UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly. Marc Spitzer,
and Philip D. Moeller.

Columbia Gas Transmission Corp. Docket No. RP06-181-001

ORDER DENYING REHEARING

(Issued July 28, 2006)

1. In this order, the Commission denies the request by Columbia Gas Transmission Corporation (Columbia) for rehearing of the order issued in this proceeding on February 22, 2006.[1] The February Order rejected Columbia's proposal to increase the penalty imposed on shippers who violate certain conditions of Columbia's Storage In Transit (SIT) imbalance management service. The Commission denies Columbia's request for rehearing.

Background

2. Rate Schedule SIT service, available on an interruptible basis to any qualifying shipper, was originally designed as a balancing service for customers with wide swings in daily demand, such as electric power plants.[2] Under section 2(a) of Rate Schedule SIT, when an SIT shipper's actual daily receipts exceed that shipper's actual daily deliveries, the pipeline will, on an interruptible basis, inject the difference ("Undertendered Balance Quantity") into storage. Similarly, when an SIT shipper's actual daily delivery quantity exceeds actual daily receipt quantity, the pipeline will, on an interruptible basis, withdraw the difference ("Overtendered Balance Quantity") from storage. Columbia bills a

[1] *Columbia Gas Transmission Corp.*, 114 FERC ¶ 61,188 (2006) (February 22 Order).

[2] *Columbia Gas Transmission Corp.*, 64 FERC ¶ 61,060 (1993) (order on compliance filings made in response to Order No. 636).

commodity charge on the daily change, if any, in the shipper's undertendered or overtendered balances. The maximum daily rate is four and eleven one-hundredths cents ($0.0411) per Dth of such changes.

3. Pursuant to section 3(b) of Rate Schedule SIT, Columbia also maintains a running net balance of each SIT shipper's undertendered or overtendered balance quantities. Such net balance is referred to as the Imbalance Quantity. That section provides that, twice during any 30-day period, SIT shippers are required to either eliminate any existing Imbalance Quantity, convert any outstanding undertendered balance to an overtendered balance, or convert any outstanding overtendered balance to an undertendered balance. For each 30-day period during which the shipper fails to satisfy this requirement (referred to as "crossing-zero-twice" in the instant proceeding), the shipper is required to pay an imbalance penalty of twenty-five cents ($0.25) per Dth of its existing Imbalance Quantity at the end of such 30-day period.

4. On January 23, 2006, Columbia filed a revised tariff sheet proposing to increase its section 3(b) imbalance penalty from twenty-five cents ($0.25) per Dth to five dollars ($5.00) per Dth. Columbia asserted that due to the recent spike in natural gas prices, the twenty-five cent SIT penalty has created unintended opportunities for shippers to realize financial gains which, Columbia alleges, negatively affect its overall system operations. In its filing, Columbia submitted an example showing how one shipper may have taken advantage of the SIT service to realize a potential financial gain totaling over $4.2 million dollars during the time period from late September through December 31, 2005.

5. Several parties intervened in opposition on the grounds that the proposed increase, inter alia: violates Commission policy by not being narrowly designed and by being unnecessary to protect system reliability (Amerada Hess Corp.); will not prevent arbitrage because a shipper can avoid the penalty entirely by crossing zero twice (Conectiv Energy Supply, Inc.); would increase penalties during non-critical periods in violation of Commission policy (United States Gypsum Co.); and is not necessary to maintain system reliability (Virginia Power Energy Marketing, Inc.).

6. Columbia answered that the Commission has approved the imposition of penalties during non-critical periods, that the proposed penalty increase is designed to avoid arbitrage opportunities and maintain reliable service by discouraging significant withdrawals under the SIT provision, and that a sufficiently high penalty is preferable to the use of operational flow orders (OFOs).

