G's reliance on *Norton Energy Storage* is likewise misplaced. In *Norton Energy Storage*, the Commission did not consider the issue of whether the applicant's compressed air storage facility could be considered transmission. Rather, the case dealt with the jurisdictional question of whether a delivery of energy to the facility as part of an energy exchange was part of a wholesale transaction or whether such a delivery would be considered an end-use, retail purchase. Further, the proposed use of the facility at issue in *Norton Energy Storage* was the reclamation of energy from the compressed air facility for delivery to the parties that supplied the compression energy for subsequent resale into wholesale markets. [39] Unlike the facility in *Norton Energy Storage*, which was intended specifically to engage in wholesale energy exchange transactions, the Projects will not be market participants; the intended purpose of the Projects is to provide transmission services at CAISO's instruction. [**18] Thus, because the cases cited by PSE&G and SWP are readily distinguishable from the facts and circumstances in this proceeding, we continue to find the Projects are wholesale transmission facilities eligible for incentive rate treatment.

14. Also unavailing is PSE&G's assertion that the determination in the Declaratory Order is inconsistent with the definition of transmission facilities under the NERC reliability standards. PSE&G did not raise this issue in its initial comments on Western Grid's proposal. It is well established that a request for rehearing is not the appropriate procedural vehicle for raising issues for the first time because it is disruptive to the administrative process and denies parties the opportunity to respond. [40] As such, we need not address PG&E's arguments on this issue. However, even if we were to consider the merits of PSE&G's rehearing request on this issue, we would find PG&E's argument unavailing. The [**19] NERC definition encompasses equipment that is associated with the movement or transfer of energy, along with the lines themselves. [41] The NERC definition does not, as PSE&G implies, require that the facilities be "necessary" for the movement of power over bulk transmission lines. When used as proposed by Western Grid, the Projects are clearly equipment that is associated with the movement or transfer of electricity

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[36] *Nevada Hydro II*, 122 FERC P 61,272 at P 82.

[37] Declaratory Order, 130 FERC P 61,056 at P 49.

[38] *Id*. at P 49.

[39] *Norton Energy Storage*, 95 FERC P 61,476 at 62,699.

[40] *PJM Interconnection, L.L.C*., 126 FERC P 61,030, at P 15 (2009) (citing *Enron Energy Servs. Inc. v. Sellers of Energy*, 122 FERC P 61,015, at P 64 n.98 (2008); *Midwest Indep. Transmission Sys. Operator, Inc*., 117 FERC P 61,113, at P 188 (2006) (denying rehearing of new issues as outside the proper scope of the rehearing)).

[41] NERC defines transmission as "[a]n interconnected group of lines and associated equipment for the movement or transfer of electric energy between points of supply and points at which it is transformed for delivery to customers or is delivered to other electric systems." NERC Glossary of Terms Used in Reliability Standards (Apr. 20, 2010), *available at* http://www.nerc.com/docs/standards/rs/Glossary_of_Terms_2010April20.pdf.

over the bulk power system; in much the same way as large electricity capacitors are used, the Projects will be called to action when the system requires them for the reliable movement of power.

[**20]

15. Likewise, we find no conflict between our findings in the Declaratory Order and the requirements of Order No. 888 and related precedent. As PSE&G and SWP correctly state, the cost of providing ancillary services cannot be rolled into wholesale transmission rates under Order No. 888. [42] However, the Projects will not be used to provide competitively-procured ancillary services, so this case does not raise the type of concern over bundled rates (i.e., rates that include both generation and transmission services) that would implicate the requirements of Order No. 888. The fact that batteries are capable of providing ancillary services is incidental because, as proposed, Western Grid will not be bidding the Projects into the CAISO markets. For the same reason, we reject SWP's claim that the Declaratory Order departs from the precedent regarding the prohibition against recovering the cost of bundled services in transmission rates in *Nevada Hydro II* on this issue. In *Nevada Hydro II*, the Commission stated that the purpose of the CAISO transmission access charge is to recover the cost of transmission [*61118] facilities under CAISO's control, and not the cost of bundled services. [**21] [43] We find, however, that the Projects are intended solely to enhance the reliability of the CAISO transmission grid and will not provide any bundled services. Our finding here is thus consistent with our finding in *Nevada Hydro II*.

16. Because the Projects will not be bid into the CAISO's markets, we continue to find that the Projects will not undercut the competitive markets for ancillary services. In fact, as the Commission found in the Declaratory Order, the Projects will only be used to provide voltage support and to address thermal overload situations, at CAISO's instruction, only if there is no other competitive bid to provide that service through the markets. [44] The record contains no evidence to indicate that the Projects will be used otherwise. In their rehearing requests, neither PSE&G nor SWP provide any facts or arguments on this issue that have not already [**22] been considered by the Commission. Thus, we reject PSE&G and SWP's claims that the record does not support the Commission's finding of no adverse market impact.

17. In addition, we reject PSE&G's contention that the Commission failed to address the concerns raised by CAISO in its comments that treating the Projects as transmission facilities will result in an undue competitive advantage for the Projects. The Commission gave meaningful consideration to the comments filed by all parties, including CAISO. [45] Upon careful consideration of the evidence, the Commission determined that the fundamental operational differences between the Projects, on one hand, and generation and pumped storage, on the other, justify a different cost recovery treatment. [46] The protection against undue discrimination prohibits the dissimilar treatment of similarly situated entities; rate differences may be justified and rendered lawful based on the specific factual differences [**23] between the entities at issue. [47] Unlike generation and pumped storage, which are active market participants that earn market revenues, the Projects will not be bid into the CAISO markets or be market participants in any way. The "products" of generation and pumped storage are energy and ancillary services that are bid into the CAISO markets, whereas the "product" created by the Projects is a transmission reliability service that will only be used when there is no competitive product available to address a potential transmission reliability issue. Therefore, we continue to find that, because the Projects are not similarly situated to generation and pumped

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[42] Order No. 888, FERC Stats. & Regs. P 31,036 at 31,654-55.

[43] *Nevada Hydro II*, 122 FERC P 61,272 at P 83.

[44] Declaratory Order, 130 FERC P 61,056 at P 51.

[45] We note that the CAISO did not request rehearing of the Declaratory Order.

[46] *Id*. P 50.

[47] *See, e.g., Cities of Bethany v. FERC*, 727 F.2d 1131, 1139, 234 U.S. App. D.C. 32 (D.C. Cir. 1984) (upholding Commission order allowing utility to charge different rates pursuant to settlement agreement, negotiated in good faith, or based on differences in general characteristics such as load profile).

storage, the Commission's finding in the Declaratory Order will not provide undue preference or discriminatory treatment to the Projects.

[**24]

18. Regarding operational control of the projects, we find that SWP appears to misunderstand the division of operational responsibilities proposed by Western Grid. First, in the Declaratory Order, the Commission explained that, in order to avoid the conflicts that arose in *Nevada Hydro II*, Western Grid has proposed to perform the duties associated with day-to-day operation and maintenance, including keeping the Projects energized. The Commission found in the Declaratory Order that this strategy preserves the independence of CAISO and minimizes the likelihood that CAISO will become a profit-seeking market participant. [48] With respect to the transmission functions to be provided by the Projects, the Commission found that the Projects will be operated under the direction of CAISO in a way that is similar to the operation of other transmission assets such as capacitors that address voltage issues or alternate transmission circuits that address line overloads or trips. [49] SWP has not submitted any information in its rehearing request to convince us that the proposed distribution of operational responsibilities will conflict with CAISO tariff requirements or Commission precedent. [**25]

19. In finding that the Projects are eligible for transmission rate treatment and conditionally approving the requested incentives, the Commission has not, contrary to SWP's assertion, improperly delegated its ratemaking authority to CAISO. In the Declaratory Order, the Commission conditionally granted the incentives requested by Western Grid, with the exception of the abandoned plant incentive, subject to the Projects' approval in the CAISO transmission planning process. Specifically, the Commission found that Western Grid had not made a factual showing sufficient to demonstrate that the Projects are needed and, therefore, failed to satisfy the requirements of FPA section 219. [50] The Commission noted, however, that, because the CAISO transmission planning process would adequately consider the reliability and congestion-relieving impacts of the Projects, conditional approval was appropriate. [51]

[**26]

20. Such conditional approval does not constitute an improper delegation of the Commission's duty to ensure just and reasonable rates. The Commission made clear in the Declaratory Order that, if CAISO does approve the Projects in its transmission planning process, Western Grid must make an additional filing with the Commission [*61119] that includes evidence not only that the Projects were approved, but also that the CAISO transmission planning process included a finding that the Projects will ensure reliability or reduce the cost of delivered power by mitigating congestion, consistent with Order No. 679-A. [52] In the Declaratory Order, the Commission also conditioned its approval of Western Grid's proposal to recover 100 percent of CWIP in rate base upon Western Grid fulfilling the Commission's requirements for CWIP inclusion in a future FPA section 205 filing. [53] Likewise, the Commission stated that it would determine whether Western Grid's requested ROE is within the zone of reasonableness when Western Grid makes a future FPA section 205 filing. [54] Finally, the Commission reserved [**27] judgment regarding the justness and reasonableness of Western Grid's recovery of pre-commercial

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[48] Declaratory Order, 130 FERC P 61,056 at P 49.

[49] *Id*. P 45.

[50] *Id*. P 67 (citing Order No. 679, FERC Stats. & Regs. P 31,222 at P 57).

[51] *Id*. P 71.

[52] *Id*. (citing Order No. 679-A, FERC Stats & Regs. P 31,236 at P 49).

[53] *Id*. P 81.

[54] *Id*. P 95, 96, 98.

expenses, if any, until it seeks such recovery in a future FPA section 205 filing. [55] Thus, the Commission, not CAISO, retains the final authority regarding whether the requested incentives are appropriate and whether the resulting rates are just and reasonable.

21. In response to the claims by PSE&G and SWP that a single-issue proceeding is inappropriate for addressing the issues presented in this case, we remind the parties that the findings in the Declaratory Order do not represent a general policy regarding the classification of energy storage devices. The Commission stated clearly in the Declaratory Order that our determination was "strictly limited to the specific circumstances identified by the applicant" and emphasized that the Commission did not "intend [**28] to classify all energy storage devices as transmission or otherwise." [56] Because, as stated in the Declaratory Order, electricity storage devices do not fit neatly into one of the traditional categories of generation, transmission, or distribution, the Commission has addressed the classification of these devices on a fact-and-circumstance-sensitive, case-by-case basis. [57] While we continue to find that a general rulemaking is not necessary to address the merits of the Petition, we note that the Commission has not ruled out a general rulemaking on this issue. [58]

22. Finally, we find that SWP's concern that the current "load pays" approach to transmission cost allocation may unduly discriminate against demand response and energy [**29] storage is beyond the scope of this proceeding. This proceeding is concerned solely with the issue of whether, under the facts and circumstances of this case, the Projects can be treated as wholesale transmission facilities that are eligible for transmission rate incentives. Accordingly, we find that it would be inappropriate to generally consider the efficacy of the predominant policy approach to transmission cost allocation within the context of this proceeding.

The Commission orders:

The requests for rehearing are hereby denied, as discussed in the body of this order.

By the Commission.

End of Document

[55] *Id*. P 103.

[56] *Id*. P 56.

[57] *Id*. P 44.

[58] We note that, on June 11, 2010, Commission staff issued a request for comments on rates, accounting and financial reporting for new electric storage technologies in Docket No. AD10-13-000. Comments were filed by numerous parties.

TAB 6

Principles of Public Utility Rates

Second Edition

by
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objective rate plan. Initiated by a utility as a means of shifting to a lower level of rates without temporary loss of revenue pending the development of an enhanced demand for service, the enjoyment of the lower rates was temporarily limited to consumers whose monthly bills under these rates would not be less than their bills for the previous year. Not all commissions approved. But even those that did admitted in words or by implication that the plan was discriminatory. More recently, Nolan (1983) has discussed the lawfulness — under an undue or unreasonable preference or discrimination standard — of discounted or reduced rates for employees of public utilities. And if they are legal, should the costs be included in the company's cost-of-service allowance? Such factors as the method of wage negotiations, managerial discretion, and reasonableness of the compensation have also been included in the hearings. There does not appear to be any consensus by the states that have most recently looked at this matter (e.g., Iowa, Maine, and Washington).

By and large the tribunals have shared a popular feeling that "discrimination," as a practice of ratemaking, is an odious and pejorative term. This virulent sentiment has made regulators reluctant to characterize as discriminatory any rates which they find lawful. Approval is more likely to be expressed by a finding of "no undue discrimination," without any commitment as to whether discrimination of even a due type was found to exist.

This tendency to treat "undue discrimination" as if it were one word has been encouraged by the failure of the rate regulators to observe any single and definitive distinction between discriminatory and nondiscriminatory rate differentials. At times, the cases suggest a distinction similar to that drawn by economists, in deeming discriminatory any rate differential not based on a cost differential. But at other times "discrimination" has been used as a mere synonym for *any* kind of rate differentiation; whereas at still other times it has become a convenient, shorthand term for *undue* discrimination — for what has been called "discrimination in a legal sense." The Robinson-Patman Act (1936), treats a price differentiation as legal price discrimination (such as quantity discounts) whether or not it is economic discrimination or not (Scherer, 1980, pp. 571-582). Also, the utility representatives seldom to our knowledge have declared that value-of-the-service ratemaking constitutes discrimination. Yet this practice is regarded as the very essence of discriminatory monopoly pricing by the academic economists, even by those economists who defend it as in the public interest. Since under conditions of steep scale economies, price discrimination may be the only method available for cost recovery, a better distinction than "just" and "unjust" discrimination would have been "efficient" and "inefficient" discrimination. While this is the approach of economists in general, it is still not memorialized in the decisions of many regulatory commissions.

In view of this confusion of language, something is to be said for the proposal to drop the word discrimination as a tool of public utility ratemaking or else to let it refer to *any* difference between rates of charge at the same time and place for different units of a physically similar types of service. But even if this proposal should win general acceptance, there would still be a need to understand the significance of the distinction that economists have attempted to draw, although with only partial success, between discriminatory and nondiscriminatory rate relationships. In the remainder of this chapter, we shall first discuss the nature of the distinction and shall then turn to the problem of setting practical limits between due and undue forms and degrees of discrimination.

The Economic Meaning of Rate Discrimination

Conditions Required for Discrimination to Be Implemented. In the literature of economics, one of the cardinal attributes of prices under assumed conditions of pure competition is that of a uniform price for any one product at any given time and place. This uniformity precludes not only the price higgling and bargaining that characterizes many markets, but also the systematic practice of price differentiation designed to impose different charges on different groups of persons depending on differences in their capacity and willingness to pay. A purely competitive price, forged through the Smith (1937, e.g., p. 13) propensity in human nature to "truck, barter, and exchange one thing for another," is the same to the rich and the poor, to the powerful and the powerless, to the person who finds the product barely worth buying and to the person who would pay many times the prevailing price rather than go without.

This pressure, exercised on all sellers in a competitive market, to sell any given product at a uniform price may be imposed more or less effectively even upon monopolists unless they can divide the market for their products so as to prevent ready transfer among buyers. Otherwise, if a monopolist should attempt to discriminate, say, by selling personal computers to general customers at $1,000 each while selling them to college students at only $500 there might arise a resale market beyond the seller's control, in which the general public could buy computers directly or indirectly from college students at less than $1,000.

But with many commodities and, particularly, with many personal

TAB 7

Federal Power Com. v. Hope Natural Gas Co.

Supreme Court of the United States

October 20, 21, 1943, Argued ; January 3, 1944, Decided

No. 34

Reporter

320 U.S. 591 *; 64 S. Ct. 281 **; 88 L. Ed. 333 ***; 1944 U.S. LEXIS 1204 ****

FEDERAL POWER COMMISSION ET AL. v. HOPE NATURAL GAS CO.

Prior History: [****1] CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT. *

CERTIORARI, 319 U.S. 735, to review a decree setting aside an order of the Federal Power Commission, 44 P. U. R. (N. S.) 1, under the Natural Gas Act.

Disposition: 134 F.2d 287, reversed.

Core Terms

natural gas, rates, consumers, industrial, regulation, rate base, domestic, depreciation, Fuel, public interest, interstate, producing, the Act, rate-making, depletion, prudent, annual, oil, operating expenses, transportation, Pipeline, interstate commerce, fair value, customers, earnings, consumption, enterprise, cases, of the Act, conservation

Case Summary

Procedural Posture

Certiorari was granted to review a judgment of the United States Court of Appeals for the Fourth Circuit, which vacated a rate order issued by petitioner Federal Power Commission with regard to rates that respondent gas company was permitted to charge on the basis that the rate order was unreasonable.

Overview

The United States Supreme Court reversed the decision to set aside the rate order issued by petitioner, the Federal Power Commission. The Court found that respondent was a natural gas company that supplied natural gas to companies in Ohio and Pennsylvania and also supplied natural gas directly to consumers. Petitioner brought a complaint against respondent, arguing that respondent's rates were unreasonable. After an extensive factual review, the Court held that the Natural Gas Act gave petitioners the power to adjust respondent's rates and that the rate determined by petitioner was just and reasonable. In so holding, the Court stated that petitioner correctly considered the factors in reaching the rate and did not exceed their authority. Further, the Court held that petitioners properly considered the impact on the state in which respondent operated when petitioner issued the rate order. Additionally, the Court held that the rate was not unfairly discriminatory between domestic and industrial users. Therefore, the Court found that the rate order was permissible and reversed the judgment of the appellate court.

Outcome

The judgment finding that the rate order covering what respondent could charge for natural gas issued by petitioner Federal Power Commission was unreasonable and vacating the order was reversed because petitioner had the power to issue the order and the rate was just and reasonable.

