EL PASO NATURAL GAS COMPANY
Statement of the Nature, the Reasons and the Basis for the Proposed Changes

Over the past decade, El Paso Natural Gas Company ("EPNG") and its shippers have adjusted to numerous changes in the regulatory and business environment of the interstate pipeline industry. These changes included a shift from unlimited receipt point access and full requirements service to shipper defined point, path and hourly service rights and were the result of several Commission orders in various proceedings, and a 2006 rate case settlement ("2006 Settlement").[1] The 2006 Settlement also re-defined the hourly and daily service structure on EPNG's system. Paragraph 15.3 of the 2006 Settlement requires EPNG to file a Section 4 general rate case on June 30, 2008 and requires EPNG to request a five-month suspension period with rates and tariff changes to become effective on January 1, 2009 ("2009 Rate Case").

EXECUTIVE SUMMARY

In this filing, EPNG proposes an increase in base tariff rates due in large part to increases in capital spending (for pipeline safety, system flexibility, and other projects), increased right-of-way costs and increased labor expenses. EPNG has proposed no change in depreciation rates and a moderate 13 percent return on equity based on the Federal Energy Regulatory Commission's ("Commission's") recent Policy Statement.

EPNG also has limited the size of the proposed rate increase by proposing a "management adjustment" which reduces the amount of requested increase in its proposed rates below the level that would be justified by the cost of service. Moreover, to minimize the rate impact in this case even further, EPNG has taken a large at-risk capacity position by assuming full subscription for rate design purposes and taking the risk that approximately $65 million in short-term contracts and approximately $60 million in long-term contracts will renew, while also designing rates on the assumption that two discounted firm contracts with Southern California Gas Company are at maximum rates.

In this filing, EPNG has worked to minimize the number of proposed rate and tariff changes. For example, EPNG's filing largely continues to use the cost allocation and rate design underlying its existing rates and/or its prior rate case filing.

EPNG's filing also addresses the rate issues raised by Article 11.2 of the 1996 rate case settlement in Docket Nos. RP95-363-000, et al., ("1996 Settlement".) EPNG's primary tariff sheets assume the continued applicability of

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1 *El Paso Natural Gas Company,* 104 FERC ¶ 61, 045 (2003), 109 FERC ¶ 61,292 (2004), 114 FERC ¶ 61,305 (2006), and 120 FERC ¶ 61,208 (2007).

Article 11.2 in accordance with the Commission's March 20, 2006 Order in Docket No. RP05-422-000, et al. However, as permitted by the March 20 Order, EPNG also contends that Article 11.2 should be terminated.

Finally, in contrast with its prior rate case, EPNG is not proposing major changes to the new service and penalty structure that was largely approved by the Commission in the March 23 Order in Docket No. RP05-422-000 and agreed to by the parties in the 2006 Settlement. EPNG has also determined not to seek authority to implement a non-critical daily scheduling penalty at this time. Instead, EPNG is proposing to implement several tariff changes intended to simplify and coordinate the service and penalty structure on the system. In particular, EPNG is proposing to lower some penalty levels, a new limited hourly firm service in its virtual area, and enhanced NNT services. In summary, EPNG is proposing a number of changes to its existing services to provide shippers more flexibility and to set the appropriate level for penalties.

Rates

EPNG's cost-of-service and rate calculations are based upon the costs and throughput levels for the base period (twelve months ended March 31, 2008) as adjusted for known and measurable changes through the test period ended December 31, 2008. The following table compares the cost-of-service, rate base, and throughput contained in this filing with the same information underlying EPNG's base tariff rates filed in the 2006 Rate Case:[2]

	This Filing	Prior Rates
Mainline Cost-of-Service	$647 million	$596 million
Mainline Rate Base	$1.86 billion	$1.69 billion
Mainline Throughput	3.27 Bcf Dth/day	3.47 Bcf Dth/day

The new base tariff rates would produce annual revenue of approximately $650 million. EPNG's overall cost-of-service, as detailed in Statement A, justifies the rate increase. The proposed rate increase reflects several factors including: 1) costs incurred for various pipeline integrity projects including those to comply with federal pipeline safety regulations; 2) system flexibility and reliability projects; 3) increased right-of-way costs for facilities located on Navajo Nation lands, and 4) increased labor costs. Despite the overall proposed rate increase, EPNG has proposed to continue its existing mainline depreciation rate of 2.2%

[2] EPNG respectfully requests a waiver from 18 C.F.R. § 154.2(a)(6) (2007) which requires a comparison of the cost of service, rate base and throughput amounts underlying the last rates to have been found to be just and reasonable. The rates for EPNG's last general, system-wide rate proceeding, Docket No. RP05-422, were established by a "black box" settlement approved by the Commission (*El Paso Natural Gas Company,* 120 FERC ¶ 61,208 (2007)). As such, those amounts are not available. Moreover, EPNG's next closest general, system-wide rate case occurred over 10 years ago and its information would provide little, if any, value.

and storage rate of 1.09%. In addition, EPNG has proposed a moderate 13% return on equity consistent with the Commission's Policy Statement concerning the Composition of Proxy Groups.[3] Items recovered separately pursuant to Commission surcharges or recovery mechanisms (i.e., ACA and fuel) are not included in EPNG's cost-of-service.