7. In the February Order, the Commission rejected the proposed tariff sheet because the proposed penalty for non-critical periods is contrary to Commission policy. The Commission found that the SIT penalty could be assessed any time that the cross-zero-twice conditions are not met, without distinguishing between critical and non-critical

periods. The Commission explained that although nominal penalties may be permitted during non-critical periods, substantial penalties such as the one Columbia proposed are permitted only during critical periods where the penalized conduct would impair system reliability, or where necessary to prevent arbitrage that would cause the pipeline to underrecover its costs.[3] The Commission found that Columbia had not justified its proposal under either ground. The Commission distinguished Columbia's proposal from Commission orders permitting pipelines to tighten their cash-out mechanisms in order to discourage arbitrage without a showing of operational harm.[4] The Commission stated that in those cases the arbitrage was causing the pipeline to underrecover its costs, since, in the context of the cash-out mechanism, the arbitrage had the effect of requiring the pipeline to sell gas to its customers at below-market levels, and buy gas from its customers at above-market prices. The Commission stated that Columbia had made no showing that whatever arbitrage was occurring here will cause it any financial loss. The Commission also found that, despite the fact that section 6 of Rate Schedule SIT permits Columbia to take action by issuing an OFO or interruption order, Columbia did not take these actions against the shipper set forth in the example in Columbia's filing and there was insufficient information to determine whether the shipper actually arbitraged or cause operational harm to the integrity of Columbia's system. Thus, the Commission found that Columbia's proposal fails because it has not shown how the proposed increased SIT penalty would be limited or narrowly designed to apply only to those shippers that harmed its system.

<u>Request for Rehearing</u>

8. On rehearing, Columbia states that it proposes to increase the SIT penalty "to ensure that SIT shippers are properly motivated to comply with the express terms of the service."[5] Columbia argues that gas price volatility, combined with the existing SIT penalty, motivates shippers to violate the terms of the SIT rate schedule by not crossing

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[3] February Order, 114 FERC ¶ 61,188 at P 16 (citing *Columbia Gas Transmission Corp.*, 113 FERC ¶ 61,191 at P 10 (2005) (penalties to preserve reliability); *Northern Natural Gas Co.*, 105 FERC ¶ 61,172 (2003), *order on reh'g*, 107 FERC ¶ 61,252 (2004), *aff'd*, *The Industrials v. FERC*, 426 F.3d 405 (D.C. Cir. 2005) (preventing arbitrage that would cause underrecovery by pipeline)) (*The Industrials v. FERC*).

[4] February Order, 114 FERC ¶ 61,188 at P 17; *see also Texas Gas Transmission Corp.*, 97 FERC ¶ 61,349, at 62,634-35 (2001); *Northern Natural Gas Co.*, 105 FERC ¶ 61,172.

[5] Request for Rehearing at 1.

zero twice and that the result is unintended arbitrage opportunity. In the event that the Commission denies rehearing, Columbia requests either (a) approval to include in its tariff a statement providing that Columbia is not obligated to provide service to a shipper that violates the tariff, or (b) approval of the withdrawal of the SIT rate schedule.

9. Columbia argues that the Commission's rejection of its proposed increase in the penalty will impermissibly require it to give customers arbitrage opportunities in contravention of Commission policy permitting pipelines to impose sufficiently high penalties to remove any incentive for arbitrage that can lead to the pipeline incurring a substantial underrecovery of costs without showing the shipper in question actually arbitraged. Columbia cites a number of cases in support of this argument, all having to do with cash-out mechanisms. Columbia also asserts that the abuse of SIT service results in lost revenue to Columbia, that the existing penalty is not of sufficient magnitude to make its incurrence economically undesirable, that the Commission's decision undermines its policy to promote imbalance management service, and that OFOs and interruption notices are not appropriate substitutes for increasing the failure to cross-zero-twice penalty.

10. United States Gypsum Company, interpreting Columbia's Request for Rehearing to also be a filing under section 4 of the Natural Gas Act, filed a pleading captioned as a protest to the section 4 aspects and, alternatively, as an answer to the request for rehearing.

Discussion

11. Rule 713(d)(1) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713(d)(1) (2006), prohibits an answer to a request for rehearing. Accordingly, we reject U.S. Gypsum's answer. As discussed below, the Commission will not, in this case, entertain the section 4-type proposals contained in Columbia's request for rehearing. Accordingly, U.S. Gypsum's protest need not be discussed here.

