

THE NARRAGANSETT DOCTRINE: A 1986 UPDATE

Prepared for

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EXECUTIVE SUMMARY

This paper is an update of a report prepared for the National Regulatory Research Institute in December 1984 entitled, "The Narragansett Doctrine: An Emerging Issue in Federal-State Electric Regulation." That report summarized the evolution of state and federal responsibility for electric power regulation with particular emphasis on the doctrine established in a 1979 Supreme Court decision dealing with the extent to which the Federal Energy Regulatory Commission (FERC) wholesale rate decisions are binding on state regulatory commissions in setting retail rates. The so called Narragansett Doctrine effectively requires that state regulators allow a utility to recover the costs of power purchases made pursuant to a FERC-approved wholesale rate when it establishes the retail rates for that utility.

In the nearly two years since the publication of our first report on the subject, there have been a number of important developments dealing with the interpretation of the Narragansett doctrine and the outlook for its continued viability. In particular, a number of actions have been initiated both in state and federal courts (including a recent decision by the U.S. Supreme Court) dealing with the application of the doctrine. In this update, we address several recent court and agency decisions and pending cases which address perhaps the most crucial issue in the interpretation of the doctrine: the ability of state commissions to invoke "prudence considerations" as a means of circumventing the otherwise restrictive provisions of the Narragansett rule which limit their ability to consider the reasonableness of a FERC-approved wholesale rate.

Perhaps the most significant development affecting the application of the Narragansett doctrine since the publication of our earlier report is a June 1986 decision by the U.S. Supreme Court in Nantahala Power and Light Company vs. FERC. This decision reversed an earlier decision by the Supreme Court of North Carolina which had provided the North Carolina Utilities Commission (NCUC) with latitude to modify a FERC-approved cost allocation scheme in setting the retail rates for a state jurisdictional utility. The North Carolina Supreme Court had remanded an initial NCUC decision with a directive to examine the prudence of the relevant contractual arrangements (i.e., were they "in the best interests of the customers of Nantahala") as distinct from the reasonableness of the underlying rate. On remand, the NCUC rejected the FERC approved cost allocation scheme in favor of an alternative method more favorable to North Carolina ratepayers. The practical effect of the NCUC decision was to limit Nantahala's ability to recover all of its wholesale power costs associated with the underlying FERC-approved rate; an apparent contradiction to the Narragansett doctrine. The

North Carolina Supreme Court, however, affirmed the NCUC decision as the proper exercise of state ratemaking authority.

The U.S. Supreme Court ruled that the calculation of retail rates based on cost allocations other than those established by the FERC was a violation of the "Filed Rate Doctrine." Under that doctrine, ". . . [FERC] alone is empowered to make that judgement [of reasonableness] and until it has done so, no rate other than the one on file may be charged. . . ." The Court acknowledged that the Nantahala case involved a relatively special application of the Filed Rate Doctrine, but nonetheless felt that the actions of the NCUC constituted an unreasonable preemption of FERC wholesale ratemaking authority. The Court also linked its reasoning with regard to the NCUC's violation of the Filed Rate Doctrine to the Narragansett doctrine noting that "when FERC sets a rate between the seller of power and a wholesaler as buyer, a state may not exercise its undoubted jurisdiction under retail rates to prevent the wholesaler as seller from recovering the costs of paying the FERC-approved rate."

The Supreme Court decision in Nantahala constitutes a strong affirmation of the Narragansett doctrine. The decision, however, does not resolve all of the outstanding decisions relating to Narragansett, especially with reference to the extent to which a state commission may deviate from a FERC-approved wholesale rate where it finds a decision imprudent. Indeed, the Court appears to suggest in Nantahala that at least in certain circumstances (i.e., the availability of lower-cost power elsewhere), it might be willing to entertain deviations from the Narragansett doctrine and allow state regulators to limit recovery of FERC-approved wholesale rates.

While the Nantahala case was working its way through the state and federal courts, several other cases have emerged which more directly address the prudence aspects of the Narragansett doctrine. Two of these cases, recently decided by the FERC, provide further insight with respect to the evolution of FERC policy regarding prudence determinations in wholesale rate proceedings. Both of these cases involve subsidiaries of American Electric Power Company (AEP). In the first case involving AEP Service Corporation, the Commission dealt with the issue of the prudence of payments made under a comprehensive intersystem coordination (power pooling) agreement. The Commission rejected intervenor efforts to address the prudence of individual aspects of the arrangement noting that the prudence of the coordination agreement must be addressed as a whole and that this larger question was not at issue in this case. Further, the Commission noted that state regulators could not review the prudence of the overall operating agreement without interfering with FERC jurisdiction by ruling to some extent on the merits of the agreement itself.

The second case deals with a unit sale by AEP Generating Company from its share of Rockport Unit No. 1, located in Indiana, to the Kentucky Power Company (KEPCO). The Kentucky Attorney General intervened in the case arguing that the agreement attempted to circumvent an earlier Kentucky Public Service Commission (KPSC) order denying KEPCO's application to acquire an interest in the unit. The

FERC initially ruled that the issue of the prudence of KEPCO's purchase was an appropriate subject for state jurisdiction and thus would not come within the scope of the Commission's own inquiries concerning the justness and reasonableness of the proposed rates for KEPCO's wholesale purchase. AEP sought reconsideration of the Commission's order on the grounds that such a state inquiry would constitute an inappropriate invasion of the Commission's exclusive authority to review the terms and conditions of transactions consummated pursuant to a FERC-approved coordination agreement. In orders issued on August 20, 1986 the FERC reversed its earlier decision to abstain from consideration of prudence issues in this case.

In addition to the FERC cases noted above, the Narragansett doctrine has also been an issue in several recent state commission decisions involving utility wholesale purchases under FERC-approved rates. Cases involving various aspects of the Narragansett doctrine and prudence exceptions thereto have occurred in Kentucky, West Virginia, Massachusetts, New Hampshire, and several southern states served by the Middle South Utility System.

The Kentucky case involves a finding of imprudence by the Kentucky Public Service Commission with reference to the KEPCO unit power purchase from the AEP generating affiliate described above. In December 1984 the Kentucky Commission had determined that KEPCO had acted imprudently because "capacity deficit" power could be purchased from the AEP pool at lower cost. The Commission's decision was affirmed by a lower court and is currently pending before the Kentucky Supreme Court. In the interim, federal courts have denied efforts by AEP to obtain injunctive relief from the Kentucky Commission order pending a decision by the Kentucky Supreme Court on the merits of the Commission's ruling.

The West Virginia case relates to efforts by the West Virginia Commission to restrict cost recovery by Appalachian Power Company (an AEP affiliate) to flow through costs of a FERC-approved transmission agreement until the West Virginia PSC had reviewed the terms of that agreement and determined they were reasonable. A U.S. District Court recently ruled that the Federal Power Act preempted state authority to consider the merits of the utility's decision to enter into a coordination agreement. The Court made a strong statement with regard to the need for FERC to maintain exclusive jurisdiction over interstate coordination agreements so that local interests in minimizing power supply costs would not take precedence over greater regional and national interests.

