

A. *Opinion No. 154, Farmers II, and FERC's Initial Reliance on Competition*

The change from the methodology of the Interstate Commerce Commission to the Federal Energy Regulatory Commission's ratemaking methodologies highlights several key aspects of what "just and reasonable" has been interpreted to mean under the Interstate Commerce Act in relation to market-based rates. The D.C. Circuit Court of Appeals' rejection of any reliance on assumed market competition as the basis for "just and reasonable" rates has served as the touchstone for the Commission's market-based rate methodology. Among other findings, it has led to the Commission's continued adherence to a determination of market-based rates on a particularized case-by-case basis, and the Commission's requirement for detailed studies showing that alternative transportation sources included in the market power statistics are viable in terms of cost.

1. *Opinion No. 154 Relies on Implied Market Competition*

In the late 1970s, a group of shippers challenged the reasonableness of a rate increase by the Williams Brothers Pipe Line Company.<sup>100</sup> The Interstate Commerce Commission upheld the rate increase and the shippers challenged that order in the D.C. Circuit Court of Appeals.<sup>101</sup> While that appeal was pending, however, Congress transferred jurisdiction over oil pipeline rates from the Interstate Commerce Commission to FERC.<sup>102</sup> FERC was granted a remand by the appeals court to consider the regulatory system it would apply to oil pipeline rates.<sup>103</sup>

In response to the remand, the Commission issued Opinion No. 154. The opinion retained the "fair valuation" methodology of the Interstate Commerce Commission for determining rate base.<sup>104</sup> The Commission revised the rate of return methodology, however, from a fixed percentage to offering the pipeline a selection of eight different index measures of the growth in the economy as a cap on the rate of return.<sup>105</sup> The Commission reasoned that oil pipeline rate regulation should serve only as a limit on egregious price exploitation by the regulated pipelines, and that competitive market forces could be principally relied upon to assure proper rate levels.<sup>106</sup> The Commission noted that competition in the oil pipeline sector was more potent than in the other sectors it regulated, and therefore, rate regulation should serve as a supplement to that competition or serve "in the nature of a check on gross abuse."<sup>107</sup>

The Commission based the opinion in significant part on its finding that the economic market for oil pipelines had become competitive since 1906, and that "[p]rohibitive pricing has

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<sup>100</sup> *Farmers I*, 584 F.2d at 410.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 416; Department of Energy Organization Act, 42 U.S.C. §§ 7101-75.

<sup>103</sup> *Farmers I*, 584 F.2d 408.

<sup>104</sup> *Williams*, Opinion No. 154, 21 FERC ¶ 61,260 at 61,632.

<sup>105</sup> *Id.* at 61,645-46. This rate of return was not applied to the book equity or actual equity in the capital structure, or to the percentage of the valuation rate base represented by the proportion of equity relative to debt in the oil pipeline's overall capital structure. Rather, this rate was the allowed return on the entire valuation rate base, less the face amount of debt. *Id.* at 61,647-48. A good example of this methodology is provided in *Farmers II*, 734 F.2d at 1525.

<sup>106</sup> *Trans Alaska Pipeline System*, 21 FERC ¶ 61,092, at 61,285 (1982) (related order issued the same day as *Williams*, Opinion No. 154, 21 FERC ¶ 61,260).

<sup>107</sup> *Id.*

become uneconomic”<sup>108</sup> and “[n]o oil company (not even the largest) is wholly self-sufficient.”<sup>109</sup> The Commission also noted the significant decline in the price of pipeline transportation from 1931–1969.<sup>110</sup> Therefore, the Commission held that oil pipeline regulation “can and should continue to rely far more heavily on the market” and “should continue to be peripheral to the pricing process. That peripheral function relates to situations in which monopolistic pockets, short-run disequilibria, or other factors produce market prices that are grossly abusive and socially unacceptable.”<sup>111</sup>

## 2. Farmers II Court Requires Pipeline Specific Analysis of Market Power

The D.C. Circuit Court of Appeals in *Farmers II* struck down Opinion No. 154 in most material respects. Ultimately, the court was not persuaded by the Commission’s determination that the oil pipeline industry was competitive or that the level of evaluation conducted to make that determination was sufficient. The court’s holding on the analysis required to deviate from cost-based ratemaking would serve as the guiding precedent for the Commission in its subsequent market-based rate methodology.

