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G. William Fowler

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PURCHASED GAS ADJUSTMENT CLAUSES: AN ADJUSTER'S VIEWPOINT

G. WILLIAM FOWLER*

The Railroad Commission of Texas is charged by statute with the responsibility of establishing fair and reasonable rates for the sale of natural gas and natural gas service to consumers within the state.¹ Although initially shared in some instances with incorporated cities,² this responsibility is two-fold. First, the commission has a duty to see that consumers of natural gas are not charged excessive rates. Second, the commission must establish rates that will also provide a fair rate of return for the gas utility company on property devoted to public service. These responsibilities, when properly satisfied, produce a rate that is reasonable to all parties involved and should insure continued adequate service.

The conventional rate process consists of determining the fair value of the utility's property devoted to public service, the reasonable revenues and expenses associated with providing the utility service, and the proper rate of return on that property.³ This process is complex and expensive and requires the services of individuals with expertise in the fields of accounting, economics, engineering and law. The process is further complicated by the demands of a fluctuating economy, the regulatory lag associated with the rate determination process, rapidly spiraling inflation, and current shortages of available supplies of natural gas. These problems require the regulating authority to institute something more than traditional methods of rate regulation in order to satisfy its statutory responsibilities. A partial solution is the incorporation of a purchased gas adjustment clause in natural gas utility

* Hearing Examiner, Gas Utilities Division, Railroad Commission of Texas; B.B.A., University of Texas at El Paso; J.D., St. Mary's University. The opinions expressed herein are the author's and not necessarily those of the Railroad Commission of Texas.

1. TEX. REV. CIV. STAT. ANN. art. 6050 (1962).

2. Incorporated cities and towns in Texas have original jurisdiction to establish rates within the city limits for natural gas service. TEX. REV. CIV. STAT. ANN. art. 1119 (1963). For a more detailed discussion see *Newcomb, Some Aspects of Regulation of Public Utilities Operating in the State of Texas*, 5 BAYLOR. L. REV. 335 (1953).

3. *Railroad Comm'n v. Houston Natural Gas Corp.*, 155 Tex. 502, 523, 289 S.W.2d 559, 562 (1956).

tariffs. Attention is therefore directed toward the legal, economic and administrative problems that a regulatory body must review when considering adoption of a purchased gas adjustment clause in a gas utility tariff. Many of the problems associated with adjusting the tariff to compensate the gas utility for changes in its cost of purchased gas are also important in adjusting other cost items.

DEVELOPMENT

An adjustment or escalator clause is a provision in a utility company's tariff whereby a change in a selected cost item will change rates charged to consumers.⁴ A purchased gas adjustment clause permits a change in the consumer's rate when the cost of purchased gas changes for the gas utility company. An adjustment clause has also been defined as

a fixed rule under which future rates to be charged the public are determined. It is simply an addition of a mathematical formula to the filed schedules of the company under which the rates and charges fluctuate as the wholesale costs of gas to the company fluctuates. Hence, the resulting rates under the escalator clause are as firmly fixed as if they were stated in terms of money.⁵

The characteristics of a purchased gas adjustment clause determine if it is automatic, non-automatic, permissive and/or mandatory. An adjustment clause is automatic in the sense that the clause itself and the method for its calculation is found in the tariff sheet. Full disclosure of the conditions affecting the rate change and the amount of the adjustment within a short period of time are usually made to the regulatory authorities which will make the rate effective.⁶ An adjustment clause is non-automatic because the regulatory authority treats the change in the costs of purchased gas as a temporary rate increase subject to refund.⁷ An adjustment clause that is permissive leaves to the utility management's discretion the decision to alter existing rates when the cost of purchased gas changes. Adjustment clauses are usually permissive if the rate increases.⁸ This allows management more control

4. The use of the term "escalator clause" should be avoided. "Escalation" has come to mean incremental price increase at regular or fixed intervals, whereas an adjustment clause adjusts a utility rate upward or downward, along with increases or decreases in an operating cost." Foy, *Cost Adjustment in Utility Rate Schedules*, 13 VAND. L. REV. 663 n.1 (1960).

5. *City of Norfolk v. Virginia Elec. & Power Co.*, 90 S.E.2d 140, 148 (Va. 1955).

6. AMERICAN GAS ASSOCIATION PROCEEDINGS 196 (1961).

7. *Id.* at 196.

8. *See Re Worcester Gas Light Co.*, 9 P.U.R.3d 152, 157 (Mass. Dept. Pub. Util.

in the conduct of its daily business. A mandatory adjustment clause requires that the existing rate must be changed when the cost of purchased gas fluctuates. Because they protect the consumer, mandatory adjustment clauses are most commonly imposed when the cost item to the utility changes downward.⁹

The primary purpose of a purchased gas adjustment clause is to permit a gas utility company's rate of return to remain at the proper level by permitting the utility to pass on any changes in the cost item under adjustment, in this case the cost of purchased gas.¹⁰ During inflationary periods increased purchased gas costs are absorbed by the utility in the absence of a purchased gas adjustment clause. This erodes a utility company's rate of return and requires frequent rate applications for relief. During periods of recession, purchased gas costs could decline, permitting the utility to earn more than a fair rate of return. Regardless of the economic conditions, purchased gas adjustment clauses generally permit the consumer's rate to fluctuate with the utility's purchased gas costs.

When natural gas was first introduced as an energy source, adjustment clauses were used by gas distribution companies for competitive as well as regulatory purposes. Gas rates were adjusted according to the prevailing price of oil in order to retain those customers with equipment capable of using gas or oil.¹¹ Today, a purchased gas adjustment clause is a competitive instrument only where one gas company is authorized to pass on changes in its cost of purchased gas and another is not, and both companies are bargaining for the same supply of natural gas.