The Massachusetts case involved the flow through of replacement power costs to Commonwealth Electric Company customers as a result of the outage of a Boston Edison unit in which Commonwealth held a small share. Because the Massachusetts Department of Public Utilities (DPU) had previously determined that Boston Edison was imprudent in relation to the outage, the DPU imputed that imprudence to Commonwealth and denied its efforts to recover its replacement power costs. On appeal to the Massachusetts Supreme Court, Commonwealth argued that the DPU was preempted under the Federal Power Act because the rates it must pay to its wholesale suppliers were fixed by FERC regulation and thus

beyond the scope of state review. Conversely, the DPU argued that federal regulation of wholesale rates was not affected by its own inquiry into the prudence of a retail seller in choosing the source of its supply and incurring particular costs. In a rather far-reaching decision, the Massachusetts Supreme Court agreed with the DPU argument that an inquiry into the prudence of a particular purchase did not constitute an invasion of FERC's exclusive authority under the Federal Power Act to set wholesale rates. Commonwealth recently filed a petition with the U.S. Supreme Court seeking a review of the Massachusetts Court's decision

The New Hampshire case involved a decision by the New Hampshire Public Utilities Commission that it was preempted by the Narragansett doctrine from addressing the reasonableness of including construction work in progress (CWIP) in a FERC-approved wholesale rate notwithstanding state legislation excluding CWIP at the retail level. The New Hampshire Supreme Court, however, ruled in favor of intervenors who argued that the Commission had abdicated its responsibilities for approving just and reasonable rates by not examining the alternatives available to the utility in arranging for its bulk power supply.

Three southern states (Arkansas, Louisiana, and Mississippi) have also addressed various aspects of the Narragansett issue in relation to the allocation of costs resulting from construction of the Grand Gulf nuclear plant by Middle South Energy (MSE), a subsidiary of Middle South Utilities (MSU). Because of the surplus power situation in the region served by MSU and the high costs of the Grand Gulf unit, each of the affected states sought to minimize its relative allocation of Grand Gulf costs. A 1985 decision by the FERC provided for the allocation of these costs among the MSU operating subsidiaries in a manner substantially different from that proposed by the utilities. In particular, the Commission's decisions had the effect of substantially increasing the percentage of Grand Gulf costs assigned to Arkansas under the System Agreement initially filed by the utilities.

Each of the MSU subsidiaries encountered strong opposition to recovery of its share of Grand Gulf costs pursuant to the Commission's order. Even before the Commission's final order had been issued, the Arkansas Public Service Commission (APSC) had attempted to void Arkansas Power and Light Company (AP&L) participation in the Grand Gulf project. The Commission's order was reversed by a federal court which held that the critical issue was, "whether the [Commission's] desire to protect Arkansas' interests has resulted in an impermissible burden on interstate commerce." The U.S. Court of Appeals ruled that it had and upheld a lower court decision enjoining further APSC efforts to nullify the Grand Gulf agreements.

The State of Louisiana and the City of New Orleans have also been active in opposing any effort by MSU affiliates to recover Grand Gulf costs from Louisiana ratepayers. The New Orleans City Council, which has regulatory authority over New Orleans Public Service Inc. (NOPSI), denied a request for rate relief related to Grand Gulf. NOPSI was subsequently able to obtain a review of this decision based on federal preemption arguments. In a related proceeding, NOPSI sought to

convince a district court that any effort by the City of New Orleans to acquire NOPSI property would constitute an illegal circumvention of FERC cost allocation with reference to Grand Gulf.

In Mississippi, the Commission reluctantly agreed to a negotiated phase-in of Grand Gulf costs. The Mississippi Commission's decision is being appealed to the Mississippi Supreme Court by the State Attorney General.

In addition to the judicial and regulatory actions noted above relating to the Narragansett doctrine, there have been several recent legislative developments which also address federal-state responsibilities for bulk power regulation. In February 1985 legislation was introduced in the House to amend the Public Utility Holding Company Act and the Federal Power Act in a way that would give the states greater authority to make independent determinations regarding the flow through of wholesale power costs in setting retail rates. Similar legislation has also been introduced in the Senate addressing Narragansett doctrine issues. The Senate bill would also allow state regulators to limit the flow through of wholesale power costs where the purchases occurred among the affiliates of a holding company system. Specifically, the legislation would give state regulators the authority to limit the recovery of the costs of a new generating unit where the state commission had not previously granted approval for construction of that unit. Both the House and Senate versions of bills restricting recovery of purchased power costs among holding company affiliates appear to be reactions to the FERC's decision in the previously described Middle South case. Hearings on the Senate bill were held in July 1986 but no final legislative action is likely on either proposal in the current session of Congress.

In reviewing trends in regulatory, judicial, and legislative developments since the publication of the 1984 report, one must conclude that there has not been significant erosion in the basic jurisdictional allocation principles set forth by the Narragansett doctrine. Both state and federal courts have consistently agreed that in fixing retail rates, a state commission may not prevent a utility from recovering costs consistent with FERC-approved rate schedules. Even those state decisions which appear to allow state commissions some latitude in restricting a utility's ability to recover certain purchase power costs have not questioned the basic line of Narragansett cases, but rather found them inapplicable to the specific facts of that case. The principal exception to the Narragansett doctrine continues to be the issue of the prudence of the purchaser in FERC-approved wholesale transactions. Under the Pike County line of cases, state commissions have claimed that restricting recovery of wholesale power costs in cases involving alleged imprudence does not contradict Narragansett. The U.S. Supreme Court has implied that it may consider prudence a valid exception to an otherwise general rule requiring states to allow recovery of FERC-approved bulk power costs.

The FERC, however, is apparently seeking to clarify its previous position that, in regulating wholesale bulk power transactions, the prudence of a purchaser is not within the scope of Commission

jurisdiction. In the AEP line of cases, the Commission appears to be suggesting that in cases involving coordination agreements, the prudence of participation (from the perspective of the purchasing entity) would be a valid consideration in the overall consideration of just and reasonable rates. While the Nantahala decision provides a strong affirmation of the Narragansett doctrine, the Court will have additional opportunities in the near future to rule more directly on Narragansett-related issues. These cases may provide the Court with a more direct opportunity to define the degree to which state commissions may restrict recovery of wholesale power costs in cases involving alleged imprudence.

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PREFACE

In December 1984 we published Occasional Paper No. 8 on the Narragansett Doctrine in federal-state regulatory relations in the electric power sector. In May of 1986 the NRRI Board of Directors requested an update on commission and court actions concerning the extent to which the FERC circumscribes the authority of state PSCs in setting retail electric rates. This publication brought out under the "Quick Response" program is the result.

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I. Introduction

Nearly two years ago, in December 1984, the National Regulatory Research Institute (NRRI) published a paper, "The Narragansett Doctrine: An Emerging Issue in Federal-State Electricity Regulation."^{1/} In that paper we summarized the evolution of state and federal responsibility for electric power regulation including the 1977 Decision by the Rhode Island Supreme Court in Narragansett Electric Company vs. FERC^{2/} and its progeny (Northern States,^{3/} Pike County,^{4/} etc.) which sought to define the extent to which Federal Energy Regulatory Commission (FERC) actions circumscribe the authority of a state regulatory commission in setting retail rates for the sale of electricity. The principle laid down by the Rhode Island Supreme Court, which has come to be known as the "Narragansett Doctrine," is that a state may not fix retail rates in such a way that a "public utility" is prevented from recovering costs of paying a wholesale rate authorized by the FERC.

During the period since December 1984 the interpretation of the Narragansett Doctrine has become increasingly controversial. A number of actions have been initiated in both state and federal courts, including the U.S. Supreme Court, relating to various aspects of the Doctrine. FERC policy with respect to this issue has undergone some modification or clarification. Efforts to modify the Doctrine legislatively have been initiated.

This paper, which is an update of our earlier paper, summarizes some of the more important cases and other developments bearing on the interpretation of the Narragansett Doctrine over the past two years and the outlook for its continued viability. Section II summarizes the recent Supreme Court decision relating to this issue. Section III describes developments in FERC policy regarding the extent to which a finding by a state commission of imprudence on the part of a purchaser of power under a FERC-authorized rate may provide an exception to the Narragansett Doctrine. Section IV describes a number of state commission cases in which the prudence exception has been asserted by a state commission or state court. Section V summarizes recent legislative developments relating to the Narragansett Doctrine. Section VI contains conclusions concerning the present state of development of interpretation of the Narragansett Doctrine and the outlook for further change.

