UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

High Island Offshore System, L.L.C. Docket Nos. RP03-221-003
RP03-221-004

ORDER ON REHEARING AND COMPLIANCE FILING

(Issued July 7, 2005)

1. On January 24, 2005, the Commission issued an order[1] which rejected a proposed settlement of this High Island Offshore System, L.L.C. (HIOS) rate case and generally affirmed the findings of the Initial Decision, with some modifications.[2] The order adopted just and reasonable rates effective on the date of the order and ordered refunds of excess amounts collected while the proposed increased rates were in effect. Requests for rehearing were filed by HIOS, Indicated Shippers,[3] and ExxonMobil.[4] HIOS submitted a compliance filing on February 14, 2005. We accept the compliance filing subject to conditions. The requests for rehearing are denied for the reasons set forth below. Late motions to intervene are denied.

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[1] *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005).

[2] *High Island Offshore System, L.L.C.*, 107 FERC ¶ 63,019 (2004).

[3] The Indicated Shippers consist of BP America Production Company, BP Energy Company, Chevron Texaco Exploration & Production Company, a division of Chevron U.S.A. Inc. and Shell Offshore, Inc.

[4] ExxonMobil Gas & Power Marketing Company, A Division of ExxonMobil Corporation (ExxonMobil).

I. **Background**

2. The January 24 Order reviewed an Initial Decision in HIOS' first rate case filing since 1994, and a settlement offer filed by HIOS on August 5, 2004. The January 24 Order rejected the settlement offer and generally affirmed the Initial Decision, but with certain modifications. These changes included requiring HIOS to calculate a management fee based on ten percent of HIOS' average rate base and overall return rather than using its pretax return.

3. In addition to ordering changes in the cost of service and rates, acting under section 5, the Commission ordered HIOS to implement a new annual fuel adjustment mechanism with a true-up provision in its tariff for the recovery of gas in-kind for compressor fuel and lost-and-unaccounted-for gas quantities (LAUF). The Commission noted that in *ANR Pipeline Co.*[5] it permitted the pipeline to use the most recent calendar year data, rather than three-year or four-year average data, to determine rates under the pipeline's fuel and LAUF gas tracker, stating that the most recent 12-month data are likely to produce a more accurate projection of actual use during the next year than the use of three and four-year average data. However, the Commission stated that should HIOS wish to retain the smoothing effect of using multiple year averages to determine its fuel retention percentages, including spreading the true-up averages of over and under-recoveries over a period of more than a year, it would be free to do so. The Commission required HIOS to file revised tariff sheets to incorporate all these changes within 21 days of the date the order issued.

Late Motions to Intervene and Answer to Requests for Rehearing

4. Late motions to intervene were filed by ConocoPhillips Company, Interstate Natural Gas Association of America (INGAA), and the American Public Gas Association (APGA). HIOS filed objections to the motions of ConocoPhillips and the APGA. APGA asserts in its motion and request for rehearing it has an interest in this proceeding because it believes our order of January 24, 2005 appears to contravene the decision in *BP West Coast Products, LLC v. FERC*[6] in permitting the inclusion of a federal income tax allowance in HIOS' cost of service and rates. INGAA asserts in its motion that it has an interest in this proceeding because the motion filed by APGA opposes tax allowances in the rates of interstate pipelines owned by Master Limited Partnerships. INGAA also is concerned that the January 24, 2005 order excluded Master Limited Partnerships from their inclusion in proxy groups employed to determine rate of return on equity. The issues related to the inclusion of a federal tax

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[5] 108 FERC ¶ 61,050 (2004), *on reh'g.*, 110 FERC ¶ 61,069 (2005).

[6] 374 F. 3d 1263 (D.C. Cir. 2004).

allowance in HIOS' cost of service are not considered on their merits in this proceeding and therefore, there is no basis on which to grant the motions to intervene. ConocoPhillips asserts it is a customer of HIOS and has an interest in the rates and refunds ordered by our order of January 24, 2005. ConocoPhillips provided no explanation for its failure to intervene at the beginning of this proceeding. With regard to movants' motions for intervention, we note that when late intervention is sought after issuance of an order resolving all issues, the prejudice to the other parties and burdens upon the Commission of granting intervention may be substantial. Thus, movants bear a higher burden to demonstrate good cause for granting such late intervention. Movants have not carried that burden. Accordingly, movants have not justified their late motions to intervene.[7] On March 9, 2005, HIOS filed a motion for leave to answer the requests for rehearing filed by Indicated Shippers and ExxonMobil. Our rules of practice and procedure, section 385.713 (d), 18 CFR section 385.713 (d) (2005), do not permit answers to requests for rehearing, and accordingly, HIOS' motion is denied.

II. Settlement

5. The January 24 Order rejected the settlement filed by HIOS in this proceeding.[8] A detailed description of the Settlement is contained in that order. In general, the settlement provided for HIOS' rates to be reduced to the level they were at before the filing of the instant rate case. HIOS would make no refunds for periods the rates proposed in this rate case were in effect. However, because Indicated Shippers were the only party to litigate the issues, HIOS would make a payment to Indicated Shippers of $3 million. Additionally, HIOS would install certain measurement facilities on its pipeline at West Cameron Block 167 and would implement an annual fuel tracker for the recovery of fuel and lost and unaccounted for fuel (LAUF) beginning in March 2005. The proposed settlement also would require HIOS to file a new section 4 rate case three years after the effective date of the settlement.

6. The settlement was opposed by the Commission's Staff and a party, ExxonMobil. The Commission found that despite the fact that Staff had submitted comments opposing the settlement, the Commission had discretion to approve the settlement as fair and reasonable and in the public interest pursuant to the standards in Rule 602 (g)(3) governing uncontested settlements.[9] As to ExxonMobil, the Commission recognized that

[7] *See, e.g., Richard Blumenthal, Attorney General of the State of Connecticut,* 104 FERC ¶ 61, 211 at P 66 (2003).

[8] 110 FERC ¶ 61,043 at P 12-15.

[9] However, the Commission stated that while the Commission may at times have a different view of the public interest than its litigation Staff, the Commission will not lightly ignore its Staff's opposition to an uncontested settlement.

ExxonMobil had not seriously contested HIOS'contention that ExxonMobil would not be significantly affected during the term of the settlement by the settlement's provisions concerning HIOS' base transportation rates or by the settlement's provisions concerning fuel and LAUF. However, the Commission concluded that even if the settlement is treated as uncontested despite ExxonMobil's comments, the settlement does not satisfy the requirement that an uncontested settlement be fair and reasonable and in the public interest.

7. The Commission held that, consistent with the decision of the U.S. Court of Appeals for the District of Columbia in *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1003 (D.C. Cir. 1990), the Commission only approves uncontested settlements if, in its independent judgment, the settlement is in the public interest. We noted that when the Commission approves an uncontested settlement, the Commission relies in part on the fact that the interests of the active parties in the case are generally similar to the interests of the inactive parties and consumers. We found that under the circumstances of this case, we could not conclude that Indicated Shippers' agreement to the settlement shows that it is in the interest of other affected parties and consumers generally. This finding was based on the fact that the proposed settlement rates were substantially higher than just and reasonable rates. In addition, the only active parties that support the settlement, the Indicated Shippers, would receive special consideration not being given to any other party, in the form of the $3 million payment. The inactive parties would receive no refunds for the period of about a year and half when rates were in effect that are substantially in excess of the level that we found to be just and reasonable. The Commission found it was unable to sanction such an arrangement in the circumstance of this case, where we found that the settlement rates are substantially higher than just and reasonable rates, and the settlement provides no refunds to the parties who have paid rates at twice the just and reasonable level for a significant period.

<u>Rehearing Request</u>

8. HIOS argues on rehearing that the Commission's concerns in rejecting the proposed settlement are misplaced and failed to show any valid reason why the settlement was rejected.

9. HIOS argues that in overriding the intentions of the settling parties under the settlement, the Commission has not only ignored its policy of favoring settlements and "the NGA regulation, in the first instance, of private contracts, but the Commission has also failed to consider other laws and regulations supporting the approval of settlements."[10]

10. HIOS asserts the Commission failed to acknowledge and recognize the major benefits to all shippers in the settlement which include the roll back of rates, a three-year moratorium on rate increases with rate certainty for that period, the filing of a new rate case in three years, establishment of a fuel tracker, and the construction of new measurement facilities. HIOS states that due to the rejection of the settlement, HIOS will not make the capital expenditures to install measurement facilities as provided for in the settlement.

11. HIOS also argues that the Commission erroneously found that because Indicated Shippers was receiving a $3 million payment, its interests were unrepresentative of the other HIOS shippers. HIOS claims that the Commission has failed to consider the special position of Indicated Shippers as the only parties that litigated the contested issues in this proceeding. HIOS also asserts that the Commission neglected to consider that all of HIOS' shippers are sophisticated consumers of pipeline transportation service.

12. HIOS maintains that the Commission's reliance on *Tejas,* is misplaced. HIOS states that in *Tejas* there a was a legitimate concern that the LDCs would fail to cut the best deal with the pipeline, since they agreed to a relatively expensive and non-cost based gas inventory charge, and since most or all of the costs of complying with the settlement would be billed to LDC's customers. Moreover, HIOS asserts that in *Tejas* the Commission simply failed to explain why the settlement in that case should be approved other than citing it was a unanimous shipper agreement. By contrast, HIOS states that in this case it has presented a mountain of record evidence demonstrating the appropriateness of granting its proposed rate increase or, alternatively, approving the Settlement.

Discussion

13. We find that HIOS has not provided a sufficient basis for us to reconsider our decision to reject the settlement and we deny rehearing.

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[10] HIOS Rehearing Request at 19, c*iting* Section 554(c)(1) of the Administrative Procedure Act, 5 U.S.C. § 554 (c)(1); the Alternative Dispute Resolution Act of 1990, 5 U.S.C. §§ 571-83 (2000).

14. While it is true that the Commission favors settlements, we can approve the settlement in this proceeding only if in our independent judgment the settlement is in the public interest.[11] Similarly, while under the NGA there is a preference for parties to set rates by private contract, that rule is tempered by the legal requirement that such contracts are subject to Commission review.[12] In this proceeding, we have found that the agreement with Indicated Shippers was not in the public interest, and as we have in other cases,[13] we properly rejected the settlement. Moreover, while we could have considered approving the settlement for Indicated Shippers and severing the other parties, we did not because HIOS stated that such severance would constitute an unacceptable modification of the offer.

15. We disagree with HIOS' argument that the Commission did not show any valid reason for rejecting the settlement. We rejected the settlement based on the fact that the proposed settlement rates were substantially higher than just and reasonable rates. Specifically, the January 24 Order showed that the proposed 12.44 cents per Dth rate is substantially higher than the approximately 9.2 cents per Dth rate[14] found to be just and reasonable based on the record. In addition, the settlement provides that the only active parties that support the settlement, the Indicated Shippers, are receiving special consideration not being given to any other party, in the form of the $3 million payment. Thus, we found that the inactive parties would receive no refunds for the period of about a year and half when rates were in effect that are substantially in excess of the level that we found to be just and reasonable. Based on these considerations, we rejected the proposed settlement.

16. In rejecting the settlement, we recognize that some of benefits of the settlement will not be implemented as a result of our ruling, including the requirement for HIOS to file a new rate case in three years and the requirement that HIOS construct certain metering facilities. However, in our view, these benefits do not outweigh the imposition of a rate that is substantially above the just and reasonable rate to all of HIOS' shippers

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[11] *See Tejas*, 908 F.2d 998 at 1003.

[12] *See, e.g., New PJM Companies*, 105 FERC ¶ 61,251 at P 88 (2003), where we stated that "the fruits of those voluntary choices, however, must be found by the Commission to be in the public interest and produce results that are just and reasonable."

[13] *See, e.g., Equitrans, L.P.*, 104 FERC ¶ 61,008 (2003), *rehearing denied*, 106 FERC ¶ 61,013 at P 12 (2004), *affirmed, Brooklyn Union Gas Co. v. FERC*, No. 04-1079 (D.C. Cir. May 31, 2005).

[14] These rates are for the FT-2 rate. Currently, no shipper takes service under FT-1.

and denying refunds to the inactive parties. In addition to requiring a lower rate, our January 24 Order also required the implementation of a fuel tracker which will provide similar benefits to the tracker provision in the settlement. Significantly, we note that no shipper has filed for rehearing of our order rejecting the settlement on the ground that they preferred the settlement to our merits decision.

17. We also disagree with HIOS' contention that we erred in finding that because Indicated Shippers would receive a $3 million payment, its interest was unrepresentative of the other HIOS shippers. The fact is HIOS offered substantially better settlement terms to Indicated Shippers than to its other shippers and therefore Indicated Shippers' agreement to the settlement offer they received does not support a finding that the less favorable terms HIOS offered the other shippers were fair and reasonable. In addition, section 4(b) of the NGA prohibits a pipeline from maintaining any unreasonable difference in rates and providing service in an unduly discriminatory manner. In the circumstances of this proceeding, we find that the fact that Indicated Shippers was the only active litigant in the proceeding does not support the disparate treatment afforded Indicated Shippers over all other HIOS shippers. We also find that in these circumstances, it is irrelevant whether the inactive parties are "sophisticated" in determining whether the provisions of the settlement are consistent with the protections afforded by the NGA.[15]

18. Finally, we reject HIOS' assertion that Commission's reliance on *Tejas* is misplaced. The court in *Tejas* held that the Commission could not simply rely on the agreement of the parties in approving a settlement but must make an independent finding that it is in the public interest. Based upon our review, we conclude that the benefits of the settlement claimed by HIOS do not offset the detriments to shippers by imposition of rates in excess of just and reasonable levels and the refusal to make refunds of excess charges subject to refund.

III. Cost of Service Issues

A. Reserve Life for Depreciation Allowance and Negative Salvage

Commission Order

19. In the January 24 Order, the Commission affirmed the ALJ's holding that HIOS' transmission plant depreciation rate and annual level of negative salvage expense should be calculated based on an economic life of 17.5 years, as of June 30, 2003, based on

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[15] "The primary aim of [the NGA] was to protect consumers against exploitation at the hands of natural gas companies." *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).

Staff's gas reserve study.[16] That study, among other things, relied on estimates for future supplies based on the entire Western Planning Area (WPA),[17] a roughly 300 by 200 mile area in the Gulf of Mexico.[18] The Commission found that use of the WPA area was supported by the record and Commission precedent. The January 24 Order rejected HIOS' proposed economic life of 10 years and reserve study[19] as unpersuasive and unreasonable because it did not consider certain supplies from the entire WPA region that were reasonably accessible to HIOS.

Request for Rehearing

20. HIOS asserts that the Commission erred when it found that the record and Commission precedent supported a depreciation rate using a reserve life estimate for the entire WPA.[20] HIOS claims that the Commission's reliance on *Trunkline Gas Company*[21] as support for the use of the entire WPA in Staff's reserve study is misplaced. According to HIOS, the Commission's holding in *Trunkline* addressed the pipeline's claim that the reserve estimates from the selected area should be adjusted to reflect well completion success ratios, not the use of a geographic area as broad as the WPA. HIOS also claims that *Trunkline* undercuts the Commission's holding here because in that proceeding the geographic area used for the reserve estimate study was limited to the offshore Louisiana area, and did not include the offshore Texas area.