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* Together with No. 35, City of Cleveland v. Hope Natural Gas Co., also on writ of certiorari to the Circuit Court of Appeals for the Fourth Circuit.

LexisNexis® Headnotes

Communications Law > Regulators > US Federal Communications Commission > Jurisdiction

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Natural Gas Industry > General Overview

HN1[] **US Federal Communications Commission, Jurisdiction**

Congress provides in § 4(a) of the Natural Gas Act that all natural gas rates subject to the jurisdiction of the Federal Power Commission shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful. Section 5(a) of the Natural Gas Act gives the Commission the power, after hearing, to determine the just and reasonable rate to be thereafter observed and to fix the rate by order. Section 5(a) of the Natural Gas Act also empowers the Commission to order a decrease where existing rates are unjust, unlawful, or are not the lowest reasonable rates. And Congress provides in § 19(a) of the Natural Gas Act that on review of these rate orders the finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN2[] **Natural Gas Industry, Natural Gas Act**

The Federal Power Commission is not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of pragmatic adjustments. And when the Commission's order is challenged in the courts, the question is whether that order viewed in its entirety meets the requirements of the Natural Gas Act. Under the statutory standard of just and reasonable it is the result reached not the method employed which is controlling.

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

HN3[] **Regulators, US Federal Energy Regulatory Commission**

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 Natural Gas Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Business & Corporate Compliance > ... > Transportation Law > Rail Transportation > Railroad Commissions

Energy & Utilities Law > Natural Gas Industry > Natural Gas Act > General Overview

Energy & Utilities Law > Regulators > US Federal Energy Regulatory Commission > General Overview

HN4[] **Railroads & Rail Transportation, Railroad Commissions**

The Federal Power Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Natural Gas Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

Energy & Utilities Law > Utility Companies > Rates > General Overview

HN5[] **Utility Companies, Rates**

Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called fair value rate base.

Energy & Utilities Law > Natural Gas Industry > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

HN6[] **Energy & Utilities Law, Natural Gas Industry**

There is no constitutional requirement that an owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it. The ultimate exhaustion of the supply is inevitable in the case of all natural gas companies. Moreover, the United States Supreme Court recognizes the propriety of basing annual depreciation on cost. By such a procedure the utility is made whole and the integrity of its investment maintained. No more is required.

Lawyers' Edition Display

Headnotes

CONSTITUTIONAL LAW, §730 > due process -- regulation of prices. -- > Headnote:
LEdHN[1][] [1]

The fact that, by the fixing of prices, the value of the property affected is reduced does not mean that the regulation is invalid.

PUBLIC UTILITIES, §10 > fixing rates -- "fair value." -- > Headnote:
LEdHN[2][] [2]

"Fair value" is the end, not the starting point, of the process of ratemaking when the value of the going enterprise depends on earnings under whatever rates may be anticipated.

GAS, §4 > Natural Gas Act -- reasonableness of rates. -- > Headnote:
LEdHN[3][] [3]

The result reached, not the method employed, is controlling in determining what is a "just and reasonable rate" within 5(a) of the Natural Gas Act (15 USC 717).

FEDERAL POWER COMMISSION, §1 > review of orders -- Natural Gas Act. -- > Headnote:
LEdHN[4][] [4]

If the total effect of a rate order of the Federal Power Commission under the Natural Gas Act cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end; the fact that the method employed by the Commission to reach that result may contain infirmities is not then important.

EVIDENCE, §251 > presumption -- validity of rate order of Federal Power Commission. -- > Headnote:
LEdHN[5][] [5]

A rate order of the Federal Power Commission issued under the Natural Gas Act (15 USC 717) carries a presumption of validity, and one who would upset such order has the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

GAS, §3 > fixing rates -- Natural Gas Act -- considering interests of investors. -- > Headnote:
LEdHN[6][] [6]

The rate-making process to be followed by the Federal Power Commission under the Natural Gas Act (15 USC 717) should include consideration of the interests, not only of the consumers, but also of the investors, in order that returns on investments may be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

GAS, §6 > rates -- valuation -- Natural Gas Act -- "actual legitimate cost" as base -- reasonableness of order. -- > Headnote:
LEdHN[7][] [7]

An order of the Federal Power Commission fixing, on the basis of "actual legitimate cost" rather than reproduction cost and trended original cost, a valuation of $ 33,712,526 on the properties of a natural gas company, allowing it a rate of return of 6 1/2 per cent, in a proceeding under the Natural Gas Act (15 USC 717), issued after full consideration of the financial history and present status of the company and the natural gas industry and of general economic conditions, and stressing the importance of maintaining the financial integrity of the company, cannot be said to be unjust and unreasonable, as against the company's contention that the rate base should be fixed at $ 66,000,000, where the par amount of the outstanding stock is $ 28,000,000 and only about $ 17,000,000 of this war issued for cash or other assets, the company, organized in 1908, had paid over $ 97,000,000 in cash dividends, and up to 1940 had accumulated an earned surplus of $ 8,000,000 and a depletion and depreciation reserve of $ 46,000,000, its average earnings had been twelve per cent on its invested capital and twenty per cent on the capital stock issued for cash or other assets, it had paid dividends of ten per cent in three recent years, and in four years its earned surplus had increased to almost half the value of its outstanding stock.

GAS, §4 > Natural Gas Act -- reasonableness of rates. -- > Headnote:
LEdHN[8][] [8]

Rates, fixed by the Federal Power Commission under the Natural Gas Act (15 USC 717), which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed, cannot be condemned as invalid, even though they may produce only a meager return on an alleged "fair value" rate base.

GAS, §6 > Natural Gas Act -- reasonableness of rates -- valuation -- reproduction cost. -- > Headnote:
LEdHN[9][] [9]

Where, in a rate proceeding under the Natural Gas Act (15 USC 717), the rate base contended for by the company, computed on reproduction cost new, would, in a recent four-year period, have produced a return of 3.27 per cent, whereas in fact the company in that period earned an average of 9 per cent, the Federal Power Commission is justified in concluding that the 3.27 per cent rate is the result of an inflation of the rate base, and that, accordingly, reproduction cost new is not a suitable measure for fixing the proper base.

GAS, §10 > reasonableness of rates -- Natural Gas Act -- allowances for depletion and depreciation. -- > Headnote:
LEdHN[10][] [10]

The use, by the Federal Power Commission in a rate proceeding under the Natural Gas Act (15 USC 717), of "actual legitimate cost" as the basis of both the accrued and annual allowances for depletion and depreciation, rejecting as such basis an excessive reserve accumulated by the company as a result of incorrect depletion and depreciation practices, is proper, as against the view that such allowances should be computed on the basis of "present fair value," where, on the basis adopted, the company, operating a wasting-asset business, is made whole, and the integrity of its investment is maintained.

GAS, §10 > reasonableness of rates -- Natural Gas Act -- allowances for depletion and depreciation. -- > Headnote:
LEdHN[11][] [11]

The fact that a natural gas company is a public utility required to continue its services to the public and not scheduled to end its business on a day certain does not, for the purpose of fixing its rates under the Natural Gas Act (15 USC 717), require a different basis of allowance for depletion and depreciation than is used in the case of other companies conducting a wasting-asset business.

CONSTITUTIONAL LAW, §733 > due process -- gas rates -- Natural Gas Act. -- > Headnote:
LEdHN[12][] [12]

A rate order which conforms to the requirement of 5(a) of the Natural Gas Act (15 USC 717) that the rate be "just and reasonable," conforms also to constitutional requirements.

GAS, §3 > Natural Gas Act -- fixing rates -- considering interests of producing state. -- > Headnote:
LEdHN[13][] [13]

The interests of the producing state and its citizens in the conservation and development of its natural gas resources, in the protection of reversionary interests in gas leaseholds, and in the maintenance of the tax value of gas properties within the state, are not proper subjects for consideration by the Federal Power Commission in a rate proceeding under the Natural Gas Act (15 USC 717), and cannot be invoked to compel or justify the fixing of a higher rate than would otherwise be warranted, in view of the primary purpose of the Act to protect consumers of gas against exploitation through high rates.

GAS, §11 > Natural Gas Act -- purpose -- relation to state regulation. -- > Headnote:
LEdHN[14][] [14]

The Natural Gas Act (15 USC 717) was designed to complement, not to usurp, state authority, its purpose being to regulate that wholesale distribution of gas in interstate commerce which is not subject to state regulation.

GAS, §4 > reasonableness of rates -- Natural Gas Act. -- > Headnote:
LEdHN[15][] [15]

The standards for the determination of the amount which a private operator should be allowed to earn from the sale of natural gas across state lines through an established distribution system are provided for by 4 and 5, not by 7, of the Natural Gas Act (15 USC 717).

FEDERAL POWER COMMISSION, §1 > review -- rate order -- court's substitution of own judgment. -- > Headnote:
LEdHN[16][] [16]

The court, in reviewing a rate order of the Federal Power Commission under the Natural Gas Act (15 USC 717), will not substitute its judgment for that of the Commission in determining whether the rate allowed is enough to induce private enterprise to perform completely and efficiently its functions for the public, where these matters have received adequate consideration by the Commission.

FEDERAL POWER COMMISSION, §1 > Natural Gas Act -- rate proceeding -- relative rates for industrial and domestic uses. -- > Headnote:
LEdHN[17][] [17]

The issue of the relative rates to be allowed for industrial and domestic uses of gas is not before the Federal Power Commission in a proceeding to fix the rates of an interstate gas company under 4 and 5 of the Natural Gas Act (15 USC 717), where the company merely sells the gas wholesale to distributors, and it is the latter who distribute it among the industrial and domestic consumers.

GAS, §3 > Natural Gas Act -- fixing rates -- higher rates for industrial uses. -- > Headnote:
LEdHN[18][] [18]

The desirability of discouraging the use of gas for industrial uses is not a proper subject of consideration by the Federal Power Commission in a rate proceeding under the Natural Gas Act (15 USC 717), and the Commission is without power, on this ground, to place a rate on industrial uses higher than would otherwise be warranted under the Act.

GAS, §3 > Natural Gas Act -- rate regulation -- conventional standards. -- > Headnote:
LEdHN[19][] [19]

The provisions of 4 and 5 of the Natural Gas Act (15 USC 717) for the fixing of "just and reasonable" rates were not intended to introduce any novel doctrines, but only to embrace the conventional standards, of rate making for natural gas companies.

FEDERAL POWER COMMISSION, §1 > review -- rate order under Natural Gas Act -- considering question not raised. -- > Headnote:
LEdHN[20][] [20]

The question of discrimination between industrial and domestic users, in violation of 4(b) of the Natural Gas Act (15 USC 717), is not properly before the courts on a petition to review a rate order of the Federal Power Commission in a proceeding under the Act, where the Commission has failed to make any findings under 4(b), and such failure is not challenged in the petition to review, and is not raised or argued by any party before the courts.

FEDERAL POWER COMMISSION, §1 > review -- functions of courts. -- > Headnote:
LEdHN[21][] [21]

Congress having intrusted administration of the Natural Gas Act (15 USC 717) to the Federal Power Commission, rather than to the courts, it is not for the courts, apart from the requirements of judicial review, to advise the Commission how to discharge its functions.

FEDERAL POWER COMMISSION, §1 > review -- unauthorized findings -- lawfulness of past rates. -- > Headnote:
LEdHN[22][] [22]

Findings as to the lawfulness of past rates, made by the Federal Power Commission under the Natural Gas Act (15 USC 717) in aid of state regulation, despite the Commission's admitted lack of authority under the Act to fix past rates or to make reparation orders, are not reviewable under 19(b) of the Act giving any party "aggrieved by an order" the right to a review "of such order," since, there being no authority to enforce findings of this kind, the parties are not adversely affected by them.

ADMINISTRATIVE LAW, §191 > reviewability of order -- future adverse effect. -- > Headnote:
LEdHN[23][] [23]

An administrative order which does not of itself adversely affect a party, but affects him only through the contingency of possible future action by some other agency, is not reviewable by the courts.

Syllabus

1. The validity of an order of the Federal Power Commission fixing rates under the Natural Gas Act is to be determined on judicial review by whether the impact or total effect of the order is just and reasonable rather than by the method of computing the rate base. P. 602.

2. One who seeks to have set aside an order of the Federal Power Commission fixing rates under the Natural Gas Act has the burden of showing convincingly that it is unjust and unreasonable in its consequences. P. 602.

3. An order of the Federal Power Commission reducing respondent's rates for sales of natural gas in interstate commerce, *held* valid under the Natural Gas Act. P. 603.

[****2] The rate base determined by the Commission was found by it to be the "actual legitimate cost" of the company's interstate property, less depletion and depreciation, plus allowances for unoperated acreage, working capital, and future net capital additions. "Reproduction cost new" and "trended original cost" were given no weight. Accrued depletion and depreciation and the annual allowance for depletion and depreciation were determined by application of the "economic-service-life" method to "actual legitimate cost."

4. Considering the amount of the annual return which the company would be permitted to earn on its property in interstate service, and the various factors which that return reflects, this Court is unable to say that the rates fixed by the Commission are not "just and reasonable" under the Act. P. 604.

5. Rates which enable a natural gas company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed can not be condemned as unjust and unreasonable under the Natural Gas Act, even though they might produce only a meager return on a rate base computed on the "present fair value" method. P. [****3] 605.

6. The rationale of the decision renders it unnecessary to determine whether the Commission's exclusion from the rate base of well-drilling and other costs, previously charged to operating expenses, was consistent with the "prudent investment" theory as developed and applied in particular cases. P. 605.

7. *United Railways Co*. v. *West*, 280 U.S. 234, so far as it rejects cost as the basis of depreciation allowances, is disapproved. P. 606.

8. The requirements of the Constitution in respect of rates are not more exacting than the standards of the Act; and a rate order valid under the latter is consistent with the former. P. 607.

9. In fixing "just and reasonable" rates under §§ 4 and 5 of the Natural Gas Act, for natural gas sold in interstate commerce by a private operator through an established distribution system, the Commission was not required to take into consideration the indirect benefits -- affecting the economy, conservation policies, and tax revenues -- which the producing State might derive from higher valuations and rates. P. 609.

10. The suggestion that the Commission did not allow for gas production a return sufficient to induce private [****4] enterprise to perform completely and efficiently its functions for the public is unsupported. P. 615.

11. The Commission is not empowered by the provisions of §§ 4 and 5, which authorize it to fix "just and reasonable" rates, to fix rates calculated to discourage intrastate resales for industrial use. P. 616.

12. The question whether the rates charged by the company discriminate against domestic users and in favor of industrial users is not presented. P. 617.

13. Findings of the Commission as to the lawfulness of past rates, *held* not reviewable under § 19 (b) of the Act. P. 618.

Counsel: Assistant Attorney General Shea, with whom Solicitor General Fahy and Messrs. Paul A. Freund, K. Norman Diamond, Melvin Richter, Charles V. Shannon, Milford Springer, A. F. O'Neil, Clyde B. MacDonald, Harold A. Scragg, and Samuel Graff Miller were on the brief, for petitioners in No. 34; and Mr. Spencer W. Reeder, with whom Messrs. Robert E. May and Robert M. Morgan were on the brief, for petitioner in No. 35.

Mr. William B. Cockley, with whom Messrs. Walter J. Milde and William A. Dougherty were on the brief, for respondent.

By Special leave of Court, Mr. M. M. Neely, Governor of West [****5] Virginia, with whom Messrs. Ira J. Partlow, Assistant Attorney General, and W. W. Goldsmith were on the brief, for the State of West Virginia, as amicus curiae, urging affirmance.

Briefs of amici curiae were filed by Mr. Gay H. Brown, on behalf of the Public Service Commission of New York, and Messrs. John E. Benton and Frederick G. Hamley, on behalf of the National Association of Railroad and Utilities Commissioners, in No. 34, urging reversal; and by Messrs. Donald C. McCreery and Robert D. Garver, on behalf of the Cities Service Gas Co., in Nos. 34 and 35, urging affirmance.

Judges: Stone, Black, Reed, Frankfurter, Douglas, Murphy, Jackson, Rutledge; Roberts took no part in the consideration or decision of this case.

Opinion by: DOUGLAS

Opinion

[*593] [**283] [***340] MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The primary issue in these cases concerns the validity under the Natural Gas Act of 1938 (52 Stat. 821, 15 U. S. C. § 717) of a rate order issued by the Federal Power Commission reducing the rates chargeable by Hope Natural Gas Co., 44 P. U. R. (N. S.) 1. On a petition for review of the order made pursuant to § 19 [****6] (b) of the Act, the [*594] Circuit Court of Appeals set it aside, one judge dissenting. 134 F.2d 287. The cases [**284] are here on petitions for writs of certiorari which we granted because of the public importance of the questions presented.

Hope is a West Virginia corporation organized in 1898. It is a wholly owned subsidiary of Standard Oil Co. (N. J.). Since the date of its organization, it has been in the business of producing, purchasing and marketing natural gas in that state. [1] It sells some of that gas to local consumers in West Virginia. But the great bulk of it goes to five customer companies which receive it at the West Virginia line and distribute it in Ohio and in Pennsylvania. [2] [***341] In July 1938 the cities of Cleveland and Akron filed complaints with the Commission charging that the rates collected by Hope from East Ohio Gas Co. (an affiliate of Hope which distributes gas in Ohio) were excessive and unreasonable. Later in 1938 the Commission on its own motion instituted an investigation to determine the reasonableness of all of Hope's interstate rates. In March [*595] 1939 the Public Utility Commission of Pennsylvania filed [****7] a complaint with the Commission charging that the rates collected by Hope from Peoples Natural Gas. Co. (an affiliate of Hope distributing gas in Pennsylvania) and two non-affiliated companies were unreasonable. The City of Cleveland asked that the challenged rates be declared unlawful and that just and reasonable rates be determined from June 30, 1939 to the date of the Commission's order. The latter finding was requested in aid of state regulation and to afford the Public Utilities Commission of Ohio a proper basis for disposition of a fund collected by East Ohio under bond from Ohio consumers since June 30, 1939. The cases were consolidated and hearings were held.