Adjustment clauses became a part of electric utility tariffs or rate schedules shortly after the turn of the century, and were initially accepted by regulatory agencies during World War I.¹² Since that time fuel adjustment clauses have become an integral part of electric com-

1955); *Re Brooklyn Borough Gas Co.*, 100 P.U.R.(ns) 271, 302-303 (N.Y. Pub. Ser. Comm'n 1953); *Houston Pipeline, Gas Utilities No. 483*, at 4 (Tex. R.R. Comm'n 1972).

9. *See Re Worcester Gas Light Co.*, 9 P.U.R.3d 152, 157 (Mass. Dept. Pub. Util. 1955); *Re Brooklyn Borough Gas Co.*, 100 P.U.R.(ns) 271, 302-303 (N.Y. Pub. Ser. Comm'n 1953); *Houston Pipeline, Gas Utilities No. 483*, at 4 (Tex. R.R. Comm'n, 1972).

10. *City of Norfolk v. Virginia Elec. & Power Co.*, 90 S.E.2d 140, 145 (Va. 1955).

11. *E.g., Re Southern Counties Gas Co.*, 1 P.U.R.3d 475, 496 (Calif. Pub. Util. Comm'n 1953).

12. For a complete discussion of the problem see Trigg, *Escalator Clauses in Public Utility Rate Schedules*, 106 PA. L. REV. 964 (1958).

pany tariffs. In the 1940's, when major interstate pipelines were completed, gas companies began using adjustment clauses to change utility tariffs as the cost of purchased gas changed.¹³ In 1952, 8 percent of the 653 natural gas distribution companies reporting to the American Gas Association's Rate Service had rate adjustment clauses.¹⁴ By 1960 with 769 natural gas companies reporting to that service approximately 40 percent had rate adjustment clauses.¹⁵ Today, 36 states, the District of Columbia and the Federal Power Commission have allowed some form of purchased gas adjustment clause in natural gas utility rate schedules.¹⁶

In Texas, the development of purchased gas adjustment clauses began when gas companies started experiencing uncertainty in the field purchase prices for natural gas. During this period, the Railroad Commission of Texas permitted gas distribution companies to establish industrial rates by private negotiation.¹⁷ Purchased gas adjustment clauses or "cost plus" contracts first appeared in these negotiated industrial sales contracts.¹⁸ The popularity of purchased gas adjustment clauses in Texas has increased significantly in recent years. In 1960, with 76 natural gas companies reporting to the American Gas Association's Rate Service, three had purchased gas adjustment clauses in their rate schedules.¹⁹ Today, Lone Star Gas Company serves 421 incorporated cities and towns in Texas²⁰ and has purchased gas adjustment clauses applicable to approximately 86 percent of its residential and commercial customers.²¹ Houston Natural Gas Corporation, serving

13. Foy, *Cost Adjustment in Utility Rate Schedules*, 13 VAND. L. REV. 663, 665 (1960).

14. AMERICAN GAS ASSOCIATION PROCEEDINGS 131 (1953). These figures include clauses that provided a variable adjustment and fixed additional charges or discounts for cost of gas. Competitive fuel prices, taxes, etc. were not included. *Id.* at 132.

15. AMERICAN GAS ASSOCIATION PROCEEDINGS 192 (1961).

16. FEDERAL POWER COMMISSION, FEDERAL AND STATE COMMISSION JURISDICTION AND REGULATION OF ELECTRIC, GAS AND TELEPHONE UTILITIES (1973). Alaska, Colorado, Connecticut, Idaho, Kansas, Minnesota (does not regulate gas utilities), Nebraska, Nevada, North Carolina, Oregon, South Dakota, Utah, Washington, and Wyoming did not report purchased gas adjustment clauses in any rate schedules.

17. *See United Gas Corp. v. Shepherd Laundries Co.*, 144 Tex. 164, 189 S.W.2d 485 (1945).

18. Letter from W.O. Crain, United Texas Transmission Company to G. William Fowler, June 24, 1974.

19. AMERICAN GAS ASSOCIATION PROCEEDINGS 194 (1961).

20. 1973 ANN. REP. OF LONE STAR GAS CO. TO THE R.R. COMM'N OF TEX. 32-1 to 32-421.

21. Letter from W.T. Satterwhite, Lone Star Gas Company to G. William Fowler, June 10, 1974.

109 Texas incorporated cities and towns,²² has purchased gas adjustment clauses in every city but two.²³ Purchased gas adjustment clauses have been approved in 133 of the 136 incorporated Texas cities and towns served by Entex.²⁴ Southern Union Gas Company has also successfully incorporated purchased gas adjustment clauses in burner-tip rates.²⁵ Pioneer Natural Gas Company reports that all of its incorporated cities and towns served by its West Texas System have adopted purchased gas adjustment clauses.²⁶

Purchased gas adjustment clauses contained in city-gate rates are also becoming more prevalent. Lone Star Gas Company²⁷ and Houston Pipe Line Company²⁸ have clauses which permit them to pass on 65 percent of any increases in their weighted average cost of purchased gas every 6 months. United Texas Transmission Company has a 100 percent flow-through in all of its seven city-gate contracts.²⁹ Operating under an interim order, Lo-Vaca Gathering Company has a 100 percent purchased gas adjustment clause.³⁰ It is apparent that these pro-

22. 1973 ANN. REP. OF HOUSTON NAT'L GAS CORP. TO R.R. COMM'N OF TEX. 33-1 to 33-109.

23. Letter from Gary W. Orloff, Houston Natural Gas Corporation to G. William Fowler, June 6, 1974.

24. Letter from David Claflin, Entex, Inc., to G. William Fowler, June 24, 1974.

25. Letter from T.A. Wright, Southern Union Gas Company to G. William Fowler, June 25, 1974. They have clauses in every city except Gruver.

The burner tip rate is the rate paid by the ultimate consumer.