In response to increasing competition and the demands of the marketplace, EPNG has moderated the size of the rate increase by proposing a "Management Adjustment" which reduces the amount of requested increase in its proposed rates below the level that would be justified by the cost of service. The Management Adjustment is detailed at Exhibit No. EPG-71. EPNG plans to file a motion seeking to move these lower pro forma rates into effect at the end of the suspension period. However, EPNG reserves its right to increase its rates during the course of these proceedings up to the rates that result absent this management adjustment. In other words, while EPNG is voluntarily agreeing to move into effect the lower rates resulting from the adjustment, the higher unadjusted rates constitute EPNG's filed rates in this proceeding. EPNG is submitting pro forma tariff sheets in Exhibit No. EPG-72 in the testimony of EPNG Witness Ms. Catherine E. Palazzari to reflect the Management Adjustment rate levels. The Management Adjustment is discussed on pages 8 through 9 of EPNG Witness Ms. Palazzari's testimony.

- **Unchanged Rate Components**

A number of components of EPNG's proposed rates represent a continuation of approved practices. EPNG generally has retained the methods of cost classification and rate design that underlie its currently effective rates. As more fully explained in EPNG's testimony:

- o **Straight-fixed Variable Method.** EPNG continues to design rates using the Commission-preferred straight-fixed variable ("SFV") method.

- o **Zone of Delivery Reservation Rates.** EPNG continues to employ zone of delivery reservation rates using the current zonal designations of EPNG's system.

- o **Discount Adjustment.** EPNG continues to calculate its billing determinants by making a discount adjustment that treats all discounts as a revenue credit[4] to EPNG's cost of service, in accordance with the goals and directives of the Commission's Rate Design Policy Statement.[5]

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[3] *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity,* 123 FERC ¶ 61,048 (2008).

[4] Under the method EPNG employed, iterations are performed to ensure only actual discounts are included in the credit.

[5] *Policy for Selective Discounting by Natural Gas Pipelines*, 111 FERC ¶ 61,309 (2005).

o **Depreciation Rate.** EPNG is submitting a transmission depreciation rate of 2.2% and a storage rate of 1.09%. Both depreciation rates are a continuation of the rates established in the last rate case.

- **Provisions from the 1996 Settlement** [6]

With this rate case, EPNG is proposing primary tariff sheets that retain the rates and tariff provisions related to Article 11.2 of the 1996 Settlement in Docket No. RP95-363-000 ("Article 11.2"), in accordance with the Commission's order issued on March 20, 2006 ("March 20 Order").[7] Article 11.2(a) provided that the rates under certain transportation service agreements ("Article 11.2 TSAs") for certain shippers would be subject to rate caps or vintage rate levels.

In the 2006 Rate Case, EPNG proposed to terminate the provisions providing the Article 11.2 specialized treatment, as EPNG believed the rights and obligations associated with the 1996 Settlement were no longer applicable. In its order issued on March 20, 2006, the Commission found that its actions in the Capacity Allocation Proceeding, which effectively required EPNG to transfer approximately $300 million of the consideration it bargained for under the 1996 Settlement to the former full requirements shippers, did not result in the termination of the obligations under Article 11.2. The Commission also stated that EPNG and the other parties would have the opportunity to present evidence at a hearing that the rates resulting from the application were not in the public interest. EPNG asserts with this rate case proposal that Article 11.2 should be terminated on the grounds that it is not just and reasonable and is contrary to the public interest. This issue is discussed in the testimony of EPNG Witness Ms. Palazzari.

EPNG's primary tariff sheets assume the continued applicability of Article 11.2 consistent with the Commission's March 20, 2006 Order in Docket No. RP05-422. However, consistent with its argument that Article 11.2 is no longer just and reasonable, no longer in the public interest, and no longer applies given previous changes to the 1996 Settlement, EPNG is also submitting alternate tariff sheets that reflect the elimination of Article 11.2. If the Commission does not allow these alternate tariff sheets to go into effect at the end of the suspension period and later finds that Article 11.2 should not apply, EPNG requests that such finding be implemented prospectively only. EPNG urges the Commission to resolve the Article 11.2 issue as expeditiously as possible, consistent with the Commission's statement in a December 2006 order that it intended to issue an order on rehearing of the March 20 Order providing guidance to assist the parties in the new June 30, 2008 rate case. An expeditious order issued in the instant docket would be more beneficial to the parties than the still pending rehearing order.

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6 *El Paso Natural Gas Company,* 79 FERC ¶ 61,028 (1997).
7 *El Paso Natural Gas Company,* 114 FERC ¶ 61,290 (2006).

- **2006 Settlement Rate Working Group**

Paragraph 8.2 of the 2006 Settlement provided for the formation of a group to study alternative rate design(s), alternative cost allocation(s) and fuel recovery mechanisms. The specific alternatives to be studied were (1) a zone matrix rate design; (2) a specific rate for transportation from the San Juan Basin to Northern California; (3) rates from Ehrenberg to the Phoenix area; (4) rates from Ehrenberg to Northern California via Line 1903; (5) rates to Ehrenberg from Line 1903 and (6) short-haul and backhaul rates. While the rates working group spent considerable time and effort in analyzing EPNG's system and customer use of pipeline assets, the participants did not arrive at any conclusions for a best practice, or a preferred methodology for rate design, cost allocation or fuel recovery. The 2006 Settlement provides that information and workpapers presenting the results of the rate analysis studies performed be included in this rate filing. Exhibit EPG-85 provides this information, fulfilling EPNG's settlement obligation. EPNG is not sponsoring any of the material at Exhibit EPG-85 as part of its proposed rates in this proceeding. The output of the rates working group is discussed in more detail in the testimony of EPNG Witness Rexford Adams.

