

120 FERC ¶ 61,255
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Fuel Retention Practices
of Natural Gas Companies

Docket No. RM07-20-000

NOTICE OF INQUIRY

(September 20, 2007)

1. In this Notice of Inquiry, the Commission is seeking comments on its policy regarding the in-kind recovery of fuel and lost and unaccounted-for gas by natural gas pipeline companies. Current policy, described below, gives pipelines two options for recovering these costs, and pipelines follow a variety of practices regarding fuel and lost and unaccounted-for gas. The Commission is seeking comments on whether it should change its current policy and prescribe a uniform method for all pipelines to use in recovering these costs.¹

¹ In this proceeding, the Commission is seeking comments on several specific proposals for rate recovery of fuel and lost and unaccounted-for gas, as well as answers to specific questions. It also should be noted that the Commission has initiated a separate proceeding in Docket No. RM07-9-000 inquiring about the need for changes or revisions in the Commission's reporting requirements for its financial forms including the Form Nos. 2 and 2-A, Annual Reports of Major and Nonmajor Natural Gas Companies. *Assessment of Information Requirements for FERC Financial Forms*, Notice of Inquiry, FERC Stats & Regs. ¶ 35,554 (February 15, 2007). The Commission received a number of comments and suggestions in that proceeding regarding the adequacy of information reported in the Form No. 2 concerning gas retained, used for compression, and lost and unaccounted-for. Accordingly, the reporting requirements related to gas retained, used for compression, and lost and unaccounted-for will be addressed in the Notice of Proposed Rulemaking which the Commission is concurrently issuing in Docket No. RM07-9-000, 120 FERC ¶ 61,256.

I. Current Commission Policy on Fuel Retention

2. Interstate natural gas pipelines frequently require that customers contribute a small percentage of the volumes of natural gas tendered for transportation service to provide fuel for compressors and to make up for lost and unaccounted-for gas.² Each pipeline states the percentage it retains in its open access tariff. Currently effective tariff fuel retention rates range from fractions of a percent to as high as 13 percent.³

3. The Commission established its current policy concerning the in-kind recovery of fuel and unaccounted-for gas in *ANR Pipeline Company (ANR)*.⁴ In its January 2005 order in the *ANR* case,⁵ the Commission stated that pipelines have two options to recover these costs. The first option is to establish a fixed fuel retention percentage in a general section 4 rate case, and leave that percentage unchanged until the pipeline files its next general section 4 rate case. The second option allows the pipeline to include in its tariff a mechanism permitting periodic changes in its fuel retention percentage outside of a general section 4 rate case, as allowed by section 154.403 of the Commission's regulations.⁶ *ANR* held that, if a pipeline chooses the second option, it must include in its tariff a mechanism to true-up any over- and under-recoveries of fuel, absent agreement otherwise by all interested parties.

² Some pipelines do not require shippers to contribute in-kind a portion of the gas tendered to the pipeline for transportation for the pipeline's use.

³ See, e.g., *MIGC, Inc.*, FERC Gas Tariff, First Revised Volume No. 1, Eleventh Revised Sheet No. 6 (fuel retention percentages up to 13 percent); *Gas Transmission Northwest*, FERC Gas Tariff, Third Revised Volume No. 1-A, Seventh Revised Sheet No. 6 (0.005 percent fuel retention).

⁴ *ANR Pipeline Co.*, order on compliance filing, 108 FERC ¶ 61,050 (2004), order inviting comments, 109 FERC ¶ 61,038 (2004), order on reh'g and compliance filing, 110 FERC ¶ 61,069 (2005), order on reh'g and compliance filing, 111 FERC ¶ 61,290 (2005).

⁵ 110 FERC ¶ 61,069, at P18-28.

⁶ 18 C.F.R. § 154.403.

4. In *ANR*, the Commission explained that its general ratemaking policy, established in Order No. 436, is that pipelines must design their rates based on estimated units of service without any type of true-up mechanism.⁷ This means that the pipeline is at risk for under-recovery of its costs between rate cases and may retain any over-recovery. This gives pipelines an incentive both to minimize their costs and maximize the service they provide. A cost tracker undercuts these incentives by guaranteeing the pipeline revenues sufficient to recover its costs regardless of the level of costs or services provided.

