139 FERC ¶ 61,095
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

El Paso Natural Gas Company | Docket No. RP08-426-000

OPINION NO. 517

OPINION AND ORDER ON INITIAL DECISION

Issued: May 4, 2012

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

El Paso Natural Gas Company Docket No. RP08-426-000

OPINION NO. 517 AND ORDER ON INITIAL DECISION

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

El Paso Natural Gas Company Docket No. RP08-426-000

OPINION NO. 517

OPINION AND ORDER ON INITIAL DECISION

(Issued May 4, 2012)

1. This order addresses briefs on and opposing exceptions to an Initial Decision issued on January 14, 2011, by the Presiding Administrative Law Judge (Presiding Judge) in the above-captioned proceeding.[1] The Initial Decision set forth the Presiding Judge's findings concerning four issues reserved for hearing in a general rate case filed by El Paso Natural Gas Company (El Paso) pursuant to section 4 of the Natural Gas Act (NGA) on June 30, 2008.[2]

2. In this order, the Commission affirms and adopts the Initial Decision on the bulk of the rulings on the four issues reserved for hearing in El Paso's 2008 rate case. Those issues concern the following: (1) what acquisition costs are attributable to the Line No. 1903 expansion project; (2) whether El Paso's proposed capital structure is just and reasonable; (3) whether El Paso's proposed short-term firm and interruptible rates capped at 250 percent of the related long-term recourse rate are just and reasonable; and (4) whether the rate caps established by Article 11.2(a) of El Paso's 1996 Settlement remain just and reasonable and in the public interest, and whether El Paso can recover the Article 11.2(a)-related revenue shortfall from non-Article 11.2(a) shippers.

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[1] Appendix A lists the Briefs on and Opposing Exceptions, showing the Participants joining each Brief along with the designations used in this opinion.

[2] *El Paso Natural Gas Co.*, 134 FERC ¶ 63,002 (2011) (ID or Initial Decision).

3. However, with respect to a subsidiary issue related to Article 11.2(b) of the 1996 Settlement, the Commission reverses the Presiding Judge's determination that El Paso failed to meet the 4,000 MMcf/d presumption which acts as a rate subsidization indicator for the settlement shippers, such that they are not bearing the costs of unsubscribed settlement capacity. Thus, no additional rate adjustment under Article 11.2(b) is required.[3]

I. Background

4. El Paso is a natural gas company that operates an interstate pipeline system for the transportation of natural gas from areas in the southwestern United States through the states of Texas, New Mexico, Colorado, and Arizona, to two points of termination at the boundary between the states of California and Arizona, near Ehrenberg and Topock, Arizona. El Paso also delivers natural gas to numerous on-system delivery points and off-system eastern markets. El Paso's system consists of the South System and North System mainlines, which can deliver natural gas from the San Juan, Permian, and Anadarko Basins to various delivery points throughout its system. Its system also includes several "cross-overs" which can deliver gas between the North and South Systems.

5. The issues addressed in this hearing relate to events on El Paso's system dating back over twenty years. Provided below is a brief summary of these major events.

A. 1990 Settlement

6. In 1990, El Paso entered into a settlement (1990 Settlement) with its customers that, among other things, implemented contract conversions from bundled sales service to transportation service. Prior to the 1996 Settlement (discussed below), El Paso's practice was to serve its firm customers under two types of contracts: full requirements contracts and contract demand contracts. Contract demand contracts provided specific delivery rights up to a specified quantity limitation at delivery points designated in the contracts. Full requirements contracts provided that El Paso deliver the customer's full gas requirements each day. There was no limit on the amount of gas the full requirements shippers could require El Paso to transport, other than the capacity of their delivery points. The contract demand contracts on El Paso were held mainly by California customers, while the full requirements contracts were held mainly by customers located east of California. The 1990 Settlement specifically provided for the continuation of full

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[3] The Initial Decision also addressed whether Article 11.2 rights persist after the original contract terms expire. No expiring contracts were at issue in this proceeding, therefore, we find that this issue is not ripe for decision here.

requirements service on the El Paso system. The 1990 Settlement also provided for *pro rata* allocations of capacity among firm shippers.

B. 1996 Settlement

7. In 1996, El Paso entered into another settlement that, among other things, set rates and terms of service for a ten-year period (1996 Settlement). At the time the Commission approved the 1996 Settlement,[4] there was substantial excess capacity on El Paso's system. Following the restructuring and unbundling of the natural gas industry in the 1990s, the California local distribution company customers turned back their rights to capacity on El Paso at the request of the California Public Utilities Commission (CPUC). As a result, approximately 35 percent of the capacity on the El Paso system became unsubscribed. This excess capacity threatened to increase the rates of the remaining El Paso customers. The 1996 Settlement resolved this issue through an agreed-upon sharing of both the risk of the unsubscribed capacity and the revenues when El Paso resold the turnback capacity.

8. The 1996 Settlement also established a rate cap for certain shippers. Specifically, Article 11.2(a) of the 1996 Settlement provided that rates for capacity then under contract by eligible shippers would be capped, subject to inflation, and that the rate cap would continue to apply until the termination of shippers' transportation service agreements (TSA).[5] Article 11.2(b) provided that even if eligible shippers entered into new service

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[4] *El Paso Natural Gas Co.*, 79 FERC ¶ 61,028, *reh'g denied*, 80 FERC ¶ 61,084 (1997) (1996 Settlement Order and 1996 Settlement Rehearing Order). *See also* El Paso filing of conforming changes to stipulation and agreement, Docket No. RP95-363-008 (June 9, 1997) (1996 Settlement).

[5] Sections (a) and (b) of Article 11.2 provide:

> 11.2 <u>Firm TSAs In Effect on December 31, 1995, That Remain in Effect Beyond January 1, 2006</u>. This paragraph 11.2 applies to any firm Shipper with a TSA that was in effect on December 31, 1995, and that remains in effect, in its present form or as amended, on January 1, 2006, but only for the period that such Shipper has not terminated such TSA. El Paso agrees with respect to such Shippers that, in all rate proceedings following the term of this Stipulation and Agreement:
>
> (a) <u>Base Settlement Rate Escalated</u>. El Paso will not propose to charge a rate applicable to service under such TSA during

(continued…)

agreements in the future, their rates would never include costs attributable to capacity, up to the level in existence on the El Paso system at the time of the 1996 Settlement, that becomes unsubscribed or is subscribed at less than the maximum applicable tariff rate.

C. Capacity Allocation Proceeding

9. During the initial term of the 1996 Settlement (1996-2005), circumstances on the El Paso system changed dramatically. Available capacity on El Paso went from an excess to a constrained condition. Several factors contributed to this turn of events, including substantial growth in full requirements shippers' load to amounts far in excess of shippers' billing determinants. As a result, in 2000 and 2001, El Paso experienced significant capacity allocation problems that culminated in complaints filed against El Paso in two separate cases, known as the Capacity Allocation Proceeding and the CPUC Complaint Case.

10. In the Capacity Allocation Proceeding, the Commission agreed with the complainants that the quality of firm service on the El Paso system had deteriorated and

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> the remainder of the term thereof that exceeds the base settlement rate established under paragraph 3.2(a) applicable to such Shipper, as adjusted pursuant to paragraphs 3.2(b) and 3.5 through the term of this Stipulation and Agreement, as escalated annually thereafter through the remainder of the term of such TSA using the procedure specified by paragraph 3.2(b) unless and until such TSA is terminated by the Shipper.
>
> (b) Unsubscribed Capacity Costs. El Paso agrees that the firm rates applicable to service to any Shipper to which this paragraph 11.2 applies will exclude any cost, charge, surcharge, component, or add-on in any way related to the capacity of its system on December 31, 1995, to deliver gas on a forward haul basis to the Shippers listed on *Pro Forma* Tariff Sheet Nos. 33-35, that becomes unsubscribed or is subscribed at less than the maximum applicable tariff rate as escalated pursuant to paragraph 3.2(b). El Paso assumes full cost responsibility for any and all existing and future step-downs or terminations and the associated CD/billing determinants related to the capacity described in this subparagraph (b).

would continue to deteriorate without Commission action.[6] The Commission found that the then current allocation methodology on El Paso, with *pro rata* allocations of firm service when El Paso had insufficient capacity to serve all of its firm customers, was not just and reasonable or in the public interest. Accordingly, the Commission established a framework for resolving the complicated capacity allocation problems that disrupted and degraded firm service on El Paso. Specifically, the Commission directed El Paso to convert its full requirements contracts to contract demand contracts with specific demand limits up to El Paso's available capacity, so that service to one firm shipper would not adversely affect firm service to others. The Commission set forth the method for converting the full requirements contracts. After reserving the amount of capacity necessary to meet the needs of the existing contact demand shippers, the Commission allocated to the former full requirements shippers, as part of their new contract demands, all of the remaining available capacity as well as expansion capacity related to the Line 2000 and Power-Up expansion projects.

11. In the Capacity Allocation Proceeding, the Commission found that to convert full requirements service to contract demand service, it was necessary and in the public interest to modify portions of the 1996 Settlement. However, the Commission also found that the 1996 Settlement should only be modified to the extent necessary to restore reliable firm service on El Paso, and that the remainder of the 1996 Settlement should remain in effect until its expiration. The Commission did not specifically modify Article 11.2 of the 1996 Settlement.

D. <u>2006 Rate Case and Settlement</u>

12. On June 30, 2005, in Docket No. RP05-422-000, El Paso filed a general NGA section 4 system-wide rate case, which modified rates, proposed a number of new services, and revised a number of terms and conditions of its tariff (2006 Rate Case). The 2006 Rate Case constituted El Paso's first general rate case in ten years, following the 1996 Settlement. In its 2006 Rate Case, El Paso, among other things, requested that the Commission find that Article 11 of El Paso's 1996 Settlement, which provides certain shippers with vintage or discounted rates in subsequent rate cases, no longer applied and

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[6] *El Paso Natural Gas Co.*, 99 FERC ¶ 61,244 (Capacity Allocation Complaint Order), *clarified*, 100 FERC ¶ 61,285 (2002) (Capacity Allocation Clarification Order), *reh'g and clarification granted in part*, 104 FERC ¶ 61,045 (2003) (Capacity Allocation Rehearing), *reh'g granted in part*, 106 FERC ¶ 61,233 (2004), *petition for review denied*, *Arizona Corp. Comm'n v. FERC*, 397 F.3d 952 (D.C. Cir. 2005) (*ACC*), *voluntary remand on other issues*, 115 FERC ¶ 61,259 (2006), *reh'g denied*, 120 FERC ¶ 61,170 (2007) (collectively the Capacity Allocation Proceeding or CAP).

that any obligations that El Paso or any other settling party had under Article 11 have been permanently extinguished and fully discharged as a result of the Capacity Allocation Proceedings. On July 29, 2005, the Commission issued an order accepting and suspending the proposed tariff sheets, subject to refund and conditions, and establishing hearing procedures and a technical conference. In the 2006 Rate Case Suspension Order, the Commission stated that issues related to the continued applicability of Article 11 would be addressed after the technical conference.[7] Thereafter, the Commission issued its March 20 Order which determined that the Article 11.2 rate caps and other rate provisions continue to apply to certain eligible shippers beyond the termination of the 1996 Settlement.[8] On December 6, 2006, El Paso submitted a settlement agreement, which the Commission subsequently approved on August 31, 2007 (2006 Settlement).[9] The 2006 Settlement, which terminated on December 31, 2008, required El Paso to file a new general rate case on June 30, 2008, to be effective on January 1, 2009, resulting in the instant proceeding.

13. On January 17, 2012, the United States Court of Appeals for the District of Columbia Circuit reviewed seven Commission orders issued in the 2006 Rate Case proceedings in Docket No. RP05-422, *et al*, and affirmed the Commission's holdings in *Freeport-McMoRan Corp. v. FERC* (*Freeport*).[10] In *Freeport*, the District of Columbia Circuit affirmed the Commission's determination that the Article 11.2 rate cap remains in effect and rejected arguments from El Paso that the Commission had applied Article 11.2

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[7] *El Paso Natural Gas Co.*, 112 FERC ¶ 61,150 (2005) (2006 Rate Case Suspension Order), *reh'g denied as to culpability issues*, 116 FERC ¶ 61,016 (2006), *reh'g denied on remaining issues*, 133 FERC ¶ 61,129 (2010) (November 10 Rehearing Order). The technical conference issues were addressed in *El Paso Natural Gas Co.*, 125 FERC ¶ 61,309 (2008).

[8] *El Paso Natural Gas Co.*, Order on Post [1996] Settlement Issues, 114 FERC ¶ 61,290 (2006) (March 20 Order), *reh'g denied*, 124 FERC ¶ 61,227 (2008) (September 5 Order), *reh'g denied*, 132 FERC ¶ 61,155 (2010) (August 24 Rehearing Order),

[9] *El Paso Natural Gas Co.*, 120 FERC ¶ 61,208 (2007) (2006 Settlement Order), *reh'g denied*, 132 FERC ¶ 61,139, *clarified*, 133 FERC ¶ 61,116 (2010).

[10] 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150, *order on reh'g*, 116 FERC ¶ 61,016; 2006 Settlement Order, 120 FERC ¶ 61,208, *reh'g denied*, 132 FERC ¶ 61,139; March 20 Order, 114 FERC ¶ 61,290; September 5 Order, 124 FERC ¶ 61,227; August 24 Rehearing Order, 132 FERC ¶ 61,155, *aff'd sub nom.*, *Freeport-McMoRan Corp. v. FERC*, 669 F.3d 302 (D.C. Cir. 2012) (*Freeport*).

too broadly, by holding that it continued to apply to the former full requirements shippers' contract demand contracts (CD), and, separately, from Freeport McMoRan Corporation that the Commission had applied Article 11.2 too narrowly, by failing to hold that it applied to expansion capacity. The Court also held that the Commission had reasonably adopted the presumption that the capacity of El Paso's system on December 31, 1995 was 4000 MMcf/d.

E. Current Proceedings

14. On June 30, 2008, El Paso made the NGA section 4 general rate case filing required by the 2006 Settlement, which is the subject of the instant proceeding. El Paso proposed to increase its base transportation rates by 25 percent over its previously effective rates, to institute a new service, and to change certain terms and conditions of service. The filing included both primary tariff records, which continued the operation of rate caps established pursuant to Article 11.2 of the 1996 Settlement, and alternate tariff records, which assumed the termination of the rate caps. El Paso also proposed short-term firm and interruptible rates capped at 250 percent of the related long-term recourse rate. El Paso proposed an effective date of January 1, 2009, pursuant to the 2006 Settlement. The Commission rejected El Paso's alternate tariff records, accepted and suspended El Paso's primary tariff sheets, to become effective on January 1, 2009, subject to refund and conditions, and established procedures for a technical conference and an evidentiary hearing.[11]

15. On March 13, 2010, El Paso filed an uncontested settlement on the majority of the issues in this case (2010 Settlement). The settlement was approved by the Commission on April 28, 2010.[12] Article V of the 2010 Settlement sets forth the four issues the participants reserved for hearing and merits determination: (1) the amount to be included in El Paso's capital account for ratemaking and accounting purposes related to Line 1903; (2) the appropriate capital structure; (3) the appropriate rate design for the maximum recourse rate for interruptible transportation service (IT), interruptible parking and lending service (PAL), and short-term firm transportation rates; and (4) issues related to Article 11.2 of the 1996 Settlement. The 2010 Settlement provides that the resolution of the issues relating to capital structure and Line 1903 will not affect the settlement rates or revenues during the term of the 2010 Settlement. The hearing on the four reserved issues commenced on May 18, 2010 and concluded on June 8, 2010.

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[11] *El Paso Natural Gas Co.*, 124 FERC ¶ 61,124 (2008) (Suspension Order), *reh'g denied*, 133 FERC ¶ 61,129 (2010) (November 10 Rehearing Order), *clarification and rehearing dismissed as moot*, 134 FERC ¶ 61,170 (2011).

[12] *El Paso Natural Gas Co.*, 131 FERC ¶ 61,077 (2010) (letter order).

16. On September 30, 2010, El Paso filed another general section 4 rate case in Docket No. RP10-1398-000, the 2011 Rate Case to be effective April 1, 2011 subject to refund. Thus, the resulting rates determined in the instant proceeding are effective only for a locked-in period from January 1, 2009 through March 31, 2011.[13]

II. Reserved Issues

A. Line 1903

17. In March 2000, El Paso purchased a 1,088-mile crude oil pipeline from All American Pipeline Company (All American) for $129.3 million for conversion to natural gas transportation service. The line is separated into three segments: (1) Line 2000, beginning in Texas and extending 785 miles to Ehrenberg, Arizona; (2) Line 1903, beginning at the western terminus of Line 2000 and extending 88 miles northwest to Cadiz, California; and (3) 215 miles of unconverted oil pipeline extending from the terminus of Line 1903 to Emidio, California (California segment).

18. When it placed Line 2000 into service in 2002,[14] El Paso used a mileage-based cost allocation methodology to calculate its rate base for that segment. El Paso allocated a portion of the total $129.3 million purchase price to the Line 2000 project based on a ratio of the length of Line 2000 (785 miles) to the total length of the All-American assets (1088 miles). El Paso allocated $93.1 million to the Line 2000 facilities, leaving $36.2 million in unallocated costs to correspond to the remaining 303 miles of the former crude oil facilities. In the Line 1903 certificate proceeding,[15] El Paso initially sought a predetermination for rolled-in rate treatment for the full $36.2 million but agreed to limit the applicability of its predetermination finding to the mileage-based percentage of the

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[13] *El Paso Natural Gas Co*., 133 FERC ¶ 61,104 (2010) (2011 Rate Case Suspension Order), *reh'g denied*, 133 FERC ¶ 61,253 (2010) (affirming that Article 11.2 issues will be decided in the instant proceeding (Docket No. RP08-426-000) and clarifying that the issue of the duration of Article 11.2 rate protection is not ripe for review because no Article 11.2 contracts expire prior to the end of the test period). The 2011 Rate Case hearing is proceeding, with Initial Briefs filed in that proceeding on January 20, 2012 and Reply Briefs on February 24, 2012.

[14] *See El Paso Natural Gas Co.*, 95 FERC ¶ 61,176 (2001) (Line 2000 Certificate Order).

[15] *See El Paso Natural Gas Co.*, 111 FERC ¶ 61,408 (Line 1903 Certificate Order), *reh'g denied*, 113 FERC ¶ 61,183 (2005) (Line 1903 Rehearing I), *reh'g denied*, 115 FERC ¶ 61,083 (2006) (Line 1903 Rehearing II).

remaining purchase costs ($10.5 million) attributed to the 87.8 miles being placed in service. However, El Paso requested that the Commission defer a finding related to the recovery of the remaining $25.7 million balance until this rate case.[16] Consequently, we now address El Paso's arguments concerning whether El Paso may roll-in and recover the remaining $25.7 million in its rates.

El Paso's Proposal

19. El Paso proposes to roll-in and recover the entire $36.2 million in its cost of service by attributing the unallocated costs solely to Line 1903. El Paso suggested its approach is appropriate and reasonable because (1) the Commission's Fair Measurement Valuation principles and generally accepted accounting principles (GAAP) require assignment of the purchase price to the converted assets; (2) Line 1903 revenues are greater than the cost of service of the Line 1903 project both at the time of the certificate proceeding[17] and during the test period (2008) in this case; (3) the purchase of the All American pipeline, including the California segment, created over $100 million in capital cost savings compared to the cost of constructing facilities (i.e., the entire All American pipeline cost less than the replacement cost of just the Line 1903 segment); and (4) even if the revenues had not exceeded the costs, Line 1903's operational benefits and fuel savings, recognized by the Commission in the Line 1903 Certificate Order, justify roll-in of the entire purchase price.[18]

20. El Paso asserts that the mileage-based methodology approximated the market value of the assets when Line 2000 was placed in service and suggests that the resulting cost was comparable to the alternative of replacing inefficient, old compressors on El Paso's Southern System.[19] El Paso claims that the market-based valuation methodology for Line 1903 is consistent with FERC accounting principles, the Financial Accounting Board's (FASB) Statement No. 157 (SFAS No. 157), and the GAAP rule that each asset purchased as part of a group be calculated on the basis of its market value.[20] El Paso asserts that SFAS No. 157 recognizes that asset value is approximated by a

[16] Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 42.

[17] Line 1903 Certificate Order, 111 FERC ¶ 61,408 at PP 27-36; Line 1903 Rehearing I, 113 FERC ¶ 61,183.

[18] El Paso Initial Brief 1-2.

[19] *Id*. at 2-3

[20] *Id*. 4-5.

replacement cost analysis consistent with the Line 1903 and California segment cost allocation methodology proposed by El Paso.

21. El Paso asserts that it has been unable to find a purchaser for the California segment for any use, and as such the segment has no market value. El Paso concludes that the remaining purchase price is properly attributable to the 88-mile Line 1903 that is used and useful in providing jurisdictional, natural gas transmission service. El Paso suggests that it did not want, but was required, to purchase the entire line because of All American's position on selling the entire line.[21] As such, El Paso asserts that the California segment has a $0 market value and the $36.2 million remaining from its purchase of the All American assets should be allocated to Line 1903.

22. Finally, El Paso argues that, if the entire $36.2 million is not rolled into rate base, then an adjustment to depreciable plant and related accounts must be made. Specifically, El Paso indicates that Depreciation, Depletion and Amortization (DD&A) in Account No. 108, and Accumulated Deferred Income Tax (ADIT) in Account Nos. 282 and 283 must be modified to reflect any Line 1903 purchase plant exclusion. El Paso suggests that its shippers would improperly benefit from both a reduction in rate base due to the gross plant purchase exclusion, while also enjoying the benefit of credits to El Paso's rates with the accumulated DD&T and ADIT assessed on that portion of rate base.

Initial Decision

23. In the Initial Decision, the Presiding Judge found El Paso's proposal to roll-in and recover, in its cost-of-service, $36.2 million as the price of the entire All American pipeline was unjust and unreasonable.[22] Noting that only 87.8 miles out of a total of 303 miles of the pipeline were certificated and put in service, the Presiding Judge rejected El Paso's attempt to roll in the remaining $25.7 million All American pipeline purchase price in its cost-of-service for Line 1903, as allowing the recovery of costs for facilities that are not "used or useful." The Presiding Judge found that it was El Paso's choice to propose rolling-in only $10.5 million of the total $36.2 million purchase cost in the Line 1903 certificate proceeding.[23] The Presiding Judge further found that the mileage-based methodology used to value Line 2000 provided the only credible evidence of El Paso's original valuation of the All American assets.

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[21] *Id.*

[22] ID, 134 FERC ¶ 63,002 at P 49.

[23] *Id.*

24. The Presiding Judge objected that El Paso's proposal would circumvent the "used and useful" doctrine by using an unsupported market-value cost methodology to arrive at a $0 current market value for the California segment. Further, the Presiding Judge found no instance in which the Commission had applied SFAS No. 157 to value plant assets and noted the Commission's long-standing policy that accounting rules do not dictate ratemaking. The Presiding Judge also agreed with Trial Staff that El Paso's depreciable plant accounts should not be adjusted to eliminate approximately $25.7 million of the Line 1903 costs proposed to be rolled in by El Paso.

Briefs on Exceptions

25. El Paso requests that the Commission reverse the Initial Decision and allow the recovery of the $25.7 million, arguing that (1) the Presiding Judge misunderstood the facts and El Paso's position; (2) the "used and useful" doctrine does not bar the proposed recovery; (3) the entire remaining purchase price is attributable to Line 1903; (4) the All American pipeline purchase resulted in substantial savings and system benefits to El Paso's customers that far exceed its cost; and (5) the Initial Decision misapplied the changed circumstances requirement in the Line 1903 Certificate Order.

26. El Paso contends that at issue is whether it should be permitted to recover the full $36.2 million of the purchase price remaining after $93.1 million of the $129.3 million purchase price was allocated to Line 2000.[24] El Paso suggests that the Presiding Judge's reliance on the "used and useful" doctrine to require the allocation of $25.7 million of costs to the California segment is erroneous and the "used and useful" doctrine does not bar recovery of the $25.7 million remaining purchase price. El Paso argues that it is not seeking to include the costs of the California segment in its rates, noting that the California segment has no market value and therefore should not be assigned part of the purchase price under the Commission's accounting guidelines. Instead, El Paso claims that the entire price of the California segment of the oil pipeline purchase should be assigned to the only segment of that purchase that the record demonstrates has market value, Line 1903, and the cost of service associated with this purchase price should be included in El Paso's rates.[25]

27. El Paso acknowledges that when a utility acquires more land than is needed for gas utility purposes, the purchase price used for utility purposes is reduced by the fair

[24] El Paso Brief on Exceptions at 55.

[25] ID, 134 FERC ¶ 63,002 at PP 48-50 (arguing that depreciable plant should not be adjusted in this proceeding for elimination of Line 1903 because the RP08-426 Settlement establishes "black box rates").

market value of the land not used for utility purposes, but argues that the Commission permits a pipeline to include the full purchase price in rates because the market value of the useful two acres is equal to the purchase price, and assuming there is no willing buyer (i.e., no market) for the remaining one acre, the market value of that one acre is zero.[26] El Paso concludes that a pipeline should not be penalized through an allocation that would result in the exclusion from rates of a portion of the purchase price because it was required to buy the entire lot, provided the purchase provides benefits to ratepayers and was prudent. El Paso argues that it did not want to acquire the California segment, but the seller, All American, insisted that El Paso purchase the entire 1,088 miles in order to acquire the pipeline.

28. El Paso indicates that it sought without success, through open seasons, to convert the California segment to gas services, but received no interest. Further, El Paso notes that it has been unable to find a party willing to purchase the California segment for any use, including product pipeline uses.[27] El Paso concludes that the lack of interest in the California segment shows that the segment has a $0 market value, and suggests that no party has challenged that the purchase of the All American assets was prudent. El Paso suggests that it would be punitive to disallow the inclusion of the full cost of the purchase in its rates.

29. El Paso claims the Presiding Judge misconstrued El Paso's argument that Commission policy requires the purchase price to be allocated only to Line 1903.[28] El Paso suggests that the prior allocation of the price of the All American pipeline purchase does not dictate or require that the same methodology be used to allocate the costs of the remaining purchase price to Line 1903. El Paso asserts that the Initial Decision's finding that the mileage-based valuation methodology, utilized in the Line 2000 proceeding, provides the only credible evidence of El Paso's original valuation is unsupported and irrelevant.[29] El Paso notes that the Line 1903 Certificate Order did not specify a methodology for allocating the price between the two portions of the California segment of the All American pipeline or preclude El Paso from recovering the remaining $25.7 million in acquisition costs.

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[26] El Paso Brief on Exceptions at 57 (citing 18 C.F.R. Part 201, Gas Plant Instruction No. 7(G) (land and land rights) (2011)).

[27] *Id.* at 56.

[28] *Id.* at 54.

[29] *Id.* at 58-59 (citing Ex. EPG-329 at 21).

30. El Paso asserts that it did not purchase each mile of the pipeline at the same embedded value because the market value of the two segments were, and continue to be, different. El Paso contends that Trial Staff's concerns regarding each mile of the All American pipeline assets being assigned a different purchase price, while factually correct, is irrelevant to the issue of the recovery of costs given El Paso's designed rate structure. El Paso indicates that the services and capacity provided by these expansions are not priced utilizing an incremental rate design based on the allocation of price among the segments of this pipeline but rather are part of El Paso's system-wide rates. Further, El Paso articulates that the costs associated with each portion of the All American pipeline are not, or required to be, constant as evidenced by the costs associated with converting the Line 2000 and Line 1903 from oil to gas service.[30]

31. El Paso asserts that at the time the Line 2000 segment was placed into service the mileage-based cost methodology approximated its market value because the mileage-based allocation in conjunction with the conversion costs was equivalent to the existing rates. El Paso suggests the mileage-based allocation was appropriate in light of the rate impact of the alternative of replacing inefficient, old compressors on the El Paso Southern System.[31] El Paso contends that it is applying a consistent valuation methodology to determine the costs associated with Line 1903.

32. In addition, El Paso suggests that the revenues associated with the Line 1903 project fully justify rate recovery of the entire remaining costs of the All American pipeline purchase. El Paso estimates that constructing a new 88-mile line in lieu of Line 1903 would have cost approximately $180 million. El Paso asserts that converting Line 1903 to natural gas transmission service cost approximately $74 million.[32] El Paso contends that purchase of the Line 1903 assets have benefitted El Paso's customers with over $100 million in savings in capital costs alone.

33. El Paso asserts that the record demonstrates that during the test period in this case, revenues derived from contracts having paths that include Line 1903 were approximately $46 million, which far exceed Line 1903's $31.1 million cost of service, even when the entire $36.2 million purchase price is included. El Paso asserts that under these

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[30] *Id.* at 60.

[31] *Id.* at 59.

[32] *Id.* at 60 (citing Ex. EPG-83 at 33).

circumstances the Commission's "roll-in" test allows El Paso to include the full $36.2 million.[33]

34. El Paso notes that under the Commission's Certificate Policy Statement,[34] even if the revenues from a project do not exceed its costs, the entire cost of the project may be rolled-in if justified by system benefits.[35] El Paso contends that the system benefits from Line 1903 justify the rolled-in rate treatment of the remaining $36.2 million. El Paso notes that the Commission found that the Line 1903 capacity provided significant benefits including increased system flexibility; increased system reliability; increased shipper segmentation opportunities; decreased reliance on displacement; and increased shipper access to additional natural gas supplies.[36] El Paso argues that the Line 1903 facilities have resulted in more efficient fuel usage on the entire El Paso system, allowing El Paso to select the most efficient path to physically move gas, irrespective of the scheduled nomination path. El Paso states that it has projected that annual fuel savings resulting from Line 1903 would be approximately $24 million.[37] El Paso further suggests that the benefits from the Line 2000 expansion project should also be considered jointly with the Line 1903 project. El Paso indicates that Line 2000 created an additional capacity of 230 MMcf/day to El Paso's south system, increasing system reliability and flexibility.[38] Further, the Line 2000 and Power-Up projects added another 320 MMcf/day, which provided similar system benefits to all shippers.[39]

35. El Paso argues that the Initial Decision misapplies the "changed circumstances" requirement in the Line 1903 Certificate Order. The Commission, at El Paso's request, made no finding on the remaining $25.7 million purchase price in the Line 1903 order.

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[33] *Id.* at 62.

[34] *Certification of New Interstate Natural Gas Pipeline Facilities*, 88 FERC ¶ 61,227, at 61,746 (1999) (Certificate Policy Statement), *clarified,* 90 FERC ¶ 61,128 (2000) (Clarification).

[35] El Paso Brief on Exceptions at 62.

[36] *Id.* (citing Line 1903 Certificate Order, Line 1903 Rehearing I and II).

[37] *Id.* at 63 (citing Ex. EPG-266 at 13-14, 16-17; Ex. EPG-372).

[38] *Id.* (citing Line 2000 Certificate Order, 95 FERC ¶ at 61,573).

[39] *Id.* at 64 (citing *El Paso Natural Gas Co.*, 103 FERC ¶ 61,280, *reh'g denied*, 105 FERC ¶ 61,202 (2003) (Power-Up Project Certificate Order)).

Thus, the "changed circumstances" reference in the order applies to whether the overall project costs should continue to be rolled-in, as opposed to incrementally priced, not whether the remaining $25.7 million purchase price should also be included in the costs rolled-in to El Paso's rates. The Commission, argues El Paso, made no predetermination on cost recovery for the remaining $25.7 million purchase price, deferring such decision to this case.

36. Finally, El Paso suggests that if the Presiding Judge's recommendation to remove $25.7 million from its rate base is adopted, there must be a corresponding reduction in El Paso's depreciable plant accounts.[40] El Paso asserts that it has recognized the depreciation on the remaining $25.7 million purchase price, and the book deferred income taxes reflects the difference between such recognized book depreciation and tax depreciation. El Paso contends that its shippers would receive a double benefit – first, by a reduction in rate base due to the gross plant purchase price exclusion and second, through the crediting of El Paso's rate base with the accumulated depreciation and deferred income taxes assessed on that portion of rate base. El Paso states that the current rates would not be affected by the accounting adjustment because those rates were settled; however, it states an adjustment should be made to ensure El Paso's rate base is calculated properly going forward.

<u>Briefs Opposing Exceptions</u>

37. Trial Staff, the Indicated Shippers, Texas Gas Service, and CPUC/SoCalGas/SDG&E support the Initial Decision and oppose El Paso's proposed rate treatment. They contend that the California segment is not used and useful, and its costs should not be included in El Paso's rates. They suggest that the costs of the All American pipeline purchase should be allocated on a mileage basis consistent with the rate treatment for Line 2000 and the Commission's predetermination granted for Line 1903. Further, Trial Staff argues that the record does not support El Paso's proposed cost of $36.2 million for Line 1903.

38. Trial Staff suggests that if El Paso's mileage-based allocation is not applied in this proceeding, then the costs allocated to the remaining All American assets will be arbitrary and potentially result in unlawful rates.[41] Trial Staff argues that El Paso failed to provide a cost-based or Commission-approved justification for allocating $0 to the California segment and thus the Presiding Judge was correct in rejecting El Paso's valuation of those assets. Trial Staff further argues that El Paso's market valuation

[40] *Id.* at 66.

[41] Trial Staff Brief Opposing Exceptions at 39.

methodology is wholly inconsistent with Commission policy which values plant assets based on their costs at the time of the acquisition rather than based on some future value to be determined at a later date. Trial Staff indicates that El Paso's Line 1903 valuation is a shell-game in which El Paso attempts to hide the costs associated with the California segment.[42] Trial Staff indicates that there is no evidence to demonstrate that El Paso paid All American $0 for the California segment. Trial Staff asserts that El Paso's original valuation of Line 1903 and the California segment cannot be determined without considering the mileage-based methodology that El Paso first used to value the All American assets.

39. Further, Trial Staff contests El Paso's argument that the proposed cost allocation for the Line 1903 project passes the Commission's roll-in test and therefore is just and reasonable.[43] Trial Staff notes that the Initial Decision does not preclude recovery of the cost associated with the used and useful Line 1903 or prohibit El Paso from seeking to recover the $25.7 million associated with El Paso's investment in the California segment should El Paso begin providing service to its customers on that segment. Trial Staff suggests that the approach adopted by the Presiding Judge is required by Commission policy and ensures that El Paso's customers' rates are based on a reasonable level of costs related to those assets that are used and useful in the provision of jurisdictional service.