- **Proposed Changes to Rate Components**

EPNG's revised rates include changes to several aspects or underlying elements of EPNG's currently effective rates. These modifications are supported by the statements and schedules enclosed with this filing pursuant to Section 154.312 of the Commission's regulations, including the prepared testimony of EPNG's witnesses. As more fully explained therein, EPNG's proposed changes include the following:

  - **Short-term Rates.** Through this filing, EPNG proposes to implement rates for short-term value based services, capped at 250% of the related long-term firm recourse rate. EPNG is proposing a maximum rate for short-term firm service, interruptible service, park and loan service, and authorized overrun for the related short-term firm services that is equal to 250% of the maximum reservation component of the recourse rate that applies to the long-term firm service, plus the applicable commodity component. The proposal is similar to provisions in effect or set for hearing for other pipelines including Texas Gas Transmission, LLC, Northern Border Pipeline Company, Gas Transmission Northwest Corporation, and Portland Natural Gas Transmission.[8] Approximately a billion cubic feet (1 Bcf/day) of EPNG's capacity is contracted on a short-term basis, reflecting a growing reticence of customers to sign long-term firm contracts. The proposed pricing structure will more properly recognize the value of short-term services, assign the appropriate prices

[8] *Texas Gas Transmission Corporation*, 98 FERC ¶ 61,244 (2002); *Northern Border Pipeline Company*, 113 FERC ¶ 61,230 (2005); *Gas Transmission Northwest Corporation*, 122 FERC ¶ 61,012 (2008); *Portland Natural Gas Transmission*, 123 FERC ¶ 61,128 (2008).

to those services, and encourage long-term firm contracting consistent with the Commission's policies as expressed in Order No. 637 and other orders.

EPNG's proposal is also consistent with Order No. 712, in which the Commission recently lifted the cap on short-term capacity releases. In Order No. 712, the Commission did not change, and in fact reaffirmed its policy expressed in Order No. 637 regarding the need to encourage long-term firm contracting, including through seasonal and term-differentiated rates. See, e.g., Order No. 712 at P 32 and n.47. In addition, under EPNG's proposal, customers that do not wish to rely on the short-term market for their capacity needs can always acquire long-term capacity from EPNG at the recourse rate. In fact, on EPNG's system, long-term rates are defined to include five-month and seven-month seasonal contracts. Thus, by permitting shippers to acquire capacity at the long-term recourse rate under these seasonal contracts, EPNG's proposal is more modest than the short-term, value-based rate proposals by other pipelines that the Commission has previously set for hearing, which generally applied to any contract of less than one year. For more details on EPNG's short-term value-based rate proposal, see the testimonies of EPNG Witnesses Ms. Palazzari and Mr. Barry Sullivan.

Given EPNG's proposal to price short-term services differently from long-term services, it has revised its tariff to specify long-term and short-term rates for its various rate schedules. EPNG proposes to modify its tariff such that long-term rates will apply to contracts for firm service with a term equal to that of a five-month winter contract, a seven-month summer contract, or a contract with a term of one year or more. Short-term rates will apply to firm service with a term that is not equal to a winter contract, a summer contract, or a contract with a term of one year or less. For example, short-term rates would apply to a three-month contract June through August, and to a contract of 11 months. All contracts in effect prior to January 1, 2009, will be grandfathered and deemed to be long-term rate contracts. In addition, both long-term and short-term rates are discountable although for purposes of scheduling priority, short-term rates that exceed the related maximum long-term rates will be deemed equivalent to the maximum long-term rate to prevent any undue scheduling advantage to short-term shippers.

Further, EPNG is proposing a revenue crediting mechanism, subject to several conditions, in response to its short-term services pricing proposal. Under the mechanism, EPNG will credit 75% of the portion of the revenue it collects from short-term rates that exceeds the related long-term rates to the extent that its total revenues exceed the annual cost of service established in this rate case. This revenue crediting mechanism is further explained in the testimony of EPNG Witness Mr. Richard

Derryberry on page 49.

Commensurate with the changes to long-term and short-term rates, EPNG is proposing that the non-critical condition penalty rate applicable to hourly scheduling penalties, daily unauthorized overruns and Rate Schedule OPAS penalties be revised to reflect a rate equal to two times the applicable rate schedule rate rather than two times the interruptible rate. As such, interruptible and other short-term shippers will be billed penalties and overruns at a rate equal to two times the applicable short-term rate, and a long-term rate shipper will be billed penalties and overruns at a rate equal to two times the applicable lower long-term rate.

- **Cost of Capital.** The proposed rates incorporate an overall cost of capital of 11.05%, based on EPNG's actual, stand-alone, test period capitalization. Thus, EPNG's filed cost of capital is as follows:

Capital Component	Weight	Cost	Weighted Cost
Long-Term Debt	39.2%	8.02%	3.14%
Cost of Common Equity Requested by EPNG	60.8%	13.0%	7.91%
Overall Cost of Capital Requested by EPNG			11.05%
Pretax Return Requested by EPNG			15.94%

EPNG's cost of equity is supported by EPNG Witness Dr. Michael J. Vilbert, who calculates a range of reasonable returns based on the recent Policy Statement’s methodology of utilizing 50% of GDP as the measure of the long-term growth rate for master limited partnerships ("MLPs"), as well as a range based on unadjusted GDP for MLPs. Based on the range of returns produced by Dr. Vilbert’s Policy Statement analysis, as well as the above average risks faced by EPNG, EPNG Witness Ms. Palazzari proposes a 13% return on equity. This return is substantiated by the fact that it is within the medians of the proxy group ranges produced by both the 50% and unadjusted GDP methodologies.

- **Negative Salvage Rate.** EPNG proposes to establish a negative salvage rate of .12%, which is a slight increase from the current allowance of .10%.