[****8] On May 26, 1942, the Commission entered its order and made its findings. Its order required Hope to decrease its future interstate rates so as to reflect a reduction, on an annual basis, of not less than $ 3,609,857 in operating revenues. And it established "just and reasonable" average rates per m. c. f. for each of the five customer companies. [3] In response to the prayer of the City of Cleveland the Commission also

[1] Hope produces about one-third of its annual gas requirements and purchases the rest under some 300 contracts.

[2] These five companies are the East Ohio Gas Co., the Peoples Natural Gas Co., the River Gas Co., the Fayette County Gas Co., and the Manufacturers Light & Heat Co. The first three of these companies are, like Hope, subsidiaries of Standard Oil Co. (N. J.). East Ohio and River distribute gas in Ohio, the other three in Pennsylvania. Hope's approximate sales in m. c. f. for 1940 may be classified as follows:

Go to table1

Local West Virginia sales	11,000,000
East Ohio	40,000,000
Peoples	10,000,000
River	400,000
Fayette	860,000
Manufacturers	2,000,000

Hope's natural gas is processed by Hope Construction & Refining Co., an affiliate, for the extraction of gasoline and butane. Domestic Coke Corp., another affiliate, sells coke-oven gas to Hope for boiler fuel.

[3] These required minimum reductions of 7 cents per m. c. f. from the 36.5 cents and 35.5 cents rates previously charged East Ohio and Peoples, respectively, and 3 cents per m. c. f. from the 31.5 cents rate previously charged Fayette and Manufacturers.

made findings as to the lawfulness of past rates, although concededly it had no authority under the Act to fix past rates or to award reparations. 44 P. U. R. (N. S.) p. 34. It found that the rates collected by Hope from East Ohio were unjust, unreasonable, excessive and therefore unlawful, by $ 830,892 during 1939, $ 3,219,551 during 1940, and $ 2,815,789 on an annual basis since 1940. It further found that just, reasonable, and lawful rates for gas sold by Hope to East Ohio for resale for ultimate public consumption were those required [*596] to produce $ 11,528,608 for 1939, $ 11,507,185 for 1940 and $ 11,910,947 annually since 1940.

[****9] The Commission established an interstate rate base of $ 33,712,526 which, it found, represented the "actual legitimate cost" of the company's interstate property less depletion and depreciation and plus unoperated acreage, working capital and future net capital additions. The Commission, beginning with book cost, made [**285] certain adjustments not necessary to relate here and found the "actual legitimate cost" of the plant in interstate service to be $ 51,957,416, as of December 31, 1940. It deducted accrued depletion and depreciation, which it found to be $ 22,328,016 on an "economic-service-life" basis. And it added $ 1,392,021 for future net capital additions, $ 566,105 for useful unoperated acreage, and $ 2,125,000 for working capital. It used 1940 as a test year to estimate future revenues and expenses. It allowed over $ 16,000,000 as annual operating expenses -- about $ 1,300,000 for taxes, $ 1,460,000 for depletion and depreciation, $ 600,000 for exploration and development costs, $ 8,500,000 for gas purchased. The Commission allowed a net increase of $ 421,160 over 1940 operating expenses, which amount was to take care of future increase in wages, in West Virginia [****10] property taxes, and in exploration and development costs. The total amount of deductions allowed [***342] from interstate revenues was $ 13,495,584.

Hope introduced evidence from which it estimated reproduction cost of the property at $ 97,000,000. It also presented a so-called trended "original cost" estimate which exceeded $ 105,000,000. The latter was designed "to indicate what the original cost of the property would have been if 1938 material and labor prices had prevailed throughout the whole period of the piecemeal construction of the company's property since 1898." 44 P. U. R. (N. S.), pp. 8-9. Hope estimated by the "per cent condition" method accrued depreciation at about 35% of [*597] reproduction cost new. On that basis Hope contended for a rate base of $ 66,000,000. The Commission refused to place any reliance on reproduction cost new, saying that it was "not predicated upon facts" and was "too conjectural and illusory to be given any weight in these proceedings." *Id*., p. 8. It likewise refused to give any "probative value" to trended "original cost" since it was "not founded in fact" but was "basically erroneous" and produced [****11] "irrational results." *Id*., p. 9. In determining the amount of accrued depletion and depreciation the Commission, following *Lindheimer* v. *Illinois Bell Tel. Co*., 292 U.S. 151, 167-169; *Federal Power Commission* v. *Natural Gas Pipeline Co*., 315 U.S. 575, 592-593, based its computation on "actual legitimate cost." It found that Hope during the years when its business was not under regulation did not observe "sound depreciation and depletion practices" but "actually accumulated an excessive reserve" [4] of about $ 46,000,000. *Id*., p. 18. One member of the Commission thought that the entire amount of the reserve should be deducted from "actual legitimate cost" in determining the rate base. [5] [****13] The majority of the [*598] Commission concluded, however, that where, as here, a business is brought under regulation for the first time and where incorrect depreciation and depletion practices have prevailed, the deduction of the reserve requirement (actual existing depreciation and depletion) rather than the excessive reserve should be made so as to [**286] lay "a sound basis for future regulation and control of rates." [****12] *Id*., p. 18. As we have pointed out, it determined accrued depletion and depreciation to be $ 22,328,016; and it allowed approximately $ 1,460,000 as the annual

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[4] The book reserve for interstate plant amounted at the end of 1938 to about $ 18,000,000 more than the amount determined by the Commission as the proper reserve requirement. The Commission also noted that "twice in the past the company has transferred amounts aggregating $ 7,500,000 from the depreciation and depletion reserve to surplus. When these latter adjustments are taken into account, the excess becomes $ 25,500,000, which has been exacted from the ratepayers over and above the amount required to cover the consumption of property in the service rendered and thus to keep the investment unimpaired." 44 P. U. R. (N. S.), p. 22.

[5] That contention was based on the fact that "every single dollar in the depreciation and depletion reserves" was taken "from gross operating revenues whose only source was the amounts charged customers in the past for natural gas. It is, therefore, a fact that the depreciation and depletion reserves have been contributed by the customers and do not represent any investment by Hope." *Id*., p. 40. And see *Railroad Commission* v. *Cumberland Tel. & T. Co*., 212 U.S. 414, 424-425; 2 Bonbright, Valuation of Property (1937), p. 1139.

operating expense for depletion and depreciation. [6]

[****14] Hope's estimate of original cost [***343] was about $ 69,735,000 -- approximately $ 17,000,000 more than the amount found by the Commission. The item of $ 17,000,000 was made up largely of expenditures which prior to December 31, 1938, were charged to operating expenses. Chief among those expenditures was some $ 12,600,000 expended [*599] in well-drilling prior to 1923. Most of that sum was expended by Hope for labor, use of drilling-rigs, hauling, and similar costs of well-drilling. Prior to 1923 Hope followed the general practice of the natural gas industry and charged the cost of drilling wells to operating expenses. Hope continued that practice until the Public Service Commission of West Virginia in 1923 required it to capitalize such expenditures, as does the Commission under its present Uniform System of Accounts. [7] The Commission refused to add such items to the rate base stating that "No greater injustice to consumers could be done than to allow items as operating expenses and at a later date include them in the rate base, thereby placing multiple charges upon the consumers." *Id*., p. 12. For the same reason the Commission excluded from the rate [****15] base about $ 1,600,000 of expenditures on properties which Hope acquired from other utilities, the latter having charged those payments to operating expenses. The Commission disallowed certain other overhead items amounting to over $ 3,000,000 which also had been previously charged to operating expenses. And it refused to add some $ 632,000 as interest during construction since no interest was in fact paid.

Hope contended that it should be allowed a return of not less than 8%. The Commission found that an 8% return would be unreasonable but that 6 1/2% was a fair rate of return. That rate of return, applied to the rate base of $ 33,712,526, would produce $ 2,191,314 annually, as compared with the present income of not less than $ 5,801,171.

The Circuit Court of Appeals set aside the order of the Commission for the following reasons. (1) It held that the rate base should reflect the "present [****16] fair value" of the [*600] property, that the Commission in determining the "value" should have considered reproduction cost and trended original cost, and that "actual legitimate cost" (prudent investment) was not the proper measure of "fair value" where price levels had changed since the investment. (2) It concluded that the well-drilling costs and overhead items in the amount of some $ 17,000,000 should have been included in the rate base. (3) It held that accrued depletion and depreciation and the annual allowance for that expense should be computed on the basis of "present fair value" of the property, not on the basis of "actual legitimate cost."

[**287] The Circuit Court of Appeals also held that the Commission had no power to make findings as to past rates in aid of state regulation. But it concluded that those findings were proper as a step in the process of fixing future rates. Viewed in [***344] that light, however, the findings were deemed to be invalidated by the same errors which vitiated the findings on which the rate order was based.

Order Reducing Rates. ***HN1***[] [****17] Congress has provided in § 4 (a) of the Natural Gas Act that all natural gas rates subject to the jurisdiction of the Commission "shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful." Sec. 5 (a) gives the Commission the power, after hearing, to determine the "just and reasonable rate" to be thereafter observed and to fix the rate by order. Sec. 5 (a) also empowers the Commission to order a "decrease where existing rates are unjust, . . . unlawful, or are not the lowest

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[6] The Commission noted that the case was "free from the usual complexities involved in the estimate of gas reserves because the geologists for the company and the Commission presented estimates of the remaining recoverable gas reserves which were about one per cent apart." 44 P. U. R. (N. S.), pp. 19-20.

The Commission utilized the "straight-line-basis" for determining the depreciation and depletion reserve requirements. It used estimates of the average service lives of the property by classes based in part on an inspection of the physical condition of the property. And studies were made of Hope's retirement experience and maintenance policies over the years. The average service lives of the various classes of property were converted into depreciation rates and then applied to the cost of the property to ascertain the portion of the cost which had expired in rendering the service.

The record in the present case shows that Hope is on the lookout for new sources of supply of natural gas and is contemplating an extension of its pipe line into Louisiana for that purpose. The Commission recognized in fixing the rates of depreciation that much material may be used again when various present sources of gas supply are exhausted, thus giving that property more than scrap value at the end of its present use.

[7] See Uniform System of Accounts prescribed for Natural Gas Companies effective January 1, 1940, Account No. 332.1.

reasonable rates." And Congress has provided in § 19 (b) that on review of these rate orders the "finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." Congress, however, has provided no formula by which the "just and reasonable" rate is to be determined. It has not filled in the [*601] details of the general prescription [8] of § 4 (a) and § 5 (a). It has not expressed in a specific rule the fixed principle of "just and reasonable."

[****18] ***LEdHN[1]***[] [1]***LEdHN[2]***[] [2]When we sustained the constitutionality of the Natural Gas Act in the *Natural Gas Pipeline Co*. case, we stated that the "authority of Congress to regulate the prices of commodities in interstate commerce is at least as great under the Fifth Amendment as is that of the States under the Fourteenth to regulate the prices of commodities in intrastate commerce." 315 U.S. p. 582. Rate-making is indeed but one species of price-fixing. *Munn* v. *Illinois*, 94 U.S. 113, 134.The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid. *Block* v. *Hirsh*, 256 U.S. 135, 155-157; *Nebbia* v. *New York*, 291 U.S. 502, 523-539 and cases cited. It does, however, indicate that "fair value" is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the [****19] matter is that rates cannot be made to depend upon "fair value" when the value of the going enterprise depends on earnings under whatever rates may be anticipated. [9]

[*602] ***LEdHN[3]***[] [3]***LEdHN[4]***[] [4]***LEdHN[5]***[] [5]We held in *Federal Power Commission* v. *Natural Gas Pipeline Co., supra*, [****20] that ***HN2***[] the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of "pragmatic adjustments." [***345] p. 586. And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. *Id*., p. 586. Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. Cf. *Los Angeles Gas & Electric Corp*. v. *Railroad* [**288] *Commission*, 289 U.S. 287, 304-305, 314; *West Ohio Gas Co*. v. *Public Utilities Commission* (No. 1), 294 U.S. 63, 70; *West* v. *Chesapeake & Potomac Tel. Co*., 295 U.S. 662, 692-693 (dissenting opinion). ***HN3***[] 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. [****21] Moreover, ***HN4***[] the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences. Cf. *Railroad Commission* v. *Cumberland Tel. & T. Co*., 212 U.S. 414; *Lindheimer* v. *Illinois Bell Tel. Co., supra*, pp. 164, 169; *Railroad Commission* v. *Pacific Gas & Electric Co*., 302 U.S. 388, 401.

[*603] ***LEdHN[6]***[] [6]The rate-making process under the Act, i. e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the *Natural Gas Pipeline Co*. case that "regulation does not insure that the business shall produce net revenues." 315 U.S. p. 590. But such considerations aside, the investor interest has a legitimate concern with the financial integrity [****22] of the company whose rates are being regulated. From

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[8] Sec. 6 of the Act comes the closest to supplying any definite criteria for rate making. It provides in subsection (a) that, "The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property." Subsection (b) provides that every natural-gas company on request shall file with the Commission a statement of the "original cost" of its property and shall keep the Commission informed regarding the "cost" of all additions, etc.

[9] We recently stated that the meaning of the word "value" is to be gathered "from the purpose for which a valuation is being made. Thus the question in a valuation for rate making is how much a utility will be allowed to earn. The basic question in a valuation for reorganization purposes is how much the enterprise in all probability can earn." *Institutional Investors* v. *Chicago, M., St. P. & P. R. Co*., 318 U.S. 523, 540.

the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. *Chicago & Grand Trunk Ry. Co*. v. *Wellman*, 143 U.S. 339, 345-346. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. See *Missouri ex rel. Southwestern Bell Tel. Co*. v. *Public Service Commission*, 262 U.S. 276, 291 (Mr. Justice Brandeis concurring). The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the [****23] investor or company viewpoint.

LEdHN[7][] [7]We have already noted that Hope is a wholly owned subsidiary of the Standard Oil Co. (N. J.). It has no securities outstanding except stock. All of that stock has been owned by Standard since 1908. The par amount presently outstanding is approximately $ 28,000,000 as compared with the rate base of $ 33,712,526 established by [*604] the Commission. Of the total outstanding stock $ 11,000,000 was issued in stock dividends. [***346] The balance, or about $ 17,000,000, was issued for cash or other assets. During the four decades of its operations Hope has paid over $ 97,000,000 in cash dividends. It had, moreover, accumulated by 1940 an earned surplus of about $ 8,000,000. It had thus earned the total investment in the company nearly seven times. Down to 1940 it earned over 20% per year on the average annual amount of its capital stock issued for cash or other assets. On an average invested capital of some $ 23,000,000 Hope's average earnings have been about 12% a year. And during this period it had accumulated in addition reserves for depletion and depreciation [****24] of about $ 46,000,000. Furthermore, during 1939, 1940 and 1941, Hope paid dividends of 10% on its stock. And in the year 1942, during about half of which the lower rates were in effect, it paid dividends of 7 1/2%. From 1939-1942 its earned surplus increased from $ 5,250,000 to about $ 13,700,000, i. e., to almost half the par value of its outstanding stock.

As we have noted, the Commission fixed a rate of return which permits Hope to earn $ 2,191,314 annually. In determining that amount it stressed the importance of maintaining the financial integrity of the [**289] company. It considered the financial history of Hope and a vast array of data bearing on the natural gas industry, related businesses, and general economic conditions. It noted that the yields on better issues of bonds of natural gas companies sold in the last few years were "close to 3 per cent," 44 P. U. R. (N. S.), p. 33. It stated that the company was a "seasoned enterprise whose risks have been minimized" by adequate provisions for depletion and depreciation (past and present) with "concurrent high profits," by "protected established markets, through affiliated distribution companies, in [****25] populous and industrialized areas," and by a supply of gas locally to meet all requirements, [*605] "except on certain peak days in the winter, which it is feasible to supplement in the future with gas from other sources." *Id*., p. 33. The Commission concluded, "The company's efficient management, established markets, financial record, affiliations, and its prospective business place it in a strong position to attract capital upon favorable terms when it is required." *Id*., p. 33.

LEdHN[8][] [8]***LEdHN[9]***[] [9]In view of these various considerations we cannot say that an annual return of $ 2,191,314 is not "just and reasonable" within the meaning of the Act. ***HN5***[] Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called [****26] "fair value" rate base. In that connection it will be recalled that Hope contended for a rate base of $ 66,000,000 computed on reproduction cost new. The Commission points out that if that rate base were accepted, Hope's average rate of return for the four-year period from 1937-1940 would amount to 3.27%. During that period Hope earned an annual average return of about 9% on the average investment. It asked for no rate increases. Its properties were well maintained and operated. As the Commission says, such a modest rate of 3.27% suggests an "inflation of the base on which the rate has been computed." *Dayton Power & Light Co*. v. *Public Utilities Commission*, 292 U.S. 290, 312. Cf. *Lindheimer* v. *Illinois Bell Tel. Co., supra*, p. 164. The incongruity between the actual operations and the return computed on the basis of reproduction cost suggests that the Commission was wholly justified in rejecting the latter as the measure of the rate base.

In view of this disposition of the controversy we need not stop to inquire whether the failure of the Commission to add the $ 17,000,000 of [***347] well-drilling and other costs to [*606] [****27] the rate base was consistent with the prudent investment theory as developed and applied in particular cases.

