134 FERC ¶ 61,155
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Marc Spitzer, Philip D. Moeller,
John R. Norris, and Cheryl A. LaFleur.

Midcontinent Express Pipeline LLC — Docket No. CP08-6-006

Enogex Inc. — Docket No. CP08-9-002

ORDER ON REMAND

(Issued March 3, 2011)

1. On December 28, 2010, the United States Court of Appeals for the District of Columbia Circuit issued its decision in *Apache Corporation v. FERC* (*Apache Corp. v. FERC*),[1] denying the petition for review in part and remanding for further explanation the Commission's ruling in *Midcontinent Express Pipeline Inc*.[2] that Enogex Inc.'s (Enogex) lease of pipeline capacity to Midcontinent Express Pipeline LLC (Midcontinent) meets the Commission's standard for approval of pipeline leases. On remand, as discussed below, the Commission clarifies its decision and reaffirms the prior orders in this proceeding.

Background

A. Pipeline Leases

2. In recent years it has become increasingly common for an interstate pipeline seeking to increase the capacity available for service on its system to propose leasing existing unsubscribed capacity from another pipeline company instead of, or in addition to, constructing additional facilities of its own.[3] The Commission has recognized that

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[1] 627 F.3d 1220 (D.C. Cir. 2010).

[2] 124 FERC ¶ 61,089 (2008), *order denying rehearing and granting clarification*, 127 FERC ¶ 61,164 (2009).

[3] *See Mobile Bay Pipeline Projects, et al.*, 55 FERC ¶ 61,358 (1991) (approving, *inter alia*, leases of pipeline capacity in the Mobile Bay area).

authorizing such leases can eliminate the need for building expensive, duplicate facilities and can avoid unnecessary disturbance to the environment.[4] Using leases in conjunction with new pipeline facilities can avoid the need to construct additional facilities in new rights-of-way, potentially avoiding the need for a pipeline to use eminent domain.[5] In addition, leases can promote the efficient use of existing facilities, reduce costs, create administrative efficiencies, and, in some cases, simplify transportation arrangements, as by allowing shippers to move gas from a production area to connecting pipelines under a single contract and with one nomination.[6]

3. The Commission views lease arrangements differently than the provision of transportation services under rate contracts. Under a lease, the lessee acquires a property interest in the lessor's pipeline. The lessee in essence owns the acquired capacity, which is allocated to the lessee's customers, subject to the lessee's tariff. While the lessor may remain the operator of the pipeline system, it no longer has the right to use the leased capacity.[7]

4. The Commission's practice has been to approve a lease, under the so-called *Islander East* test,[8] if it finds that: (1) there are benefits from using a leasing arrangement; (2) the lease payments are less than, or equal to, the lessor's firm transportation rates for comparable service over the term of the lease; and (3) the lease arrangement does not adversely affect existing customers.[9] We have not previously had cause to expound upon precisely what would constitute an adverse effect in the context of a proposed lease, but we have, by noting that the positive benefits of a lease outweighed "any possible changes" to existing interruptible shippers,[10] indicated that "adverse affect"

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[4] *Midwestern Gas Transmission Company and Trunkline Gas Company*, 73 FERC ¶ 61,320, at 61,888 (1995).

[5] *Islander East Pipeline Company* (*Islander East*), 100 FERC ¶ 61,276, at P 69 (2002).

[6] *See Gulf Crossing Pipeline Company LLC* (*Gulf Crossing*), 123 FERC ¶ 61,100, at P 114 (2008).

[7] *Id*. P 110.

[8] *See Islander East*, 100 FERC ¶ 61,276, at P 69.

[9] *Gulf Crossing*, 123 FERC ¶ 61,100 at P 111, *citing Texas Gas Transmission, LLC*, 113 FERC ¶ 61,185, at P 10 (2005); *Islander East*, 100 FERC ¶ 61,276 at P 69 (2002).