- **Billing Determinants.** The billing determinants used in this filing reflect total contracted capacity of approximately 5.7 Bcf/day as of December 31, 2008. However, the applicable long-term contract firm billing determinants are approximately 4.8 Bcf/day. The difference is assumed to be received as short-term firm and interruptible revenues. The billing determinants are detailed on Exhibit No. EPG-63 and discussed in the testimony of EPNG Witness Ms. Cathy Rezendes. Mr. Sean Kolassa and Mr. George Wayne support the reservation and commodity billing determinants.

- **Rate Base**. The proposed rates reflect a rate base of $1.86 billion. This is an increase of approximately $200 million over the $1.69 billion rate base filed in the 2006 rate case.

- **Capital Expansions.** EPNG proposes to roll into its system-wide rates the costs of the following expansions (see pages 17 through 53 of the testimony of EPNG Witness Mr. Adams for a more complete explanation, except for the Hobbs and Eunice projects which are discussed in the testimony of EPNG Witness Mr. Lynn Dougherty):

  - **Samalayuca Lateral**: EPNG's 308,000 Mcf/day Samalayuca Lateral (Docket No. CP93-252-000, et al.), which extends from EPNG's Southern Mainlines in El Paso and Hudspeth Counties, Texas for approximately 21 miles to the border of the United States and Mexico. The lateral was previously afforded incremental rate treatment. (79 FERC ¶ 61,315) However, EPNG is proposing to roll-in the remaining costs of the lateral for several reasons, including mainline maintenance activities in this area of the system that have changed the future use and need for this facility by mainline customers.

  - **East Valley Lateral**: EPNG's 342,500 Mcf/day East Valley Lateral Project (Docket No. CP06-57), which extends from the Southern Mainlines for approximately 37 miles to SRP's Santan Power Plant east of Phoenix, Arizona. The Commission in its certificate order deferred a finding on the rate treatment to EPNG's next rate case. (115 FERC ¶ 61,074) EPNG proposes to roll-in these costs into its system-wide rates for several reasons, including because these facilities allowed EPNG to forgo construction costs of at least $90 million of new facilities and $9.5 million in maintenance costs as detailed in Exhibit Z of its certificate application.

  - **Picacho Compressor Station**: EPNG's 372,500 Mcf/day Picacho Compressor Station Project (Docket No. CP07-448-000), which is located at the junction of the Southern Mainlines and the East Valley Lateral. The Commission in its certificate order deferred a finding on the appropriate rate treatment to EPNG's next rate case. (122 FERC ¶ 61,132) EPNG proposes to roll-in the costs of this compressor station into its system-wide rates for several reasons, including because the facilities are integrated in the Phoenix lateral system, support the East Valley Lateral and they assist EPNG in providing premium hourly services needed by its shippers.

- **Hobbs Lateral and Compressor Station**: EPNG's 150,000 Mcf/day Hobbs Compressor Station Project (Docket No. CP08-14), which involves the construction of a compressor station and approximately seven miles of pipeline in Lea County, New Mexico. The Commission found in its certificate order that these facilities qualify for rolled-in rate treatment in a future general section 4 rate filing absent changed circumstances (123 FERC ¶ 61,101).

- **Eunice Compressor Station**: EPNG's 340 MMcf/day Eunice Compressor Station Project (Docket No CP08-2), which involves the replacement of an obsolete compressor station in Lea County, New Mexico. The Commission found in its certificate order that these facilities qualify for rolled-in rate treatment in a future general section 4 rate filing absent changed circumstances (123 FERC ¶ 62,049).

In addition, EPNG supported the roll-in of a number of construction projects in the Docket No. RP05-422 rate case filing. However, the 2006 Settlement was a "black box" settlement as to cost coverage. As a result, the roll-in of construction and operating costs for those projects was not specifically addressed in the Commission’s order accepting the settlement. Therefore, EPNG re-submits the support for its proposal to roll into its system-wide rates the costs of the Line 2000 Conversion, Line 2000 Power-up, Line 1903 Project, and Havasu Crossover.

- **Line 2000 Conversion:** EPNG's 230 MMcf/day, Line 2000 Conversion Project (Docket No. CP00-422-000, et al.), which involved the conversion of an existing oil-products pipeline paralleling the Southern Mainlines to natural gas service. The Commission found in its certificate order that the conversion would not be subsidized by existing shippers, because the benefits of the project outweighed any potential adverse impacts. (95 FERC ¶ 61,176)

- **Line 2000 Power-up:** EPNG's 320 MMcf/day, Line 2000 Expansion Project (Docket No. CP03-1-000), which involved the installation of compression to the new Line 2000. The Commission found in its certificate order that the project should receive rolled-in rate treatment absent changed circumstances. (103 FERC ¶ 61,280)

- **Line 1903 Project:** EPNG's 502 MMcf/day Line 1903

Project (Docket No. CP05-2-000), which involved the construction of approximately 6 miles of pipeline and the conversion to natural gas service of approximately 88 additional miles in California to provide better access between the Northern and Southern Systems, access to Rockies supplies, and other benefits. The Commission found in its certificate order the facilities should receive rolled-in rate treatment absent changed circumstances. (111 FERC ¶ 61,408)

- **Havasu Crossover:** EPNG's 180 MMcf/day Havasu crossover facilities (Docket No. CP96-321-000), which involved the installation of additional compressor facilities along the Havasu Crossover in western Arizona to provide better access between the Northern and Southern Systems. The facilities originally were afforded incremental rate treatment. (77 FERC ¶ 61,129) However, the original contracts have expired and EPNG has already largely recovered the capital costs of this expansion, which provides significant system benefits.