LEdHN[10][] [10]***LEdHN[11]***[] [11]***LEdHN[12]***[] [12]Only a word need be added respecting depletion and depreciation. We held in the *Natural Gas Pipeline Co*. case that ***HN6***[] there was no constitutional requirement "that the owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it." 315 U.S. p. 593.The Circuit Court of Appeals did not think that that rule was applicable here because Hope was a utility required to continue its service to the public and not scheduled to end its business on a day certain as was stipulated to be true of the Natural Gas Pipeline Co. But that distinction is quite immaterial. The ultimate exhaustion of the supply is inevitable in the case of all natural gas companies. Moreover, this Court recognized in *Lindheimer* v. *Illinois Bell Tel. Co., supra*, the propriety of basing [****28] annual depreciation on cost. [10] [****29] By such a procedure the [**290] utility is made whole and the integrity of its investment maintained. [11] No more is required. [12] We cannot approve the contrary holding [*607] of *United Railways Co*. v. *West*, 280 U.S. 234, 253-254. Since there are no constitutional requirements more exacting than the standards of the Act, a rate order which conforms to the latter does not run afoul of the former.

LEdHN[13][] [13]*The Position of West Virginia*. The State of West Virginia, as well as its Public Service Commission, intervened in the proceedings before the Commission and participated in the hearings before it. They have also filed a brief *amicus curiae* here and have participated in the argument at the bar. Their contention is that the result achieved by the rate order "brings consequences which are unjust to West Virginia and its citizens" and which [****30] "unfairly depress the value of gas, gas lands and gas leaseholds, unduly restrict development of their natural resources, and arbitrarily transfer their properties to the residents of other states without just compensation therefor."

West Virginia points out that the Hope Natural Gas Co. holds a large number of leases on both producing and unoperated properties. The owner or grantor receives from the operator or grantee delay rentals as compensation for postponed drilling. When a producing well is successfully brought in, the gas lease customarily continues indefinitely for the life of the field. In that case the [***348] operator pays a stipulated gas-well rental or in some cases a gas royalty equivalent to one-eighth of the gas marketed. [13] [****33] Both the owner and operator have valuable property interests in the gas which are separately taxable under West Virginia law. The contention is that the reversionary interests in the leaseholds should be represented in the rate proceedings since it is their gas which is being sold in interstate [*608] commerce. It is argued, moreover, that the owners of the reversionary interests should have the benefit of the "discovery value" [****31] of the gas leaseholds, not the interstate consumers. Furthermore, West Virginia contends that the Commission in fixing a rate for natural gas produced in that State should consider the effect of the rate order on the economy of West Virginia. It is pointed out that gas is a wasting asset with a rapidly diminishing supply. As a result West Virginia's gas deposits are becoming increasingly valuable. Nevertheless the rate fixed by the Commission reduces that value. And that reduction, it is said, has severe repercussions on the economy of

[10] Chief Justice Hughes said in that case (292 U.S. pp. 168-169): "If the predictions of service life were entirely accurate and retirements were made when and as these predictions were precisely fulfilled, the depreciation reserve would represent the consumption of capital, on a cost basis, according to the method which spreads that loss over the respective service periods. But if the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers for the telephone service are required to provide, in effect, capital contributions, not to make good losses incurred by the utility in the service rendered and thus to keep its investment unimpaired, but to secure additional plant and equipment upon which the utility expects a return."

[11] See Mr. Justice Brandeis (dissenting) in *United Railways Co*. v. *West*, 280 U.S. 234, 259-288, for an extended analysis of the problem.

[12] It should be noted that the Act provides no specific rule governing depletion and depreciation. Sec. 9 (a) merely states that the Commission "may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used or useful in the production, transportation, or sale of natural gas."

[13] See Simonton, The Nature of the Interest of the Grantee Under an Oil and Gas Lease (1918), 25 W. Va. L. Quar. 295.

the State. It is argued in the first place that as a result of this rate reduction Hope's West Virginia property taxes may be decreased in view of the relevance which earnings have under West Virginia law in the assessment of property for tax purposes. [14] Secondly, it is pointed out that West Virginia has a production tax [15] on the "value" of the gas exported from the State. And we are told that for purposes of that tax "value" becomes under West Virginia law "practically the substantial equivalent of market value." Thus West Virginia argues that undervaluation of Hope's gas leaseholds will cost the State many thousands of dollars in taxes. [****32] The effect, it is urged, is to impair West Virginia's tax structure for the benefit of Ohio and Pennsylvania consumers. West Virginia emphasizes, moreover, its deep interest in the conservation of its natural resources including its natural gas. It says that a reduction of the value of these leasehold values will jeopardize these conservation policies in three respects: (1) [**291] exploratory development of new fields will be discouraged; (2) abandonment of low-yield high-cost marginal wells will be hastened; and (3) secondary recovery of oil will be hampered. [*609] Furthermore, West Virginia contends that the reduced valuation will harm one of the great industries of the State and that harm to that industry must inevitably affect the welfare of the citizens of the State. It is also pointed out that West Virginia has a large interest in coal and oil as well as in gas and that these forms of fuel are competitive. When the price of gas is materially cheapened, consumers turn to that fuel in preference to the others. As a result this lowering of the price of natural gas will have the effect of depreciating the price of West Virginia coal and oil.

West Virginia insists that in neglecting this aspect of the problem the Commission failed to perform the function which Congress entrusted to it and that the case should be remanded to the Commission for a modification of its order. [16]

We have considered these contentions at length in view of the earnestness with which they have been urged upon us. We have searched the legislative history of the Natural Gas Act for any indication that Congress entrusted to the Commission the various considerations [****34] which [***349] West Virginia has advanced here. And our conclusion is that Congress did not.

LEdHN[14][] [14]We pointed out in *Illinois Natural Gas Co*. v. *Public Service Co*., 314 U.S. 498, 506, that the purpose of the Natural Gas Act was to provide, "through the exercise of the national power over interstate commerce, an agency for regulating the wholesale distribution to public service companies of natural gas moving interstate, which this Court had declared to be interstate commerce not subject to certain types of state regulation." As stated in the House Report the "basic purpose" of this legislation was "to occupy" the field in which such cases as *Missouri* v. [*610] *Kansas Gas Co*., 265 U.S. 298, and *Public Utilities Commission* v. *Attleboro Steam & Electric Co*., 273 U.S. 83, had held the States might not act. H. Rep. No. 709, 75th Cong., 1st Sess., p. 2. In accomplishing that purpose the bill was designed to take "no authority from State commissions" [****35] and was "so drawn as to complement and in no manner usurp State regulatory authority." *Id*., p. 2. And the Federal Power Commission was given no authority over the "production or gathering of natural gas." § 1 (b).

The primary aim of this legislation was to protect consumers against exploitation at the hands of natural gas companies. Due to the hiatus in regulation which resulted from the *Kansas Gas Co*. case and related decisions state commissions found it difficult or impossible to discover what it cost interstate pipe-line companies to deliver gas within the consuming states; and thus they were thwarted in local regulation. H. Rep. No. 709, *supra*, p. 3. Moreover, the investigations of the Federal Trade Commission had disclosed that the majority of the pipe-line mileage in the country used to transport natural gas, together with an increasing percentage of the natural gas supply for pipe-line transportation, had been acquired by a handful of holding companies. [17] State commissions, independent producers, and communities having or seeking the service were growing quite helpless against these

[14] *West Penn Power Co*. v. *Board of Review*, 112 W. Va. 442, 164 S. E. 862.

[15] W. Va. Rev. Code of 1943, ch. 11, Art. 13, §§ 2a, 3a.

[16] West Virginia suggests as a possible solution (1) that a "going concern value" of the company's tangible assets be included in the rate base and (2) that the fair market value of gas delivered to customers be added to the outlay for operating expenses and taxes.

[17] S. Doc. 92, Pt. 84-A, ch. XII, Final Report, Federal Trade Commission to the Senate pursuant to S. Res. No. 83, 70th Cong., 1st Sess.

combinations. [18] These were the types of problems with which those participating [****36] in the hearings were preoccupied. [19] Congress addressed itself to those specific evils.

[*611] The Federal Power Commission was given [**292] broad powers of regulation. The fixing of "just and reasonable" rates (§ 4) with the powers attendant thereto [20] was the heart of the new regulatory system. Moreover, the Commission was given certain authority by § 7 (a), on a finding that the action was necessary or desirable "in the public interest," to require natural gas companies to extend or improve their transportation facilities and to sell gas to any authorized local [****37] distributor. By § 7 (b) it was given control over the abandonment of facilities or of service. And by § 7 (c), as originally enacted, no natural gas company could undertake the construction or extension of any facilities for the transportation of natural gas to a market in which natural gas was already being served by another company, or sell any natural gas in such a market, without obtaining a certificate of public convenience [***350] and necessity from the Commission. In passing on such applications for certificates of convenience and necessity the Commission was told by § 7 (c), as originally enacted, that it was "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption for domestic, commercial, industrial, or any other use at the lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." The latter provision was deleted from § 7 (c) when that subsection was amended by the Act of February 7, 1942, 56 Stat. 83. By that amendment limited grandfather rights were granted companies desiring to extend their facilities and services over the routes or within [****38] the area which they were already serving. Moreover, § 7 (c) was broadened so as to require certificates [*612] of public convenience and necessity not only where the extensions were being made to markets in which natural gas was already being sold by another company but in other situations as well.

LEdHN[15][] [15]These provisions were plainly designed to protect the consumer interests against exploitation at the hands of private natural gas companies. When it comes to cases of abandonment or of extensions of facilities or service, we may assume that, apart from the express exemptions [21] contained [****39] in § 7, considerations of conservation are material to the issuance of certificates of public convenience and necessity. But the Commission was not asked here for a certificate of public convenience and necessity under § 7 for any proposed construction or extension. It was faced with a determination of the amount which a private operator should be allowed to earn from the sale of natural gas across state lines through an established distribution system. Secs. 4 and 5, not § 7, provide the standards for that determination. We cannot find in the words of the Act or in its history the slightest intimation or suggestion that the exploitation of consumers by private operators through the maintenance of high rates should be allowed to continue provided the producing states obtain indirect benefits from it. That apparently was the Commission's view of the matter, for the same arguments advanced here were presented to the Commission and not adopted by it.

[****40] We do not mean to suggest that Congress was unmindful of the interests of the producing states in their natural gas supplies when it drafted the Natural Gas Act. As we have said, the Act does not intrude on the domain traditionally reserved for control by state commissions; and the Federal Power Commission was given no authority over [*613] "the production or gathering of natural gas." § 1 (b). In addition, Congress recognized the legitimate interests of the States in the conservation of natural gas. By § 11 Congress instructed the Commission to make reports on compacts between two or more States dealing with the conservation, production and transportation of natural gas. [22] The Commission was also [**293] directed to

[18] S. Doc. 92, Pt. 84-A, chs. XII, XIII, *op. cit., supra*, note 17.

[19] See Hearings on H. R. 11662, Subcommittee of House Committee on Interstate & Foreign Commerce, 74th Cong., 2d Sess.; Hearings on H. R. 4008, House Committee on Interstate & Foreign Commerce, 75th Cong., 1st Sess.

[20] The power to investigate and ascertain the "actual legitimate cost" of property (§ 6), the requirement as to books and records (§ 8), control over rates of depreciation (§ 9), the requirements for periodic and special reports (§ 10), the broad powers of investigation (§ 14) are among the chief powers supporting the rate-making function.

[21] Apart from the grandfather clause contained in § 7 (c), there is the provision of § 7 (f) that a natural gas company may enlarge or extend its facilities within the "service area" determined by the Commission without any further authorization.

[22] See Act of July 7, 1943, c. 194, 57 Stat. 383, containing an "Interstate Compact to Conserve Oil and Gas" between Oklahoma, Texas, New Mexico, Illinois, Colorado, and Kansas.

recommend further legislation appropriate or necessary to carry out any proposed compact and "to aid in the conservation of natural-gas resources within the United States and in the orderly, equitable, and economic production, transportation, and distribution of natural gas." § 11 (a). Thus Congress was quite aware of the interests [***351] of the producing states in their natural gas supplies. [23] But it left the protection of [*614] those interests [****41] to measures other than the maintenance of high rates to private companies. If the Commission is to be compelled to let the stockholders of natural gas companies have a feast so that the producing states may receive crumbs from that table, the present Act must be redesigned. Such a project raises questions of policy which go beyond our province.

[****42] It is hardly necessary to add that a limitation on the net earnings of a natural gas company from its interstate business is not a limitation on the power of the producing state either to safeguard its tax revenues from that industry [24] or to protect the interests of those who sell their gas to the interstate operator. [25] The return which [**294] the Commission [*615] allowed was the net return after all such charges.

[****43] ***LEdHN[16]***[] [16]It is suggested that the Commission has failed to perform its duty under the Act in that it has not allowed a return for gas production that will be [***352] enough to induce private enterprise to perform completely and efficiently its functions for the public. The Commission, however, was not oblivious of those matters. It considered them. It allowed, for example, delay rentals and exploration and development costs in operating expenses. [26] No serious attempt has been made here to show that they are inadequate. We certainly cannot say that they are, unless we are to substitute our opinions for the expert judgment of the administrators to whom Congress entrusted the decision. Moreover, if in light of experience they turn out to be inadequate for development of new sources of supply, the doors of the Commission are open for increased allowances. This is not an order for all time. The Act contains machinery for obtaining rate adjustments. § 4.

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[23] As we have pointed out, § 7 (c) was amended by the Act of February 7, 1942 (56 Stat. 83) so as to require certificates of public convenience and necessity not only where the extensions were being made to markets in which natural gas was already being sold by another company but to other situations as well. Considerations of conservation entered into the proposal to give the Act that broader scope. H. Rep. No. 1290, 77th Cong., 1st Sess., pp. 2-3. And see Annual Report, Federal Power Commission (1940) pp. 79, 80; Baum, The Federal Power Commission and State Utility Regulation (1942), p. 261.

The bill amending § 7 (c) originally contained a subsection (h) reading as follows: "Nothing contained in this section shall be construed to affect the authority of a State within which natural gas is produced to authorize or require the construction or extension of facilities for the transportation and sale of such gas within such State: Provided, however, That the Commission, after a hearing upon complaint or upon its own motion, may by order forbid any intrastate construction or extension by any natural-gas company which it shall find will prevent such company from rendering adequate service to its customers in interstate or foreign commerce in territory already being served." See Hearings on H. R. 5249, House Committee on Interstate & Foreign Commerce, 77th Cong., 1st Sess., pp. 7, 11, 21, 29, 32-33. In explanation of its deletion the House Committee Report stated, pp. 4-5: "The increasingly important problems raised by the desire of several States to regulate the use of the natural gas produced therein in the interest of consumers within such States, as against the Federal power to regulate interstate commerce in the interest of both interstate and intrastate consumers, are deemed by the committee to warrant further intensive study and probably a more detailed and comprehensive plan for the handling thereof than that which would have been provided by the stricken subsection."

[24] We have noted that in the annual operating expenses of some $ 16,000,000 the Commission included West Virginia and federal taxes. And in the net increase of $ 421,160 over 1940 operating expenses allowed by the Commission was some $ 80,000 for increased West Virginia property taxes. The adequacy of these amounts has not been challenged here.

[25] The Commission included in the aggregate annual operating expenses which it allowed some $ 8,500,000 for gas purchased. It also allowed about $ 1,400,000 for natural gas production and about $ 600,000 for exploration and development.

It is suggested, however, that the Commission in ascertaining the cost of Hope's natural gas production plant proceeded contrary to § 1 (b) which provides that the Act shall not apply to "the production or gathering of natural gas." But such valuation, like the provisions for operating expenses, is essential to the rate-making function as customarily performed

[****44] ***LEdHN[17]***[] [17]***LEdHN[18]***[] [18]***LEdHN[19]***[] [19]But it is said that the Commission placed too low a rate on gas for industrial purposes as compared with gas for domestic purposes and that industrial uses should be discouraged. It should be noted in the first place that the rates which the Commission has fixed are Hope's interstate wholesale rates to distributors, not interstate rates to industrial users [27] and domestic consumers. We hardly [*616] can assume, in view of the history of the Act and its provisions, that the resales intrastate by the customer companies which distribute the gas to ultimate consumers in Ohio and Pennsylvania are subject to the rate-making powers of the Commission. [28] But in any event those rates are not in issue here. Moreover, we fail to find in the power to fix "just and reasonable" rates the power to fix rates which will disallow or discourage resales for industrial use. The Committee Report stated that the Act provided "for regulation along recognized [****45] and more or less standardized lines" and that there was "nothing novel in its provisions." H. Rep. No. 709, *supra*, p. 3. Yet if we are now to tell the Commission to fix the rates so as to discourage particular uses, we would indeed be injecting into a rate case a "novel" doctrine which has no express statutory sanction. The same would be true if we were to hold that the wasting-asset nature of the industry required the maintenance of the level of rates so that natural gas companies could make a greater profit on each unit of gas sold. Such theories of rate-making for this industry may or may not be desirable. The difficulty is that § 4 (a) and § 5 (a) contain only the conventional standards of rate-making for natural gas companies. [29] [****47] The [*617] Act of February 7, 1942, by broadening § 7 gave the Commission some additional authority to deal with the conservation aspects [***353] of the problem. [30] But § 4 (a) and § 5 (a) were not changed. If the standard [**295] of "just and reasonable" is to sanction the maintenance of high rates by a natural gas company because they restrict the use of natural gas for certain purposes, the Act must be further amended. [****46]

LEdHN[20][] [20]***LEdHN[21]***[] [21]It is finally suggested that the rates charged by Hope are discriminatory as against domestic users and in favor of industrial users. That charge is apparently based on § 4 (b) of the Act which forbids natural gas companies from maintaining "any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service." The power of the Commission [****48] to eliminate any such unreasonable differences or discriminations is plain. § 5 (a). The Commission, however, made no findings under § 4 (b). Its failure in that regard was not challenged in the petition to review. And it has not been raised or argued here by any party. Hence the problem of discrimination has no proper place in the present decision. It will be time enough to pass on that issue when it is presented to us. Congress has entrusted the administration of the Act to the Commission, not to the

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in this country. Cf. Smith, The Control of Power Rates in the United States and England (1932), 159 The Annals 101. Indeed § 14 (b) of the Act gives the Commission the power to "determine the propriety and reasonableness of the inclusion in operating expenses, capital, or surplus of all delay rentals or other forms of rental or compensation for unoperated lands and leases."