21. HIOS also claims that our holding is inconsistent with court decisions in *South Dakota Public Utilities Commission v. FERC*[22] and *Memphis Light, Gas and Water Division v. FPC*.[23] HIOS states that these court decisions require that a reasoned reserve estimate must consider, *inter alia*, "the extent and location of reserves that the utility

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[16] 110 FERC ¶ 61,043 at P 74-79.

[17] *See* Testimony of Kevin Pewterbaugh, Exhs. S-4 through 6, S-14, S-15.

[18] Exh. HIO 129; Tr. 633.

[19] *See* Testimony of J. Scott Jenkins, Exhs. HIO-76 through 82.

[20] HIOS Request for Rehearing at 27-33.

[21] 90 FERC ¶ 61,017 at 61,055 (2000).

[22] 668 F.2d 333 (8th Cir. 1981).

[23] 504 F.2d 225 (D.C. Cir. 1974).

may utilize"[24] and must be based upon "the particular property involved."[25] HIOS claims the Commission's decision completely contravenes this precedent because the Commission accepted Staff's reserve life study based upon the entire WPA, notwithstanding that Staff's own witness acknowledged that HIOS does not receive gas from the entire WPA.

22. HIOS also argues that the factors the Commission relied upon to support the use of the entire WPA to determine its gas reserves estimate are inadequate. Specifically, HIOS asserts that the fact that areas accessed by HIOS make up two thirds of the WPA does not establish that the entire WPA is an appropriate proxy for those areas accessed by HIOS, nor does it account for that fact that various areas of the WPA are not all equal in their reserve potential. Additionally, HIOS maintains that the fact that HIOS identified various prospects that could be connected to its system and six prospective gas supplies are within a portion of the WPA provides no support for the logical leap that use of the entire WPA is an appropriate geographic area.

23. HIOS claims that the Commission should not have accepted Staff's reserve life study based on the entire WPA because that study is internally inconsistent. HIOS states that on the one hand, Staff uses the entire WPA as a proxy for reserve life estimates for shallow waters, even though Staff admits HIOS does not receive gas from the entire WPA, but when estimating deep water reserves, the Staff study adjusts a Gulf of Mexico wide estimate to reflect only those reserves in the locations actually accessible to HIOS. HIOS also states that the Commission does not explain why the Staff witness' own location-specific study, similar to the study of HIOS' witness, does not factor in any way into Staff's reserve life estimate or why it is appropriate to use the entire WPA in a departure from the location-specific study used in the previous HIOS rate case.

24. HIOS maintains that the Commission has never adequately explained the choice of a twenty-year life, even assuming that use of the entire WPA is appropriate. HIOS claims that Staff's upward limit in its range of reserve life estimates is calculated erroneously. HIOS states that even assuming use of the entire WPA was appropriate, the resulting reserve life developed using standards engineering calculations is only 13.9 years, not 17.5 years from the end of the test period.

25. In addition, HIOS maintains that the use of the entire WPA does not adequately account for the competition faced by HIOS from other pipelines attaching new reserves in the Gulf. According to HIOS, any reasoned reserve estimate must adjust for the

[24] *Citing South Dakota*, 668 F.2d 333 at 337.

[25] *Citing Memphis*, 504 F.2d 225 at 235.

virtual certainty that a single pipeline operating in a competitive environment will not attach one hundred percent of the available supply prospects. HIOS concludes that the Commission's decision to develop a reserve life estimate for HIOS based upon the entire WPA, without any adjustment in recognition of the competition from other pipelines, was thus arbitrary, capricious, and contrary to existing precedent.

26. Finally, HIOS argues that the record evidence supports the adoption of the ten-year reserve life estimate and resulting depreciation rate calculated by HIOS. HIOS asserts that this study considered those existing and future reserve reasonably accessible to the particular HIOS facilities, as required by *Memphis* and *South Dakota*.

Commission Decision

27. For the following reasons, we deny rehearing and affirm our ruling that the use of the entire WPA for calculating a reserve life for HIOS' transmission plant depreciation rate and annual level of negative salvage expense is supported by the record and falls within the zone of reasonableness.

28. HIOS' claim that the Commission decision is inconsistent with precedent is incorrect. In adopting Staff's area-wide WPA reserve estimate, the Commission properly relied on its holding in *Trunkline*, where the Commission held:

> The Commission's depreciation decisions are made in the context of gas ratemaking proceedings. They consider the foreseeable future of the pipeline and its supply areas and must be based on long-term forecasts of supply over large areas. They are based on the resources available within whole gas supply provinces. The full universe of available supplies must be considered in determining the remaining life of the pipeline as an active operation and its corresponding depreciation rates. [26]

29. While HIOS is correct that the *Trunkline* holding addressed the pipeline's claim that the reserve estimate from the selected area should be adjusted to reflect a completion success ratio, the holding also set forth the Commission's policy regarding the proper approach in determining reserve estimates. Under *Trunkline*, the reserve estimate must be based on reserves that a pipeline can reasonably attach in the future based on long term forecasts of supplies over large areas. The Commission use of the entire WPA in determining the reserve life for HIOS meets this standard.

[26] 90 FERC ¶ 61,017 at 61,055 (2000).

30. We also reject HIOS' claim that our reserve life estimate is inconsistent with *South Dakota* and *Memphis* because it was not based on the location of the particular facilities in question. Our decision specifically relied on the location of HIOS' facilities. However, it was not limited to a consideration of just reserves that are now physically connected to HIOS, as HIOS proposes. Rather it considered gas supplies currently beyond the reach of HIOS' pipeline that are reasonably forecasted to be accessible to the pipeline in the future. As required by the court in *South Dakota*, in determining depreciation rates, the Commission "must estimate the potential recoverable natural gas reserves available to pipeline companies."[27] Similarly, in *Memphis*, the court stated that '[i]n arriving at a reasoned [reserve] estimate, the Commission must exercise its own judgment based upon evidence pertinent to what it really expects will happen."[28] Accordingly, adopting a reserve estimate that includes gas supplies that are reasonably forecasted to be available to the pipeline in the future is consistent with these court rulings.

31. The ALJ and the Commission fully explained the reasonableness of using the reserves from the entire WPA in determining HIOS' reserve life. The Commission noted that HIOS currently receives, or has the potential to receive gas from areas representing approximately two-thirds of the WPA's total area.[29] Moreover, HIOS identified over 57 drilling prospects in various stages of development that could be connected to it.[30] HIOS conceded that six prospective gas supplies are within the WPA and some supply areas extend beyond the WPA.. HIOS has also attached 16 new supply sources throughout the WPA to the HIOS system during just the base and test periods.[31] HIOS has the ability to attach significant new reserves to its 200-mile, multi-pronged system such as the increased throughput provided by the East Breaks lateral.[32]

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[27] 668 F.2d 333 at 345.

[28] 504 F.2d 225 at 235.

[29] 110 FERC ¶ 61,017 at P 77.

[30] Exh. IND-1 at 12.

[31] *Ibid.*

[32] Exh. S-4 at 22

The Commission also considered the demand for natural gas that is expected to increase from 22.3 trillion Btu (TBtu) going back to 1999 to 32.498 TBtu in the year 2020.[33] In light of all these factors, HIOS' claim that it is unreasonable to adopt the Staff's reserve study is clearly erroneous.

32. We also find that HIOS' claim that the Commission's erred by not adjusting its reserve estimate for competition is without merit. The Staff witness expressly took into account competition in his supply analysis and concluded that HIOS' supply life will not be shortened by competition.[34]

33. Finally, we find that HIOS' argument that the Staff study is internally inconsistent and otherwise not supported is without merit. The Staff witness explained that he adjusted the Potential Gas Committee (PGC) data for undiscovered gas in deep water because the data was not broken out for the WPA alone, but also included data for all of the Gulf of Mexico. Because the Staff witness found that HIOS will not receive gas from the entire Gulf of Mexico (only the WPA), he used only 25 percent of the PGC's estimate for this category of deep water gas to account for the portion of the potential available to HIOS.[35] HIOS does not explain why this assumption was unreasonable. A similar adjustment was not made to the shallow water supply estimate because the PGC data for shallow water only included resources within the WPA. [36]

34. We also do not find that Staff's upper limit is calculated incorrectly and that the resulting reserve life should be 13.9 years, not 17.5 years from the end of the test period. HIOS' calculation is not supported by historical data because its calculation included a production decline rate of 6.83 percent per year while historical production from the WPA for the years 1995 through 2000 declined an average of only 2.79 percent.[37]

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[33] *Id.* at 26.

[34] *Id.* at 27-28. He based his conclusion on the fact that most of the gas moved on HIOS' system does not have a ready alternative pipeline path to market as well as HIOS' superior competitive position.

[35] *Id.* at 20-21.

[36] The Staff witness also noted that with respect to the shallow areas, HIOS already has a large coverage. Exh. S-4 at 22.

[37] Exh. S-16 at 4-5.

35. HIOS' claim that the Commission has not explained why it is appropriate to use the entire WPA in a departure from the location-specific study used in the previous HIOS rate case is without merit. The simple answer is that our decision here is based on the record in this proceeding.[38] HIOS has not shown that its operations have remained the same and we know from this record that they have not. For instance, HIOS now has access to and is transporting deepwater gas through its connection to the East Breaks Gathering System.[39] Finally, we reject HIOS' claim that the Commission failed to explain why the Staff witness' own location-specific study does not factor in any way into the reserve life estimate adopted. Basing HIOS' reserve estimate on only HIOS' existing connected supply is not appropriate for the reasons stated herein. Therefore, the Staff relied on its analysis which considers both existing and future supply[40] and we adopt that analysis in this order.

36. We also affirm our ruling that rejected HIOS' study that calculated a reserve life of 10 years. That study erroneously excluded potential production from deep gas in the shallow OCS waters and unleased prospects in the Gulf of Mexico that are not currently active or have not yet been discovered. Additionally, the deepwater estimates included in the study were derived from El Paso's proprietary database, which is based on information that has not been offered or supported by the record in this proceeding.[41] We find the record does not support the finding that HIOS will not be able to access gas supplies after 2013, the economic end-life proposed by HIOS.

B. Management Fee

37. HIOS has a negative rate base. That is because the $385,510,921 original cost of HIOS' gas plant in service has been almost fully depreciated, leaving net plant of only $13,405,796. HIOS has collected through its past rates deferred tax revenue of $1,093,882 and negative salvage revenue of $13,256,294. When these two amounts are subtracted from HIOS' net plant, it is left with a negative rate base.[42]

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[38] For the same reason, we reject HIOS' attempt to challenge our ruling here based on its claim that in *Trunkline* the geographic area used for the reserve estimate study was limited to offshore Louisiana area, and did not include the offshore Texas area.

[39] Exh. S-4 at 22.

[40] Exh. S-14 at 8.

[41] 110 FERC ¶ 61,043 at P 77-78.

[42] *Citing* Exh. HIO-106.

38. In the January 24 Order, the Commission held that HIOS should be allowed a management fee in lieu of the return on net rate base that the Commission ordinarily includes in a pipeline's rates. However, the Commission rejected HIOS' proposed management fee of $9,323,608, and instead approved a management fee of $1,734,008, together with a tax allowance of $893,277. The starting point for the Commission's calculation of the management fee was the formula used to calculate the management fee granted in *Tarpon Transmission Co.*,[43] the only other litigated case in which the Commission has awarded a management fee. In *Tarpon*, the Commission calculated the management fee by multiplying (1) 10 percent of the pipeline's historical average rate base by (2) the overall current pretax cost of capital. Thus, the *Tarpon* formula contains two variables, the historical rate base and the pretax cost of capital. The January 24 Order applied the *Tarpon* formula, with two adjustments: (1) the January 24 Order used a different calculation to determine historical rate base than was used in *Tarpon* and (2) used HIOS' overall cost of capital without any adjustment for taxes.

39. The January 24 Order used a different method to calculate historical average rate base, because of the difference in the depreciation methods used by the two pipelines. In *Tarpon*, the Commission calculated the average of the pipeline's net rate base at the end of each year of its life. In that case, the pipeline had used straight-line depreciation, and the Commission expressly noted that its average rate base was approximately 50 percent of gross investment.[44] Here, however, HIOS used a high initial depreciation rate of 8.33 percent in the early years of the project and credited additional transportation revenues to accumulated depreciation, recorded as Supplemental Depreciation.[45] HIOS also has had a negative rate base since 1998. As a result, calculating HIOS' average rate base in the same manner used in *Tarpon* results in an average rate base of $54.7 million, far below 50 percent of HIOS' gross investment in plant. The Commission found that differences in the timing of the pipeline's past recovery of its original investment should not have a major effect on a fee whose purpose is to provide the pipeline with modest compensation for future activities in operating the pipeline. Therefore, based on testimony by HIOS' witness that a normal average rate base over the life of HIOS' pipeline would be $180 million, the Commission concluded that the substitute rate base to be used in calculating HIOS' management fee should be 10 percent of an average rate base of $180,625,854.

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[43] 57 FERC ¶ 61,371 (1991).

[44] 57 FERC ¶ 61,371 at 62,241.

[45] Exh. HIO-64 at 5-6; *High Island Offshore System, L.L.C.*, 5 FERC ¶ 61,267 at 61,580 (1978).

40. The January 24 Order calculated overall return on capital, as follows. The Commission determined that, in the circumstances of this case, HIOS' overall return should be determined using a hypothetical capital structure. The Commission determined the hypothetical capital structure based on the average equity ratio of the same proxy group as used in determining HIOS' return on equity. The Commission accepted staff's proposed four company proxy group drawn from the Value Line Investment Survey's group of diversified natural gas companies that own Commission regulated natural gas pipelines. The Commission determined return on equity based on the same Discounted Cash flow (DCF) analysis it uses in other natural gas pipeline rate cases, where dividend growth is determined based on a two-step procedure averaging short-term and long-term growth forecasts. The Commission found that HIOS' return on equity should be set at the 11.22 percent median of proxy group's returns on equity. Combining this return on equity with the agreed-upon debt cost of 8.04 percent resulted in an overall post-tax return of 9.6 percent.

41. Finally, the Commission decided not to adjust this overall return upward to permit recovery of income taxes on the equity component. That was because the Commission determined that HIOS should be awarded a separate tax allowance on the overall management fee. Given this fact, the Commission held that it would be anomalous both to use a pretax return in the determination of the management fee and to allow a tax allowance on the resulting management fee, since that would result in a double recovery of taxes. Based on all of the above findings, the Commission approved a management fee for HIOS of $1,734,008. This was calculated by multiplying the overall rate of return of 9.60 percent by 10 percent of the modified average rate base of $180,625,854. The Commission also approved an income tax allowance of $893,277, calculated by multiplying the management fee by the 34 percent corporate income tax rate. The total of the approved management fee and tax allowance is $2,627,285.

42. HIOS seeks rehearing of the Commission's rejection of its proposed management fee of over $9,000,000 and adoption of a $1,734,008 management fee instead. HIOS' contentions on rehearing fall into two main categories. First, HIOS contests several of the Commission's rulings on the specific components of its calculation of the management fee, including the Commission's calculation of the substitute rate base, the choice of a proxy group for calculating the return on equity, and the setting of HIOS' return on equity at the median of the proxy group range of reasonable returns. Second, HIOS makes the more general contention that the end result of the Commission's management fee calculation is an unreasonably low management fee that fails to properly compensate HIOS for the risks of continuing to operate the HIOS system.