o **Mileage-based Cost Allocation.** Although EPNG is largely continuing its mileage-based zone of delivery cost allocation, it is proposing two changes from the cost allocation proposed in the last rate case. First, for "contra-flow" quantities, which in this context means those quantities that flow in the opposite direction of the predominant flows on EPNG's system, EPNG is proposing to change from a "negative mileage" allocation to a "zero mileage" allocation. Under a negative mileage allocation, which EPNG was required to use in its prior rate case (but not in this case) under the terms of another settlement, EPNG subtracts the mileage related to contra flows from the total system mileage. Under the proposed zero mileage allocation, the mileage related to contra flow is treated as a zero value (it is neither subtracted from or added to the total system miles). As discussed in the testimony of EPNG Witness Mr. Adams, EPNG believes the use of the zero mile approach is appropriate at this time. With the last rate case, and resulting settlement, EPNG has commenced service under a variety of new rate schedules, such as services which provide for varying hourly delivery quantities. With the new hourly services and other contract changes, it is no longer safe to assume that transactions that were once contra-flow will continue to be so, or that any theoretical "benefit" of contra-flow will be operationally consistent with an increased portfolio of hourly services given the need to pack and draft the system to support those services.

Furthermore, EPNG is proposing in this case to include the mileage from all discounted long-term rate transactions in the determination of its total system mileage for purposes of mileage cost allocation. In the last rate case, EPNG did not include mileage from any discounted transactions in such total system mileage allocation units. See pages 9 through 11 of the testimony of EPNG Witness Ms. Cathy Rezendes and pages 10 through 13 of the testimony of EPNG Witness Mr. Adams for a complete description of these changes.

Services and Penalties

EPNG is also proposing several modest, incremental changes to its services and to the penalty structure agreed to in the 2006 Settlement. However, EPNG has decided not to seek authority to implement a non-critical daily scheduling penalty at this time. While EPNG continues to see significant daily scheduling differences at some of its delivery points that are not deterred by EPNG's hourly scheduling penalty, EPNG has decided to focus in this rate case on several tariff changes intended to simplify and coordinate the service and penalty structure on the system. As explained in more detailed below, EPNG is proposing to lower some penalty levels, a new limited hourly firm service in its virtual area, enhanced NNT services, and other improvements.

- **New Limited Firm Hourly Virtual Area Service.** EPNG is proposing a new small shipper firm hourly service available at delivery points within the Permian virtual area. The service, designated as Rate Schedule FTH-V, will provide small Permian area shippers with greater firm flexibility within the Virtual area. Among other things, this service will offer firm non-uniform hourly transportation of gas to small shippers within an area that EPNG has historically been able to provide only ratable service. EPNG proposes to price its new hourly service at a level comparable to that of the Rate Schedule FTH-3 service option, after which it is modeled. This proposed new service is described in more detail on pages 39 through 40 of the testimony of EPNG Witness Mr. Derryberry and is defined at Sheet Nos. 129 through 129I of the attached tariff sheets.

- **Enhanced NNT Services.** EPNG is also proposing revisions to its existing firm NNT services to enhance the potential use of the services. While one shipper currently holds an NNT contract, that shipper has notified EPNG that it will terminate the contract prior to the end of the test period. EPNG hopes these service changes may encourage other shippers to request NNT service in the future (despite the absence of a daily scheduling penalty that would otherwise encourage shippers to pay for costs associated with daily scheduling differences). Currently, no-notice balances under an NNT contract are held at each delivery point and netting is not permitted across those points on a daily basis. EPNG proposes here to revise its tariff to permit daily netting of NNT balances among all delivery points on a contract. This change will allow an NNT shipper to take advantage of offsetting positive and negative balances among its delivery points, which will provide the shipper increased flexibility to manage its no-notice requirements.

In addition, EPNG is proposing to allow for the transfer of delivery point entitlements to alternate points located on the primary receipt-to-delivery flow path. Currently, EPNG transfers any unused daily/hourly entitlement quantities to a shipper's next upstream operationally equivalent primary delivery point in the same geographic region. This allows the shipper to combine any unused entitlements with the shipper's other hourly/daily scheduled entitlements at the delivery point. With EPNG's proposed change to include within-the-path alternate points in the transfer process, premium service shippers will have increased flexibility under their contracts. EPNG is also proposing to allow for the transfer of delivery points entitlements to alternate points located on the primary receipt-to-delivery flow path of Rate Schedule FT-H shippers. The proposed enhancement is described in more detail on pages 43 through 44 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet Nos. 147C, 148E, and 148F of the attached tariff sheets.

- **MDO/MHO Penalties.** As defined by EPNG's tariff, an MDO ("maximum delivery obligation") is the maximum daily quantity that a delivery point operator may take from a meter. As specified in Rate Schedule OPAS, the related MHO ("maximum hourly obligation") is no less than the MDO divided by 24 hours and no more than the MDO divided by 24 hours times 300% based on service type. Since the inception of MDOs, EPNG has reviewed with its shippers appropriate delivery meter limits and has worked with its shippers to revise the MDO/MHO quantities to the appropriate level for each area.

EPNG's shippers have questioned whether its system operationally requires the application of MDO/MHO penalties in non-critical conditions. EPNG has reviewed the operation of its system since the implementation of MDO/MHOs and has concluded that there may be enough flexibility in its mainline system to suspend the use of MDO/MHOs penalties (i.e., bill at a zero rate) in non-critical conditions on a trial basis as discussed below. However, EPNG's lateral distribution system consists of much smaller diameter and lower pressure pipelines that do not afford the flexibility of its larger mainline system. Violations of MDO/MHO limits have the potential to create system harm and affect transportation service. Furthermore, the distribution system cannot operate with a high level of variance from MDO/MHO levels and the current four-hour timeline for declaring a critical condition is inadequate for ensuring protection of the laterals. To address this limitation, EPNG is proposing a new Lateral COC (critical operating condition) declaration provision that will allow a critical condition to be immediately declared if necessary to protect the operational integrity of a delivery lateral. The new Lateral COC is described in more detail below.