5. However, as the Commission explained in *ANR*, it had permitted an exception to this policy for a few cost items that are subject to significant changes from year to year and thus are difficult to predict. Among these cost items is fuel. The Commission explained that section 154.403 of its regulations permits a pipeline to adjust its fuel retention percentages in periodic limited section 4 rate filings pursuant to a methodology set forth in the pipeline's tariff. The Commission stated that section 154.403 does not expressly require that pipelines include true-up mechanisms as part of the tariff provision permitting periodic adjustments to their fuel retention percentages. Instead, the Commission stated, it had addressed this issue on a case-by-case basis and required a true-up when the facts of a particular case so warranted.

6. In *ANR*, the Commission changed this approach and held that, if a pipeline wishes to take full advantage of the incentives underlying our general ratemaking policy with respect to in-kind fuel recovery, then it can choose the first option which requires establishing a fixed fuel retention percentage. However, if the pipeline chooses the second option and tracks its fuel costs, then there must be an assurance that the fuel costs are tracked accurately so that the pipeline does not over-recover its fuel costs under any circumstances. Therefore, the second option requires a true-up mechanism. The Commission explained that allowing a particular cost item to be tracked gives the pipeline the opportunity to increase that cost item without regard to the possibility of any offsetting cost reductions. The Commission stated that in return for this opportunity, there should be an assurance that the individual cost item is tracked accurately, and the pipeline should not in any circumstances be permitted to over-recover those costs.

7. In reaching this conclusion, the Commission rejected *ANR*'s contention that it should be permitted to retain its existing tracker without a true-up mechanism because the existing tracker provided it with an incentive to reduce fuel costs and a true-up

⁷ 18 C.F.R. § 284.10(c)(2).

mechanism would eliminate this incentive. ANR argued that because its fuel recovery mechanism bases each year's fuel retention percentage on the average of fuel use on its system during the three preceding years, ANR was able to retain a portion of any over-recoveries of fuel resulting from a downward trend in fuel use and, on the other hand, must absorb a portion of any under-recoveries if fuel use trends upward. ANR argued that with this tracker in place, it had in fact reduced its fuel use which resulted in savings to its customers.

8. The Commission rejected ANR's argument, stating that allowing ANR to over-recover fuel from its customers is not a necessary incentive to encourage the company to minimize its use of fuel gas. The Commission concluded, with regard to fuel use and lost and unaccounted-for gas, that the benefits of requiring a true-up outweigh any disadvantages.

9. While ANR established a general policy of requiring pipelines such as ANR that have a fuel tracker to include true-up mechanisms, the Commission has only enforced that policy in individual cases where parties raise the issue. Thus, pipelines continue to follow a variety of practices regarding fuel and lost and unaccounted-for gas which can be described as fitting into one of three categories.

- The first category is the stated-rate approach, where a fixed percentage is stated in the tariff as a non-negotiable fee-in-kind retained from the volumes tendered for shipment by each shipper and changed only in a general section 4 rate case. Of 70 major pipelines, 24 have a stated rate.⁸
- The second category is the tracker approach, where provisions in a pipeline's tariff allow the pipeline to make prospective adjustments to its fuel retention rates from time-to-time, but do not include a mechanism to allow the pipeline to reconcile past over- or under-recoveries of fuel. Eight pipelines have tracker mechanisms without true-up requirements.

⁸ These categories and the number of pipelines noted within each category were identified in a Commission staff analysis of the FERC tariffs of 70 major pipelines.

- The third category is the tracker with a true-up approach, where provisions in a pipeline's tariff allow for periodic adjustments to its fuel retention rates, and also provide for a true-up of past over- and under-recoveries of fuel and lost and unaccounted-for gas. Thirty-eight pipelines have tracker mechanisms with true-ups in their tariffs.

II. Discussion

10. Pipeline customers have expressed concerns that in-kind gas retained by pipelines for fuel and unaccounted-for gas requirements is excessive, and provides pipelines with significant profits. For example, the Natural Gas Supply Association, in its recent study of pipeline returns, estimated that in aggregate 32 pipelines, representing 80 percent of interstate throughput, generated about \$2.1 billion in excess retained fuel over the five-year period ending in 2005.⁹ In a recent complaint against National Fuel Gas Supply Corporation, the principal concern was excessive fuel retention.¹⁰

11. The Commission's review of information filed by pipelines in their 2005 Form No. 2 filings indicates that major pipelines appear to have retained or carried over in their accounts a net sum of over 97 Bcf in fuel beyond what was consumed, lost, or unaccounted-for.¹¹ At average 2005 prices, this represents over \$711 million in value.¹² Of that amount, 58 Bcf, with a value of \$427 million, is attributable to those pipelines that do not have a tracker mechanism in their tariff, and nearly 39 Bcf, with a value of

⁹ Natural Gas Supply Association, *Pipeline Cost Recovery of 32 Major Pipelines, FERC Form No. 2 Data (2001 – 2005)* at 4, available upon request at Natural Gas Supply Association, 805 15th Street, N.W., Suite 510, Washington, D.C. 20005.