40. Finally, Trial Staff indicates that El Paso provided no evidence showing that it has booked accumulated depreciation and deferred income taxes assessed on the California segment. Trial Staff suggests El Paso has not had the occasion to depreciate gas plant in service amounts and record ADIT applicable to the cost of the California segment, noting that, in the Line 1903 Certificate Order, the Commission only approved and allowed El Paso to begin depreciating the $10.5 million Line 1903 costs ultimately adopted by the Presiding Judge in this proceeding.[44]

41. CPUC/SoCalGas/SDG&E contend that the Initial Decision appropriately applied the "used and useful" standard to determine the amount of the purchase price related to Line 1903 that should be included in rate base for ratemaking and accounting purposes.[45] Texas Gas Service contends that El Paso attempts to subvert the fact that it is seeking to

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[42] *Id.* at 44.

[43] *Id.* at 45-46.

[44] *Id.* at 47 (citing Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 42).

[45] CPUC/SoCalGas/SDG&E Brief Opposing Exceptions at 3.

recover in rates the costs of the California segment.[46] CPUC/SoCalGas/SDG&E and Texas Gas Service note that El Paso fails to cite examples in which the Commission allowed SFAS No. 157 principles to value plant assets and point out that the proposed approach would use two different valuation methodologies for Line 2000 and Line 1903.[47] CPUC/SoCalGas/San Diego contend that the All American assets were purchased as a single package; using differing methodologies would result in parts of the same pipeline facilities being valued completely differently.

42. Texas Gas Service objects to El Paso's assertion that recovery of the costs associated with the California segment will have no impact on rates. Texas Gas Service contends that El Paso was not simply allocating the purchase price among the three segments but instead was attempting to increase the overall rates by (1) excluding a portion of the costs assignable to Line 2000 to justify rolled-in treatment; (2) assigning the excluded costs to a second pipeline segment (California segment); (3) revaluing the California segment at $0 by assigning the costs associated with that segment to Line 1903; and (4) arguing that rolled-in treatment of the costs of Line 1903 is appropriate.[48]

43. The Indicated Shippers argue that the Presiding Judge clearly understood El Paso's position and properly rejected its approach. The Indicated Shippers object to El Paso's contention that the "used and useful" doctrine does not apply, claiming it is a circular argument. The Indicated Shippers assert that El Paso's theory would render the "used and useful" doctrine meaningless because unused facilities, by definition, would have no market value allowing costs related to any unused facilities to be allocated to other portions of the pipeline that are being used.[49]

Commission Determination

44. We affirm the Presiding Judge's findings that El Paso (1) may not recover $25.7 million in costs associated with the All American pipeline and (2) need not adjust its depreciable plant accounts to reflect the exclusion. El Paso's proposal to roll-in and recover in its cost of service the full remaining cost of the All American pipeline ($36.2 million) as the value of the Line 1903 segment is not just and reasonable and is

[46] Texas Gas Service Brief Opposing Exceptions at 58.

[47] CPUC/SoCalGas/SDG&E Brief Opposing Exceptions at 6; Texas Gas Service Brief Opposing Exceptions at 59.

[48] Texas Gas Service Brief Opposing Exceptions at 60.

[49] Indicated Shippers Brief Opposing Exceptions at 38-39.

inconsistent with Commission policy. El Paso's attempt to roll in and recover the $36.2 million would allow the recovery of $25.7 million of costs for facilities that are not "used or useful."

45. In the Line 1903 certificate proceeding, El Paso agreed to limit its request for a predetermination of rolled-in rate treatment to the mileage-based percentage of the remaining acquisition costs attributed to Line 1903 ($10.5 million of the total $36.2 million purchase cost). The Commission agreed to limit its predetermination of rolled-in treatment "to the costs associated with the 87.8 mile portion,"[50] and found that, absent a material change in circumstances, these costs will qualify for rolled-in rate treatment.[51] The Commission's predetermination was based on the cost estimates and facts presented in the certificate proceeding, i.e., that the portion of the acquisition cost attributable to Line 1903 was $10.5 million. The Commission deferred the issue of the costs related to the California segment ($25.7 million) to this rate case.

46. The Presiding Judge correctly found that by requesting rolled-in rate treatment for the $25.7 million of costs associated with the California segment, El Paso is attempting to seek recovery of costs for facilities that are not "used or useful." It is undisputed that the California segment is not used for the provision of jurisdictional service. As a result, the costs attributed to the California segment may not be included in El Paso's capital accounts for ratemaking and accounting purposes.[52] El Paso argues that the "used and useful" test does not bar recovery of the $25.7 million because the value of the California segment is $0 and the true cost of Line 1903 is $36.2 million based on a fair market valuation, rather than the mileage-based allocation it proposed for Line 2000 and Line 1903 and the Commission accepted. El Paso's attempt to sidestep the "used and useful" test is unavailing.

47. El Paso endeavors to demonstrate that the market value of the California segment is $0 by presenting open season announcements and testimony describing its efforts to sell the California segment. El Paso then argues that a market valuation of $0 necessitates a cost allocation of $0 for the California segment. Finally, El Paso argues that the full purchase price of $36.2 million should be allocated to Line 1903, the only portion of the remaining All American pipeline that the record demonstrated had value.

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[50] Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 42.

[51] Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 52.

[52] Trial Staff Brief Opposing Exceptions at 37 (citing *Smyth v. Ames*, 169 U.S. 466, 546 (1898); *Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094 (D.C. Cir. 1979); 15 U.S.C. § 717h(a) (2010)).

El Paso reasons that it was only able to purchase the Line 1903 and Line 2000 segments if it agreed to purchase the California segment as part of the acquisition; therefore, the $25.7 million cost of the California segment was a necessary expense associated with Line 1903. The Presiding Judge, however, correctly found that the mileage-based methodology El Paso used to value Line 2000 provides the only credible evidence of El Paso's original valuation of the All American assets and therefore provides the original valuation of Line 1903 and the California segment.[53]

48. The Commission's Uniform System of Accounts requires that gas plant be valued and recorded at actual cost.[54] The market value of the California segment has no bearing on the actual acquisition costs incurred by El Paso when it acquired the pipeline in 2000. El Paso's reliance on SFAS No. 157 principles is also unavailing. El Paso was unable to present any instances in which the Commission has applied SFAS No. 157 principles to value plant assets. Furthermore, as opposing parties note, SFAS No. 157 was not issued until September 2006, well after the purchase of the All American pipeline. Consequently, El Paso could not have utilized the accounting treatment at the time of purchase. El Paso has provided no evidence to support replacing the mileage-based cost allocation El Paso proposed in the Line 1903 certificate proceeding.

49. El Paso further suggests that the system benefits associated with the Line 1903 project fully justify rate recovery of the entire remaining costs of the All American pipeline purchase.[55] However, a project's benefits do not establish plant asset acquisition costs. While El Paso is correct that, under the Commission's Certificate Policy Statement,[56] if the revenues from a project do not exceed its costs, the entire cost of the project may be rolled-in if justified by system benefits, this is irrelevant to determining the appropriate asset cost.[57] El Paso misconstrues the Certificate Policy Statement to suggest that the system benefits from Line 1903 justify the rolled-in rate treatment of

[53] ID, 134 FERC ¶ 63,003 at PP 47, 51 (noting that El Paso's witness did not participate in sale negotiations and provided no evidence to support his assertion that All American insisted that El Paso assume ownership of all All American assets).

[54] Trial Staff Brief on Exceptions at 41 (citing 18 C.F.R. Part. 201, Gas Plant Instruction Nos. 2, Gas plant recorded at cost and 5, Gas plant purchased or sold).

[55] El Paso Brief on Exceptions at 56-61.

[56] Certificate Policy Statement, 88 FERC at 61,746.

[57] El Paso Brief on Exceptions at 62.

costs other than the actual acquisition cost – the mileage-based allocation of $10.5 million.

50. The Commission recognizes the value of repurposing or acquiring existing infrastructure in lieu of construction of new infrastructure. Our longstanding policy is to only allow the net book value of facilities in rate base for pipelines, such as El Paso, which continue to provide regulated natural gas services. While there have been limited exceptions to that policy, a pipeline cannot, in most instances, recover amounts in excess of book value through its jurisdictional rates.[58] Thus, we reject El Paso's reliance on Part 201, Gas Plant Instruction No. 7(G), which applies to land acquisitions. This proceeding addresses El Paso's attempt to recover the cost of oil-pipeline facilities that have never been converted to gas use, not land appurtenant to gas facilities.

51. Finally, we deny El Paso's request to adjust the depreciable plant accounts to reflect the exclusion of $25.7 million. El Paso provided no evidence to show that it has booked accumulated depreciation and deferred income taxes assessed on the California segment and as such no adjustment is necessary at this time.

52. In summary, El Paso's depreciable plant balance should reflect El Paso's end of test period actual book amounts, adjusted to include only the $10.5 million associated with El Paso's investment in Line 1903.

B. <u>Capital Structure</u>

53. El Paso requests an overall rate of return of 11.04 percent based on a capital structure composed of 60.8 percent equity and 39.2 percent debt, with a 13 percent cost of equity and an 8.02 percent cost of debt. El Paso adjusted the base period total capital of $2,888,879,485 for changes through the end of the test period – adding $197,864 of long-term debt and $88,184,303 of common equity. El Paso's total capital during the adjusted test period equals $2,977,261,652.[59] After adjustment for amortization, the outstanding debt for the test period ending December 31, 2008 was $1,166,495,929,[60] leaving $1,810,765,723 in equity.

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[58] *Enbridge Pipelines*, 100 FERC ¶ 61,260, at P 48 (2002) (*Enbridge*).

[59] Ex. EPG-189 at 5.

[60] *Id.* at 4-6. Trial Staff cites El Paso's filed rate base as $1.86 billion. Trial Staff 2010 Settlement Comments at 3 (March 16, 2010). *See also* ACC, Salt River, and Southwest Gas Initial Brief at 4 (citing Ex. SWG-1 at 5:1-2 ("El Paso's total capitalization, at over $2.9 billion, exceeds its requested rate base of $1.87 billion by over

(continued…)

54. El Paso asserts that its proposed capital structure of approximately 60 percent equity and 40 percent debt is representative of El Paso's actual amount of equity and debt capitalization at the end of the test period. El Paso asserts that its proposal is consistent with the Commission's preference to use a pipeline's actual capital structure for ratemaking purposes, citing Opinion Nos. 414 and 414-A. El Paso contends it satisfied the criteria set forth in these opinions for using its own, actual capital structure to develop rates because it (1) issues its own debt, (2) has its own separate bond rating, and (3) has an equity ratio that is not excessive in comparison with the equity ratios approved by the Commission in other cases and with the equity ratios of the proxy companies.[61]

55. El Paso objects to two adjustments to its capital structure that were approved by the Presiding Judge. El Paso participates in a cash management program, pooling its money in one account with its parent corporation El Paso Corporation (El Paso Corp.) and other affiliates (Cash Management Program). The Presiding Judge found that El Paso's balance in the Cash Management Program represents a $615 million loan to El Paso Corp. and adjusted El Paso's equity downward to offset this amount, which she held was not available for jurisdictional purposes. In addition, the Presiding Judge likewise excluded $145 million in undistributed subsidiary earnings resting with El Paso's wholly-owned subsidiary, Mojave Pipeline, as not being available for jurisdictional purposes.

56. We affirm the Presiding Judge's finding that El Paso's proposed capital structure is not just and reasonable and will direct El Paso to make adjustments to its equity capitalization, as discussed below.

1. <u>Equity Capitalization</u>

<u>Participants' Positions</u>

57. At hearing, several participants argued that the equity component of El Paso's capital structure should be revised to remove the $145 million of undistributed earnings

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55%"); Ex. IS-1 at 7:7-12 ("El Paso's proposed capitalization is almost $1 billion, or 33% higher, than it needs to be in order to finance rate base")).

[61] El Paso Initial Brief at 14 (citing *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414, 80 FERC ¶ 61,157, at 61,665 (1997); *order on reh'g*, Opinion No. 414-A, 84 FERC ¶ 61,084, at 61,415; *order on reh'g*, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998), *aff'd sub nom. North Carolina Utilities Comm'n v. FERC*, 203 F.3d 53 (D.C. Cir. 2000) (unpublished opinion)).

from Mojave Pipeline and the $615 million balance in the Cash Management Program.[62] They further argued that these amounts exceed El Paso's rate base by approximately 33 percent and are therefore not representative of its actual capital structure used for ratemaking purposes. The reflected adjustment would reflect an "actual" capital structure of approximately 46.5 percent equity and 53.5 percent debt. Southwest Gas, Salt River, and ACC (Joint Parties)[63] indicate that El Paso's proposed capital structure does not adequately reflect the risk profile of its jurisdictional operations because it includes substantial risk associated with the unregulated business operations of El Paso Corp. and other El Paso Corp. subsidiaries.[64]

58. El Paso objected to any adjustments to its equity capitalization as using a hypothetical capital structure contrary to the Commission's preference to use the pipeline's own, actual capital structure.[65] El Paso suggested that it has a relatively high business risk which necessitates a thicker equity ratio, and subsequent lower debt ratio and lower financial risk, and claimed that a higher equity ratio benefits El Paso ratepayers by creating a lower cost of debt.[66]

59. El Paso argued that the loans under the Cash Management Program are short-term investments, asserting that the outstanding balance under the Cash Management Program rolls over on a continual basis with an ability to demand repayment within one year. El Paso argued that the fact that its total capitalization exceeds its rate base does not justify the removal of the $615 million loan balance from El Paso's equity capitalization. El Paso emphasizes that the loan balance is not included in its rate base, suggesting that the loan balance may have been financed with debt and other sources of cash.[67] Finally, El Paso suggests that the proposed adjustments will reduce its total capitalization below a level needed to fund rate base related needs. El Paso suggests that the removal of an amount falling between $760 to $800 million from its total capitalization, resulting in

[62] The Indicated Shippers, Joint Parties, and Trial Staff.

[63] Southwest Gas, Salt River and ACC filed a joint brief on Capital Structure and Cash Management Practices issues as "Joint Parties."

[64] Joint Parties Initial Brief at 10-12.

[65] El Paso Initial Brief at 14-15.

[66] *Id.* at 16-17.

[67] El Paso Reply Brief at 21-22.

approximately $2.1 to $2.2 billion in total capitalization, would leave El Paso unable to fund its $2.7 billion in "rate base-related assets."[68]

Initial Decision

60. The Presiding Judge found El Paso's proposed capital structure of 39.2 percent debt and 60.8 percent equity was not just and reasonable because the equity component of El Paso's capital structure includes $145,307,340 of undistributed subsidiary earnings in FERC Account No. 216.1, Unappropriated Undistributed Subsidiary Earnings, and the $615,456,458 Cash Management Program balance in FERC Account No. 123, Investment in Associated Companies.[69] The Presiding Judge found that El Paso does not use those monies to provide jurisdictional service to El Paso customers which would artificially inflate El Paso's rates to the detriment of El Paso customers.

61. The Presiding Judge noted that a pipeline's capital structure should represent its investment in rate base.[70] The Presiding Judge stated that undistributed subsidiary earnings do not represent investment in rate base because they are not available to pipelines for investment in rate base and because a pipeline's rate base does not include investments attributable to undistributed subsidiary earnings.[71] The Presiding Judge noted that the Mojave undistributed subsidiary earnings were booked as retained earnings in Account No. 216.1, which is a stockholder's equity account under the Commission's Uniform System of Accounts.[72] Thus, the Presiding Judge concluded the undistributed subsidiary earnings are equity regardless of how El Paso financed its investment in its

[68] El Paso Initial Brief at 28-29; *see also* Brief on Exceptions at 30-31; Exs. EPG-46-48, EPG-387 (discussing witness Palazzari's determination of $2.7 billion in rate base and cost of service related assets and subsidiary investments).

[69] *See* ID, 134 FERC ¶ 63,002 at P 182.

[70] *Id.* P 184.

[71] *Id.* P 184 (paraphrasing *United Gas Pipeline Co.*, 13 FERC ¶ 61,044, at 61,096 (1980) (*United Gas*)).

[72] 18 C.F.R. Part 201 Uniform System of Accounts (Natural Gas), Balance Sheet Chart of Accounts; s*ee also* El Paso Form No. 2 for 2008, Page 112 (Apr. 20, 2009) (showing Proprietary Capital, Account Nos. 201-219, including 216.1). The Commission uses the term stockholders equity and Proprietary Capital interchangeably. *E.g.*, *Regulation of Cash Management Practices*, Notice of Proposed Rulemaking, FERC Stats. & Regs. ¶ 32,561, at P 3 (2002) (NOPR).

subsidiary Mojave. The Presiding Judge relied on *United Gas Pipeline Co.* (*United Gas*), which held that undistributed subsidiary earnings must be excluded from capitalization, because they are not available for purposes of rate base investment.[73] Applying *United Gas*, the Presiding Judge found the $145 million of undistributed subsidiary earnings should not be included in El Paso's equity capitalization. The Presiding Judge rejected claims that *United Gas* was no longer good law, citing the Commission's approval in *Golden Spread Elec. Coop., Inc.* (*Golden Spread*). In *Golden Spread*, the Commission applied *United Gas* in the negative to determine that proceeds from subsidiary operations would not be excluded from use in calculating the pipeline's capitalization because the funds had been moved from Account 216.1 to Account 216, Unappropriated Retained Earnings, an account that does not require such exclusion.[74]

62. The Presiding Judge also found that the $615 million Cash Management Program balance should be removed from El Paso's equity capitalization for ratemaking purposes. The Presiding Judge described the balance as $615 million in unsecured, long-term notes receivable from El Paso Corp., representing a long-term $615 million loan to El Paso Corp. under the Cash Management Program.[75]

63. The Presiding Judge also found that, as monies booked to Account No. 123, the Cash Management Program balance is not available for investment in El Paso's jurisdictional services. The Presiding Judge held that this loan balance cross-subsidizes El Paso Corp. and El Paso Corp.'s subsidiaries' non-jurisdictional operations while providing no benefit to El Paso customers, thereby artificially inflating El Paso's cost of service. The Presiding Judge stated that the interest revenues that El Paso receives for its loan to El Paso Corp. under the Cash Management Program do not reduce El Paso's customers' rates or offset their cost of service, and found that the Cash Management Program's short-term interest rate is not sufficient to compensate El Paso for the risk associated with its long-term loan to El Paso Corp. The Presiding Judge noted that a fundamental ratemaking principle is that a pipeline's capitalization should as closely as

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[73] *United Gas*, 13 FERC at 61,096.

[74] *See* ID, 134 FERC ¶63,002 at P 184; *Golden Spread Elec. Coop., Inc.*, 123 FERC ¶ 61,047, at P 120, 124 (2008) (noting that undistributed subsidiary earnings "are only represented on paper, and not actually available for the utility to use") (*Golden Spread*)).

[75] ID, 134 FERC ¶ 63,002 at PP 668-69.

possible represent its investment in rate base.[76] The Presiding Judge found that if El Paso declared dividends to El Paso Corp. in the amount of $615 million, instead of loaning those dollars to the parent, El Paso's equity capitalization would decrease by $615 million.

Briefs on Exceptions

64. El Paso argues that the Commission should overturn the Presiding Judge's ruling that the loan balance and undistributed subsidiary earnings totaling $760 million should be removed from the equity component of El Paso's capital structure. El Paso argues that (1) Commission policy requires that El Paso's actual capital structure be used to set rates; (2) total capitalization in excess of rate base does not justify removal of the assets; (3) the source of the loan balance and undistributed subsidiary earnings can not be traced to equity; (4) ratepayers are not subsidizing El Paso's loan to its parent; and (5) the proposed adjustments would increase El Paso's debt costs and inappropriately reduce El Paso's total capitalization below the cost of its rate base-related assets.[77]

65. El Paso cites its position at the hearing that the Commission's preference is to use a pipeline's actual capital structure for ratemaking purposes, and the Presiding Judge's finding that it meets the criteria established in Opinion Nos. 414 and 414-A for use of its own capital structure, because it (1) issues its own debt; (2) has its own separate bond rating; and (3) has an equity ratio that is not excessive in light of other equity ratios approved by the Commission in other cases and in comparison with the equity ratios of the proxy companies.[78] El Paso argues that there is no requirement that a pipeline's actual capital structure be based only on the portion of its capitalization underlying its rate base, or that non-rate base assets must be eliminated from the equity component of capital structure.[79]

[76] *Id.* P 185 (citing *El Paso Natural Gas Co.*, Opinion No. 582, 44 FPC 73, 77 (1970) (*El Paso I*), *aff'd El Paso Natural Gas Co*. v. *FPC,* 449 F.2d 1245 (5th Cir. 1971) (*El Paso II*)).

[77] El Paso Brief on Exceptions at 29 (citing summary in ID, 134 FERC ¶ 63,002 at P 64, 107-09).

[78] El Paso Brief on Exceptions at 14 (citing ID, 134 FERC ¶ 63,002 at P 183); Opinion No. 414, 80 FERC at 61,665, *order on reh'g*, Opinion No. 414-A, 84 FERC at 61,415.

[79] El Paso Brief on Exceptions at 15.

66. El Paso contests the Initial Decision as illogical stating that the fact that a pipeline's total capitalization exceeds rate base is neither unusual nor harmful to ratepayers.[80] El Paso asserts that the fact that capitalization is larger than rate base does not affect a pipeline's capital structure unless the assets not in rate base are financed in a different proportion than the assets used to provide service to the regulated company.[81] El Paso concludes that the mere existence of the loan balance is irrelevant to the determination of the justness and reasonableness of its capital structure.

67. El Paso argues that the Commission's baseline approach is to treat rate base as having been sourced in the same proportion of debt and equity as total capitalization.[82] El Paso contends that the Commission places the burden of asset tracing on the party seeking to exclude the assets from a pipeline's capitalization.[83] El Paso argues that there is a lack of record evidence tracing the source of the loan balance or the undistributed subsidiary earnings to equity.

68. El Paso notes that, since it receives cash from many sources and the loan balance accumulated over time, it is impossible to trace the source of either the $615 million loan balance or the $145 undistributed subsidiary earnings.[84] El Paso suggests that the most likely source of the $615 million loan is depreciation expense and Accumulated Deferred

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[80] *Id.* at 16.

[81] El Paso Brief on Exceptions at 17.

[82] El Paso Brief on Exceptions at 17 (citing *Kern River Gas Transmission Co.*, Order No. 486-A, 123 FERC ¶ 61,056, at P 127 (2008) (*Kern River*); and *Wyoming Interstate Company Ltd*., 69 FERC ¶ 61,259, at 61,984-85 (1994) (*WIC*)).

[83] El Paso Brief on Exceptions at 17-20 (citing *El Paso II*, 449 F.2d 1245; *Indiana & Michigan Electric Co.*, 4 FERC ¶ 63,039, at 65,312 (1978), *summarily aff'd*, 10 FERC ¶ 61,238 (1980) (*Indiana-Michigan*); *Southern Calif. Edison Co.*, 3 FERC ¶ 63,033 (1978) (*SoCal Ed.*), *aff'd without discussion*, 8 FERC ¶ 61,198 (1979); *Philadelphia Elec. Co.*, 10 FERC ¶ 63,034, *aff'd and rev'd in part*,13 FERC ¶ 61,057 (1980) (*Phila. Elec.*); *Mountain Fuel Resources, Inc.*, Opinion No. 214, 27 FERC ¶ 61,171, at 61,315 (1984) (*Mountain Fuel*); *Southern Natural Gas Co.*, 44 FPC 567 (1970) (*Southern Natural*); *Kansas-Nebraska Natural Gas Co.*, 54 FPC 923 (1975), *aff'd*, *Kansas-Nebraska Natural Gas Co. v. FPC*, 534 F.2d 227 (10th Cir. 1976) (*Kansas Nebraska*); *Ozark Gas Transm. Sys.*, 39 FERC ¶ 61,142 (1987) (*Ozark*); *WIC*, 69 FERC ¶ 61,259; and *Kern River*, 123 FERC ¶ 61,056 at P 127).

[84] El Paso Brief on Exceptions at 20.

Income Tax (ADIT).[85] El Paso concludes that absent tracing the source of such assets solely to an equity or debt issuance, removal of the loan balance and undistributed subsidiary earnings should be done using El Paso's total capitalization ratio, resulting in no impact to that ratio.

69. El Paso argues that it is no longer current Commission policy to require that the rate of return capitalization should, as nearly as possible, be representative of the types and relative amounts of capital invested in the company's rate base to which the rate of return is applied.[86] El Paso characterizes the Commission's finding in *United Gas* as based on an "outdated notion" in light of other cases adopting the tracing requirement (citing the 1994 *WIC* order),[87] as well as current Commission policy of using actual capital structure absent asset tracing, reflected in Opinion No. 414. El Paso also contests reliance on *Golden Spread* to affirm the findings in *United Gas*,[88] arguing that because the earnings in *Golden Spread* were not undistributed the holding is distinguishable and the reference to *United Gas* is *dicta*.

70. El Paso argues that, even if *United Gas* is still good law, the facts in this case do not warrant an adjustment to El Paso's equity capitalization. El Paso suggests that it would be unreasonable to remove the undistributed subsidiary earnings and leave in the debt costs that are used to finance the subsidiary investments.[89] El Paso argues that some portion of the investments in subsidiaries can reasonably be traced to a 2007 debt

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[85] El Paso Brief on Exceptions at 20 (citing Ex. EPG-297 at 7). El Paso explains that ADIT is a temporary source of cash that will be needed in the future to satisfy El Paso's tax obligations.

[86] *Id.* at 26 (citing *United Gas*, 13 FERC at 61,096).

[87] *WIC*, 69 FERC at 61,984-85 (applying rule that project-financed pipelines should not use traditional approach of dividing rate base between debt and equity based on capital structure percentages).

[88] El Paso Brief on Exceptions at 27 (citing *Golden Spread*, 123 FERC ¶ 61,047 at P 124)).

[89] *Id.* at 28 (citing *Arkansas-Louisiana Gas Co.*, 19 FERC ¶ 63,008, at 65,057 (1982) (initial decision) (*Arkla Gas*); *Arkansas – Louisians Gas Co.*, Opinion No. 160, 22 FERC ¶ 61,125 (1983)).

refinancing and that ratepayers benefit from the subsidiary investment and retained earnings through lower debt costs and ultimately lower rates.[90]

71. El Paso challenges the Presiding Judge's finding that El Paso's ratepayers are subsidizing El Paso's loan to its parent.[91] El Paso asserts that the Cash Management Program allows for greater financing flexibility, reduced borrowing and transactional costs, and increased liquidity. El Paso states that it uses the Cash Management Program as a checking account, in which funds are transferred on a daily basis based on cash needs. El Paso contests the claims that the interest rate El Paso charges its parent under the Cash Management Program was below-market and provided a benefit to El Paso Corp. at the expense of El Paso's ratepayers, as lacking merit. El Paso states that the interest rate paid by El Paso Corp. under the Cash Management Program is a market-tested floating LIBOR-based variable interest rate which is the same variable rate applicable to the revolver that El Paso Corp. negotiated at arms-length with a consortium of lenders.[92] El Paso suggests that the Cash Management Program limits funds available to El Paso Corp. to El Paso's excess funds.

72. Finally, El Paso claims the Presiding Judge failed to address El Paso's arguments that the proposed adjustments to capital structure would increase El Paso's debt costs and inappropriately reduce El Paso's total capitalization below the cost of El Paso's rate base-related assets.[93] El Paso claims that the effects of the proposed reductions to El Paso's equity capitalization would increase El Paso's cost of debt and lower El Paso's capitalization below a level needed to fund its rate base related assets.[94]

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[90] *Id.* (citing Ex. EPG-374 at 41, arguing that the 2007 debt received favorable rating by pledging Mojave assets and undistributed earnings).

[91] El Paso Brief on Exceptions at 22.

[92] *Id.* (citing El Paso Initial Brief at 18; El Paso Reply Brief at 13; Exs. EPG-374 at 20-22, EPG-379 and EPG-380; Ex. SWG-1 at 19).

[93] *Id.* at 30-31.

[94] The Commission rejects El Paso's April 4, 2001 Supplemental Brief discussing the impact of purchase accounting adjustments on capital structure. No. purchase accounting adjustment is present in this proceeding and the brief is untimely.

Briefs Opposing Exceptions

73. Participants supporting the Presiding Judge's removal of the $615 million loan balance and $145 million undistributed subsidiary earnings from El Paso's equity capitalization argue that (1) Opinion No. 414 does not preclude cost-based adjustments to El Paso's actual capital structure, (2) the Presiding Judge's findings are supported by Commission precedent, (3) El Paso's dollar tracing arguments are without merit, and (4) El Paso's contention that adjustments would reduce El Paso's capitalization below its capital needs is misleading.[95]

74. The Pro-Adjustment Participants support the Presiding Judge's holding that Opinion No. 414 does not preclude adjustments to El Paso's proposed capital structure.[96] According to Trial Staff, Opinion No. 414 summarized and amended the Commission's policy that, if a pipeline issues its own bonds, has a bond rating separate from its parent, and its proposed capital structure is not anomalous, the Commission will not impute a hypothetical capital structure, and will instead use the company's capital structure for ratemaking.[97] Trial Staff argues that Opinion No. 414 does not apply because no Party argued for, and the Presiding Judge did not adopt, a hypothetical capital structure.

75. The Pro-Adjustment Participants also contest El Paso's contention that, if a pipeline's capital structure meets the Opinion No. 414 test, then it is deemed to be just and reasonable for setting rates.[98] Trial Staff states that in Opinion Nos. 414, *et seq.*, the Commission affirmed that its goal in setting a company's capital structure for ratemaking purposes remains the determination of just and reasonable rates.[99] To that end, Trial Staff states that Commission policy provides that a company's actual capital structure will be

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[95] Trial Staff, Joint Parties and the Indicated Shippers are referred to in this section as the Pro-Adjustment Participants.

[96] Trial Staff Brief Opposing Exceptions at 29-30; Indicated Shippers Brief Opposing Exceptions at 12; Joint Parties Brief Opposing Exceptions at 7-11.

[97] Trial Staff Brief Opposing Exceptions at 30 (citing Opinion No. 414, 80 FERC at 61,657,*order on reh'g*, Opinion No. 414-A 84 FERC ¶ 61,084, *order on reh'g*, Opinioin No. 414-B 85 FERC ¶ 61,323).

[98] Trial Staff Brief Opposing Exceptions at 30-33; Indicated Shippers Brief Opposing Exceptions at 13; Joint Parties Brief Opposing Exceptions at 8-9, 20-22.

[99] Trial Staff Brief Opposing Exceptions at 31 (citing Opinion No. 414-A, 84 FERC at 61,415; Opinion No. 414-B, 85 FERC at 62,265).

used only if that capital structure produces just and reasonable rates; the Commission will make cost-based adjustments to the capital structure to ensure that rates are just and reasonable.[100] The Indicated Shippers suggest that El Paso's proposed capital structure does not pass the Opinion No. 414 test because its total capitalization significantly exceeds rate base.[101]

76. Trial Staff and Joint Parties assert that the $145 million undistributed subsidiary earnings and the $615 million loan balance are not available for investment in pipeline operations and accordingly warrant an adjustment to El Paso's capital structure for ratemaking purposes.[102] These Participants defend the adjustment as consistent with Commission policy requiring a pipeline to remove funds from equity or debt capitalization when those funds are not available for investment in jurisdictional operations and can be distinctly identified and surely isolated. According to Trial Staff and Joint Parties, the cases seek to ensure that these capital costs are not borne by the company's jurisdictional ratepayers.[103]

77. The Pro-Adjustment Participants defend the application of *United Gas* and *Golden Spread* to support the finding that El Paso's undistributed subsidiary earnings must be excluded from El Paso's capitalization because these funds are not available for rate base investment.[104] Trial Staff specifies that Commission policy requires the stockholder to exclude the undistributed earnings of subsidiaries from its equity.[105]

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[100] *Id.* (citing *Enbridge*, 100 FERC ¶ 61,260 at P 173).

[101] Indicated Shippers Brief Opposing Exceptions at 13-15.

[102] Trial Staff Brief on Exceptions at 12-14, 19-21; Joint Parties Brief Opposing Exceptions at 38-39.

[103] Trial Staff Brief Opposing Exceptions at 11 (citing *El Paso I*, 44 FPC 73; *El Paso II*, 449 F.2d at 1250); Joint Parties Brief Opposing Exceptions at 38-39 (citing *United Gas*, 13 FERC ¶ 61,044).

[104] Trial Staff Brief Opposing Exceptions at 13-15 (citing *Golden Spread*, 123 FERC ¶ 61,047 at P 124; *SoCal Ed.*, 3 FERC ¶ 63,033; *Phila. Elec.*, 13 FERC ¶ 61,057); Indicated Shippers Brief Opposing Exceptions at 19 (citing *Niagara Mohawk Power Corp.*, 29 FERC ¶ 61,768, at 61,770 (1984)); Joint Parties Brief Opposing Exceptions at 17 (citing *SFPP, L.P.*, 113 FERC ¶ 61,277, at PP 64-65 (2005)).

[105] Trial Staff Brief Opposing Exceptions at 13 (citing *Revisions in the Uniform System of Accounts, and Annual Reports Forms No. 1 and No. 2 to Adopt the Equity*

(continued…)

78. Trial Staff supports the adjustment to exclude the $615 million Cash Management Program balance from El Paso's equity capitalization. Trial Staff identifies the *Distrigas* proceeding, where the Commission held that a regulated entity's loans to its corporate parent were not available for investment in jurisdictional services, because the regulated entity's right to call on the funds was dependent on the desire of the corporate parent rather than the desires of the regulated entity.[106] Joint Parties indicate that El Paso's non-current loan balance has never fallen below $615 million since the beginning of the test period and that the amount has been on loan for at least three years.[107] Joint Parties assert that the entire balance of El Paso's FERC Account No. 123, Investment in Associated Companies, represents the non-current cash management loans and argue that the capital invested in associated companies cannot be simultaneously invested in El Paso's jurisdictional operations and rate base.[108]

79. Trial Staff asserts that there is no requirement that investments producing undistributed subsidiary earnings, and more generally any asset requested to be excluded from a utility's equity capitalization, must be traced to an equity issuance before those dollars may be excluded.[109] Trial Staff indicates that the Commission's definition of "tracing" is such that the Commission does not require strict capital tracing, and instead uses the term to describe a showing that establishes a reasonable conclusion as to the source of the funds.[110] Trial Staff and the Indicated Shippers suggest that El Paso misconstrues the evidentiary standard to require a demonstration that the assets in question were financed with debt or equity issuances to support an adjustment to a regulated entity's debt or equity capitalization.[111] Trial Staff maintains that Commission

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Method of Accounting for Long-Term Investments in Subsidiaries, Order No. 469, 49 FPC 326 (1973) (Equity Accounting Rule)).