43. Indicated Shippers argue that the Commission erred in authorizing HIOS to collect a management fee without specifying standards to be maintained or goals to be accomplished through the management fee granted. Indicated Shippers asserts that the

allowance of a management fee is arbitrary and not supported by substantial evidence. Indicated Shippers request that the Commission specify the actions HIOS is expected to take as a *quid pro quo* for allowance of a management fee.

44. Below we first address HIOS' contentions concerning specific components of our management fee calculation. We then address the broader contentions of both HIOS and Indicated Shippers concerning the reasonableness of the end result.

1. Historical average rate base.

45. As described above, in determining the average historical rate base to be used in the management fee calculation, the January 24 Order took into account the fact that HIOS, unlike Tarpon, did not use straight line depreciation, but used a high initial depreciation rate of 8.33 percent and credited additional transportation revenues to accumulated depreciation as supplemental depreciation. The Commission stated that it did not believe that differences in the timing of the pipeline's past recovery of its original investment in order to arrive at its current situation of a negative rate base should have a major effect on a fee whose purpose is to provide the pipeline modest compensation for future activities in operating the pipeline. Citing Exhibit No. HIO-64 at 15, the Commission found that HIOS' witness, Mr. Porter, had computed a normal average rate base over the life of the project of $180,625,854, based on total investments in plant. Mr. Porter testified that this calculation assumes HIOS' average cost of facilities as an average rate base at the midpoint of the pipeline's useful life, as assumed in *Tarpon*.[46] The Commission stated that it concurred with this testimony and exhibit and accordingly adopted the average historical rate base set forth in Mr. Porter's testimony.

46. HIOS seeks rehearing of this holding. HIOS claims we failed to take into account the special circumstances of HIOS' depreciation history.[47] That claim is wrong as we specifically adjusted the historical average rate base used in the management fee calculation to replicate what that average historical rate base would have been had HIOS used a straight line depreciation method to arrive at its current negative rate base, based on the testimony of its witness Mr. Richard Porter, a company official. In *Tarpon* the

[46] Exh. HIO-64 at 15.

[47] *Citing* Exh. HIO-91 at 5 and Exh. HIO-92.

Commission expressly noted that the average rate base used to calculate the management fee was approximately 50 percent of the pipeline's gross investment.[48] Our adoption of Mr. Porter's proposed normal average rate base led to the same result in this case.

47. In its rehearing request, HIOS contends that the Commission should have adopted a later proposal made by Mr. Porter in his rebuttal testimony. In that testimony, Mr. Porter presented two calculations in which he revised HIOS' current net rate base (two variations) to show what HIOS' current rate base would be, if it had used straight-line depreciation and not credited any revenues to supplemental depreciation. These calculations produced current positive net rate bases of $33 million and $31 million, on which Mr. Porter than calculated traditional returns of $3.2 million and $2.9 million, respectively.[49]

48. The Commission rejects these alternative proposals of Mr. Porter's as being inconsistent with the *Tarpon* methodology. That methodology generates a management fee for a company which currently has a negative rate base, based on its average historical net rate base during the period before its rate base became negative. Mr. Porter's alternative proposals do not calculate such an average historical rate base. Rather, Mr. Porter hypothesizes that HIOS might now have a positive net rate base had it chosen to depreciate its rate base in a manner differently than it actually did. However, the Commission does not believe the management fee should be calculated based on a hypothetical current positive rate base that the pipeline does not actually have. Rather, the Commission prefers to adhere to the principle of using an average historical rate base during the period when the pipeline actually did have a positive rate base, taking into account the special circumstances of the pipeline's actual depreciation history. As described above, based on Mr. Porter's testimony, we did take into account the special circumstances of HIOS' depreciation history. Further, its claim that we ignored its negative rate base in the 1998-2002 years is incorrect as our substitute rate base calculation assumes a positive rate base in every year from the beginning in 1979 through 2002. Finally, we reject the claim that our allowed management fee is result-oriented as it is based on a direct application of the *Tarpon* methodology.

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[48] 57 FERC ¶ 61,371 at 62,241.

[49] Exhs. HIO-92; HIO-91 at 5.

2. Overall Cost of Capital

49. On rehearing, HIOS contests only two aspects of our determination of its overall cost of capital for purposes of calculating the management fee. These are: (1) our choice of a proxy group for use in the DCF analysis and (2) our holding that HIOS' return on equity should be the median of the range or equity returns established by the proxy group. HIOS does not challenge our holdings concerning its capital structure or any other aspect of the DCF analysis used to determine its return on equity.

Proxy Group

50. The Commission has historically used only corporations in the proxy group used to determine return on equity in natural gas pipeline rate cases. It has never used a master limited partnership. The Commission has required each corporation included in the proxy group to satisfy the following conditions. First, the company's stock must be publicly traded. Second, the Commission has required that the company be recognized as a natural gas pipeline company and that its stock be recognized and tracked by an investment information service. Third, the Commission has required that pipeline operations constitute a high proportion of the company's business.[50] However, in recent years fewer and fewer companies have met these standards, because of mergers, acquisitions, and other changes in the natural gas industry. In a July 2003 order in *Williston Basin Interstate Pipeline Co. (Williston)*, 104 FERC ¶ 61,036 at P 35 (2003), the Commission found that only three companies remained that met the Commission's traditional standards for inclusion in the proxy group. In those circumstances, the Commission approved the pipeline's proposal to use a proxy group based on nine companies listed among the Value Line Investment Survey's group of diversified natural gas companies that own Commission regulated natural gas pipelines.

51. The January 24 Order in this case adopted Staff's proposed proxy group, consisting of four companies: Kinder Morgan, Inc. (Kinder Morgan), Equitable Resources, Inc. (Equitable), National Fuel Gas Company (National Fuel), and Questar. In developing this proxy group, Staff used as its starting point the nine companies which the Commission approved for use in the proxy group in *Williston.* However, Staff excluded five of the companies it no longer considered appropriate.[51] It excluded

[50] *Transcontinental Gas Pipe Line Corp.*, 90 FERC ¶ 61,279 at 61,933 (2000). In *Williston*, 104 FERC at P 35 fn. 46, the Commission stated that it determined whether pipeline operations constituted a high proportion of the company's business based on whether its pipeline business accounted for, on average, over the most recent three-year period for which data was available, approximately 50 percent or more of the total dollars in at least one of the two areas, operating income and total assets.

[51] Exh. S-11 at 11-12.

Columbia and Coastal Corp. because these entities were acquired by other companies and are no longer publicly traded. It excluded Enron because it was in bankruptcy, and excluded El Paso and Williams because financial difficulties have resulted in lowered dividends for these companies.

52. The January 24 Order rejected HIOS' contention that three of the companies in Staff's proposed proxy group (Equitable, National Fuel, and Questar) should be excluded because they are predominantly local distribution companies (LDCs). The Commission pointed out that the companies are all companies listed in the Value Line Group of diversified natural gas companies whose business includes FERC-regulated natural gas pipelines. Thus, the companies are not solely in the distribution business. The Commission also stated that, in *Williston,* it had approved the use of a proxy group that included the same diversified natural gas companies as Staff proposes to use in this case. Because of changes in the natural gas industry, gas companies can no longer be classified as pure transmission or pure distribution companies, and thus, the proxy companies reflect characteristics of both. The Commission concluded that, while not pure transmission companies as is HIOS, these diversified gas companies are the best available proxies on the current record on which to base the DCF analysis.

53. The January 24 Order also rejected HIOS' proposal to include four master limited partnerships (MLPs) in the proxy group.[52] The Commission recognized that, in theory, it might be appropriate to compare HIOS, an L.L.C. owned by an MLP, with other MLPs whose business is made up primarily of pipeline operations. However, the Commission stated that, before it could consider including an MLP in the proxy group, the record would have to contain reliable financial data concerning the MLP, comparable to that for corporations, so as to permit the Commission to determine a return on equity for the MLP under the DCF methodology. Under that analysis, return on equity is considered to equal dividend yield (dividends divided by stock price), plus the estimated constant growth in dividends.

54. The Commission found that it was not clear from the evidence presented by HIOS that the "dividend" figures supplied by HIOS for the MLPs it proposed to include in the proxy group are comparable to the corporate dividends the Commission uses in its DCF analysis. The Commission explained that partnerships make distributions to their partners, rather than pay dividends to stockholders. Those distributions may include payment to the partners of a share of the partnership's earnings; to that extent the distribution is comparable to corporate dividend payments. However, the distributions may also include a return of a portion of the partners' original investment, unlike a

[52] The four MLPs were: GulfTerra Energy, Kinder Morgan Energy Partners, Northern Border Partners, and Enterprise Products Partners. HIOS agreed that Kinder Morgan, Inc., is an interstate pipeline company eligible for inclusion in the proxy group.

corporate dividend.[53] Use of a distribution payment that includes both earnings and a return of investment as an MLP' "dividend" for purposes of a DCF analysis would skew the DCF results, since the dividend yield would appear higher than it actually was. Thus, the Commission said it would not consider including an MLP in the proxy group, unless the record demonstrates that the distribution used as the "dividend" includes only a payment of earnings and not a return of investment.

55. On rehearing, HIOS contends that the Commission erred (1) by adopting a proxy group that includes three predominantly distribution companies that do not reflect the risk profile of HIOS and (2) by rejecting its proposal to include four MLPs in the proxy group. We deny rehearing, and reaffirm our holding that Staff's proposed proxy group is the best available proxy group based on the record developed in this proceeding.

56. HIOS contends that the inclusion of Equitable, National Fuel, and Questar in the proxy group improperly departs from the Commission's long standing policy to exclude companies whose primary business is gas distribution, since such companies have dissimilar operations and risk profiles. HIOS cites various prior decisions [54] wherein the Commission declined to include companies whose primary business is gas distribution proxy groups. The Commission recognizes that pipeline operations do not represent as high a percentage of the operations of Equitable, National Fuel, and Questar as the Commission has historically required for inclusion in the proxy group. However, all the parties agree that the record in the present case contains only one corporation that meets our historical proxy group standards and need not be excluded for other reasons. That is Kinder Morgan, whose pipeline operations constitute a high proportion of its business. While several other corporations satisfied the standard of being primarily pipeline companies (Enron, El Paso, and Williams), all the parties agree that those companies should be excluded from the proxy group because of their anomalous financial circumstances.

57. As a result, in the present case, the Commission has no choice but to depart from its historical proxy group standards for natural gas pipelines in one way or another. The only issue is whether (1) to use some corporations whose pipeline operations are not as significant as the Commission historically required, as the January 24 Order did or (2) to use MLPs instead of corporations, as HIOS proposes. The Commission has already faced a similar problem in *Williston Basin Interstate Pipeline Co. (Williston)*, 104 FERC ¶ 61,036 at P 35 (2003), where the Commission stated that, with recent

[53] Exh. IND-17 at 4.

[54] HIOS refers to *EPGT Texas Pipeline L.P.*, 99 FERC ¶ 61,295 (2002), *Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,264 (1999), and *Mountain Fuel Resources, Inc.*, 28 FERC ¶ 61,195 at 61,370 (1984).

mergers, only three corporations would remain that meet the Commission's traditional standards for inclusion in the proxy group. In those circumstances, the Commission approved the pipeline's proposal to use a proxy group based on nine corporations listed among the Value Line Investment Survey's group of diversified natural gas companies that own Commission regulated natural gas pipelines.

58. The Commission continues to believe that the better choice, based on the record developed at the hearing in this case, is to use a proxy group based upon the corporations listed among the Value Line Investment Survey's group of diversified natural gas companies that own Commission regulated natural gas pipelines, consistent with *Williston*. The selection of the three natural gas companies which HIOS objects to all meet the criteria used in *Williston*. The 2002 data supplied by HIOS' witness Dr. Williamson confirms this finding.[55] In each instance, the natural gas company has significant interstate pipeline operations, is subject to Commission jurisdiction and is included in the Value Line group of diversified natural gas companies. These data support the ALJ's and our findings that these companies are not purely distribution entities and are suitable for inclusion in pipeline oriented proxy groups.

59. HIOS states that distribution companies have lower risk for operations within a non-competitive franchised service territory. We reject HIOS' claim. First, a substantial portion of the natural gas business of each of the proxy group companies involves operating natural gas pipelines subject to the Commission's jurisdiction.[56] Second, the portion of these companies' natural gas business involving franchised service territories are not significantly less competitive than HIOS' connections to existing and future gas supply in its operating territory in the Gulf of Mexico.[57] The

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[55] Exh. HIO-139 at 2:

	Transmission %	Distribution%
Questar, operating income	24.79	26.35
	Pipeline & Storage%	Utility%
National Fuel, net income	24.77	41.27
	Pipeline%	Distribution%
Equitable Resources, EBIT	9.50	22.48

[56] Exh. S-11 at 11; *see also* Exh. HIO-139 at 2.

[57] Exhs. S-11 at 15; IND-1 at 12.

record reflects that virtually all of the gas moving though HIOS is captive to the system and has no direct alterative means of transportation. Further, HIOS identified 57 drilling prospects in various stages of development that could potentially be connected to HIOS in the future and attached 16 new supply sources to its system during the base and test period in this case.[58] Additionally, the ALJ found that the WPA was not an unreasonably large portion of the Gulf of Mexico to determine available gas reserves for HIOS, and a finding that, among other things, HIOS' arguments overlook the significant growth in estimates of reserves in the Gulf of Mexico. She disagreed with HIOS that Staff witness Pewterbaugh failed to take sufficient account of declining production trends from existing sources, noting that HIOS' throughput had not exhibited a constant decline and that Staff witness Ekzarkhov's testimony indicates that near-term future trends predict slightly increased throughput.[59] We find sufficient similarity in the operations of these companies to make them appropriate for inclusion in a proxy group for the purpose of computing the rate of return.

60. HIOS also argues that our selection of the three companies it disputed is inconsistent with our rejection of eight distribution companies recommended for inclusion in the proxy group by Indicated Shippers. We reject that claim for these reasons. Indicated Shippers' witness Elizabeth H. Crowe included in her proposed proxy group, in addition to Questar, National Fuel, and Equitable, these companies classified as distribution companies by Value Line: AGL Resources, Atmos Energy Corp., Laclede Group., New Jersey Resources, Nicor, Inc., Peoples Energy, Piedmont Natural Gas and South Jersey Industries.[60] We declined to include these eight natural gas companies because they do not have significant interstate pipeline operations and are not regulated by the FERC, in addition to being outside the diversified natural gas group as described by Ms. Crowe's data. These eight companies do not meet our criteria for inclusion in a pipeline-oriented proxy group. Accordingly, we reject HIOS claim that our decision on this matter is inconsistent with the selection of members of the proxy group.

61. HIOS contends that the Commission failed to distinguish certain of its decisions before *Williston*, rejecting the use of distribution companies in the proxy group. Those decisions are readily distinguishable because we have found that significant changes in the natural gas industry because of mergers and acquisitions made it necessary, as found in the *Williston* decision, to revise our policy on proxy groups. Furthermore, earlier cases such as *Mountain Fuel, Inc.*, 28 FERC ¶ 61,195 at 61,369-370 (1984), did not

[58] Exh. IND-1 at 12.