12. We also deny rehearing. In Order No. 637, the Commission adopted section 284.12(b)(2)(v) of its regulations,[6] stating that a pipeline may include penalties in its tariff "only to the extent necessary to prevent the impairment of reliable service." In Order No. 637-A, the Commission also stated that it "is not permitting pipelines to impose penalties for other purposes such as the enforcement of contractual obligations, where unrelated to system reliability. The Commission has determined that shippers should be given the flexibility to exceed contractual limitations, unless such action

[6] 18 C.F.R. § 284.12(b)(2)(v) (2006).

jeopardizes system reliability and integrity."[7] On the other hand, Order No. 637-A also stated that the existence of arbitrage "demands that pipelines revise the level and structure of their penalty provisions to minimize the opportunity for arbitrage. For example, as the Commission stated in Order No. 637, pipelines may be able to change their imbalance cash-out procedures or methods to eliminate the incentives for shippers to borrow gas from the pipeline because the cash-out price is less than the market price for gas."[8]

13. As the U.S. Court of Appeals for the D.C. Circuit stated in *The Industrials v. FERC, supra,* note 3, in individual cases decided since Order No. 637, the Commission has permitted pipelines to tighten their cash-out mechanisms to minimize the opportunity for arbitrage without a showing that the arbitrage was causing operational problems.[9] However, the court also pointed out that the Commission has rejected "any change that is beyond what is necessary to remove a customer's incentive to game the system and unnecessarily removes a customer's flexibility would be an inappropriate penalty."[10] The court in *The Industrials v. FERC* described this as the "happy medium principle," and further stated that "in the absence of a perfect mechanism, one that neither overdeters nor underdeters arbitrage, pipelines and the Commission can be expected to test the waters, gradually ratcheting up any scheme that generates substantial imbalances." [11]

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[7] Order No. 637-A, at 31,608.

[8] *Id*. at 31,607.

[9] *See, e.g., Texas Gas Transmission Corp.*, 95 FERC ¶ 61,093, *order after tech. conference*, 96 FERC ¶ 61,318, *order on reh'g*, 97 FERC ¶ 61,349 (2001); *Gulf South Pipeline Co.*, 97 FERC ¶ 61,093, *order on reh'g*, 98 FERC ¶ 61,349 (2002); *see also Northern Natural Gas Co.*, 107 FERC ¶ 61,252 (2004); *Transcontinental Gas Pipe Line Corp.*, 98 FERC ¶ 61,213 (2002).

[10] *The Industrials v. FERC*, 426 F.3d at 408 (quoting *Texas Gas Transmission Corp.*, 96 FERC ¶ 61,318, at 62,218 (2001)); *see ANR Pipeline Co*., 103 FERC ¶ 61,252 (2003), *order on reh'g*, 105 FERC ¶ 61,236 (2003); *Williams Gas Pipelines Central, Inc.*, 100 FERC ¶ 61,232, *order on reh'g*, 102 FERC ¶ 61,119 (2003); *Transcontinental Gas Pipe Line Corp*., 91 FERC ¶ 61,004 (2000) (rejecting penalty proposals which the Commission held went too far).

[11] 426 F.3d at 408.

14. The Commission continues to find that Columbia has failed to show that its $5.00 penalty proposal is consistent with the penalty policies adopted in Order No. 637. The proposed penalty goes beyond what is necessary either (1) to accomplish the primary purpose of penalties of preventing impairment of reliable service or (2) to minimize costly arbitrage. The penalty cannot be justified as necessary to prevent impairment of service. That is because Columbia proposes to apply the penalty whenever a shipper violates the cross-zero twice requirement, regardless of whether the violation impaired Columbia's ability to provide reliable service. Yet Columbia has not shown that any violations of the cross zero twice requirement have actually impaired reliable service. As explained in the February Order, in situations where a pipeline has a penalty for conduct that might, but will not necessarily, threaten system reliability, the Commission has required the pipeline to limit the penalty to situations where the conduct does in fact cause operational harm.[12] If Columbia were to modify its proposed penalty to provide that the $5.00 penalty would be waived whenever there was no impairment of service, the penalty would be acceptable.[13]