[10] *Gulf Crossing*, 123 FERC ¶ 61,100 at P 121.

is a less than absolute standard, to be at least to some extent balanced against the benefits of a lease.

B. The Certificate Order

5. On July 25, 2008, the Commission issued an order (July 25 Order)[11] authorizing, among other things, Enogex's lease of up to 272,000 dekatherms per day (Dth/d) of capacity on its intrastate pipeline system to Midcontinent, an interstate pipeline. In approving the lease (Enogex-Midcontinent lease), the Commission addressed several protests, one of which was filed by Apache Corporation (Apache), a natural gas producer and shipper on Enogex's system receiving interruptible transportation service pursuant to section 311 of the Natural Gas Policy Act of 1978 (NGPA).[12]

6. As pertinent here, the July 25 Order addressed Apache's claim that the lease of capacity from Enogex to Midcontinent, in concert with Enogex's lease of capacity to Gulf Crossing Pipeline Company, LLC (Gulf Crossing),[13] would impair Apache's rights as an NGPA section 311 interruptible shipper on Enogex's system by reducing the amount of capacity that would be available to Apache for its existing NGPA section 311 interruptible service.

7. Applying the *Islander East* test, the July 25 Order concluded that the lease arrangement had substantial benefits, including: avoiding the need for Midcontinent to construct duplicative facilities that would essentially parallel the Enogex system; preventing consequent impacts on the environment and on landowners; allowing for the efficient use of the Enogex system; reducing the cost of constructing the Midcontinent system and allowing the system to be placed in service earlier; and allowing Midcontinent's shippers seamless access, under a single contract, from the Oklahoma production area to multiple pipelines serving the southern and eastern United States.[14] As to the second prong of *Islander East*, the Commission concluded that, although there was no comparable rate against which to judge Midcontinent's proposed payments because Enogex did not currently offer firm service, analysis of Enogex's most similar

[11] *Midcontinent Express Pipeline LLC,* 124 FERC ¶ 61,089 (2008).

[12] 15 U.S.C. § 3371 (2006).

[13] *See Gulf Crossing Pipeline Company LLC* (*Gulf Crossing*), 123 FERC ¶ 61,100 (2008), in which the Commission approved, inter alia, Gulf Crossing's lease of 90,000 Dth/d of capacity on Enogex's system.

[14] July 25 Order, 124 FERC ¶ 61,089 at P 35.

rates indicated that the demand charges Midcontinent would pay under the lease would be less than comparable demand charges on Enogex's system.[15]

8. The Commission then examined potential impacts of the lease arrangement on Enogex's existing customers. Based on engineering information provided by Enogex, the Commission concluded that Enogex's system, as it will be configured by the time of the in-service dates of the Enogex-Midcontinent and Enogex-Gulf Crossing leases, would not only be able to accommodate the capacity commitments under those leases, but would actually have more overall system capacity, even though there might be decreases in capacity at certain individual receipt points. In response to Apache's claim that it would be adversely affected, the Commission concluded that "[w]hile the amount of capacity Enogex can provide as interruptible section 311 transportation service could change at some point in the future, those transactions are, by definition, interruptible and subject to change."[16] Based on this analysis, the Commission found that "the lease arrangement will not have an unduly adverse impact on Enogex's existing services." [17]

9. As summarized earlier in the order, the Commission determined that, because the lease payments were satisfactory, the lease provided significant benefits, and those benefits outweighed any potential harm to Enogex's existing customers, "the proposed lease is required by the public convenience and necessity."[18]

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[15] *Id*. P 36-37.