[26] See note 25, *supra*.

[27] The Commission has expressed doubts over its power to fix rates on "direct sales to industries" from interstate pipelines as distinguished from "sales for resale to the industrial customers of distributing companies." Annual Report, Federal Power Commission (1940), p. 11.

[28] Sec. 1 (b) of the Act provides: "The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas." And see § 2 (6), defining a "natural-gas company," and H. Rep. No. 709, *supra*, pp. 2, 3.

[29] The wasting-asset characteristic of the industry was recognized prior to the Act as requiring the inclusion of a depletion allowance among operating expenses. See *Columbus Gas & Fuel Co*. v. *Public Utilities Commission*, 292 U.S. 398, 404-405. But no such theory of rate-making for natural gas companies as is now suggested emerged from the cases arising during the earlier period of regulation.

[30] The Commission has been alert to the problems of conservation in its administration of the Act. It has indeed suggested that it might be wise to restrict the use of natural gas "by functions rather than by areas." Annual Report (1940) p. 79.

The Commission stated in that connection that natural gas was particularly adapted to certain industrial uses. But it added that the general use of such gas "under boilers for the production of steam" is "under most circumstances of very questionable social economy." *Ibid*.

courts. Apart from the requirements of judicial review it is not [*618] for us to advise the Commission how to discharge its functions.

LEdHN[22][] [22]*Findings as to the Lawfulness of Past Rates*. As we have noted, the Commission made certain findings as to the lawfulness of past rates which Hope had charged its interstate customers. Those findings were made on the complaint of the City of Cleveland and in aid of state regulation. It is conceded that under the Act the Commission has no power to make reparation orders. And its power to fix rates admittedly is limited to those "to be thereafter observed [****49] and in force." § 5 (a). But the Commission maintains that it has the power to make findings as to the lawfulness of past rates even though it has no power to fix those rates. [31] However that may be, we do not think that these findings were reviewable under § 19 (b) of the Act. That section gives any party "aggrieved by an order" of the Commission a review "of such order" in the circuit court of appeals for the circuit where the natural gas company is located or has its principle place of business or in the United States Court of Appeals for the District of Columbia. We do not think that the findings in question fall within that category.

[****50] ***LEdHN[23]***[] [23]The Court recently summarized the various types of administrative action or determination reviewable as orders under the Urgent Deficiencies Act of October 22, [*619] 1913, 28 U. S. C. [***354] §§ 45, 47a, and kindred statutory provisions. *Rochester Telephone Corp*. v. *United States*, 307 U.S. 125. It was there pointed out that where "the order sought to be reviewed does not of itself adversely affect complainant but only affects his rights adversely on the contingency of future administrative action," it is not reviewable. *Id*., p. 130. The Court said, "In view of traditional conceptions of federal judicial power, resort to the courts in these situations is either premature or wholly beyond their province." *Id*., p. 130. [**296] And see *United States* v. *Los Angeles & Salt Lake R. Co*., 273 U.S. 299, 309, 310; *Shannahan* v. *United States*, 303 U.S. 596. These considerations are apposite here. The Commission has no authority to enforce these findings. They are "the exercise [****51] solely of the function of investigation." *United States* v. *Los Angeles & Salt Lake R. Co., supra*, p. 310. They are only a preliminary, interim step towards possible future action -- action not by the Commission but by wholly independent agencies. The outcome of those proceedings may turn on factors other than these findings. These findings may never result in the respondent feeling the pinch of administrative action.

Reversed.

MR. JUSTICE ROBERTS took no part in the consideration or decision of this case.

Opinion of MR. JUSTICE BLACK and MR. JUSTICE MURPHY:

We agree with the Court's opinion and would add nothing to what has been said but for what is patently a wholly gratuitous assertion as to Constitutional law in the dissent of MR. JUSTICE FRANKFURTER. We refer to the statement that "Congressional acquiescence to date in the doctrine of *Chicago, M. & St. P. Ry. Co*. v. *Minnesota, supra*, may fairly be claimed." That was the case in which a majority of this Court was finally induced to expand the meaning [*620] of "due process" so as to give courts power to block efforts of the state and national governments to regulate economic [****52] affairs. The present case does not afford a proper occasion to discuss the soundness of that doctrine because, as stated in MR. JUSTICE FRANKFURTER's dissent, "that issue is not here in controversy." The salutary practice whereby courts do not discuss issues in the abstract applies with peculiar force to Constitutional questions. Since, however, the dissent adverts to a highly controversial due process doctrine and implies its acceptance by Congress, we feel compelled to say that we do not understand that Congress voluntarily has acquiesced in a Constitutional principle of government that courts, rather than legislative bodies, possess final authority over regulation of economic affairs. Even this Court has not always fully embraced that principle, and we wish to repeat that we have never acquiesced in it, and do not now. See

[31] The argument is that § 4 (a) makes "unlawful" the charging of any rate that is not just and reasonable. And § 14 (a) gives the Commission power to investigate any matter "which it may find necessary or proper in order to determine whether any person has violated" any provision of the Act. Moreover, § 5 (b) gives the Commission power to investigate and determine the cost of production or transportation of natural gas in cases where it has "no authority to establish a rate governing the transportation or sale of such natural gas." And § 17 (c) directs the Commission to "make available to the several State commissions such information and reports as may be of assistance in State regulation of natural-gas companies." For a discussion of these points by the Commission see 44 P. U. R. (N. S.) pp. 34-35.

Federal Power Commission v. *Natural Gas Pipeline Co*., 315 U.S. 575, 599-601.

Dissent by: REED; FRANKFURTER

Dissent

MR. JUSTICE REED, dissenting:

This case involves the problem of rate making under the Natural Gas Act. Added importance arises from the obvious fact that the principles stated are generally applicable to all federal agencies [****53] which are entrusted with the determination of rates for utilities. Because my views differ somewhat from those of my brethren, it may be of some value to set them out in a summary form.

The Congress may fix utility rates in situations subject to federal control without regard to any standard except the constitutional standards of due process and for taking private [***355] property for public use without just compensation. *Wilson* v. *New*, 243 U.S. 332, 350. A Commission, however, does not have this freedom of action. Its powers are limited not only by the constitutional standards but also by the standards of the delegation. Here the standard added by the Natural Gas Act is that the rate be "just [*621] and reasonable." [1] Section 6 [2] [**297] throws additional light on the meaning of these words.

[****54] When the phrase was used by Congress to describe allowable rates, it had relation to something ascertainable. The rates were not left to the whim of the Commission. The rates fixed would produce an annual return and that annual return was to be compared with a theoretical just and reasonable return, all risks considered, on the fair value of the property used and useful in the public service at the time of the determination.

Such an abstract test is not precise. The agency charged with its determination has a wide range before it could properly be said by a court that the agency had disregarded statutory standards or had confiscated the property of the utility for public use. Cf. *Chicago, M. & St. P. Ry. Co*. v. *Minnesota*, 134 U.S. 418, 461-66, dissent. This is as Congress intends. Rates are left to an experienced agency particularly competent by training to appraise the amount required.

The decision as to a reasonable return had not been a source of great difficulty, for borrowers and lenders reached such agreements daily in a multitude of situations; and although the determination of fair value had been troublesome, its essentials had been worked out [****55] in fairness to investor and consumer by the time of the enactment [*622] of this Act. Cf. *Los Angeles Gas & Electric Corp*. v. *Railroad Commission*, 289 U.S. 287, 304 *et seq*. The results were well known to Congress and had that body desired to depart from the traditional concepts of fair value and earnings, it would have stated its intention plainly. *Helvering* v. *Griffiths*, 318 U.S. 371.

It was already clear that when rates are in dispute, "earnings produced by rates do not afford a standard for decision." 289 U.S. at 305. Historical cost, prudent investment and reproduction cost [3] were all relevant factors in determining fair value. Indeed, disregarding the pioneer investor's risk, if prudent investment and reproduction cost were not distorted by changes in price levels or technology, each of them would produce the same result. The realization from the risk of an investment in a speculative field, such as natural gas utilities, should be reflected [***356] in the present fair

[1] Natural Gas Act, § 4 (a), 52 Stat. 821, 822, 15 U. S. C. § 717 (a).

[2] 52 Stat. 821, 824, 15 U. S. C. § 717e:

"(a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.

"(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction."

[3] "Reproduction cost" has been variously defined, but for rate-making purposes the most useful sense seems to be, the minimum amount necessary to create at the time of the inquiry a modern plant capable of rendering equivalent service. See I Bonbright, Valuation of Property (1937) 152. Reproduction cost as the cost of building a replica of an obsolescent plant is not of real significance.

"Prudent investment" is not defined by the Court. It may mean the sum originally put in the enterprise, either with or without additional amounts from excess earnings reinvested in the business.

value. [4] The amount of evidence to be admitted on any point was of course in the agency's reasonable discretion, and it was free to [****56] give its own weight to these or other factors and to determine from all the evidence its own judgment as to the necessary rates.

[****57] [*623] I agree with the Court in not imposing a rule of prudent investment alone in determining the rate base. This leaves the Commission free, as I understand it, to use any available evidence for its finding of fair value, including both prudent investment and the cost of installing at the present time an efficient system for furnishing the needed utility service.

My disagreement with the Court arises primarily from its view that it makes no [**298] difference how the Commission reached the rate fixed so long as the result is fair and reasonable. For me the statutory command to the Commission is more explicit. Entirely aside from the constitutional problem of whether the Congress could validly delegate its rate-making power to the Commission, *in toto* and without standards, it did legislate in the light of the relation of fair and reasonable to fair value and reasonable return. The Commission must therefore make its findings in observance of that relationship.

The Federal Power Commission did not, as I construe their action, disregard its statutory duty. They heard the evidence relating to historical and reproduction cost and to the reasonable rate of return, [****58] and they appraised its weight. The evidence of reproduction cost was rejected as unpersuasive, but from the other evidence they found a rate base, which is to me a determination of fair value. On that base the earnings allowed seem fair and reasonable. So far as the Commission went in appraising the property employed in the service, I find nothing in the result which indicates confiscation, unfairness or unreasonableness. Good administration of rate-making agencies under this method would avoid undue delay and render revaluations unnecessary except after violent fluctuations of price levels. Rate making under this method has been subjected to criticism. But until Congress changes the standards for the agencies, these rate-making bodies should continue the conventional theory of rate [*624] making. It will probably be simpler to improve present methods than to devise new ones.

But a major error, I think, was committed in the disregard by the Commission of the investment in exploratory operations and other recognized capital costs. These were not considered by the Commission because they were charged to operating expenses by the company at a time when it was unregulated. [****59] Congress did not direct the Commission in rate making to deduct from the rate base capital investment which had been recovered during the unregulated period through excess earnings. In my view this part of the investment should no more have been disregarded in the rate base than any other capital investment which previously had been recovered and paid out in dividends or placed to surplus. Even if prudent investment throughout the life of the property is accepted as the formula for figuring the rate base, it seems to me [***357] illogical to throw out the admittedly prudent cost of part of the property because the earnings in the unregulated period had been sufficient to return the prudent cost to the investors over and above a reasonable return. What would the answer be under the theory of the Commission and the Court, if the only prudent investment in this utility had been the seventeen million capital charges which are now disallowed?

For the reasons heretofore stated, I should affirm the action of the Circuit Court of Appeals in returning the proceeding to the Commission for further consideration and should direct the Commission to accept the disallowed capital investment [****60] in determining the fair value for rate-making purposes.

MR. JUSTICE FRANKFURTER, dissenting:

My brother JACKSON has analyzed with particularity the economic and social aspects of natural gas as well as [*625] the difficulties which led to the enactment of the Natural Gas Act, especially those arising out of the abortive attempts of States to regulate natural gas utilities. The Natural Gas Act of 1938 should receive application in the light of this analysis, and MR. JUSTICE JACKSON has, I believe, drawn relevant inferences regarding the duty of the Federal Power Commission in fixing natural gas rates. His exposition seems to me unanswered, and I shall say only a few words to emphasize my basic agreement with him.

For our society the needs that are met by public utilities

[4] It is of no more than bookkeeping significance whether the Commission allows a rate of return commensurate with the risk of the original investment or the lower rate based on current risk and a capitalization reflecting the established earning power of a successful company and the probable cost of duplicating its services. Cf. *A. T. & T. Co*. v. *United States*, 299 U.S. 232. But the latter is the traditional method.

are as truly public services as the traditional governmental functions of police and justice. They are not less so when these services are rendered by private enterprise under governmental regulation. Who ultimately determines the ways of regulation, is the decisive aspect in the public supervision of privately-owned utilities. Foreshadowed nearly sixty years ago, *Railroad Commission Cases*, 116 U.S. 307, 331, [****61] it was decided more than fifty [**299] years ago that the final say under the Constitution lies with the judiciary and not the legislature. *Chicago, M. & St. P. Ry. Co*. v. *Minnesota*, 134 U.S. 418.

While legal issues touching the proper distribution of governmental powers under the Constitution may always be raised, Congressional acquiescence to date in the doctrine of *Chicago, M. & St. P. Ry. Co*. v. *Minnesota, supra*, may fairly be claimed. But in any event that issue is not here in controversy. As pointed out in the opinions of my brethren, Congress has given only limited authority to the Federal Power Commission and made the exercise of that authority subject to judicial review. The Commission is authorized to fix rates chargeable for natural gas. But the rates that it can fix must be "just and reasonable." § 5 of the Natural Gas Act, 15 U. S. C. § 717 (d). Instead of making the Commission's rate determinations final, Congress [*626] specifically provided for court review of such orders. To be sure, "the finding of the Commission as to the facts, if supported by substantial evidence" was made "conclusive, [****62] " § 19 of the Act, 15 U. S. C. § 717r. But obedience of the requirement of Congress that rates be "just and reasonable" is not an issue of fact of which the Commission's own determination is conclusive. Otherwise, there would be nothing for a court to review except questions of compliance with the procedural provisions of the Natural Gas Act. Congress might have seen fit so to cast its legislation. But it has not done so. It has committed to the administration of the Federal Power Commission the duty of applying standards of fair dealing and of reasonableness relevant to the purposes expressed by the Natural Gas Act. The requirement that rates must be "just and reasonable" means just and reasonable in [***358] relation to appropriate standards. Otherwise Congress would have directed the Commission to fix such rates as in the judgment of the Commission are just and reasonable; it would not have also provided that such determinations by the Commission are subject to court review.

To what sources then are the Commission and the courts to go for ascertaining the standards relevant to the regulation of natural gas rates? It is at this point that MR. JUSTICE [****63] JACKSON's analysis seems to me pertinent. There appear to be two alternatives. Either the fixing of natural gas rates must be left to the unguided discretion of the Commission so long as the rates it fixes do not reveal a glaringly bad prophecy of the ability of a regulated utility to continue its service in the future. Or the Commission's rate orders must be founded on due consideration of all the elements of the public interest which the production and distribution of natural gas involve just because it is natural gas. These elements are reflected in the Natural Gas Act, if that Act be applied as an entirety. See, for [*627] instance, §§ 4 (a) (b) (c) (d), 6, and 11, 15 U. S. C., §§ 717c (a) (b) (c) (d), 717c, and 717j. Of course the statute is not concerned with abstract theories of rate-making. But its very foundation is the "public interest," and the public interest is a texture of multiple strands. It includes more than contemporary investors and contemporary consumers. The needs to be served are not restricted to immediacy, and social as well as economic costs must be counted.

It will not do to say that it must all be left to the skill of [****64] experts. Expertise is a rational process and a rational process implies expressed reasons for judgment. It will little advance the public interest to substitute for the hodge-podge of the rule in *Smyth* v. *Ames*, 169 U.S. 466, an encouragement of conscious obscurity or confusion in reaching a result, on the assumption that so long as the result appears harmless its basis is irrelevant. That may be an appropriate attitude when state action is challenged as unconstitutional. Cf. *Driscoll* v. *Edison Co*., 307 U.S. 104. But it is not to be assumed that it was the design of Congress to make the accommodation of the conflicting interests exposed in MR. JUSTICE JACKSON's opinion the occasion for a blind clash of forces or a partial assessment of relevant factors, either before the Commission or here.

The objection to the Commission's action is not that the rates it granted were too low but that the range of its vision was too narrow. And since the issues before the Commission involved no less than the [**300] total public interest, the proceedings before it should not be judged by narrow conceptions of common law pleading. And so I conclude [****65] that the case should be returned to the Commission. In order to enable this Court to discharge its duty of reviewing the Commission's order, the Commission should set forth with explicitness the criteria by which it is guided [*628] in determining that rates are "just and reasonable," and it should determine the public interest that is in its keeping in the perspective of the considerations set forth by MR. JUSTICE JACKSON.

By MR. JUSTICE JACKSON:

Certainly the theory of the court below that ties rate-making to the fair-value-reproduction-cost formula should be overruled as in conflict with *Federal Power Commission* v. *Natural Gas Pipeline Co*. [1] But the case should, I think, be the occasion for reconsideration of our rate-making doctrine as applied to natural gas and should be returned to the Commission, for further consideration in the light thereof.