[59] 107 FERC ¶ 63,019 at P 54.

[60] Exh. IND-3; Exh. IND-1 at 11.

reject gas companies with distribution functions as such but declined to include a group of companies which appeared to be arbitrarily proposed for inclusion in the proxy group. In the earlier *Williston* proceeding, 87 FERC ¶ 61,264 at 62,007 (1999), the Commission rejected the inclusion of LDCs on the basis that the proxy group provided no better representation and was unnecessary to determine the equity return for Williston. There, the Commission selected Coastal, Enron, Panhandle, Sonat, Williams and El Paso as an appropriate proxy group and held that the four other gas companies proposed by Williston did not appear to be as representative of pipeline transportation industry as those six companies. Further, the Commission held that the approved proxy group was not an unjust and unreasonable selection. In *EPGT,*[61] cited by HIOS, the proxy group adopted by the Commission was made up of interstate pipelines taken out of the Staff's evidence in *Williston*, namely, El Paso, Enron, Williams and Coastal.[62] We have previously explained why these four companies are no longer available or suitable for inclusion in this proceeding.

62. As HIOS recognizes, its alternative proposal to use MLPs in the proxy group would also be a departure from the Commission's prior policy concerning the proxy group to be used in natural gas pipeline cases.[63] Based on this record, we continue to prefer the proxy group proposed by Staff based on the *Williston* approach. As discussed in the January 24 Order, under the DCF analysis, return on equity is considered to equal dividend yield (dividends divided by stock price), plus the estimated constant growth in dividends. Thus, data concerning the dividends paid by the proxy group companies is a key component of any DCF analysis. HIOS does not dispute the finding of the January 24 Order that the "dividend" figures HIOS presented for the MLPs it seeks to include in the proxy group have not been shown to be comparable to the corporate dividend the Commission uses in its DCF analysis. Partnerships make distributions to their partners, rather than pay dividends to their stockholders. Those distributions may include a return of the partners' original investment as well as a share in the partnership's earnings, unlike a corporate dividend. Thus, as the January 24 Order found, use of a distribution payment that includes both earnings and a return of investment as an MLP's dividends for purposes of the DCF analysis could skew the DCF results, since the dividend yield would appear higher that it actually was.

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[61] *EPGT Texas Pipeline L.P.*, 99 FERC ¶ 61,295 (2002) (*EPGT*).

[62] *Id.* at 62,250.

[63] *See* HIOS' rehearing request at 36, describing the use of MLPs in the proxy group as an "issue of first impression."

63. In its rehearing request, HIOS contends that the Commission has used MLPs in the proxy groups used to determine return on equity for oil pipelines, without requiring a showing that that the "dividend" data relied on excludes any return of capital. However, in oil pipeline cases, MLPs are the only available companies for use in the proxy group without going outside the oil pipeline industry altogether, since all publicly traded oil pipeline companies are MLPs. Thus, in the *SFPP, L.P.*, case relied on by HIOS,[64] the issue was whether to continue to include natural gas pipelines in the proxy group, despite the fact the two industries appeared to have significantly different risks. In this case, however, the choice is not between using natural gas pipeline MLPs or using companies that are not engaged in the natural gas pipeline industry at all. Rather, as discussed above, all four companies in the proxy group we have adopted are engaged in the transportation of natural gas and own and operate natural gas interstate pipelines subject to our NGA jurisdiction. In these circumstances, we prefer the proxy group we have chosen to the option of using MLPs whose "dividend" data has not been shown to be comparable to the corporate dividend payments upon which the DCF methodology is premised.

64. HIOS objects to the Commission's reliance on testimony by a staff witness in a separate rate case involving Trailblazer Pipeline Co., a portion of which was attached to surrebuttal testimony filed by Indicated Shippers at the hearing in this case as Exh. No. IND-17. The January 24 Order cited Indicated Shippers' Exh. IND-17 as support for its statement that partnership distributions may include a return of a portion of the partners' original investment.[65] The January 24 Order also relied on that testimony to provide an example of how the DCF results could be skewed by use of a distribution payment that includes both earnings and a return of investment as "dividend," pointing out that, over the period 2001-2003, two of the MLPs which HIOS proposes to include in its proxy group made distributions substantially in excess of their earnings, while a group of natural gas pipelines paid dividends that were less than their earnings.[66] Finally, the January 24 Order noted that the exhibit filed by Indicated Shippers showed that Value Line had warned investors that Northern Border Energy Partners' dividends include a return of capital, although the Commission also recognized that HIOS' exhibit used data reported by IBES, rather than Value Line.[67]

[64] *SFPP,L.P.*, 86 FERC ¶ 61,022 at 61,099 (2001).

[65] 110 FERC ¶ 61,043 at P 126.

[66] *Id*. at n. 112.

[67] *Id*. at n. 116.

HIOS contends that this use of Indicated Shippers' exhibit was improper, since HIOS did not have an opportunity to cross examine the staff witness in question who did not appear at the hearing in this case.

65. The Commission finds that HIOS has no basis at this stage of this proceeding to object to the use of the exhibit submitted by Indicated Shippers. That exhibit was admitted into evidence on November 19, 2003, with the statement of counsel for HIOS that it had no objection to the admission of this exhibit.[68] Furthermore, on February 12, 2004, the Staff submitted its reply brief to the ALJ, specifically relying on the exhibit submitted by Indicated Shippers and raising the same objections to HIOS' proposed inclusion of MLPs in the proxy group, as set forth in that exhibit.[69] The ALJ adopted those positions and evidence in her Initial Decision issued on April 22, 2004, rejecting HIOS' proxy group.[70] In its brief on exceptions, HIOS raised no procedural issues with respect to the use of Indicated Shippers' exhibit. Thus, both at the hearing and in its brief on exceptions, HIOS waived its right to object to the admission of that exhibit.[71]

66. HIOS also requests that, if the Commission continues to require information about whether the "dividend" payments of the MLPs it desires to include in the proxy group are comparable to corporate dividends, the Commission either accept an affidavit of Dr. Williamson attached to its rehearing request or remand the case to the ALJ. Dr. Williamson's affidavit states that he does not believe there is any return of investments in MLP distributions he used in his evidence, but that he knows of no way to match earnings with distributions for the purpose of making the required calculation of return allowance at the time testimony is submitted.[72] He also attached to his affidavit 127 Value Line reports for eight oil pipeline and six gas pipeline MLPs, including Kaneb, Lakehead, El Paso Energy Partners and Northern Border Partners, which showed return of capital in some years.

67. The Commission rejects HIOS' request to reopen the record in this proceeding. There has already been a full hearing before an ALJ in this proceeding, with all sides given an opportunity for discovery and presentation of evidence. In proposing to include MLPs in the proxy group in reliance solely on precedent involving oil pipelines,

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[68] Tr. 552.

[69] Staff Reply Brief at 23-24.

[70] 107 FERC ¶ 63,019 at P 126.

[71] 18 C.F.R. § 385.711(d)(2).

[72] Affidavit at P 12.

HIOS was aware that it was seeking a change in Commission policy concerning the proxy group to be used in natural gas pipeline rate cases. The issue of the comparability of partnership distributions to corporate dividends can hardly have come as a surprise to HIOS or its witness Dr. Williamson, particularly since Dr. Williamson had made a similar proposal in the Trailblazer proceeding and, as shown by Indicated Shippers' Exh. IND-17, Staff had raised that issue in the Trailblazer proceeding. In any event, once Indicated Shippers submitted that exhibit at the hearing in this case, HIOS had an opportunity to present this same evidence through the testimony of Dr. Williamson, who testified on the same day that Exh. IND-17 was submitted. If Dr. Williamson was not prepared to address Exh. IND-17 on that day, HIOS could have requested that the ALJ allow him to supplement his testimony on a later day. HIOS having failed to take any action to present further evidence on this issue until now, the Commission will not further delay resolution of this proceeding, by reopening the record for further presentation of evidence.

Return in the zone of reasonableness

68. HIOS' one other objection on rehearing to the Commission's determination of the return on equity to be used in calculating the management fee is that the Commission erred in not placing it at the top of the range of returns.

69. The January 24 Order concurred with the ALJ that HIOS had not made a very persuasive case in support of the need for any adjustment above average risk. The Commission stated that its risk analysis assumes that pipelines generally fall into a broad range of average risk, absent highly unusual circumstances that indicate an anomalously high or low risk as compared to other pipelines. HIOS has recovered almost all of its initial investment in the pipeline, and thus it has no financial risk. HIOS also has not shown that its business risk exceeds the business risks of the diversified natural gas companies in the proxy group, all of which have significant interstate pipeline business. Even though large volumes of interruptible transportation are moving on HIOS, which would seem to increase its business risk, in fact those volumes are shipped by captive shippers who have no alternative means of transportation to bring their gas to market. If HIOS' throughput does decline, HIOS can file a new rate case to increase its rates. Also, HIOS argues that the approved proxy group has less risk than HIOS and therefore it should be placed at the top of the range.

70. In its rehearing request, HIOS contends that the Commission's customary assumption that pipelines generally fall within the broad range of average risk does not apply here, since the proxy group adopted by the Commission includes companies whose returns reflect the lower risks associated with the operations of companies that are predominantly in the distribution business. We deny rehearing on this issue. HIOS does not contest our finding in the January 24 Order that, having recovered almost all of its initial investment in the pipeline, HIOS has no financial risk. In this respect, HIOS has less risk than the four companies in the proxy group, all of whom have at least some

financial risk since they have not recovered their original investment. Thus, in order to show above average risk, HIOS would have to show that its business risk is so much greater than that of the proxy group companies, that that higher business risk more than offsets HIOS' lower financial risk. For the reasons stated earlier in this order concerning our choice of the proxy group and for the reasons stated in the January 24 Order and the Initial Decision, HIOS has failed to show such high business risk.

71. Accordingly, we find that HIOS has raised no new issues on rehearing requiring us to revise our decision on setting the return for HIOS.

3. Justness of End Result

72. The Commission has now addressed and rejected all of HIOS' contentions on rehearing objecting to the specific calculations the Commission used to determine its management fee. Based on those calculations, the Commission awarded HIOS a management fee of $1,734,008. On rehearing, HIOS also makes a number of other contentions, all of which have the same essential theme: that regardless of the particular calculations the Commission used, the $1,734,008 end result is not just and reasonable. These contentions are that: (1) the Commission failed to adequately address HIOS' proposed management fee of over $9 million based on a methodology entirely different from the *Tarpon* method, (2) the approved $1.7 million management fee is inadequate to attract additional investment, and (3) the approved management fee provides insufficient cash flow.

HIOS' proposed $9,323,608 management fee

73. HIOS argues that the Commission did not give serious consideration to HIOS' request for a $9,323,608 management fee. The Commission was given no justifiable reason to approve a management fee of $9,323,608, which would have generated a margin of nearly 50 percent over HIOS' operating expenses, to a pipeline that has been able to make $87.4 million in cash distributions to its owners in the recent years. HIOS did not justify its proposed management fee of $9,323,608.

74. In *Tarpon* we found that the size of the management fee should be high enough to encourage such activities as efficient operations, reducing costs, increasing throughput, and maintaining needed transportation facilities, but not so high that it would be equivalent to a monopoly return unavailable to a firm operating under competitive conditions."[73] HIOS' proposed $9,323,608 management fee, if approved, would amount to nearly one third of HIOS' cost of service, even without any additional allowance for taxes. The approved management fee is fully sufficient to accomplish

[73] 57 FERC ¶ 61,371 at 62,241.

these purposes, and the much higher management fee proposed by HIOS is unjustified. HIOS' proposed management fee would be of comparable magnitude to the management fee of almost half the pipeline's cost of service, which the pipeline proposed in *Tarpon.* In *Tarpon*, the Commission described a management fee of such magnitude as "huge,"[74] and rejected it as contrary to its policy of permitting a "modest management fee" to encourage efficiency.[75]

75. Further, HIOS' proposed management fee and methodology used to compute the fee is plainly out of step with the methodology set out in *Tarpon,* as the Commission explained in the January 24 Order. Accordingly, we reject HIOS' argument that we did not give serious consideration to its $9,323,608 proposal. We have carefully given it serious consideration but found it unjustified, for all of the reasons set out in our orders.

Attract additional investment in the pipeline

76. HIOS raises the issue of whether the management fee we approved is sufficient to attract additional investment in its pipeline system. HIOS claims that any new investment will be discouraged because HIOS would lose its management fee as it would have a small rate base on which to earn a return. HIOS suggests that using the *Tarpon* methodology to calculate a management fee creates a disincentive to invest in pipeline infrastructure, because if the pipeline continues to make the investments necessary to maintain its system, it thereby creates a small positive rate base and could lose its management fee. HIOS seeks to avoid this result by its proposal to place a floor on the rate base used to calculate its management fee/return of twenty percent of its original investment.

77. The Commission rejects these contentions. First, HIOS assumes that the Commission would refuse to allow any management fee, if the pipeline had a positive rate base regardless of how small, and regardless of whether that rate base was less than the portion of the pipeline's original investment that would be used to calculate a management fee. The Commission has never been faced with a case where the pipeline had such a small positive rate base, and has thus never addressed the question whether to permit a management fee in such circumstances. However, as a general matter, the Commission believes that the policy underlying its allowance of a management fee where there is no rate base would support allowing a sufficient management fee in the situation of a very small positive rate base, such that a pipeline in that situation would not be worse off than if it had a negative rate base, with or without a return on that small

[74] *Id*.

[75] *Id*. at 62,240.

rate base.[76] On the other hand, however, a large investment in a new HIOS project, similar to the $80 million invested in the non-jurisdictional East Breaks Gathering System, would terminate the management fee in favor of a return to the traditional return on rate base methodology. Thus, HIOS' concern about the possible, complete loss of its management fee is at this time speculative and without basis in the record.

Cash flow for system operations

78. HIOS also claims it requires a large management fee to provide sufficient cash flow to avoid insolvency and to offset significant business risks, declining throughput, and a lack of economically accessible new gas supplies. Two reasons militate to reject this argument. First, the owners have a responsibility to provide the necessary cash flow and second, our cost of service allowance includes a substantial cash flow above actual current operating costs that would be available to meet any such exigencies.

79. The management fee we approved is fully adequate to compensate HIOS' owners for the risks of continuing to operate the pipeline. In the first place, we believe HIOS overstates its business risks. HIOS transports gas from the High Island and West Cameron offshore production areas to major interstate pipelines. Its two major firm shippers have contractually committed to transporting production from their gas reserves in those areas through HIOS. Moreover, the record shows that even the large volumes of gas transported on an interruptible basis through HIOS are in fact captive to HIOS, since shippers would face high hookup costs in order to access a different pipeline. While HIOS claims that it suffers from a lack of additional accessible gas reserves, the record shows that its owners recently invested $80 million to build the non-jurisdictional East Breaks Gathering System in order to attach additional reserves to its system. Also, as discussed in the depreciation section of this order, we find that substantial additional accessible reserves also exist.