15. However, in this proceeding, Columbia seeks to justify imposing the $5.00 penalty, even when there is no impairment of service, as a means of eliminating arbitrage. Columbia's showing of a need for such a substantial penalty to discourage arbitrage falls far short of the showings made in the cases where the Commission has approved increased penalties to deter arbitrage. Those cases have all involved pipeline cash-out mechanisms. Those mechanisms require the pipeline, in essence, to purchase from its shippers any excess gas they have left on the system during a month, and sell to its shippers any excess gas the shipper took from the system during the month at an index price provided for in the tariff. A number of pipelines whose tariffs based the cash-out price on the average weekly price for the month asserted that this gave their shippers an incentive to engage in arbitrage. That was because towards the end of each month the shippers could predict with reasonable accuracy whether the cash-out price for that month would be above or below the prevailing market price at the end of the month. For example, if the market price had been rising during the month, shippers could be relatively certain during the latter part of the month that the cash-out price would be less than the market price. The pipelines also presented evidence that they were, in fact, incurring substantial imbalances, and that the pipelines were incurring a substantial

[12] February Order, 114 FERC ¶ 61,118, at P 16.

[13] In fact, the Commission has accepted substantial penalties proposed by Columbia for other conduct, such as unauthorized overruns of contract demand, on the ground that Columbia only applies those penalties on critical days. *See Columbia Gas Transmission Corp.*, 115 FERC ¶ 61,134, at P 17 (2006).

underrecovery of costs in connection with the operation of their cash-out mechanisms. The pipelines, accordingly, proposed to modify the index prices used to cash out imbalances, for example, to use the high/low weekly price for the month such that excess of gas left on the system would be deemed sold to the pipeline at a less than market rate and excess gas taken off the system would be deemed sold at higher than market price. Also, to inhibit shippers' ability to predict prices in order to engage in arbitrage, the pipelines proposed to add a fifth week in the following month before net imbalances are calculated for purposes of cash-out.

16. The Commission accepted the proposals. The Commission found that, "since the current system provides obvious opportunity and incentive to game the system, we think it reasonable to assume that there is a danger of such gaming occurring."[14] The Commission also found that "when price arbitrage occurs, the pipeline is, in essence, required to sell gas to its customers at below market levels and buy gas from them at above-market levels" and that it was not just and reasonable to require pipelines to give their customers such an opportunity.[15]

17. As Columbia itself notes, "the facts here do not involve the type of "cash-out" mechanism at issue in" the cases discussed above.[16] In the instant case, Columbia has not shown that SIT service provides a similarly obvious incentive to arbitrage, nor that SIT service causes Columbia to lose revenue.

18. In the cash-out case, the incentive to engage in arbitrage arose from the fact that shippers could be reasonably certain near the end of each month that the cash-out price would be either above or below the market price, thus giving them an almost guaranteed ability to earn profits through the incurrence of imbalances. However, Columbia has not shown any similar guaranteed ability to profit from violating the cross-zero twice requirement in the SIT rate schedule. In an effort to illustrate shippers' incentive to violate the cross-zero twice requirement, Columbia refers to Attachment A from its initial filing. This attachment purports to show potential profits to be made by shippers utilizing SIT service even while paying a 25 cent penalty for not crossing zero twice within 30 days. However, a shipper who maintains an undertendered balance, as in the example Columbia provided, incurs the risk that the market price for gas will increase or remain the same. Such a strategy entails significant market risk and would not likely be

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[14] *Transco*, 98 FERC at 61,814.

[15] *Texas Gas*, 97 FERC at 62,634.

[16] Request for Rehearing at 7.

routinely profitable. Accordingly, Columbia has not shown that its current SIT imbalance penalty mechanism creates the kind of opportunity for actual losses that the Commission has found warrant significant penalties in the absence of a showing of operational harm.