The Commission appears to have [***359] understood the effect of the two opinions in the *Pipeline* case to [****66] be at least authority and perhaps direction to fix natural gas rates by exclusive application of the "prudent investment" rate base theory. This has no warrant in the opinion of the Chief Justice for the Court, however, which released the Commission from subservience to "any single formula or combination of formulas" provided its order, "viewed in its entirety, produces no arbitrary result." 315 U.S. at 586. The minority opinion I understood to advocate the "prudent investment" theory as a sufficient guide in a natural gas case. The view was expressed in the court below that since this opinion was not expressly controverted it must have been approved. [2] I disclaim this imputed [*629] approval with some particularity, because I attach importance at the very beginning of federal regulation of the natural gas industry to approaching it as the performance of economic functions, not as the performance of legalistic rituals.

[1] 315 U.S. 575.

[2] Judge Dobie, dissenting below, pointed out that the majority opinion in the *Pipeline* case "contains no express discussion of the Prudent Investment Theory" and that the concurring opinion contained a clear one, and said, "It is difficult for me to believe that the majority of the Supreme Court, believing otherwise, would leave such a statement unchallenged." The fact that two other Justices had as matter of record in our books long opposed the reproduction cost theory of rate bases and had commented favorably on the prudent investment theory may have influenced that conclusion. See opinion of Mr. Justice Frankfurter in *Driscoll* v. *Edison Light & Power Co*., 307 U.S. 104, 122, and my brief as Solicitor General in that case. It should be noted, however, that these statements were made, not in a natural gas case, but in an electric power case -- a very important distinction, as I shall try to make plain.

[****67] I.

Solutions of these cases must consider eccentricities of the industry which gives rise to them and also to the Act of Congress by which they are governed.

The heart of this problem is the elusive, exhaustible, and irreplaceable nature of natural gas itself. Given sufficient money, we can produce any desired amount of railroad, bus, or steamship transportation, or communications facilities, or capacity for generation of electric energy, or for the manufacture of gas of a kind. In the service of such utilities one customer has little concern with the amount taken by another, one's waste will not deprive another, a volume of service can be created equal to demand, and today's demands will not exhaust or lessen capacity to serve tomorrow. But the wealth of Midas and the wit of man cannot produce or reproduce a natural gas field. We cannot even reproduce the gas, for our manufactured product has only about half the heating value per unit of nature's own. [3]

[****68] [**301] Natural gas in some quantity is produced in twenty-four states. It is consumed in only thirty-five states, and is [*630] available only to about 7,600,000 consumers. [4] Its availability has been more localized than that of any other utility service because it has depended more on the caprice of nature.

The supply of the Hope Company is drawn from that old and rich and vanishing field that flanks the Appalachian mountains. Its center of production is Pennsylvania and West Virginia, with a fringe of lesser production in New York, Ohio, Kentucky, Tennessee, and the north end of Alabama. Oil was discovered in commercial quantities at [***360] a depth of only 69 1/2 feet near Titusville, Pennsylvania, in 1859. Its value then was about $ 16 per barrel. [5] The oil branch of the petroleum industry went forward at once, and with unprecedented speed. The area productive of oil and gas was roughed out by the drilling of over 19,000 "wildcat" wells, [****69] estimated to have cost over $ 222,000,000. Of these, over 18,000, or 94.9 per cent, were "dry holes." About

[3] Natural gas from the Appalachian field averages about 1,050 to 1,150 B. T. U. content, while by-product manufactured gas is about 530 to 540. Moody's Manual of Public Utilities (1943) 1,350; Youngberg, Natural Gas (1930) 7.

[4] Sen. Rep. No. 1162, 75th Cong., 1st Sess., 2.

[5] Arnold and Kemnitzer, Petroleum in the United States and Possessions (1931) 78.

five per cent, or 990 wells, made discoveries of commercial importance, 767 of them resulting chiefly in oil and 223 in gas only. [6] Prospecting for many years was a search for oil, and to strike gas was a misfortune. Waste during this period and even later is appalling. Gas was regarded as having no commercial value until about 1882, in which year the total yield was valued only at about $ 75,000. [7] Since then, contrary to oil, which has become cheaper, gas in this field has pretty steadily advanced in price.

While for many years natural gas had been distributed on a small scale for lighting, [8] its acceptance was slow, [*631] facilities for its utilization were primitive, and not until 1885 did it take on the appearance of a substantial industry. [9] Soon monopoly [****70] of production or markets developed. [10] To get gas from the mountain country, where it was largely found, to centers of population, where it was in demand, required very large investment. By ownership of such facilities a few corporate systems, each including several companies, controlled access to markets. Their purchases became the dominating factor in giving a market value to gas produced by many small operators. Hope is the market for over 300 such operators. By 1928 natural gas in the Appalachian field commanded an average price of 21.1 cents per m. c. f. at points of production and was bringing 45.7 cents at points of consumption. [11] The companies which controlled markets, however, did not rely on gas purchases alone. They acquired and held in fee or leasehold great acreage in territory proved by "wildcat" drilling. These large marketing system companies as well as many small independent owners and operators have carried on the commercial development of proved territory. The development risks appear from the estimate that up to 1928, 312,318 proved area wells had been sunk in the Appalachian field of which 48,962, or 15.7 per cent, failed to produce oil or gas in commercial [****71] quantity. [12]

[*632] With the source of supply thus tapped to serve centers of large demand, like Pittsburgh, Buffalo, [****72] Cleveland, Youngstown, Akron, and other industrial communities, the distribution of natural gas fast became big business. Its advantages as a [**302] fuel and its price commended it, and the business yielded a handsome return. All was merry and the goose hung high for consumers and gas companies alike until about the [***361] time of the first World War. Almost unnoticed by the consuming public, the whole Appalachian field passed its peak of production and started to decline. Pennsylvania, which to 1928 had given off about 38 per cent of the natural gas from this field, had its peak in 1905; Ohio, which had produced 14 per cent, had its peak in 1915; and West Virginia, greatest producer of all, with 45 per cent to its credit, reached its peak in 1917. [13]

Western New York and Eastern Ohio, on the fringe of the field, had some production but relied heavily on imports from Pennsylvania and West Virginia. Pennsylvania, a producing and exporting state, was a heavy consumer and supplemented [****73] her production with imports from West Virginia. West Virginia was a consuming state, but the lion's share of her production was exported. Thus the interest of the states in the North Appalachian supply was in conflict.

Competition among localities to share in the failing supply and the helplessness of state and local authorities in the presence of state lines and corporate complexities is a part of the background of federal intervention in the industry. [14] West Virginia took the boldest measure. It legislated a priority in its entire production in favor of its own inhabitants. That was

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[6] *Id*. at 62-63.

[7] *Id*., at 61.

[8] At Fredonia, New York, in 1821, natural gas was conveyed from a shallow well to some thirty people. The lighthouse at Barcelona Harbor, near what is now Westfield, New York, was at about that time and for many years afterward lighted by gas that issued from a crevice. Report on Utility Corporations by Federal Trade Commission, Sen. Doc. 92, Pt. 84-A, 70th Cong., 1st Sess., 8-9.

[9] In that year Pennsylvania enacted "An Act to provide for the incorporation and regulation of natural gas companies." Penn. Laws 1885, No. 32.

[10] See Steptoe and Hoffheimer's Memorandum for Governor Cornwell of West Virginia (1917) 25 West Virginia Law Quarterly 257; see also Report on Utility Corporations by Federal Trade Commission, Sen. Doc. No. 92, Pt. 84-A, 70th Cong., 1st Sess.

[11] Arnold and Kemnitzer, Petroleum in the United States and Possessions (1931) 73.

[12] *Id*. at 63.

[13] *Id*. at 64.

[14] See Report on Utility Corporations by Federal Trade Commission, Sen. Doc. No. 92, Pt. 84-A, 70th Cong., 1st Sess.

frustrated by an injunction [*633] from this Court. [15] Throughout the region clashes in the courts and conflicting decisions evidenced public anxiety and confusion. It was held that the New York Public Service Commission did not have power to classify consumers and restrict their use of gas. [16] That Commission held that a company could not abandon a part of its territory and still serve the rest. [17] Some courts admonished the companies to take action to protect consumers. [18] [****75] Several courts held that companies, regardless of failing supply, must continue to take on customers, but such [****74] compulsory additions were finally held to be within the Public Service Commission's discretion. [19] There were attempts to throw up franchises and quit the service, and municipalities resorted to the courts with conflicting results. [20] Public service commissions of consuming states were handicapped, for they had no control of the supply. [21]

[****76] [*634] Shortages [**303] during World War I occasioned the first intervention in [***362] the natural gas industry by the Federal Government. Under Proclamation of President Wilson the United States Fuel Administrator took control, stopped extensions, classified consumers and established a priority for domestic over industrial use. [22] After the war federal control was abandoned. Some cities once served with natural gas became dependent upon a mixed gas of reduced heating value and relatively higher price. [23]

[****77] Utilization of natural gas of highest social as well as economic return is domestic use for cooking and water [*635] heating, followed closely by use for space heating in homes. This is the true public utility aspect of the enterprise, and its preservation should be the first concern of regulation. Gas does the family cooking cheaper than any other fuel. [24] But its advantages do not end with dollars and cents cost. It is delivered without interruption at the meter as needed and is paid for after it is used. No money is tied up in a supply, and no space is used for storage. It requires no handling, creates no dust, and leaves no ash. It responds to thermostatic control. It ignites easily and immediately develops its maximum heating capacity. These incidental advantages make domestic life more liveable.

[****78] Industrial use is induced less by these qualities than by low cost in competition with other fuels. Of the gas exported from West Virginia by the Hope Company a very substantial part is used by industries. This wholesale use speeds exhaustion of supply and

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[15] *Pennsylvania* v. *West Virginia*, 262 U.S. 553. For conditions there which provoked this legislation, see 25 West Virginia Law Quarterly 257.

[16] *People ex rel. Pavilion Gas Co*. v. *Public Service Commission*, 188 App. Div. 36, 176 N. Y. S. 163.

[17] Village of Falconer *v*. Pennsylvania Gas Co., 17 State Department Reports (N. Y.) 407.

[18] See, for example, *Public Service Commission* v. *Iroquois Natural Gas Co*., 108 Misc. 696, 178 N. Y. S. 24; *Park Abbott Realty Co*. v. *Iroquois Gas Co*., 102 Misc. 266, 168 N. Y. S. 673; *Public Service Commission* v. *Iroquois Natural Gas Co*., 189 App. Div. 545, 179 N. Y. S. 230.

[19] *People ex rel. Pennsylvania Gas Co*. v. *Public Service Commission*, 196 App. Div. 514, 189 N. Y. S. 478.

[20] *East Ohio Gas Co*. v. *Akron*, 81 Ohio St. 33, 90 N. E. 40; *Newcomerstown* v. *Consolidated Gas Co*., 100 Ohio St. 494, 127 N. E. 414; *Gress* v. *Village of Ft. Loramie*, 100 Ohio St. 35, 125 N. E. 112; *Jamestown* v. *Pennsylvania Gas Co*., 263 F. 437, 264 F. 1009. See also *United Fuel Gas Co*. v. *Railroad Commission*, 278 U.S. 300, 308.

[21] The New York Public Service Commission said: "While the transportation of natural gas through pipe lines from one state to another state is interstate commerce . . . , Congress has not taken over the regulation of that particular industry. Indeed, it has expressly excepted it from the operation of the Interstate Commerce Commissions Law (Interstate Commerce Commissions Law, section 1). It is quite clear, therefore, that this Commission can not require a Pennsylvania corporation producing gas in Pennsylvania to transport it and deliver it in the State of New York, and that the Interstate Commerce Commission is likewise powerless. If there exists such a power, and it seems that there does, it is a power vested in Congress and by it not yet exercised. There is no available source of supply for the Crystal City Company at present except through purchasing from the Potter Gas Company. It is possible that this Commission might fix a price at which the Potter Gas Company should sell if it sold at all, but as the Commission can not require it to supply gas in the State of New York, the exercise of such a power to fix the price, if such power exists, would merely say, sell at this price or keep out of the State." Lane *v*. Crystal City Gas Co., 8 New York Public Service Comm. Reports, Second District, 210, 212.

[22] Proclamation by the President of September 16, 1918; Rules and Regulations of H. A. Garfield, Fuel Administrator, September 24, 1918.

[23] For example, the Iroquois Gas Corporation which formerly served Buffalo, New York, with natural gas ranging from 1050 to 1150 b. t. u. per cu. ft., now mixes a by-product gas of between 530 and 540 b. t. u. in proportions to provide a mixed

displaces other fuels. Coal miners and the coal industry, a large part of whose costs are wages, have complained of unfair competition from low-priced industrial gas produced with relatively little labor cost. [25]

Gas rate structures generally have favored industrial users. In 1932, in Ohio, the average yield on gas for domestic consumption was 62.1 cents per m. c. f. and on industrial, [*636] 38.7. In Pennsylvania, the figures were 62.9 against 31.7. West Virginia showed the least spread, domestic consumers paying 36.6 cents; and industrial, [***363] 27.7. [26] Although this [****79] spread is less than [**304] in other parts of the United States, [27] it can hardly be said to be self-justifying. It certainly is a very great factor in hastening decline of the natural gas supply.

About the time of World War I there were occasional and short-lived efforts by some hard-pressed companies to reverse this discrimination and adopt graduated rates, giving a low rate to quantities adequate for domestic use and graduating it upward to discourage industrial use. [28]

[*637] These rates met opposition from industrial sources, of course, and since diminished revenues from industrial sources tended [****80] to increase the domestic price, they met little popular or commission favor. The fact is that neither the gas companies nor the consumers nor local regulatory bodies can be depended upon to conserve gas. Unless federal regulation will take account of conservation, its efforts seem, as in this case, actually to constitute a new threat to the life of the Appalachian supply.

[****81] II.

Congress in 1938 decided upon federal regulation of the industry. It did so after an exhaustive investigation of all aspects including failing supply and competition for the use of natural gas intensified by growing scarcity. [29] [****82] Pipelines from the Appalachian area to markets were in the control of a handful of holding company systems. [30] This created a highly concentrated control of the producers' market and of the consumers' supplies. While holding companies dominated both production [***364] and distribution they segregated those activities in separate [*638]

gas of about 900 b. t. u. per cu. ft. For space heating or water heating its charges range from 65 cents for the first 10 m. c. f. per month to 55 cents for all above 25 m. c. f. per month. Moody's Manual of Public Utilities (1943) 1350.

[24] The United States Fuel Administration made the following cooking value comparisons, based on tests made in the Department of Home Economics of Ohio State University:

Natural gas at 1.12 per M. is equivalent to coal at $ 6.50 per ton.

Natural gas at 2.00 per M. is equivalent to gasoline at 27 cents per gal.

Natural gas at 2.20 per M. is equivalent to electricity at 3 cents per k. w. h.

Natural gas at 2.40 per M. is equivalent to coal oil at 15 cents per gal.

Use and Conservation of Natural Gas, issued by U.S. Fuel Administration (1918) 5.

[25] See Brief on Behalf of Legislation Imposing an Excise Tax on Natural Gas, submitted to N. R. A. by the United Mine Workers of America and the National Coal Association.

[26] Brief of National Gas Association and United Mine Workers, *supra* note 26, pp. 35, 36, compiled from Bureau of Mines Reports.

[27] From the source quoted in the preceding note the spread elsewhere is shown to be:

Go to table2

State

Industrial

Domestic

Illinois

29.2

1.678

Louisiana

10.4

59.7

Oklahoma

subsidiaries, [31] the effect of which, if not the purpose, was to isolate [**305] some end of the business from the reach of any one state commission. The cost of natural gas to consumers moved steadily upwards over the years, out of proportion to prices of oil, which, except for the element of competition, is produced under somewhat comparable conditions. The public came to feel that the companies were exploiting the growing scarcity of local gas. The problems of this region had much to do with creating the demand for federal regulation.

[****83] The Natural Gas Act declared the natural gas business to be "affected with a *public interest*," and its regulation "necessary in the *public interest*." [32] Originally, and at the time this proceeding was commenced and tried, it also declared "the intention of Congress that natural gas shall be sold in interstate commerce for resale for ultimate public consumption for domestic, commercial, industrial, or any other use at the lowest possible reasonable rate *consistent with the maintenance of adequate service in the public interest*."[33] While this was later dropped, there is nothing to indicate that it was not and is not still an accurate statement of purpose of the Act. Extension or improvement of facilities may be ordered when "necessary or desirable in the public interest," abandonment of facilities may be ordered when the supply is "depleted to the extent that the continuance of service is unwarranted, or that the *present or future public convenience or necessity* [*639] permit" abandonment and certain extensions can only be made on finding of "the *present or future* convenience and necessity." [34] The Commission is required to take account of the ultimate [****84] use of the gas. Thus it is given power to suspend new schedules as to rates, charges, and classification of services except where the schedules are for the sale of gas "for resale for industrial use only," [35] which gives the companies greater freedom to increase rates on industrial gas than on domestic gas. More particularly, the Act expressly forbids any undue preference or advantage to any person or "*any unreasonable difference in rates* . . . either as between localities *or as between classes of service*." [36] And the power of the Commission expressly includes that to determine the "just and reasonable *rate, charge, classification, rule, regulation, practice, or contract* to be thereafter observed and in force." [37]

11.2

41.5

Texas

13.1

59.7

Alabama

17.8

1.227

Georgia

22.9

1.043

[28] In Corning, New York, rates were initiated by the Crystal City Gas Company as follows: 70 cents for the first 5,000 cu. ft. per month; 80 cents from 5,000 to 12,000; $ 1.00 for all over 12,000. The Public Service Commission rejected these rates and fixed a flat rate of 58 cents per m. c. f. Lane *v*. Crystal City Gas Co., 8 New York Public Service Comm. Reports, Second District, 210.