80. We also find that HIOS has not shown that a management fee of the level we approved in this order would leave it with insufficient cash reserves to manage fluctuations in revenues or expenses or create an unacceptable risk that HIOS could become insolvent. HIOS' operating costs, depreciation, and negative salvage totaling over $20 million are already included in the allowed cost of service and provide the cash flow HIOS requires to continue to be solvent. Additionally, about $3,569,761of that

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[76] In *Tarpon*, we granted a return on its small, new investment in office equipment, as well as a management fee. 57 FERC ¶ 61,371 at 62,236, 62,241.

$20 million represents non-current expenses over and above HIOS' the actual O&M expenses requested by HIOS.[77] Such expenses do not represent actual payments that HIOS must make on a current basis and thus the inclusion of these amounts in HIOS' cost of service all contribute to an operating margin above actual current expenses.

81. The increased management fee we have approved provides a greater operating margin than that approved in the Initial Decision. In any event, it is the responsibility of prudent management to maintain cash on hand necessary to weather downturns in its business.[78] Accordingly, we reject HIOS' argument that the management fee would generate insufficient cash flow to sustain downturns in its revenues or increases in its costs.

82. The Commission also pointed our in the January 24 Order that if HIOS' costs increased or throughput decreased substantially, HIOS could file to increase its rates. HIOS claims that future rate increases would be too slow to save it from insolvency, as they take effect only after a six months delay to enable HIOS to collect higher rates. HIOS suggests that the management fee would leave it with such a thin margin over operating expenses, that it might not have time to prepare a new rate case and place the new rates into effect after a five month suspension before being forced into bankruptcy. HIOS suggests various reasons why it might not be able to collect the full cost of service approved in this case. For example, it states that its throughput has declined from 341 MMDth in 1998 to 270 MMDth in 2003, and it projects a continuing decline. However, if HIOS determines it cannot recover its cost of service through the rates approved in this rate case because of a change in circumstances, it is free to file a new rate case proposing higher rates. We know of nothing that would prevent HIOS from requesting a short suspension of any new rate filing if circumstances warrant. The Natural Gas Act does not mandate maximum suspension of every rate increase filing. Furthermore, as shown by the record, HIOS will receive under the cost of service we have approved $3.5 million per year in non-current expenses. This cash flow provides a substantial cushion to absorb the normal variations in income from operations. The owners of HIOS, who at present have no net investment in the company, would also have the option of allowing HIOS to raise capital or obtain a bank loan. Accordingly, increasing rates in the future remain a viable option for HIOS, if needed.

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[77] Annual depreciation of $1,110,646, negative salvage of $734,107, and management fee of $1,734,008.

[78] HIOS has made distributions to its partners of $23.2 million in 1998, $15.3 million in 1999, $23.9 million in 2000, and $25 million in 2001, for a total of $87 million.

4. Standards required to support collection of a management fee

83. Indicated Shippers argue that the Commission erred in authorizing HIOS to collect a management fee without specifying standards to be maintained or goals to be accomplished through the granted management fee. Indicated Shippers request that the Commission specify the actions HIOS is expected to take as a *quid pro quo* for allowance of a management fee. In *Tarpon,* the Commission held that a management fee was appropriate, once there was no longer a rate base on which to earn a return, "to compensate Tarpon's owners for the risks of continuing to operate the pipeline and to provide an incentive for efficient operations."[79] Since HIOS no longer has a rate base on which to earn a return, it is appropriate to include a management fee in its cost of service.

84. The Commission found that establishing rates for HIOS that would only recover its projected costs of continuing to operate the pipeline without any allowance for earning a profit would leave HIOS' owners with "only limited incentives to manage the operations of the pipeline on an efficient basis."[80] Giving HIOS an opportunity to earn a modest profit through a management fee is an effective means of encouraging efficient operations, including reducing costs and increasing throughput and maintaining needed transportation facilities.

85. We have therefore set the standards to be used in future rate cases by which to measure HIOS' performance, namely, encouraging efficient operations, reducing costs, increasing throughput, and maintaining needed transportation facilities.

C. Federal Income Tax Allowance

86. The January 24 Order approved an income tax allowance of $893,277 calculated by multiplying the management fee by the federal corporate income tax rate of 34 percent. The Indicated Shippers argue that the Commission erred in allowing HIOS to receive a federal income tax allowance as part of its cost of service. Indicated Shippers argue that HIOS does not generate taxable income because it is owned by GulfTerra Partners, an MLP, and because of its status, does not generate any taxable income. Indicated Shippers assert that GulfTerra incurs no tax liability on the income passed through to individual partners and hence there is no justification for authorizing an income tax allowance for HIOS.[81] In making these contentions, Indicated Shippers

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[79] *Tarpon*, 57 FERC ¶ 61,371 at 62,240.

[80] *Id.*

[81] Indicated Shippers Request for Rehearing at 6.

rely on the Court of Appeals' recent decision in *BP West Coast Products, LLC v. FERC,*[82] reversing and remanding a Commission order approving a tax allowance for an oil pipeline to the extent its partners were corporations.[83] Indicated Shippers argue that the Commission's decision contradicts that decision and does not constitute reasoned decision making.

87. We reject Indicated Shippers' request for rehearing on the tax allowance issue on the ground that they failed to raise this issue in a timely manner that would have permitted the parties to litigate it at the hearing before the ALJ.

88. The ALJ found that all parties, including Indicated Shippers, agreed to a 34 percent federal tax rate. In fact, Indicated Shippers' witness Elizabeth H. Crowe testified that "income taxes still needed to be included in the cost of service because the pipeline will continue to be subject to income taxes on the profit portion of its income, now represented by the management fee."[84]

89. In addition to a failure to raise this issue at the hearing, Indicated Shippers also failed to take a timely exception to the Initial Decision which specifically approved the 34 percent federal income tax allowance for HIOS on the issue it now raises in its rehearing request.[85] Our rules, 18 CFR section 385.711 (2004) require that if a participant does not object to a part of an initial decision in a brief on exceptions, any

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[82] 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast).*

[83] On December 2, 2004, the Commission in Docket No. PL05-5-000, initiated a comment procedure to allow interested parties to comment on the impact of *BP West Coast.* On May 4, 2005, the Commission issued a policy statement on income tax allowances which, *inter alia,* held that it would permit an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets. 111 FERC ¶ 61,139 at P 32.

[84] Exh. IND-7 at 4.

[85] The only issue concerning taxes raised by Indicated Shippers on exceptions was its assertion that the ALJ had improperly used a pre-tax return on equity to determine the management fee and then also awarded a tax allowance on the resulting management fee, thereby permitting a double recovery of taxes. The Commission agreed with that contention, 110 FERC ¶ 61,043 at P 164-165, and Indicated Shippers does not seek rehearing of that part of the Commission order.

objection to that part of the initial decision is waived and the participant may not raise such objection before the Commission on rehearing. As Indicated Shippers did not file such an objection on this matter in its brief on exceptions, it may not now raise an objection to the inclusion of a federal income tax allowance in HIOS' cost of service.

90. Finally, the federal income tax allowance issue was fully in the public domain at the time Indicated Shippers on October 3, 2003 filed their testimony in this proceeding.[86] Nevertheless, Indicated Shippers chose to file testimony in support of a federal income tax allowance for HIOS in this proceeding. For all of the above findings and reasons, we hold that our decision to allow a federal income tax allowance in HIOS' cost of service remains a reasonable conclusion based on the record in this proceeding.

F. Rate Levels and Refunds

91. HIOS argues that the Commission's rate order set its rates outside the zone of reasonableness and violates section 5 of the NGA. HIOS states it sought to increase its FT-2 rate from 12.4 cents to 17.6 cents, a 40 percent increase, and that it recognizes the Commission's authority under section 4 of the NGA to deny that rate increase.[87] However, HIOS argues that the reduction in its FT-2 rate to 9.2 cents must be justified under section 5 of the NGA. HIOS asserts that the rate is insufficient to maintain the financial integrity of the pipeline and to fairly compensate the investors for their risk and to attract capital. HIOS also argues that the Commission must follow the procedures under section 5 to change the pre-existing rate, and has the burden of proof that the rate of 12.4 cents per Dth is unjust and unreasonable and the replacement rate is just and reasonable. HIOS asserts that adjudicative rulings that would deny interstate pipelines an appropriate right to recover cost are inconsistent with the needs of the gas consuming public.

Discussion

92. We do not agree that HIOS has been denied the appropriate right to recover its costs. First, we granted HIOS $19,638,019 for payment of maintenance and operational expenses. Second, we granted depreciation allowances on remaining undepreciated plant in service and a negative salvage allowance, with the only differences being the remaining life of the project. Third, we granted a reasonable management fee and associated federal income taxes even though HIOS has a negative rate base of

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[86] *See Lakehead Pipeline LLC,* Docket No. IS 92-27-000, 75 FERC ¶ 61,181 at 61,593-99 (1996).

[87] HIOS sought to raise all of its rates.

$944,380.[88] We have addressed every issue raised by HIOS regarding its cost of providing service to its shippers. Accordingly, we hold that HIOS has a full opportunity to recover its costs through its approved rates.

93. HIOS argues that under section 5 of the NGA, the Commission has the burden to show that its pre-existing rate of 12.4 cents was unjust and unreasonable and the rate established by our rate order, which calls for a 9.2 cent rate, is just and reasonable. We agree that, to the extent we not only reject HIOS' proposed rate increase, to which it had the burden of proof, but also ordered a rate decrease, we have the section 5 burden described by HIOS. Pursuant to NGA section 5, we have found that the 9.2 cent rate is just and reasonable based on the evidence contained in the record, as found by the ALJ in the hearing and our decision upon review. The higher rate of 12.4 cents is clearly unjust and unreasonable based on our findings of fact both as to the appropriate cost of service, cost allocation, throughput, and rate design. Accordingly, we reject HIOS' arguments regarding the lawful rate levels we have set at the conclusion of this proceeding.

94. HIOS argues the rate must attract capital and ensure the financial integrity of the pipeline. We agree and have found that the rate order accomplishes that goal. Our order addresses the essential elements of the rate, *i.e.*, the cost of service, rate of return, cost allocation, throughput and rate design supported by substantial evidence reasonably expected to maintain financial integrity, to attract needed capital, and fairly compensate investors for risks they have assumed while appropriately protecting relevant public interests.[89] The 9.60 percent rate of return allowed is within the range of reasonable returns and will maintain the financial integrity, attract capital and compensate the investor for assumed risks.[90]

95. HIOS seeks clarification of the January 24 Order that it is not required to make refunds to its shippers until the resolution of its request for rehearing has been resolved. This order does so, and therefore we concur with HIOS' request for clarification and will require that refunds are to be made to shippers within 30 days of the date of issuance of this order.

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[88] HIOS has a negative salvage reserve of $13,256,294, an accumulated deferred income tax balance of $1,093,882, an a net undepreciated plant of $13, 405,380, which results in a negative rate base of $944,380. 107 FERC ¶ 63,019 at P 91.

[89] *Permian Basin Area Rate Cases,* 390 U.S. 747, 791-792 (1968); *FPC v. Hope Natural Gas Co.,* 320 U.S. 591 (1944).

[90] *Permian Basin Area Rate Cases,* 390 U.S. 747, 806.

IV. Throughput and Cost Allocation

96. HIOS offers two firm transportation services under Rate Schedules FT-1 and FT-2. The FT-1 rates are two-part rates with a reservation and usage charge designed using the straight fixed variable (SFV) rate design consistent with section 284.7(e) of the Commission's regulations. The FT-2 service features a one-part volumetric rate, instead of the two-part rate with reservation and usage charges that is traditionally associated with firm service. The FT-2 service is available to shippers that have rights to estimated proven recoverable reserves of at least 40 Bcf, which they have committed to shipping on HIOS. HIOS has only two firm customers, and they receive service under Rate Schedule FT-2.

97. Any party desiring transportation service under Rate Schedule FT-2 must support its maximum daily quantity (MDQ) by a life of reserves forecast. As part of its initial request for service, an FT-2 shipper may request a separately stated MDQ for specified Delivery Periods of not less than three consecutive months, and those MDQ's will be set forth in Exhibit A to its services agreement. Prior to the initiation of service under a shipper's FT-2 agreement and thereafter at least six months before each calendar year, HIOS may request a shipper to update its production profile to support its MDQs and, when available, to provide an actual production history for its committed leases and an update of its technical data. The shipper must reduce, and may increase, its MDQ as may be appropriate based on the production profile. In addition, the shipper has the right to change at any time and for any reason, the MDQs for any Delivery Period set forth in Exhibit A to its FT-2 Agreement on six months prior written notice to HIOS.

98. Rate Schedule FT-2 also includes a provision that, if the average throughput level for the production month being billed and the immediately preceding two months (the "three month period") is less than 80 percent of the average of MDQs specified in the FT-2 agreement for the three-month period, the shipper will be subject to reservation and usage charges for the second production month following the three-month period. Rate Schedule FT-2 also includes a rate for authorized overrun service in excess of MDQ which is equal to the one-part volumetric rate for service within MDQ.

99. In the January 24, 2005 Order, we affirmed the ALJ's finding that HIOS had failed to justify its proposal to use end-of-test-period MDQs of its two firm FT-2 shippers as the starting point for determining its firm rate design volumes, with various adjustments described in the January 24 Order.[91] We found that the circumstances of the case warranted deviating from out usual policy of using contract demand on the last day of the test period as the firm billing determinants used in designing the pipeline rates. We found that in the ordinary case, the pipeline charges a two-part rate for firm service, with

[91] 110 FERC at P 172.

all fixed costs recovered through a reservation charge billed on each unit of contract demand. Here, however, HIOS charges the FT-2 shippers a one-part volumetric rate so long as they maintain throughput of at least 80 percent of contract demand, which HIOS argues its FT-2 shippers will do. Thus, we found that HIOS will recover the fixed costs allocated to FT-2 service through a volumetric rate based on actual usage of the system. We found that it therefore is appropriate to design that one-part rate based on a projection of the FT-2 shippers' actual usage of the system as opposed to their contract demand. Further, we found that it is appropriate to include overrun throughput in total billing determinants because the FT-2 rates includes a one-part overrun rate that is the same as the one-part rate for service within contract demand. The Commission also pointed out various flaws in HIOS' proposal to use shippers' MDQ nominations in effect on the last day of the test period as the starting point for developing rate design volumes. The Commission found, among other things, that the shippers' nominated MDQs were "only a prediction of how much throughput they will take in any given month,"[92] and that while the shippers gradually reduced their MDQ nomination during the twelve months ending June 30, 2003, their throughput did not decline.

100. In its request for rehearing, HIOS argues that it is the Commission's policy to use actual MDQs to design firm rates, instead of using imputed units that include firm shippers' interruptible overrun volumes. Moreover, HIOS claims that it is established Commission policy to base rates on contract demands in effect on the last day of the test period.[93] HIOS states that the Commission uses actual end-of-test period firm MDQs to design firm rates because such billing determinants reflect the best evidence of what will exist for the pipeline once the rates go into effect.[94] HIOS argues that in accordance with this precedent, HIOS' proposed firm billing determinants were based on actual end-of-test period MDQs. HIOS further argues that the Commission abandoned this policy in the January 24 Order without giving a valid explanation. HIOS argues that by using calculations including interruptible overruns, the Commission overstated HIOS' firm contract volumes by several orders of magnitude. HIOS claims that this is one of the major factors that led to the January 24 Order imposing a 9.2 cent rate for HIOS service.