II. Nantahala Power and Light Company Case

On June 17, 1986, the U.S. Supreme Court issued its opinion in Nantahala Power and Light Company vs. FERC^{5/} reversing an opinion by the Supreme Court of North Carolina.^{6/} The latter affirmed an opinion of the North Carolina Utilities Commission (NCUC) fixing retail rates of Nantahala Power and Light Company (Nantahala) in North Carolina which did not reflect the effects of FERC-authorized wholesale agreements on the purchased power costs of Nantahala.

A. Background

Nantahala, Tapoco, Inc. (Tapoco) and the Tennessee Valley Authority (TVA) each have projects for the generation of hydroelectric power on the Little Tennessee River and its tributaries. Nantahala

owns several plants in North Carolina; Tapoco owns plants in both Tennessee and North Carolina. Nantahala and Tapoco both are wholly-owned subsidiaries of Aluminum Company of America (ALCOA). In 1962, TVA, Nantahala, Tapoco, and ALCOA entered into the New Fontana Agreement (NFA), which provides for coordination of the electric production of Nantahala and Tapoco with the TVA system. Generation of power at Nantahala and Tapoco facilities is controlled by TVA. Such generation is delivered into the TVA system, and, in return, Nantahala and Tapoco receive capacity entitlements and energy entitlements. The division of the TVA entitlement power between Nantahala and Tapoco is prescribed in a 1971 Apportionment Agreement (AA). Both the NFA and the AA are subject to FERC jurisdiction under Part II of the Federal Power Act.

After 1971, the power to which Nantahala was entitled under the AA became insufficient to serve all of its needs. Consequently Nantahala began to purchase additional, more expensive power from TVA.

In 1976 Nantahala sought to increase its wholesale rates by a filing with FERC, and sought to increase its retail rates by way of a filing with the NCUC. In the FERC proceedings,^{7/} the customers contended that ALCOA had manipulated the terms of the NFA and the AA to benefit ALCOA's aluminum production operations in Tennessee at the expense of Nantahala's North Carolina customers. The FERC rejected the claim that the NFA was unfair to Nantahala and that ALCOA (through Nantahala) had improperly traded off the needs of Nantahala's customers in North Carolina to benefit ALCOA's plant in Tennessee but upheld the claim that the AA was unfair to Nantahala. The FERC found that the NFA gave Nantahala greater benefits than the AA and found no indication in the record why Nantahala gave up those benefits without

compensation. The FERC therefore required a reallocation of the energy entitlements under the AA and ordered refunds to Nantahala's wholesale customers. On appeal to the U. S. Court of Appeals for the Fourth Circuit, the decision of the FERC was affirmed.^{8/}

In the retail rate proceeding before the NCUC, that Commission initially determined that Nantahala's cost of obtaining power for resale were fixed by the FERC-regulated rate schedules. On appeal, however, that decision was remanded by the North Carolina Supreme Court to the NCUC to determine whether the contractual arrangements were "in the best interests of the customers of Nantahala."^{9/} On remand, the NCUC rejected the allocation of power as prescribed by the FERC-regulated agreements and reallocated the power in accordance with another method. According to the NCUC, its action was "nicely suited as a proper alternative to reformation of the [FERC-regulated] contracts."^{10/} Its practical effect was to bar Nantahala from recovering all of the wholesale power costs associated with the FERC-regulated NFA and AA. In accordance with its method of allocating power costs, the NCUC ordered substantial reductions in Nantahala's retail rates, together with a refund. Since the refund would have exceeded Nantahala's net worth, the NCUC ordered ALCOA, as the "beneficiary" of the FERC-regulated agreements, to fund the refunds to the extent that Nantahala might not be able to do so without impairing its capital.

B. The North Carolina Supreme Court Decision

On appeal through the North Carolina courts, the NCUC decision was ultimately affirmed by the North Carolina Supreme Court.^{11/} While the Court acknowledged that FERC has exclusive jurisdiction over interstate wholesale rates, it nevertheless concluded that the NCUC in preventing Nantahala from recovering costs in accordance with

agreements on file with the FERC was "well within the field of exclusive state ratemaking authority engendered by the 'bright line' between state and federal regulatory jurisdiction under the Federal Power Act."^{12/} The Court emphasized that the NCUC had not required Nantahala to disobey any order of the FERC. As stated by the Court:^{13/}

[NCUC's] examination of the [agreements on file with the FERC] was not undertaken in an effort to either establish wholesale rates or to modify agreements filed with and approved by the FERC. In its order reducing rates [NCUC] expressly rejected the remedy of reforming these agreements to award Nantahala its just level of entitlements and nothing contained in [NCUC's] order purports to change or modify a single word of the several contracts or agreements involved or the actual flow of power thereunder.

C. The U.S. Supreme Court Opinion

On appeal, the U.S. Supreme Court (in a 20-page opinion) reversed the decision of the Supreme Court of North Carolina and remanded the case for further proceedings on the ground that calculation of retail rates, based upon the assignment of costs reflecting rate schedules subject to the jurisdiction of the FERC on any basis other than that employed by the FERC, is a violation of the "filed-rate doctrine." Under that doctrine, as stated in earlier court opinions and quoted by the Court in the instant opinion, ". . . the [FERC] alone is empowered to make that judgement [of reasonableness] and until it has done so, no rate other than the one on file may be charged. . ."^{14/} The Court cites a number of decisions by various state courts relating to the filed-rate doctrine in FERC ratemaking proceedings. In such cases, the Court notes:^{15/}

. . . these courts have concluded that a state utility commission setting retail prices must allow, as reasonable operating expenses, costs incurred as a result of paying a FERC-determined wholesale price. . .

The Court rejects the notion that the filed-rate doctrine does not apply where the issue is cost allocation rather than a specific wholesale rate per kW or kWh. According to the Court:^{16/}

. . . the filed-rate doctrine is not limited to "rates" per se: "Our inquiry is not at an end because the orders do not deal in terms of prices or volumes of purchases." (Citation omitted.) Here FERC's decision directly affects Nantahala's wholesale rates by determining the amount of low-cost power that it may obtain, and FERC required Nantahala's wholesale rate to be filed in accordance with that allocation. The FERC's allocation of entitlement power is therefore presumably entitled to more than the negligible weight given it by NCUC.

The Court makes clear that the Narragansett Doctrine does not require that an increase in wholesale rates automatically leads to an increase in retail rates. The effect of a change in wholesale rates on retail rates will depend upon what is happening to other costs. In the words of the Court:^{17/}

If, for example, the FERC-approved price of wholesale power rises slightly but a retailer's cost of transformation and transmission significantly decline, the retailers overall costs might well decrease. A decrease in its retail rates might therefore be appropriate even though the cost of purchasing FERC-regulated power had increased. But in this case, there is no [such] finding or indication . . . there is only NCUC's assumption that Nantahala should have obtained more of the low-cost, FERC-regulated power than Nantahala is in fact entitled to claim under FERC's order. Such a rationale runs directly counter to FERC's order and therefore cannot withstand the preemptive force of FERC's decision.

The Court acknowledges that the situation in this case differs somewhat from a typical application of the filed-rate doctrine in which a "middle man" buys power under a FERC-fixed wholesale rate charged by a power supplier and resells it at retail under a rate regulated by a state utility commission. In that situation, according to the Court, ". . . for a state ratemaking agency to disregard a FERC-filed rate would clearly be inconsistent with the exclusive federal regulatory scheme over interstate wholesale power prices."^{18/} In this case, in contrast,

Nantahala obtains power under the highly complex NFA and the 1971 AA. Nevertheless, according to the Court, FERC's regulation of these agreements has a direct effect on Nantahala's cost of producing retail power:^{19/}

From Nantahala's point of view, then, it is in a situation quite similar to that of a purchaser of wholesale power at FERC-approved rates: Nantahala is entitled to include only a certain, FERC-specified amount of low-cost entitlement power among the sources of power from which it can draw in providing retail power. The fact that NCUC is setting retail rates does not give it license to ignore limitations that FERC has placed upon Nantahala available sources of low-cost power.