26. Letter from W.N. Lampe, Pioneer Natural Gas Company to G. William Fowler, June 13, 1974.

27. Lone Star Gas Co., Gas Utilities No. 453 (Tex. R.R. Comm'n 1972).

28. Houston Pipe Line Company, Gas Utilities No. 483 (Tex. R.R. Comm'n 1972).

29. See Pennzoil Pipeline Co., Gas Utilities No. 454 (Tex. R.R. Comm'n 1971). A city-gate rate is the amount paid at "a location at which gas changes ownership . . . neither of which is the ultimate consumer." GLOSSARY FOR THE GAS INDUSTRY, AMERICAN ASSOCIATION 26 (1967).

30. Lo-Vaca Gathering Company, Gas Utilities No. 500 (Tex. R.R. Comm'n 1973). The Interim Order provides:

IT IS THEREFORE ORDERED BY THE RAILROAD COMMISSION OF Texas that its September 27, 1973, Interlocutory Order establishing an interim rate for Lo-Vaca shall and is hereby amended to provide the following revised purchased gas adjustment clause:

The interim rate shall include a cost of gas, or commodity, element which shall be the weighted average cost of gas to Lo-Vaca as of June 1973, indicated by Lo-Vaca's evidence to be 24.55 cents/Mcf. The interim rate shall be adjusted each month to include Lo-Vaca's current weighted average cost of purchased gas. Lo-Vaca's current weighted average cost of purchased gas for a billing month shall be Lo-Vaca's weighted average cost of purchased gas for that month determined to the nearest one-one hundredth of one percent per Mcf (1/100 of 1-cent/Mcf) at a pressure base of 14.65 psia. The current weighted average cost of gas shall be determined initially by estimation by Lo-Vaca and this estimated current weighted average cost of gas shall be used in Lo-Vaca's invoices sent to Lo-Vaca System customers in the month immediately following the billing month. Any difference in the estimated weighted average cost of purchased gas and the actual weighted average cost of purchased gas will be refunded or billed on the

visions which were once unknown have practically become a way of life.

The Federal Power Commission recently reversed its regulatory practices and issued Order No. 452 permitting its jurisdictional pipeline companies to make application for a purchased gas adjustment clause in their tariffs.³¹ Requisite to the commission's approval is a recent 12-month cost of service study which is to be included in the application. Approval by the commission not only entitles the gas company to adjust its cost every 6 months,³² but also allows it to pass on 100 percent of its increased gas costs.

Purchased gas is defined by the Federal Power Commission as gas purchases from well heads, field lines, plant outlets, transmission lines, and pipeline production from leases acquired on and after October 7, 1969.³³ The cost of underground storage and nonconcurrent exchange transactions are also included in determining the price of purchased gas. New pipeline supplies, liquid natural gas (LNG), synthetic natural gas (SNG) and gas from coal gasification may not be included without prior Federal Power Commission approval.³⁴

Upon the inclusion of a purchased gas adjustment clause in a tariff, a new base tariff rate is established every 36 months.³⁵ Provisions for refunds are made if the new cost of service study shows that collected revenues exceed the actual cost of service.³⁶ The Federal Power Commission also requires each company to file a monthly summary of its unrecovered purchased gas costs to enable the Commission to monitor any changes in the price of gas.³⁷

LEGAL CONSIDERATIONS

The first consideration that any regulatory body must make is

subsequent month's invoice. If during a calendar month Lo-Vaca received any refunds of monies paid by it for gas purchased during a prior period, such refunds shall be applied to reduce Lo-Vaca's cost of gas purchased during said calendar month. Accrued and deferred items shall be included in the computation of purchased gas during the month in which they are expensed.

IT IS FURTHER ORDERED that if Lo-Vaca's current monthly estimation of its cost of purchased gas should exceed its actual cost of purchase gas from the same period by more than 5%, then Lo-Vaca shall, in addition to refunding the difference, pay interest at the rate of 8½% per annum on the excess amounts billed.

31. Purchased Gas Cost Adjustment Provisions in Natural Gas Pipeline Companies' FPC Tariffs, Order No. 452, 74 F.P.C. 1049 (1972).

32. 18 CFR § 154.38(d)(4)(i), (iv) (1973).

33. 18 CFR § 154.38(d)(4)(vi) (1973).

34. *Id.*

35. 18 CFR § 154.38(d)(4)(vi) 1973).

36. *Id.*

37. 18 CFR § 154.38(d)(4)(iv) (1973).

whether it has the legal authority to permit purchased gas adjustment clauses in gas utility tariffs. While several state statutes authorize specific adjustment provisions,³⁸ Texas' statutory grant of authority is expressed in general terms.³⁹ The Texas Legislature adopted the Gas Utilities Act and delegated to the Railroad Commission the authority to establish fair and equitable rates for the sale of natural gas and natural gas service to consumers. The general language of article 6053 provides the commission with "full power and authority to prescribe such rules and regulations as in its wisdom may be deemed necessary to carry out the purpose of this Act."⁴⁰ Article 6058 also provides that the commission "may make such order or decision in regard to the matter involved therein as it may deem just and reasonable" when a gas utility appeals to the commission from actions of a city government.⁴¹

While no Texas court has ever determined the validity of pur-

38. At least nine states have specific statutory authority permitting adjustment clauses or sliding scale of charges in rate schedules. ARIZ. REV. STAT. ANN. § 40-368 (1956); ARK. STAT. ANN. § 73-219 (1957); CALIF. PUB. UTIL. CODE § 457 (Deering 1970); MD. ANN. CODE art. 78, § 54 (1969); N.H. REV. STAT. ANN. Ch. 378, art. 11 (1966); N.Y. PUB. SER. LAW § 65.4 (McKinney 1955); PURDOM'S PA. STAT. ANN. tit. 66, § 1147 (1959); WIS. STAT. § 196.11 (1957). The Arizona and Pennsylvania provisions are representative. The Arizona statute provides:

A. Any person engaged in the production, generation, transmission or furnishing of heat, cold air, light, water or power, or telegraph or telephone service, may establish a sliding scale of charges, and may enter into an arrangement for a fixed period for the automatic adjustment of charges for heat, cold air, light, water, or power, or telegraph or telephone service, in relation to the profit to be realized by such person. A schedule showing the scale of charges under such arrangement shall first be filed with the commission and the schedule and each rate set out therein approved by it.