101. HIOS contends that the Commission should examine the facts surrounding HIOS' contractual relationship with its firm and interruptible shippers. It states that its shippers' MDQs are more than a "prediction". Instead, HIOS argues that the gas transported by it for its FT-2 shippers is casinghead, must-take gas from the deepwater Gulf of Mexico.

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[92] 110 FERC at P 184.

[93] HIOS Request for Rehearing at 56, citing *Iroquois Gas Transmission Sys., L.P.*, 81 FERC ¶ 63,012 at 65,110-11 (1997).

[94] *Id*.

HIOS notes that its witness Porter explained that both ExxonMobil and BP were adamant during contract negotiations that their reserves be contracted under a firm service. HIOS explains that the two companies required absolute assurance of an uninterrupted flow along with the crude production, and that if the gas is for some reason not transported by HIOS, there in no storage into which to place that gas on other facility to which that gas may be diverted.

102. HIOS further argues that it acted in reliance upon the Commission's continuing use of actual MDQs with an 80 percent minimum bill for calculating rates. It asserts that it might have altered its 80 percent nomination policy if it had known that its program to bring flexibility to its shippers would be used against HIOS. HIOS states that the Commission's ruling will chill offshore pipeline development, where many pipelines offer similar flexible service.[95] HIOS argues that pipelines that find themselves similarly situated with HIOS will know that shipper-friendly volume provisions such as those put in place by HIOS will put the pipelines in peril of gamesmanship by shippers, inaccurate and inefficient firm contracting and MDQ adjustments and, ultimately, lowered rates in the next case. HIOS claims that the provision was put in place solely for the flexibility of HIOS' shippers, and that it would be unfair to penalize HIOS for actions intended to benefit HIOS shippers.

Commission Determination

103. We deny HIOS' request for rehearing on this issue. HIOS is correct that the Commission usually uses contract demand on the last day of the test period as the firm billing determinants used in designing rates. However, HIOS is mistaken in its assertion that we gave no reason for departing from our usual practice. The Commission has stated clearly – as noted in the January 24 Order, citing *Trunkline Gas Co*.[96] -- that we will consider other approaches to projecting long-term contract demand when the circumstances of a case so require.[97] In the January 24 Order, the Commission decided that this was such a case and explained in detail why a departure from our usual practice is necessary. Most importantly, our usual policy has been applied in the context of an ordinary firm service, where the firm customers' contract demands are fixed for the terms of their contracts and the pipeline charges a two-part rate for firm service with all, or a

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[95] HIOS cites Sea Robin Pipeline Co., LLC, Nautilus Pipeline Co., LLC, Discover Gas Transmission LLC and Trunkline Gas Co. LLC as examples. HIOS Request for Rehearing at 60.

[96] *Trunkline Gas Co*., 90 FERC ¶ 61,017 (2000).

[97] Initial Decision at P 183, citing *Trunkline Gas Co*., 90 FERC ¶ 61,017 at 61,084 (2000).

substantial part, of the pipeline's fixed costs recovered through a reservation charge billed on each unit of contract demand. In that situation, the recovery of the pipeline's fixed costs is based on contract demand levels, irrespective of actual throughput. Here, the firm customers' contract demands may be renominated every three months and, as HIOS argues, the firm customers will be charged a one-part volumetric rate billed on each unit of throughput. Therefore, unlike the typical situation, HIOS will recover its cost of service based on actual throughput, not on the basis of contract demand.

104. In addition, HIOS' own proposal does not use contract demand in effect on the last day of the test period. Recognizing that the firm customers will be billed on a volumetric basis, HIOS proposes to convert the daily MDQs in effect on the last day of the test period into an annual entitlement. It then reduces that annual entitlement by 20 percent on the ground that FT-2 shippers were only required to maintain throughput at 80 percent of their entitlements to be billed on a volumetric basis. In essence, it projects that the FT-2 shippers will use the end of test period nominated MDQs at an 80 percent load factor usage. However, that projection is not reasonable. As the Commission found,[98] and HIOS does not contest on rehearing, the FT-2 shippers' load factor usage including overrun services was above 100 percent for eleven of the past twelve months of the test period, and substantially above 100 percent during the last five months of the test period. HIOS' projection that the FT-2 shippers would only use their MDQs at about an 80 percent load factor usage was based on data showing the FT-2 shippers'average load factor usage during the period 2000 to 2003 was 83 percent. However, the Commission generally considers usage over the last twelve months of the test period most representative data for projecting future usage (here July 2002-June 2003), since it is more reflective of the conditions that will occur during the period that the rates will be in effect.[99] That is particularly true here, where the FT-2 shippers have reduced their MDQs over the period since 2000, so that the data HIOS relies on from before the July 2002 period is not reflective of their current reduced MDQs. Designing rates based upon a lower throughput level than is reasonably predicted to occur, as HIOS proposes, is not appropriate because it will allow HIOS to over collect its cost of service.

105. In its rehearing request, HIOS asserts that firm service is very important to FT-2 shippers in disputing our statement that the nominated MDQs were only predictions of future usage, as opposed to more typical contract demands. But MDQs could be renominated every three months, unlike usual CDs that are fixed for the duration of the contract. Moreover, the rehearing request actually concedes that some HIOS shippers

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[98] 110 FERC at P 185.

[99] *Trunkline,* 90 FERC ¶ 61, 017 at 61,081.

game the system and nominate MDQs at much lower volumes than they will actually be delivering,[100] and that a gaming shipper knows that it is in no real jeopardy for receiving all the firm overrun service that it desires, because HIOS' system is underutilized.

106. HIOS also argues that the Commission improperly included interruptible overrun volumes in its calculation of the reservation billing units used to design HIOS' FT-2 rates. However, interruptible throughput is appropriately reflected in the reservation billing units used to design a pipeline's rates in order to ensure an appropriate allocation of the pipeline's fixed costs to interruptible services.[101] Therefore, in addition to including a representative level of throughput for service within contract demand in designing the FT-2 rates, it is also appropriate to include a representative level of interruptible overrun throughput for volumes transported in excess of contract demand. HIOS proposed to take into account interruptible overrun service by including 11.1 MMDth of overrun volumes in its IT projection, based on overruns during 2002. However, that proposal is not consistent with Commission policy that IT and overrun volumes should be projected based on usage of these services over the last 12 months of the test period. Overrun volumes during the last 12 months of the test period were over 16 MMDth per month,[102] and that is the amount reflected in the reservation billing determinants we have used to design HIOS' rates. In addition, we reject the notion that we are penalizing HIOS for attempting to put in place "shipper friendly" provisions. Instead, we are merely attempting to design HIOS' rates based upon a reasonable projection of the customers' utilization of the system. Accordingly, we find that the Commission was correct to affirm the ALJ's decision.

V. Fuel Use and LAUF Gas

107. HIOS'existing tariff has a provision that allows it to retain a portion of the volume of gas it receives for transportation from each shipper that is attributable to its system compressor fuel and LAUF gas. Section 1.6 of the GT&C in HIOS' tariff based the level of this retention on the ratio of HIOS' total system fuel use and LAUF during the preceding three calendar months to HIOS' total received volumes during the preceding three calendar months. The tariff does not, however, expressly state the fuel and LAUF retention percentage. Instead, HIOS posts the applicable percentages, as they may change from month to month, on its website.[103] The posting lists only one combined

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[100] HIOS Request for Rehearing at 58-59.

[101] *See, e.g., Panhandle Eastern Pipe Line Co.*, 71 FERC ¶ 61,228 at 61,065 (1995).

[102] January 24 Order at P 186.

[103] Exh. EM-1 at 5.

percentage that represents the charge for both fuel and LAUF. For more than a decade until November 1, 2002, HIOS consistently posted a fuel retention percentage of 1.00 percent. Beginning in that month, HIOS posted an increase in its fuel retention percentage above the historical level to 1.25 percent. In January 2003, the percentage rose to 1.50 percent, and remained there until May 2003 when the percentage rose to 2.18 percent, more than double the historical level. The percentage dipped slightly to 1.97 percent in July 2003, and dipped again in August 2003 to 1.71 percent.

108. HIOS did not propose any changes to its tariff provisions concerning fuel in its original filing in this rate case. However, Indicated Shippers and ExxonMobil contended HIOS should be required to implement a fuel tracker with an annual true-up of over or underrecoveries. At the hearing, HIOS offered to adopt a fuel tracking mechanism, under which each year's fuel retention percentage would be based on the average of the last three-years' fuel use and LAUF and there would be no mechanism for truing up past over or underrecoveries. ExxonMobil also sought an investigation into whether HIOS had retained more fuel in the past than its tariff then in effect allowed.

109. In the January 24 Order, we ordered HIOS, pursuant to NGA section 5, to revise its tariff to implement a fuel tracking mechanism that includes a "true up" provision. We found, citing a contemporaneous order in *ANR Pipeline Co.*,[104] that when a pipeline is permitted to track changes in a particular cost item without regard to changes in other cost items, there should be a guarantee that the changes in that cost item are tracked accurately. We found that this can only be accomplished if the tracking mechanism includes a provision for truing up over and underrecoveries.[105]

110. The January 24 Order also stated that, in light of the requirement that HIOS add a true-up mechanism, HIOS could modify the fuel recovery mechanism it proposed in the hearing to use a one-year average rather than a three-year average of fuel use to project its future fuel use. The Commission pointed out that in *ANR*, the Commission was permitting ANR to use the most recent calendar year data on the grounds that such data is likely to produce a more accurate projection of actual use during the next year than the use of three and four year average data.[106] The Commission noted that it is reasonable to believe use of the most recent calendar year data is more likely to minimize the need for

[104] 108 FERC ¶ 61,050 (2004), *reh'g denied*, Docket No. RP04-201-002 (2005).

[105] *Id*. at P 26.

[106] *Id*. at P 174.

substantial true-up surcharges. However, the Commission stated that, if HIOS wished to retain the smoothing effect of using multiple year averages to determine its fuel retention percentages, including spreading the true-up of averages of over and underrecoveries over a period of more than a year, it would be free to do so.

111. Finally, the Commission stated that it was requiring modifications to HIOS' existing tariff without any showing that HIOS has been in violation of its previously effective FERC gas tariff, and the Commission therefore held that any retroactive remedies would be inappropriate.

112. No party sought rehearing of our requirement that HIOS implement a tracker with a true-up mechanism. The only rehearing requests focus on the fact that we gave HIOS the option of using multiple year average data to project fuel use, and our failure to require a further investigation into whether HIOS had violated its current tariff during previous periods.

A. Data for Projecting Fuel Use

113. The Indicated Shippers argue that the Commission erred in giving HIOS the option of projecting fuel use based on average fuel use over a multiple year past period. Indicated Shippers contend that the January 24 Order should have ordered HIOS to project future fuel use based solely on the preceding year's fuel use. The Indicated Shippers argue that in permitting HIOS to use multiple-year averaging, the Commission has mistakenly assumed that this approach will provide a smoothing effect to benefit ratepayers. The Indicated Shippers argue that the record does not support this assumption. Instead, they argue that use of three year or four year averages would permit HIOS to continue to include in its fuel rates the unexpected LAUF increases that surfaced in November 2002 for several years.[107]

114. The Commission denies rehearing on this issue, but does clarify its ruling in the January 24 Order. In that order, the Commission exercised its authority under NGA section 5 only to order HIOS to implement a fuel tracker that included a true-up mechanism. We left open for further consideration, in light of HIOS' compliance filing, all issues concerning the exact provisions of the fuel tracker and true-up mechanism. Thus, our intent in stating that HIOS would be free in its compliance filing to use multiple-year average fuel use data to determine its fuel retention percentages was only to permit HIOS to propose the use of multiple-year averages, not to pre-approve such use. Allowing HIOS to make such a proposal was consistent with our holding in *ANR* that the Commission had only found that ANR's failure to have a true-up mechanism was unjust and unreasonable, and ANR could propose to use multiple year average date to project

[107] Indicated Shippers Request for Rehearing at 6.

fuel use in its compliance filing.[108] We therefore clarify that the January 24 Order made no ruling on the justness or reasonableness of the use of one-year vs. multiple year average fuel use data in order to project fuel use. That issue will be considered below when we consider HIOS' proposal in its compliance filing to use three-year average fuel use data to project its future fuel use.

B. Refunds for Past Tariff Violations

115. In its rehearing request, ExxonMobil contends that the Commission erred in refusing to investigate further into whether HIOS during the past failed to comply with existing provisions of its tariff concerning fuel retention. ExxonMobil seeks an opportunity to determine whether HIOS overcharged for its fuel use and LAUF during the period beginning in November 2002 by failing to comply with section 1.6 of its GT&C as then in effect, which required that the fuel retention percentage be based on the ratio of HIOS' total system fuel use and LAUF during the preceding three calendar months to HIOS' total received volumes during the preceding three calendar months. ExxonMobil asserts that, to the extent HIOS violated that tariff provision during the period it was in effect, the Commission may order refunds of any overcollections. ExxonMobil adds that it does not seek retroactive application of the new fuel/LAUF tariff provision, and therefore the requirement that section 5 action be prospective only does not apply to this aspect of the case.

116. ExxonMobil contends that HIOS' 2002 annual Form No. 2 report to the Commission raises legitimate questions regarding the basis for HIOS' historical fuel retention under its tariff beginning in November 2002, when HIOS substantially increased its fuel retention percentages above the historical one percent level. In that report, HIOS advised the Commission that it was "taking numerous steps to determine the cause of the fuel differences, including a review of receipt and delivery measurement data. At December 31, 2002, the Company had recorded fuel differences of approximately $5.2 million included in FERC account 186, deferred debits. At March 31, 2003, this difference was $8.2 million. At this time, the Company is not able to determine what amount, if any, may be collectible from its customers." ExxonMobil claims that HIOS never released the results of its investigation to the Commission or the parties. ExxonMobil reiterates its request that the Commission require HIOS to file a report on the outcome of its investigation, including data sufficient to support its conclusions.

[108] *ANR*, 110 FERC at P 43 and 51.

117. ExxonMobil argues that HIOS' contention that refunds are foreclosed is contradicted by HIOS' reservation of the right to surcharge for under-collections for the same period and under the same tariff. ExxonMobil explains that although HIOS did not previously take this position in this rate case, in its compliance filing pursuant to the January 24 Order, HIOS has apparently proposed retroactive fuel and LAUF surcharges in its February 14, 2005 compliance filing pursuant to the January 24 Order.

118. ExxonMobil further argues that the Commission must clarify on rehearing that HIOS may not seek surcharges attributable to the period that the previous fuel and LAUF provision was in effect. ExxonMobil states that HIOS has never responded directly to ExxonMobil's arguments that the Commission should not permit future surcharges in this case.