With the implementation of a new Lateral COC provision, EPNG will consider a limited suspension of the MDO/MHO penalties in non-critical conditions. Therefore, EPNG is proposing, on a limited trial basis, to charge a zero rate for all MDO/MHO penalties that occur during non-critical operating conditions. Critical condition MDO/MHO penalties will continue to be billed the tariff rate. During this trial period (January 1, 2009 through March 31, 2010), EPNG will monitor delivery point operator activities and determine whether non-critical MDO/MHO penalties are necessary. EPNG will continue to calculate and report all MDO/MHO violations as MDO/MHO variance activity. This information will be submitted in a report to the Commission no later than April 1, 2010. Moreover, depending on the results of the trial period, EPNG will remove these penalties from its Tariff or return to billing non-critical MDO/MHO penalties at the applicable rates. The proposed change is described in more detail on pages 32 through 34 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 150C of the attached tariff sheets.

- **Charge/Penalty Structure.** EPNG’s existing penalty structure is the result of several Commission proceedings. Several years ago, in compliance with Order No. 637, EPNG implemented overrun penalties and critical condition daily charges. More recently, EPNG instituted hourly and operator penalties related to the 2006 Rate Case service structure. EPNG endorses the "pay for what you use" principle, which recognizes and accommodates the operational and economic impacts of shipper behavior on EPNG's system assets and on other shippers.

Currently, the appropriate contracting and scheduling of transportation service on EPNG is supported by a penalty structure that includes daily unauthorized contract overruns and hourly scheduling penalties. Further, during strained/critical operating conditions ("SOC/COC"), SOC/COC charges provide EPNG a tool that encourages shipper behavior, thereby ensuring system integrity and reliable service.

A review of the existing penalty structure indicates that at this time some existing penalty rates may be higher than necessary to provide the appropriate signals for contracting and scheduling. Therefore, EPNG is proposing the following tariff modifications:

- Currently, the critical condition penalty rate applicable to daily unauthorized overruns, hourly scheduling penalties, and Rate Schedule OPAS is ten times the monthly system cash out index price ("monthly spot"). EPNG is proposing to lower that rate to two times the higher of monthly spot or the daily mid-point spot price ("daily spot”) for hourly scheduling penalties and an average of two times the higher of monthly spot or daily spot for daily penalties.

For consistency, EPNG is also proposing to change the critical condition (SOC/COC) penalty rate from two times daily spot to two times the higher of monthly spot or daily spot.

Prices in EPNG's service territory do not always react in a predictable manner during declared critical condition events. During certain past critical condition events, the monthly spot has been the highest price, while during other critical condition events the daily spot has been the highest price. EPNG's analysis of prices during critical condition events since January 2007 has shown no trends on what the likely highest price will be. As either the monthly spot or daily spot may be the higher rate, EPNG is proposing a comparison of the two prices for determination of the critical condition penalty rate. Use of the monthly spot and daily spot prices are already authorized by EPNG's tariff for various penalties; EPNG is simply electing to use the higher price for the calculation of the critical condition penalty. This price comparison also permits EPNG to use the lowest possible overall penalty rate (two times the spot price). Without this comparison, EPNG would need to use a higher overall penalty rate of three or four times the spot price to ensure that its penalty rates were high enough to achieve the necessary shipper response. The uncertainty of whether the monthly spot or daily spot will be the higher rate will also help to prevent gaming or price arbitrage. These proposed changes are described in more detail on pages 24 through 26 of the testimony of EPNG Witness Mr. Derryberry and are shown on Sheet Nos. 28H and 202 of the attached tariff sheets.

- In response to suggestions by certain customers, EPNG also proposes a tiered critical condition daily penalty assessment which increases the penalty rate as shippers go increasingly out of balance. EPNG's penalty structure already provides shippers a range of tolerance levels (from 3% to 10%) during critical conditions. Tiered penalty levels extend the tolerance range to a range of penalty rates. The application of critical condition penalty rate for daily penalties will be determined with a tiering structure based on the lower of a shipper's daily delivery variance percentage or the shipper's daily imbalance quantity. However, the new tiering structure does not excuse shippers from the requirement to reduce their delivery variances during a critical condition. Furthermore, the inclusion of an absolute quantity element acknowledges that smaller shippers may be out of balance by a small quantity that results in a large percentage. As detailed below, a tiering structure that evaluates both the out-of-balance quantity and the imbalance percentage is necessary on daily delivery variances to allow for a reasonable relationship between various shippers' imbalance activities during critical condition events. The proposed change is described in more detail on pages 26 through 29 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 28H of the attached tariff sheets.

The proposed critical condition tiering and related rate structure is shown below, as applicable to daily charges/penalties:

Daily Charges/Penalties [9]

	Lower of the Delivery Variance Quantity or Percentage		Charge/Penalty Rate
Tier Level I	3,500 dth or less	0% to 15%	1.5 x CCR
Tier Level II	3,501 dth to 5,000 dth	>15% to 50%	2 x CCR
Tier Level III	5,001 dth or greater	>50%	2.5 x CCR

- EPNG is also proposing a revision to the daily overrun rate applicable to a shipper that has multiple transportation service agreements ("TSAs") under various rate schedules. As a negotiated 2006 Settlement item, overrun charges are determined based on the aggregation of all service provided under all of a shipper's contracts on that day. Therefore, a shipper will be billed daily overrun charges only when it exceeds its contract quantity on all of its contracts. These overrun charges are billed at a weighted average rate of all the delivery points included in all of the contracts held by a shipper. While EPNG is proposing to continue the contract aggregation feature in determining overruns, it is only appropriate that shippers pay for overrun service at rates comparable to, and based on, the service provided. This rate averaging causes EPNG to under-collect for the transportation service actually provided. Therefore, EPNG is revising the authorized and unauthorized daily overrun rates for shippers with multiple TSAs to be the highest rate for the applicable zone of delivery under all of the shipper's aggregated TSAs for which service was provided on a gas day. This change to the overrun rates appropriately values the transportation service provided. The proposed change is described in more detail on pages 12 through 13 of the testimony of EPNG Witness Mr. Derryberry and an example of this change is shown on Sheet No. 114A of the attached tariff sheets.