The Court states the Narragansett Doctrine in the following terms:^{20/}

The filed-rate doctrine ensures that sellers of wholesale power governed by FERC can recover the costs incurred by their payment of just and reasonable FERC-set rates. When FERC sets a rate between a seller of power and a wholesaler as buyer, a state may not exercise its undoubted jurisdiction over retail rates to prevent the wholesaler as seller from recovering the costs of paying the FERC-approved rate. (Citation omitted.) Such a "trapping" of costs is prohibited.

The Court finds that this doctrine was violated in this case even though the NFA and AA do not purport explicitly to set a sales price for power. The reason for this, as given by the Court, is as follows:^{21/}

Because purchased power is more expensive than entitlement power, NCUC's order prevents Nantahala from recovering the full costs of acquiring power under the FERC-approved scheme: Nantahala must under NCUC's order calculate its retail rates as if it received more entitlement power than it does under FERC's order, and as if it needed to procure less of the more expensive purchase power than under FERC's order. A portion of the costs incurred by Nantahala in procuring its power is therefore "trapped."

In its opinion, the Court deals only in passing with the issue of the prudence of the power purchase since, according to the Court, this issue was not present in this case. Nevertheless, the Court does

provide some guidance with respect to the prudence issue. In the words of the Court:^{22/}

Without deciding this issue, we may assume that a particular quantity of power procured by a utility from a particular source could be deemed unreasonably excessive if lower-cost power is available elsewhere, even though the higher-cost power actually purchased is obtained at a FERC-approved, and therefore reasonable, price. (Emphasis in original.)

D. Unresolved Issues

The Supreme Court's opinion in Nantahala constitutes a strong affirmation of the Narragansett Doctrine.^{23/} It also makes clear that the "filed rate" that cannot be changed by a state commission in fixing retail rates is more than the specific charges for specific quantities for power and energy. It extends at least to allocations of power among affiliated systems that are parties to a coordinating arrangement. The Court opinion does not, however, resolve all of the issues relating to the Narragansett Doctrine, particularly the extent to which a state commission may depart from FERC-determined wholesale rates where it finds that the purchase was imprudent. The guidance offered by the Court indicates that while it may be prepared to accept the imprudence exception reflected in Pike County,^{24/} such exception may be limited to cases in which lower cost power is available elsewhere. A state commission may not be free, for example, to find that a utility was imprudent in paying a FERC-authorized price for power at wholesale that included CWIP in rate base unless the utility could have obtained the power from another source at lower cost.

Issues related to the imprudence exception to the Narragansett Doctrine have been considered in various state and federal forums over the past two years. Some of the more significant of these cases are discussed in subsequent sections of this paper.

III. Prudence Issue: FERC Policy

In our earlier paper, we noted that:^{25/}

. . . several states have asserted authority to examine the prudence of the transaction itself in the context of alternative resource acquisition decisions that (arguably) could have been made by the utility. In at least one instance, the state's authority to initiate such inquiries has been upheld by a state court. Furthermore, a series of recent FERC decisions seems to support the notion that such an examination by a state Commission of the purchasers prudence in entering into a particular wholesale transaction is consistent with Narragansett.

Two recent cases decided by the FERC provide further insight with respect to the evolution of its policy regarding prudence determinations. Both of these cases involve subsidiaries of American Electric Power Company (AEP).

A. AEP Service Corporation

In the first of these cases the Commission dealt with the issue of prudence of payments under a comprehensive intersystem coordination agreement, and determined that the prudence of participating in such an agreement is a different matter than a simple purchase from a neighboring power supplier. This case involved an agreement filed with the FERC providing for the sharing among the AEP operating companies of the cost of ownership and operation of the AEP extra high voltage transmission system. The sharing is effected through monthly cost equalization payments which result in each company bearing a proportion of the total cost associated with the AEP EHV system equal to its demand ratio.

Several intervenors in the proceeding requested clarification from the FERC to the effect that the scope of the proceeding would not include the question of whether the payments under the agreement were prudent, citing an earlier FERC order in the AEP Generating Company

case (discussed below). The FERC refused to make such a ruling, however, and instead stated the following:^{26/} -

Transmission and allocation of the costs of the established AEP transmission network are integral parts of the operation of the AEP pool. Therefore, the prudence of being a party to the EHV Transmission Agreement cannot be considered separately from the prudence of being a party to the entire AEP pool relationship. A challenge to the membership in a public utility holding company power pool of a member of the holding company is a federal matter. (Footnote omitted.) However, the prudence of membership in the AEP pool has not been challenged, and we do not address that issue. . .

Moreover, a state commission could not review the prudence of an AEP operating company in entering into the EHV Transmission Agreement without invading our jurisdiction by ruling to some extent on the merits of the agreement itself.

B. AEP Generating Company

The second of these cases involved the "unit" sale of 15 percent of the power from AEP Generating Company's Rockport unit located in Indiana to Kentucky Power Company (KEPCO), an AEP subsidiary operating in Kentucky. Upon the filing of the agreement with the FERC, the Attorney General of Kentucky intervened and argued that the agreement attempted to circumvent an earlier Kentucky Public Service Commission order denying KEPCO's application to acquire an ownership interest in the unit. FERC accepted the rate schedule for filing subject to refund and set the matter for hearing.^{27/} -

Intervenors in the proceeding then requested a clarification as to whether the FERC would make a prudence determination in the case with respect to the reasonableness of the purchase on the part of KEPCO. As a basis for the request for clarification, the intervenors quoted from a prior FERC order in Pennsylvania Power and Light Company:^{28/} -

We do not view our responsibilities under the Federal Power Act as including a determination that the purchaser has

purchased wisely or has made the best deal available. . . these are legitimate concerns of the state commissions and this Commission as well in determining whether purchases reflect prudently incurred expenses for purposes of determining the purchaser's rates for sales to others.

The FERC granted the motion for clarification. In its "Order Clarifying Prior Order, etc.," the FERC indicated that it would not consider the prudence issue in the proceeding:^{29/}

. . . the issue before the Commission in this proceeding concerns only the justness and reasonableness of the proposed rates and terms for AEGCo's sales of power to KEPCO, the question of prudence on the part of KEPCO in entering into the agreement could arise in the context of a rate proceeding before this commission involving KEPCO's wholesale rates. However, in this proceeding, we do not intend to make or consider any findings concerning KEPCO's prudence in entering the agreement, in light of the availability of alternative power supplies.

Subsequently, the AEP Companies sought rehearing of this order and, through a separate petition for declaratory order (Docket No. EL86-10), requested that the Commission declare that the AEP System Interconnection Agreement, "did not permit KEPCO to continue to purchase additional power from the AEP System Pool at average embedded cost rates and required KEPCO to provide capacity to the pool, which KEPCO has done through the AEGCO/KEPCO Unit Power Agreement for Rockport capacity."

On August 20, 1986 the Commission issued orders reversing its decision to abstain from consideration of prudence issues.^{30/} In one of these orders (in Docket No. ER84-579-005) the Commission affirmed its earlier determination that in more typical circumstances its responsibilities do not include a determination of the prudence of a decision to purchase power from a particular source in light of available alternatives. According to the Commission, "Under narrow, non-pool circumstances, that view would remain sufficient and dispositive."^{31/} Where

the issues involve participation in a comprehensive coordination agreement, however, the Commission finds that it cannot so easily abstain from dealing with questions that may be related to the prudence of purchases. In the words of the Commission:^{32/}

The continuing controversy that has ensued, however, makes it clear that where, as here, the transaction involves affiliated, jurisdictional utilities, which are members of an integrated, interstate holding company arrangement, performing diverse functions on a coordinated basis, and particularly where differing interpretations are advocated concerning the parties' rights and obligations under the basic system agreements, the relevant issues may not be so readily segregated. Under these circumstances, more complex, interrelated questions arise and, whether one characterizes the questions as related to prudence, interpretation, or cost allocation, they are clearly matters most appropriately resolved by this Commission as part of its overriding authority to evaluate and implement all applicable wholesale rate schedules.