B. The commission may revoke its approval at any time and fix other rates and charges for the product or commodity or device, as authorized in this chapter.

ARIZ. REV. STAT. ANN. § 40-368 (1956).

The Pennsylvania statute provides:

(a) Any public utility, except a common carrier, may establish a sliding scale of rates or such other method for the automatic adjustment of the rates of the public utility as shall provide a just and reasonable return on the fair value of the property used and useful in the public service, to be determined upon such equitable or reasonable basis as shall provide such fair return: Provided, That a tariff showing the scale of rates under such arrangement is first filed with the commission, and such tariff, and each rate set out therein, approved by it. The commission may revoke its approval at any time and fix other rates for any such public utility if, after notice and hearing, the commission finds the existing rates unjust or unreasonable.

(b) The commission, by regulation or order, upon reasonable notice and after hearing, may prescribe for any class of public utilities, except a common carrier, a mandatory system for the automatic adjustment of their rates, by means of a sliding scale of rates or other method, on the same basis as provided in paragraph (a), to become effective when and in the manner prescribed in such regulation or order

PURDOM'S PA. STAT. ANN. tit. 66, § 1147 (1959).

39. TEX. REV. CIV. STAT. ANN. arts. 6050-6066 (1962).

40. TEX. REV. CIV. STAT. ANN. art. 6053 (1962).

41. TEX. REV. CIV. STAT. ANN. art. 6058 (1962).

chased gas adjustment clauses, they have dealt with the commission's authority to determine fair and reasonable rates for gas sold within the state. In *State v. Public Service Corp.*⁴² the court interpreted the commission's regulatory authority in city gate-rate applications, stating that

[d]etails are left to the administrative and supervisory discretion of the Commission, with complete authority to make all rules, regulations or orders deemed to be necessary to effectuate the legislative intent, and to ultimately fix just and reasonable burner-tip rates for gas.⁴³

It is apparent, then, that the courts have heeded legislative mandate and allowed the commission broad discretion.

Once the regulatory authority is satisfied that it has the jurisdiction to authorize a purchased gas adjustment clause as a method of determining rates, several other legal issues should be analyzed. Although these legal problems have been solved by numerous state authorities, a brief discussion of each area should help to avoid the plight expressed by Philip Ardery:

A lawyer who attempts to chop his way around in the legal opinion on the subject of these clauses is apt to find himself wandering in circles with his intellectual machete so dulled he is soon brought to a standstill.⁴⁴

While retroactive rate making is illegal,⁴⁵ it has been argued that the adoption of a purchased gas adjustment clause permits such actions. In a landmark decision, *City of Norfolk v. Virginia Electric & Power Co.*,⁴⁶ the Virginia Supreme Court of Appeals stated that the commission

[i]n approving the escalator clause . . . did not fix rates retroactively, but on the contrary . . . authorized and prescribed a fixed mathematical formula to be inserted in the schedules of the company which will serve as a 'guide, direction or rule of action' for determining future rates.⁴⁷

Consumer representatives have also contended that approval of a purchased gas adjustment clause results in a denial of procedural due process for consumers because there is no public notice and hearing

42. 88 S.W.2d 627 (Tex. Civ. App.—Austin 1935, writ ref'd).

43. *Id.* at 630.

44. Ardery, *Should There Be Rules About Escalator Clauses?*, 53 PUB. UTIL. FORT. 35, 39 (1954).

45. *Railroad Comm'n v. Houston Natural Gas Corp.*, 155 Tex. 502, 507, 289 S.W.2d 559, 562 (1956).

46. 90 S.E.2d 140 (Va. 1955).

47. *Id.* at 148.

before each rate change.⁴⁸ After review of applicable state statutes the Illinois Supreme Court stated that

it is clear that notice is not required on each occasion when there is a change in the rate payers bill, but that notice is required for every change in the filed schedules which are the underlying basis for the computation of those bills. This requirement gives the rate payer ample opportunity to be heard as to the just and reasonable character of the rates charged or to be charged.⁴⁹

Similarly, the Supreme Court of Arkansas found that the consuming public had sufficient notice of any rate changes in their bills resulting from the operation of a purchased gas adjustment clause filed in a rate tariff when the "raise is effected."⁵⁰ The consumers have ample protection since they can ask the commission to set aside the rate increase under Arkansas law.⁵¹ The North Carolina Utilities Commission, however, rejected a purchased gas adjustment clause which would permit the commission, in its discretion, to allow the gas company to automatically pass on any increased gas costs without notice and hearing.⁵² The commission reasoned that

members of the public would be without any opportunity to examine the rates of the applicant to determine if they are just and reasonable and nondiscriminatory and would not have an opportunity to determine the fair rate of return on the fair value of the applicant's property.⁵³

While every change in a customer's billing statement resulting from the operation of a purchased gas adjustment clause will not permit the public to determine the fair rate of return on the fair value of the utility's property as suggested by the North Carolina Utilities Commission, this does not constitute a denial of procedural due process.⁵⁴ The public interest does require that the regulatory authority establish procedures for the subsequent supervision of rates and the utility's rate of return to keep the adjustment clause from being defective.⁵⁵ Inherent in the

48. *Id.*; *City of Chicago v. Illinois Commerce Comm'n*, 150 N.E.2d 776 (Ill. 1958).

49. *City of Chicago v. Illinois Commerce Comm'n*, 150 N.E.2d 776, 779-80 (Ill. 1958), *quoting* *City of Norfolk v. Virginia Elec. & Power Co.*, 90 S.E.2d 140, 148-49 (Va. 1955):

50. *City of El Dorado v. Arkansas Pub. Serv. Comm'n*, 362 S.W.2d 680, 693 (Ark. 1963).