The Pennsylvania Gas Company (National Fuel Gas Company group) also attempted a sliding scale rate for New York consumers, net per month as follows: First 5,000 feet, 35 cents; second 5,000 feet, 45 cents; third 5,000 feet, 50 cents; all above 15,000, 55 cents. This was eventually abandoned, however. The company's present scale in Pennsylvania appears to be reversed to the following net monthly rate: first 3 m. c. f., 75 cents; next 4 m. c. f., 60 cents; next 8 m. c. f., 55 cents; over 15 m. c. f., 50 cents. Moody's Manual of Public Utilities (1943) 1350. In New York it now serves a mixed gas.

For a study of effect of sliding scale rates in reducing consumption see 11 Proceedings of Natural Gas Association of America (1919) 287.

[29] See Report on Utility Corporations by Federal Trade Commission, Sen. Doc. 92, Pt. 84-A, 70th Cong., 1st Sess.

[30] Four holding company systems control over 55 per cent of all natural gas transmission lines in the United States. They are Columbia Gas and Electric Corporation, Cities Service Co., Electric Bond and Share Co., and Standard Oil Co. of New Jersey. Columbia alone controls nearly 25 per cent, and fifteen companies account for over 80 per cent of the total. Report on Utility Corporations by Federal Trade Commission, Sen. Doc. 92, Pt. 84-A, 70th Cong., 1st Sess., 28.

In view [****85] of the Court's opinion that the Commission in administering the Act may ignore discrimination, it is interesting that in reporting this Bill both the Senate and the House Committees on Interstate Commerce pointed out that in 1934, on a nation-wide average the price of natural gas per m. c. f. was 74.6 cents for domestic use, 49.6 cents for commercial use, and 16.9 for industrial use. [38] I am not ready to think that supporters of a bill called attention to the striking fact that householders were being charged five times [***365] as much for their gas as industrial users only as a situation which the Bill would do nothing to remedy. On the other hand the Act gave to the Commission what the Court aptly describes as "broad powers of regulation."

[*640] III.

This proceeding was initiated by the Cities of Cleveland and Akron. They alleged that the price charged by Hope for natural gas "for resale to domestic, commercial and small industrial consumers in [****86] Cleveland and elsewhere is excessive, unjust, unreasonable, greatly in excess of the price charged by Hope to nonaffiliated companies at wholesale for resale to domestic, commercial, and small industrial consumers, and *greatly in excess of the price charged by Hope to East Ohio for resale to certain favored industrial consumers in Ohio, and therefore is further unduly discriminatory between customers and between classes of service*" (italics supplied). The company answered admitting differences in prices to affiliated and nonaffiliated companies and justifying them by differences in conditions of delivery. [**306] As to the allegation that the contract price is "greatly in excess of the price charged by Hope to East Ohio for resale to certain favored industrial consumers in Ohio," Hope did not deny a price differential, but alleged that industrial gas was not sold to "favored consumers" but was sold under contracts and schedules filed with and approved by the Public Utilities Commission of Ohio, and that certain conditions of delivery made it not "unduly discriminatory."

The record shows that in 1940 Hope delivered for industrial consumption 36,523,792 m. c. f. and for domestic [****87] and commercial consumption, 50,343,652 m. c. f. I find no separate figure for domestic consumption. It served 43,767 domestic consumers directly, 511,521 through the East Ohio Gas Company, and 154,043 through the Peoples Natural Gas Company, both affiliates owned by the same parent. Its special contracts for industrial consumption, so far as appear, are confined to about a dozen big industries.

[*641] Hope is responsible for such discrimination as exists in favor of these few industrial consumers. It controls both the resale price and use of industrial gas by virtue of the very interstate sales contracts over which the Commission is exercising its jurisdiction.

Hope's contract with East Ohio Company is an example. Hope agrees to deliver, and the Ohio Company to take, "(a) all natural gas requisite for the supply of the domestic consumers of the Ohio Company; (b) such amounts of natural gas as may be requisite to fulfill contracts made with the consent and approval of the Hope Company by the Ohio Company, or companies which it supplies with natural gas, for the sale of gas upon special terms and conditions for manufacturing purposes." The Ohio Company is required to read [****88] domestic customers' meters once a month and meters of industrial customers daily and to furnish all meter readings to Hope. The Hope Company is to have access to meters of all consumers and to all of the Ohio Company's accounts. The domestic consumers of

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In 1915, so it was reported to the Governor of West Virginia, 87 per cent of the total gas production of that state was under control of eight companies. Steptoe and Hoffheimer, Legislative Regulation of Natural Gas Supply in West Virginia, 17 West Virginia Law Quarterly 257, 260. Of these, three were subsidiaries of the Columbia system and others were subsidiaries of larger systems. In view of inter-system sales and interlocking interests it may be doubted whether there is much real competition among these companies.

[31] This pattern with its effects on local regulatory efforts will be observed in our decisions. See *United Fuel Gas Co*. v. *Railroad Commission*, 278 U.S. 300; *United Fuel Gas Co*. v. *Public Service Commission*, 278 U.S. 322; *Dayton Power & Light Co*. v. *Public Utilities Commission*, 292 U.S. 290; *Columbus Gas & Fuel Co*. v. *Public Utilities Commission*, 292 U.S. 398, and the present case.

[32] 15 U. S. C. § 717 (a). (Italics supplied throughout this paragraph.)

[33] § 7 (c), 52 Stat. 825.

[34] 15 U. S. C. § 717f.

[35] *Id*., § 717c (e).

[36] *Id*., § 717c (b).

[37] *Id*., § 717d (a).

[38] Sen. Rep. No. 1162, 75th Cong., 1st Sess., 2.

the Ohio Company are to be fully supplied in preference to consumers purchasing for manufacturing purposes and "Hope Company can be required to supply gas to be used for manufacturing purposes only where the same is sold under special contracts which have first been submitted to and approved in writing by the Hope Company and which expressly provide that natural gas will be supplied thereunder only in so far as the same is not necessary to meet the requirements of domestic consumers supplied through pipe lines of the Ohio Company." This basic contract was supplemented from time to time, chiefly as to price. The last amendment was in a letter from Hope to East Ohio in 1937. It contained a special discount on industrial gas and a schedule of special [***366] industrial contracts, Hope reserving the right to make eliminations therefrom and agreeing that others might be added from time to [*642] time with its approval in writing. [****89] It said, "It is believed that the price concessions contained in this letter, *while not based on our costs*, are, under certain conditions, to our mutual advantage in maintaining and building up the volumes of gas sold by us [italics supplied]." [39]

[**307] The Commission took no note of the charges of discrimination [****90] and made no disposition of the issue tendered on this point. It ordered a flat reduction in the price per m. c. f. of all gas delivered by Hope in interstate commerce. It made no limitation, condition, or provision as to what classes of consumers should get the benefit of the reduction. While the cities have accepted and are defending the reduction, it is my view that the discrimination of which they have complained is perpetuated and increased by the order of the Commission and that it violates the Act in so doing.

The Commission's opinion aptly characterizes its entire objective by saying that "bona fide investment figures now become all-important in the regulation of rates." It should be noted that the all-importance of this theory is not the result of any instruction from Congress. When the Bill to regulate gas was first before Congress it contained [*643] the following: "In determining just and reasonable rates the Commission shall fix such rate as will allow a fair return upon the actual legitimate prudent cost of the property used and useful for the service in question." H. R. 5423, 74th Cong., 1st Sess., Title III, § 312 (c). Congress rejected this language. See [****91] H. R. 5423, § 213 (211 (c)), and H. R. Rep. No. 1318, 74th Cong., 1st Sess., 30.

The Commission contends nevertheless that the "all important" formula for finding a rate base is that of prudent investment. But it excluded from the investment base an amount actually and admittedly invested of some $ 17,000,000. It did so because it says that the Company recouped these expenditures from customers before the days of regulation from earnings above a fair

[39] The list of East Ohio Gas Company's special industrial contracts thus expressly under Hope's control and their demands are as follows:

Go to table3

Customer	**Ordinary Daily Requirements.**
Republic Steel Corporation	15,000,000 cu. ft.
Otis Steel Company	10,000,000
Timken Roller Bearing Co	7,500,000
Youngstown Sheet & Tube Co	7,000,000
U.S. Steel Corp. -- Subsidiaries	6,500,000
General Electric Company	2,500,000
Pittsburgh Plate Glass Co	2,000,000
Niles Rolling Mill Company	1,500,000
Chase Brass & Copper Company	700,000
U.S. Aluminum Company	400,000
Mahoning Valley Steel Company	400,000
Babcock & Wilcox Company	400,000
Canton Stamping & Enameling Co	350,000

return. But it would not apply all of such "excess earnings" to reduce the rate base as one of the Commissioners suggested. The reason for applying excess earnings to reduce the investment base roughly from $ 69,000,000 to $ 52,000,000 but refusing to apply them to reduce it from that to some $ 18,000,000 is not found in a difference in the character of the earnings or in their reinvestment. The reason assigned is a difference in bookkeeping treatment many years before the Company was subject to regulation. The $ 17,000,000, reinvested chiefly in well drilling, was treated on the books as expense. (The Commission now requires that drilling costs be carried to capital account.) The allowed rate base thus actually was determined [****92] by the Company's bookkeeping, not its investment. [***367] This attributes a significance to formal classification in account keeping that seems inconsistent with rational rate regulation. [40] Of [*644] course, the [**308] Commission would not and should not allow a rate base to be inflated by bookkeeping which had improperly capitalized expenses. I have doubts about resting public regulation upon any rule that is to be used or not depending on which side it favors.

[****93] [*645] The Company on the other hand, has not put its gas fields into its calculations on the present-value basis, although that, it contends, is the only lawful rule for finding a rate base. To do so would result in a rate higher than it has charged or proposes as a matter of good business to charge.

The case before us demonstrates the lack of rational relationship between conventional rate-base formulas and natural gas production and the extremities to which regulating bodies are brought by the effort to rationalize them. The Commission and the Company each stands on a different theory, and neither ventures to carry its theory to logical conclusion as applied to gas fields.

IV.

This order is under judicial review not because we interpose constitutional theories between a State and the business it seeks to regulate, but because Congress put upon the federal courts a duty toward administration of a new federal regulatory Act. If we are to hold that a given rate is reasonable just because the Commission has said it was reasonable, review becomes a costly, time-consuming pageant of no practical value to anyone. If on the other hand we are to bring judgment of our own to [****94] the task, we should for the guidance of the regulators and the [***368] regulated reveal something of the philosophy, be it legal or economic or social, which guides us. We need not be slaves to a formula but unless we can point out a rational way of reaching our conclusions they can only be accepted as resting on intuition or predilection. I must admit that I possess no instinct by which to know the "reasonable" from the "unreasonable" in prices and must seek some conscious design for decision.

The Court sustains this order as reasonable, but what makes it so or what could possibly make it otherwise, [*646] I cannot learn. It holds that: "it is the result reached not the method employed which is controlling";

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[40] To make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates. Even as a recording of current transactions, bookkeeping is hardly an exact science. As a representation of the condition and trend of a business, it uses symbols of certainty to express values that actually are in constant flux. It may be said that in commercial or investment banking or any business extending credit success depends on knowing what not to believe in accounting. Few concerns go into bankruptcy or reorganization whose books do not show them solvent and often even profitable. If one cannot rely on accountancy accurately to disclose past or current conditions of a business, the fallacy of using it as a sole guide to future price policy ought to be apparent. However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive. Few writers have ventured to challenge this American idolatry, but see Hamilton, Cost as a Standard for Price, 4 Law and Contemporary Problems 321, 323-25. He observes that "As the apostle would put it, accountancy is all things to all men. . . . Its purpose determines the character of a system of accounts." He analyzes the hypothetical character of accounting and says "It was no eternal mold for pecuniary verities handed down from on high. It was -- like logic, or algebra, or the device of analogy in the law -- an ingenious contrivance of the human mind to serve a limited and practical purpose." "Accountancy is far from being a pecuniary expression of all that is industrial reality. It is an instrument, highly selective in its application, in the service of the institution of money making." As to capital account he observes "In an enterprise in lusty competition with others of its kind, survival is the thing and the system of accounts has its focus in solvency. . . . Accordingly depreciation, obsolescence, and other factors which carry no immediate threat are matters of lesser concern and the capital account is likely to be regarded as a secondary phenomenon. . . . But in an enterprise, such as a public utility, where continued survival seems assured, solvency is likely to be taken for granted. . . . A persistent and ingenious attention is likely to be directed not so much to securing the upkeep of the physical property as to making it certain that capitalization fails in not one whit to give full recognition to every item that should go into the account."

"the fact that the method employed to reach that result may contain infirmities is not then important" and it is not "important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at." The Court does lean somewhat on considerations of capitalization and dividend history and requirements for dividends on outstanding stock. But I can give no real weight to that for it is generally and I think [****95] deservedly in discredit as any guide in rate cases. [41]

Our books already contain so much talk of methods of rationalizing rates that we must appear ambiguous if we announce results without our working methods. We are confronted with regulation of a unique type of enterprise which I think requires considered rejection of much conventional utility doctrine and adoption of concepts of "just and reasonable" rates and practices and of the "public interest" that will take account of the peculiarities of the business.

The Court rejects the suggestions of this opinion. It says that the Committees in reporting the bill which became the Act said it provided "for regulation along recognized and more or less standardized lines" and that there was "nothing novel in its provisions." So saying it sustains a rate calculated on a novel variation of a rate base theory which itself had at the time of enactment of the legislation been recognized only in dissenting opinions. [****96] Our difference seems to be between unconscious innovation, [42] and the purposeful [**309] and deliberate innovation I [*647] would make to meet the necessities of regulating the industry before us.

Hope's business has two components of quite divergent character. One, while not a conventional common-carrier undertaking, is essentially a transportation enterprise consisting of conveying gas from where it is produced to point of delivery to the buyer. This is a relatively routine operation not differing substantially from many other utility operations. The service is produced by an investment in compression and transmission facilities. Its risks are those of investing [****97] in a tested means of conveying a discovered supply of gas to a known market. A rate base calculated on the prudent investment formula would seem a reasonably satisfactory measure for fixing a return from that branch of the business whose service is roughly proportionate to the capital invested. But it has other consequences which must not be overlooked. It gives marketability and hence "value" to gas owned by the company and gives the pipeline company a large power over the marketability and hence "value" of the production of others.

The other part of the business -- to reduce to possession an adequate supply of natural gas -- is of opposite [***369] character, being more erratic and irregular and unpredictable in relation to investment than any phase of any other utility business. A thousand feet of gas captured and severed from real estate for delivery to consumers is recognized under our law as property of much the same nature as a ton of coal, a barrel of oil, or a yard of sand. The value to be allowed for it is the real battleground between the investor and consumer. It is from this part of the business that the chief difference between the parties as to a proper rate [****98] base arises.

Is it necessary to a "reasonable" price for gas that it be anchored to a rate base of any kind? Why did courts in the first place begin valuing "rate bases" in order to "value" something else? The method came into vogue [*648] in fixing rates for transportation service which the public obtained from common carriers. The public received none of the carriers' physical property but did make some use of it. The carriage was often a monopoly so there were no open market criteria as to reasonableness. The "value" or "cost" of what was put to use in the service by the carrier was not a remote or irrelevant consideration in making such rates. Moreover the difficulty of appraising an intangible service was thought to be simplified if it could be related to physical property which was visible and measurable and the items of which might have market value. The court hoped to reason from the known to the unknown. But gas fields turn this method topsy turvy. Gas itself is tangible, possessible, and does have a market and a price in the field. The value of the rate base is more elusive than that of gas. It consists of intangibles -- leaseholds and freeholds -- operated [****99] and unoperated -- of little use in themselves except as rights to reach and capture gas. Their value lies almost wholly in predictions of discovery, and of price of gas when captured, and bears little relation to cost of tools and supplies and labor to develop it. Gas is what Hope sells

[41] See 2 Bonbright, Valuation of Property (1937) 1112.

[42] Bonbright says, ". . . the vice of traditional law lies, not in its adoption of excessively rigid concepts of value and rules of valuation, but rather in its tendency to permit shifts in meaning that are inept, or else that are ill-defined because the judges that make them will not openly admit that they are doing so." *Id*., 1170.

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.

But if found, and by whatever method found, a rate base is little help in determining reasonableness of the price of gas. Appraisal of present value of these intangible rights to pursue fugitive gas depends on the value assigned to the gas when captured. The "present fair value" rate base, generally in ill repute, [43] is not even [**310] urged by the gas company for valuing its fields.

[****100] [*649] The prudent investment theory has relative merits in fixing rates for a utility which creates its service merely by its investment. The amount and quality of service rendered by the usual utility will, at least roughly, be measured by the amount of capital it puts into the enterprise. But it has no rational application where there is no such relationship between investment and capacity to serve. There is no such relationship between investment and amount of gas produced. Let us assume that Doe and Roe each produces in West Virginia for delivery to Cleveland the same quantity of natural gas per day. Doe, however, through luck or foresight or whatever it takes, gets his gas from investing $ 50,000 in leases and drilling. Roe drilled poorer territory, got smaller wells, and has invested $ 250,000. Does anybody imagine that Roe can get or ought to get for his gas five times as much as Doe because [***370] he has spent five times as much? The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the results than in a game of poker.

[****101] Two-thirds of the gas Hope handles it buys from about 340 independent producers. It is obvious that the principle of rate-making applied to Hope's own gas cannot be applied, and has not been applied, to the bulk of the gas Hope delivers. It is not probable that the investment of any two of these producers will bear the same ratio to their investments. The gas, however, all goes to the same use, has the same utilization value and the same ultimate price.