- Hourly Entitlement Enhancement Nominations or "HEEN" is an hourly service feature that allows a firm shipper to reserve its contracted capacity for non-ratable hourly flows. When a shipper nominates HEEN quantities, EPNG sets aside the appropriate

[9] For application of SOC/COC Daily Imbalance Charges, daily unauthorized overrun penalties, and MDO violation penalties. The "CCR" is the Critical Condition Rate, which is the higher of the daily spot and the monthly spot.

capacity in its pipeline to support the requested hourly swing variations. Daily unauthorized overruns are calculated by adding the shipper’s flowing gas scheduled quantities and HEEN scheduled quantities together and comparing that total to the shipper's contract demand. This is appropriate, since HEEN requires the physical use of pipeline capacity. See pages 46 and 47 of the testimony of EPNG Witness Mr. Mark Westhoff for a more detailed description of the use of capacity that occurs when a HEEN is used.

During the 2006 Settlement negotiations, EPNG recognized that its customers would need time to transition to the new service and penalty structure, including the use of their contracted capacity for HEEN. Therefore, the 2006 Settlement provided that until December 31, 2008 only 50% of the HEEN scheduled quantities would be used in determining daily unauthorized overruns.[10] As HEEN is a physical use of the pipeline and of a shipper's contracted capacity, HEEN must be considered in the calculation of any daily unauthorized contract overruns. Further, should the sum of a shipper's flowing gas and HEEN exceed a shipper's contract demand it reflects the use of EPNG's operationally available capacity. However, EPNG realizes that its shippers may still require some time to transition to the new service and penalty structure implemented in the 2006 Settlement. Therefore, for purposes of billing daily unauthorized overruns, EPNG is proposing to apply 75% rather than 100% of HEEN scheduled quantities to the calculation of daily unauthorized overrun for calendar year 2009. On January 1, 2010, 100% of HEEN scheduled quantities will be included in the calculation of daily unauthorized overruns. The proposed change is described in more detail on pages 35 through 38 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 290A of the attached tariff sheets.

- EPNG is proposing no change to the 2006 Settlement tolerance levels. For example, the 7% tolerance level for daily unauthorized overruns and the 13% tolerance level for hourly scheduling penalties remain unchanged.

o **Strained and Critical Condition Procedures.** EPNG is proposing certain changes to its strained operating condition ("SOC") and critical operating condition ("COC") procedures. The proposed tariff changes support existing SOC/COC ("Critical Condition") procedures, obligations, and requirements and improve EPNG's ability to manage, mitigate, and resolve Critical Condition events. Shippers will continue to enjoy the full range of SOC/COC tools, such as tolerance thresholds, netting, and

[10] *See* Article 6.2(d) of the 2006 Settlement.

catch-up nominations to help them resolve delivery point imbalances incurred during a Critical Condition event. The Critical Condition changes are described below:

- Currently, EPNG posts a "Probability Notice" of a system-wide SOC event based on current linepack levels and the operating parameters of the Washington Ranch storage facility.[11] To ensure that non-critical hourly system fluctuations do not unnecessarily prompt the issuance of SOC warnings, EPNG is proposing to change the Probability Notice linepack level review from a one-hour average reading to a six-hour average. The current one-hour average reading of system linepack levels may be disproportionately impacted by various operating factors such as receipt and delivery point gas flow fluctuations, metering spikes, and compressor conditions and outages. A change to a consecutive six-hour average reading more reasonably represents operating conditions, is a better indicator of trends, and will help to eliminate hourly anomalies that are not affecting the overall condition of linepack levels. The proposed change is described in more detail on page 18 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 363.01 of the attached tariff sheets.

- EPNG's tariff currently provides for the posting of an updated Probability Notice each nomination cycle. However, the posting of such notices during a declared SOC event has caused some confusion among shippers, especially when the Probability Notice is posted after an SOC has been declared. Furthermore, a Probability Notice is unnecessary when EPNG has declared a Critical Condition. Therefore, in order to alleviate any confusion, EPNG is proposing to discontinue posting Probability Notices during a declared SOC event. The proposed change is described in more detail on page 18 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 363 of the attached tariff sheets.