[106] Trial Staff Brief Opposing Exceptions at 20 (citing *Distrigas Mass. Corp. v. FERC*, 737 F.2d 1208, 1218 (1st Cir. 1984) (*Distrigas I*), *aff'g in pertinent part, Distrigas of Mass. Corp.*, Opinion No. 178, 23 FERC ¶ 61,416 (1983) (*Distrigas II*), *summarily aff'g in relevant part*, 18 FERC ¶ 63,036 (1982) (initial decision) (*Distrigas III*).

[107] Joint Parties Brief Opposing Exceptions at 15-16. *See also* Ex. SWG-1 at 46 (Table 1, showing outstanding balance due from the Cash Management Program to El Paso ranging from $615 million in 2006 to $819 million in Aug. 2007).

[108] Joint Parties Brief Opposing Exceptions at 15-16.

[109] Trial Staff Brief Opposing Exceptions at 15.

[110] *Id.* at 16 (citing *Arkla Gas*, 19 FERC ¶ 63,008).

policy excludes assets from debt or equity based on evidence that supports a reasonable inference as to the source of the investment in that asset.

80. Trial Staff and the Indicated Shippers contend that El Paso failed to demonstrate that El Paso used debt to invest in Mojave or forward its loan to El Paso Corp., so as to shift a portion of the adjustment to debt.[112] According to Trial Staff, El Paso fails to provide any evidence or isolate a specific dollar amount to directly attribute El Paso's investment in Mojave to any debt incurred by El Paso – instead El Paso merely asserts that some unspecified portion of its investment in Mojave is sourced from debt.[113] The Indicated Shippers likewise argue that El Paso has not proven that the Cash Management Program loans cannot be traced to equity.[114] Trial Staff argues that Commission policy does not allow companies to assume that dollars invested in the subsidiary were sourced from debt.[115]

81. Trial Staff asserts that the record shows the $615 million loan was sourced from El Paso's equity, and most likely by El Paso's retained earnings.[116] Trial Staff asserts that El Paso Corp. pays a short-term interest rate for its loans under the Cash Management Program,[117] and asserts that it would be illogical for El Paso to borrow money from lenders to lend money to its parent company at a lower rate than it must pay its lenders.[118] Joint Parties suggest that the non-current Cash Management Program loans

[111] Trial Staff Brief on Exceptions at 22-23 (citing El Paso Brief on Exceptions at 21); Indicated Shippers Brief Opposing Exceptions at 16.

[112] Trial Staff Brief Opposing Exceptions at 16; Indicated Shippers Brief Opposing Exceptions at 15.

[113] Trial Staff Brief Opposing Exceptions at 16.

[114] Indicated Shippers Brief Opposing Exceptions at 15.

[115] Trial Staff Brief Opposing Exceptions at 16-17 (citing *Arkla Gas*, 19 FERC ¶ 63,008).

[116] *Id.* at 21 (citing *El Paso I*, 44 FPC 73 at 77; *El Paso II*, 449 F.2d at 1250; Ex. S-9 at 10; Ex. SWG-1 at 15, 18).

[117] *Id.* at 22, 33 (citing Ex. SWG-1 at 51:3-16; Ex. IS-1 at 12:12-16; Ex. EPG-438; Ex. EPG-329 at 9:27-10:1; Ex. S-9 at 10; Ex. SWG-1 at 15,18).

[118] *Id.* at 22 (citing Ex. IS-1 at 12:12-16).

are an asset on El Paso's balance sheet, located in FERC Account No. 123.[119] Trial Staff and Joint Parties conclude that, consistent with Commission precedent, it is unnecessary to perform capital tracing because the non-jurisdictional operations (the $145 million in undistributed earnings from Mojave and the $615 million loan balance to El Paso Corp.) are clearly severable.[120]

82. Trial Staff disputes El Paso's suggestion that because ADIT and depreciation expense are a potential source of the loan balance proceeds, that the proceeds be treated as coming from a loan. According to Trial Staff, any such "loan" would come from rate payers, and the Commission has found that deferred income taxes are not a loan, but instead are a form of cost-free financial capital.[121] Trial Staff states that deferred income taxes are deducted from rate base to reflect the fact that a certain portion of rate base is not financed by investor funds so that there is no interest cost to the utility on that portion of its rate base.[122] Trial Staff concludes that Commission policy presumes that ADIT finances El Paso's investment in its own plant and thus it is not available to loan to El Paso Corp.'s Cash Management Program. Trial Staff claims Commission policy does not acknowledge or establish a general rule that the debt ratio portion of depreciation expenses be considered as an available source of funds for non-utility investment.[123]

83. Trial Staff and the Indicated Shippers conclude that El Paso's proposed equity capitalization increases the equity component of El Paso's weighted average cost of capital above a just and reasonable level.[124] Trial Staff claims that, because equity costs more than debt, El Paso's unadjusted capital structure results in El Paso's customers

[119] Joint Parties Brief Opposing Exceptions at 32 (citing Tr. 367:13-15).

[120] Trial Staff Brief Opposing Exceptions at 23 (citing *El Paso Natural Gas Co. v. FPC*, 449 F.2d at 1250); Joint Parties Brief Opposing Exceptions at 32.

[121] Trial Staff Brief Opposing Exceptions at 24 (discussing El Paso Brief on Exceptions at 20).

[122] *Id.* (citing *Regulations Implementing Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes*, Order No. 144, FERC Stats. & Regs. ¶ 30,254 (1981); Order No. 144-A, Order Denying Rehearing, Lifting Stay and Clarifying Order, FERC Stats. & Regs. ¶ 30,340 (1982)).

[123] *Id.* at 25 (citing *Distrigas I*, 737 F.2d at 1218).

[124] *Id.* at 27; Indicated Shippers Brief Opposing Exceptions at 9-10.

paying higher rates than they would if the $615 million were excluded from El Paso's equity capitalization.[125] The Indicated Shippers estimate that El Paso's proposed capital structure results in approximately $35 million additional cost of service annually due to the higher ROE.[126] Trial Staff indicates that, while El Paso argues that the Cash Management Program benefits its ratepayers, El Paso has not demonstrated that it has passed any interest income or transaction-cost-related savings on to its customers. Furthermore, Trial Staff disputes El Paso's claims of benefits from financing flexibility and liquidity under the Cash Management Programs, because El Paso's status as a perpetual lender results in El Paso providing, rather than receiving, any such benefits.[127]

84. The Pro-Adjustment Participants further suggest that El Paso's ratepayers subsidize El Paso's $615 million cash management loan to El Paso Corp.[128] Trial Staff suggests that while the LIBOR-based interest rate is market tested and appropriate for El Paso Corp.'s $1.5 billion revolving line of credit, that does not mean it is appropriate for the Cash Management Program. Trial Staff distinguishes El Paso's Cash Management Program loans because they are unsecured, do not mature, and the corresponding agreement does not include any credit limit or financial covenant on its face.[129] Trial Staff suggests that El Paso Corp. controls how much and when El Paso contributes to the cash management program and can exercise control to El Paso's detriment. Trial Staff and the Indicated Shippers conclude that El Paso's cash management practices allow El Paso Corp. to borrow funds at a below-market rate to then invest in its unregulated subsidiaries.[130]

85. Trial Staff and Indicated Shippers dispute El Paso's claims that the Presiding Judge's adjustment to its capital structure will detrimentally affect customers by increasing El Paso's cost of debt and lowering El Paso's total capitalization amount

[125] Trial Staff Brief Opposing Exceptions at 27.

[126] Indicated Shippers Brief Opposing Exceptions at 10 (citing Ex. IS-1 at 8:8-10, Ex. SWG-1 27:6-8, and 63: Table 7).

[127] Trial Staff Brief Opposing Exceptions at 27-28 (citing Ex. SWG-1 n.15).

[128] *Id.* at 28; Indicated Shippers Brief Opposing Exceptions at 18.

[129] Trial Staff Brief Opposing Exceptions at 33.

[130] *Id*. at 34; Indicated Shippers Brief Opposing Exceptions at 18.

below a level needed to fund rate base plus other assets.[131] Trial Staff indicates the Presiding Judge's capital structure for ratemaking has no effect on El Paso's operating capitalization.

Commission Determination

86. We affirm the Presiding Judge's finding that El Paso's proposed capital structure of 39.2 percent debt and 60.8 percent equity is not just and reasonable because the equity component of El Paso's capital structure includes $145,307,340 of undistributed subsidiary earnings in FERC Account 216.1 and the $615,456,458 loan balance in FERC Account No. 123.[132] El Paso does not use those monies to provide jurisdictional service to El Paso customers, and failure to deduct these amounts from El Paso's capital structure results in an artificial inflation of El Paso's rates to the detriment of El Paso customers.

87. A pipeline must show that the capital structure it proposes to use for ratemaking purposes will produce just and reasonable rates.[133] "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed that is controlling."[134] In setting just and reasonable rates the Commission must determine that the rates are based on a reasonably balanced capital structure that reflects the risk of the regulated entity.[135] Because equity costs more than debt, the aim is to protect the ratepayer from excessive rates resulting from a capital structure with an unduly high equity ratio.[136]

88. El Paso contends that its actual, unadjusted capital structure must be used, because El Paso meets the criteria established in Opinion Nos. 414 and 414-A for the use of the pipeline's own capital structure. Those opinions provide that the Commission will use a pipeline's own capital structure instead of a hypothetical capital structure derived from its parent or other entities, if the pipeline (1) issues its own debt; (2) has its own separate bond rating; and (3) has an equity ratio that is not excessive in light of other equity ratios approved by the Commission and in comparison with the equity ratios of the proxy

[131] Trial Staff Brief Opposing Exceptions at 29 (citing El Paso Brief on Exceptions at 29-30); Indicated Shippers Brief Opposing Exceptions at 21.

[132] *See* ID, 134 FERC ¶ 63,002 at P 182.

[133] Opinion No. 414-A, 84 FERC at 61,415.

[134] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) (*Hope*).

[135] *Consolidated Gas Supply Corp*., 24 FERC ¶ 61,046, at 61,133 (1983).

[136] Opinion No. 414, 80 FERC at 61,665.

companies. The issue addressed in the Opinion No. 414 series was whether to use Transco's own capital structure, as Transco proposed, or whether to use its parent's capital structure, as staff and the protesters wanted. Thus, the policy and standards adopted in the Opinion No. 414 series address that issue.[137]

89. In this case, unlike the *Transco* rate case addressed by Opinion No. 414, no party has requested the use of a hypothetical capital structure, such as that of El Paso's parent. All parties (and the Commission) agree that El Paso's own capital structure should be used as the starting point for determining El Paso's rate of return. Instead, parties raise the issue of whether some elements of El Paso's own capital structure are not devoted to jurisdictional service and thus should be excluded. That issue was not raised or addressed in the Opinion No. 414 series. Therefore, those opinions do not stand for the proposition that a pipeline's unadjusted capital structure will always be used if it meets the Opinion No. 414-A criteria, without any examination of whether all elements of that capital structure are devoted to jurisdictional service.[138]

90. As the Commission held in *United Gas*, "The rate of return capitalization should, as nearly as possible, be representative of the types and relative amounts of capital

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[137] *See also Williams Natural Gas Co.*, 80 FERC ¶ 61,158, at 61,683 (1997):

> Traditionally, the Commission has preferred to utilize the applicant's own capital structure and will continue to do so if the applicant issues its own non-guaranteed debt and has its own bond rating. But the Commission will utilize an imputed capital structure (most often that of the corporate parent) if the record in a particular case reveals that the pipeline's own equity ratio is so far outside the range of other equity ratios approved by the Commission and the range of proxy company equity ratios that it is unreasonable.

order on reh'g, 86 FERC ¶ 61,323, *order on reh'g*, 84 FERC ¶ 61,080 (1998), *aff'd sub nom. Missouri PSC v. FERC*, 215 F.3d 1 (D.C. Cir. 2000) (rejecting challenges that Commission should have used an imputed capital structure or lowered rate of return to reflect lower risk in response to 64% equity ratio, absent stronger showing on relationship between equity ratio, risk, and rate of return).

[138] *See* Opinion No. 414, 80 FERC at 61,665 (rejecting suggestion that the Commission need only ascertain whether a pipeline issues its own debt); Opinion No. 414-B, 85 FERC ¶ 61,323 at 62,266 ("the focus of the Commission's analysis in all cases continues to be the reasonableness of the pipeline's equity ratio").

invested in the pipeline's rate base to which the return is applied."[139] In addition, in *Distrigas of Massachusetts v. FERC*,[140] the court affirmed the Commission's exclusion of a pipeline's loan to its parent from its capital structure, explaining that, only if assets "are related to [the pipeline's] regulated activities is it fair to count them as a 'regulatory' balance sheet asset for purposes of apportioning regulated-related assets among equity, long- term debt, and other liabilities."

91. Nothing in the Opinion No. 414 series of orders was intended to, or did, reverse the *United Gas* or *Distrigas* precedent. In fact, in Opinion No. 414-B, the Commission recognized that "many important cases were decided long before Opinion No.414-A . . . but that does not diminish their value as precedent."[141] Moreover, after the Commission issued Opinion No. 414, it issued an order applying Opinion No. 414 to approve the use of a pipeline's own capital structure, but nevertheless required an adjustment to the capital structure to correct excess capitalization.[142] Thus, *Iroquois* and Opinion No. 414-B indicate that it remains appropriate to make adjustments to a pipeline's capital structure to remove elements not devoted to jurisdictional service, despite the fact that the pipeline meets the Opinion No. 414 and 414-A criteria for using the pipeline's own capital structure, rather than a hypothetical capital structure.

92. The Presiding Judge correctly held that El Paso's undistributed subsidiary earnings and its loan to El Paso Corp. should be removed from its capital structure, because they are not part of its investment in rate base.[143] El Paso's undistributed subsidiary earnings and its loan to El Paso Corp. were not devoted to El Paso's jurisdictional pipeline services during the test period in this rate case. El Paso does not attempt to suggest otherwise.[144] However, it argues that the Commission treats the pipeline's rate base as

[139] *United Gas,* 13 FERC at 61,096.

[140] 737 F.2d 1208, 1227 (1st Cir. 1984) (Breyer, J.).

[141] Opinion No. 414-B, 85 FERC at 62,265.

[142] *See Iroquois Gas Transm. Sys., L.P*., 84 FERC ¶ 61,086, at 61,448 (1998) (*Iroquois*) (applying Opinion No. 414, and adopting adjusted capital structure after excluding cash reserves that were held for distribution after the test period).

[143] ID, 134 FERC ¶ 63,002 at P 185 (citing *El Paso I*, 44 FPC 73 at P 10, *El Paso II*, 449 F.2d 1245, 1251).

[144] El Paso Brief on Exceptions at 16, 24 (El Paso argues that the cash that El Paso loans under the Cash Management Program is not ratepayer money and ratepayers have no claim to the interest El Paso receives from the $615 million loan to El Paso Corp.).

having been financed in the same proportion of debt and equity as its total capitalization,[145] unless the party seeking to exclude an asset from a pipeline's capitalization bears the burden of tracing the source of that asset to a specific equity issuance by the pipeline.[146] El Paso argues that there is a lack of record evidence tracing the source of the undistributed subsidiary earnings or the loan balance to equity.

93. In order to remove an asset not devoted to jurisdictional service from the equity portion of a pipeline's capitalization, there must be a basis to attribute that asset to equity. However, we disagree that Commission policy requires a party seeking to exclude from equity undistributed subsidiary earnings or a long term loan to a parent the burden of tracing the source of those assets to a specific equity issuance. For example, in *SoCal Ed.*, *Indiana-Michigan* and *Phila. Elec.*, the Commission held that the undistributed earnings of subsidiaries are attributable to equity and should be excluded from equity capitalization, without reference to asset tracing.[147] Similarly, in *Distrigas*, the Commission excluded the pipeline's loan to its parent from equity "because the amount originated from internally generated funds – [the pipeline] had no debt or preferred stock issuances in either 1978 or 1979,"[148] and the court affirmed that decision. Thus, in *Distrigas*, there was no tracing of the excluded asset to a specific equity issuance. Rather, there was no basis to attribute the asset to any debt or preferred stock issuance. El Paso has the ultimate burden of persuasion to demonstrate the justness and reasonableness of its proposed capital structure for ratemaking purposes, and as part of that burden, it must, consistent with the above precedent, provide some basis for

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[145] El Paso Brief on Exceptions at 17 (citing *Kern River*, 123 FERC ¶ 61,056 at P 127; and *WIC*, 69 FERC at 61,984-85).

[146] El Paso Brief on Exceptions at 17-20 (citing *El Paso II*, 449 F.2d 1245; *Indiana-Michigan Electric Co.*, 4 FERC ¶ 63,039 at 65,312; *SoCal Ed.*, 3 FERC ¶ 63,033; *Phila. Elec.*, 13 FERC ¶ 61,057; *Mountain Fuel*, 27 FERC ¶ 61,171 at 61,315; *Southern Natural*, 44 FPC 567; *Kansas-Nebraska*, 54 FPC 923; *Ozark*, 39 FERC ¶ 61,142; *WIC*, 69 FERC ¶ 61,259; and *Kern River*, 123 FERC ¶ 61,056 at P 127).

[147] *SoCal. Ed.*, 3 FERC ¶ 63,033 at 65,203 (stating "[T]he undistributed earnings of subsidiaries are to be excluded from the common stockholder's equity in determining rate of return" and discussing asset tracing as a requirement to exclude remainder of investments in non-utility subsidiaries or "businesses not required for efficient operation of the jurisdictional business"); *Indiana-Michigan*, 10 FERC ¶ 61,238, *aff'g*, 4 FERC ¶ 63,039 (citing Equity Accounting Rule, Order No. 469, 49 FPC 326); *Phila. Electric*, 10 FERC ¶ 63,034, *aff'd and rev'd' in part*, 13 FERC ¶ 61,057 at 61,118, n.3.

[148] *Distrigas III*, 18 FERC at 65,121, *aff'd*, 23 FERC ¶ 61,416.

concluding that the undistributed subsidiary earnings and loan to its parent are partially sourced from debt.

94. The Commission has only required a showing that an asset can be traced to a specific equity issuance when considering whether to exclude a pipeline's investment in a subsidiary, as opposed to the undistributed earnings of that investment.[149] In that context, the Commission has found that it is reasonable to assume that a company invested in the subsidiary using funds available in the same ratio as that reflected in its overall capitalization, absent a showing tracing the source of the funds used for the investment to equity.[150]

95. We find that the other cases relied on by El Paso do not justify a different result. The cases demonstrate a case-by-case analysis based on the facts in each case whether the capital structure and resulting cost of capital is just and reasonable.[151] Several of the cases cited by El Paso support the exclusion from equity of undistributed subsidiary earnings without any asset tracing requirement.[152] Other cases are distinguishable because they address pipelines featuring specific rate design characteristics, such as project-financed pipelines or levelized rates, and did not calculate capital costs in the same manner as traditionally-financed pipelines.[153] Still other cases express skepticism for excluding the cost of facilities or projects that were integrated with the parent company's operations and were therefore not severable,[154] or did not involve a long-term

[149] *E.g.*, *Phila. Electric*, 13 FERC ¶ 61,057 (reversing exclusion of investments in subsidiary companies, where finances are managed on a consolidated basis, and subsidiary assets are pledged to obtain debt); *Indiana-Michigan*, 4 FERC ¶ 63,039, *aff'd* 10 FERC ¶ 61,238 (rejecting exclusion of investment in nuclear power generating subsidiary as not traceable to equity).

[150] *See Indiana-Michigan*, 4 FERC ¶ 63,039 at 65,312.

[151] *See id.* (rejecting adjustment for investment in subsidiary nuclear generator, because doing so would result in unreasonable 8 to 12 % equity ratio).

[152] *El Paso II*, 449 F.2d 1245; *Southern Natural*, 44 FPC 567 (1970), *Kansas Nebraska*, 54 FPC 923.

[153] *Kern River*, 123 FERC ¶ 61,056 at P 127 (rejecting methodology change in the middle of levelized rate period); *WIC*, 69 FERC ¶ 61,259.

[154] *SoCal. Ed.*, 3 FERC at 65,203 (citing evidence indicating that one subsidiary investment proposed for exclusion was for a businesses "required for efficient operation"

(continued…)

investment.[155] These cases do not establish asset tracing as a controlling factor, but one of many factors to be considered depending upon the nature of the asset at issue, with the focus being on whether the end result is just and reasonable.

96. In the case of the undistributed subsidiary earnings, we affirm the Presiding Judge's finding that *United Gas* supports the exclusion of the undistributed subsidiary earnings as not being available for investment in jurisdictional activities.[156] This finding is fully consistent with the Commission's assessment in *Golden Spread* that undistributed subsidiary earnings "are only represented on paper, and not actually available for the utility to use. Once the subsidiary pays a dividend or the utility sells the subsidiary, the amount becomes available for the utility to use at its discretion."[157] Thus, these paper accounting entries do not represent actual capital available for El Paso's use, and may not be counted towards El Paso's outstanding capital to calculate rate of return. As these funds are booked to Account No. 216.1, a Proprietary Capital/equity account under our Uniform System of Accounts, it is appropriate to reflect the exclusion from the equity component of El Paso's capitalization, rather than apply the exclusion proportionately to debt and equity as El Paso advocates.[158]

97. El Paso has failed to demonstrate that undistributed subsidiary earnings arose from a debt issuance or that its 2007 debt refinancing activities resulted in additional funds available for investment in jurisdictional activities. Instead, as our accounting reflects, the undistributed subsidiary earnings represent unrealized equity in the subsidiary,

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of the investing parent); *Indiana-Michigan*, 4 FERC ¶ 63,039 (noting that subsidiary is an integral part of parent's operations, parent purchases all power from nuclear generating plant and parent meets all operating expenses).

[155] *Mountain Fuel*, 27 FERC ¶ 61,171 (addressing current receivables in Account No. 145, Notes Receivable from Associated Companies).

[156] *United Gas*, 13 FERC at 61,096; *Golden Spread*, *Golden Spread*, 123 FERC 61,047 at PP 124-125; 115 FERC ¶ 63,043 at PP 62, 68-69 (initial decision). *See also Holyoke Water Power Co.*, 28 FERC ¶ 61,361, at 61,650-51 (1984) ("The capital structure should represent the sources of funds used to finance rate base. Since Account 216.1 does not represent cash received or generated by the company, it cannot be a source of financing for the rate base").

[157] *Golden Spread*, 123 FERC ¶ 61,047 at P 120.

[158] *United Gas*, 13 FERC at 61,096; *Golden Spread*, 123 FERC at PP 124-25; 115 FERC ¶ 63,043 at PP 62, 68-69.

generated from pipeline operations. When that equity is in fact appropriated by the parent, it will be recognized in Account 216 as retained earnings, or equity. Therefore we affirm the Presiding Judge's finding that the $145 million of undistributed subsidiary earnings should be removed from El Paso's equity capitalization for ratemaking purposes.

98. In light of our precedent and findings, we do not find El Paso's argument that the potential availability of these funds permitted it to obtain lower debt costs. Initially, we note that our precedent generally considers unified financing activities, when examining whether to exclude investments in subsidiaries. That issue is not present in this case, since no party has sought to exclude El Paso's investment in its Mojave subsidiary from the equity portion of its capital structure. Furthermore, El Paso's conclusory assertion fails to establish that the lower debt costs were not available, and thus taken advantage of, based on some other consideration, such as that the rates reflected the then-current market for the debt. Finally, assuming that El Paso was able to obtain lower debt costs by pledging readily available assets, El Paso has failed to quantify these savings and demonstrate that they exceed the savings in liquidating the undistributed subsidiary earnings and paying down debt or equity.

99. As for the Cash Management Program balance, the protestors assert that the Cash Management Program balances are large, constituting a 33 percent increase over rate base; they represent a significant long-term cash outlay to El Paso Corp. The record shows that El Paso has maintained a large balance in the Cash Management Fund.[159] Furthermore, we agree with Trial Staff's assessment that by lending the funds to the parent corporation, El Paso limited its own financial liquidity and flexibility rather than expanded. Furthermore, Trial Staff alleges that El Paso has failed to obtain adequate compensation for the risks it undertakes in the Cash Management Program, since it is receiving compensation appropriate for a short-term loan for this unsecured long-term loan to its parent. On this basis, we find that protestors have provided sufficient evidence to raise a legitimate question as to the reasonableness of the use of the loan amount for capitalization purposes in this proceeding, and that the burden properly shifts to El Paso to demonstrate that its proposed equity ratio is just and reasonable. In light of these

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[159] Ex. SWG-1 at 46 (Table 1, showing outstanding balance due from the Cash Management Program to El Paso ranging from $615 million in 2006 to $819 million in Aug. 2007). *Compare* Opinion No. 414, 80 FERC at 61,666 (proposed 2 percent adjustment for parent corporation's advance to subsidiary rejected as having "only a minor effect") and *Iroquois*, 84 FERC ¶ 61,086 at 61,448 (applying Opinion No. 414, and adopting adjusted capital structure after excluding $30 million in cash reserves that were held for distribution after the test period).

concerns, the burden is on El Paso to explain why the outstanding equity that is used on a long-term basis for non-jurisdictional purposes should be reflected in its capital structure.

100. El Paso argues that (1) its capital structure is not unjust and unreasonable due to the fact that its capitalization exceeds rate base, (2) any adjustments should be made pro rata to both debt and equity to reflect that the source of the funds cannot be attributed solely to El Paso's equity capitalization, (3) it would be unreasonable to remove the undistributed subsidiary earnings without making a corresponding adjustment to debt costs used to finance the subsidiary, and (4) the undistributed subsidiary earnings and loan to El Paso Corp. are beneficial to El Paso's customers and the adjustment would raise debt costs and lower capitalization below a level needed to service "rate base related assets."

101. For the reasons discussed below, we reject these arguments as a basis for overturning the Presiding Judge's decision to remove the $615 million loan balance from El Paso's equity capitalization.

102. As with the undistributed subsidiary earnings, excluding the loan balance from equity because the funds are not available for jurisdictional activities is consistent with our precedent. In *Distrigas*, the Commission found that funds loaned by a regulated entity to its parent are not available for investment in jurisdictional services.[160] The Commission determined that ratepayers are responsible for payment of a return on only those funds devoted to jurisdictional services and removed the loan balance from the pipeline's equity capitalization because the amount originated from internally generated funds.[161] The Commission found that the funds were not available, despite being owed to the subsidiary through a demand note, due to the control that the parent exercised over the transaction.[162]

103. Likewise in *Southern Natural*, the Commission approved a $29 million exclusion from equity representing dividends and sales proceeds from received from a non-utility subsidiary that were advanced to another subsidiary. Applying *El Paso*, the Commission reasoned that if the appropriate deduction from equity were not made, the capitalization

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[160] *See Distrigas I*, 737 F.2d at 1218 (affirming Commission determination that funds due under demand note were not available, because the right to call for money on deposit with a sole shareholder depends on the desires of the shareholder, not the lending subsidiary, and upholding exclusion); *Distrigas III*, 18 FERC at 65,121.

[161] *Distrigas III*, 18 FERC at 65,121.

[162] *Distrigas I*, 737 F.2d 1208 at 1218 (citing *El Paso II*, 449 F.2d at 1250-51).

would reflect" investment in properties not related to the jurisdictional business which we are regulating."[163] Again, this order supports the Presiding Judge's exclusion, demonstrating that funds that have been realized as earnings in general equity need not be traced to some former debt or equity issuance.

104. Similarly, in this instance, we affirm the Presiding Judge's findings that the Cash Management Program balance was not available to El Paso in the test period. El Paso acknowledges that it receives the cash that it loans under the Cash Management Program from various business activities, including from ratepayers for services rendered.[164] The $615 million in the Cash Management Program was not in El Paso's hands at the close of the test year such that the funds were not "available" to El Paso. As in *Distrigas*, we believe that it is appropriate to consider more than the form of the debt instrument, and find the funds not available based on the underlying practical realities.[165] Despite characterizing the Cash Management Program as akin to a checking account, El Paso does not account for the balance as a current asset, but instead accounts for the balance in Account No. 123 as a long-term investment. Consequently, we affirm the Presiding Judge that the loan funds were properly excluded under *El Paso II* and *Distrigas* as not being available for investment in jurisdictional activities.

105. El Paso argues that the lack of record evidence tracing the source of the $615 million loan to equity should result in the $615 million being removed from El Paso's capital structure in the same 60/40 equity/debt ratio as El Paso's total capitalization.[166] El Paso notes that since it receives cash from many sources, and the loan balance accumulated over time rather than being funded from a particular debt or equity issuance, it is impossible to trace the source of the $615 million loan balance.[167] El Paso maintains that the most likely source of the $615 million loan is not equity, but depreciation expense and ADIT.[168]

[163] *Southern Natural*, 44 FPC 567, 571-72 (1970) (citing *El Paso I*, 44 FPC 73).

[164] El Paso Brief on Exceptions at 24.

[165] *Distrigas I*, 737 F.2d at 1218.

[166] El Paso Brief on Exceptions at 16-20, 27.

[167] *Id.* at 20.

[168] *Id.* (citing Ex. EPG-297 at 7). El Paso explains that ADIT is a temporary source of cash that will be needed in the future to satisfy El Paso's tax obligations.

106. We disagree with El Paso that, based on an asset tracing theory, adjustments to debt are appropriate, since such adjustments would only serve to increase costs to ratepayers to finance activities that provide them no benefit.[169] We disagree that asset tracing is necessary in this instance. El Paso has taken funds generated from general revenue and operations. Once earned, no debt issuance has any claim on these funds, but instead they represent additional equity available to the pipeline to dispose of at its discretion. In this instance, however, El Paso has chosen to dispose of these funds by delivering them to its corporate parent by way of the Cash Management Program. As such, they represent an asset that offsets the liability that it owes its shareholder parent by way of common stock.

107. The precedent cited in this case establishes that funds that are not available for investment in jurisdictional operations and can be distinctly identified and isolated may be removed from a company's capitalization to ensure that the capital costs are not borne by the jurisdictional ratepayers.[170] Once such a determination is made, the Commission must determine what adjustment to the capital structure is necessary to ensure just and reasonable rates.

108. El Paso dismisses the fact that its capitalization exceeds rate base, arguing that the fact does not require an adjustment, and that the adjustment will cause its capitalization to fall below its needs for "rate base related assets."[171] Consequently, El Paso predicts that it will face higher debt costs and greater risk, because as a company's debt capitalization increases, so does its cash flow devoted to debt servicing, and thus its risk to investors.[172]

109. We find these assertions unconvincing. The Commission is not ordering El Paso to take any action to increase its debt, to devote additional funds to debt servicing or to exclude funds from being available to meet capital needs as they may arise. In this proceeding, El Paso has taken funds that appear to be generated from general revenue and

[169] *See Enbridge Pipelines*, 109 FERC ¶ 61,042, at P 94 (2004) (citing *Transcontinental Gas Pipe Line Co.*, 71 FERC ¶ 61,305, at 62,193 n.14 (1995) (in general, the Commission does not impute equity, because this can overcompensate the equity holder at the expense of the ratepayer)).

[170] *See El Paso I*, 44 FPC 73, *El Paso II*, 449 F.2d at 1250.

[171] El Paso Brief on Exceptions at 30-31; Ex. EPG-229 (Vilbert resume); Ex. EPG-374 at 46 (Palazzari rebuttal), Ex. EPG-387.

[172] *Id.* at 29-31; Ex. EPG-374 at 44-47 (Palazzari rebuttal); Ex. EPG-335 at 27-28 (Vilbert rebuttal).

earnings, and delivered them to its sole shareholder through the Cash Management Account. Regardless of the propriety of this action from a financial perspective, the Commission anticipates that the economic realities of El Paso's action will remain unchanged by our ruling on its capital structure for ratemaking purposes. That is, we anticipate that El Paso's debtors are able to independently weigh the risks of El Paso's financial position, including the benefits and risks of the outstanding Cash Management Program balance, without awaiting the Commission's assessment of the facts for rate making purposes.[173]

110. The Commission has elsewhere rejected the idea that adjustments are needed when capitalization falls below rate base.[174] Here, the adjusted capitalization of $2.216 billion continues to exceed El Paso's filed rate base of $1.86 billion by a healthy margin.[175] While it is typical and usual for a pipeline's capital to be higher than rate base, in this case, El Paso is carrying a substantial balance representing 33 percent of its rate base as a long-outstanding debt issue spanning several years.[176] The Commission has elsewhere approved adjustments for smaller amounts.[177]

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[173] *El Paso II*, 449 F.2d 1245, 1249-50 (affirming Commission assumption "that a potential shareholder or lender-investor could determine the value of the regulated versus the non-regulated operations and calculate the sureness of his regulated return on the one and the commercial risk he assumes on the other").

[174] *Williston Basin Interstate Pipeline Co.*, 84 FERC ¶ 61,081, at 61,378 (1998).

[175] El Paso's capitalization exceeds its rate base (or reflects "excess capitalization") by about a billion dollars. Consequently, we disagree that El Paso will be under funded if we approve the proposed adjustments, which total approximately $760 million.

[176] Despite its claims that it needs the funds to cover "rate base related" needs, and that the Cash Management Program is used like a checking account, El Paso has failed to demonstrate any significant draw down or that the Cash Management Program funds are being held to meet any current needs in the test period. To the extent that El Paso needs the funds to address rate base related needs, it can be expected that El Paso will draw down the account to meet those needs. As noted in *Distrigas*, to the extent these loans are repaid, El Paso may, in any future rate proceedings, properly claim these amounts as part of its equity capitalization. *See Distrigas III*, 18 FERC at 65,121 (initial decision).

[177] *Iroquois*, 84 FERC at 61,448 (applying Opinion No. 414 and also requiring adjustment to capital structure that exceeded rate base by $60 million, or 11.5 percent of rate base).