119. We deny ExxonMobil's request on rehearing that we initiate an investigation into whether HIOS properly complied with section 1.6 of its GT&C during the period starting in November 2002. We recognize that, when a pipeline violates its tariff, as ExxonMobil suggests HIOS may have done, the Commission has the authority to order refunds of any excess amounts the pipeline collected. However, whether to initiate such an investigation is within the Commission's discretion.[109] The Commission does not believe the current circumstances warrant devoting the Commission's limited resources to investigating whether HIOS may have determined the fuel retention percentages posted on its website during the period starting in November 2002 in a manner different than that provided in section 1.6 of its tariff. The mere facts that (1) HIOS' posted fuel use retention percentage increased during the period beginning November 2002 and (2) HIOS stated in its 2002 Form No. 2 report that it was seeking to determine why its fuel use had increased do not provide a basis, by themselves, for suspicions that HIOS was not following its tariff. Under the previous tariff, increased fuel use would lead to a relatively quick increase in the posted fuel use retention percentage, since each month's fuel retention percentage was based on the previous three months fuel use, and it was certainly reasonable for HIOS to investigate why its fuel use had suddenly increased.

[109] *Heckler v. Chaney*, 470 U.S. 821, 831-2 (1985) ("an agency decision not to enforce often involves a complicated balancing of a number of factors which are peculiarly within its expertise. Thus, the agency must not only assess whether a violation has occurred, but whether agency resources are best spent on this violation or another, whether the agency is likely to succeed if it acts, whether the particular enforcement action requested best fits the agency's overall policies, and, indeed, whether the agency has enough resources to undertake the action at all.")

120. However, the Commission will grant ExxonMobil's request that we hold that HIOS may not initiate a surcharge to collect any underrecoveries of fuel that may have occurred under its tariff in effect prior to our section 5 action in this proceeding. As previously discussed, HIOS' previous tariff contained no mechanism for truing up past over- underrecoveries. Therefore, while HIOS could retain any overrecoveries under the previous tariff (apart from those resulting from a tariff violation), it also had to absorb any underrecoveries. For HIOS now to propose to surcharge such past underrecoveries to its customers would violate the filed rate doctrine and the rule against retroactive ratemaking.

VI. Compliance Filing

121. In its February 14 compliance filing, HIOS filed Second Revised Sheet No. 10, *pro forma* tariff sheets,[110] and a summary of its fuel calculation, to comply with the January 24 Order. HIOS states it tendered Second Revised Sheet No. 10 to restate the subject-to-refund rates to the previously approved rates for the retroactive period, and *pro forma* Sheet No. 10 to set forth the rates for the prospective period, reflecting the rates resulting from the required changes in the cost of service. HIOS proposes a July 1, 2003, effective date for Second Revised Sheet No. 10, because that is the date that the rates were placed into effect subject to refund in this proceeding.

122. HIOS states the remaining *pro forma* sheets implement the requisite fuel adjustment mechanism and true-up provision. HIOS notes that *pro forma* Sheet No. 11 sets forth the initial compressor fuel, LAUF, and true-up percentages calculated pursuant to the new mechanism, *pro forma* Sheet Nos. 173A and 173B reflect new section 28 of the General Terms and Conditions of the tariff, which establishes the methodology for the new fuel mechanism, and *pro forma* Sheet Nos. 2, 64, 65, 67 and 69 reflect miscellaneous conforming changes to implement this mechanism. HIOS proposes that the tariff sheets implementing the fuel adjustment mechanism and true-up provision be effective on the first day of the month following the Commission's acceptance of those tariff sheets. HIOS states that an effective date on the first day of the month eliminates the need for split-month billings and services.

123. HIOS states the annual fuel adjustment mechanism established in section 28 provides that HIOS will compute separate compressor fuel and LAUF percentages, as required by the January 24 Order. The compressor fuel percentage will be the quotient of (a) the average of the three previous calendar years' actual compressor fuel use, and (b) the projected receipts on HIOS for the recovery year. The LAUF percentage will be calculated in the same way using the average of three previous calendar year's LAUF. HIOS states that each year, to account for variances due to both actual versus billed

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[110] *See* the Appendix for a full listing of the tendered tariff sheets.

company-use gas and projected versus actual receipts, HIOS will separately calculate and state a company-use gas true-up percentage. HIOS explains that the company-use true-up percentage will be calculated as the quotient of (a) any over or under collection of company-use gas, and (b) the projected receipts on HIOS for the recovery year. HIOS states that total company-use gas consists of three components: (1) compressor fuel, (2) LAUF, and (3) company-use true-up gas.

124. HIOS proposes, pursuant to this mechanism, to establish an initial compressor fuel percentage of 0.90 percent, an LAUF percentage of 0.64 percent, and an initial true-up percentage of 1.30 percent, for a total of 2.84 percent, all as shown on *pro forma* Sheet No. 11. In support of the proposed fuel and LAUF rates, HIOS included Attachment B, a summary of the fuel calculation. Attachment B provides: (a) 2002, 2003, and 2004 fuel and LAUF quantities, with three-year averages (Lines 1-8); (b) Company Use True-up of 2,630,701 (Line 9); (c) Carrying Charges of 506,706 (Line 10); (d) Total Company Use True-up of 3,137,407 (Line 11), which is the sum of Lines 9 and 10; (e) Projected Receipts (April 2005 – March 2006) of 240,608,000 (Line 12); and (f) the percentage fuel, LAUF, Company Use True-up and Total Company Use rates (Lines 13-16). Although not specified, the Commission assumes all of these quantities reflected on Lines 1-12 are stated in dekatherms.

<u>Notice, Interventions and Protests</u>

125. Public notice of the instant filing was issued on February 17, 2005. Protests were due as provided in section 154.210 of the Commission's regulations.[111] On February 28, 2004, Indicated Shippers and ExxonMobil filed a protest. On March 15, 2004, HIOS filed an answer to these protests. HIOS states the answer will provide relevant information, clarify certain errors and misstatements in the protests, and will lead to a more complete and accurate record, as well as a better understanding of the filing, which should assist the Commission in reaching a decision on the compliance filing. Although answers to protests are not generally permitted, the Commission will accept HIOS' answer as it will assist the Commission with a more complete record in this case.[112]

126. Indicated Shippers assert that the Commission should: (1) order HIOS to revise its proposed tariff provision to require that its annual fuel charge be calculated on the basis of actual throughput during the prior year, rather than projected throughput for the coming year, and (2) reject the proposed true-up as an impermissible retroactive rate mechanism. ExxonMobil requests that the Commission reject *pro forma* Sheet No. 11, or

[111] 18 C.F.R.§ 154.210 (2004).

[112] 18 C.F.R. § 385.213 (a) (2) (2004).

suspend the rates for the maximum period and set the charges set forth on Sheet No. 11 for an evidentiary hearing to resolve the material issues of fact raised by these unsupported and unlawful rates.

127. Further, ExxonMobil asserts the filing is legally deficient under section 154.403 of the Commission's regulations because it fails to provide the information required under that provision.[113] Additionally, ExxonMobil asserts the filing is an attempt to impose an unauthorized and unlawful "Company Use True-up" that contravenes the January 24 Order, the Commission's regulations, and constitutes unlawful retroactive ratemaking in violation of the NGA and Commission precedent.

Discussion

Averaging Method versus One-Year Method

128. In the January 24 Order, the Commission held that in light of the requirement that HIOS add a true-up mechanism, HIOS *may* modify the fuel recovery mechanism it proposed in the hearing to use a one-year average rather than a three-year average of fuel use to project its future fuel use. (Emphasis added.) In its compliance filing, HIOS has opted to project its fuel use and LAUF for purposes of calculating its compressor fuel and LAUF retention percentages based upon actual fuel use and LAUF use from the previous three years.

129. In their opposition to the use of average three-year fuel and LAUF data to calculate current fuel rates, Indicated Shippers reiterate the same arguments as discussed in their request for rehearing of the January 24 Order, arguing that data from the most recent one-year period will more accurately reflect HIOS' fuel costs. Similarly, ExxonMobil suggests that the Commission may want to reconsider and require HIOS to use a one-year period, rather than a three-year period, to project fuel use and LAUF, asserting that the dramatic swings in the LAUF quantities during 2002-2004 appear to make smoothing HIOS' year-to-year rates fairly hopeless.

130. In its answer to the protests, HIOS asserts that the use of a three-year period does in fact have a smoothing effect, noting that the three years included in the filing demonstrate such a smoothing effect. HIOS explains that, as reflected in Attachment B, LAUF was as low as 897 MDth in 2004 and as high as 2,361 MDth in 2003, but the average LAUF rate for 2002, 2003 and 2004 was 0.64 percent. HIOS concedes that if only data from the lowest year of 2004 were used, the LAUF rate would be 0.37 percent, which is lower than the three-year average. However, in contrast, HIOS notes it is also

[113] Section 154.403 applies to, among other things, revisions on a periodic basis of a gas reimbursement percentage.

true that if only the highest year of 2003 were utilized then the LAUF rate would be 0.98 percent, which is nearly 50 percent higher than the rate under the three-year average. Thus, HIOS states the purpose of the three-year average is to smooth out the highs and lows and promote rate stability.

131. The Commission accepts HIOS' proposal to calculate its fuel and LAUF percentages based upon average three-year fuel data and denies the protests in this regard. While the Commission is acting here under NGA section 5 to require HIOS to implement a fuel tracker with a true-up mechanism, the Commission also takes into account the fact that the NGA delegates to the pipeline the primary initiative to propose the rates, terms, and conditions for its services under NGA section 4. If the rates, terms, and conditions proposed by the pipeline are just and reasonable, the Commission must accept them, regardless of whether other rates, terms and conditions may be just and reasonable.[114] Consistent with this structure of the NGA, the Commission believes it appropriate in this case to give HIOS a similar initiative in proposing the specific provisions of the required fuel tracker and true-up mechanism. To the extent the provisions of HIOS' proposed tracker and true-up mechanism are just and reasonable, the Commission will approve those provisions, even though other just and reasonable provisions might exist.

132. We find reasonable HIOS' proposal to calculate its fuel retention percentages based on its average fuel use and LAUF over the preceding three calendar years in order to retain the smoothing effect that such averaging allows. Further, HIOS has demonstrated in its filing that it is likely that such a smoothing effect will, in fact, occur. Thus, HIOS' proposal in this regard is accepted to be in compliance with the January 24 Order.

Projected Throughput vs. Actual Throughput

133. In the January 24 Order, the issue of whether to use projected throughput or actual throughput from a past period as the denominator for calculating annual fuel and LAUF percentages was not discussed, because the issue was never raised in the proceeding.[115] In its compliance filing, HIOS proposes to use projected throughput as the denominator for calculating the annual fuel and LAUF percentages.

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[114] *Consolidated Edison Co. v. FERC*, 165 F.3d 992, 998, 1002-1004 (D.C.Cir. 1999), and cases cited.

[115] Although HIOS' witness, Richard W. Porter, did propose in his rebuttal testimony a fuel tracker based on average fuel and LAUF for the previous three years divided by the average billed volumes for the same period. *See* Exh. HIO-91 at 37-42.

134. Indicated Shippers argue that the prior year's actual throughput, instead of the forecasted future throughput, should be used for the purpose of calculating the fuel charge. Indicated Shippers assert that the relatively high level of gas prices underscores the importance of calculating fuel charges based on current data, which would be the prior year's actual throughput. Indicated Shippers note that as a general matter such a procedure is similar to the approach the Commission uses in rate cases of accepting the most recent actual test-period data as the best evidence of what volumes are expected to be once the rates take effect.

135. HIOS answers that the use of projected throughput volumes in the calculation of its fuel charge is simply a refinement of its hearing proposal designed to implement the tracker with the best and most current estimate of the volumes for which LAUF will be recovered. HIOS asserts this approach should benefit shippers by making fuel and LAUF collections and actual fuel and LAUF use correspond more closely, thus reducing the size of the level of the following year's true-up.

136. The Commission finds Indicated Shippers' argument unpersuasive. As discussed above, we will accept HIOS' proposed calculation method if it is just and reasonable, even if other just and reasonable methods may be available. While the Commission has approved provisions in some pipelines' tariffs for the use of actual throughput in their calculations of fuel and LAUF charges,[116] the use of projected throughput, rather than actual throughput from a past period, gives the pipeline greater flexibility to adjust the throughput volumes used to calculate its fuel retention percentage based on its best estimate of the next year's throughput as of the date of its filing. The pipeline is free to take into account recent developments such as contract terminations and expected new contracts. Also, the fact that the true-up mechanism ensures that the pipeline must return any over-recoveries leaves the pipeline little incentive to lowball its projection for purposes of raising its fuel retention percentage. The Commission has also approved other pipelines' use of projected throughput. Thus, we find HIOS' method to be reasonable and not inconsistent with the methodology used by other pipelines in the calculation of their annual fuel and LAUF percentages. Accordingly, the Commission accepts HIOS' use of a forecasted throughput to calculate its proposed fuel and LAUF percentages. Indicated Shippers' protest in this regard is denied.

[116] *See, e.g.*, the methodology in the tariff provisions of Florida Gas Transmission Company and Gulfstream Natural Gas System, L.L.C., which are based on projected throughput, and Chandeleur Pipe Line Company and Destin Pipeline Company, L.L.C., which are based on actual throughput.

The True-Up Mechanism

137. In the January 24 Order, the Commission required HIOS to add a true-up mechanism to a modified annual fuel and LAUF recovery mechanism. In its compliance filing, HIOS proposed a separate true-up mechanism. HIOS explains that the company-use true-up percentage will be calculated as the quotient of (a) any over or under collection of company-use gas, including compressor fuel, LAUF, or the prior year's true-up percentage, and (b) the projected receipts on HIOS for the recovery year.

138. The protestors do not contest HIOS' proposed true-up mechanism. However, they do protest HIOS' proposal to use that true-up mechanism to recover under-recoveries incurred before the effective date of the new mechanism. HIOS also proposes to establish an initial true-up retention percentage of 1.30 percent for the purpose of recovering (1) alleged under-recoveries reflected on its books at the end of the calendar year prior to the proposed effective date of its new fuel recovery mechanism, and (2) carrying charges on those under-recoveries. The protestors assert that the proposal should be rejected as unlawful, retroactive ratemaking. They argue that, under HIOS' new fuel mechanism, a true-up should not occur until the year following the first year that the new fuel tariff provision is in effect. The protestors note that this proposed initial true-up retention percentage could recover in excess of $16 million of previously un-recovered fuel costs, plus carrying charges.[117]

139. The protestors argue that the filed rate doctrine forbids a regulated entity to charge rates for its services other than those properly filed with the appropriate regulatory authority, and enables purchasers to know in advance the consequences of the purchasing decisions they make. They assert that HIOS' true-up for past under-recoveries would violate the ban on retroactive rates, because HIOS would be able to use its new fuel charge to recover under-recovered fuel costs associated with the period that goes back three years before the Commission approved the fuel tracker mechanism. This retroactive rate would have the practical impact of increasing the fuel rate that shippers paid during this retroactive period to allow HIOS to recoup the under-recovery of fuel costs, even though the fuel charge during the retroactive period was a fixed charge unilaterally established by HIOS without a true-up provision. Further, the protestors note that section 5(a) action can only have prospective impact, but state that the proposed true-up would give retroactive effect to the Commission's finding.

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[117] The $16 million estimate was calculated assuming different gas prices. Indicated Shippers used the Gulf Coast February bid-week gas price of $6.32 per Dth to calculate the true-up, resulting in a Company Use True up, without carrying charges, of $16.6 million. ($6.32 * 2,630,701 = $16,626,220) ExxonMobil used HIOS' January 2005 posted cash-out price of $6.19 to calculate the true-up, resulting in a Company Use True up, without carrying charges, of $16.3 million.