51. ARK. STAT. ANN. § 73-219 (1957).

52. *Re Public Serv. Co.*, 89 P.U.R.3d 146, 157 (N.C. Util Comm'n 1971).

53. *Id.* at 157.

54. *See* *City of Norfolk v. Virginia Elec. & Power Co.*, 90 S.E.2d 140 (Va. 1955).

55. For discussion of regulatory supervisory responsibilities when adopting purchased gas adjustment clauses, see pp. 581-84 *infra*.

supervisory power is the authority to suspend rates or to initiate other remedial actions deemed necessary in the public interest.

The clause should contain provisions giving the commission the power to suspend and investigate the new rates resulting from the operation of the purchased gas adjustment clause.⁵⁶ The Wisconsin Public Service Corporation in *Re Wisconsin Gas Co.*⁵⁷ approved a purchased gas adjustment clause subject to the condition that

suspension of the operation of such adjustment clauses may be made where consideration indicates offsets in the cost of service, a reasonable level of return, or for any other reason upon a finding that placing such clause into effect would not be reasonable and just to ultimate consumers subject to notice and hearing permitting the utility the opportunity to introduce evidence pertaining to the effect of a change in cost of purchased gas with respect to total cost of service and associated matters.⁵⁸

Another legal problem urged as a reason for denying a purchased gas adjustment clause is that such a clause shifts the burden of proving the reasonableness of a rate increase from the utility to the commission or the customer.⁵⁹ In all proceedings, however, the burden of proof is on the utility. The adoption of a purchased gas adjustment clause does not amount to a shifting of the burden of proof from the utility to the commission or the consumer because the only responsibility that a commission or a consumer has is to seek suspension or to demand an investigation of a rate increase.⁶⁰ This argument would therefore be tenable only if the regulatory authority had no power to suspend or investigate any increases resulting from the operation of the clause.⁶¹

ECONOMIC CONSIDERATIONS

One of the regulatory authority's responsibilities is to fully understand the economic consequences associated with adopting a purchased gas adjustment clause. The economic consequences should be observed from both the utility's and the consumer's points of view as well as from that of the regulatory authority.

Economic problems often result from the tension created by rigid

56. *Re Worcester Gas Light Co.*, 9 P.U.R.3d 152, 157 (Mass. Dept. Pub. Util. 1955).

57. 78 P.U.R.3d 461 (Wis. Pub. Ser. Comm'n. 1968).

58. *Id.* at 464.

59. *City of Chicago v. Illinois Commerce Comm'n.*, 150 N.E.2d 776 (Ill. 1958).

60. *Id.* at 781.

61. *Id.* at 780.

public utility rates in a non-rigid general price situation.⁶² Because a purchased gas adjustment clause is designed to maintain a utility company's rate of return at an authorized level,⁶³ its implementation can point the way toward solution of this problem. Stabilization can be achieved regardless of the change in the price of the cost item if the clause permits adjustments upward or downward from the base price as the cost of purchased gas fluctuates. During periods of falling prices the clause reduces the cost to the consumer when he most needs it.⁶⁴ Similarly, during an upward swing, the increase in the price of the fuel occurs when the ability of a consumer to pay has also moved upward.⁶⁵ The clause thus protects the interests both of the utility and of the consumer.

To determine if there is actually a need for adjustment, the commission must consider the utility's sources of gas supply. Obviously there would be no need for a purchased gas adjustment clause in the situation where the available supply of natural gas originates from one company under a long-term fixed price contract. At the other extreme, a purchased gas adjustment clause does become very important when the distribution company is supplied by an interstate transmission company regulated by the Federal Power Commission, or the supplier has several sources of natural gas supply and those contracts contain some form of price adjustment clause.⁶⁶ Even though a utility's weighted average cost of gas probably will not decline over the long term, it will rise and fall over a short term period. Downward adjustment provisions are important to consumers in those situations where the utility must rely on spot purchases of natural gas, LNG, SNG, or

62. *Re The Conn. Light & Power Co.*, 44 P.U.R.(ns) 65, 68 (Conn. Pub. Util. Comm'n 1942).

63. *City of Norfolk v. Virginia Elec. & Power Co.*, 90 S.E.2d 140, 145 (Va. 1955).

64. *Re The Conn. Light & Power Co.*, 44 P.U.R.(ns) 65, 67 (Conn. Pub. Util. Comm'n 1942).

65. A. KAUFMAN, AUTOMATIC ADJUSTMENT CLAUSES REVISITED ECONOMIC PAPER No. 1R, SUBCOMMITTEE OF STAFF EXPERTS ON ECONOMICS, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS 2 (July 8, 1974).

66. Three types of indefinite price escalation clauses can be found in producer's gas supply contracts.

1. Favored Nations Clause: a special form of adjustment clause on gas supply contracts providing for automatic increases in purchased price if the price other parties pay or receive is increased. GLOSSARY FOR THE GAS INDUSTRY, AMERICAN GAS ASSOCIATION 22 (1967).
2. Price redetermination clauses which authorize "renegotiation of the price at specified times or at the request of one party." *The FPC and Indefinite Price Escalation Clauses: Remedy for Administrative Breakdown*, 73 YALE L.J. 1283, 1290 (1964).
3. Automatic escalation clauses which establish "increases which will be based on the movement of standardized price indices." *Id.* at 1290.

gasified coal to meet its peak requirements. These higher priced purchases of gas disappear from the system when consumer demand is lessened, and the weighted average cost of gas is, therefore, reduced.

Purchased gas adjustment clauses when made applicable in gas utility tariffs confer economic benefits upon the public. A purchased gas adjustment clause reduces the business risks of a gas utility since the utility is better able to timely recover operating costs. Thus, investors will find utility stocks and bonds more attractive. If the risks of doing business are minimized, the fair rate of return requirements can be reduced by regulatory authorities, ultimately resulting in lower rates for consumers.⁶⁷ Regulatory expenses for the utility company, the consumer, and the regulatory authority are substantially reduced because the need for more frequent rate applications has been minimized. The consumer again derives an economic benefit in the form of reduced rates.