The court held that the Commission’s reliance on competitive market forces and other non-cost factors (for example, the need to incentivize infrastructure development), was appropriate in certain circumstances. But, how those factors justified a particular rate must be specified and reasoned:

Because the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is “less than compensatory” or “excessive,” the most useful and reliable starting point for rate regulation is an inquiry into costs. At the same time, non-cost factors may legitimate a departure from a rigid cost-based approach. The mere invocation of a non-cost factor, however, does not alleviate a reviewing court of its duty to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. On the contrary, each deviation from cost-based pricing must be found not to be unreasonable and to be consistent with the Commission’s statutory responsibility. Thus, when FERC chooses to refer to non-cost factors in ratesetting, it must specify the nature of the relevant non-cost factor and offer a reasoned explanation of how the factor justifies the resulting rates.<sup>112</sup>

The Commission’s methodology, however, did not provide a check to ensure that market forces would actually hold prices at a just and reasonable rate. Instead, the Commission instituted price ceilings that would seldom be reached in practice, and by the Commission’s own admission allowed “creamy returns.”<sup>113</sup> Importantly, the Commission failed to provide a

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<sup>108</sup> *Williams*, Opinion No. 154, 21 FERC ¶ 61,260 at 61,608.

<sup>109</sup> *Id.* at 61,609. The Commission also considered the legislative history of the Interstate Commerce Act, and the non-cost factor of increased infrastructure development in support of its light-handed regulation. *Farmers II*, 734 F.2d at 1503-07.

<sup>110</sup> *Williams*, Opinion No. 154, 21 FERC ¶ 61,260 at 61,608.

<sup>111</sup> *Id.* at 61,649.

<sup>112</sup> *Farmers II*, 734 F.2d at 1502 (citations omitted).

<sup>113</sup> *Id.* at 1509.

mechanism to determine or monitor whether competition in the oil pipeline industry would actually keep prices at a just and reasonable level.<sup>114</sup>

The court was particularly concerned with what it characterized as a lack of meaningful analysis by the Commission on the level of competition in the oil pipeline industry.<sup>115</sup> The court held “that to have any relevance at all, competition must be evaluated in terms of discrete regional markets.”<sup>116</sup> Akin to the requirements for deregulating rail carriers under the Interstate Commerce Act, a specific particularized finding that a pipeline does not have “market dominance” is required before competition might be properly taken into account.<sup>117</sup>

Without reasoned analysis into the market competition of the oil pipeline industry, the court was not persuaded that the reliance on competitive market forces was justified or amounted to anything other than an assumed check on rates.<sup>118</sup> “We believe that this apologia for virtual deregulation of oil pipeline rates oversteps the proper bounds of agency discretion under the ‘just and reasonable’ standard.... Whether the purpose of oil pipeline rate regulation is ‘consumer protection’ or ‘producer protection,’ the statute requires meaningful rate regulation.”<sup>119</sup> The court concluded that “presumed market forces may not comprise the principal regulatory constraint.”<sup>120</sup> Instead, “[d]epartures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors.”<sup>121</sup>

Therefore, if competition was relied upon to ensure just and reasonable rates, the court in *Farmers II* directed FERC to conduct further analysis into the level of competition in the applicant pipeline’s relevant markets. The court held that for competition to serve as the non-cost factor justifying rates it must be evaluated pursuant to a reasoned method that analyzes the pipeline’s discrete regional markets. In addition, that analysis must result in a finding that the particular pipeline in question does not have market dominance.

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<sup>114</sup> *Id.*

<sup>115</sup> *Id.* at 1509 n.50. The Commission’s finding on competition was the following:

It is obvious that something has been holding these rates down. That something must be a marketplace force. The industry labels that force “competition.” The parties have spent much time and great energy debating this matter of competition. Each set of protagonists makes valid points. This is a rather “soft” kind of competition. It appears to be of a live and let-live kind. But this does not mean that it is not there. Nor does it necessarily negate a finding of considerable potency.

*Williams*, Opinion No. 154, 21 FERC ¶ 61,260 at 61,608.

<sup>116</sup> *Farmers II*, 734 F.2d at 1509 n.50.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 1508.

<sup>119</sup> *Id.* at 1507.

<sup>120</sup> *Id.* at 1530.

<sup>121</sup> *Farmers II*, 734 F.2d at 1530.