[16] *Id*., *citing Gulf Crossing*, *supra* at P 121. In *Gulf Crossing*, the Commission dismissed for the same reasons a similar claim by Unimark LLC, another interruptible NGPA section 311 shipper on Enogex, that approval of the Enogex-Gulf Crossing lease would result in diminished availability of interruptible section 311 service. The Commission found that the lease should not adversely affect Enogex's existing customers because it was undisputed that Enogex would continue to provide section 311 interruptible service after implementation of the lease, with the same rights. The Commission stated that "[w]hile the amount of capacity Enogex can provide as interruptible section 311 transportation service could change at some point in the future, those transactions are, by definition, interruptible and subject to change." As in the July 25 Order, the Commission in *Gulf Crossing* also found that the benefits from the Enogex lease outweighed any possible changes that might result to shippers receiving interruptible section 311 service. *Gulf Crossing*, 123 FERC ¶ 61,100 at P 121.

[17] *Id*. P 43.

[18] *Id*. P 32.

C. The Rehearing Order

10. Apache sought rehearing of the July 25 Order, arguing, among other things, that the Commission's finding that Apache would not be harmed by the Enogex-Midcontinent lease was not based on substantial evidence.

11. On May 21, 2009, the Commission issued an order denying rehearing (May 21 Order).[19] In the May 21 Order, the Commission agreed with Apache that capacity available on Enogex's system could be reduced at some time, but found that a shut-in of production was not likely to result from lease operations. Aside from the effects of lease operations, the Commission explained, capacity constraints on Enogex's system would be primarily due to increased production in the area served by Enogex, thus leading to increased demand.[20] In essence, the Commission found that Apache's claims that the lease would lead to adverse effects were speculative and not consistent with the best reading of the record. The Commission also explained that, "because interruptible shippers have no claim of right to system capacity, the limited potential reduction in the capacity available for section 311 interruptible transportation service of the result of the lease cannot be viewed an as undue adverse effect."[21] In light of this analysis, the Commission affirmed that the benefits of the lease outweighed possible changes in the service to Enogex's existing interruptible customers.[22]

D. The Court Opinion

12. On judicial review, the court held that the Commission had not, as required by the third prong of the *Islander East* test, found that the Enogex-Midcontinent lease did not adversely affect existing customers. Rather, the court explained, the Commission had stated that the lease would not have an unduly adverse impact on Enogex's existing services, and that the lease's benefits outweighed any potential harm to Enogex's customers. The court noted that the Commission could (1) have explained that diminished interruptible service does not constitute an "adverse effect" for purposes of pipeline lease analysis because interruptible service is inherently subject to disruption and therefore cannot be "adversely affected" by a lease, and/or (2) have modified the *Islander East* test to preclude only "undue" adverse effects and to expressly permit balancing of benefits against burdens. Because the Commission's analysis regarding undue adverse

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[19] *Midcontinent Express Pipeline LLC*, 127 FERC ¶ 61,164 (2009).

[20] *Id*. P 25. The Commission cited as an example Enogex's connection to the Waynoka Gas Processing Plant.

[21] *Id*. P 26; *see also id*. P 18-19.

[22] *Id*.

effects was not consistent with the *Islander East* test as previously articulated by the Commission, the court remanded the case to the Commission for further explanation.

Discussion

13. Because the issue of adverse effects (other than rates) on existing shippers in lease cases has not previously been so squarely posed, the Commission has not had the occasion to parse "adverse affect" or to consider the interplay among the three prongs of the *Islander East* test. The third – "no impact" – prong of the *Islander East* test is a relative, rather than absolute, standard. That is, in applying the test the Commission will consider whether a proposed lease arrangement would have an undue adverse affect on existing customers, such that the impact would outweigh the positive benefits identified in the first prong of the test.[23] Moreover, we will not consider any of the prongs of the test in isolation, but rather will balance them, on a case-by-case basis. Given the facts of individual lease cases, we will determine whether a proposal meets all of the three established criteria, and, if it does not, weigh the significance of the lease's failure to satisfy any criterion against the benefits it would provide with respect to other criteria.

14. We note that it would make no sense for us to insist that a lease must have absolutely no adverse impact on existing customers. Were that the case, then, for example, a customer that might occasionally lose one percent of the service it wants could bar a lease that would circumvent the need for a lengthy new pipeline that would traverse environmentally sensitive areas and result in higher rates and decreased supply to many other customers. Reading "undue" into "adverse impact" allows us to engage in more reasoned decision making.