¹⁰ Pub. Serv. Comm'n of N.Y. v. National Fuel Gas Supply Corp., 115 FERC ¶ 61,299, reconsideration granted in part, 115 FERC ¶ 61,368 (2006), order on settlement, 118 FERC ¶ 61,091 (2007).

¹¹ Commission staff examined available Form No. 2 data for 2005 to derive the sum of the net fuel retained (the amount received from shippers minus the amount consumed for operations or lost or unaccounted-for).

¹² The Energy Information Administration (EIA) reports the average wellhead price of natural gas for 2005 was \$7.33 per MMBtu. (http://tonto.eia.doe.gov/dnav/ng/ng_sum_lsum_dcunus_a.htm).

over \$285 million, is attributable to pipelines with a tracker and no true-up or a tracker with a true-up mechanism.

12. Moreover, with the tightening in natural gas supplies in recent years, there have been substantial increases in the price of natural gas. As a result, the pipeline's fuel charges now make up a significantly greater percentage of the overall cost of transporting natural gas.¹³

13. The increasing significance of pipeline fuel charges in the overall cost of transportation and the concerns about pipeline cost over-recoveries suggest that further investigation of in-kind fuel retention practices is warranted. Therefore, the Commission is seeking comments on whether its current policy with regard to the in-kind recovery of fuel and unaccounted for gas should be modified, both for the purpose of providing pipelines a greater incentive to reduce their fuel use and lost gas and for the purpose of minimizing pipeline over-recoveries of these costs. Specifically the Commission is requesting comments on the following questions:

(1) **Should the Commission continue to allow recovery of pipeline fuel costs through fixed fuel retention percentages?**

14. As described above, the Commission's review of pipeline Form No. 2 data indicates that some pipelines, particularly those with fixed fuel retention percentages, are

¹³ A comparison between 2002 and 2006 data for Texas Eastern Transmission Corporation (Texas Eastern) illustrates this point. According to EIA, the average wellhead natural gas price rose from \$2.95 per MMBtu in 2002, to \$6.42 per MMBtu in 2006. Texas Eastern's maximum rate for interruptible transportation through the full length of the system (Zone STX to Zone M3) in 2002 was \$0.6639 per MMBtu, and Texas Eastern retained 8.94 percent of the gas for fuel use, at an additional cost to the shipper of \$0.2637 (fuel retention rate times the wellhead price). FERC Gas Tariff, Seventh Revised Volume No. 1, Seventh Revised Sheet No. 49. Thus, the shipper's total cost was \$0.9276 per MMBtu. The fuel cost equaled 28.4 percent of the total. In 2006, the maximum rate for interruptible transportation was \$0.6231, and Texas Eastern retained 7.94 percent of the gas for fuel, at an additional cost to the shipper of \$0.5097. FERC Gas Tariff, Seventh Revised Volume No. 1, Thirty-Second Revised Sheet No. 49. Thus, in 2006, the shipper's total cost was \$1.1328 per MMBtu. Here, the fuel cost equaled 45 percent of the total, an increase of about 17 percentage points over the 2002 figure.

over-recovering their fuel costs. By contrast, a properly designed fuel tracker and true-up mechanism would ensure that a pipeline does not over-recover its fuel costs. However, allowing pipelines to establish a fixed in-kind fuel retention percentage in a general section 4 rate case is consistent with the Commission's general ratemaking policies and section 154.403 of the Commission's regulations. In *ANR*, the Commission continued to permit pipelines to use that recovery method, stating that the method gives pipelines an incentive to minimize their fuel use through more efficient operations. These efficiencies could benefit customers when the pipeline files its next general section 4 rate case, although until the pipeline does file a new section 4 rate case it would retain the benefit from any savings. Also, a fixed in-kind fuel retention percentage avoids potentially disruptive changes in the pipeline's fuel rates outside a general section 4 rate case, thereby giving customers the benefit of greater certainty as to the pipeline's fuel rates. For that reason, shippers may favor fixed fuel retention percentages.