One economic objection to including purchased gas adjustment clauses in rate tariffs is that undue consideration is given to a single cost item—the cost of gas—which could distort the relationship of rates to costs. Thus, the argument is that no consideration is given to compensating economies accruing from other cost items. Only to the extent that the changes in the cost of gas parallel a change in the total cost of service would the adjusted rate be just and reasonable.⁶⁸ Theoretically this objection has merit, but in practice, it is no more dangerous than promulgating a future rate based on historical information. Since a purchased gas clause isolates the cost of gas and handles it in a “speedy, summary fashion,”⁶⁹ the numerous advantages of such a clause far outweigh this problem. This objection can be minimized by a subsequent cost of service filing and a provision for refund to the customers if the overall rates are excessive.⁷⁰ Distortion of the relationship between rates and costs is actually more applicable to electric utilities because they must convert their fuel into electricity while a gas utility passes the product directly to its customers. The cost of purchased gas as a single cost item also represents in many cases a higher percent-

67. Mervin, *Why Not a Purchased Gas Adjustment Clause?*, 82 PUB. UTIL. FORT. 35, 37 (1968).

68. A. KAUFMAN, AUTOMATIC ADJUSTMENT CLAUSES REVISITED, ECONOMIC PAPER NO. 1R, SUBCOMMITTEE OF STAFF EXPERTS ON ECONOMICS, NATIONAL ASSOCIATION OF REGULATORY COMMISSIONERS 3 (July 8, 1974).

69. Mervin, *Why Not a Purchased Gas Adjustment Clause?*, 82 PUB. UTIL. FORT. 35, 36 (1968).

70. See 18 CFR § 154.38(d)(4)(vi) (1973).

age of total costs for gas utilities than does fuel for electric companies.⁷¹ Thus compensating economies would be more difficult for gas utilities to implement, unless the pipeline was operated at less than capacity.

Another objection is that a purchased gas adjustment clause permits a gas utility to recover increased gas costs too easily. This decreases management's incentive to bid the lowest prices for gas supplies which would ultimately benefit the consuming public. If the gas company never assumed any part of the increase, the argument might be meritorious. The contrary is more realistic, however, since there is usually a delay between the time that the utility incurs the increased costs and the time that it ultimately recovers these costs through customer billing. Moreover, the regulatory authority can control the length of time between incurred costs and recovery of these costs. The regulatory authority can also influence management by permitting less than a 100 percent pass on of increased costs; or, it can deny an unrecovered purchase gas costs account.⁷²

Today's energy situation raises another issue for consideration when discussing incentives for utilities to pay the lowest prices for new gas supplies. When the demand for natural gas exceeds the available supply and when a natural gas utility must continue to attach new supplies and reserves to the gas system for the benefit of its customers, a purchased gas adjustment clause becomes a necessary aid to the utility in effectively bargaining for new gas supplies. In Texas, the situation is even more critical for intrastate pipelines for three reasons: (1) the Railroad Commission has no jurisdiction over well-head prices;⁷³ (2) the Federal Power Commission now permits purchased gas adjustment clauses in interstate pipeline tariffs;⁷⁴ and (3) private industries are competing against gas utilities and purchasing for their own use.⁷⁵ If residential and commercial customers expect to have an adequate

71. AMERICAN GAS ASSOCIATION PROCEEDINGS 104 (1955).

72. The Federal Power Commission assures recovery of all purchased gas costs by the deferred accounting of such costs which are not included in the gas utility's current rate schedules. The balance accumulated is thus amortized over the succeeding 6-month period and recovered under future rate schedules with a negative or positive surcharge. 18 CFR § 154.38(d)(4)(iv) (1973).

73. *Humble Oil & Refining Co. v. Railroad Comm'n*, 133 Tex. 330, 128 S.W.2d 9 (1939).

74. Purchased Gas Cost Adjustment Provisions in Natural Gas Pipeline Companies FPC Tariffs, Order No. 452, 47 F.P.C. 1049 (1972).

75. *Re Delhi Gas Pipeline Corp. & Lower Colo. River Authority*, Gas Utilities No. 564 (Tex. R.R. Comm'n 1974); *Re Delhi Gas Pipeline Corp. & Lower Colo. River Authority*, Gas Utilities No. 513 (Tex. R.R. Comm'n 1973).

gas supply, the gas utility must be able to pay for those supplies and connect them to the system.

A related problem arises in the situation where a gas distribution company owns all or part of the transmission and/or production facilities that supply the distribution system. Any contracts and dealings with affiliates should be closely scrutinized by the regulatory authority to prevent compromise of the public interest.⁷⁶ This problem has been handled in various ways. The Louisiana Public Service Commission has denied a purchased gas adjustment clause to a distribution company when its parent company had a financial interest in higher field prices.⁷⁷ In *Maestas v. New Mexico Public Service Commission*⁷⁸ it was argued that there existed a potential for abuse of the public interest if an integrated gas company was permitted to institute a purchased gas adjustment clause in domestic customer rate schedules. The court found no evidence to indicate such abuse where "the parent purchased 3/4 of its gas from non-affiliated suppliers and the subsidiaries sell 70-80% of their gas to non-affiliated purchasers."⁷⁹

The Railroad Commission of Texas has also recognized the potential abuse of the parent-subsidiary relationship. In its attempt to deal with this problem, the commission has excluded from the purchased gas adjustment clause computations of any affiliated supplier's gas prices that exceed the weighted average cost of purchased gas from non-affiliated suppliers.⁸⁰ In *Re Houston Pipe Line Co.*⁸¹ the Railroad Commission of Texas provided that

field purchases by either HPL or Intratex from any producing subsidiary of Houston Natural Gas Corporation shall not be permitted to increase the Domestic Gate Rate above the level which it would be if adjusted solely on the basis of field purchases from all other producers, excluding such producing subsidiary of Houston Natural Gas Corporation.⁸²

Another method of minimizing any abuse of the parent-subsidiary relationship would be to require prior commission approval of all purchases from affiliated suppliers.⁸³ The Rhode Island Public Utilities

76. See *City of Chicago v. Illinois Commerce Comm'n*, 150 N.E.2d 776 (Ill. 1958).

77. *Re United Gas Pipeline Co.*, 38 P.U.R.3d 209, 229 (La. Pub. Ser. Comm'n 1961); *Re United Gas Pipeline Co.*, 34 P.U.R.3d 78, 107 (La. Pub. Ser. Comm'n 1960).