111. El Paso cites testimony that it needs additional capital to service needs related to rate base or cost of service items and investments in subsidiaries.[178] We find that this testimony supports the exclusion, because the testimony demonstrates that El Paso may have capital needs beyond the rate base needed to serve its jurisdictional customers. El Paso's calculation does not account for retained earnings and includes investments in its subsidiary and construction work in product that does not support jurisdictional service.[179]

112. Based on the facts in this case, we find the adjustment to exclude the loan balance appropriate. The record in this proceeding demonstrates that El Paso has taken available funds, which it claims arose from ADIT and depreciation expense,[180] and delivered those funds to its sole shareholder El Paso Corp. through the instrument of the Cash Management Program. El Paso does not account for these funds as a current liability, but instead assigns them to Account No. 123, Investments in Associated Companies. The resulting loan to the parent is significant and long-standing, preceding the beginning of the test period in this proceeding. The outstanding balance does not reflect any activity which would demonstrate that the loan balance arose out of El Paso's debt operations, and El Paso does not demonstrate that its 2007 debt financing activities resulted in any new funds available to fund its parents' operation, nor why it would borrow money pledging rate base assets in order to make a long-term loan to its parent corporation at short-term rates. Instead, the record supports the finding that El Paso made the loan out of then-available funds and, in doing so, made those funds unavailable.[181]

113. We disagree with El Paso that reflecting the assets in question in the capital structure does not harm El Paso's ratepayers. Doing so would subject the ratepayers to

[178] *See* El Paso Brief on Exceptions at 30-31 and supporting testimony and exhibits (i.e., Ex. EPG-387).

[179] The orders rejecting an adjustment to capitalization for subsidiary investments did not consider that the funds were not used for jurisdictional purposes, but determined that any adjustment would be made in an adjustment allocable to debt and equity using the existing proportions.

[180] The Commission has previously described ADIT as "a source of cost-free capital" used to reduce the financing costs borne by the ratepayer. *Trunkline LNG Co.*, 29 FERC ¶ 61,195, at 61,392 (1984).

[181] *See Distrigas III*, 18 FERC at 65,121 (initial decision) ("The adjustment shall be made to equity because the amount originated from internally generated funds"), *summarily aff'd*, *Distrigas II*, 23 FERC ¶ 61,416.

the immediate harm of higher capital costs over and above the cost of the capital needed to provide jurisdictional services. Furthermore, we agree that El Paso's status as a perpetual net lender under El Paso Corp.'s control means that El Paso provides, rather than receives, the financing flexibility and liquidity typically afforded cash management participants.[182]

114. In sum, asking El Paso ratepayers to bear increased capital costs, which are above the level necessary to provide a reasonable return on those assets devoted to jurisdictional service, is not just and reasonable if the Cash Management Program loan is included in El Paso's capital structure.[183]

115. To protect El Paso's ratepayers, it is necessary to sever and exclude the loan balance from El Paso's capitalization or provide El Paso's customers receive some offsetting benefits.[184] El Paso attempts to argue that its ratepayers derive many benefits from El Paso's investments in Mojave and the Cash Management Program such as lower debt costs and ultimately lower rates.[185] However, the Presiding Judge found that El Paso customers do not benefit from the loan to El Paso Corp.[186] El Paso makes generalized claims of benefits stemming from borrowing against a larger capital base. However, it has not quantified such benefits or shown that they are significant in light of the immediate costs of asking El Paso ratepayers to bear increased capital costs, which are above the level necessary to provide a reasonable return on those assets devoted to jurisdictional service. We find the increased costs are not just and reasonable in this instance if the Cash Management Program loan is included in El Paso's capital structure.[187] Therefore, we find that El Paso's proposed capital structure harms El Paso's ratepayers and is not just and reasonable, and that an adjustment to its total capitalization for ratemaking purposes is appropriate.

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[182] Trial Staff Brief Opposing Exceptions at 28.

[183] *Id*. at 11.

[184] *El Paso I*, 44 FPC 73 at 77; *El Paso II,* 449 F.2d at 1250.

[185] El Paso Brief on Exceptions at 28 (citing Ex. EPG-374 at 42:17-18, 44:2-4).

[186] ID, 134 FERC ¶ 63,002 at P 182, Findings of Fact at P 674 (The interest revenues that El Paso receives for its loan to El Paso Corp. under the Cash Management Program do not reduce El Paso's customers' rates or offset their cost-of-service), Conclusions of Law at P 685.

[187] *See* Trial Staff Brief Opposing Exceptions at 11.

116. Based on these findings, El Paso must revise its capital structure consistent with this determination. The Commission estimates that the required changes would result in a capital structure of approximately 47 percent equity and 53 percent debt.[188]

117. Further, we find that Trial Staff and Indicated Shippers have persuasively shown that El Paso's claim that such an adjustment to its capital structure will detrimentally affect customers has no merit.[189] El Paso's capital structure for ratemaking purposes has no effect on El Paso's operating capitalization. The Commission will not require El Paso to divest its assets contained in the Cash Management Program; therefore El Paso's concerns are rendered moot. Accordingly, removing the $615 million loan balance to El Paso Corp. from El Paso's equity capitalization for ratemaking purposes provides sufficient protection from the cross-subsidization concerns raised by Trial Staff, Joint Parties, and the Indicated Shippers, as discussed more fully below.[190]

2. <u>Cash Management Practices</u>

118. In its Initial Brief, Trial Staff argued that the proposed adjustments to El Paso's capital structure do not address the fact that El Paso's cash management practices continue to result in unlawful cross-subsidization and transfer unmitigated risk to El Paso and its customers. Trial Staff therefore argued that ring-fencing measures[191] should be adopted prospectively to protect El Paso and its customers from the detrimental effects resulting from the Cash Management Program. Trial Staff proposed that all El Paso

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[188] El Paso proposed a capital structure of 60.8 percent equity and 39.2 percent debt on total capital of $2.977 billion as representing El Paso's actual amount of equity and debt capitalization at the end of the test period on December 31, 2008. According to Trial Staff El Paso's filed rate base was $1.86 billion (March 16, 2010 Settlement Comments). The Commission estimates that El Paso's capital structure as determined here would have an approximately 47 percent equity ratio on a combined debt and equity total of $2.216 billion. *See* Ex. EPG-335 at 26.

[189] Trial Staff Brief Opposing Exceptions at 29 (citing El Paso Brief on Exceptions at 29-30); Indicated Shippers Brief Opposing Exceptions at 21.

[190] El Paso is directed to calculate its capital structure consistent with this order in the compliance filing directed below.

[191] *See* ID, 134 FERC ¶ 63,002 at P 124 ("'Ring-fencing' involves mechanisms intended to separate and protect the financial assets and ratings of a regulated utility from the business risks of other companies in a holding company;" (citing *FPA Section 203 Supplemental Policy Statement*, 120 FERC ¶ 61,060 n.14 (2007))).

Corp. money pool transactions be short term (one year or less) and continue to be payable on demand. Trial Staff further proposed that either (1) El Paso Corp. participate in the money pool as a lender only and not borrow from El Paso or any El Paso Corp. money pool participants or (2) the money pool for FERC-regulated subsidiaries with captive customers be maintained separately from the money pool for El Paso Corp. and all other non-regulated subsidiaries. Joint Parties also argued that the Commission's use of ring-fencing provisions for public utilities should be extended to natural gas companies and that the lack of ring-fencing for cash management transactions causes credit ratings downgrades. Joint Parties further argued that the repeal of the Public Utility Holding Company Act of 1935 (PUHCA 1935) will create a regulatory gap unless the Commission considers ring-fencing measures for natural gas companies. Joint Parties argue that this rate proceeding is the logical forum for considering these consumer protections.[192]

El Paso's Position

119. In its Reply Brief, El Paso argued that the ring-fencing proposals appear to be directed at pipeline cash management programs generally and that parties wising to pursue these measures should petition the Commission to institute a rulemaking to revisit cash management practices.

Initial Decision

120. The Presiding Judge found that El Paso's cash management practices seem to comply with the Commission's cash management policies, and no participant in this proceeding alleges otherwise. The Presiding Judge found, however, that a determination whether El Paso's cash management practices comply with Commission policy was not necessary to her findings regarding El Paso's proposed capital structure. Therefore, the Presiding Judge made no determination whether ring-fencing measures were needed for El Paso's Cash Management Program.

Briefs on Exceptions

121. Trial Staff argues that the Presiding Judge erred in observing that "El Paso's cash management practices seem to comply with the Commission's cash management policies [and] no Participant in this proceeding alleges otherwise."[193] Trial Staff alleges that the Presiding Judge fails to distinguish between the Commission's cash management

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[192] Joint Parties Initial Brief at 29-35.

[193] Trial Staff Brief on Exceptions at 8 (citing ID, 134 FERC ¶ 63,002 at P 187).

"policies" and the Commission's cash management documentation and reporting requirements.[194] Acknowledging that no participant alleges that El Paso failed to comply with the Commission's cash management documentation and reporting requirements, Trial Staff and Intervenors allege that El Paso's cash management practices violate the Commission's cash management policies.

122. Trial Staff argues that the Presiding Judge erred in declining to rule on El Paso's failure to comply with the Commission's cash management policies.[195] Trial Staff and Joint Parties argue that El Paso's cash management practices detrimentally affect El Paso's ratepayers by transferring significant financial risk from El Paso Corp. to El Paso in a manner that harms El Paso's customers.[196]

123. Trial Staff argues that El Paso's cash management practices provide El Paso Corp. the benefit of below-market interest rates and lower debt costs while increasing El Paso's capital costs and providing no offsetting benefits to El Paso's customers.[197]

124. Trial Staff and Joint Parties argue that both ratemaking and ring-fencing remedies are required, and that the exclusion of the $615 million cash management amount from El Paso's equity capitalization is an insufficient remedy. Therefore, Trial Staff and Joint Parties recommend that the Commission impose ring-fencing measures to interrupt the alleged transfer of benefits from El Paso and its customers to El Paso Corp.[198]

125. Joint Parties argue that this proceeding provides an opportunity for the Commission to close a substantial regulatory gap resulting from the repeal of PUHCA 1935; Joint Parties conclude that the Commission has already implemented a ring-fencing policy for public utilities and suggest that ring-fencing should now be extended to natural gas pipelines.[199]

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[194] *Id.* at 9-10.

[195] *Id.* at 11.

[196] *Id*. at 14-16; Joint Parties Brief on Exceptions at 14-15.

[197] Trial Staff Brief on Exceptions at 26.

[198] *Id*. at 30; Joint Parties Brief on Exceptions at 15.

[199] Joint Parties Brief on Exceptions at 17.

Briefs Opposing Exceptions

126. El Paso argues that the Commission should decline the invitation to impose ring-fencing on natural gas company cash management programs, for these conditions are not supported by evidence, would destroy the benefits of such cash management programs, and are beyond its authority to impose under the NGA.[200] El Paso notes that not one commenter in the cash management program rulemaking requested the Commission to impose ring-fencing measures on such programs; the reason is that the theories upon which ring fencing are based rest on a fundamental misconception of the financial considerations, relationships and benefits underlying cash management programs, and the Commission's authority to regulate them.

127. El Paso points out that no witness in this case proposed ring-fencing measures, and if the Commission considers these proposals on brief, it would deprive El Paso of due process because El Paso did not have an opportunity to respond to these proposals with expert testimony or evidence.[201] The only evidence in the record concerning the desirability of adopting ring-fencing measures was elicited through examination of El Paso's witnesses, and such testimony supports the conclusion that such measures should not be adopted. The Commission should not consider such a significant change in its cash management policies based on such an incomplete record.[202]

128. El Paso argues that it did not violate the Commission's cash management policies. El Paso explains that, like most pipelines, it participates in a cash management program in which El Paso Corp. and other of its affiliates pool their money into one account. El Paso states that it uses the Cash Management Program as a checking account in which funds are transferred every day based on its cash needs.[203]

129. Trial Staff claims that when the Presiding Judge found that El Paso's cash management practices "seem to comply" with the Commission's cash management policies, she really meant that El Paso did not violate the Commission's cash management documentation and reporting requirements and not its cash management policies. El Paso argues that Trial Staff's attempt to recharacterize the Presiding Judge's finding is unavailing; the only cash management policy the Commission has is embodied

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[200] El Paso Brief Opposing Exceptions at 4.

[201] *Id.* at 1-2.

[202] *Id*. at 6-7.

[203] *Id.* at 7.

in the documentation and reporting requirements promulgated in Order No. 634.[204] El Paso disagrees with the efforts of Trial Staff and Joint Parties to liken El Paso's cash management practices to those of Transwestern Pipeline Company and Northern Natural Gas Company, the two former subsidiaries of Enron Corporation that gave rise to the Order No. 634 rulemaking. El Paso argues that there is no evidence in this record that El Paso Corp. instructed El Paso to borrow money for the purpose of loaning the money to El Paso Corp. under the Cash Management Program, El Paso did not incur additional debt to fund the Cash Management Program, and El Paso Corp. is not near bankruptcy nor is there evidence of any risk that El Paso Corp. may default on the loan balance. El Paso notes that the Commission in Order No. 634 ultimately determined not to impose any requirements or conditions on pipelines' participation in cash management programs and did not establish the cash management "policies" Trial Staff urges.[205]

130. El Paso argues that its participation in the Cash Management Program does not transfer financial risk to El Paso and its ratepayers, and El Paso Corp.'s non-investment grade credit rating is not evidence of a risk of default. El Paso points out that Order No. 634 declined to adopt a condition that a parent company have an investment grade credit rating as a prerequisite to participation in a cash management program.[206] El Paso argues that Trial Staff and Joint Parties show a fundamental misunderstanding of the benefits of cash management programs and the financial relationship between pipelines and their parents. El Paso suggests that without the liquidity of the cash management loan balance, El Paso's cost of debt might actually increase, and that the liquidity provided by cash management programs is a positive factor on a pipeline's credit quality.[207]

131. El Paso argues that even if the interest rate El Paso received under the Cash Management Program is somewhat low, El Paso's customers are not harmed because they are not entitled to the interest El Paso receives under the Cash Management

[204] *Id.* at 8 (citing *Regulation of Cash Management Practices*, NOPR, FERC Stats. & Regs. ¶ 32,561; Order 634, Interim Rule, FERC Stats. & Regs. ¶ 31,145, *as modified*, Order No. 634-A, Final Rule, FERC Stats. & Regs. ¶ 31,152 at P 1 (2003)).

[205] *Id.* at 9.

[206] *Id.* at 10 (citing Order No. 634 at P 16-24).

[207] *Id.* at 12-14.

Program; excess funds that El Paso invests in the Cash Management Program or any other third-party institution are El Paso's money, not ratepayer money.[208]

132. El Paso argues that restrictions imposed or considered on electric utility companies under section 203 of the Federal Power Act or the repealed PUHCA do not support the imposition of ring-fencing measures on natural gas company cash management programs. El Paso argues that, unlike the electric utility industry, there is no corresponding requirement for natural gas companies to obtain authority to merge, there is no statutory proscription on cross-subsidization in connection with natural gas mergers, and this case does not involve a merger. El Paso argues that the Commission's action in *Exelon Corp*. is not on point, because the parent in that case was a holding company under PUHCA 1935, and was therefore prohibited at the time from borrowing money from its subsidiary companies. El Paso concludes that the Commission merely approved a merger in which a public utility holding company made a commitment required by the then-existing statute (PUHCA 1935) and did not establish precedent applicable to cash management programs.[209]

133. Finally, El Paso suggests that Trial Staff and Joint Parties recognize that the Commission lacks the statutory authority to impose the proposed ring-fencing measures by arguing that the Commission can impose ring-fencing under the "enabling" authority provided under section 16 of the NGA or section 5.[210] El Paso points out that section 16 allows the Commission to remedy violations of other substantive sections of the NGA but does not confer upon the Commission independent authority to act.[211] El Paso argues that neither Trial Staff nor Joint Parties point to any substantive provision of the NGA that would authorize the Commission to impose conditions on the operation of El Paso Corp.'s cash management program and that the Commission has never heretofore modified pipeline cash management agreements. El Paso additionally argues that section 5 does not provide the Commission with the authority to regulate the terms and conditions of a natural gas company's financial transactions, such as investment of cash proceeds, issuance of debt or assumption of financial liabilities. Therefore, El Paso concludes that, even if Trial Staff and Joint Parties had supported a need for such ring-

[208] *Id.* at 17.

[209] *Id.* at 18-20.

[210] *Id.* at 21.

[211] *Id.* at 22 (citing *Consolidated Gas Transmission Corp. v. FERC*, 771 F.2d 1536, 1550-51 (D.C. Cir. 1985)).

fencing measures with direct testimony, evidence, and a reasoned analysis, which they have not, the Commission would lack the statutory authority to impose such measures.[212]

Commission Determination

134. We affirm the Presiding Judge's finding that a determination regarding the appropriateness of ring-fencing measures is not needed in this case due to our findings on capital structure above. The Presiding Judge held that El Paso has fulfilled its obligations under the Commission's cash management policies, which required it to file its Cash Management Program with the Commission. Our decision to require El Paso to remove the $615 million loan from El Paso's equity capitalization for ratemaking purposes appropriately excludes from El Paso's proposed capital structure funds that are not available for investment in jurisdictional services, and adequately protects ratepayers. The ring-fencing measures urged by Trial Staff and Joint Parties are not supported on the record. Our decision to exclude the $615 million loan ensures that El Paso's rates will include a rate of return only on the assets that El Paso has invested in its jurisdictional services. We find no further action is required, such as the proposed ring-fencing measures, which was raised only on brief, and have not been justified on this record.

C. Short-term Firm and Interruptible Rates

135. In response to the market's growing reliance on short-term services and the need to discount services to retain load, El Paso proposed to implement short-term value-based services consistent with Order No. 637,[213] to more properly recognize the value of short-term services, assign the appropriate prices to those services, and encourage long-term firm contracting.[214]

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[212] *Id.* at 23.

[213] *Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, Order No. 637, FERC Stats. & Regs. ¶ 31,091, *clarified*, Order No. 637-A, FERC Stats. & Regs. ¶ 31,099, *reh'g denied*, Order No. 637-B, 92 FERC ¶ 61,062 (2000), *aff'd in part and remanded in part sub nom. Interstate Natural Gas Ass'n of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002), *order on remand*, 101 FERC ¶ 61,127 (2002), *order on reh'g*, 106 FERC ¶ 61,088 (2004), *aff'd sub nom. American Gas Ass'n v. FERC*, 428 F.3d 255 (D.C. Cir. 2005).

[214] El Paso, June 30, 2008 transmittal letter, Docket No. RP08-426-000, Statement of the Nature, the Reasons, and the Basis for the Proposed Changes, at 5-6.

136. In Order No. 637, the Commission allowed pipelines to propose peak/off-peak and term differentiated rate structures. The Commission stated that use of peak/off-peak rates for pipeline services could improve efficiency in the market place by better accommodating regulation to seasonal demand for capacity, and at the same time could benefit long-term captive customers. The Commission noted that it already permitted pipelines to propose and implement seasonal rates applicable to both short- and long-term services.[215] Order No. 637 set forth parameters for implementing the two rate structures: peak/off peak rates and term-differentiated rates.

137. Order No. 637 contemplated that a peak/off-peak rate structure would allow pipelines to charge more for use during peak periods, with offsetting lower charges during off-peak periods. The Commission clarified that peak/off-peak rates need not be based on cost differences between providing peak and off-peak services, but may reflect differences between peak and off-peak demand without regard to cost differences, such as "value of capacity" pricing that permits the maximum rate to follow more closely the demand curve for the service over the course of the year (i.e., higher rates during peak periods and lower rates during off-peak periods), provided the total revenue does not exceed the annual revenue requirement.[216] The Commission stated that it would consider any reasonable method of implementing peak/off-peak rates that is consistent with the general principles of Order No. 637, but the pipeline will have the burden of proof to show that its proposed method is just and reasonable.[217]

138. Order No. 637 articulated somewhat different requirements for term-differentiated rates. Such rates must be designed so that the posted rates for longer terms are lower than rates for shorter term service on a per unit basis and at comparable load factors. Term-differentiated rates should not differentiate based on seasons, but only based on the length of the contract. Like peak/off-peak rates, term-differentiated rates would be cost-based, just and reasonable rates because the rates in the aggregate would need to be designed to provide the pipeline's annual revenue requirement, but not more.[218] In order to protect ratepayers from the potential for price discrimination by increasing the rate caps for

[215] Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,289.

[216] The Commission noted, as a secondary benefit, that reducing the rates in off-peak periods could reduce the need for discounts and therefore the need to make discount adjustments. Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,288, *clarified*, Order No. 637-A, FERC Stats. & Regs. ¶ 31,099 at 31,574.

[217] Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,291.

[218] *Id.* at 31,293.

short-term service during off-peak periods, the Commission required pipelines proposing term-differentiated rates for short-term services to fully explain the basis and justification for any price differences. In addition, because the term-differentiated rates would raise the maximum tariff rates for some customers, there must be a commensurate decrease in the maximum tariff rates for long-term customers. The general reallocation of revenue responsibility among customer classes must be done through rate changes for all customers simultaneously in the section 4 rate filing in which the pipeline seeks to implement term-differentiated rates.[219]

139. In the instant proceeding, El Paso proposed to charge a maximum rate for short-term firm service, IT service, PAL service, and authorized overrun service equal to 250 percent of the maximum reservation component of the recourse rate applicable to long-term firm service, plus the applicable commodity component. Long-term service includes seasonal contracts (seven-month summer or five-month winter) and contracts with terms of one year or more. El Paso proposed a revenue crediting mechanism to prevent over-collection in which 90 percent of short-term revenues in excess of the 100 percent long-term firm rate will be credited once El Paso collects its annual cost-of-service.[220]

Initial Decision

140. The Presiding Judge found that El Paso's short-term and IT rate design proposal did not comport with Commission policy and therefore was not just and reasonable.[221] The Presiding Judge ruled that El Paso's proposed short-term rates did not meet the Order No. 637 requirement that any increases in peak rates must be offset by decreases in off-peak rates, so that the sum of the daily or monthly rates, multiplied by the quantity used or reserved must not exceed the pipeline's annual revenue requirement.[222] The Initial Decision found that El Paso's proposed revenue crediting mechanism did not properly allocate costs, and did not allow higher rates for short-term services only when coupled to a related decrease in rates for long-term services, as required by Order No. 637. The

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[219] *Id.*

[220] Ex. EPG-153 at 49. El Paso proposes that the revenue crediting mechanism would be effective if (1) El Paso collects any revenues resulting from short-term firm rates that exceed the related long-term firm rate and (2) revenues exceed the annual cost of service established in this rate case.

[221] ID, 134 FERC ¶ 63,002 at PP 286-293.

[222] *Id.* P 290 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,290).

Presiding Judge noted that Order No. 637 requires that the rates be cost based and that, in aggregate, they be limited to recover the pipeline's annual revenue requirement.[223] The Presiding Judge also pointed out that Order No. 637 also requires a full explanation of the basis and justification for the price differentials. The Presiding Judge found that El Paso's proposal did not meet these Order No. 637 requirements, and thus failed to establish an appropriate peak/off-peak or term-differentiated rate.

Briefs on Exceptions

141. El Paso argues that its proposal is consistent with Order No. 637, and stresses that there may be a number of reasonable methods of designing peak/off-peak or term-differentiated rates based on value-of-service concepts.[224] El Paso relies on Order No. 637's flexibility in this regard by proposing to use term-differentiated rates that incorporate peak/off peak concepts. El Paso suggests that its proposed rates incorporate peak/off-peak concepts because El Paso expects that it will only be able to charge a rate in excess of a 100 percent load factor rate during peak demand periods, despite the fact that the maximum short-term rate will be the 250 percent rate all year. El Paso argues that its proposal promotes allocative efficiency, provides a greater opportunity to recover the cost of unsubscribed capacity, and in turn reduces the total revenue requirement that needs to be recovered from long-term customers.[225] El Paso argues that its system does not follow a traditional seasonal pattern and can have peak demand on any day of the year; accordingly El Paso avers its rate proposal will provide customers with better protection against an over-recovery than attempting to design higher peak and lower off-peak rates in advance.[226]

142. El Paso states that it did make an initial allocation of costs to short-term services, but did not project additional revenues based on the 250 percent rate because of the difficulty of making such projections for a new rate design.[227] El Paso based its 250 percent rate proposal on similar proposals made by four other pipelines. While those four proposals culminated in settlements, they were set for hearing and not found to be

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[223] *See* Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,270.

[224] El Paso Brief on Exceptions at 33 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,291, 31,293-94).

[225] *Id.* at 34-35.

[226] *Id.* at 39-40.

[227] *Id.* at 42.

facially inconsistent with Commission policy.[228] Similarly, the Commission has approved three short-term rate settlements that applied the higher short-term rates to interruptible service.[229] El Paso concludes that the data available since its short-term rates became effective demonstrate that the proposal is achieving the objectives of Order No. 637. In the first 15 months that the new rates were in effect, El Paso sold 45 short-term firm contracts at a discount and none at the 250 percent maximum rate, and El Paso's interruptible service decreased by 163,000 Dth/d and its seasonal service increased by over 200,000 Dth/d.[230]

143. SoCalGas/San Diego support El Paso's proposal and argue that the Initial Decision erred in limiting its analysis to a strict interpretation of Order No. 637's parameters for peak/off-peak rates.[231] SoCalGas/San Diego argue that the rationale for the Commission's method of limiting maximum annual transportation rates to permit recovery of a pipeline's annual cost of service revenue requirement is to limit the pipeline's ability to exercise market power, so that it does not charge excessive rates.[232] SoCalGas/San Diego also argued that without the ability to raise rates by creating scarcity, pipelines have a financial incentive to build new capacity when demand exists. Thus, SoCalGas/San Diego argue that the key question in reviewing a short-term rate proposal is whether the proposed rates are so excessive as to take away the incentive to respond to increased demand by constructing additional capacity. SoCalGas/San Diego argue that the Presiding Judge's judgment that El Paso's proposal to retain 10 percent of revenues creates too great a risk that El Paso would choose not to construct such additional capacity is unreasonable, given the current market conditions El Paso faces, with at-risk capacity under short-term contracts of approximately 1 Bcf/d.[233]

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[228] *Id.* at 47 (citing *Gas Trans. Northwest Corp*., 117 FERC ¶ 61,315, at P 75 (2006); *Portland Gas Transm. Sys*., 123 FERC ¶ 61,108, at PP 17-21, 24 (2008), *Texas Gas Transm. Corp*. 91 FERC ¶ 61,215, at 61,781-84 (2000); *Northern Border Pipeline Co*., 113 FERC ¶ 61,230, at PP 22-23 (2005); *Columbia Gulf Transm. Co*., 133 FERC ¶ 61,182, at P 56 (2010)).

[229] *Id.* at 49 (citing Exs. SCE-30, SCE-31, SCE-32).

[230] *Id.* at 50.

[231] SoCalGas/San Diego Brief on Exceptions at 6.

[232] *Id.* at 7 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,270).

[233] *Id.* at 8.

144. SoCalGas/San Diego argue that Order Nos. 637 and 712 make clear that short-term customers are not captive to the pipeline and that it is appropriate for shippers using the system only during peak periods to pay higher prices to reflect the greater demand on the system.[234] SoCalGas/San Diego argue that the Initial Decision included Findings of Fact that presume that short-term customers must be assured of discounts during off-peak periods and that El Paso's proposal does not provide this assurance because some short-term shippers are captive due to laterals being fully subscribed. SoCalGas/San Diego argue that the Initial Decision incorrectly implies that short-term shippers have a "right" to discounted off-peak rates.[235]

145. In addition, SoCalGas/San Diego state that Order No. 712 contains findings specific to the El Paso system that (1) the market value of transportation for most of the year is less than the long-term firm rates and (2) that El Paso generally experiences two peak periods annually – summer and winter – but that peak demand also occurs in the shoulder months of October, April, and May.[236] Notwithstanding that the burden is on El Paso to justify its rates, SoCalGas/San Diego argue that the Initial Decision fails to explain how peak/off-peak rates could be designed for El Paso given these facts, if increases in peak rates must be offset by decreases in off-peak rates. They also suggest the judge should have given more weight to the significance of El Paso's seasonal rates as an alternative to the 250 percent short-term rates. Without the 250 percent short-term rates, SoCalGas/San Diego argue that the availability of both discounted off-peak short-term rates and a recourse rate cap on peak period short-term rates works to the disadvantage of El Paso and its long-term customers.[237]

146. SoCalGas/San Diego argue that if the lack of offsetting off-peak rates were a sufficient basis to reject the proposal, it could have been rejected in the Suspension Order. Instead, SoCalGas/San Diego argue that the proposed revenue sharing mechanism should have been found after hearing to be an acceptable regulatory control in place of discounted off-peak rates. SoCalGas/San Diego contend that the Initial Decision presents

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[234] *Id.* at 8-9 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,281, 85; *Promotion of a More Efficient Capacity Release Market*, Order No. 712, 73 FERC Stats. & Regs. ¶ 31,271, at P 50 (2008), *order on reh'g*, Order No. 712-A, FERC Stats. & Regs. ¶ 31,284 (2008)).

[235] *Id.* at 9-10.

[236] *Id.* at 10-11 (citing Order No. 712, 73 FERC Stats. & Regs. ¶ 31,271 at P 47, 59; Ex. EPG-149 at 20-23).

[237] *Id.* at 12.

the first case in which a pipeline's short-term rate proposal has been litigated to a decision, and the Commission's response will determine how to weigh the interests of El Paso and its shippers in light of Order No. 637's goals where El Paso serves peak demands throughout the year.[238]

Briefs Opposing Exceptions

147. The Generator Coalition, the Indicated Shippers, MGI, New Mexico Gas/PNM, Edison, Texas Gas Service, Trial Staff, and UNS/Tucson Electric argue that the Presiding Judge correctly found that El Paso's proposed short-term rates are unjust and unreasonable and fail to meet the requirements of Order No. 637.

148. The Generator Coalition and the Indicated Shippers argue that the 250 percent rate contravenes the overall goal of peak/off-peak rates which Order No. 637 defined as "promoting allocative efficiency that is consistent with the goal of protecting customers from monopoly power."[239] New Mexico Gas/PNM argue that El Paso improperly cherry-picked the most favorable aspects of the term-differentiated and peak/off-peak rate designs and discarded those that required corresponding rate offsets.

149. The Generator Coalition argues that the Commission's regulations require that a rate must be designed to recover the costs properly allocable to that service, but El Paso's proposal is designed to provide for over-collection for each short-term service.[240] They assert the 250 percent rate also violates section 284.7(e) of the Commission's regulations by guaranteeing revenue.[241] Edison emphasizes that El Paso's rate proposal does not ensure all customers are charged just and reasonable rates on all available services, as required by the NGA.[242]

150. Edison argues that the proposed rates fail to satisfy the revenue and cost constraints of the traditional regulatory model and fail to comply with the explicit

[238] *Id.* at 14.

[239] Generator Coalition Brief Opposing Exceptions at 19 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,287); Indicated Shippers Brief Opposing Exceptions at 24-25.

[240] Generator Coalition Brief Opposing Exceptions at 8 (citing 18 C.F.R. §§ 284.10(b) and 284.10(c)).

[241] *Id.* at 40.

[242] Edison Brief Opposing Exceptions at 28.

parameters for peak/off-peak rates and term-differentiated rates set forth in Order No. 637 because the rates would apply year-round with no offsetting lower rates at off-peak periods or for longer term contracts. Edison contends that El Paso proposes to go beyond what the Commission allowed in Order No. 637 or in any other order and has cited no case in which the Commission has held "value based rates," similar to those proposed here, to be just and reasonable.[243] Edison argues that, although some deviation from traditional cost-based rates may be allowed subject to particular parameters and rate-payer protections, El Paso's proposal fails to comply with such parameters and eliminates any protections.[244] Because El Paso's proposal does not comply with the general principles set forth in Order No. 637 by proposing peak rates every day of the year, Edison maintains El Paso has not met its burden of proof to show that the proposed rates are just and reasonable.[245]

151. The Generator Coalition argues that SoCalGas/San Diego posits a theory not expressed in either direct or rebuttal testimony that the only test as to whether the 250 percent rate should be accepted is whether it impermissibly provides a disincentive for the pipeline to construct capacity to accommodate new demand. However, the Generator Coalition argues that the passage of Order No. 637 cited by SoCalGas/San Diego has nothing to do with peak/off-peak rates but relates to the lifting of the rate cap for released capacity. Therefore, the test SoCal Gas/San Diego proposes (whether a pipeline will have incentive to build new capacity) is not applicable to how peak/off-peak rates should be designed.[246]

152. Trial Staff, Edison, Texas Gas Service, the Indicated Shippers, and the Generator Coalition argue that El Paso's rates cannot qualify as peak/off-peak rates because they do not comport with the Order No. 637 requirement that the higher peak rates must be offset with lower off-peak rates.[247] The Generator Coalition and Trial Staff argue that such

[243] *Id.* at 4.

[244] *Id.* at 9.

[245] *Id.* at 10.

[246] Generator Coalition Brief Opposing Exceptions at 14-15 (citing SoCalGas/San Diego Brief on Exceptions at 7-8, 10).

[247] Trial Staff Brief Opposing Exceptions at 52; Texas Gas Service Brief Opposing Exceptions at 66; the Indicated Shippers Brief Opposing Exceptions at 33-34; Generator Coalition Brief Opposing Exceptions at 6-7.

offsetting rates are not an optional, but a mandatory requirement.[248] The Indicated Shippers also insist that SoCalGas/San Diego are simply wrong to say short-term shippers have no "right" to a lower off-peak rate. Order No. 637 is unambiguous on this requirement, which prevents the pipeline from over-recovering its costs and allows shippers to mitigate the effects of the higher peak rate.[249]

153. The Generator Coalition, the Indicated Shippers, MGI, and Edison reject El Paso's and SoCalGas/San Diego's argument that El Paso need not follow the offsetting rate requirement in Order No. 637 due to the particular characteristics of the El Paso system, specifically that El Paso has two peak periods and that peak demand may take place any time during the year.[250] They also argue that El Paso and SoCalGas/San Diego cannot simply invent an exception for compliance with Order No. 637.[251] Additionally, the Generator Coalition, MGI, and Edison argue that there is no demonstrated need for such an exception. They note that two of the settlements cited by El Paso accommodate summer and winter peaks, or unpredictable peaks, and nevertheless comply with the offsetting rate requirement.[252] Furthermore, Edison argues that the four settlements cited by El Paso are not precedent and are not similar to El Paso's proposal: El Paso proposes a more extreme version of "peak" pricing than any other pipeline has ever implemented even through a settlement.[253] MGI argues that El Paso could have proposed a rate design like GTN's under which it would be able upon adequate advance notice to designate which months are premium-priced and which are price-reduced.[254]

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[248] Trial Staff Brief Opposing Exceptions at 52; Generator Coalition Brief Opposing Exceptions at 7 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,290).

[249] Indicated Shippers Brief Opposing Exceptions at 33-34.

[250] Generator Coalition Brief Opposing Exceptions at 15, Indicated Shippers Brief Opposing Exceptions at 35, MGI Brief Opposing Exceptions at 5, Edison Brief Opposing Exceptions at 7 n.13.

[251] Generator Coalition Brief Opposing Exceptions at 15.