In light of these considerations, the Commission set these cases for hearing for the specific purpose of determining whether a participant in the AEP System Agreement is permitted under the agreement to become capacity-deficient, purchasing its capacity shortfall from other members on a permanent basis. The Commission has directed that the proceeding be expedited and that the Administrative Law Judge issue an initial decision in 90 days.

IV. Prudence Issue: State Cases

In several states the prudence exception has been claimed as a means of avoiding federal preemption where a utility whose retail rates are subject to the jurisdiction of the state commission is purchasing power under a FERC-regulated rate. Some of these cases are proceeding through the state courts. Concurrently, the utilities involved have in some cases sought to invoke federal injunctive procedures.

A. Kentucky Public Service Commission (KPSC): Treatment of Purchased Power Cost

Beginning in the late 1970s, Kentucky Power Company (KEPCO) sought permission from the KPSC to buy a 15 percent undivided ownership interest in two large electric generating units under construction by another AEP subsidiary in Rockport, Indiana. This proposal was ultimately denied by the KPSC in an order issued August 2, 1984. Meanwhile, KEPCO entered into a unit power agreement with AEP Generating Company whereby KEPCO agreed to purchase 15 percent of the output of Rockport. As described above, the FERC accepted the rate schedule for filing subject to refund and set the case for hearing.

On December 4, 1984 the KPSC determined that KEPCO acted imprudently in entering the unit power agreement because the same amount of power (according to the KPSC) could be purchased under the pool agreement as surplus power. This was possible, according to the KPSC, because the pool had excess capacity even without the Rockport plant. This determination was appealed to the Franklin Circuit Court, Division II, of the Commonwealth of Kentucky. In affirming the order of the KPSC, the Court stated:^{33/}

The mere filing of a rate schedule for a Unit Power Agreement with FERC does not preempt the PSC from considering the prudence of [KEPCO] in entering into the agreement in light of alternative power supplies, and from denying recovery of excessive costs when they are imprudently incurred. . . The PSC Orders complained of are not clearly in conflict with the Federal Power Act.

In reaching these conclusions the Court gave great weight to the FERC's interpretation of its authority under the Federal Power Act. It noted the findings of the FERC in its parallel order in Docket ER84-579-000:^{34/}

. . . in this proceeding we do not intend to make or consider any findings concerning KEP Company's prudence in entering the agreement, in light of the availability of alternative power supplies.

This case has been appealed to the Kentucky Supreme Court.

In an action initiated in the U.S. District Court for the Eastern District of Kentucky, KEPCO and other AEP subsidiaries sought an injunction against the December 4, 1984 order of the KPSC denying the pass through of the purchased power cost from the Rockport generating units. On January 16, 1985 the District Court granted motions by the Kentucky Commission and certain intervenors to dismiss the federal lawsuit. The Court did not accept the claim of the Kentucky Commission and intervenors that the Johnson Act (which limits federal district court jurisdiction in state ratemaking matters involving local concerns) barred jurisdiction; it simply determined to refrain from exercising jurisdiction under the Burford and Younger abstention doctrines.^{35/}

The determination to refrain from exercising jurisdiction by the District Court was upheld in a recent opinion of the Sixth Circuit Court of Appeals.^{36/} The three-judge panel issued an opinion reflecting considerable disagreement concerning the applicability of the Burford and Younger abstention doctrines.^{37/} Its holding was that the District Court was incorrect in applying Burford as a basis for abstention, but that abstention on the basis of Younger was proper in light of the pending appeal in the state courts. Action has been initiated to appeal the Sixth Circuit decision to the U.S. Supreme Court.

B. Public Service Commission of West Virginia (PSC): Treatment of AEP Transmission Agreement

This case involves the AEP Transmission Agreement filed with the FERC on March 29, 1984, and permitted by that agency to become effective subject to refund by issued on August 21, 1984.^{38/} Subsequent to the FERC action setting the matter for hearing, but prior to the proposed effective date of the Transmission Agreement, the PSC, on December 28, 1984, entered an order requiring Appalachian Power Company (APC) to submit the agreement to the PSC for its approval. The order denied APC any recovery from its customers in West Virginia of the FERC-authorized costs to be incurred under the Transmission Agreement until PSC approval of the agreement had been obtained after it was satisfied that the costs resulting therefrom for inclusion in APC's retail rates in West Virginia were reasonable. This order reversed an order of the PSC entered three months earlier wherein the PSC concluded that it could not require APC to submit the Transmission Agreement for approval nor deny APC recovery of its FERC-approved costs incurred under that agreement. The reason given in the earlier order was that the PSC's power to regulate the Transmission Agreement and the cost recovery thereunder had been preempted by the Federal Power Act which was said to give the FERC exclusive jurisdiction to regulate the transmission and sale for resale of electric energy in interstate commerce.

APC and other AEP subsidiaries filed an action in U.S. District Court challenging the later order of the PSC and seeking a declaration that the PSC order was unenforceable on the ground that it violated the supremacy, commerce, and due process clauses. The PSC argued before the Court that pursuant to West Virginia law, it has the power

to determine whether APC acted prudently in becoming a signatory to a transmission agreement which would obligate its retail customers to pay in the future a greater share of the cost of the AEP interstate transmission network than they would have paid if APC had not become a party to the agreement.

In an order issued February 14, 1986 the District Court held that the PSC was preempted from granting or withholding consent and approval to the utility to enter into the Transmission Agreement and that submission of the Transmission Agreement to the PSC was preempted by the Federal Power Act.^{39/} The Court reasoned that the "public interest" standard embodied in the Federal Power Act requires consideration of "the collective interests of the 50 states which is not only greater, but may be quite different from the interest of the public in any one state."^{40/} The Court went on to say, "The FERC is the only forum in which all the state regulatory bodies, including the PSC as well as the other parties, may appear and represent their various interests."^{41/} The Court concluded that the PSC does not have the power to deny APC's recovery of costs under a FERC-approved transmission agreement since this would be doing indirectly what the PSC could not do directly, i.e., regulate the agreement. According to the Court, "[c]ontrol of cost recovery provides a superior power over the agreement and would stand as a clear obstacle to the accomplishment and execution of the purposes and objectives of the Federal Power Act."^{42/} Thus the District Court appears to have generally concurred in the FERC conclusion that the FERC is the proper forum for determining the prudence of entering into a comprehensive interstate transmission agreement.

C. Grand Gulf Cases at the State Level

1. Background

Grand Gulf Nuclear Unit No. 1 is owned by Middle South Energy (MSE), a subsidiary of Middle South Utilities, Inc. (MSU). Grand Gulf is MSE's only electric power facility. Power from the unit is sold as unit power by MSE to the four operating subsidiaries of MSU under an agreement filed with the FERC. A separate "System Agreement," also filed with FERC, provides for the sharing of reserves among the four operating subsidiaries. A proposed change in this agreement was filed with the FERC at about the same time as the filing of the MSE agreement. Separate hearings on each of these cases were held before different FERC Administrative Law Judges, but the cases were consolidated for consideration by the Commission.

In Opinion Nos. 234 and 234(A) issued June 13 and September 26, 1985^{43/} the FERC provided for the allocation of the costs of the Grand Gulf plant among the MSU operating subsidiaries in a manner substantially different from the allocation proposed by the utilities. In particular, the Commission's opinions have the effect of substantially increasing (from 0 to 36 percent) the portion of the Grand Gulf costs assigned to Arkansas Power and Light Company (AP&L). Appeals of the Commission's Order have been filed with the U.S. Court of Appeals for the District of Columbia Circuit. Those appeals are currently pending.