78. 514 P.2d 847 (N.M. 1973).

79. *Id.* at 850.

80. *Re Lone Star Gas Co.*, 93 P.U.R.3d 414, 416 (Tex. R.R. Comm'n 1972).

81. Gas Utilities No. 483 (Tex. R.R. Comm'n 1972).

82. *Id.* at 4-5.

83. See *Purchased Gas Cost Adjustment Provisions in Natural Gas Pipeline Companies' FPC Tariffs*, Order No. 452, 47 F.P.C. 1049 (1972).

Commission requires commission approval of all purchases of liquid natural gas and propane gas used for peak shaving purposes.⁸⁴ The commission specifically prohibits any purchases from a supplier where any officer or director of the utility has any financial interests in the supplier.⁸⁵

ADMINISTRATIVE CONSIDERATIONS

Any regulatory body that has made the initial policy decision to permit the adoption of purchased gas adjustment clauses where the utility experiences changing costs for gas purchased must then devise a clause with sufficient safeguards to protect the public. The proper construction of a purchased gas adjustment clause will depend almost entirely on the nature of the gas utility seeking the clause and on the utility's source of supply.

The first consideration in developing a purchased gas adjustment clause is the adequacy of existing rates.⁸⁶ Unless the present rate provides a fair rate of return, the utility company will not generate enough revenues to adequately serve the public. Conversely, if the current rate is excessive, the consuming public will be paying too much. In either case, adopting a purchased gas adjustment clause will perpetuate the existing situation to the detriment of either the utility company or the customer. Unless the regulatory authority has recently studied an existing rate, a cost of service study is needed to test the adequacy of the existing rate.

The second consideration in developing a purchased gas adjustment clause is the establishment of an appropriate base cost for purchased gas. The base cost will remain stable and the amount of each adjustment will depend on the extent to which the current cost of purchased gas varies from the base cost. Development of a correct base cost is important because it may remain constant for some length of time.⁸⁷ Utilization of the most recent data practically available elimin-

84. *Re Providence Gas Co.*, 88 P.U.R.3d 430, 434 (R.I. Pub. Util. Comm'n 1971). Peak shaving is "the use of fuels and equipment to generate or manufacture gas to supplement the normal supply of pipeline gas during periods of extremely high demand." GLOSSARY FOR THE GAS INDUSTRY, AMERICAN GAS ASSOCIATION 44 (1967).

85. *Re Providence Gas Co.*, 88 P.U.R.3d 430, 434 (R.I. Pub. Util. Comm'n 1971).

86. Purchased Gas Cost Adjustment Provisions in Natural Gas Pipeline Companies' FPC Tariffs, Order No. 452, 47 F.P.C. 1049 (1972); *Re The Mont. Power Co.*, 42 P.U.R.3d 241, 270 (Mont. Pub. Ser. Comm'n 1962); *Re Washington Gas Light Co.*, 4 P.U.R.3d 105, 108 (D.C. Pub. Util. Comm'n 1954).

87. *Re Brooklyn Borough Gas Co.*, 100 P.U.R.(ns) 271, 278 (N.Y. Pub. Ser. Comm'n 1953).

ates an unusually high change for the first adjustment period and simplifies later calculations.

The computation of the base cost established according to the total volume of gas purchased from suppliers, rather than the total volume of gas delivered to utility customers, more adequately adjusts the expense item of lost and unaccounted for gas. Additionally, the cost of gas used by the company would be adjusted unless separately metered. The adjustment of expense items other than actual customer gas deliveries may be desirable for reasons of simplicity, but the acceptability of any expense item for inclusion in a purchased gas adjustment clause generally depends on two requirements. First, the expense item sought to be adjusted should be relatively uncontrollable in order to prevent utility management from being able to trigger rate increases.⁸⁸ Second, the expense item should be directly proportional to the volume of business done.⁸⁹ Thus, the utility would not be recovering additional revenues resulting solely from operational economies of scale. Of course, the more variable expense items included in a purchased gas adjustment clause would not provide proper motives for utility management to seek the potential economic benefits associated with operational economies of scale.

The base cost is suspect if the amount of the lost and unaccounted for gas used in determining the base cost does not represent normal or average conditions.⁹⁰ Inclusion in the base cost of lost and unaccounted for gas at a desirable operational level could reduce any doubts concerning its acceptability in the purchased gas adjustment clause.⁹¹ The complexity of determining the base cost depends upon the number and types of supply sources. Little, if any, difficulty is encountered when a gas utility has only one supplier, but a multitude of factors arise when the utility has numerous sources of supply from well heads, field lines, plant outlets and transmission lines. When the gas utility purchases from affiliated companies, operates storage facilities, or has non-current exchange transactions, additional factual matters are raised for determination.

88. *Re Lynchburg Gas Co.*, 6 P.U.R.3d 33, 35 (Va. St. Corp. Comm'n 1954).

89. *See re South Carolina Generating Co.*, 23 P.U.R.3d 499 (FPC 1958).

90. *Re Brooklyn Borough Gas Co.*, 100 P.U.R.(ns) 271, 279 (N.Y. Pub. Ser. Comm'n 1953).

91. When establishing reasonable operating expenses for a gas company in a traditional rate case, the Railroad Commission of Texas adjusts lost and unaccounted for gas to reflect desirable operating conditions. *Re Lone Star Gas Co.*, Gas Utilities No. 470, at 2 (Tex. R.R. Comm'n 1972). This encourages the conservation of natural gas and promotes safe operating conditions.