[252] *Id.* at 16 (citing *Northern Border Pipeline Co.*, 117 FERC ¶ 61,217 (2006) (*Northern Border*) (Ex. SCE-31); *Gas Transmission Northwest Corp.*, 122 FERC ¶ 61,012 (2002) (*GTN*) (Ex. SCE-32)).

[253] Edison Brief Opposing Exceptions at 4-5.

[254] MGI Brief Opposing Exceptions at 5.

154. MGI, New Mexico Gas/PNM, Trial Staff, and the Generator Coalition argue that the purported similarity of El Paso's 250 percent proposal to other cases does not render El Paso's proposal just and reasonable. The Indicated Shippers argue that El Paso has offered no legal rationale that is based on accepted ratemaking principles for its decision to cap the short-term rates at the 250 percent level, but rather argues that the rate was based on four similar proposals. However, the Generator Coalition suggests that none of these four cases were litigated, and the ultimate settlement provisions differed significantly from El Paso's proposal such that the peak/off-peak rates equaled the 100 percent load factor long-term rate on an annual basis, consistent with the requirements of Order No. 637.[255] MGI argues that in none of the settled cases has there been a settled rate design under which the pipeline was allowed to charge a premium short-term and/or interruptible rate in every month.[256]

155. The Indicated Shippers, the Generator Coalition, New Mexico Gas/PNM, Edison, and Trial Staff also argue that El Paso's 250 percent rate does not qualify as a term-differentiated rate. New Mexico Gas/PNM argues that term-differentiated rates cannot be value-based; Order No. 637 only extended that option to peak/off-peak rates to let rates fluctuate over a given period in line with the market.[257] Trial Staff argues that the 250 percent rate is not rationally differentiated by the length of the contract term, as required by Order No. 637.[258] The Generator Coalition argues that El Paso's testimony did not demonstrate the differences in the level of risks associated with short-term services versus that for longer seasonal or long-term firm contracts, much less why those differences justify radically different rates for short-term versus seasonal and long-term services, as required by Order No. 637. El Paso's proposal undermines any notion that it is term-differentiated, since the 250 percent rate for 8, 9, 10 or 11 month short-term firm contracts is 2.5 times higher than the rate for shorter five and seven month seasonal contracts.[259]

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[255] Generator Coalition Brief Opposing Exceptions at 23 (citing *GTN*, 122 FERC ¶ 61,012; *Northern Border*, 117 FERC ¶ 61,217; *Portland Natural Gas Transm. Co.*, 132 FERC ¶ 61,256 (2010)). *See also* Trial Staff Brief Opposing Exceptions at 59-60.

[256] MGI Brief Opposing Exceptions at 6.

[257] New Mexico Gas/PNM Brief Opposing Exceptions at 7.

[258] Trial Staff Brief Opposing Exceptions at 58.

[259] Generator Coalition Brief Opposing Exceptions at 31-32 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,294).

156. The Generator Coalition, the Indicated Shippers, and Trial Staff argue that El Paso's proposal violates another fundamental requirement for term-differentiated rates, namely that the rate differentials are to be accomplished by a general cost reallocation among services in a section 4 proceeding. Trial Staff points out that El Paso concedes that it did not project additional revenues for short-term services; its rates are based on projected revenues associated with the firm rate levels and exclude all of the revenues expected from gas transported at the 250 percent premium portion of the rate. The 250 percent rate is no different than any other proposed rate increase for which El Paso is expected to project billing determinants.[260] The Indicated Shippers further argue that it is inconsistent with Order No. 637 to include a revenue-sharing mechanism in a term-differentiated rate proposal. Term-differentiated rate proposals are designed to provide immediate relief through cost allocation, resulting in lower rates for longer term firm shippers; a revenue-sharing mechanism does not provide that immediate rate relief. The Indicated Shippers argue that El Paso has thus shifted the risk of under-recovery from its term-differentiated rates away from itself and to its long-term firm customers.[261]

157. Edison argues that the market cannot be relied upon to limit El Paso's rates. El Paso witness Sullivan admitted that the rate is not based on cost at all, but that El Paso plans to rely on the market's competitive forces to set the rate up to its 250 percent cap.[262] Edison contends that El Paso essentially asks the Commission to rely on the market to constrain its short-term rates, but offers no market power analysis of likely market results or of its ability to exercise market power and maintain rates above competitive levels.[263] El Paso conceded that no studies were prepared to compare the use and impact of the 250 percent rate versus some other rate.[264] Edison also asserts that the arbitrariness of the rate is further evidenced by the fact that El Paso would apply the rate even during off-peak periods when the value of the capacity is reduced. Edison finds alarming Mr. Sullivan's view that the rates would still be "cost-based derivative rates" rather than market-based rates if the cap were equal to the cost-based rate multiplied by 5, 10 or

[260] Trial Staff Brief Opposing Exceptions at 54.

[261] Indicated Shippers Brief Opposing Exceptions at 30-31.

[262] Edison Brief Opposing Exceptions at 12, 14.

[263] *Id*. at 13.

[264] Generator Coalition Brief Opposing Exceptions at 17-18 (citing Ex. EGC-7; Tr. 718-719 (Sullivan cross).

even 100.[265] Edison, Trial Staff, the Generator Coalition and New Mexico Gas/PNM conclude that El Paso failed to demonstrate that its proposed 250 percent differential is just and reasonable, offered no reasoned basis for its selection of the 250 percent price differential, and prepared no studies to justify its selection.[266]

158. MGI argues that El Paso's argument that none of its shippers would actually be required to pay these rates is a red herring. MGI contends that the ability to escape a 250 percent rate is not the standard by which to judge whether the rate is just and reasonable and not unduly discriminatory under the NGA. According to MGI, establishing an artificially inflated rate and then telling shippers they can avoid the rate by subscribing to other services or taking service from other vendors is the functional equivalent of denying shippers the use of these services. MGI maintains that it is a long-term firm shipper that contracts for IT/short-term firm service from time to time to supplement, not escape from, its long-term service.[267]

159. Edison acknowledges that there is a legitimate role for short-term firm service, but insists shippers should be able to purchase contracts for an appropriate term based on their needs and proper price signals and not on a pricing scheme designed to sell them service for longer terms than they need or want.[268]

160. Trial Staff notes that during the first six months that the proposal was in effect, the short-term firm transactions did not result in any revenues that would be subject to crediting because El Paso did not charge any customer the 250 percent short-term firm rates; the only short-term firm services El Paso sold were contracts to which the revenue sharing provision did not apply.[269] New Mexico Gas/PNM argues that El Paso improperly cites this post-period data concerning the effects of implementing the short-term rates to justify its rates, contrary to Commission policy.[270] MGI argues, however,

[265] Edison Brief Opposing Exceptions at 14 (citing Tr. at 712: 2-22; 715:7-18; 717: 14-22 (Sullivan)).

[266] Edison Brief Opposing Exceptions at 15, Trial Staff Brief Opposing Exceptions at 18, New Mexico Gas/PNM Brief Opposing Exceptions at 10, Generator Coalition Brief Opposing Exceptions at 2.

[267] MGI Brief Opposing Exceptions at 6-7.

[268] Edison Brief Opposing Exceptions at 16.

[269] Trial Staff Brief Opposing Exceptions at 65.

[270] New Mexico Gas/PNM Brief Opposing Exceptions at 9.

that the fact that El Paso has been unable to charge anyone the 250 percent maximum rate since it was implemented is entitled to no weight and questions how El Paso's inability to sell short-term firm service at maximum rates signifies that the proposal is "working as intended."[271] New Mexico Gas/PNM argues that because it is the "overriding interest of the Congress to give full protective coverage to the consumer as to price," the Commission cannot elevate a pipeline's desire to affect shipper contracting behavior above the rights of shippers to receive service at a just and reasonable rate.[272]

161. The Generator Coalition and Edison argue that El Paso's proposal violates Order No. 712. The Generator Coalition finds absurd El Paso's argument that Order No. 712 found that no pipeline has market power over any short-term service because short-term customers were not captive customers. The Generator Coalition argues that Order No. 712 rejected pipeline proposals to deregulate the price of short-term services on the repeated, explicit and critical finding that a cost-based, just and reasonable rate for short-term services was required to ensure competitive markets for released capacity. According to the Generator Coalition, the Commission routinely rejects market-based rate proposals for short-term services, such as interruptible transportation, when there is an insufficient showing that such customers would be protected from the exercise of a pipeline's market power.[273]

162. While El Paso argues that the Commission, in the Suspension Order, rejected the argument that El Paso's proposal was contrary to Order No. 712, Edison contends that in fact the Commission merely "did not find the proposal was necessarily inconsistent with Order No. 712" "[b]ecause the proposed rate may act as a recourse rate to the uncapped capacity release rate."[274] Edison argues that the Commission should now conclude, given the evidence established in the hearing, that El Paso's proposal does not comport with Order No. 712 because the 250 percent rates are not just and reasonable recourse rates.[275] Edison argues that the importance of Order No. 712 to this case is that the Commission explicitly considered and rejected pipelines' proposals to lift the rate cap on pipeline-supplied short-term services; El Paso's proposal here would have a similar effect. If

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[271] MGI Brief Opposing Exceptions at 7.

[272] New Mexico Gas/PNM Brief Opposing Exceptions at 15.

[273] Generator Coalition Brief Opposing Exceptions at 27.

[274] Edison Brief Opposing Exceptions at 17 (citing November 10 Rehearing Order, 133 FERC ¶ 61,129 at P 23).

[275] *Id.* at 17-20.

El Paso had fully justified its 250 percent price differentials and linked that differential to actual costs, then the rates could provide recourse rates as required by Order No. 712, but El Paso has failed to do so.

163. Edison claims that the issue of captive shippers is beside the point; the relevant inquiry is not whether "captive customers" might be charged 250 percent of the cost-based rate but whether any customers will be charged any rates above the just and reasonable level. Edison argues that while Order No. 712 concluded that a releasing shipper's ability to exercise market power in the short-term capacity release market is limited because short-term customers are not captive, the Commission did not conclude that the short-term customers of a pipeline are not susceptible to the exercise of market power.[276] El Paso's proposal would free both El Paso and the releasing shippers to charge whatever the market will bear, limited only by the arbitrary, unsupported and excessive 250 percent cap, contrary to the regulatory structure established in Order No. 712 and upheld by the D.C. Circuit in *Interstate Natural Gas Association of America v. FERC*, under which pipelines' short-term rates must continue to be cost-based, and where the availability of that cost-based alternative provides a check on capacity release prices.[277]

164. Texas Gas Service states that the Initial Decision was correct that El Paso has failed to show that there are good substitutes for short-term firm service, since East of California (EOC) laterals are generally fully subscribed. Thus, many captive customers cannot utilize additional firm service as an alternative to short-term services and must pay the 250 percent rate if they overrun their contracts due to events beyond their control.[278] New Mexico Gas/PNM argue that some EOC customers do not have reasonable alternatives to El Paso's system because they have isolated service areas that branch off from El Paso's mainline and are not interconnected with the rest of that customer's system or otherwise captive to El Paso.[279] The Indicated Shippers state that El Paso

[276] *Id.* at 20 (citing Order No. 712, FERC Stats. & Regs. ¶ 31,271 at P 50; *Interstate Natural Gas Association of America v. FERC*, 617 F.3d 504, 509-10 (D.C. Cir. 2010)).

[277] *Id.* at 22.

[278] Texas Gas Service Brief Opposing Exceptions at 70-71.

[279] For instance, New Mexico Gas serves communities in Southern New Mexico from separate distribution systems, and PNM is wholly dependent on El Paso for transportation to three of its gas fired electric generation plants. New Mexico Gas/PNM Brief Opposing Exceptions at 15.

argues that there is no such thing as a captive short-term shipper, but if such shippers were not captive to El Paso, they presumably would have sought out the other pipeline or capacity release alternatives claimed to exist by El Paso.[280]

165. UNS/Tucson Electric argue that the proposed short-term and interruptible rates as applied to captive customers are unjust and unreasonable.[281] Captive customers that contract for services to meet daily and hourly requirements still may require intra-month short-term incremental service. UNS/Tucson Electric argue that such captive customers would not likely get a discount or authorized overrun but instead would be charged the full 250 percent rate if they needed short-term or interruptible service over and above their firm service. If the Commission does not adopt the Initial Decision's finding, UNS/Tucson state it should require El Paso to limit the interruptible and short-term firm rates for a captive shipper at a captive delivery point to a 100 percent FT-1 load factor rate.

166. While El Paso and SoCalGas/San Diego tout the "success" of El Paso's rate proposal in forcing customers to contract for longer-term firm service, Edison states that the only "success" is El Paso's exercise of market power pushing customers to contract for services that they do not want or need.[282] Edison asserts that the 250 percent rate has little to do with ensuring allocative efficiency but instead allows El Paso to exert monopoly power to force customers with insufficient alternatives either to purchase services at inflated rates or for inflated periods of time.[283]

167. The Indicated Shippers, the Generator Coalition, New Mexico Gas/PNM, Edison, MGI, and Trial Staff all maintain that the Presiding Judge correctly rejected El Paso's attempt to use its proposed revenue crediting mechanism to cure the flaws of the 250 percent rate proposal.

168. Edison adds that El Paso is wrong to claim that the Presiding Judge's rejection of the short-term rate proposal "rests solely on the notion that El Paso's proposal must be rejected because it contains a revenue crediting mechanism in lieu of a cost allocation as a means of ensuring that the rates be designed to meet El Paso's annual revenue

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[280] Indicated Shippers Brief Opposing Exceptions at 32.

[281] UNS/Tucson Electric Brief Opposing Exceptions at 4-7.

[282] Edison Brief Opposing Exceptions at 16-17.

[283] *Id.* at 22-24.

requirement."[284] Edison suggests that Order No. 637 only contemplated revenue crediting as a substitute for offsetting lower rates through cost reallocation for peak/off-peak rates proposed in a limited section 4 rate filing, not in a general rate case like this one, or for term-differentiated rates at all.[285] Edison argues that even a perfectly designed revenue crediting mechanism could not take the place of offsetting lower off-peak rates which ensure that a customer buying the service year-round would not pay more than the annual revenue requirement allocated to the service.[286] Trial Staff notes that El Paso does not explain how its revenue crediting proposal creates any disincentive for it to raise its peak period rate to an unrealistically high level.[287] In addition, New Mexico Gas/PNM argue that because the mechanism is only triggered after El Paso recovers its overall cost of service, it would permit El Paso to make up any potential revenue shortfall from other shippers at the expense of customers subject to the inflated 250 percent rates.[288]

169. Trial Staff, Edison, New Mexico Gas/PNM, and Texas Gas Service thus all support the Presiding Judge's finding that El Paso's revenue crediting proposal is an unjust and unreasonable method for addressing the requirement that El Paso's rates be designed to recover no more than its annual revenue requirement.[289] While El Paso argues that its proposal to retain 10 percent of the revenues will provide an incentive to market its services, Indicated Shippers argue that under Order No. 637 El Paso's rates are governed by cost-of-service ratemaking principles, not incentive ratemaking.[290] Trial Staff further argues that there is no need for an incentive and that ratepayers should not pay for it. Mr. Sullivan conceded that even if the Commission does not allow El Paso to retain a portion of the revenues, El Paso would still have an obligation to market all its

[284] *Id.* at 25 (citing El Paso Brief on Exceptions at 38).

[285] *Id.* at 25, Trial Staff Brief Opposing Exceptions at 62.

[286] *Id.* at 27 (citing Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,290).

[287] Trial Staff Brief Opposing Exceptions at 52.

[288] New Mexico Gas/PNM Brief Opposing Exceptions at 16-17.

[289] Trial Staff Brief Opposing Exceptions at 60; Edison Brief Opposing Exceptions at 14; New Mexico Gas/PNM Brief Opposing Exceptions at 16; Texas Gas Service Brief Opposing Exceptions at 67.

[290] Indicated Shippers Brief Opposing Exceptions at 29-30.

available capacity. Thus, El Paso is already obligated to market interruptible capacity, and is legally bound to do so without additional payment.[291]

170. Edison and Trial Staff argue that El Paso's proposal forces shippers to contract for longer term service but those increased long-term revenues are not covered by the revenue credits.[292] Thus, asserts Texas Gas Service, the Initial Decision correctly found that El Paso's 250 percent rate proposal should be rejected because it is not designed to benefit El Paso's long-term shippers and allows El Paso to retain revenues in excess of its annual revenue requirement.[293]

171. Trial Staff argues that the record demonstrates that, while the revenue crediting provision will serve to insulate El Paso from the risk of any under-collection, it will not provide benefits equivalent to those that would be provided with an immediate rate reduction. In fact, it is unlikely that any revenue sharing dollars actually will be credited for the benefit of El Paso's off-peak or long-term shippers.[294]

172. Edison, the Generator Coalition, the Indicated Shippers, and Trial Staff support the Presiding Judge's finding that interruptible service is not properly included within the 250 percent rate proposal. El Paso's proposal improperly increases IT rates, contrary to long-standing Commission policy that the rate for interruptible service should be designed on a 100 percent load factor basis and not multiples of that rate, as proposed by El Paso.[295]

173. The Generator Coalition argues that El Paso cites two passages of Order No. 637 which, according to El Paso, state that both term-differentiated and peak/off-peak rates apply to interruptible transportation, yet the two passages are in the context of peak/off-

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[291] Trial Staff Brief Opposing Exceptions at 66-67.

[292] Edison Brief Opposing Exceptions at 33-34; Trial Staff Brief Opposing Exceptions at 64.

[293] Texas Gas Service Brief Opposing Exceptions at 67.

[294] Trial Staff Brief Opposing Exceptions at 63.

[295] Generator Coalition Brief Opposing Exceptions at 35; Indicated Shippers Brief Opposing Exceptions at 25; Trial Staff Brief Opposing Exceptions at 68; Edison Brief Opposing Exceptions at 22 n.80 (citing *High Island Offshore System, LLC*, 110 FERC ¶ 61,043, at P 199 (2005) (*HIOS*); *Ohio Valley Hub LLC*, 100 FERC ¶ 61,238, at P 13 (2002); *Southern Natural Gas Co.*, 99 FERC ¶ 61,345, at P 87 (2002) (*Southern*); *Tennessee Gas Pipeline Co.*, 80 FERC ¶ 61,070 (1997) (*Tennessee*).

peak rates and do not mention term-differentiated rates.[296] The Commission has found that "[t]he discussion in Order No. 637 regarding term-differentiated rates was limited to shippers who were using firm service. Order No. 637 did not suggest that it was appropriate to price [interruptible] service in a manner that would encourage [interruptible] shippers to purchase firm service."[297] The Generator Coalition points out that El Paso's brief fails to address these two Commission decisions interpreting Order No. 637.[298]

174. Trial Staff and Edison argue that the Commission has consistently held that arguments based on the Order No. 637 discussion of term-differentiated rates cannot alter the requirement of 100 percent load factor IT rates.[299] Trial Staff, Edison, and the Indicated Shippers argue that El Paso's proposed IT rates here are thus contrary to Commission policy for all the reasons explained by the Commission when rejecting El Paso's similar, but less extreme, IT proposal in El Paso's previous rate case.[300] Edison argues that El Paso's suggestion that the expansion of its proposal (increasing the short-term firm rate and basing the IT rate on the inflated short-term firm rate) somehow resolves the multitude of problems that led the Commission to reject El Paso's IT rate proposal in the last rate case strains credulity and must be rejected.[301]

175. The Indicated Shippers argue that El Paso has not demonstrated that it needs a higher interruptible rate to ration scarce capacity or to maximize throughput. El Paso has not priced IT service in a manner that recognizes its inferior nature compared to FT

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[296] Generator Coalition Brief Opposing Exceptions at 35 (citing El Paso Brief on Exceptions at 48-49; Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,287; Order No. 637-A, FERC Stats. & Regs. ¶ 31,099 at 31,574).

[297] *Id*. at 35 (citing 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150 at P 54; *Southern*, 99 FERC ¶ 61,345 at PP 85-87).

[298] *Id*. at 34-45.

[299] Trial Staff Brief Opposing Exceptions at 69-70; Edison Brief Opposing Exceptions at 22-23 n. 82 (citing *Southern*, 99 FERC ¶ 61,345 at PP 83-87 & n.83; 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150 at P 55).

[300] Trial Staff Brief Opposing Exceptions at 69-70; Indicated Shippers Brief Opposing Exceptions at 26-27; Edison Brief Opposing Exceptions at 23 (citing 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150, at PP 50-53, 56-57).

[301] Edison Brief Opposing Exceptions at 25.

service. The Indicated Shippers characterize El Paso's 250 percent short-term rate proposal as nothing more than a penalty for using shorter term services.[302]

176. The Indicated Shippers argue that the evidence demonstrates that El Paso has been exercising market power by refusing to discount its IT rate in order to provide an impetus to sign long-term firm contracts. Indicated Shippers argue that the Commission has rejected this rationale for higher short-term rates, in both *HIOS* and the 2006 Rate Case Suspension Order.[303] The Generator Coalition argues that El Paso's arguments that *HIOS* and *El Paso* are inapposite are unfounded. El Paso cites the November 10, 2010 order in this proceeding that denied requests to summarily reject the 250 percent rate for interruptible transportation. Yet, the November 10 Order made clear that it was only denying a summary rejection to allow for a full exploration of the issue at the hearing; the November 10 Order was not summarily accepting the rate either. El Paso's reliance on *HIOS* and the 2006 Rate Case Suspension Order, is misplaced. There the Commission determined that a deviation from the 100 percent load factor was inappropriate, but in this case El Paso has used a novel methodology to apply a 2.5 multiplier of the 100 percent load factor rate design, which is not apposite, as the Commission in those cases was not assessing the particular methodology underlying the rate, but the level of maximum rates it would produce.[304]

Commission Determination

177. The Commission affirms the Presiding Judge's finding that El Paso's short-term and interruptible rate proposal does not comport with Commission policy and is not just and reasonable. The Commission finds that El Paso's proposal meets neither the clear parameters for designing peak/off-peak and term-differentiated rates set forth in Order No. 637 nor the fundamental principle of ratemaking that a pipeline must design its rates to recover the costs properly allocated to that service.[305]

178. El Paso's proposal fails to meet the requirements of Order No. 637.[306] El Paso is proposing short-term rates as part of its section 4 rate case and thus had the opportunity to

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[302] Indicated Shippers Brief Opposing Exceptions at 27-28.

[303] *Id.* at 28-29.

[304] Generator Coalition Brief Opposing Exceptions at 37-38.

[305] *See* 18 C.F.R. §§ 284.10(b) and 284.10(c).

[306] Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,287-94.

project levels of revenues for these services and reallocate costs among services, as required by Order No. 637. El Paso failed to do so. El Paso states that it projected revenues for short-term services based on firm recourse rates, but did not project any additional revenues at the 250 percent rate due to the difficulty of projecting revenues for a new rate design. Nevertheless, difficulty in projecting revenues does not relieve El Paso of the obligation to design just and reasonable rates, and it is El Paso's burden to do so. While Order No. 637 sets forth parameters for designing either peak/off-peak or term-differentiated rates, El Paso proposed a hybrid of the two that fails to meet either set of requirements but instead "cherry picks" the most favorable aspects of each, as New Mexico Gas/PNM argue.[307] El Paso proposes a maximum peak rate that is available every day of the year, yet does not designate any lower off-peak rates. As a result, the proposal contravenes the Order No. 637 requirement that increases in rates at peak must be offset by decreases in off-peak rates to ensure that the pipeline does not over-recover its annual revenue requirement. El Paso proposes the 250 percent rate for short-term service of less than one year (excluding five-month winter or seven-month summer seasonal service), yet does not propose any gradation in rates based on length of contract; a one-month contract is priced the same as an eleven-month contract, and a one-year contract is the same as a twenty-year contract. Thus, the proposal fails to meet the requirement for term-differentiated rates that they be differentiated based on the length of the contract.

179. El Paso argues that Order No. 637 allows for several reasonable methods of designing these short-term rates, but as Edison counters, a full reading of Order No. 637 shows that the Commission will "consider any reasonable method of implementation that is consistent with the general principles discussed in this section, but the pipeline will have the burden of proof to show that its proposed method is just and reasonable."[308] El Paso has failed to justify its proposed rate. El Paso did not prepare or provide studies to support the choice of 250 percent as the rate multiplier or to compare the use and impact of the 250 percent rate versus some other rate. The sole support for the 250 percent multiplier offered by El Paso is that it was proposed by four pipelines in prior cases involving short-term rates.[309] But those cases do not support El Paso's proposal. While each of the four pipelines initially proposed a 250 percent rate, each proposal resulted in settlement at a lower rate than the 250 percent rate and included offsetting off-

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[307] New Mexico Gas/PNM Brief Opposing Exceptions at 7.

[308] Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,291.

[309] Trial Staff Brief Opposing Exceptions at 59 (citing Ex. S-12 at 19:1-6; Ex. EGC-7).

peak rates, as required by Order No. 637.[310] Furthermore, these cases have no precedential value because they were settled. El Paso has therefore failed to demonstrate that its method of designing short-term rates is just and reasonable. In addition, these cases undermine SoCalGas/San Diego's claim that the Initial Decision failed to explain how peak/off-peak rates could be designed to accommodate a system with multiple peak periods. Two of the pipelines in these cases (GTN and Northern Border) have more than one peak period and nevertheless were able to design peak rates with off-setting off-peak rates to comply with Order No. 637. Thus, the fact that El Paso's system may experience two peak periods throughout the year does not exempt El Paso from Order No. 637's requirement to provide lower off-peak rates to offset the higher peak rates.

180. SoCalGas/San Diego and El Paso argue that the Initial Decision errs in finding that certain short-term shippers are captive to El Paso and cannot rely on El Paso to offer discounts during off-peak periods. SoCalGas/San Diego argue that Order Nos. 637 and 712 state that short-term customers are not captive to the pipeline. Order Nos. 637 and 712, however, addressed removing the price cap on released capacity and relied on the availability of regulated pipeline transportation to limit the pipeline's ability to exercise market power. On El Paso's system certain shippers on fully subscribed laterals are captive to El Paso and do not have good substitutes for short-term firm service now that the price cap on released capacity has been removed and El Paso proposes a higher IT rate.[311]

181. While El Paso and SoCalGas/San Diego argue that El Paso's experience since the peak/off-peak rates went into effect demonstrates that the proposal is achieving Order No. 637's objectives by increasing revenue recovery from short-term shippers, we disagree. The fact that most shippers who relied on short-term service opted to extend their short-term contracts at long-term rates or contracted for seasonal service demonstrates that while the proposal may have been effective in shifting short-term shippers to longer term service, it appears to have done so by forcing shippers to contract for service at terms other than those which they desired.[312] Thus, contrary to El Paso assertions, the data does not demonstrate that the rates are just and reasonable.

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[310] *Id*. at 59-60 (citing Tr. 750:10-18; Ex. SCE-29, SCE-30, SCE-31, and SCE-32).

[311] *See* New Mexico Gas/PNM Brief Opposing Exceptions at 16 (citing Ex. TNM-1 at 52:22-53:1); ID, 134 FERC 63,002 at PP 272, 689 ("El Paso does not prove that there are good substitutes for the services to which the 250 percent rate proposal will apply."), P 691 ("Most laterals on the El Paso system are fully subscribed.").

[312] Edison Brief Opposing Exceptions at 16-17.

182. We do not agree with SoCalGas/San Diego's reading of Order No. 637 that the key question is whether rates are so excessive as to take away the incentive to construct additional facilities. Providing better price signals about the need for new construction is just one of the policy goals underlying Order No. 637. The Commission stated that peak/off-peak pricing for short-term services could also promote several important policy goals: removing one of the biases favoring short-term contracts, lowering the share of costs allocated to long-term shippers, and increasing efficiency in short-term markets by allowing prices to better reflect demand during peak periods.[313] Order No. 637 also repeatedly stressed that the Commission will permit peak/off-peak pricing within the pipeline's current cost-based revenue requirement,[314] as one possible method of promoting allocative efficiency but only if customers are protected from any exercise of monopoly power.[315]

183. We further affirm the Initial Decision's finding that El Paso's proposed revenue crediting is insufficient to act as a substitute for the failure to project revenues for these services and properly allocate costs. Order No. 637 contemplated that a revenue crediting mechanism would only be necessary for peak/off-peak rates proposed in a *pro forma* tariff filing in between rate cases because the pipeline would not be able to reallocate costs among services in the *pro forma* tariff filing.[316] Revenue sharing was not contemplated for term-differentiated rates; for term-differentiated rates the Commission required a general reallocation of revenue responsibility among customer classes done for all customers simultaneously in a general section 4 rate filing.[317] El Paso's revenue crediting proposal, however, is not designed to provide an immediate benefit to off-peak or long-term shippers. In fact, as illustrated by the parties opposing exceptions, long-term and/or off-peak shippers may never benefit from revenue crediting since it is not triggered until El Paso recovers its cost of service and short-term revenues exceed the cost allocated to the services. This result is contrary to Order No. 637 which requires that long-term/off-peak rates be lower than short-term/peak rates in the present time, not in the future. Furthermore, El Paso's proposal to retain 10 percent of the revenues ensures that El Paso will over-recover its revenue requirement if revenue crediting is triggered.

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[313] Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,288-89.

[314] *Id.* at 31,288.

[315] *Id.* at 31,287.

[316] *Id.* at 31,292.

[317] *Id.* at 31,294.

Therefore, El Paso's revenue crediting proposal cannot cure the flaws in its short-term rate proposal.

184. We affirm the Presiding Judge's holding that interruptible service is not properly included within the 250 percent rate proposal. We find that El Paso's proposal improperly increases IT rates, contrary to long-standing Commission policy that the rate for interruptible service should be designed on a 100 percent load factor basis.[318] The proposed IT rate is effectively moot because the short-term firm rates are unjust and unreasonable (i.e., rejection of the 250 percent short-term rate nullifies the IT proposal since the IT rate was designed as the 100 percent load factor equivalent of the 250 percent short-term rate). Our action here is consistent with the Commission's rejection of El Paso's proposed 60 percent load factor IT rate in the prior rate case.[319] There we stated that shippers should be able to choose whether to purchase firm or interruptible service based on their needs and proper price signals, not based on a pricing scheme that discourages use of one type of service, and compels certain choices. The Commission there concluded that El Paso had not presented any evidence or argument that warrants a departure from the Commission's general policy favoring a 100 percent load factor IT rate. We find the same conclusion warranted in this case, where El Paso has proposed a significantly higher IT rate.

185. Finally, the Commission's decision to deny summary rejection of the short-term rate proposal in the suspension order was not a ruling on the merits of the proposal, either pro or con. Rather, the Commission suspended the proposal and set it for hearing so that it could be reviewed along with El Paso's other cost and rate proposals.

186. Accordingly, we affirm the Presiding Judge's determination that El Paso's short-term firm and interruptible rate proposal is unjust and unreasonable.

D. 1996 Settlement – Article 11.2 Issues

187. The Presiding Judge determined that the Article 11.2 rate caps of the 1996 Settlement remain in effect, are just and reasonable, and should not be eliminated under

[318] 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150 at PP 50-51; *HIOS*, 110 FERC ¶ 61,043 at P 200; *Southern*, 99 FERC ¶ 61,345 at PP 85-87; *Tennessee*, 80 FERC at 61,202-05.

[319] 2006 Rate Case Suspension Order, 112 FERC ¶ 61,150 at P 50-58.

the *Mobile-Sierra* public interest standard in light of changes to the El Paso system.[320] In the Capacity Allocation Proceeding, the Commission rejected similar arguments that abrogation of Article 11.2 was required because the circumstances that made the 1996 Settlement just and reasonable no longer existed due to operational changes on the El Paso system.[321]

188. In the 2006 Rate Case, the Commission deferred consideration of El Paso's arguments that the changes ordered in the Capacity Allocation Proceeding terminated the Article 11.2 obligations under the 1996 Settlement. In addition, the Commission reviewed El Paso's position that the 1996 Settlement unfairly transferred $300 million in potential revenue from "Block" capacity remarketing to customers while permitting rate caps to continue and that the possibility of reallocating costs from capped shippers to other shippers could pose a substantial burden on the uncapped shippers.[322]

189. In the March 20 Order, the Commission concluded that the Capacity Allocation Proceeding determined that the *Mobile-Sierra* public interest standard applied to any further modification of the Settlement to eliminate Article 11.2.[323] The Commission discussed relevant precedent and noted that public interest is not the same as the interests of contracting parties, and the Commission does not protect parties from the consequences of their bargains.[324] The Commission explained that it is not enough to justify contract modification that a contract has become uneconomic for one of the parties; "the parties may be required to live with their bargains as time passes and various projections about the future are proved correct or incorrect."[325] The Commission also

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[320] *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) (*Mobile*); *Federal Power Comm'n v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (*Sierra*).

[321] Capacity Allocation Rehearing, 104 FERC ¶ 61,045 at PP 92-93.

[322] March 20 Order, 114 FERC ¶ 61,290 at PP 36-37.

[323] *Id.* P 34 (citing Capacity Allocation Complaint Order, 99 FERC at 62,005).

[324] *Id.* P 35 (citing Capacity Allocation Rehearing, 104 FERC ¶ 61,045 at PP 42, 43; *Sierra*, 350 U.S. at 350; *Nevada Power Co. v. Enron Power Marketing, Inc.*, 103 FERC ¶ 61,353 (2003); *Pub. Utils. Comm'n of Calif. v. Sellers of Long-Term Contracts*, 103 FERC ¶ 61,354 (2003); *PacifiCorp v. Reliant Energy Servs., Inc.*, 103 FERC ¶ 61,355 (2003)).

[325] *Id.* (citing *Town of Norwood v. FERC*, 587 F.2d 1306, 1312 (D.C. Cir. 1978). *Public Utils. Comm'n of Calif. v. FERC*, 894 F.2d 1372, 1383 (D.C. Cir. 1990) (reliance

(continued…)

noted that it is not sufficient to justify contract modification under *Mobile-Sierra* that some shippers pay a different rate under a contract or settlement agreement than other shippers on the system.[326]

190. Finally, the Commission stated its understanding that, in the case of a shipper claiming that a rate is too low, "the Commission considers whether the rate will impair the financial ability of the pipeline to provide service, impose excessive burdens on third parties, or be unduly discriminatory."[327]

191. The Commission found the record in the 2006 Rate Case insufficient to establish that El Paso's rate was too low and rejected as speculative El Paso's suggestion that the public interest standard had been met because it may seek to reallocate costs from capped shippers to other shippers, burdening those shippers. The Commission noted that it would not be known whether overall rates are greater or less than the capped rates, until rates are established at hearing, and "the question of whether the other shippers on [El Paso's system] should be allocated, through a discount adjustment, costs associated with the rate cap is an issue to be resolved at the hearing."[328] The Commission stated that "if El Paso or any other party believes that the rates that result from applying Article 11.2 are not in the public interest, they may argue at the hearing that Article 11.2 should be modified under the public interest standard of the *Mobile-Sierra* doctrine."