15. Do the benefits of a fixed retention percentage for recovery of fuel in-kind outweigh the potential for cost over-recovery? Have pipelines with fixed retention percentages reduced their fuel use? If so, provide specific examples. Have pipelines with fixed in-kind retention percentages that have reduced their fuel use filed section 4 rate cases, thereby passing through to customers the benefit of any prospective fuel cost savings? Do pipelines with fixed fuel retention percentages have less incentive to file new section 4 rate cases, such that shippers are not receiving the benefit of any reduced fuel use? Are there barriers that make it difficult for shippers to file section 5 complaints to police over-recovery of fuel costs?

16. Does the benefit to shippers of greater rate certainty from a fixed fuel percentage justify continuing to permit pipelines to use a fixed fuel retention rate? If pipelines were to be allowed to continue using the fixed fuel retention rate approach, should the Commission consider imposing explicit incentive requirements, such as the application of an RPI – X methodology¹⁴ on either a generic or case-specific basis? If the Commission were to adopt incentive provisions to encourage pipelines to reduce fuel use and lost and unaccounted-for gas, should the Commission adopt a standardized incentive approach, such as the sharing between the pipeline and its shippers of any fuel cost over-recoveries

¹⁴ An "RPI-X" methodology would allow fuel costs to rise with inflation minus some X-factor deduction to provide a strong incentive towards efficiency and an implicit sharing of future efficiencies with ratepayers. Such methods, if employed in fuel retention provisions, would need to be adapted to fit the circumstances of in-kind retention requirements, rather than monetary payments.

and/or under-recoveries? If so, which standardized incentive approach should the Commission consider?

17. New compressor stations can be designed to minimize fuel use through, for example, motor selection (size, fuel efficiency, throughput flexibility) as well as minimizing pressure drops through the station (yard pipe and facility sizing). Existing compressors stations can also be redesigned to reduce fuel by minimizing pressure drops through the station or installing gas coolers to reduce the need for compression. How does the type of fuel cost recovery mechanism (fixed fuel retention percentages, tracker with no true-up or tracker with true-up) affect these decisions, if any? Similarly, is the fuel cost recovery or other mechanism a factor when deciding whether to construct a larger diameter pipe instead of compression or use advanced SCADA/control systems to manage line pack?

18. As stated above, if the Commission were to adopt incentive provisions to encourage pipelines to reduce fuel use and lost and unaccounted-for gas, one option would be a mechanism for sharing between the pipeline and its shippers of any fuel cost recoveries and /or under-recoveries. How could such a cost-and-benefit-sharing mechanism affect the decisions discussed immediately above? Could a cost-and-benefit-sharing mechanism between the pipeline and its customers ameliorate any concerns that fuel efficient investment is “gold plating” rate base, *i.e.*, making an investment that increases the rate base and the corresponding return without necessarily creating a corresponding benefit to the pipeline’s customers?

19. What are the barriers to cost effective, fuel efficient investment, if any? If barriers exist, how does the Commission remove such barriers? What factors, including, if applicable, the type of fuel cost recovery mechanism, affect the amount of research and development (R&D) being done to advance technology in these areas? How could a cost-and-benefit-sharing mechanism between the pipeline and its customers affect the level of R&D? Could fuel efficiency measures impact either directly or indirectly throughput or reliability on the pipeline grid, and if so, in what manner?

20. Some fixed fuel retention provisions were established through settlements. How important are fixed fuel retention provisions to these settlements? If the Commission adopts a new generic policy, should it modify these existing settlements to apply its new policy? If the Commission adopts a generic fuel retention policy, should it permit pipelines and shippers to reach settlements thereafter that provide for recovery of fuel costs in a manner different from that policy?

(2) **Should the Commission mandate that all pipelines must have a tracker mechanism for the recovery of fuel?**

21. While the Commission's general policy is that rates should be based on projections of future costs based on test period experience, the Commission permits certain costs that are volatile and thus particularly difficult to project, to be tracked. Is fuel use and lost and unaccounted-for gas difficult to predict with precision? If so, does the volatility of pipeline fuel use and the experience with the fixed retention percentage justify a blanket requirement that all pipelines recover their fuel costs through a tracker? If not, should the Commission continue the exception that permits pipelines to make limited section 4 filings tracking their fuel costs? Do the recent increases in the cost of fuel further justify use of a tracker?

22. In Order No. 637, the Commission established a principle that pipelines should not profit from the penalty provisions in their tariffs for imbalances, unauthorized overruns, scheduling violations, etc.¹⁵ This was intended to eliminate any incentive for pipelines to propose unnecessary penalties that hinder efficiency.¹⁶ Does permitting pipelines to profit from fuel retention also create undesirable incentives for pipelines? For example, do the profits from excess fuel retention lead some pipelines to avoid updating their base tariff rates because, on balance, they are receiving an adequate cash flow in aggregate?