To regulate such an enterprise by undiscriminatingly transplanting any body of rate doctrine conceived and [*650] adapted to the ordinary utility business can serve the "public interest" as the Natural Gas Act requires, if at all, only by accident. Mr. Justice Brandeis, the pioneer juristic advocate of the prudent investment theory for manmade utilities, never, so far as I am able to discover, proposed its application to a natural gas case. On the other hand, dissenting in *Pennsylvania* v. *West Virginia*, he reviewed the problems of gas supply and said, "In no other field of public service regulation is the controlling body confronted with factors so baffling as in the natural gas industry; and in none is continuous [****102] supervision and control required in so high a degree." 262 U.S. 553, 621. If natural gas rates are intelligently to be regulated we must fit our legal principles to the economy of the industry and not try to fit the industry to our books.

As our decisions stand the Commission was justified in believing that it was required to proceed by the rate base method even as to gas in the field. For this reason the Court may not merely wash its hands of the method and rationale of rate making. The fact is that this Court, with no discussion of its fitness, simply transferred the rate base method to the natural gas industry. It happened in *Newark Natural Gas & Fuel Co*. v. *City of Newark, Ohio*, 242 U.S. 405 (1917), in which the company wanted 25 cents per m. c. f., and under the Fourteenth Amendment challenged the reduction to 18 cents by ordinance. This Court sustained the reduction because the court below "gave careful consideration to the questions of the value of the property at the time of the inquiry," and whether the rate "would be sufficient to provide a fair return on the value of the property." The Court said this method was "based upon principles [****103] thoroughly established by repeated decisions of this court," citing many cases, not one of which involved natural gas or a comparable wasting natural resource. Then came issues as to state power to [*651] regulate as affected by the commerce clause. *Public Utilities Commission* v. *Landon*, 249 U.S. 236 (1919); *Pennsylvania Gas Co*. v. *Public Service Commission*, 252 U.S. 23 (1920). These questions settled, the Court again was called upon in natural gas cases to consider state rate-making claimed to be invalid under the Fourteenth Amendment. *United Fuel Gas Co*. v. *Railroad Commission of Kentucky*, 278 U.S. 300 (1929); *United Fuel Gas Co*. v. *Public Service Commission of West Virginia*, 278 U.S. 322 (1929).

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[43] "The attempt to regulate rates by reference to a periodic or occasional reappraisal of the properties has now been tested long enough to confirm the worst fears of its critics. Unless its place is taken by some more promising scheme of rate control, the days of private ownership under government regulation may be numbered." 2 Bonbright, Valuation of Property (1937) 1190.

Then, as now, the differences were "due [**311] chiefly to the difference in value ascribed by each to the gas rights and leaseholds." 278 U.S. 300, 311. No one seems to have questioned that the rate base method must be pursued and the controversy was as to what rate base must be used. Later the "value" of gas in the field was [***371] questioned in determining the amount [****104] a regulated company should be allowed to pay an affiliate therefor -- a state determination also reviewed under the Fourteenth Amendment. *Dayton Power & Light Co*. v. *Public Utilities Commission of Ohio*, 292 U.S. 290 (1934); *Columbus Gas & Fuel Co*. v. *Public Utilities Commission of Ohio*, 292 U.S. 398 (1934). In both cases, one of which sustained and one of which struck down a fixed rate, the Court assumed the rate base method as the legal way of testing reasonableness of natural gas prices fixed by public authority, without examining its real relevancy to the inquiry.

Under the weight of such precedents we cannot expect the Commission to initiate economically intelligent methods of fixing gas prices. But the Court now faces a new plan of federal regulation based on the power to fix the price at which gas shall be allowed to move in interstate commerce. I should now consider whether these rules devised under the Fourteenth Amendment are the exclusive tests of a just and reasonable rate under the federal statute, inviting reargument directed to that point [*652] if necessary. As I see it now I would be prepared to hold that these rules [****105] do not apply to a natural gas case arising under the Natural Gas Act.

Such a holding would leave the Commission to fix the price of gas in the field as one would fix maximum prices of oil or milk or coal, or any other commodity. Such a price is not calculated to produce a fair return on the synthetic value of a rate base of any individual producer, and would not undertake to assure a fair return to any producer. The emphasis would shift from the producer to the product, which would be regulated with an eye to average or typical producing conditions in the field.

Such a price fixing process on economic lines would offer little temptation to the judiciary to become back seat drivers of the price fixing machine. The unfortunate effect of judicial intervention in this field is to divert the attention of those engaged in the process from what is economically wise to what is legally permissible. It is probable that price reductions would reach economically unwise and self-defeating limits before they would reach constitutional ones. Any constitutional problems growing out of price fixing are quite different than those that have heretofore been considered to inhere in rate making. [****106] A producer would have difficulty showing the invalidity of such a fixed price so long as he voluntarily continued to sell his product in interstate commerce. Should he withdraw and other authority be invoked to compel him to part with his property, a different problem would be presented.

Allowance in a rate to compensate for gas removed from gas lands, whether fixed as of point of production or as of point of delivery, probably best can be measured by a functional test applied to the whole industry. For good or ill we depend upon private enterprise to exploit these natural resources for public consumption. The function which an allowance for gas in the field should perform [*653] for society in such circumstances is to be enough and no more than enough to induce private enterprise completely and efficiently to utilize gas resources, to acquire for public service any available gas or gas rights and to deliver gas at a rate and for uses which will be in the future as well as in the present public interest.

The Court fears that "if we are now to tell the Commission to fix the rates so as to discourage particular uses, we would indeed be injecting into a rate case a 'novel' doctrine [****107] . . ." With due deference I suggest that there is nothing novel in the idea that any change in price of a service or commodity reacts to encourage or discourage its use. The question is not whether such consequences [***372] will or will not follow; the question is whether effects must be suffered blindly or may be intelligently selected, whether price control shall have targets at which it deliberately aims or shall be handled like a gun in the hands of one who does not know it is loaded.

We should recognize "price" for what it is -- a tool, a means, an expedient. In public [**312] hands it has much the same economic effects as in private hands. Hope knew that a concession in industrial price would tend to build up its volume of sales. It used price as an expedient to that end. The Commission makes another cut in that same price but the Court thinks we should ignore the effect that it will have on exhaustion of supply. The fact is that in natural gas regulation price must be used to reconcile the private property right society has permitted to vest in an important natural resource with the claims of society upon it -- price must draw a balance between wealth and welfare.

[****108] To carry this into techniques of inquiry is the task of the Commissioner rather than of the judge, and it certainly is no task to be solved by mere bookkeeping but requires the best economic talent available. There would doubtless be inquiry into the price gas is bringing in the [*654] field, how far that price is established by arm's length bargaining and how far it may be influenced by agreements in restraint of trade or monopolistic influences. What must Hope really pay to get and to replace gas it delivers under this order? If it should get more or less than that for its own, how much and why? How far are such prices influenced by pipe line access to markets and if the consumers pay returns on the pipe lines how far should the increment they cause go to gas producers? East Ohio is itself a producer in Ohio. [44] What do Ohio authorities require Ohio consumers to pay for gas in the field? Perhaps these are reasons why the Federal Government should put West Virginia gas at lower or at higher rates. If so what are they? Should East Ohio be required to exploit its half million acres of unoperated reserve in Ohio before West Virginia resources shall be supplied on a devalued [****109] basis of which that State complains and for which she threatens measures of self keep? What is gas worth in terms of other fuels it displaces?

A price cannot be fixed without considering its effect on the production of gas. Is it an incentive to continue to exploit vast unoperated reserves? Is it conducive to deep drilling tests the result of which we may know only after trial? Will it induce bringing gas from afar to supplement or even to substitute for Appalachian gas? [45] Can it be had from distant fields as cheap or cheaper? If so, that competitive potentiality is certainly a relevant consideration. Wise regulation must also consider, as a private buyer would, what alternatives the producer has [*655] if the price is not acceptable. Hope has intrastate business and domestic and industrial customers. What can it do by way [****110] of diverting its supply to intrastate sales? What can it do by way of disposing of its operated or reserve acreage to industrial concerns or other buyers? What can West Virginia do by way of conservation laws, severance or other taxation, if the regulated rate offends? It must be borne in mind that while West Virginia was prohibited from giving her own inhabitants a priority that [***373] discriminated against interstate commerce, we have never yet held that a good faith conservation act, applicable to her own, as well as to others, is not valid. In considering alternatives, it must be noted that federal regulation is very incomplete, expressly excluding regulation of "production or gathering of natural gas," and that the only present way to get the gas seems to be to call it forth by price inducements. It is plain that there is a downward economic limit on a safe and wise price.

[****111] But there is nothing in the law which compels a commission to fix a price at that "value" which a company might give to its product by taking advantage of scarcity, or monopoly of supply. The very purpose of fixing maximum prices is to take away from the seller his opportunity to get all that otherwise the market would award him for his goods. This is a constitutional use of the power to fix maximum prices, *Block* v. [**313] *Hirsh*, 256 U.S. 135; *Marcus Brown Holding Co*. v. *Feldman*, 256 U.S. 170; *International Harvester Co*. v. *Kentucky*, 234 U.S. 216; *Highland* v. *Russell Car & Snow Plow Co*., 279 U.S. 253, just as the fixing of minimum prices of goods in interstate commerce is constitutional although it takes away from the buyer the advantage in bargaining which market conditions would give him. *United States* v. *Darby*, 312 U.S. 100; *Mulford* v. *Smith*, 307 U.S. 38; *United States* v. *Rock Royal Cooperative*, 307 U.S. 533; *Sunshine Anthracite Coal Co*. v. *Adkins*, 310 U.S. 381. The Commission has power to fix [*656] [****112] a price that will be both maximum and minimum and it has the incidental right, and I think the duty, to choose the economic consequences it will promote or retard in production and also more importantly in consumption, to which I now turn.

If we assume that the reduction in company revenues is warranted we then come to the question of translating the allowed return into rates for consumers or classes of consumers. Here the Commission fixed a single rate for all gas delivered irrespective of its use despite the fact that Hope has established what amounts to two rates -- a high one for domestic use and a lower one for industrial contracts. [46] The Commission can fix two prices for interstate gas as readily as one -- a price for

[44] East Ohio itself owns natural gas rights in 550,600 acres, 518,526 of which are reserved and 32,074 operated, by 375 wells. Moody's Manual of Public Utilities (1943) 5.

[45] Hope has asked a certificate of convenience and necessity to lay 1,140 miles of 22-inch pipeline from Hugoton gas fields in southwest Kansas to West Virginia to carry 285 million cu. ft. of natural gas per day. The cost was estimated at $ 51,000,000. Moody's Manual of Public Utilities (1943) 1760.

[46] I find little information as to the rates for industries in the record and none at all in such usual sources as Moody's Manual.

resale to domestic users and another for resale to industrial users. This is the pattern Hope itself has established in the very contracts over which the Commission is expressly given jurisdiction. Certainly the Act is broad enough to permit two prices to be fixed instead of one, if the concept of the "public interest" is not unduly narrowed.

[****113] The Commission's concept of the public interest in natural gas cases which is carried today into the Court's opinion was first announced in the opinion of the minority in the *Pipeline* case. It enumerated only two "phases of the public interest: (1) the investor interest; (2) the consumer interest," which it emphasized to the exclusion of all others. 315 U.S. 575, 606. This will do well enough in dealing with railroads or utilities supplying manufactured gas, electric power, a communications service or transportation, where utilization of facilities does not impair their future usefulness. Limitation of supply, however, brings into a natural gas case another phase of the public interest that to my mind overrides both the owner [*657] and the consumer of that interest. Both producers and industrial consumers have served their [***374] immediate private interests at the expense of the long-range public interest. The public interest, of course, requires stopping unjust enrichment of the owner. But it also requires stopping unjust impoverishment of future generations. The public interest in the use by Hope's half million domestic consumers is quite a different [****114] one from the public interest in use by a baker's dozen of industries.

Prudent price fixing it seems to me must at the very threshold determine whether any part of an allowed return shall be permitted to be realized from sales of gas for resale for industrial use. Such use does tend to level out daily and seasonal peaks of domestic demand and to some extent permits a lower charge for domestic service. But is that a wise way of making gas cheaper when, in comparison with any substitute, gas is already a cheap fuel? The interstate sales contracts provide that at times when demand is so great that there is not enough gas to go around domestic users shall first be served. Should the operation of this preference await the day of actual shortage? Since the propriety of a preference seems conceded, should it not operate to prevent the coming of a shortage as well as to mitigate its effects? Should industrial use jeopardize tomorrow's service to householders any more than today's? If, however, it is decided to cheapen domestic use by resort to industrial sales, should they be limited to the few uses [**314] for which gas has special values or extend also to those who use it only [****115] because it is cheaper than competitive fuels? [47] And how much cheaper should industrial [*658] gas sell than domestic gas, and how much advantage should it have over competitive fuels? If industrial gas is to contribute at all to lowering domestic rates, should it not be made to contribute the very maximum of which it is capable, that is, should not its price be the highest at which the desired volume of sales can be realized?

[****116] If I were to answer I should say that the household rate should be the lowest that can be fixed under commercial conditions that will conserve the supply for that use. The lowest probable rate for that purpose is not likely to speed exhaustion much, for it still will be high enough to induce economy, and use for that purpose has more nearly reached the saturation point. On the other hand the demand for industrial gas at present rates already appears to be increasing. To lower [***375] further the industrial rate is merely further to subsidize industrial consumption and speed depletion. The impact of the flat reduction [*659] of rates ordered here admittedly will be to increase the industrial advantages of gas over competing fuels and

[47] The Federal Power Commission has touched upon the problem of conservation in connection with an application for a certificate permitting construction of a 1,500-mile pipeline from southern Texas to New York City and says: "The Natural Gas Act as presently drafted does not enable the Commission to treat fully the serious implications of such a problem. The question should be raised as to whether the proposed use of natural gas would not result in displacing a less valuable fuel and create hardships in the industry already supplying the market, while at the same time rapidly depleting the country's natural-gas reserves. Although, for a period of perhaps 20 years, the natural gas could be so priced as to appear to offer an apparent saving in fuel costs, this would mean simply that social costs which must eventually be paid had been ignored.

"Careful study of the entire problem may lead to the conclusion that use of natural gas should be restricted by functions rather than by areas. Thus, it is especially adapted to space and water heating in urban homes and other buildings and to the various industrial heat processes which require concentration of heat, flexibility of control, and uniformity of results. Industrial uses to which it appears particularly adapted include the treating and annealing of metals, the operation of kilns in the ceramic, cement, and lime industries, the manufacture of glass in its various forms, and use as a raw material in the chemical industry. General use of natural gas under boilers for the production of steam is, however, under most circumstances of very questionable social economy." Twentieth Annual Report of the Federal Power Commission (1940) 79.

to increase its use. I think this is not, and there is no finding by the Commission that it is, in the public interest.

There is no justification in this record for the present discrimination against domestic users of gas in favor of industrial users. It is one of the evils against which the Natural Gas Act was aimed by Congress and one of the evils complained of here by Cleveland and Akron. If Hope's revenues should be cut by some $ 3,600,000 [****117] the whole reduction is owing to domestic users. If it be considered wise to raise part of Hope's revenues by industrial purpose sales, the utmost possible revenue should be raised from the least consumption of gas. If competitive relationships to other fuels will permit, the industrial price should be substantially advanced, not for the benefit of the Company, but the increased revenues from the advance should be applied to reduce domestic rates. For in my opinion the "public interest" requires that the great volume of gas now being put to uneconomic industrial use should either be saved for its more important future domestic use or the present domestic user should have the full benefit of its exchange value in reducing his present rates.

Of course the Commission's power directly to regulate does not extend to the fixing of rates at which the local company shall sell to consumers. Nor is such power required to accomplish the purpose. As already pointed out, the very contract the Commission is altering classifies the gas according to the purposes for which it is to be resold and provides differentials between the two classifications. It would only be necessary for the Commission [****118] to order [**315] that all gas supplied under paragraph (a) of Hope's contract with the East Ohio Company shall be [*660] at a stated price fixed to give to domestic service the entire reduction herein and any further reductions that may prove possible by increasing industrial rates. It might further provide that gas delivered under paragraph (b) of the contract for industrial purposes to those industrial customers Hope has approved in writing shall be at such other figure as might be found consistent with the public interest as herein defined. It is too late in the day to contend that the authority of a regulatory commission does not extend to a consideration of public interests which it may not directly regulate and a conditioning of its orders for their protection. *Interstate Commerce Commission* v. *Railway Labor Executives Assn*., 315 U.S. 373; *United States* v. *Lowden*, 308 U.S. 225.

Whether the Commission will assert its apparently broad statutory authorization over prices and discriminations is, of course, its own affair, not ours. It is entitled to its own notion of the "public interest" and its judgment of policy must prevail. [****119] However, where there is ground for thinking that views of this Court may have constrained the Commission to accept the rate-base method of decision and a particular single formula as "all important" for a rate base, it is appropriate to make clear the reasons why I, at least, would not be so understood. The Commission is free to face up realistically to the nature and peculiarity of the resources in its control, to foster their duration in fixing price, and to consider future interests in addition to those of investors and present consumers. If we return this case it may accept or decline the proffered freedom. This problem presents the Commission an unprecedented opportunity if it will boldly make sound economic considerations, instead of legal and accounting [***376] theories, the foundation of federal policy. I would return the case to the Commission and thereby be clearly quit of what now may appear to be some responsibility for perpetrating a short-sighted pattern of natural gas regulation.

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ONTARIO ENERGY BOARD

ASSOCIATION OF MAJOR POWER CONSUMERS IN ONTARIO

APPLICATION TO REVIEW AMENDMENTS TO THE MARKET RULES MADE BY THE INDEPENDENT ELECTRICITY SYSTEM OPERATOR

EB-2019-0242

IESO BOOK OF AUTHORITIES

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