192. On rehearing, the Commission affirmed these holdings and rejected El Paso's argument that the *Mobile-Sierra* doctrine should not apply to any arguments or evidence that El Paso should be excused from its obligations under Article 11.2. In the September 5 Order, the Commission stated,

> In the Capacity Allocation Proceeding, the Commission found that any changes to the 1996 Settlement must be justified under the *Mobile-Sierra* public interest standard, and the court upheld the Commission's decision. Therefore, [the]

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on a settlement "outweighs the value of being able to correct for decisions that in hindsight may appear unsound")).

[326] Citing *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000); *Cities of Bethany v. FERC*, 727 F.2d 1131, 1139 (D.C. Cir. 1984); *United Mun'l Distribs. Group v. FERC*, 732 F.2d 202 (D.C. Cir. 1984).

[327] *Northeast Utils. Service Co. v. FERC*, 55 F.3d 686, 690 (1st Cir. 1995).

[328] March 20 Order, 114 FERC ¶ 61,290 at P 37.

> Commission's decision to apply *Mobile-Sierra* to changes to the 1996 Settlement is final and not subject to review here. Despite El Paso's contention, there is no justifiable reason to make an exception for changes to Article 11.2, while holding the rest of the 1996 Settlement to review under *Mobile-Sierra*.[329]

193. In the 2008 Suspension Order, the Commission set for hearing issues raised in the protests concerning cost-of-service, cost allocation, and rate design for existing and new services, including the cost shift to non-Article 11.2 shippers and the proposed discount adjustment.[330] In the 2008 Rate Settlement, the parties reserved for litigation these issues concerning Article 11.2 of the 1996 Settlement: (1) whether Article 11.2 should be terminated or modified; (2) whether the Article 11.2 rates are unjust and unreasonable, unduly discriminatory or violative of the public interest; (3) whether El Paso should be permitted to allocate or reallocate costs not otherwise recovered due to the operation of the Article 11.2(a) rate caps; and (4) whether El Paso has met the requirements of Article 11.2(b), and if not, how a rate adjustment should be determined.[331]

1. <u>Issues (1) and (2)–Whether Article 11.2 and the Rates it Produces Should be Changed, and Under What Standard</u>

194. In this proceeding, we review a voluminous record addressing the issue whether Article 11.2 still produces just and reasonable rates, consistent with the public interest.

195. The Presiding Judge held that Article 11.2 should not be abrogated under the *Mobile-Sierra* standard as not being in the public interest, finding that the record did not support findings that (1) El Paso's revenue shortfalls impaired its ability to provide service or (2) competitive advantages held by Article 11.2 Shippers resulted in "actual harm" to the general public, but instead forecast possible future harm.[332]

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[329] September 5 Order, 124 FERC ¶ 61,227 at P 41 (citing *ACC*, 397 F.3d 952).

[330] Suspension Order, 124 FERC ¶ 61,124 at P 27

[331] In addition, the Parties to the settlement stipulated parameters to address rate issues if the Commission (1) abrogates Article 11.2 or (2) authorizes reallocation of any revenue shortfall due to the application of Article 11.2(a). The Parties also stipulated how to calculate any revenue credit triggered by any shortfall under Article 11.2(b).

[332] ID, 134 FERC ¶ 63,002 at PP 507-10.

196. On exceptions, some parties fault the Presiding Judge for allegedly failing to address their arguments that Article 11.2 should be rejected under the just and reasonable standard or abrogated under the public interest standard for various reasons, including that (1) the 1996 Settlement is no longer serving its purpose; (2) the rate cap causes a revenue shortfall and disincentive to build future expansions; (3) the resulting rate disparity is anticompetitive and unduly discriminatory; and (4) the rate cap continues in perpetuity, in violation of Commission preference.

197. El Paso and other Parties seek to rely on new evidence, requesting the Commission to overrule its decisions in the Capacity Allocation Proceeding and March 20 Order that the *Mobile-Sierra* standard is the applicable standard. As discussed more fully below, we decline to overturn our prior holdings and affirm the Presiding Judge's determination that the *Mobile-Sierra* standard applies.

Briefs on Exceptions

198. El Paso argues that the Presiding Judge erred in holding that El Paso failed to demonstrate Article 11.2 will impair the financial ability of El Paso to provide service. El Paso confirms, however, that it is not submitting financial evidence in this proceeding, but instead seeks to rely on non-Article 11.2 shippers' evidence and argues the second part of the *Sierra* test – that Article 11.2 imposes excessive burdens on third parties or is unduly discriminatory such that the public interest is seriously harmed.[333]

199. El Paso claims that this is so because, in the Capacity Allocation Proceeding, the former full requirements customers demanded expansion facilities to serve their growing loads, but subsequently failed or declined to pay for a portion of the expansion and/or improvement capacity needed to provide reliable service to all customers.[334] El Paso contests the Presiding Judge's statement that it assumed some risk when it agreed to Article 11.2, arguing that El Paso should have a reasonable opportunity to recover its costs plus a return on investment.

200. Some Parties support El Paso's position that Article 11.2(a) unfairly permits shippers to avoid paying for a proportionate share of post-settlement expansions and safety improvements.[335] California Parties cite prior Commission orders as holding that

[333] El Paso Brief on Exceptions at 68.

[334] *Id*. at 72-73.

[335] *Id*. at 95-96 (citing 109 FERC ¶ 61,359 at P 23-24 (2005); March 20 Order, 114 FERC ¶ 61,290 at P 15; September 5 Order, 124 FERC ¶ 61,227 at P 12); *see also*

(continued…)

the former full requirements shippers would be required to bear the costs of expansion capacity after the term of the settlement.[336] California Parties argue on that basis that expansion costs must be included in the Article 11.2 rate cap. California Parties argue that Article 11.2 shippers could not have bargained in the 1996 Settlement to be absolved from paying the costs of post-1996 expansions, which were undertaken to meet the former full requirements shippers' natural gas needs. California Parties acknowledge that El Paso and its shareholders assumed some risks and costs under the 1996 Settlement, but claim that El Paso could not have assumed the risks and costs associated with post-1996 expansion facilities or providing allegedly "subsidized" rates in perpetuity to a select class of customers, even as those customers take their business to competing pipelines.[337]

201. California Parties object that Article 11.2 rates are over 20 percent below the maximum recourse rate for other customers.[338] They cite El Paso's estimations that the new construction accounts for 55 percent of El Paso's total cost of service, and note that the new construction includes expansions, and flexibility and reliability projects that benefit all customers.[339] California Parties assert that absent this new construction, the system rates would not exceed the rate caps.

202. California Parties assert that it cannot be in the public interest for Article 11.2 to shield shippers from paying for the cost of expansion and reliability projects that benefit them.[340] El Paso, California Parties, and El Paso Electric assert that continued operation of Article 11.2(a) will create a disincentive to make needed improvements.[341]

California Parties Brief on Exceptions at 8, 12-14; El Paso Electric Brief on Exceptions at 17-19.

[336] California Parties Brief on Exceptions at 10-11 (citing Capacity Allocation Rehearing, 104 FERC ¶ 61,045 at P 109; August 24 Rehearing Order, 132 FERC ¶ 61,155 at P 105; September 5 Order, 124 FERC ¶ 61,227 at PP 72-79).

[337] *Id*. at 15-16.

[338] *Id*. at 9, 12 (citing El Paso Reply Brief at 29-30).

[339] California Parties Brief on Exceptions at 9-10 (citing Ex. EPG-289).

[340] California Parties Brief on Exceptions at 11 (citing Ex. EPG-374 at 49-63).

[341] *E.g.*, El Paso Brief on Exceptions at 69-70; California Parties Brief on Exceptions at 12-14; El Paso Electric Brief on Exceptions at 17-19. California Parties

(continued…)

203. Following the *Sierra* factors for a pipeline claiming that a contract rate is too low, the Presiding Judge found that the record does not demonstrate, with sufficient detailed analysis, that continuation of Article 11.2 will (1) impair the financial ability of El Paso to provide service, (2) impose excessive burdens on third parties, or (3) be unduly discriminatory such that the public interest is seriously harmed.[342] Parties object to the Presiding Judge's application of the *Mobile-Sierra* standard as overly narrow, arguing that the factors applied in her analysis are not exclusive.[343] El Paso Electric cites the Supreme Court's *Morgan Stanley* order, where the Supreme Court clarified that the three *Sierra* factors summarized in the Initial Decision are not the exclusive components of the public interest and stated "only when the mutually agreed-upon contract rate seriously harms the consuming public may the Commission declare it not to be just and reasonable."[344]

204. Competitive Suppliers attempt to distinguish Supreme Court precedent confirming that the *Mobile-Sierra* public interest standard applies to non-contracting parties as well as contracting parties.[345] Competitive Suppliers argue against application of a "practically insurmountable" standard citing Commission language to the effect that a more relaxed, flexible application of the public interest standard is appropriate to protect persons who are not parties to the contract.[346]

205. California Parties cite changes to the El Paso system to support their claims that Article 11.2 is no longer serving the purpose of the 1996 Settlement, described as

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also cite additional material as to the continued applicability of Article 11.2 from the rate case in Docket No. RP10-1398-000. Such issues may be raised in that proceeding.

[342] ID, 134 FERC ¶ 63,002 at P 507.

[343] *E.g.*, California Parties Brief on Exceptions at 16; El Paso Electric Brief on Exceptions at 6-7.

[344] *Morgan Stanley Capital Group. v. PUD No. 1 of Snohomish County, Washington*, 554 U.S. 527, 545 (2008) (*Morgan Stanley*).

[345] Competitive Suppliers Brief on Exceptions at 32-33 (citing *NRG Power Marketing, LLC v. Maine PUC*, 130 S. Ct. 693, 700 (2010) (*NRG*); *reversing and remanding Maine PUC v. FERC*, 520 F.3d 464, 478 (D.C. Cir. 2008) (*Maine PUC*)).

[346] Competitive Suppliers Brief on Exceptions at 25-26 (citing *Florida Power & Light Co.*, 67 FERC ¶ 61,141, at 61,399 (1994)).

protecting shippers from turnbacks of El Paso's 1995 capacity.[347] These Parties cite the construction of Line 2000 and the Power Up projects, the rise in pipeline integrity project/safety costs, dramatic load growth experienced by East of California former full requirements shippers, and recent turnbacks of capacity. El Paso in particular objects to turnbacks by Article 11.2 shippers as improperly shifting expansion costs. El Paso Electric adds that changes to be considered include the termination of full requirements service, revision of firm transmission service excluding hourly flexibility due to uniform hourly flow requirements, and the fact that former full requirements shippers are now contractually free to take service from other pipelines.[348] El Paso Electric cites the Supreme Court's finding in *NRG* that preservation of contractual integrity is the animating purpose of the *Mobile-Sierra* doctrine and faults the Presiding Judge for ignoring the "disintegration" of the 1996 contract.

206. El Paso argues these new circumstances justify re-review of Article 11.2: (i) recourse rates exceeding Article 11.2 rates, (ii) the rate differential between Article 11.2 shippers and recourse shippers, and (iii) evidence of the rate differential produced by "the Article 11.2 shippers' actions."[349]

207. According to California Parties, no one envisioned the current circumstances of an increase in demand, with the ensuing expansion projects, followed by decreased demand (with former full requirements shippers taking service from competing pipelines).[350] El Paso Electric indicates that the changes it identifies show that the essential components of the bargain were destroyed, arguing that the 1996 Settlement was based on a premise that most Article 11.2(a) shippers would continue to renew their contracts (with the East-of-California Shippers remaining captive customers).[351]

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[347] California Parties cite shipper testimony to demonstrate that Article 11.2(a) was also intended to encourage El Paso to keep costs low and protect customers from excessive costs from a reduction in contracted capacity. California Parties Brief on Exceptions at 9.

[348] El Paso Electric Brief on Exceptions at 10-12.

[349] El Paso Brief on Exceptions at 95-96.

[350] California Parties Brief on Exceptions at 15.

[351] El Paso Electric calculates the Article 11.2(a) shippers' 2010 billing determinants as only 15 percent of 1996 values.

208. Several Parties question the continuation of the bargain under the 1996 Settlement claiming that Article 11.2(a) shippers recouped their risk sharing payments,[352] suggesting that they would unfairly benefit by continued application of the Article 11.2(a) rate cap.[353] El Paso and the California Parties compare $54 million in risk sharing payments with $50 million in capacity remarketing credits and contest the Presiding Judge's characterization of the risk sharing payments as a quid pro quo.[354] They note that California Shippers paid more than the East of California shippers in risk sharing payments, while East of California shippers continue to enjoy the protections of Article 11.2. Competitive Suppliers claim that Phelps Dodge Corporation (now Freeport-McMoRan) and APS received revenue credits that exceeded their risk sharing amounts, claiming that the Article 11.2 shippers now are getting something for nothing.

209. Competitive Suppliers argue that Article 11.2 gives shippers an unfair advantage in electric generation and supply markets by providing certain shippers reduced transportation costs thus lowering their cost to produce electricity, and claim that Article 11.2 ensures that non-Article 11.2 shippers pay higher recourse rates.[355] They claim that

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[352] Under the 1996 Settlement, the parties addressed the capacity turnback problem by sharing of the costs and risks of the unsubscribed capacity. Settling firm shippers paid to El Paso $ 254.8 million in risk-sharing amount payments in exchange for a share of revenues from remarketing the turned-back capacity for the next eight years. *See* September 5 Order, 127 FERC ¶ 61,227 at P 28.

[353] *See, e.g.*, Competitive Suppliers Brief on Exceptions at 39-40 (estimating net benefits through 2019 of $200 million (including Article 11.2(b) relief) in exchange for risk sharing payments of $2 million); California Parties Brief on Exceptions at 17-18 (citing testimony as showing that a shipper receives a benefit from Article 11.2 more than 10 times its actual out of pocket costs under the risk sharing payments).

[354] *See also* El Paso Electric Brief on Exceptions at 9 (citing East of California shipper payments of $53.67 million for $50.26 million in revenue credits and objecting to continued benefits of $32 million per year under Article 11.2(a) and (b)).

[355] Competitive Suppliers Brief on Exceptions at 42-45 (citing corrected Ex. CPS-4-A; noting APS construction of new intermediate natural gas fired generation served under the 1996 Settlement rates). *See also* California Parties Brief on Exceptions at 8-9, 14 (speculating that rate discrepancy could cause inefficient power dispatch and societal harm); El Paso Electric Brief on Exceptions at 19 (supporting Competitive Suppliers).

Article 11.2 shippers bought generators from shippers not protected by the rate cap and argue that the discount gives Article 11.2 shippers an advantage in expanding markets.[356]

210. El Paso Electric argues that Article 11.2 provides an incentive for shippers to game the system, thereby harming the public interest. El Paso Electric argues that assignment of an Article 11.2 contract can create a secondary market for Article 11.2(a) capacity and permit shippers that were never part of the 1996 Settlement to reap its benefits.[357]

211. Although the Presiding Judge held that the Article 11.2 rate differential is not unduly discriminatory because Article 11.2 shippers are parties to the 1996 Settlement giving them this benefit, and are not similarly situated to non-Article 11.2 shippers,[358] Competitive Suppliers nevertheless maintain that El Paso's tariff is discriminatory because El Paso's tariff contains a single rate sheet for service to its six zones, but provides a lower set of transportation rates for the Article 11.2 shippers for the same service.[359]

212. Competitive Suppliers object to the Presiding Judge's determination that claims of anticompetitive effect are unproven, as failing to give proper weight to evidence concerning the anti-competitive effect Article 11.2 rates have on the Competitive Suppliers members and energy markets.

213. Other Parties argue that Article 11.2 should be abrogated because they fear it operates in perpetuity, and they disagree with the Presiding Judge's finding that the provision will "fade away" as the rate cap rises due to inflation and shippers find

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[356] Competitive Suppliers Brief on Exceptions at 45.

[357] El Paso Electric Brief on Exceptions at 15-16.

[358] California Parties Brief on Exceptions at 15; Competitive Suppliers Brief on Exceptions at 33.

[359] Competitive Suppliers Brief on Exceptions at 54 (citing *Mojave Pipeline Co.*, 62 FERC ¶ 61,195, at 62,365-66 (1993) (discussing rate design after nationwide gas restructuring in 1992)).

alternative supply.[360] They also contest the import of the Presiding Judge's finding that volumes served under the rate cap cannot grow.

214. According to El Paso, Article 11.2 casts a cloud over future rate design issues. El Paso Electric similarly asserts that Article 11.2 should be abrogated in order to facilitate a future rate design change, such as to postage stamp or zone matrix rates, perhaps in the next rate case.[361]

215. Finally, El Paso and other Parties seek to rely on new evidence, consisting of an errata to the 1996 Settlement that was filed March 15, 1996. They argue that this errata indicates that the parties to the settlement intended to reserve a right to have the Commission review El Paso's rate filing under the just and reasonable standard, and request the Commission to overrule its decisions in the Capacity Allocation Proceeding and March 20 Order that the *Mobile-Sierra* standard is the applicable standard.

Briefs Opposing Exceptions

216. Parties opposing exceptions rebut the central premises of El Paso's theory that Article 11.2 allows shippers to avoid paying for expansion facilities and that the Article 11.2 shortfall stems from El Paso's expansion costs. RPS/Salt River/ACC note that Article 11.2 shippers were allocated a portion of expansion costs on the same basis as any other shipper, with Article 11.2 shippers' contract demand (CD) service to be met through existing 1995 capacity (which, after an additional turnback, was sufficient to meet that demand), while additional reservations of expansion capacity would be separately priced for all customers at the maximum recourse rate. According to APS, El Paso agreed in the Capacity Allocation Proceeding that the arrangement provided El Paso the opportunity to recover 100 percent of its post-1995 expansion costs.

217. APS contests El Paso's suggestion that the post-1995 expansion was built solely in response to demands from former full requirements shippers. APS notes that the expansions were made to restore system reliability and allocated to the former full requirements shippers as part of a complex resolution of the Capacity Allocation Proceeding.

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[360] *E.g.*, El Paso Electric Brief on Exceptions at 13 (claiming perpetual contract provisions harm the public interest and predicting future litigation costs), El Paso Brief on Exceptions at 79; Competitive Suppliers Brief on Exceptions at 54-55.

[361] El Paso Electric Brief on Exceptions at 14.

218. RPS/Salt River/ACC and APS question whether a failure to recover certain expansion safety costs arises due to the rate cap, since Article 11.2(a) shippers use only six percent of system resources. They point out that El Paso's revenue recovery via its recourse rates is affected by El Paso's own discounting. APS submits that an increase in discounted capacity sales to California at less than the Article 11.2(a) rates causes a reduction in revenue and a corresponding increase to the recourse rates.[362] RPS/Salt River/ACC argues that El Paso's rates would exceed settlement rates if discounted contracts were priced at the Article 11.2(a) rates.[363] RPS/Salt River/ACC also asserts that it is misleading for El Paso to claim that capacity subscriptions of the former full requirements customers dropped, arguing that the bulk of any decline comes from California shippers.[364]

219. Parties supporting Article 11.2 thus contest the significance of any revenue shortfall. APS notes that El Paso does not claim that Article 11.2 will threaten its ability to provide service (one of the requirements for acting under the *Mobile-Sierra* public interest standard), and APS and RPS/Salt River/ACC characterize the financial exposure in this proceeding as modest – $12.8 million for Article 11.2(a) and less than $20 million for Article 11.2(b).[365]

220. RPS/Salt River/ACC asserts that Article 11.2(b) was intended to protect shippers from ever having to bear stranded costs. Also, they assert that Article 11.2 continues to provide an incentive for El Paso to keep its costs low and keep stranded capacity costs at a minimum.

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[362] APS Brief Opposing Exception at 45 (citing change in discounted sales from 391 MMcf/d in Docket No. RP05-422 to 1,123 MMcf/d in Docket No. RP08-426).

[363] RPS/Salt River/ACC Brief Opposing Exceptions at 19-20 (citing decline in California maximum rate contracts and comparing stipulated billing determinants for long-term firm discounted contracts, 1,724,616 Dth, and Article 11.2(a) contracts, 633,843 Dth).

[364] *Id.* at 22 (asserting "El Paso's current recourse rates exceed its current Article 11.2(a) rates because of the substantial rate discounts that El Paso provides to shippers predominantly in the California rate zone.").

[365] $12.8 million represents 2.1 percent of El Paso's $600 million stipulated cost of service. APS Opposing Brief at 9 (citing Hearing Exh. 2, Stipulation Schedules at 9 n.1 and 10).

221. RPS/Salt River/ACC supports the Presiding Judge's reliance on the statement in the Commission's March 20 Order that parties have to live with the bargains they make, and the fact that a contract has become uneconomic to one of the parties does not necessarily make the contract contrary to the public interest.[366]

222. APS objects to Competitive Suppliers' allegation that its eligibility under Article 11.2 has been stretched beyond the original bargain and has become "contrary to the public interest," as unsupported and a collateral attack on the Commission's orders in the Capacity Allocation Proceeding and the March 20 Order.[367]

223. These Parties support the Presiding Judge's finding that Article 11.2 has not been shown to create a disincentive to construct facilities.[368] RPS/Salt River/ACC challenge Competitive Suppliers' suggestion that Article 11.2 discourages generation development, since Article 11.2 has long been in effect and has not been shown to affect plant-siting decisions.[369]

224. APS states that El Paso has failed to demonstrate its current difficulties are comparable in severity to those the Commission addressed in the Capacity Allocation Proceeding by applying the *Mobile-Sierra* standard to modify parts of the 1996 Settlement. RPS/Salt River/ACC argue that a nebulous, equivocal concern does not rise to the level of "circumstances of unequivocal public necessity" that require action under *Mobile-Sierra*.[370]

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[366] ID at P 506 (citing March 20 Order, 114 FERC ¶ 61,290 at P 35 (footnote omitted)); *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 407 (D.C. Cir. 2000).

[367] APS Brief Opposing Exceptions at 28 (citing Competitive Suppliers Brief on Exceptions at 14).

[368] RPS/Salt River/ACC Brief Opposing Exceptions at 34 (citing ID, 134 FERC ¶ 63,002 at P 510); APS Brief Opposing Exceptions at 32 (characterizing disincentive arguments as overstated).

[369] RPS/Salt River/ACC Brief Opposing Exceptions at 28.

[370] *Id.* at 35 (citing *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968) (*Permian Basin*)).

225. APS supports the Presiding Judge's holding that contract termination is not justified merely because some shippers pay a different rate than other shippers.[371] APS also approves the Presiding Judge's finding that Article 11.2 shippers are not similarly situated to non-Article 11.2 shippers because they bargained for the benefits in the 1996 Settlement, inasmuch as new shippers, including Competitive Suppliers, did not pay upfront costs in return for an Article 11.2 price.

226. RPS/Salt River/ACC cites the Commission's holding that it "is not sufficient to justify contract modification under *Mobile-Sierra* that some shippers pay a different rate under a contract or settlement than other shippers on the system."[372] They cite Commission and Court precedent to the effect that a "mere difference [in rates], however, is not discriminatory; there must also be a demonstration that the two classes of customers are similarly situated for purposes of the rate."[373] RPS/Salt River/ACC also cites Opinion No. 507, where the Commission relied in 2010 on a 1975 settlement to support a finding that certain shippers were not similarly situated to new shippers that were not parties to the settlement. The Commission approved a bifurcated rate proposal on that basis.[374]

227. APS argues that the risk sharing payments made by Article 11.2 shippers serve to differentiate them from Competitive Suppliers, noting that it made a substantial outlay without any assurance of any credits coming back.[375] APS notes that, at a time when El Paso was facing an unprecedented capacity turnback problem, the Article 11.2 shippers undertook the risk of significant capacity turnback costs in exchange for the future rate protection provided by Article 11.2.[376]

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[371] APS Brief Opposing Exceptions at 18-19 (citing *Transmission Agency of Northern Cal. v. FERC*, 628 F.3d. 538 (D.C. Cir. 2010); *Sacramento Mun. Utils Dist. v. FERC*, 474 F.3d 797, 802 (D.C. Cir. 2007)).

[372] March 20 Order, 114 FERC ¶ 61,290 at P 35.

[373] *Tenn. Gas Pipeline Co. v. FERC*, 860 F.2d 446, 452 n.9 (D.C. Cir. 1988); *Tennessee*, 80 FERC at 61,245.

[374] *Transcon. Gas Pipe Line Corp.*, Opinion No. 507, 130 FERC ¶ 61,043, at P 65 (2010).

[375] APS Brief Opposing Exceptions at 19-20 (weighing $4.2 million risk sharing surcharge as 81 percent of its total demand charge).

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

228. APS contests the El Paso and Competitive Suppliers' claims that Article 11.2 distorts the natural gas and wholesale electric energy markets as simplistic and hyperbolic, given the relatively small market-wide impact likely to arise from the rate differential between Article 11.2 shippers and other shippers on one gas pipeline.

229. APS argues that regulatory abrogation of long-standing contractual arrangements is likely to be more detrimental to wholesale markets than the impact of a small rate differential on one pipeline.

230. RPS/Salt River/ACC point out that the Article 11.2 service agreements should not be characterized as perpetual, because (1) shippers may terminate their agreements, (2) the rates include an inflation adjustment, (3) Article 11.2(b) is only triggered when recourse rates are greater than Article 11.2(a) rates, and (4) the quantity of capacity subject to Article 11.2(a) is subject to decline but can never increase.

231. Finally, RPS/Salt River/ACC argues that El Paso cannot rely on the so-called "corrected version" of Article 11.2 as new evidence because the Commission dismissed that argument in Docket No. RP05-422 when it made clear that any change to the original Article 11.2 required a *Mobile-Sierra* public interest showing.

Commission Determination

232. The Commission affirms and adopts the Presiding Judge's determination that Article 11.2 should not be abrogated under the *Mobile-Sierra* public interest standard. The Commission has previously found that abrogation of the terms of the 1996 Settlement, which include Article 11.2, must be supported under the pubic interest standard, and the Court of Appeals for the D.C. Circuit upheld application of the public interest standard.[377] The Commission cannot find on this record that (1) El Paso's Article 11.2 revenue shortfalls, to the extent they occur, have clearly impaired its financial stability or its ability to provide service, or (2) competitive advantages held by Article 11.2 Shippers have resulted in such actual harm to the general public (as opposed to some inchoate possibility of harm), such that rescission of Article 11.2 is warranted.

[377] Order on Capacity Allocation and Complaints, 99 FERC at 62,005, *aff'd*, *ACC*, 397 F.3d 952. *See also* September 5 Order, 124 FERC ¶ 61,227 at P 41 (characterizing as final the Commission's determination in Capacity Allocation Proceeding that public interest standard applied to changes to 1996 Settlement, including Article 11.2); *Freeport*, 669 F.3d 302,307 (noting that 2006 Rate Case Settlement provided that applicability of *Mobile-Sierra* would be resolved on rehearing).

233. Under the *Mobile-Sierra* doctrine, the Commission must presume that the rates set forth in the agreement at issue here meet the "just and reasonable" requirement of the NGA; this presumption may be overcome only if the Commission concludes that the contract seriously harms the public interest.[378] In the March 20 Order, the Commission re-affirmed application of the public interest standard, stating, "if El Paso or any other party believes that the rates that result from applying Article 11.2 are not in the public interest, they may argue at the hearing that Article 11.2 should be modified under the public interest standard of the *Mobile-Sierra* doctrine."[379]

234. Article 11.2(a) requires El Paso to propose rates consistent with the rate cap; to find those rates not just and reasonable, the Commission must overcome the *Mobile-Sierra* presumption that the rates that El Paso has filed are just and reasonable, as having been agreed to by contracting parties. In *NRG*, the Supreme Court rejected the argument that the public interest standard should not apply to shippers that are not parties to the contract.[380] Consequently, non-contracting parties as well as contracting parties and the Commission can be bound by the *Mobile-Sierra* public interest standard.[381]

235. We affirm and adopt the Presiding Judge's determination that the rates are just and reasonable and in the public interest under the *Mobile-Sierra* public interest standard. As discussed more fully below, the Parties opposed to the application of Article 11.2 in this proceeding have failed to demonstrate circumstances to justify abrogating Article 11.2(a) or rejecting the rates that it produces under the public interest standard. The Presiding Judge correctly contrasted the record in this proceeding with that in the Capacity Allocation Proceeding, where the Commission's finding of extraordinary circumstances justifying contract modification "was not based merely on generalized statements of policy goals, but was based on a detailed analysis of how the [full requirements] contracts on the [El Paso] system harmed the public interest;" including an unequivocal showing

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[378] *Morgan Stanley*, 554 U.S. at 530; *Mobile*, 350 U.S. 332; and *Sierra*, 350 U.S. 348. *See* March 20 Order, 114 FERC ¶ 61,290 at P 36 ("In the Capacity Allocation Proceeding, the Commission found that there were extraordinary circumstances on El Paso at that time that required the Commission to exercise its authority under section 5 of the NGA to make limited modifications to the 1996 Settlement in the public interest.").

[379] March 20 Order, 114 FERC ¶ 61,290 at P 37.

[380] *NRG*, 130 S.Ct. 693, 700-01 (finding *Mobile-Sierra* doctrine "is not limited to challenges to contract rates brought by contracting parties. It applies, as well, to challenges initiated by third parties").

[381] ID, 134 FERC ¶ 63,002 at P 505 (citing *NRG*).

that service disruptions had occurred due to capacity shortfall.[382] In the Capacity Allocation Proceeding, the Commission explained that its policy is to encourage settlement and that it is reluctant to alter a settlement, but nevertheless found "extraordinary circumstances" that required the limited modification of the former full requirements shippers' contracts, converting them to contract demand service.[383]

236. No such extraordinary circumstances are shown on the record here. There is a lack of a convincingly detailed analysis sufficient to establish that Article 11.2 will impair the financial ability of El Paso to provide service, impose excessive burdens on third parties, or be unduly discriminatory such that the public interest is seriously harmed, as *Mobile-Sierra* requires.[384] The record also is insufficient to support a finding that the competitive advantages held by Article 11.2 Shippers resulted in unequivocal actual harm to the general public, as opposed to predictions of possible future harm. Thus, the Presiding Judge reviewed the record and applied the proper standard under *Mobile-Sierra* to determine whether a pipeline's rate is too low, or the rate in question causes harm to the general public.[385]

237. In the 2006 Rate Case, the Commission reviewed the history of El Paso's provision of service following the Capacity Allocation Proceeding and determined that Article 11.2(a) cannot be abrogated under the public interest standard based on that history.[386] In this proceeding, the Presiding Judge cited the March 20 Order finding that the main purpose of Article 11.2 was to ensure that El Paso would not try to recover in a future rate case any of the existing capacity costs it had agreed to absorb.[387] The

[382] *Id*. P 506 (citing Capacity Allocation Complaint Order, 99 FERC ¶ 61,244 at P 14, 19).

[383] Capacity Allocation Complaint Order, 99 FERC ¶ 61,244 at 62,008.

[384] *See* ID, 134 FERC ¶ 63,002 at P 507.

[385] El Paso questions the relevance of this finding, given that it did not present evidence on its financial situation; nevertheless, a pipeline's financial instability could have far ranging impact to the general public. In addition, El Paso asserts that it seeks an opportunity to recover its costs, suggesting that it does indeed make a cost shortfall argument. El Paso Brief on Exceptions at 83, 99.

[386] March 20 Order, 114 FERC ¶ 61,290 at PP 33-37; *aff'd Freeport*, 669 F.3d 302.

[387] ID, 134 FERC ¶ 63,002 at P 545 (citing March 20 Order, 114 FERC ¶ 61,290 at P 83; El Paso Electric Initial Brief at 31-34).

Presiding Judge likewise responded to Parties' suggestion that the 1996 Settlement had fulfilled its purpose:

> The parties to the 1996 Settlement agreed to pay El Paso approximately $254.8 million dollars for unsubscribed capacity. The opportunity for El Paso to recover those costs expired on December 31, 2003. That is what Section 2.2 of the 1996 Settlement and attached *pro forma* tariff sheets provide. The fact that El Paso was able to repay most of the $254.8 million by selling the unsubscribed capacity to third parties does not change the fact that the parties to the Settlement gave El Paso a guarantee and had no way of knowing at the time of giving the guarantee in the Settlement whether or not El Paso would be able to sell the capacity.[388]

238. The Commission finds that what was exchanged in the 1996 Settlement were the up front risk *sharing* payments in exchange for a share of the future revenues from remarketing the turned back capacity. Thus, the bargain was made to share unknown risks, not to exchange comparable present and future amounts of money. The fact that this bargain turned out favorably for some Parties (and less unfavorably for others) once the risks became known is not an indication of an inequitable bargain, or grounds for negating remaining obligations.[389] It is well established that a company is not typically entitled to be relieved of its improvident bargain.[390]

239. In the Capacity Allocation Proceeding and 2006 Rate Case, the Commission rejected claims that changed circumstances justified abrogating Article 11.2 because the changes ordered in the Capacity Allocation Proceeding frustrated the purpose of the 1996 Settlement. In the 2006 Rate Case El Paso alleged that the Capacity Allocation Proceeding terminated its right to remarket turned back 1995 "Block" capacity and caused El Paso to absorb $250 million in expansion costs. In the Capacity Allocation

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[388] *Id*.

[389] On exceptions, certain parties attribute to the Settlement conditions that do not appear in the settlement itself, such as that full requirements shippers would remain captive customers or be required to pay for system improvements over and above the rate caps.

[390] *Exxon Mobil Corp. v. FERC*, 430 F.3d 1166, 1177 n.7 (D.C. Cir. 2005) (citing *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667, 710 (D.C. Cir. 2000); *Sierra*, 350 U.S. at 355).

Proceeding itself, participants argued that the actions taken would result in unduly preferential rates for the converting full requirements customers and that circumstances have changed drastically since the 1996 Settlement was executed and circumstances supporting the 1996 Settlement no longer existed.[391] In the March 20 Order, the Commission considered the claim that system expansions supported elimination of Article 11.2, but affirmed continuing applicability of Article 11.2, finding the claim unsupported. The Commission noted El Paso's offer to provide free service over expansion facilities would alleviate the need for future curtailments and was not related to modification of Article 11.2.[392]

240. On exceptions, Parties cite a host of changes that they claim justify revisiting the continued efficacy of Article 11.2(a). However, with the exception of the current rate differential between recourse rates and the Article 11.2(a) rate cap, and recent turnbacks, including those attributed to Article 11.2(a) shippers, the factors cited appear to have all been present in the Capacity Allocation Proceeding, where we did not find abrogation of Article 11.2(a) supported.