15. In the alternative, as the Commission stressed in its July 25 Order and May 21 Order, interruptible shippers have no claim of right to any specific amount of capacity on a pipeline. The Commission explained that "[a]s an NGPA section 311 interruptible shipper, Apache has no claim on Enogex's capacity. If, in fact, there is a reduction in the availability of interruptible section 311 services in the future as a result of the Enogex-Midcontinent lease, that is a consequence inherent to the nature of interruptible service." Moreover, the Commission stated that "while the amount of capacity available for interruptible section 311 service may decrease in the future, those transactions are, by definition, interruptible and subject to change."[24] The relative status of interruptible service is always a function of how firm services are being used and what remaining

[23] *See, e.g., Gulf Crossing Pipeline Company, LLC.*, 123 FERC ¶ 61,100 at P 121 (2008) (stating that "[t]he Commission finds that the benefits from the Enogex lease outweigh any possible changes that may result to shippers receiving interruptible 311 service.").

[24] July 25 Order, 124 FERC ¶ 61,089 at P 25.

capacity is available.[25] Consequently, Apache's claim of right to continue receiving its current levels of service after implementation of the Enogex-Midcontinent leases is wholly at odds with "the intermittent quality of [interruptible] service … which all purchasers of such service must accept." [26] That being the case, the "loss" of capacity which Apache has only a contingent ability to use is not an adverse effect of the type that the *Islander East* test is designed to consider and, where possible, avoid.[27]

16. Moreover, any proposal to lease capacity has the potential to adversely impact existing interruptible shippers of the lessor pipeline, since any capacity committed to a lease would no longer be available under the lessor pipeline's tariff. Thus, if the "no adverse effects" provision of the *Islander East* test is taken as an absolute, the Commission could not approve leases of capacity by any pipeline with existing interruptible shippers.

<u>Conclusion</u>

17. As we have explained above, under the *Islander East* test we will balance the benefits of a proposed lease, the propriety of the lease rate, and any adverse effects the lease arrangement may have on existing customers. As detailed in the July 25 Order and the May 21 Order, we have found that the lease here would have substantial benefits. Specifically, use of the lease arrangement will provide capacity for a significant portion of Midcontinent's system without construction of duplicative facilities, thus avoiding environmental impacts and impacts on the landowners who would otherwise be affected by such construction, substantially reducing the costs of constructing the Midcontinent system, and allowing the Midcontinent system to be placed into service earlier than would be possible if construction of additional facilities were required. In addition, the lease arrangement enables Midcontinent shippers to receive seamless service, under a single firm transportation contract, from the production area in Oklahoma to multiple pipelines serving the southern and eastern United States. We have also found that the rate Midcontinent will pay Enogex under the lease meets the rate requirement of the *Islander East* test. These findings have not hitherto been challenged and so are no longer subject to debate in this proceeding. Finally, after having examined the potential adverse effects of the lease on existing service, we have determined that the lease will not likely lead to adverse effects, that if it does so it would only affect interruptible section 311

[25] May 21 Order, 127 FERC ¶ 61,164 at P 18.

[26] *Columbia Gas Transmission Corp*, 55 FERC ¶ 61,366, at 62,144 (1991).

[27] In fact, the Commission has found, *see* P 12, *supra*, that it is relatively unlikely that Apache's production will be shut it, or, if that occurs, that the lease will be the cause. Where, as here, we find a party's assertion of adverse effects unconvincing, we cannot not find an adverse effect.

service, the diminution of which we, as a general matter, do not consider a disqualifying adverse affect, and that, in any event, the many significant benefits of the lease outweigh the potential adverse effects that Apache has posited. We therefore affirm our approval of the lease.

The Commission orders:

(A) The authorizations contained in the July 25 Order and May 21 Order are affirmed.

(B) The July 25 Order and May 21 Order are clarified, as discussed in the body of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.