The third consideration in the development of a purchased gas adjustment clause is establishing the current cost of purchased gas. The current cost should be computed consistently with the base cost.⁹² Almost every jurisdiction uses the utility's weighted average cost of pipeline gas in determining the base cost as well as the current cost of purchased gas.⁹³ Since the current cost should reflect the actual amounts paid for the gas delivered to the customer, the higher costs of supplemental supplies needed to meet peak day responsibilities are calculated as part of the current cost and omitted from the base cost computation. Similarly, gas used for peak shaving purposes is not included in the base cost because it is not found in the system year around. As gas shortages become more prevalent on a particular system and as supplemental gas supplies are needed to meet average day requirements as well as peak day requirements, the inclusion of peak shaving gas could, however, be averaged over a period of time to establish the base cost.⁹⁴ The New York Public Service Commission has determined that monthly computations of the purchased gas adjustment clause based on the latest 12 billing months is desirable because it reduces any wide variations in monthly billings to customers and minimizes distortions in the utility's current earnings.⁹⁵ Connecticut has used as a base the weighted average for a 5-year period.⁹⁶

Other conditions could exist in a particular utility system that might necessitate additional adjustments to both the base and the current cost calculations. For example, a gas company which operates an underground storage facility to meet peak day demand usually fills the storage facilities on off-peak days. If the utility later delivers that storage gas to its customers on a peak day, it could earn additional revenues to the extent that the current cost exceeds the price paid for gas in storage. Of course, if the current costs were to decline, the utility could show a loss. To avoid this problem, all storage withdrawals should be billed to customers at the same price paid for the gas in the storage facility. The operation of liquid extraction plants and numerous sources of supply with various BTU contents could also require ad-

92. *Re Brooklyn Borough Gas Co.*, 100 P.U.R.(ns) 271, 279 (N.Y. Pub. Ser. Comm'n 1953).

93. FEDERAL POWER COMMISSION, FEDERAL AND STATE COMMISSION JURISDICTION AND REGULATION OF ELECTRIC, GAS AND TELEPHONE UTILITIES (1973).

94. *Re Columbia Gas, Inc.*, 61 P.U.R.3d 491, 519 (N.Y. Pub. Ser. Comm'n 1965).

95. *Id.* at 519.

96. *Re The Conn. Light & Power Co.*, 44 P.U.R.(ns) 65, 68 (Conn. Pub. Util. Comm'n 1942).

justments unless BTU adjustment clauses regulate the price with the BTU value of gas received into the system.⁹⁷ Once the methods for determining base costs and current costs are established, other problems arise of concern to the regulator if a purchased gas adjustment clause is to be properly constructed. As noted earlier, the regulator should retain supervisory powers over the operation of a purchased gas adjustment clause. These supervisory powers should include reporting procedures which allow the regulator to follow any changes in the cost of purchased gas. In formulating reporting procedures, enough detail must be supplied by the utility for the regulatory authority to properly review and evaluate the validity of any gas cost changes and application of those cost changes to the existing rate schedules.

Regulatory authorities have also been concerned with the way a purchased gas adjustment clause will affect the consumer's bill and with which classes of consumers will be affected. Historically, regulators have been reluctant to add purchased gas adjustment clauses to residential and small commercial rate schedules because of a belief that the public would not understand and accept periodic adjustments.⁹⁸ Thus, purchased gas adjustment clauses were originally found only in industrial sales contracts. Today, with the increase in prices, these clauses are commonplace. Once a purchased gas adjustment clause is applied to a rate schedule, the next consideration is how often the adjustment will be made. Purchased gas adjustment clauses may become operative either monthly,⁹⁹ semi-annually¹⁰⁰ or annually.¹⁰¹ The sensitivity of an adjustment clause can be controlled by the operation of a neutral zone where minor fluctuations in the cost of purchased gas will not trigger the clause and result in a change in the customer's bill.¹⁰²

97. In the event that the total BTU content of the gas deviates from 1,000 BTU per cubic foot, an adjustment from such deviation is made by multiplying the delivered volume by the applicable price and by a fraction the denominator of which is 1,000 and the numerator of which is the average BTU content per cubic foot of the gas delivered during the billing period.

98. Trigg, *Escalator Clauses in Public Utility Rate Schedules*, 106 U. PA. L. REV. 964 (1958).

99. *Re Arkansas Power & Light Co.*, 13 P.U.R.3d 1, 20 (Ark. Pub. Ser. Comm'n 1956).

100. *Purchased Gas Cost Adjustment Provision in Natural Gas Pipeline Companies FPC Tariffs*, Order No. 452, 47 F.P.C. 1049 (1972).

101. *Re Western Ky. Gas Co.*, 21 P.U.R.3d 394, 398 (Ky. Pub. Ser. Comm'n 1957).

102. *Re Uniform Fuel Clause for Elec. Utility Co.*, 57 P.U.R.(ns) 250, 252 (Conn. Pub. Util. Comm'n 1945).

CONCLUSION

Today there is considerable evidence of increasing concern for the ability of a public utility to meet its financial responsibilities and to continue to adequately serve the public. This places additional burdens upon regulatory bodies to use something more than the traditional rate making procedures. Adoption of purchased gas adjustment clauses with sufficient safeguards to protect the consuming public should help relieve a capital intensive utility industry from increasing inflationary pressures and rigid rate structures. I have attempted to analyze and discuss the areas of concern associated with adopting purchased gas adjustment clauses with hopes that a clearer understanding may be achieved.

It is recommended that after careful consideration and when deemed advantageous to the utility, the consumer, and the regulatory authority, purchased gas adjustment clauses should be adopted to help eliminate the financial crisis that public utilities face today. The adoption of these clauses should provide both short and long term stability for utilities and should reduce the costs to the public through more efficient regulation.