19. Moreover, Columbia has not presented any evidence as to how many shippers are violating the cross-zero twice requirement, in contrast to the evidence presented in the cash-out cases that shippers were incurring substantial imbalances. For all that appears in the present record, the shipper whose violations of the cross zero twice requirement are illustrated in Attachment A is the only shipper who has violated that requirement. As Columbia points out, the Commission in the cash-out cases did not require the pipeline to show specific evidence that the reason the shippers incurred the imbalances at issue there was because they were engaging in arbitrage.[17] However, in those cases, the pipelines did present evidence that shippers were incurring significant imbalances. That evidence, combined with the obvious incentive to engage in arbitrage of the pipeline's cash-out mechanism, was sufficient to infer that arbitrage was a significant problem on those pipelines. Here, there is neither evidence of an obvious incentive to engage in arbitrage nor evidence of widespread violations of the cross-zero twice requirement. For these reasons, the Commission finds that Columbia has not presented sufficient evidence to show that arbitrage of the SIT service is a significant problem.

20. Columbia also argues that "abuse" of SIT service results in lost revenue to Columbia.[18] Specifically, Columbia states that "the loss of a portion of Columbia's retained storage capacity through abuse of the service prevents Columbia from providing [imbalance management services], thus resulting in the loss of revenue."[19] Columbia relatedly argues that shippers are deprived of imbalance management services by SIT shippers withholding gas (by failing to cross zero twice).

21. Here, again, the Commission finds that Columbia has not presented sufficient evidence to show that shippers' use of SIT service results in the type of loss of revenue that would compel the Commission to approve the penalties for SIT service violations that Columbia seeks. Other than vague references to various imbalance management services, Columbia provides no example, let alone evidence, of how it has or could underrecover costs with the existing SIT tariff. The fact that it could be providing other,

[17] Request for Rehearing at 6-7.

[18] Request for Rehearing at 7.

[19] Request for Rehearing at 7.

perhaps more expensive services, using the capacity allocated to SIT service is true whether or not shippers cross zero twice under that service. There is no dispute that Columbia profits from providing SIT service. While there are other services for which Columbia charges rates higher than that for SIT service, and while the ability to offer some of those services may be limited by the degree to which shippers utilize SIT service, SIT service does not require Columbia to sell gas for less than it costs to purchase, or purchase gas for more than it can sell the gas, as in the cash-out situation described above, where the pipelines presented evidence of actual underrecoveries. This would be the type of loss that concerns the Commission. Here, though, where Columbia has not shown that the cost of providing SIT service when shippers fail to cross zero twice is higher than the rate it charges for that service, Columbia cannot be said to be losing money. Allowing Columbia to impose the proposed penalty would appear to only serve the purpose of discouraging use of one profitable service (SIT) so that shippers are effectively coerced into use of a more profitable service.

22. Columbia argues that the Commission "must provide Columbia with the means to enforce [the SIT rate schedule].[20] Columbia cites section 284.12(b)(2)(v) of the Commission's Regulations, 18 C.F.R. § 284.12(b)(2)(v) (2005), for the proposition that Columbia should be permitted to charge the proposed $5.00/Dth penalty so that it can "render service in accordance with the purpose for which the rate schedules were designed."[21] Columbia's position is that the Commission erred by too narrowly interpreting the language of the regulation to be limited to preventing harm to the operational integrity of the system.

23. As the court recently observed in *The Industrials* v. *FERC*, pipelines may properly seek to deter arbitrage in cash-out situations without showing that the change is necessary to prevent impairment of reliable service.[22] But, as we have explained above, the instant case does not involve cash-outs. Yet, even in those cases, the court stated that "lest cash-out rules unduly limit shipper flexibility, pipelines' efforts against arbitrage should not go too far."[23] Such is the case here. Columbia has not explained how shippers' failure to meet the SIT rate schedule's cross-zero-twice requirement negatively affects it ability to manage its system. As for critical periods, when a higher penalty would be permissible,

[20] Request for Rehearing at 8.

[21] Request for Rehearing at 8.

[22] *The Industrials v. FERC*, 426 F.3d at 407.

[23] *Id*.

Columbia has apparently declined the opportunity offered in the February Order to impose a $5.00/Dth penalty when the pipeline's operational integrity is at risk.