- As described above, EPNG is proposing a new Lateral COC provision to permit it to immediately declare a critical condition on a delivery lateral. The change is proposed in conjunction with and to support the non-critical MDO/MHO trial period, also described above. The new Lateral COC is necessary to ensure that EPNG can protect system operations and service to shippers on delivery laterals that are no longer protected by the non-critical MDO/MHO restrictions. The Lateral COC is subject to the existing SOC/COC

[11] *El Paso Natural Gas Company,* 121 FERC ¶ 61,219 (2007). *See* Section 33.1 of the General Terms and Conditions ("GT&C") of EPNG's Tariff.

rules already contained in the tariff. EPNG will declare a Lateral COC when system conditions require and will use the existing SOC/COC notification procedures. The proposed change is described in more detail on pages 19 through 20 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 364 of the attached tariff sheets.

o **Flow Control Equipment.** EPNG is proposing to remove the existing tariff provisions concerning the installation and use of flow control equipment in COCs. Instead, EPNG is proposing a more general flow control equipment provision indicating that EPNG may install and/or operate flow control equipment at any time. However, the new provision deletes the current option requiring the shipper to reimburse EPNG for its installation costs. Flow control equipment is already installed and used at many locations on the EPNG system upon mutual agreement of the parties where such equipment has been installed for pressure control reasons to meet contractual obligations. It is common industry practice to utilize flow control equipment to manage pipeline flowing gas quantities at receipt and delivery points. In fact, a number of interstate pipelines connected to EPNG specifically provide in their tariffs for the use of equipment to set flow rates at points to manage the receipt and delivery of gas regardless of whether the pipeline is experiencing a critical condition.[12] EPNG will provide for the use of such equipment, in a not unduly discriminatory manner. The proposed language is similar to that of other pipelines and seeks to respond in a reasonable manner to fluctuations on the pipeline that can be detrimental to system operations and/or are inconsistent with a shipper's contractual rights.

In addition, EPNG is proposing a new provision stating that hourly scheduling penalties will not be assessed in any period in which flow control equipment is used to physically restrict the flow of gas. This will allow shippers the option of requesting the use of flow control in lieu of the application of hourly scheduling penalties. This may benefit shippers that do not want any exposure whatsoever to hourly penalties.

The use of flow control equipment does not prevent a shipper from drafting at a receipt point or packing at a delivery point. This makes it imperative that EPNG continue to have the appropriate tools, including the proper Critical Condition procedures and penalty rates, needed to prevent, mitigate and resolve Critical Condition events. These proposed changes are described in more detail on pages 21 through 23 of the testimony of EPNG Witness Mr. Derryberry and is shown on Sheet No. 211A of the attached tariff sheets.

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[12] *See North Baja Pipeline, LLC*, GT&C Section 16.1(a); *Southern Natural Gas Company*, GT&C Section 11; *Natural Gas Pipeline Company of America, LLC,* GT&C Section 7.4.

o **Tariff Revisions.** In addition to the changes discussed above, EPNG proposes the following tariff revisions. Further explanation as to the nature and basis for the proposed changes can be found in the testimony of EPNG Witness Mr. Derryberry. Those proposed changes include:

- The removal of the pipeline integrity surcharge and revenue crediting provisions related to the termination on December 31, 2008 of the 2006 Settlement. (see page 7 of that testimony)

- An expansion of park and loan service to include locations within the California pools. (see pages 41 through 42 of that testimony)

- Revising the monthly spot price to include a California border spot price. This change reflects the effect of California spot prices on the overall system index price, since EPNG does receive gas from California. (see pages 44 through 45 of that testimony)

- A provision allowing EPNG and a delivery point operator to agree to waive the existing tariff gas quality specifications and accept deliveries of gas that do not conform to those specifications. EPNG must determine that its operations and commitments to its customers will not be adversely affected by the delivery of such gas. (see pages 45 through 46 of that testimony)

- A provision that allows EPNG to act in a more timely manner to restore or maintain pipeline operations and/or service to its shippers when a force majeure event occurs on EPNG's system. This provision will allow EPNG to waive tariff provisions, such as deadlines related to scheduling, contract request and amendment procedures, capacity release, point re-designation, capacity sales timelines, and imbalance resolution procedures but only if the aforementioned actions do not place new obligations on shippers. Such waiver authority will help EPNG more efficiently manage the force majeure event and allow for continued service to shippers. (see pages 47 through 48 of that testimony)

- A provision clarifying that a shipper may offer to assist in system loading needs without being assessed an overrun, hourly or Critical Condition penalty. If EPNG agrees to the shipper’s offer using its best operational judgment, the shipper will not be assessed a daily unauthorized overrun penalty, hourly scheduling penalty or Critical Condition charges for those actions. However, Shippers are required to communicate with EPNG and obtain EPNG's consent before taking any such actions. (see pages 34 through 35 of that testimony)

- A provision providing that daily overrun quantities related to non-telemetered meters within a multi-meter D-Code will be charged the authorized overrun rate for daily unauthorized overrun quantities (rather than the unauthorized overrun rate) on overrun quantities related to non-telemetered meters within a multi-meter D-Code. This will minimize the shipper's exposure to penalty rates when overrunning its daily contract quantity using non-telemetered meters. (see page 38 of that testimony)

- A provision stating that reservation charge credits are based on final scheduled quantities rather than scheduled volumes resulting from the Cycle 2 and/or Cycle 3 nomination scheduling process. EPNG has experienced situations where in Nomination Cycles 2 and/or 3 a shipper's nomination was reduced for lack of capacity but the shipper was able to fully schedule its nomination in a later nomination cycle. EPNG Exhibit No. EPG-158 provides an example of these instances. Further, EPNG is clarifying that reservation credits apply to alternate points when the constraint exists on the shipper's primary path. (see pages 51 through 52 of that testimony)

Summary

EPNG's proposed general system-wide rate case proposals are reasonable and justified, as shown in this Statement and the attached testimonies, exhibits, and work papers. EPNG proposes a rate increase to recover its increased cost of service. Furthermore, EPNG proposes a number of tariff changes to, among other things, offer a new limited hourly firm service promoting flexibility for small shippers, enhance critical condition procedures, decrease penalty levels, and revise certain business practices. In summation, EPNG's proposed rate case serves to advance the simplification of its tariff while offering appropriate and reasonable rates for services.