241. Despite El Paso's claim that these arguments have not been heard before, they have. The Commission has elsewhere rejected the argument that its actions in the Capacity Allocation Proceeding justified abrogating Article 11.2(a), and therefore El Paso's obligation to charge rates within the rate cap.[393] In fact, the Commission has reviewed and rejected similar concerns as grounds for abrogating Article 11.2(a):

> *El Paso asserts that by applying the Article 11.2 rate cap to Block Capacity, the Commission gave the former FR shippers an undeserved free ride by allowing them to meet load growth with rate-capped capacity rather than uncapped Expansion Capacity*. The Commission disagrees. In the Capacity Allocation Proceeding, the Commission found that El Paso did not have sufficient capacity to meet the firm service demands of its shippers and that additional capacity was needed to provide reliable firm service to El Paso's CD shippers, as well as the former FR shippers. El Paso offered

[391] March 20 Order, 114 FERC ¶ 61,290 at P 21; Capacity Allocation Rehearing Order, 104 FERC ¶ 61,045 at P 92.

[392] March 20 Order at, 114 FERC 61,290 P 26 (citing Capacity Allocation Complaint Order, 99 FERC at 62,012).

[393] *Freeport*, 669 F.3d 302,309; *ACC*, 397 F.3d 952, 954.

> to use its Expansion Capacity to provide firm service for the former FR shippers at no cost through the term of the 1996 Settlement. Because not all of the Expansion Capacity was in service at the time and because the Expansion Capacity was not enough to entirely resolve the capacity shortage, additional capacity was needed. Fortuitously, a certain amount of Block Capacity was turned back to El Paso during that time and the Commission directed El Paso to use that capacity to meet the current firm service needs of its former FR shippers. Thus, both the Expansion Capacity and the turned-back Block Capacity were needed to meet existing firm service obligations.[394]

242. Thus, the Commission has already considered and rejected the core premise of El Paso's argument, that the changes made in the Capacity Allocation Proceeding give Article 11.2(a) shippers a free ride on expansion costs. Because these shippers must serve load growth with uncapped expansion capacity at maximum recourse rates, the same as any other shipper, we reject El Paso's suggestion. In upholding the August 24 Rehearing Order in Freeport, the D.C. Circuit court reviewed and found no fault with the shippers' decision to take less than their full requirements contracts (under the converted contract demand agreements) at Article 11.2(a) rates. The court found that the shippers' choice "did not compel El Paso to pursue an economically unjustified expansion of its system."[395]

243. In the September 5 Order, the Commission stated that "[s]ince the expansion capacity at issue here was not a part of El Paso's system when the former [full requirements] shippers entered into their 1995 TSAs, El Paso is not obligated to serve the former [full requirements] shippers with the expansion capacity at capped rates. The former [full requirements] shippers must pay the full rate for this capacity, just as historical [contract demand] shippers do for capacity above the level of their 1995 TSAs."[396]

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[394] August 24 Rehearing Order, 132 FERC ¶ 61,155 at P 102 (emphasis added; notes omitted).

[395] *Freeport*, 669 F.3d at 309; *see also id.* at 10 (noting that at the time of the Capacity Allocation Proceeding, El Paso lacked the capacity to meet both full requirements customers needs and commitments to remarket turned back capacity).

[396] September 5 Order, 124 FERC ¶ 61,227 at P 84.

244. To meet its obligation under the full requirements contracts, El Paso offered to provide its expansion capacity for free for two years, until the termination of the 1996 Settlement. Thereafter as previously discussed, El Paso charged maximum recourse rates for service on the expansion capacity, because Article 11.2(a) rates do not apply to expansion capacity. The Presiding Judge thus found that Article 11.2(a) shippers also take non-Article 11.2 service.[397] The suggestion that the Expansion Capacity was constructed at the demand of the former full requirements shippers, and that the former full requirements shippers are utilizing the expansion capacity without paying a share of that capacity, is therefore unfounded. Moreover, the U.S. Court of Appeals for the D.C. Circuit has agreed that, rather than constructing the expansion capacity at the urging of its former full requirements customers or because those customers demanded it, El Paso was already obligated under its full requirements contracts to meet those customers' full requirements, and the Capacity Allocation Proceeding merely implemented a reasonable way to do so.[398] Upon expiration of the initial term of the 1996 Settlement, those former full requirements shippers using expansion capacity began paying recourse rates for that capacity. Thus, we cannot find that former full requirements shippers have by their actions improperly avoided paying for expansion capacity, since those that are receiving service on expansion capacity are paying the full recourse rate for such capacity.[399]

245. The *Freeport* court also rejected El Paso's argument that the Capacity Allocation Proceeding contravened the "central purpose" of the 1996 Settlement, because it limited El Paso's ability to remarket the Block capacity. The Court noted that remarketing may have been an issue in 1996, when energy demand was low, but upheld the Article 11.2(a) shippers' right to be insulated from costs of unsold turnback capacity and at the same time be entitled to demand service as full requirements customers via available turnback capacity. The Court concluded, "El Paso's quarrel is with the vicissitudes of the energy market and the nature of its full requirements, not with the Commission's refusal to abrogate Article 11.2."[400]

[397] ID at P 724. RPS/Salt River/ACC affirms that most Article 11.2 shippers hold multiple contracts: those to which the Article 11.2(a) rates apply and those associated with the expansion capacity currently priced at maximum recourse rates. RPS/Salt River/ACC Brief Opposing Exceptions at 23-24.

[398] The Commission's determination was upheld in *Freeport*, 669 F.3d at 309.

[399] *Freeport*, 669 F.3d at 312 (approving Commission finding that Article 11.2 does not apply to expansion capacity).

[400] *Id.*, at 310.

246. The 1996 Settlement provided immediate financial security to El Paso and it would be inequitable to relieve El Paso of its performance of the rate cap side of the bargain. Further, the 1996 Settlement contains offsetting consequences, such as an inflation adjustment and provision for additional capacity turnbacks, that demonstrate that the parties considered changes in circumstances similar to the facts at hand. As the Presiding Judge found, "El Paso could not have had a reasonable expectation that the 1996 Settlement would absolutely not cost its stockholders anything[.]"[401]

247. We agree. So long as El Paso agreed to provide service to a discrete set of customers at capped rates, it always faced the prospect of a revenue shortfall with respect to those customers, should the costs to serve those customers exceed the capped rates.

248. The Court in *Freeport* affirmed the Commission's finding that El Paso has a contractual obligation to serve the former full requirements shippers, currently through the successor contract demand agreements. This obligation carries with it the obligation to make needed system improvements and upkeep. El Paso does not allege that it is unable to cover its costs such that it is facing dire financial straits under *Sierra*,[402] nor that it will be unable to make necessary upgrades.[403] Furthermore, the Article 11.2(a) rate cap increases with inflation.[404] These revenue streams may be applied to system improvements. Absent a showing to justify abrogation of the contract under *Mobile-Sierra*, the Commission cannot relieve El Paso of the negative consequences of its bargain. Although a pipeline should have a reasonable opportunity to recover its costs plus a reasonable return, nothing prohibits a pipeline from agreeing to limits on what that return may be. Consequently, we do not find that the Article 11.2(a) revenue shortfall (to the extent of any such shortfall) constitutes serious enough harm to the public or the pipeline that would support abrogating Article 11.2(a).

249. El Paso and shippers opposed to Article 11.2 and particularly the rate cap mechanism of Article 11.2(a), have failed to present a detailed analysis of how the

[401] ID, 134 FERC ¶ 63,002 at P 509.

[402] El Paso Brief on Exceptions at 68-69 (acknowledging that it did not present financial testimony to establish cost recovery).

[403] *Id*. at 82 ("El Paso will always operate and maintain a safe pipeline system [and] [s]afety is and always will be El Paso's number one priority").

[404] *See* ID, 134 FERC ¶ 63,002 at P 510. We also agree with the Presiding Judge, that if El Paso feels the circumstances warrant, it may propose and seek to justify a surcharge, consistent with our policies and precedent under the NGA.

continuation of Article 11.2(a) harms the public interest to justify abrogation. In the Capacity Allocation Proceeding, on the other hand, there was an unequivocal showing that service disruptions had occurred due to the full requirements contracts, which supported the Commission's changing those contracts to contract demand arrangements.

250. On exceptions, some Parties suggest that Article 11.2 may distort natural gas or electric markets, in that shippers with contracts subject to the cap have an advantage in electric generation and supply markets. For its part, El Paso suggests that eliminating Article 11.2 might lower electricity prices by lowering recourse rates. However, these comments do not chronicle any extraordinary market dysfunction, but merely reflect the fact that El Paso's various customers take service at varying rates. As shippers defending Article 11.2(a) note, shippers attacking Article 11.2 sometimes receive even deeper discounts than those afforded Article 11.2 shippers. Furthermore, abrogating Article 11.2 would raise rates for Article 11.2 shippers and downstream customers. We find the record lacks sufficient evidence to establish some wide-spread market dysfunction or to justify abrogation of Article 11.2 as being in the public interest. The revenue shortfall and rate differentials are foreseeable circumstances of the rate cap.[405]

251. The Presiding Judge found that "Article 11.2 has not created a disincentive for the pipeline to construct new facilities and has not hampered El Paso's ability to construct needed maintenance and safety upgrades, including [pipeline integrity projects;]" nor has it had anti-competitive effects."[406] We agree. Article 11.2 is not unduly discriminatory and does not harm competition by somehow shielding Article 11.2 shippers from expansion costs. As approved in the Capacity Allocation Proceeding, Article 11.2 shippers taking service using the expansion capacity must do so pursuant to the separate, fully allocated rates.[407] Article 11.2 shippers are paying fully allocated recourse rates for expansion capacity and, as the Presiding Judge found, "the impact of El Paso's discounts to California and other shippers exceeds the impact of Article 11.2(a) rates."[408]

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[405] *See Revisions to the Blanket Certificate Regulations and Clarification Regarding Rates*, 115 FERC ¶ 61,338, at P 95 (2006) (citing *Cities of Bethany v. FERC*, 727 F.2d 1131, 1139 (D.C. Cir. 1984) (holding that a rate disparity does not establish unlawful rate discrimination and rate differences may be justified by cost of service or contract)).

[406] ID, 134 FERC ¶ 63,002 at P 718.

[407] *Freeport*, 669 F.3d at 312; March 20 Order, 114 FERC ¶ 61,290 at P 69.

[408] ID, 134 FERC ¶ 63,002 at P 507.

252. The Presiding Judge rejected the claims of competitive harm, characterizing the testimony of Parties advocating termination of Article 11.2 as forecasting possible harm, as opposed to detailing actual harm to the general public.[409] Although parties advocating abrogation of Article 11.2 argue that it provides a disincentive to build needed facilities in the future, they have not provided evidence of a significant improvement that is not being built due to Article 11.2. Accordingly, these claims are unsupported and speculative, and we reject these allegations as insufficient to support rescinding or modifying Article 11.2 under the *Mobile-Sierra* public interest standard.

253. Furthermore, as the Presiding Judge found, "New expansion projects are normally supported by prospective customers that commit to projects though open seasons and pay incremental rates. In sum, the claim of inability to meet maintenance needs and disincentive to build is too speculative to meet the *Mobile-Sierra* standard."[410] We affirm the Presiding Judge and note the *Freeport* court's finding that El Paso's quarrel is once again with "the vicissitudes of the energy market," which makes it difficult to remarket all of its capacity, including California service.

254. Regarding the complaints that Article 11.2 will inhibit changes to El Paso's rate structure, these claims are inchoate and at best refer to future circumstances. As for the assertion that Article 11.2, as written, applies in perpetuity, we find that the record in this proceeding does not establish that Article 11.2 is unchanging. Rather, the class of Article 11.2 contracts can never increase and is indeed subject to diminution and termination. As the Presiding Judge noted, some shippers have in fact terminated their contracts as better opportunities have come along.[411] In addition, it is not a foregone conclusion that Article 11.2(a) rates will be perpetually lower than recourse rates, since Article 11.2(a) rates have increased since 1998 by at least one percent annually to account for inflation.[412] Consequently, we do not find the predictions that Article 11.2 will have a negative impact on the El Paso system in perpetuity justify abrogation of Article 11.2(a) as being in the public interest.

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[409] *Id*. P 508 (characterizing testimony as "replete" with words indicating possible harm, i.e., "likely," "could," "eventually," "anticipate," etc.).

[410] *Id.* P 510.

[411] We do not address on this record whether Article 11.2 contracts may be rolled over incorporating the rate cap. Such issues will be examined on a full record as contracts expire.

[412] ID, 134 FERC ¶ 63,002 at P 482, 507.

255. El Paso seeks to rely on a prior amendment to the 1996 Settlement that was omitted in June 1997 when it re-filed conforming changes resulting from post-filing negotiations.[413] The relevance of the evidence is strongly disputed, with many shippers testifying that they did not view the language as providing for a waiver of the public interest standard, as El Paso now argues.[414] The document El Paso and other seeks to rely on is dated March 15, 1996; we find it is not "new evidence" that warrants reversal of our consistent holding that the *Mobile-Sierra* standard applies to any changes in the 1996 Settlement.

2. <u>Issue (3) Whether Article 11.2 Shortfalls may be Reallocated to Non-Settlement Customers</u>

256. El Paso argues that the Article 11.2 rates do not recover the full cost of Article 11.2 service. Specifically, El Paso argues it does not recover an appropriate share of post-1995 and safety project costs.[415] El Paso sought to reallocate this alleged shortfall. The Presiding Judge disagreed with El Paso that it should be allowed to reallocate revenue shortfalls caused by the rate cap to other customers, noting that nothing in the 2008 Settlement indicated that El Paso would seek recovery from other customers of such shortfall amounts, and rejecting El Paso's attempt to recover the shortfall by characterizing the 1996 Settlement rates as discount rates, or alternatively as vintage rates.[416]

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[413] *See* RPS/Salt River/ACC Brief on Exceptions at 44-45 (describing Ex. EPG-432 (the "correct" version of Article 11.2(a) from the 1996 Settlement) as an unsponsored cross-examination exhibit revealed only at hearing); *see also El Paso Natural Gas Co.*, Order Granting Joint Movants' Motion for Summary Disposition and to Strike Testimony and Exhibits, Docket Nos. RP08-426-000, *et al.* (May 12, 2009) (Hardnett, ALJ) (striking El Paso testimony arguing that *Mobile-Sierra* standard does not apply as collateral attack on September 5 Order).

[414] *See* Southwest Gas Corporation witness Jordan testimony, Tr. 1585-86 (May 27, 2010).

[415] The 2008 Rate Settlement, Article 6.7 defines the shortfall as follows: "the annual amount related to costs not otherwise recovered due to the Article 11.2(a) rate caps is deemed to be $12.8 million. Of that annual amount, $5.8 million is deemed to have been reallocated to the non-Article 11.2(a) contracts in the black box Settlement Rates and the remaining $7 million is deemed to have been removed from the costs used to develop the Settlement Rates."

[416] ID, 134 FERC ¶ 63,002 at P 564.

Briefs on Exceptions

257. El Paso objects to the Presiding Judge's holding that it may not recover Article 11.2 shortfall costs under any of the theories El Paso advances. El Paso asserts that general cost recovery principles support recovery of all prudently-incurred costs, including Article 11.2 shortfall costs.[417] El Paso objects to the position that the only way it could recover the Article 11.2(a) shortfall is by meeting the standard criteria under the Commission's Discount Adjustment Policy.[418] El Paso concedes that a pipeline could contractually agree to waive recovery of certain costs, but argues that it did not agree in the 1996 Settlement not to collect any shortfall from other, non-settling customers.[419]

258. El Paso relies on language in the Commission's March 20 Order, which states "[t]he specific method of including the costs in the rates can be addressed at the hearing, but the Commission makes clear that Article 11.2(a) does not preclude inclusion of the costs of these expansions in all shippers' rates in this proceeding."[420] It also relies on the September 5 Order, which states "[t]he Commission finds it unreasonable to interpret Article 11.2(b) to require El Paso to absorb such costs, which only arise because of the expansions."[421] El Paso reads these statements to mean that El Paso is free to propose other methods to reallocate the shortfall, and is not limited to meeting the criteria for a discount adjustment.

259. El Paso denies it contracted away the right to recover Article 11.2 shortfall costs from non-Article 11.2 shippers.[422] El Paso argues that the Presiding Judge's holding to

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[417] El Paso Brief on Exceptions at 101-02 (citing *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923); *Hope*, 320 U.S. 591, 603; *AES Ocean Express LLC v. Florida Gas Transm. Co.*, Opinion No. 495-A, 121 FERC ¶ 61,267, at P 88 (2007)). El Paso describes the shortfall costs as "costs the Article 11.2 shippers would avoid paying by virtue of the Article 11.2 rate provisions." El Paso Brief on Exceptions at 70.

[418] *Policy for Selective Discounting by Natural Gas Pipelines*, 111 FERC ¶ 61,309, *reh'g denied*, 113 FERC ¶ 61,173 (2005) (Discount Adjustment Policy).

[419] El Paso Brief on Exceptions at 104, 103 n.171.

[420] March 20 Order, 114 FERC ¶ 61,290 at P 69.

[421] September 5 Order, 124 FERC ¶ 61,227 at P 98.

[422] El Paso Brief on Exceptions at 109-10 (citing ID at P 564: "El Paso agreed as a part of the Settlement to absorb the costs of any underutilized capacity as part of the 1996

(continued…)

the contrary conflicts with the Commission's language allowing the issue to be litigated. El Paso argues that it never expressly waived its ability to recover the shortfall from other customers, and contests shippers' testimony to the contrary concerning the parties' and El Paso's intent in the 1996 Settlement negotiations.

260. El Paso states that denying it recovery of the shortfall could signal that it may have to abandon facilities and reduce capacity to minimize its exposure to the shortfall, stating that it cannot keep capacity in service that customers are unwilling to pay for.[423]

261. El Paso defends the proposed shortfall recovery as consistent with the Commission's 1995 order encouraging El Paso to find new customers to address the 1995 turnbacks.[424] El Paso argues that it should not be barred from allocating Article 11.2 shortfall costs to the customers that it found through its remarketing efforts.

262. El Paso objects to the Presiding Judge's rejection of a discount adjustment to recoup the Article 11.2 shortfall. El Paso contests the Presiding Judge's finding that the rates "have not been shown to be as a result of competitive concerns" as they were provided to many "already captive customers." El Paso points to evidence that these customers retained termination rights and had competitive alternatives in 1995 and 2006. El Paso disputes the notion that East of California shippers were captive in 1995-96 as grossly oversimplifying the situation and ignoring evidence showing that shippers had competitive alternatives in 1995 and during the term of Article 11.2. El Paso cites customer termination rights and claims that significant competition existed in every East of California state.[425]

263. El Paso faults the Presiding Judge for focusing on pipe-to-pipe competition in 1995-96, stating that the Commission's discounting policy requires an assessment of the competitive options the pipeline anticipated would be a factor during the term in which

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Settlement. . . . It is not permissible, nor just and reasonable to allow El Paso to get around its agreement by reallocating Section 11.2 shortfalls to other customer groups;" March 20 Order, 114 FERC ¶ 61,290 at P 92).

[423] *Id.* at 107.

[424] *Id.* at 108 (citing *El Paso Natural Gas Co.*, 72 FERC ¶ 61,083 (1995) (1995 Suspension Order)).

[425] *Id.* at 119-20 (citing Ex. EPG-374, Palazzari rebuttal testimony, which discussed competition for Southwest Gas and Gas Company of New Mexico loads, as well as another major customer and "crown jewel" loads).

the discount applies.[426] El Paso characterizes the issue as "what competition El Paso could reasonably have expected to face in 2006 when it agreed to the Article 11.2 provisions." El Paso objects to the Presiding Judge's determination that competitive concerns in 2006, ten years after the 1996 Settlement, are of little relevance because such concerns could not have been reliably considered at the time of the settlement. El Paso states that customers holding Article 11.2 contracts engaged in turnbacks; took service from competitors; had other options (including interruptible or released capacity); had the ability to purchase power or use alternate fuels; and that smaller shippers had the same alternatives.

264. To attempt to demonstrate by contemporaneous evidence that it considered competition at the time it agreed to the 1996 Settlement, El Paso submits an internal memo (Ex. EGC-27) analyzing its failure to purchase a pipeline and discussing the potential that the buyer could access its markets and evidence that, during the 1996 Settlement negotiations, it sought to retain major Arizona customers.[427] El Paso states that East of California shippers wanted termination rights because they had other alternatives to El Paso firm service, including other pipelines, interruptible service on El Paso, and acquiring capacity in the secondary market, and asserts that these shippers also could reduce load by using other fuels or purchased power.[428] Finally, El Paso contests the judge's assertion that a discount analysis should be done contract by contract, not on an entire customer base.[429]

265. El Paso also contests the Presiding Judge's description of the Article 11.2 rates as more akin to negotiated rates, than discounted rates. Finally, El Paso alternatively seeks

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[426] *Id.* at 123 (citing *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,094 (2000) (*Trunkline*) (referring to "expected market conditions over the term of discount, the customer's competitive alternatives, such as its access to other pipelines or ability to use alternate fuels, and the cost of those alternatives."); *see also Iroquois*, 84 FERC at 61,477 (discussing need to focus on market conditions expected to exist during a long-term discount); Discount Adjustment Policy, 111 FERC ¶ 61,309 at PP 65-66).

[427] *Id.* at 122 (citing Ex. EGC-27, post sale analysis discussing failure to purchase a pipeline that could give another company access to its markets, and Ex. SRP-5, settlement materials).

[428] *Id.* at 122 (stating such concerns are competitive factors justifying discounts and citing Discount Adjustment Policy, 111 FERC ¶ 61,309 at PP 7, 26; *Southern Natural Gas Co.*, 67 FERC ¶ 61,155, at 61,458 (1994)).

[429] *Id.* at 118 (citing ID, 134 FERC ¶ 63,002 at P 565).

to justify the allocation of the Article 11.2 shortfall to other customers by way of a "vintage rate analogy," and argues that Article 11.2 rates should be considered akin to vintage rates. El Paso describes Article 11.2 rates as based on a cost of service solely related to El Paso's 1995 facilities that apply to shippers with 1995 contracts in effect. El Paso argues that there is a strong correlation between this case and vintage rate cases.[430] El Paso asks the Commission to approve its shortfall recovery proposal through recourse rate contracts as akin to vintage rates, even though the Presiding Judge rejected this analogy."

Briefs Opposing Exceptions

266. Other Parties[431] contest any reallocation of the Article 11.2 shortfall and support the Presiding Judge's finding that El Paso agreed to absorb the costs of any underutilized capacity as part of the 1996 Settlement,[432] and is not entitled to reallocate the Article 11.2 shortfall to other contracts.

267. Joint Parties argue that a pipeline may forego certain cost recovery rights as consideration to achieve the benefits of a settlement. Joint Parties cite the Commission's response to the original El Paso rate filing that led to the 1996 Settlement. There, the Commission rejected El Paso's proposed exit fee to Pacific Gas & Electric Company for leaving the system, and stated that:

> [w]hen historic customers terminate service at the end of their contracts it is not appropriate to expect the remaining customers, specifically the EOC customers in this case, to pay for all the remaining costs of the pipeline. The pipeline has

[430] *Id.* at 114-16 (citing Palazzari testimony, Ex. EPG-289-A; EPG-374 at 89).

[431] In this section addressing Reallocation of the Article 11.2(a) shortfall, the following parties filed a Joint Brief Opposing Exceptions Regarding Reallocation (Joint Brief) as "Joint Parties:" ACC; AEPCo; APS; ConocoPhillips; El Paso Electric; El Paso Municipal Customer Group; Freeport; Gila River; Golden Spread Electric Cooperative, Inc.; MGI; New Harquahala; New Mexico Gas; PNM; Salt River; Sempra Global; Southwest Gas; Southwestern Public Service Company; Tucson Electric Tucson Electric and UNS.

[432] E.g., Joint Brief at 4; California Parties Brief on Exceptions at 1 n.3 (citing ID, 134 FERC ¶ 63,002 at PP 564-67 and support conclusion that El Paso is not permitted to reallocate any shortfall to others if Article 11.2 is not eliminated); Edison and Competitive Suppliers also support the Presiding Judge's finding.

> some obligation to attempt to develop new business opportunities to make use of its unused capacity.[433]

268. Joint Parties also cite another Commission pronouncement that "[t]he primary purpose of Article 11.2 was to ensure that El Paso would not seek, in a future rate case, to recover any of the existing capacity costs it had agreed to absorb."[434]

269. California Parties assert that it is neither permissible nor just and reasonable to allow El Paso to get around the 1996 Settlement agreement by reallocating Article 11.2 shortfalls to other customer groups, and they object to the proposed reallocation of the Article 11.2 shortfall to only the non-Article 11.2 customers.

270. Joint Parties contest El Paso's assertions that it has a statutory and constitutional right to recover the revenue shortfall, because El Paso has not provided any evidence that its rates are confiscatory, and El Paso has had an adequate opportunity to recover its costs as provided for in *Hope*.[435]

271. Edison contests El Paso's theory that it must be allowed to recover all its costs from someone. Edison notes that El Paso had the opportunity to collect the costs from the Article 11.2 customers, but it traded that right away in the 1996 Settlement, and El Paso must honor the deal it made.

272. Edison asserts that El Paso's proposed reallocation of costs from Article 11.2(a) contracts to other customers would violate the fundamental ratemaking principle that "[p]roperly designed rates should produce revenues from each class of customers *which match, as closely as practicable, the costs to serve each class or individual customer*."[436]

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[433] 1995 Suspension Order, 72 FERC at 61,441.

[434] Joint Parties at 7 (citing March 20 Order, 114 FERC ¶ 61,290 at P 83; September 5 Order, 124 FERC ¶ 61,227; August 24 Rehearing Order, 132 FERC ¶ 61,155).

[435] *Hope*, 320 U.S. 591, 602 ("And when the Commission's order is challenged in the courts, the question is whether that order, 'viewed in its entirety,' meets the requirements of the Act. Under the statutory standard of 'just and reasonable,' it is the result reached, not the method employed, which is controlling.").

[436] Edison Brief Opposing Exceptions at 30 (citing *Ala. Electric Coop., Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982) (emphasis in original)).

Edison reports that the shortfall costs at issue were incurred to provide service to the Article 11.2 shippers, not to provide service to the other shippers.

273. Joint Parties object to El Paso's assertion that it has a right to recover costs from other shippers that are already paying the full recourse rate because Article 11.2 rates have fallen below recourse rates. Joint Parties assert that by definition a negotiated rate cap under an agreed upon formula constitutes a waiver of the pipeline's right to recover revenues from such customers and that once a pipeline agrees to cap its rights to certain customers, it cannot construe silence as an intent to maintain its right to collect the unrecovered costs from other customers.[437]

274. These Parties also contest El Paso'S assertion that it reserved the right to collect shortfall costs from other customers. Joint Parties argue that, absent an express reservation of a right to seek recovery of a shortfall from other customers or contracts, El Paso agreed to forego the right to collect such revenues.

275. Joint Parties assert that denying recovery is consistent with the Commission's statement in the 1995 Suspension Order, which admonished El Paso to aggressively market its unsubscribed capacity to produce additional revenue rather than surcharge East of California Shippers. Joint Parties cite testimony indicating that El Paso could have avoided a revenue shortfall, by raising billing determinants through marketing or cost containment. Joint Shippers assert that East of California customers cannot be expected to guarantee El Paso's cost recovery when El Paso has substantial unsubscribed capacity on its system.

> Joint Parties, APS, and others argue that the Commission's statements in the March 20 and September 5 Orders have been taken out of context by El Paso, and do not stand for what El Paso claims they do.

276. Joint Parties also reject El Paso's suggestion that applying the standard criteria under the Discount Adjustment Policy here sends the wrong signals industry-wide on cost recovery, and may even affect pipeline safety. Joint Parties point out that Article 11.2 is

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[437] Joint Brief at 8 (distinguishing precedent cited in El Paso Brief on Exceptions at 111; *Sithe/Independence Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 76 FERC ¶ 61,285 (1996), *remanded on other grounds*, 165 F.3d 944 (D.C. Cir. 1999); *So. Cal. Edison Co.*, Opinion No. 289, 41 FERC ¶ 61,188 (1987)).

unique to El Paso, so an unfavorable discount holding here is unlikely to affect other pipelines and shippers.[438]

277. Various Parties interpret the Commission's prior statements which El Paso claims show that it is entitled to recover any shortfall as actually meaning that El Paso may seek such recovery, but must fully satisfy the Commission's discount adjustment policy to obtain such recovery.[439] According to Joint Parties, the Commission's prior statements establish that the discount adjustment is the only mechanism by which El Paso may seek to recover an Article 11.2 shortfall. Consequently, El Paso's failure to accept this fact amounts to an impermissible collateral attack on these orders.

278. Edison objects to any finding that Article 11.2 represents a selective discount because the rate caps were not structured as discounts under the 1996 Settlement, but were instead rates agreed upon as part of complex settlement negotiations. Edison asserts every witness in the proceeding that was actually present at the time of negotiation of the 1996 Settlement maintains that the Article 11.2 agreement was not motivated by a need to meet competition.

279. California Parties, Edison and Joint Parties therefore assert that the proposed reallocation is not authorized by the Commission's selective discounting policy which requires that the discount was given to meet competition to retain a particular customer's business. California Parties note that Article 11.2(a) rates were made available to all customers on the El Paso system. Edison sees El Paso's decision to provide Article 11.2(a) rates to customers as equivalent to a negotiated rate agreement, as the Presiding Judge concluded.

280. Edison rejects the notion that an examination of the level of competition in 2006, rather than in 1995-96, can provide the relevant showing of a need to meet competition. Joint Parties also point out that under the Discount Adjustment Policy, "the competitive circumstances at the time of the discount are relevant and an 'after-the-fact' justification that does not meet that standard would not support a discount adjustment."[440]

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[438] *Id*. at 26 ("[M]erely waving the 'bloody shirt' of pipeline safety and permanent abandonments is not an adequate, appropriate or sufficient reason to ignore the law of the case and justify reallocation of any Article 11.2 revenue shortfall").

[439] *Id*. at 21-22; March 20 Order, 114 FERC ¶ 61,290 at P 93; September 5 Order, 124 FERC ¶ 61,227 at P 120; August 24 Rehearing Order, 132 FERC ¶ 61,155 at PP 119, 127-28 (citing Discount Adjustment Policy).

[440] Discount Adjustment Policy, 113 FERC ¶ 61,173at P 126.

281. Edison adds that no evidence has been presented that shows that El Paso actually evaluated the level of competition for its customers at the time of the 1996 Settlement, and that in the absence of such evidence, El Paso cannot possibly satisfy the burden of proof required under the selective discount policy.

282. Joint Parties conclude that El Paso has failed to meet its obligation to demonstrate through thorough analysis that competition led to the development of Article 11.2. Joint Parties compare the record in this proceeding to that in a *Trunkline* decision where a discount adjustment was disallowed because the pipeline produced "nothing more than general claims" by the pipeline that competition required the discounts to the shipper, without any specification of what alternatives were available to the shipper.[441]

283. Edison also notes that *Trunkline* questions the motivation for giving discounts in the middle of a long-term contract, "since the pipeline already has the load and the revenues under the contract,"[442] suggesting that there was no reason to offer discounts to the full requirements shippers. Joint Parties contest El Paso's representations as to the scope and significance of competition in the East of California markets and reaffirm the evidence adopted by the Presiding Judge demonstrating that the majority of East of California shippers were captive at the time of the Settlement. Joint Parties reject El Paso's attempts to establish that concerns with competition drove the 1996 Settlement negotiation of Article 11.2(a) rates. They claim that it was the existence of competitive alternatives in California that led to the turnback problems in 1995-96 that were addressed in the 1996 Settlement.

284. Joint Parties cite the declarations of shippers' witnesses that they participated substantially and directly in the 1996 Settlement negotiations, and the Arizona Corporation Commission witness's testimony as to the lack of competitive options available to Arizona shippers in 1996 and beyond. These shipper's witnesses testified that they did not recall competition being a concern for El Paso during the negotiations and attested to the captive status of the shippers.[443]

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[441] Joint Brief at 37.

[442] Edison Brief Opposing Exceptions at 35; *Trunkline*, 90 FERC at 61,093 (discount provided in order to settle a rate case was not provided for competitive reasons).

[443] Joint Brief at 33 (discussing AEPCO and Salt River and citing the Capacity Allocation Complaint Order, 99 FERC at 62,003 ("The full requirements customers state that they must rely on the FR contracts because they are captive customers, yet FR

(continued…)

285. Joint Parties cite the term of shippers' full requirements service agreements as limiting their ability to reduce their load on El Paso. Joint Parties assert that at the time of the 1996 Settlement, nearly every East of California shipper was a full requirements customer of El Paso and, with the very limited exception of Southwest Gas's service in Southern Nevada, was contractually prohibited from taking service from any other pipeline.[444] In addition, they cite shipper witness Neustaedter's testimony that shippers could not have realistically taken advantage of any competitive opportunities, even if they did exist. Joint Parties cite testimony questioning El Paso's theory that it faced competition in the form of the threat that shippers would seek interruptible contracts or alternative fuels – first because El Paso did not provide any contemporaneous evidence that such matters entered into its deliberations in developing Article 11.2, and second because interruptible service would not have met the needs of electric utility shippers and economic and environmental concerns limited consumption of alternate fuels.[445]

286. These Parties also support the Presiding Judge's rejection of El Paso's contention that reallocation is akin to "vintage" rates. According to California Parties, El Paso is trying to achieve cross-subsidization, whereby holders of contracts that are not part of a privileged group (non-Article 11.2 contracts) would subsidize shippers with Article 11.2 contracts. California Parties assert that El Paso has failed to produce any precedent supporting a reallocation of costs across rate vintages.

287. Edison also objects to treatment of Article 11.2 rates as vintage rates, under which different customers are charged different rates associated with capacity that was constructed at different times. If El Paso's post-1995 facilities had been incrementally priced, new customers would bear the costs of the new facilities and the older, Article 11.2 shippers would not bear those costs. Or if the post-1995 facilities served new expansion customers while also improving service for pre-existing customers, the costs could have been divided to reflect benefits to various shippers. Edison argues that this is not the case, due to El Paso's rolled in rate design. Edison asserts that there is no incremental pricing on El Paso's system and thus no vintage rates.