24. In *The Industrials* v. *FERC*, the court recognized that the Commission would "test the waters" in the absence of a perfect mechanism, to craft "a happy medium" in which a penalty neither overdeters nor underdeters arbitrage.[24] In the instant case, we find that a $5.00 penalty is "beyond what is necessary to remove a customer's incentive to game the pipeline's system and unnecessarily removes a customer's flexibility."[25]

25. However, the Commission's rejection of the $5.00 penalty proposal is without prejudice to Columbia proposing less drastic changes to the existing penalty to give shippers an added incentive to comply with the cross-zero twice requirement. For example, in answering a protest by Conectiv Energy Supply, Inc. at the initial stage of this proceeding, Columbia explained that it imposes the $0.25 penalty on any undertendered or overtendered Imbalance Quantity in existence at the end of any 30-day period only once.[26] Columbia's explanation, along with the illustration in Attachment A to its initial filing, indicates that once thirty days pass without a shipper crossing zero twice a $0.25/Dth penalty is assessed on the Imbalance Quantity, but thereafter it seems that no further penalty is assessed regardless of how many days the shipper continues to be in violation of the cross zero twice requirement. The Commission recognizes that imposing a single $0.25/Dth penalty for a shipper's failure to cross zero twice within 30 days may not be sufficient to prevent shippers from far exceeding thirty days between crossing zero twice. Therefore, the Commission is receptive to proposals to change the language of the SIT tariff so that, for example, the $0.25 penalty would be assessed on the imbalance on a daily basis once thirty days pass without the shipper crossing zero twice. At roughly six times the cost of SIT service, a $0.25 penalty for each day until the crossing zero twice requirement is met would be a real disincentive to not crossing zero twice within 30 days, while being far less onerous than the proposed $5.00 penalty for

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[24] *The Industrials v. FERC*, 426 F.3d at 408.

[25] *The Industrials v. FERC*, 426 F.3d at 408 (quoting *Texas Gas Transmission Corp.*, 96 FERC ¶ 61,318, at 62,218 (2001)).

[26] Columbia Answer dated Feb. 14, 2006, at 8.

even a single days' violation. A filing under section 4 of the Natural Gas Act would be the appropriate means to make such a proposal.[27]

26. Columbia argues that the Commission's decision in the February Order undermines its policy to promote imbalance management services. The Commission notes that the services at issue are interruptible and the tariff already accounts for how to prioritize the various services. Thus, our decision here does not harm Columbia's ability to offer imbalance management services.

27. Columbia argues that Operational Flow Orders (OFOs) and Interruption Notices are not appropriate substitutes for increasing the failure to cross zero twice penalty.[28] The Commission agrees, and suggested implementation of these options in the February Order only if system operations or integrity are threatened. Columbia has not offered evidence that SIT violations have caused problems that would merit an OFO. If Columbia is concerned that such a problem could result, however, the Commission clearly told Columbia that a $5.00 penalty to deter such behavior would be permitted. Instead, Columbia would rather impose the $5.00 penalty even when system integrity is not threatened. This, the Commission will not permit.

28. Columbia argues that, by rejecting the $5.00 penalty proposal, the Commission is essentially directing Columbia "to provide a new service, *i.e.*, one that due to the low penalty allows a shipper to avoid having to cross zero twice; and at a rate (in this case a penalty) chosen by the Commission."[29] The Commission rejects this argument. In rejecting the proposed $5.00 penalty the Commission is adhering to its precedent of not permitting substantial penalties for behavior that does not threaten system operations or integrity in critical periods or that causes the pipeline to underrecover its costs. The argument that the Commission chose the penalty is without basis. The penalty to be charged is the existing penalty contained in the tariff that Columbia itself filed with the Commission. We are simply rejecting an unjust and unreasonable proposal to change the

[27] The Commission will not address here Columbia's alternate requests that the Commission either approve new language in the tariff regarding the SIT rate schedule proposed in Columbia's request for rehearing or approve the withdrawal of the SIT rate schedule. Columbia would have to make a separate filing under section 4 of the Natural Gas Act if it wishes to change its tariff language as it proposes or to withdraw the SIT rate schedule altogether.

[28] Request for Rehearing at 11.

[29] Request for Rehearing at 12.

existing penalty, and requiring Columbia to continue to honor the existing penalty provision in the tariff that is on file.

The Commission orders:

Columbia's request for rehearing is denied.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.