(3) **If the Commission requires pipelines to use a tracker, should it require a true-up mechanism?**

23. As stated above, in *ANR*, the Commission concluded that if a pipeline has a tracker and is therefore able to recover its fuel costs outside of a general section 4 proceeding, it should track those costs accurately and not be permitted to over-recover its fuel costs in any circumstances. Accordingly, the Commission required all pipelines with trackers to include a true-up mechanism. With both a tracker and a true-up mechanism, the pipeline simply passes through its fuel costs to its customers, and, therefore, there may in fact be little incentive for the pipeline to try to reduce those costs.

24. In *ANR*, the Commission found that the inclusion of a true-up mechanism in a tracker does not remove all incentives for the pipeline to reduce its fuel use. The

¹⁵ 18 C.F.R. § 284.12(b)(v).

¹⁶ Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,315.

Commission explained that pipelines do face some competitive pressures in obtaining marginal throughput, for example, obtaining customers with access to alternative fuels. Because the Commission has held that pipelines may not discount their fuel use percentages since those costs are variable, the only way a pipeline can reduce its fuel percentages in order to help obtain marginal business is by reducing its fuel usage.

25. Was the Commission's conclusion in *ANR*, that the benefits of requiring a true-up as part of a tracker outweigh the disadvantages of reduced incentives for efficient operation accurate? What impact does a true-up mechanism have on a pipeline's incentive to reduce fuel costs? Is there evidence that pipelines with tracker and true-up mechanisms operate less efficiently than pipelines without such mechanisms?

26. Is there a benefit to giving pipelines an incentive to reduce fuel use, such as the inclusion in the tracker of a profit or loss sharing mechanism? If the pipeline could retain some benefit of fuel cost reductions, would it have a greater incentive to reduce those costs? Would customers benefit from the reduced costs and from sharing in any cost over-recoveries? How important are fuel costs relative to total transportation costs?

(4) Should the Commission retain its current policy?

27. Finally, the Commission seeks comments on whether it should retain its current policy which gives pipeline discretion over whether to have a tracker mechanism governing the recovery of fuel costs. What are the benefits and/or costs of retaining the current policy? What factors should the Commission consider in deciding whether a change in fuel retention policy is warranted at this time

III. Procedure for Comments

28. The Commission invites interested persons to submit comments, and other information on the matters, issues and specific questions identified in this notice. Comments are due 60 days from the date of publication in the *Federal Register*. Comments must refer to Docket No. RM07-20-000, and must include the commenter's name, the organization it represents, if applicable, and its address.

29. To facilitate the Commission's review of the comments, commenters are requested to provide an executive summary of their position. Commenters are requested to identify each specific question posed by the Notice of Inquiry that their discussion addresses and to use appropriate headings. Additional issues the commentors wish to raise should be identified separately. The commenters should double space their comments.

30. Comments may be filed on paper or electronically via the eFiling link on the Commission's web site at <http://www.ferc.gov>. The Commission accepts most standard

word processing formats and commentors may attach additional files with supporting information in certain other file formats. Commentors filing electronically do not need to make a paper filing. Commentors that are not able to file comments electronically must send an original and 14 copies of their comments to: Federal Energy Regulatory Commission, Secretary of the Commission, 888 First Street N.E., Washington, D.C. 20426.

31. All comments will be placed in the Commission's public files and may be viewed, printed, or downloaded remotely as described in the Document Availability section below. Commentors are not required to serve copies of their comments on other commentors.

IV. Document Availability

32. In addition to publishing the full text of this document in the *Federal Register*, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through the Commission's Home Page (<http://www.ferc.gov>) and in the Commission's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street, N.E., Room 2A, Washington D.C. 20426.

33. From the Commission's Home Page on the Internet, this information is available in the Commission's document management system, eLibrary. The full text of this document is available on eLibrary in PDF and Microsoft Word format for viewing, printing, and/or downloading. To access this document in eLibrary, type the docket number (excluding the last three digits) in the docket number field.

34. User assistance is available for eLibrary and the Commission's website during normal business hours. For assistance, please contact the Commission's Online Support at 1-866-208-3676 (toll free) or 202-502-6652 (e-mail at FERCOnlineSupport@ferc.gov) or the Public Reference Room at 202-502-8371, TTY 202-502-8659 (e-mail at public.referenceroom@ferc.gov).

By direction of the Commission.

(S E A L)

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