288. Joint Parties assert that the Presiding Judge appropriately noted that vintage rates are to be established at the time facilities are certificated, when the pipeline can choose to

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contracts serve to keep them captive."); Capacity Allocation Rehearing, 104 FERC 61,045 at P 49).

[444] *Id*. at 45 n.188 (citing testimony).

[445] *Id.* at 46-47.

price new facilities via rolled in rates, or incremental rates.[446] Joint Parties note that the Presiding Judge found that no new facility vintage scenario was present in this proceeding; Joint Parties cite testimony indicating that the Article 11.2(a) rate does not represent a situation where a pipeline with a fully allocated system-wide rate subsequently builds expansion facilities.

Commission Determination

289. The Commission has elsewhere described the issues set for hearing in the 2006 Rate Case, including "[w]ithin this general framework, parties may address at the hearing issues concerning … whether [El Paso] is entitled to a discount adjustment for any discounted rates….,"[447] and "the question of whether the other shippers on [El Paso] should be allocated, through a discount adjustment, costs associated with the rate cap is an issue to be resolved at the hearing."[448] In addition, in the September 5 Order, the Commission referred again to "[a]ny discount adjustment that [El Paso] could propose."[449]

290. We affirm the Presiding Judge's conclusion that El Paso may not reallocate to non-Article 11.2(a) shippers or contracts any shortfall arising as a result of Article 11.2(a) rates being lower than recourse rates. We find that the 1996 Settlement was essentially a risk sharing arrangement. While El Paso's risk was mitigated by the possibility that El Paso could remarket turned-back capacity, there is nothing in the 1996 Settlement or the evidence presented here that suggests El Paso would not bear the costs if it failed to

[446] *Id*. at 48-49 (citing Certificate Policy Statement Clarification, 90 FERC ¶ 61,128; *Transcon. Gas Pipe Line Corp.*, 106 FERC ¶ 61,299, at P 57 (2004) ("when a project is first certificated, the Commission requires that existing shippers not be required to subsidize the expansion. This generally means that expansions will be priced incrementally so that expansion shippers will have to pay the full costs of the project, without subsidy from the existing customers through rolled-in pricing"), *aff'd*, *Transcon. Gas Pipe Line Corp. v. FERC*, 518 F.3d 916 (D.C. Cir. 2008); *Northern Natural Gas Co.*, 131 FERC ¶ 61,209, at P 17 (2010) ("the threshold requirement for pipelines proposing new projects is that the pipeline must be prepared to financially support the project without relying on subsidization from existing customers").

[447] March 20 Order, 114 FERC ¶ 61,290 at P 43.

[448] *Id.* P 27.

[449] September 5 Order, 124 FERC ¶ 61,227 at P 120.

remarket. Any remarketing must, naturally, be made at rates that are just and reasonable. To that extent, El Paso assumed the risk in Article 11.2 of any shortfall.

291. The 2006 Rate Case orders indicated that El Paso could seek to recover any shortfall under our Discount Adjustment Policy, but that did not guarantee El Paso would be able to show it met the discount adjustment criteria to enable it to recover these costs.[450] At the hearing, El Paso was not able to show it met the criteria in the Discount Adjustment Policy for a discount adjustment, and presented no other viable justification why its remaining customers should pay for costs foregone in order to implement El Paso's 1996 Settlement with the Article 11.2(a) shippers.

292. The pipeline has the ultimate burden of showing that its discounts were required to meet competition.[451] Parties opposing reallocation have made a more persuasive case that the Article 11.2 discount was not motivated by a need to meet competition at the time the 1996 Settlement was signed. El Paso has not met its burden to show otherwise.

293. El Paso claims that it offered the discount out of "concern" for competition, but fails to present any witness who participated in the settlement negotiations to demonstrate how such concerns affected its negotiations. Furthermore, El Paso admits the Article 11.2 rates are unusual in that they were to take effect ten years after the settlement was negotiated. The applicable discount-adjustment cases require the pipeline to present its expectation of market conditions at the time of the discount. It is not shown on the record how El Paso could have even been sure in 1996 that the Article 11.2 rate would in fact represent a discount ten years later. Lacking such fore-knowledge, El Paso could not have known in 1996 that the Article 11.2 rates would be required to meet competition to

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[450] August 24 Rehearing Order, 132 FERC ¶ 61,155 at PP 119, 127-28 (citing Discount Adjustment Policy):

> …nothing in Article 11 prevents El Paso from proposing a discount adjustment to recover costs it cannot recover from the Article 11.2(a) shippers as a result of their capped rates ….
>
> …This is not to say a discount adjustment to recover the costs El Paso cannot recover from the Article 11.2(a) shippers will necessarily be accepted. Any discount adjustment El Paso proposes will be evaluated at the hearing in El Paso's current rate case in Docket No. RP08-426 pursuant to the Commission's discount policy.

[451] Discount Adjustment Policy, 111 FERC ¶ 61,309 at P 59.

retain customers, since it was conceivable that Article 11.2 rates could have exceeded the recourse rates ten years in the future.

294. The Discount Adjustment Policy allows pipelines an opportunity at hearing to present evidence on the purpose and level of each discount, but a proposed discount adjustment must be supported and is not an entitlement. In this case, however, Article 11.2 was not negotiated to adjust individual customer rates in recognition of competitive alternatives, but was negotiated as a global settlement to resolve the issue of how to allocate the risks and costs of turnback capacity. Thus, the Article 11.2 rates were offered in consideration for the shippers' agreement to make the risk sharing payments and settle the outstanding rate case – not for competitive reasons.[452]

295. In explaining the Discount Adjustment Policy, the Commission cited two instances where discount adjustments to long-term firm contracts were disallowed when parties opposing the adjustments had raised a question about the circumstances in which those long-term, firm discounts were given. The Commission stated its expectation for supporting a discount adjustment:

> [W]hen a pipeline gives a long-term discount, the Commission would expect that the pipeline would make a thorough analysis whether competition required such a long-term discount, and in both these cases the pipeline had failed to present any evidence of such an analysis. A discount adjustment is not an entitlement and the pipelines would be ill-advised to consider it so.[453]

296. Although El Paso provides some evidence that competitive alternatives existed for some loads at the time Article 11.2 was developed, it does not provide an adequate detailed analysis to support its contention that Article 11.2 was required by that competition to retain customers. El Paso does not assert that Article 11.2 was required by competition, but instead asserts that the provision was "driven by competitive concerns," without providing persuasive support for this claim. El Paso never posted the Article 11.2(a) rates on its website as "discount rates" and did not provide contemporaneous record evidence that the concession in Article 11.2 was granted to respond to market

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[452] *Trunkline*, 90 FERC at 61,094.

[453] Discount Adjustment Policy Rehearing, 113 FERC ¶ 61,173 at P 24 (citing *Iroquois*, 84 FERC at 61,476-78; *Trunkline*, 90 FERC at 61,092-95).

conditions that it anticipated it would be experiencing in ten years.[454] El Paso indicated that it failed to follow its normal practice to request a letter from the shipper indicating the market conditions that support a discount.[455]

297. Shippers provided evidence that the fundamental issue in the proceeding that produced the 1996 Settlement was determining which shippers should pay for California turnback capacity and that El Paso resisted rate protections.[456] The fact that the rate caps applied to every shipper on El Paso's system on December 31, 1995 further undermines El Paso's assertion that the rates were discounts required by competition.

298. Furthermore, Joint Parties cite evidence contradicting El Paso's claims that the potential volumes subject to competition were significant, or that termination rights indicated that shippers were not captive customers.[457] Shippers also provided evidence that termination rights were used to adjust changes in demand due to circumstances that were beyond the customers' control, and not in recognition of a desire to switch suppliers.[458]

299. El Paso misreads statements in the March 20 Order as giving tacit assent to novel theories to justify recovery of the Article 11.2 shortfall. Rather, the Commission anticipated review of El Paso's proposal under the established Discount Adjustment Policy.[459] Thus, El Paso has failed to justify reallocation based on general cost recovery

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[454] 18 C.F.R. § 284.13(b); Discount Adjustment Policy, 111 FERC ¶ 61,309 at P 80.

[455] Price testimony, Tr. at 604. *See also Trunkline*, 90 FERC at 61,094 (rejecting discount adjustment and noting that pipeline had failed to follow its general practice to perform a market analysis as to whether a discount was required).

[456] Joint Brief at 34-35 (citing testimony and exhibits); e.g., Ex. SRP-5.

[457] *E.g.*, Joint Brief at 34 n.133 ("The Transwestern Section 7(c) certificate application, filed on September 15, 2006, was 'the first concrete proposal offering competitive gas transportation alternatives for Arizona shippers to come before this Commission since the 1996 Settlement was negotiated.'" Citing Reeves, Ex. SRP-1 at 7:5-9; Jordan, Tr. 1625; Gray, Ex. ACC-1 at 5:4-7).

[458] Capacity Allocation Complaint Order, 99 FERC ¶ 61,244 at 62,003-04 ("The full requirements customers state that they must rely on the FR contracts because they are captive customers, yet FR contracts serve to keep them captive.").

[459] March 20 Order, 114 FERC ¶ 61,290 at PP 20, 27, 43.

or cost allocation theories.[460] To exclude shortfall billing determinants from recourse rates would improperly require the Article 11.2 shippers to bear a portion of the shortfall, which was not required to meet competition, through their non-Article 11.2 service agreements; such a result would be inconsistent with the 1996 Settlement.[461]

300. Finally, El Paso's vintage rate analogy is inapposite, as the decision whether to design rates according to vintage or utilize a roll-in approach is made in the certificate proceeding, not post-hoc in a rate case. El Paso has chosen to roll in the expansion and safety costs into its recourse rates, and we need not revisit that decision here. Consequently, we affirm the Presiding Judge's determination that El Paso may not reallocate Article 11.2 revenue short falls to other shippers' rates in this case.

3. Issue (4) – Did El Paso meet the 4,000 MMcf/d Subscription Presumption to Avoid Having to Make an Article 11.2(b) Rate Adjustment

301. Under Article 11.2(b) of the 1996 Settlement, El Paso must reduce its rates to reflect certain unsubscribed capacity costs. The Commission established a presumption that this requirement would not be triggered if El Paso had subscribed service of at least 4,000 MMcf/d (a rough equivalent of the capacity El Paso had under subscription in 1995). The Presiding Judge found that El Paso did not meet the 4,000 MMcf/d subscription requirement and directed El Paso to develop rates implementing the Article 11.2(b) rate adjustment. In finding that El Paso failed to identify 4,000 MMcf/d of firm forward haul capacity at or above the settlement subscription, the Presiding Judge declined to include the following services: short-term firm, sculpted, backhaul, short haul, east flow, the maximum rate equivalent of discounted capacity, and capacity reserved for hourly services.

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[460] In particular, we reject El Paso's untimely proposal on exceptions to increase the non-Article 11.2(a) usage rates to reflect higher Article 11.2(a) usage rates. Such an adjustment is inconsistent with Article 6.7 of the Docket No. RP08-426-000 Rate Settlement limitation of the reallocation issue to whether El Paso may "allocate or reallocate costs not otherwise recovered due to the operation of the Article 11.2(a) rate caps."

[461] *See* September 5 Order, 124 FERC ¶ 61,227 at P 120 (clarifying that "any discount adjustment . . . to recover the capacity costs covered by Article 11.2(b) may only involve 'other shippers' that were 'non-parties to the Settlement,'" and not the eligible shippers entitled to protection under Article 11.2(b)).

302. The Presiding Judge excluded short-term firm service, because El Paso did not count it as a billing determinant, and determined that short-term firm services did not represent fully subscribed capacity so as to protect against cost shifting as intended under the 1996 Settlement. Furthermore, the Presiding Judge rejected use of maximum rate equivalents for discounted capacity as inconsistent with Article 11.2(b), and rejected the argument that the 1996 Settlement be viewed as establishing "vintage" rates. The Presiding Judge also declined to consider "sculpted" capacity (NCP/MDQ) because, citing the fact that El Paso does not set aside a matching capacity each month for a shipper to use in other months, which would utilize billing determinants. The Presiding Judge also did not count backhaul, short haul, and east flow capacity because she understood Article 11.2(b) as limited to forward haul service only.

Briefs on Exceptions

303. El Paso faults the Presiding Judge's finding that it failed to meet the 4,000 MMcf/d test, and her holding that the 4,000 MMcf/d threshold was the only showing El Paso could make to avoid the Article 11.2(b) rate adjustment. El Paso argues that it met the presumption, but even lacking that, it met the underlying purpose of the requirement, namely that no Article 11.2(b) shipper bear costs of capacity identified in the 1996 Settlement that becomes unsubscribed. The California Parties object that the Initial Decision adopts too formalistic an approach to Article 11.2(b) that departs from any reasonable interpretation of both the Article and the Commission's presumption. El Paso argues that the Commission adopted the presumption to assist in determining whether El Paso satisfied Article 11.2(b), but the presumption approach does not preclude other appropriate means of analyzing the issue.[462]

304. California Parties assert that the Commission should find the Article 11.2(b) threshold met, because El Paso has met the requirement, with contracted capacity in excess of the minimum levels in the Settlement and no costs related to stranded or discounted pre-1995 capacity included in rates. California Parties assert that El Paso has significantly more than 4,000 MMcf/d of firm capacity subscribed based on testimony and record evidence.

305. California Parties object to two limitations that the judge applied to the presumption calculation: (1) that only forward haul capacity counts toward the 4,000 MMcf/d presumption and (2) that capacity must be included as billing determinants (BD) to be considered in the presumption analysis. According to California Parties, the first

[462] El Paso Brief on Exceptions at 145 (citing *Pennzoil*, 789 F.2d, 1128 1140-41 (5th Cir. 1986)).

limitation is based on a misinterpretation of the Commission's March 20 Order,[463] where the Commission concluded that Article 11.2(b) only *protects* firm forward haul capacity. However, the March 20 Order did not hold that only firm forward haul capacity counts to satisfy the presumption.[464] California Parties object to a limitation on direction of flow because the pre-existing shippers would be equally protected from a cost shift regardless of whether the service is forward or backhaul, as long as it secures revenues from some firm service. El Paso agrees, arguing that the purpose of the Article 11.2(b) language was not to limit the types of new transactions that count towards the Article 11.2(b) threshold, but to clarify what capacity is entitled to the rate protections of Article 11.2(b).[465]

306. El Paso, California Parties, and Competitive Suppliers object to the Presiding Judge's second limitation, as drawing a distinction based on rate design, namely including contracts included as billing determinants over which costs are spread but not contracts treated as revenue credits to the cost of service – even though the effect of these two methods on the resulting rates is the same.[466] Competitive Suppliers cite the Article 11.2(b) requirement that El Paso assume "full cost responsibility for any and all of the associated CD/billing determinants related to" unsubscribed capacity as indicating that the Settlement parties knew that service agreements could be treated as billing determinants for rate purposes but treated in other ways related to contract demand, such as revenue credits. Competitive Suppliers also note Staff witness Ekzarkhov's testimony that rates would be the same, regardless of whether discounted transactions are treated as a revenue credit with billing units excluded from rate design or included as full rate equivalent billing determinants (FREBD) pursuant to the *Williston* methodology.[467]

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[463] *See* ID, 134 FERC ¶ 63,002 at P 620; *see also* Competitive Suppliers Brief on Exceptions at 62.

[464] California Parties Brief on Exceptions at 20 (citing SoCalGas/SDG&E witness Jones' hearing testimony (TR 2269: 19-22) and El Paso witness Palazzari testimony (Ex. No. APS-25 at 2, response of El Paso to APS data request)); *see also* Competitive Suppliers Brief on Exceptions at 63-64.

[465] El Paso Brief on Exceptions at 134; ID, 134 FERC ¶ 63,002 at P 620.

[466] California Parties Brief on Exceptions at 20-21 (citing Ex. S-12 at 14; Tr. 2604; Tr. 2157: 20-25).

[467] Competitive Suppliers Brief on Exceptions at 70-71 (citing *Williston Basin Interstate Pipeline Co.*, 107 FERC ¶ 61,164 (2004)).

307. El Paso contends that counting the maximum rate "equivalent" of discounted capacity for Article 11.2(b) purposes is analogous to how the Commission treats discounted capacity in permitting a discount adjustment. Under this theory, El Paso converted its 2,237 MDth/day of discounted volumes into maximum rate equivalent quantities of 1,410 MDth/day.

308. El Paso asserts that excluding short-term, maximum rate contracts is directly contrary to the goal of the 1996 Settlement to encourage El Paso to find new uses for the capacity relinquished by the California shippers. El Paso contends that the short-term contracts excluded by the Initial Decision have brought in revenues that helped defray the costs of the 1995 capacity.[468]

309. Similarly, El Paso argues that exclusion of daily capacity reservation nomination (CRN) capacity conflicts with the March 20 Order where the Commission did not find that FTH service is a storage service but made clear that non-ratable hourly transportation services use more daily capacity than ratable transportation and that it is appropriate for customers to pay a higher rate for the increased use of the system.[469] El Paso argues that CRN capacity is not a "storage service" as the Initial Decision appears to have found, but that El Paso is required to use the "horizontal" capacity of its pipeline system to pack and draft the system in order to provide the needed flexibility for the non-ratable services.[470] El Paso also asserts that the peak day quantity of sculpted contracts is the proper measure of the contracts' impact on the need for constructed physical system capacity and therefore should be used for Article 11.2(b) purposes.

310. California Parties assert that if the Article 11.2(b) presumption is correctly applied, by including all firm contracts that contribute to rate recovery and prevent costs of unsubscribed 1995 capacity from being shifted, then El Paso has met the threshold. Competitive Suppliers assert that even if the threshold is not met, the threshold is only a presumption, and that the obligations under Article 11.2(b) are still fulfilled because El Paso's revenues exceed the cost of 1995 facilities by a wide margin and the pipeline

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[468] El Paso Brief on Exceptions at 131 (citing Ex. EPG-374 at 114, 117, 127).

[469] *Id.* (citing March 20 Order, 114 FERC ¶ 61,290 at PP 29-32, 47, 51 ("The Commission further finds that it is reasonable to allocate the cost of such capacity to customers whose usage patterns place a higher burden on the system's operations. The Commission finds such allocations consistent with cost causation principles.").

[470] *Id*. at 133-34 (citing Exs. EPG-91 at 58-59, EPG-69 at 41, EPG-91 at 56-60, EPG-374 at 116, 130; Tr. 2101).

has not been required to shift any costs associated with unsubscribed or discounted 1995 capacity to the Article 11.2(b) shippers.[471]

Briefs Opposing Exceptions

311. APS, RPS/Salt River/ACC and Texas Gas Service support the Presiding Judge's finding that an Article 11.2(b) rate adjustment is required. They assert that El Paso has not shown that it has 4,000 MMcf/d of 1995 capacity subscribed at rates at or above the Article 11.2(a) price cap.

312. RPS/Salt River/ACC argues that Article 11.2(b) provides that El Paso assumes full cost responsibility for any and all of the associated CD/billing determinants related to un- or under-subscribed 1995 capacity."[472] RPS/Salt River/ACC contests the notion that the Commission intended services other than forward haul to count toward the threshold. RPS/Salt River/ACC asserts that if the Commission wished to count the service to the east, it would have established a 5,600 MMcf/d threshold to account for service in both directions.[473]

313. APS also asserts that non-forward haul and short haul contracts should be excluded in determining whether the 4,000 MMcf/d presumption level has been reached. APS reasons that the fact that the Commission's presumption refers generally to whether El Paso has 4,000 MMcf/d of "firm capacity" subscribed at the price cap does not support a conclusion that non-forward haul capacity may be counted towards the threshold.

314. APS asserts that revenue from east flow and other nontraditional capacity was included in the $34 million revenue credit underlying the 1996 Settlement. According to APS, counting billing determinants related to these types of services would shift costs in violation of the intent of Article 11.2(b).

315. APS asserts that El Paso's position that short-term firm maximum rate contracts should count towards the threshold would have some merit if the related billing determinants were reflected in rates, which is not the case. RPS/Salt River/ACC asserts that short-term firm contracts should not count because under the Rate Case Stipulation, a

[471] Competitive Suppliers Brief on Exceptions at 66; *see also* California Parties Brief on Exceptions at 24.

[472] RPS/Salt River/ACC Brief on Exceptions at 58.

[473] *Id.* at 61-62.

representative level of revenues attributable to short-term firm contracts was included as a revenue credit against the cost of service.[474]

316. APS acknowledges that a significant amount of short-term firm transportation service is now provided into California and other traditional forward haul markets; thus, short-term contracts in the traditional forward haul market area zones should be counted towards the threshold, provided such services are reflected in the billing determinants.

317. APS and RPS/Salt River/ACC defend the Presiding Judge's exclusion of capacity reservation nominations (CRNs) from the calculation of the threshold because CRNs are not reflected in El Paso's billing determinants and are not subscribed and not daily capacity. Texas Gas Service argues that the Commission deemed CRNs to be horizontal storage and was explicit that storage was not to be counted toward meeting the threshold.[475] APS objects to El Paso's description of the March 20 Order as holding that CRNs should count towards the threshold as inaccurate. APS characterizes El Paso's representation of the daily FTH services capacity of 970,976 Dth/d as inflated by 503,482 Dth/d to account for CRNs. According to APS, CRNs relate to hourly swings and such hourly swings do not entitle the holder of the service to exceed the amount of daily capacity subscribed in their contracts.[476]

318. APS concludes that the existence of CRNs helps rather that hinders El Paso in meeting the 4,000 MMcf/d threshold. APS states that El Paso's sale of 5,771 MDth/d of firm capacity during the test period, which is a level at or near total system capacity, confirms that CRNs have not interfered with El Paso's marketing efforts. According to APS, if 523 MDth/d of CRNs are added to that amount, the resulting total of 6,284 MDth/d clearly exceeds system capacity and confirms that including CRNs towards the threshold is double counting capacity.

319. APS, RPS/Salt River/ACC, and Texas Gas Service support the Presiding Judge's exclusion of discounted transportation from the threshold calculation. APS objects to the

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[474] *Id.* at 63.

[475] Texas Gas Service Brief Opposing Exceptions at 46 (citing September 5 Order, 124 FERC ¶ 61,227 at P 109; March 20 Order, 114 FERC ¶ 61,290 at PP 17-19, 61 ("Article 11.2(b) applies only to firm forward haul capacity. Therefore, it does not apply to interruptible service and does not apply to service performed using a backhaul or to services such as storage or park and loan."); Crisp, Tr. 2180:6-20).

[476] *See also* RPS/Salt River/ACC Brief Opposing Exceptions at 67 (noting that level of daily service is unaffected by CRNs).

use of the "discount adjustment" to transform 2,273 MDth/d of long-term and short-term capacity priced below the Article 11.2(a) rate cap into 1,410 MDth/d of "max rate equivalent" capacity. APS argues that the Commission did not intend or suggest that El Paso could use a discount adjustment (by converting 1995 and post-1995 discounted capacity into maximum rate equivalent billing determinants) to meet the threshold and thereby include costs of 1995 discounted capacity in rates.

320. Texas Gas Service argues that El Paso inappropriately averaged discounted contracts with contracts at rates above the cap, rather than analyzing discounted contracts on a contract-by-contract basis, thereby unreasonably inflating the amount of capacity that counts toward the threshold. RPS/Salt River/ACC defend the Presiding Judge's exclusion of discounted rate adjustments based on the plain language of Article 11.2(b) and the March 20 Order.[477]

321. Texas Gas Service argues that based on the analysis performed by its witness Crisp, El Paso is approximately 642 MMcf/d below the presumption; therefore, the Initial Decision's conclusion that El Paso has not met the presumption is supported by substantial evidence.

Commission Determination

322. The Commission finds that the Presiding Judge has incorrectly excluded certain services that provide revenue covering 1995 capacity, and finds that, with the inclusion of these services, El Paso has satisfied the Article 11.2(b) requirements. The Commission thus reverses the Initial Decision on this issue. Article 11.2(b) prohibits El Paso from including the cost of unsubscribed or discounted 1995 capacity in the rates of Article 11.2(b) shippers. To simplify a determination of whether Article 11.2(b) is satisfied, the March 20 Order established a presumption that "if El Paso has 4,000 MMcf/d of firm capacity subscribed at the rate cap level or above, there will be a presumption that there is no 1995 stranded or discounted capacity." The March 20 Order further explained that "the first 4,000 MMcf/d presumption ensures that El Paso must have subscribed capacity at maximum rates that is equivalent to the capacity that existed on its system in 1995 before it can propose to include the cost of unsubscribed or discounted capacity in the rates of eligible shippers." Thus, an Article 11.2(b) analysis includes two parts: (1) a calculation of whether El Paso's firm contracts at or above the rate cap exceed 4,000 MMcf/d and (2) a determination of whether El Paso proposes to shift the costs of unsubscribed or discounted capacity to the rates of Article 11.2(b) shippers.

[477] *Id.* at 64.

323. In determining whether an Article 11.2(b) rate adjustment is required in this case, the Parties primarily focused on whether El Paso met the 4,000 MMcf/d presumption. In addition, Parties argued whether the presumption is the only means to determine whether the Article 11.2 rate adjustment required. We clarify that the presumption is just that, a presumption established to “simplify compliance,” as described in the March 20 Order. The presumption is not the only method for determining compliance with Article 11.2(b). If the presumption is not met, other evidence might show that Article 11.2(b) is otherwise satisfied. However, we find that El Paso has met the presumption.

324. Based on references to “forward haul capacity” in Article 11.2(b) and the March 20 Order, some Parties argue that only forward haul firm contracts can be included. The Initial Decision agreed and found that only firm, forward haul contracts counted as billing determinants can be included in the presumption. The Initial Decision therefore rejected El Paso’s position that short-term firm, backhaul, short haul, east flow, sculpted, CRNs, and maximum rate equivalent contracts should count toward the presumption.

325. The Presiding Judge refers to statements in the March 20 Order for the proposition that Article 11.2(b) applies only to firm forward haul capacity. We disagree. “Forward haul” capacity defines the scope of 1995 capacity that is protected from cost-shifting, not the services that can be counted toward compliance. In other words, El Paso may not shift the cost of unsubscribed or discounted forward haul capacity that existed in 1995. The Commission’s presumption simplified a determination of what capacity was and was not 1995 capacity by establishing a presumption that the first 4,000 MMcf/d of subscribed capacity was the equivalent of 1995 capacity. The March 20 Order did not define the specific services that would count toward the 4,000 MMcf/d presumption. In a later statement in the March 20 Order, the Commission also clarified that “capacity is not stranded if it is being used, and all shippers are required to pay reasonable rates for the services they purchase from El Paso.” Consequently, the March 20 Order does not provide a basis for excluding non-forward haul firm services.

326. The Commission also finds that the Initial Decision incorrectly excluded contracts that are not counted as billing determinants. Article 11.2(b) does not specify that only contracts included as billing determinants for rate design purposes can count as subscribed capacity toward the Article 11.2(b) threshold. The only reference to billing determinants in Article 11.2(b) is the provision that “El Paso assumes full cost responsibility for any and all existing and future step-downs or terminations and the associated CD/billing determinants related to the capacity described in this subparagraph (b).” We do not interpret this provision as excluding capacity treated for rate design purposes on a revenue credit basis rather than on a billing determinant basis. In addition, as El Paso notes, El Paso’s rates were settled on a black box basis; it is therefore not clear which contracts were included as billing determinants. We therefore shall not exclude

maximum rate firm contracts that are creating revenue solely on the basis of their not being reflected as a billing determinant.

327. Accordingly, we find that the Initial Decision incorrectly excluded maximum rate short-term firm, short haul, backhaul, east flow, and production area contracts. These contracts provide revenues that contribute to El Paso's cost of service. As El Paso states, the 1996 Settlement encouraged El Paso to find new uses for the capacity turned back by the California shippers. Nothing in Article 11.2(b) or the Commission's orders requires the exclusion of these services.

328. The Initial Decision also erred in not counting CRNs associated with El Paso's premium hourly services, in part because the capacity used to provide the hourly flexibility in the FTH services is not included in a billing determinant, but also because the Presiding Judge determined that CRNs were not subscribed. In the March 20 Order, the Commission found that the non-ratable transportation services use more daily capacity than ratable transportation services and that use of turnback capacity for FTH service did not violate Article 11.2(b), holding that "capacity is not stranded if it is being used to provide the new services."[478] El Paso provided evidence that it must set aside 514 MDth/d of physical daily capacity to accommodate the hourly variations provided under the FTH service, in addition to the CD contract established by the FTH contracts.[479] That capacity is excluded from the operationally available capacity El Paso posts on its EBB and cannot be sold to other shippers. Thus, CRN capacity is not "unsubscribed," and it is reasonable to include CRNs in the calculation of the capacity toward the threshold.

329. The Parties have stipulated that 3,236 MDth/day of firm, long-term capacity has been contracted at maximum rates at or above the rate cap. With the inclusion of these short haul contracts and CRNs, El Paso meets the 4,000 MMcf/d presumption and has satisfied Article 11.2(b). The Commission, however, affirms the Initial Decision's finding that El Paso improperly included the maximum rate equivalent of its discounted contracts. While the revenues from discounted firm contracts are a revenue source for El Paso, the March 20 Order intended that only maximum rate contracts count toward the Article 11.2(b) threshold. Thus, maximum rate "equivalents" of what are in reality discounted contracts cannot be counted toward the presumption.

330. While we find that the 4,000 MMcf/d presumption has been met and Article 11.2(b) is satisfied, Article 11.2(b) shippers are not being asked to bear the cost of any

[478] March 20 Order, 114 FERC ¶ 61,290 at P 63.

[479] El Paso Brief on Exceptions at 132.

unsubscribed or discounted 1995 capacity. That capacity is being remarketed using new products and services that were not in use at the time of the 1996 Settlement. Article 11.2(b) was to ensure that the Article 11.2(b) shippers "would not be required to again pay costs associated with the original turned-back capacity after the 1996 Settlement."[480] Accordingly we reverse the judge and find El Paso has met the 4,000 MMcf/presumption, for the reasons stated above.

4. <u>Remaining Issues – Duration of Article 11.2(b) Rate Protections and Application to Shippers Acquiring an Article 11.2 Contract</u>

331. Following the Commission's prior holding, the Presiding Judge found, based on the language in Article 11.2(b) that a shipper that acquires or retains a small Article 11.2 subscription is entitled to the benefit of the Article 11.2(b) rate adjustment for all its load. El Paso's excepts to the Presiding Judge's finding.[481] Because we find that Article 11.2(b) is not triggered in this proceeding, the subsidiary issue as to the rights of shippers that acquire Article 11.2 contracts is moot and is not addressed here.

332. Finally, the issue related to expiration of Article 11.2 protections is not yet ripe. Such issues are not ripe until a party requests adjudication in a separate proceeding of a dispute arising upon the expiration of the primary term of an Article 11.2 contract.[482] The first set of Article 11.2 contracts were to expire August 31, 2011.[483] Because that expiration date is well beyond the test period ending December 31, 2008 in this proceeding, there is no basis for addressing this issue in this proceeding, consistent with the 2011 Rate Case rehearing order. These issues may be addressed upon an appropriate record developed in a proceeding addressing an expiring contract.

<u>The Commission orders</u>:

(A) The Initial Decision is affirmed and adopted, except with respect to El Paso's qualifying for the 4,000 Mcf/d threshold presumption, as discussed in the body of this order.

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[480] September 5 Order, 124 FERC ¶ 61,227 at P 96.

[481] UNS/Tucson Brief Opposing Exceptions at 7 (citing ID, 134 FERC ¶ 63,002 at P 519).

[482] *El Paso Natural Gas Co*., 133 FERC ¶ 61,253 at P 12 (denying rehearing and clarifying 2011 Rate Case Suspension Order).

[483] *Id.*

(B) To the extent this order omits discussion of particular exceptions, they have been considered and are denied.

(C) Within 30 days of the issuance of this order, El Paso must file revised tariff sheets and rates, including proposed accounting and workpapers, reflecting the Commission's rulings in this order.

(D) Within 30 days of a final order in this case, El Paso must refund amounts recovered in excess of the just and reasonable rates approved by the Commission.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

Docket No. RP08-426-000: Appendix A, List of Briefs on and Opposing Exceptions

Briefs on Exception:

California Parties: the California Public Utilities Commission (CPUC), Southern California Edison Company (Edison), Southern California Gas Company (SoCalGas), San Diego Gas & Electric Company (San Diego), and Pacific Gas and Electric Company (PG&E).

Commission Trial Staff (Trial Staff)

Competitive Power Suppliers: Gila River Power, L.P. (Gila River) and New Harquahala Generating Company, LLC. (New Harquahala) (Competitive Suppliers)

El Paso Electric Company (El Paso Electric)

El Paso

Joint Parties on Capital Structure and Cash Management Practices issue: Southwest Gas Company (Southwest Gas), Salt River Project Agricultural Improvement and Power District (Salt River), and the Arizona Corporation Commission (ACC).

SoCalGas/San Diego (on Short-term Rate issue)

Briefs Opposing Exceptions:

Arizona Public Service Company (APS)

Competitive Suppliers

ConocoPhillips Company (ConocoPhillips)

CPUC, SoCalGas, and San Diego (CPUC/SoCalGas/San Diego)

Edison

Electric Generator Coalition (Generator Coalition)

El Paso

Indicated Shippers: BP America Production Company, BP Energy Company, ConocoPhillips, and Shell Energy North America (U.S.) L.P.

Joint Parties on Capital Structure and Cash Management Practices issue

Joint Parties on Reallocation of Article 11.2 Costs issue: ACC; Arizona Electric Power Cooperative, Inc.; APS; ConocoPhillips; El Paso Electric; El Paso Municipal Customer Group; Freeport-McMoRan Corporation (Freeport); Gila River; Golden Spread Electric Cooperative, Inc.; MGI Supply Ltd. (MGI); New Harquahala; New Mexico Gas Company, Inc. (New Mexico Gas); Public Service Company of New Mexico (PNM); Salt River; Sempra Global; Southwest Gas; Southwestern Public Service Company; Tucson Electric Power Company (Tucson Electric) and UNS Gas, Inc. (UNS).)

MGI (on Short-term Rates issue)

New Mexico Gas and PNM (New Mexico Gas/PNM)

Rate Protected Shippers, Salt River, ACC; RPS includes ConocoPhillips, El Paso Municipal Customer Group (composed of 10 members), Freeport, New Mexico Gas, Southwest Gas, and UNS (RPS/Salt River/ACC)

Texas Gas Service Company, a Division of ONEOK, Inc. (Texas Gas Service)

Trial Staff

UNS and Tucson Electric (UNS/Tucson Electric)