Meanwhile, the MSU operating companies have sought to comply with the FERC's orders. They have, however, encountered considerable opposition in seeking to pass through costs associated with Grand Gulf as allocated by the FERC to ratepayers in retail rate proceedings.

2. Arkansas Public Service Commission (APSC) Action

Prior to the issuance of the FERC orders reallocating Grand Gulf costs, the APSC issued an order on August 1, 1984 directing AP&L to show cause why all contracts and agreements made by it with respect to any obligations to purchase power from or to pay for construction and operation costs of the Grand Gulf project should not be held to be void because prior approval had not been obtained from the APSC.^{44/} This order was challenged in the U.S. District Court for the Eastern District of Arkansas on various grounds. Following a hearing, the Court permanently enjoined APSC from further proceedings in the matter.^{45/} On appeal to the Eighth Circuit Court of Appeals, that Court affirmed the decision of the District Court on August 23, 1985. According to the Circuit Court, the critical issue was, "whether the APSC's desire to protect Arkansas's interest has resulted in an impermissible burden on interstate commerce."^{46/} The Court ruled that it had, and upheld the injunction against the APSC's investigation of the Grand Gulf Contracts.

On November 21, 1985, Ratepayers Fight Back, a ratepayer group, filed a petition for certiorari with the U.S. Supreme Court with respect to the decision of the Eighth Circuit. Certiorari was subsequently denied.^{47/}

3. City of New Orleans Actions

FERC Opinion Nos. 234 and 234A had allocated approximately 17 percent of the costs of Grand Gulf to NOPSI. When NOPSI filed to recover such costs in its retail rates, the New Orleans City Council, which has regulatory authority over NOPSI, denied the request for interim rate relief pending further regulatory action before the City Council.^{48/} NOPSI then filed a petition (on August 1, 1985) with the

U.S. District Court for the Eastern District of Louisiana seeking to enjoin the City Council to recognize NOPSI's FERC-allocated costs as a legitimate operating expense and to grant rates to cover that expense. NOPSI claimed that the action of the City Council violated the FERC's exclusive authority to regulate the wholesale agreement.

The District Court dismissed NOPSI's claim citing lack of subject matter jurisdiction on the ground that the proceeding involved retail ratemaking.^{49/} The Fifth Circuit Court of Appeals, however, reversed and remanded the case holding that a preemption claim was a basis for federal district court jurisdiction.^{50/} The Court did not rule on the merits of the preemption claim, however, which was remanded for further proceedings.

In a related case, MSE and NOPSI on April 17, 1985 filed suit in the U.S. District Court for the Eastern District of Louisiana against the City of New Orleans seeking to enjoin the City from taking any action, including acquisition of the electric properties of NOPSI, having the intent or effect of circumventing or negating the regulation of the FERC over the allocation of costs of the Grand Gulf station and the arrangements for the sale of power at wholesale among the MSU companies. The suit also sought a judgement declaring that any coerced sale or other disposition of NOPSI's electric properties to the city without FERC approval is in violation of the Federal Power Act. On September 5, 1985 the Court granted a motion by the City to dismiss on the ground that the law suit was premature since the City Council had not yet voted to acquire NOPSI's electric properties.^{51/} This decision has been appealed by MSE and NOPSI to the Fifth Circuit Court of Appeals.

4. Mississippi Public Service Commission (MPSC) Action

In Mississippi, the MPSC issued an order on June 14, 1985 denying the request of Mississippi Power and Light (MP&L) for increased rates relating to Grand Gulf.^{52/} On September 16, 1985 the MPSC issued an order on rehearing recognizing certain Grand Gulf costs but requiring the phase in of portions of such costs.^{53/} The Mississippi Attorney General then filed a notice of appeal with the Mississippi Supreme Court. That appeal is currently pending.

D. Commonwealth Electric Company: Imputed Imprudence

This case involves a unit power purchase by Commonwealth Electric Company (Commonwealth) of 11 percent of the capacity of the Pilgrim I nuclear unit from Boston Edison Company. The agreement had been filed with the Federal Power Commission and accepted in FPC Docket No. E-8138. Boston Edison's Pilgrim I unit was out of service for several months during 1981 and 1982 which made it necessary for both Boston Edison and Commonwealth to obtain replacement power for their customers at costs greater than the cost of power they normally would have sustained from Pilgrim I. In a subsequent proceeding involving rates to be charged by Boston Edison, the Massachusetts Department of Public Utilities (DPU) found that Boston Edison had acted imprudently with respect to certain aspects of the outages and denied recovery by Boston Edison of replacement power costs.

When Commonwealth sought to recover its replacement power costs, the DPU similarly denied recovery of such costs:^{54/}

The Department finds that the Company shares responsibility for BECo's (Boston Edison's) imprudence during the Pilgrim I outage. Pursuant to its life-of-the-unit contract [Commonwealth] was not relieved of its service responsibilities, which include providing electricity at the lowest possible fuel cost; therefore, we believe that the

company is imputedly liable under G.L. c. 164, §94G, for Boston Edison's imprudence and that under that statute the company's ratepayers should not pay the costs associated with the imprudent practices during the Pilgrim 1 outage.

On appeal to the Supreme Judicial Court for the Commonwealth of Massachusetts, Commonwealth argued among other things that the DPU acted beyond its statutory authority and that the regulation of its purchased power costs by the DPU had been preempted by the Federal Power Act. Commonwealth's position was that because the rates it must pay to its wholesale suppliers are fixed by FERC regulation, oversight by the DPU of the company's costs based on those rates is an obstacle to the realization of the purposes behind the FPC. The DPU, on the other hand, argued that federal regulation of the rates for wholesale transactions was not disturbed by its inquiry into the prudence of a retail seller in choosing the source of its supply and in incurring particular costs.

The Court agreed with the DPU argument and quoted with approval the following statement from the DPU order:^{55/}

A retail electric company may decline to execute a wholesale supply contract upon the discovery of less expensive alternatives. If it chooses to ignore those alternatives and execute the wholesale contract, however, or if it incurs wholesale costs as a result of its imprudence. . . , it may be ruled imprudent notwithstanding the fact that the rate at which it purchased wholesale electricity was approved by FERC.

The Court found that while the DPU cannot inquire into the reasonableness of wholesale rates fixed by FERC, the DPU may inquire whether a purchaser such as Commonwealth is warranted in agreeing to purchase at such a rate, considering its alternatives. The Court concluded that the company failed to demonstrate how the action of the DPU will frustrate the full purposes and objectives of the Federal Power

Act. Commerce clause arguments were largely disposed of on the basis that the FERC does not have jurisdiction over retail rates and thus is not the appropriate forum for consideration of the prudence issue.