140. For the same reasons, the protestors assert the Commission should reject HIOS' proposed, unexplained and unsupported carrying charges, contending these charges should be a dollar amount and not a thermal quantity, and asserting that they constitute an impermissible retroactive rate, just like the associated true-up quantity, that effectively preclude HIOS from recovering its past period un-recovered fuel costs. ExxonMobil asserts that if the Commission does not reject the true-up it must direct HIOS to support its proposal by filing a report on the outcome of its investigation into its historical fuel and LAUF.

141. In its answer to the protests, HIOS asserts the compliance filing should be accepted by the Commission, but states that, because of apparent confusion by the protestors, if the Commission does not reject the protests, a technical conference might assist the parties in a better understanding of how the filing complies with both the January 24 Order and applicable law. HIOS states it has no incentive to over-recover fuel under its proposed tracker mechanism because it is required to true up all such volumes together with carrying charges calculated at the rates established by the Commission.

142. HIOS states, pursuant to its proposal in the hearing, fuel would have been calculated based upon a three-year average, with no true-up. HIOS contends this approach would have obviated any need for any annual or transitional true-up. However, HIOS notes at the insistence of protestors the Commission ordered HIOS to implement an annual true-up mechanism in connection with fuel and LAUF recovery in the January 24 Order. Thus, HIOS states the proposal provides for a true-up of the un-recovered fuel and LAUF balance as reflected on its books at the end of the calendar year prior to the commencement of the true-up period, which is what is reflected in the compliance filing and what will be reflected in each subsequent filing.

143. HIOS asserts that the proposed true-up does not constitute unlawful retroactive ratemaking. HIOS states if the filed rate doctrine and prohibition against retroactive ratemaking prohibit all adjustments to current rates to make up for previous over or under collections, then no tracker would pass muster, since all trackers by definition adjust current rates to make up for over or under collections. HIOS asserts that neither its proposal nor any other tracker is unlawful retroactive ratemaking, because such trackers operate to establish a charge, applicable upon proper notice to all customers, which applies only prospectively to service taken after the true-up surcharge is established. In addition, HIOS asserts that, for the same reason, the addition of carrying charges to the un-recovered fuel and LAUF balance used to determine the true-up surcharge is also consistent with the filed rate doctrine.

144. HIOS explains that it calculated the proposed carrying charges by pricing out any over or under collection of fuel and LAUF at the HIOS cash-out price in the month that it occurred. Further, HIOS notes that interest was calculated on these monthly values at the Commission-approved interest rates, and the total dollar interest was converted back to a volume at the weighted average cash-out price for the over or under collection period for purposes of calculating a carrying charge percentage.

145. The Commission rejects HIOS' proposed initial true-up percentage of 1.30 percent, which reflects the true up of under-recoveries that occurred before the effective date of the new tariff mechanism and carrying charges, and directs HIOS to reflect a 0.00 percentage for this component when it files an actual, revised tariff sheet in place of the applicable *pro forma* tariff sheet. While we recognize that the January 24 Order required HIOS to add a true-up mechanism to a modified annual fuel and LAUF recovery mechanism, we agree with the protestors that HIOS' proposed initial true-up percentage constitutes retroactive ratemaking, because the true-up percentage has been calculated to collect past under-recovered fuel costs before the new fuel tracker including the true-up mechanism becomes effective. We direct HIOS to implement the true-up mechanism in its second annual fuel filing to be effective April 1, 2006, reflecting the surcharge of over and under collection of gas during the calendar year of 2005. This action is consistent with our order in *ANR Pipeline Company (ANR)*,[118] where the under-recoveries and over-recoveries to be trued up by the pipeline are only those accruing after the date of our section 5 action.[119]

146. In addition, the Commission declines to set HIOS' compliance filing for hearing, as requested by ExxonMobil, or to initiate a technical conference, as suggested by HIOS. The Commission finds that HIOS' proposed tracker and three-year averaging methodology sufficiently conforms to our directives and precedent, thereby making such proceedings unnecessary.

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[118] 110 FERC ¶ 61,069 (2005); *on reh'g.*, 111 FERC ¶ 61,290 (2005).

[119] In *ANR*, the Commission required the true-up mechanism for the pipeline's March 1, 2005 fuel filing to become effective in the pipeline's next fuel filing of March 1, 2006, reflecting the surcharge of over and under collection of gas during the period April 1, 2005 through December 31, 2005, with subsequent annual filings accounting for over/under recoveries for the entire calendar year.

Supporting Data for Annual Fuel and LAUF Percentage

147. ExxonMobil asserts that, although section 154.403(d) of the Commission's regulations requires the filing of specific supporting information regarding gas reimbursement percentages, HIOS' proposed current fuel and LAUF components do not provide the minimum information needed to comply with the regulations. For example, ExxonMobil asserts that HIOS has not provided (1) workpapers to show the mathematical calculations in support of its proposed fuel and LAUF rates, sources, public or otherwise, for any fuel or LAUF quantities, (2) the projected annual throughput utilized to derive the rate, (3) the requisite monthly data of actual gas inflows and outflows used to calculate the surcharge, and (4) the requisite summary statements showing the accrual of the balance. Further, ExxonMobil asserts that the dramatic swings in the LAUF quantities during 2002-2004 are particularly unusual on a seemingly simple system with only a handful of delivery points, and require explanation.

148. The Commission agrees. HIOS' compliance filing lacks supporting data. Consistent with the requirements of section 154.403 of the regulations, the Commission directs HIOS to file workpapers to support its proposed quantities used to calculate its proposed percentages and to address ExxonMobil's concerns in detail.

Other Tariff Related Issues

149. The Commission has certain concerns regarding HIOS' proposed language in new section 28 of its tariff. As discussed below, the Commission directs HIOS to make certain tariff clarifications when it files revised tariff sheets in place of the *pro forma* tariff sheets.

150. Regarding the new section 28.1(b), the language provides for Intra-Period filings, and states that HIOS may file to make an adjustment to the Company Use Percentage. The section states that such adjustment shall not increase the Company Use Percentage, but shall only decrease the Company Use Percentage. However, HIOS does not state how it will compute the Company Use Charge in the Intra-Period filings. Thus, to ensure a full understanding of this provision, the Commission will require HIOS to revise the language to state that any Intra-Period filing shall, like the annual filing, include workpapers setting forth the calculation of the prospective Compressor Fuel and Unaccounted-For Gas percentages as determined in accordance with section 28.2.

151. Section 28.1 (b) also states that notification of an adjustment shall at a minimum be posted on HIOS' website and may also be provided by other means of electronic communication at least five business days prior to the nomination deadline for the timely nomination cycle as set forth under section 7. Although the language states that HIOS may at any time file to make an adjustment to the Company Use Percentage, it also refers to notification of such adjustment on HIOS' website. The Commission believes this language needs clarifying to state that HIOS is required to file with the Commission for

such an adjustment, which shall be stated in the tariff, but may also post notice of such an adjustment on its website. Thus, because HIOS can not change tariff Company Use rates exclusively through a web site posting, the Commission directs HIOS to modify this language to state that these adjustment will be stated in the tariff.

152. Further, section 28.1(b) states that tariff sheets reflecting the adjustment shall become effective on the date proposed, provided that HIOS files such tariff sheets no more than 60 days and at least seven days before the effective date and shall become effective without prior Commission approval. This provision appears to bind the Commission to approve a fuel rate in advance, possibly without any supporting information. The Commission will not approve tariff language that permits HIOS to change a rate at will on as little as seven days notice through a tariff amendment that the Commission is bound to make effective. Thus, the Commission directs HIOS to modify the proposed language so that any tariff changes must be subject to Commission approval and subject to Commission's notice requirement.

153. As stated above, section 28.1(a) states that HIOS' annual filings shall include workpapers setting forth the prospective fuel and LAUF percentages in accordance with section 28.2. Sections 28.2(a) and 28.2(b) govern, respectively, the methodology HIOS will employ in calculating the compressor fuel and unaccounted-for gas. However, in contrast to the statement in section 28.1(a) that HIOS shall include workpapers in its filings, both sections 28.2(a) and 28.2(b) state that "HIOS shall include supporting workpapers as necessary." (Emphasis added.) Additionally, section 28.2(c), which provides for the company use true-up, states that "HIOS shall include supporting workpapers as necessary." (Emphasis added.) Because section 154.403(d) of the Commission's regulations provides that workpapers must be filed with periodic rate filings, without exception, the Commission directs HIOS to delete the words "as necessary" from these sections.

154. The Commission accepts Second Revised Sheet No. 10 to be effective July 1, 2003, as proposed. With respect to *pro forma* Tariff Sheet No. 10, because it reflects the resulting rates of the required changes in the cost of service, the Commission directs HIOS to file an actual superceding Revised Sheet No. 10, to become effective on January 24, 2005, the date of the order setting just and reasonable rates. The Commission also directs HIOS to file actual, revised tariff sheets in place of the remaining *pro forma* tariff sheets, reflecting the Commission's findings discussed above regarding the fuel issues and fuel charges, to become effective on the first day of the month after this order issues.

The Commission orders:

(A) Second Revised Sheet No. 10 is accepted to become effective July 1, 2003.

(B) HIOS is directed to file an actual tariff sheet superceding Revised Sheet No. 10, to become effective on January 24, 2005, within 15 days of the date of issuance of this order.

(C) HIOS is directed to file actual, revised tariff sheets in place of the *pro forma* tariff sheets, to become effective on the first day of the month following issuance of this order, within 15 days of the date of issuance of this order, consistent with the discussion in the body of this order. HIOS should also include detailed workpapers supporting the derivation of the fuel and LAUF percentages.

(D) The requests for rehearing filed by HIOS, Indicated Shippers, and ExxonMobil are denied for the reasons set out in this order.

(E) Within 30 days of the date of issuance of this order, HIOS is directed to refund to its shippers all revenues collected in excess of the charges approved herein in this proceeding subject to refund, with interest, as specified in section 154.501 of the Commission's regulations.

By the Commission. Commissioner Brownell dissenting in part with a
separate statement attached.

(S E A L)

Magalie R. Salas,
Secretary.

Appendix

High Island Offshore System, L.L.C.
Docket No. RP03-221-003

Tariff Sheet Effective July 1, 2003

Second Revised Sheet No. 10

Pro Forma Tariff Sheets

Pro Forma Tariff Sheet No. 2
Pro Forma Tariff Sheet No.10
Pro Forma Tariff Sheet No. 11
Pro Forma Tariff Sheet No. 64
Pro Forma Tariff Sheet No. 65
Pro Forma Tariff Sheet No. 67
Pro Forma Tariff Sheet No. 69
Pro Forma Tariff Sheet No. 173A
Pro Forma Tariff Sheet No. 173B

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

High Island Offshore System, LLC. Docket Nos. RP03-221-003
RP03-221-004

(Issued July 7, 2005)

BROWNELL, Commissioner, dissenting in part:

Although the order in many instances attempts to limit its holdings to the particular facts of this case, the rejection of the uncontested settlement and certain merits decisions are contrary to the our legal precedent and long-standing policies. Therefore, I dissent for the reasons set forth in *High Island Offshore System, LLC.*, 110 FERC ¶ 61,043 (2005).

While acknowledging that the Commission favors settlements, the order states that we can approve a settlement only if in our independent judgment the settlement is fair and reasonable and in the public interest. I agree. In this case, however, it seems that the Commission has departed from the factors previously used to determine what is "fair and reasonable" and "in the public interest" without stating clearly the reason for the different outcome.

The order continues to point out that the settlement rate (12.44 cents per Dth) is higher than a rate that is a result of litigation (9.2 cents per Dth) and emphasizes that the litigated rate is a just and reasonable rate.[1] HIOS reasserts the argument that the settled rate (12.44 cents per Dth) is substantially lower than the proposed rate (16.16 cents per Dth). With the give and take that is the essence of a settlement, it is expected that the settled rate would somewhere in-between. In approving settlements in the past, the Commission has generally cited a substantial reduction from the proposed rate to be a benefit.[2] Here, the settled rate represents no increase from the pre-existing rate with a three year rate moratorium. Further, there is a come-back provision requiring HIOS to

[1] Order at P15.

[2] *See, e.g., Florida Gas Transmission Company*, 109 FERC ¶ 61,320 at P57 (2004), where the Commission stated that "[w]e find that FTG and its customers benefit from the Settlement. As noted by Trial Staff, the Settlement rates represent very substantial reductions from the rates FGT proposed in its October 1, 2003 general NGA Section 4 rate filing."

justify its rates after three years. Again, the Commission has frequently relied on these types of provisions to find settlements in the public interest because consumers receive the benefits of rate certainty and protection.[3]

The order also continues to point out that the only active party, Indicated Shippers, will receive a $3,000,000 payment while the inactive parties will receive no payment. The order states that the agreement with Indicated Shippers is not in the public interest, citing *Equitrans*.[4] *Equitrans* is inapposite. *Equitrans* involved a contested settlement, a contested settlement that would abrogate a prior settlement, and a severance issue. It did not involve a payment to one party and not others.

In contrast, the Commission did recently approve a settlement with a similar payment provision ($4,500,000) in *Stingray*.[5] In *Stingray*, the settled rate of 10 cents per Dth, which we found to be just and reasonable, was a 21 percent increase from the preexisting rate.[6] Here, the settled rate represents no increase from the pre-existing rate. Yet, the order fails to adequately distinguish the case.

Citing *Williams Natural Gas Company*, 54 FERC ¶ 61,134 at 61,448 (1991), both HIOS and Indicated Shippers argued that the Commission has recognized the appropriateness of providing an additional benefit to a settling party that has shouldered the burden of litigation, as Indicated Shippers have here. Indicated Shippers also asserted that Commission and court precedent endorse the principle that a settlement with special provisions applicable only to active parties is not unduly discriminatory.[7] The Commission fails to offer any factual distinction for the different outcome reached in this case.

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[3] Id. at P37 and 57, where the Commission relied on Trial Staff's assertion that "these provisions afford certainty to all affected parties and allows the Commission the opportunity to review FGT's rates in a reasonable time frame."

[4] Order at P 14.

[5] 101 FERC ¶ 61,365 (2002).

[6] The 100 percent load factor FTS rate ($2.49) is 8.25 cents per Dth including 0.07 cent commodity rate. See Eighth Revised Sheet No. 5 in Docket No. RP99-166-000.

[7] Citing *United Municipal Distribution Group v. FERC*, 732 F.2d 202, 212 (D.C. Cir. 1984) and *Town of Norwood v. FERC*, 202 F.3d 392, 402 (1st Cir. 2000).

The $3,000,000 payment to Indicated Shippers is not an "unreasonable difference in rates" if the parties are not similarly situated. HIOS states that the Indicated Shippers were the only active litigant to contest the entire range of issues in the rate proceeding and assume the associated litigation expense and risk. They were the only party who presented testimony on all issues, prepared and conducted cross-examination of all other witnesses, and fully briefed the contested issues. Because the inactive shippers would realize substantial benefits from other aspects of the settlement, as detailed in my prior statement, I find the payment only to Indicated Shippers an appropriate recognition of their unique role in this proceeding.

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Nora Mead Brownell
Commissioner