On July 18, 1986, Commonwealth filed a petition in the U.S. Supreme Court seeking review of the opinion of the Supreme Judicial Court of Massachusetts in this case. Among the questions presented by the petitioner was, "[w]hether the Federal Power Act permits a state regulatory commission setting retail rates to avoid the filed-rate doctrine and 'trap' costs incurred by the retailer as a result of the terms of a federal tariff by imputing to the retailer the imprudence of its wholesale supplier."^{56/}

E. Connecticut Valley Electric Company (CVEC): Requirement for Prudence Review

In this case the New Hampshire Public Utilities Commission (NHPUC) ruled that it was preempted from questioning the reasonableness of costs incurred under a FERC-approved wholesale rate in determining the retail rates of CVEC. The NHPUC found that it must "deem a FERC approved wholesale rate as a reasonable operating expense, even when that rate includes a CWIP element in violation of New Hampshire legislation."^{57/}

On appeal to the Supreme Court of New Hampshire by retail customers of CVEC, the decision was reversed and remanded for further proceedings.^{58/} The Court found that the NHPUC, by declining to determine whether the wholesale rate was a reasonable expense for the utility, had abdicated its responsibility for approving only those rates it finds to be just and reasonable. According to the Court:^{59/}

Given the PUC is not preempted from an inquiry into alternatives to the [wholesale] rate, the question becomes whether CVEC's participation under the [wholesale] rate is reasonable. The burden of showing the reasonableness of CVEC's participation in this agreement rests with CVEC. . . . The wholesale rate must be justified by the utility as the product of reasonable efforts to secure the lowest cost in light of appropriate alternatives available to the company. . . . [The] assumption by the PUC [that the decision to purchase was a reasonable exercise of managerial discretion] overlooks CVEC's underlying burden of proof in this case and abdicates the PUC's responsibility for approving only those rates it finds to be just and reasonable.

V. Legislative Activity

In February 1985, legislation was introduced in the U.S. House of Representatives proposing to amend the Public Utility Holding Company Act of 1935 and the Federal Power Act to clarify the regulatory authority of federal and state agencies with respect to certain transactions by electric utility companies.^{60/} Among the provisions of that legislation is a section amending the Federal Power Act to provide that a state public service commission shall have the power to refuse to pass through the costs of power purchased by an electric utility from any other public utility even though the purchase has been made under rates approved by the FERC. Another section of the legislation would prohibit the FERC from setting a rate for power purchased by an electric utility from an affiliated company within a holding company system without the prior approval of the state commission which regulates the retail rates of the purchasing utility. To date, no hearings on this proposed legislation have been held.

In March of 1986 the Energy Conservation and Power Subcommittee of the Committee of Energy and Commerce of the U.S. House of Representatives held hearings focused primarily on the issue of cancelled power plants. For purposes of that hearing the Committee

sought hearing on a variety of questions including: "Should the Narragansett Doctrine be modified legislatively and, if so, in what manner?" While most of the witnesses in the hearing did not respond directly to this question, the testimony of the representative of the Environmental Action Foundation did contain such a response, as follows:^{61/}

We prefer to see the Pike doctrine--granting state commission authority to review the transactions of the purchasing utility--and the Narragansett Doctrine--granting FERC the exclusive authority to regulate the selling utility--as complementary and not in conflict. In that sense, the Narragansett Doctrine per se needs no legislative modification. Legislation guaranteeing this state authority, along the lines of HR931 and S. 1149, is essential, however, to clarify and reconcile conflicting court opinions in this area.

In the Senate, legislation has also been introduced designed to modify the Narragansett Doctrine. In April 1985, Senator Bumpers of Arkansas introduced S.1149, a bill, "to amend the Federal Power Act to allow state commissions to determine whether to exclude all or part of a rate set by the FERC based on construction costs."^{62/} The legislation is limited to cases of rates subject to the jurisdiction of the FERC that are charged by one affiliate of a public utility holding company system to another where the rate is based upon an allocation of costs from a generating unit. The legislation provides that where the affiliate company is subject to the jurisdiction of a state commission which did not approve the construction costs of such generating unit, then the state commission may make a determination not to take into account the federally-approved rate in establishing rates for retail sales by the associate company. In summary, this legislation would cause the Narragansett Doctrine to be inoperative in specific kinds of cases, namely circumstances similar to the FERC allocation of the costs of the

Grand Gulf unit owned by Middle South Energy among various affiliated utilities. Any state commission that had not approved the construction of a generating unit could determine that retail ratepayers within its state would bear no part of the costs of that unit.

A hearing on this proposed legislation was held during the fourth week of July 1986 before the Senate Energy and Natural Resources Subcommittee on Water and Power. In testimony before that committee, William F. Martin, Deputy Secretary of the U.S. Department of Energy expressed the opposition of the administration to this legislation:

S. 1149 would work against the increasingly regional nature of the electric power industry, and would threaten the efficiency gains available to the industry through power pooling and joint ventures on new capital facilities.

Under S. 1149 a utility which constructed a new facility subject to FERC's regulatory oversight may not be able to fully recover capital costs due to inconsistent and uncoordinated regulatory decisions. Such a circumstance would pose large uncompensated financial risks to utilities undertaking future capital programs.

By creating significant uncompensated risks to utilities involved in interstate electric power trade, S. 1149 would inhibit new utility investments and threaten the efficiency and sufficiency of future electric power supply.

According to Electrical Week, "Action on the bill is unlikely this year because full Committee Chairman, Senator James McClure (R-Idaho), is unenthusiastic about the proposal."^{63/}

In other testimony before the Committee, an official of the National Association of Regulatory Utility Commissioners (NARUC) stated that that organization is seeking to promote legislation that would set up joint boards comprising state regulators and members of the FERC to review and make recommendations on broad issues affecting the electric and gas industries. Such boards are said to be needed to prevent a future "breakdown" in the federal/state regulatory relationship similar

to that which occurred following FERC decisions on the allocation of costs of the Grand Gulf nuclear unit. Under the proposal, the joint board would include four state commissioners designated by the president of NARUC and three FERC commissioners. Questions referred to the board by the FERC would be reviewed and orders would be recommended that the FERC could either accept or ignore.

VI. Conclusions and Outlook

The Supreme Court in Nantahala has left little doubt as to the general rule that in fixing retail rates a state commission may not prevent a utility from charging rates that reflect rate schedules on file with the FERC. State courts that have considered this question have "uniformly agreed" with this principle. Indeed, the North Carolina Supreme Court did not reject the Narragansett line of cases in Nantahala, but rather, found them inapplicable to the specific facts of that case.

The principal exception to the general rule relates to the prudence of the purchaser under a rate schedule on file with the FERC. Under the Pike County line of cases, state commissions claim that they need not reflect FERC-filed rates in retail rates where the purchaser is found to have been imprudent in entering or failing to terminate an agreement on file with the FERC. The Supreme Court has implied that it may consider this to be a valid exception.

Until recently, it appeared that the FERC was in accord with the proposition that the prudence of a purchaser under a wholesale rate schedule was not within its responsibility or concern, as reflected in cases beginning with Philadelphia Electric Company in 1981.^{64/} In AEP Service Corporation and in AEP Generating Company, however, the

Commission has determined that the prudence of the buyer is within its jurisdiction where the issue is the prudence of participating in a power coordination agreement (at least a power coordination agreement among affiliated systems). It is not clear how far this modification or clarification of the Commission's responsibility with respect to the prudence issue may extend.

Meanwhile, other variations of the prudence issue are proceeding through the courts. Among the most controversial of these are cases related to the FERC's decision in the Grand Gulf cases, described above. According to Nixon and Johnston:^{65/}

Regardless of the outcome of the appeal of the Middle South cases pending in the District of Columbia Court of Appeals, one or more parties will seek Supreme Court review within the next year. (The cases involve approximately a \$4 billion reallocation in rates to be collected over ten years.) The Court will be presented with the opportunity to examine FERC's equalization remedy, its disavowal of forced purchases, and its rationale for treating wholesale transactions among integrated power pool and holding company system members differently from other wholesale power arrangements with respect to prudence of the purchase.

The Supreme Court will also have the opportunity to review the decision of the Supreme Judicial court of Massachusetts in Commonwealth Electric Company. This case may determine whether the "imputation" of imprudence from the owner/operator of a power plant to a unit power purchaser can serve as an exception to the Narragansett Doctrine.

Legislative efforts to change the Narragansett Doctrine have been quite limited to date. The only piece of legislation that has been the subject of Congressional hearings has been S.1149 introduced by Senator Bumpers. This legislation would make the Narragansett Doctrine inoperative in highly limited circumstances that are inapplicable to most cases in which the Narragansett Doctrine has been at issue.

As mentioned above, the outlook for even this limited legislation does not appear to be bright, at least over the near term. The proposal for more comprehensive consultation between the FERC and the state commissions with respect to issues involving federal/state regulatory relationships (through joint boards or some other mechanism) may prove to be a more promising approach to the problem.

NOTES

1/ Jerry L. Pfeffer and William W. Lindsay, The Narragansett Doctrine: An Emerging Issue in Federal-State Electricity Regulation, Occasional Paper No. 8, The National Regulatory Research Institute, The Ohio State University (December 1984).

2/ 119 RI 559, 381 A2d 1359 (R.I. 1977), cert. den. 435 U.S. 972 (1979).

3/ Northern States Power Company vs. Hagen, 314 N.W. 2d 32 (N.D. 1981); Northern States Power vs. Minnesota Public Service Commission, 344 N.W. 2d 374 (Minn.) cert. denied, 104 S. Ct. 3546 (1984).

4/ Pike County Light and Power Company vs. Pennsylvania PUC, 77 Pa. Commw. 268, 465A.2d 735 (1983).

5/ Nantahala Power and Light Company, et al. vs. Thornburg, Attorney General of North Carolina, et al., slip opinion, No. 85-568 (1986). The decision was unanimous with two justices not participating.

6/ North Carolina ex rel. Utilities Commission, 313 N.C. 614, 332 S.E. 2d 397 (1985).

7/ These included a complaint proceeding (Docket No. EL78-18) growing out of a complaint filed by Nantahala's wholesale customers which was consolidated for hearing purposes with a rate increase application (Docket No. ER76-828). The FERC Opinion in the consolidated case was issued May 14, 1982, 19 FERC ¶61,152.

8/ Nantahala Power and Light vs. FERC, 727 F.2d 1342 (1984).

9/ North Carolina ex rel Utilities Commission, B. Edminsten, 299 N.C. 432, 434, (1980).

10/ Unreported opinion of the North Carolina Utilities Commission, dated September 2, 1981.

11/ See note 6.

12/ Ibid.

13/ Ibid., at 688, 332 S.E. 2d, at 440-441.

14/ Nantahala Power and Light Company et al. vs. Thornburg, Attorney General of North Carolina et al., op. cit., p. 10.

15/ Ibid., p. 11.

16/ Ibid., p. 13.

17/ Ibid., p. 14-15.

^{18/} Ibid., p. 15-16.

^{19/} Ibid., p. 16.

^{20/} Ibid., p. 16-17.

^{21/} Ibid., p. 17.

^{22/} Ibid., p. 19.

^{23/} Other recent Supreme Court cases have involved federal/state preemption issues under the Natural Gas Policy Act of 1978 and The Communications Act of 1934. These are Transcontinental Gas Pipeline Corp. vs. State Oil and Gas Board of Mississippi et al., ___ U.S. ___ (1986) and Louisiana Public Service Commission vs. Federal Communication Commission et al., ___ U.S. ___ (1986) respectively. These cases involved interpretation of different statutes; they are not directly relevant to the regulatory scheme under the Federal Power Act relating to electric wholesale rate regulation and the extent to which that regulation affects state authority for regulation of retail rates.

^{24/} Pike County Light and Power Company vs. Pennsylvania (PUC), 465 A. 2d 735, 738 (1983). In this case the Court concluded:

[W]hile the FERC determines whether it is against the public interest for [the supplier] to charge a particular rate in light of its costs, the PUC determines whether it is against the public interest for [the buyer] to pay a particular price in light of its alternatives. The regulatory functions of the FERC and the PUC thus do not overlap. . .

^{25/} Jerry L. Pfeffer and William W. Lindsay, op. cit., p. 110.

^{26/} 32 FERC ¶61,363 at 61,818 (1985).

^{27/} Docket No. ER84-579-000, 29 FERC ¶61,002 (1984).

^{28/} 23 FERC ¶61,325 (1983).

^{29/} 29 FERC ¶61,246 (1984).

^{30/} AEP Generating Company, Order on Rehearing, Docket No. ER84-579-005; Kentucky Power Company, Order Setting Issues for Hearing and Consolidating Dockets, Docket Nos. EL86-10-000 and ER84-579-006.

^{31/} AEP Generating Company, *ibid.*, p. 4.

^{32/} *Ibid.*, pp. 4-5.

^{33/} Kentucky Power Company vs. Kentucky Public Service Commission et al., Commonwealth of Kentucky Franklin Circuit Court, 84-CI-1760 (March 24, 1986). Slip opinion, p. 7.

^{34/} Ibid., p. 6.

^{35/} Burford vs. Sun Oil, 319 U.S. 315 (1943); Younger vs. Harris, 401 U.S. 37 (1971).

^{36/} American Electric Power Company vs. Kentucky Public Service Commission et al., 787 F.2d 58 (Sixth Circuit 1986).

^{37/} While the opinion of the three judge panel was issued per curium, there were two concurring opinions.

^{38/} 28 FERC ¶61,228 (1984).

^{39/} Appalachian Power Company et al. vs. Public Service Commission of West Virginia, 630 F. Supp. 656 (S.D.W.Va. 1986)

^{40/} Ibid. at 662.

^{41/} Ibid. at 664.

^{42/} Ibid.

^{43/} 31 FERC ¶61,305 (1985) and 32 FERC ¶61,424 (1985).

^{44/} For background of this case see, Middle South Energy, Inc. vs. Arkansas Public Service Commission, 772 F.2d 404 (8th Cir. 1985).

^{45/} Ibid.

^{46/} Ibid.

^{47/} Cert. denied subnom., Ratepayers Fight Back vs. Middle South Energy, Inc., ___ U.S. ___, 106 S. Ct. 884 (1986).

^{48/} See background discussion in New Orleans Public Service Inc. vs. City of New Orleans et al., 782 F.2d 1236 (5th Cir. 1986).

^{49/} Ibid.

^{50/} Ibid.

^{51/} Middle South Energy, Inc., et al. vs. City of New Orleans, et al., No. 85-1670 (E.D.La September 5, 1985).

^{52/} Middle South Utilities, Inc., 1985 Annual Report, p. 25.

^{53/} Ibid.

^{54/} D.P.U. 1003-G-6, pp. 17-18.

^{55/} Commonwealth Electric Company vs. Department of Public Utilities, Supreme Judicial Court for the Commonwealth of Massachusetts, SJC-3913, Issued April 22, 1986. Slip Opinion, pp. 27-28.

^{56/} Commonwealth Electric Company, Petition for Writ of Certiorari in the Supreme Court of the United States (July 18, 1986) p. i.

^{57/} New Hampshire Public Utilities Commission, Application of Connecticut Valley Electric Company (June 18, 1984).

^{58/} Appeal of Sinclair Machine Products, Inc., 498 A.2d 696 (N.H. 1985).

^{59/} Ibid., at 705.

^{60/} H.R. 931, 99th Congress, 1st Session.

^{61/} Alan G. Noguee, "Federal vs. State Regulatory Standards for Allocating Power Plant Construction Costs," Testimony before the U.S. House of Representatives, Subcommittee on Energy Conservation and Power, Washington, DC (March 20, 1986), p. 31 of prepared statement.

^{62/} S. 1149, 99th Congress, 1st Session.

^{63/} Electric Utility Week (July 28, 1986) p. 3.

^{64/} 15 FERC ¶61,264 (1981) Indeed, in Southern Company Services, 26 FERC ¶61,360, (1984) the Commission stated that it is not empowered to disapprove a power sale agreement on the ground of imprudence of the buyer.

^{65/} Walter W. Nixon III and Robert E. Johnston, "Nantahala Affirms Narragansett--Where is FERC/Pike County?" unpublished paper received from authors (July 1, 1986) p. 18.

