Federal Energy Regulatory Commission
November 16, 2006
Open Commission Meeting
Statement of
Commissioner Suedeen G. Kelly

Items G-1: Northern Natural Gas Company (RP06-437-000)

"I dissent from this order because I believe the applicant has failed to meet the requirements of Order No. 678 to: (1) prove that market-based rates are in the public interest (i.e. needed to permit the expansion) and (2) provide adequate customer protection.

When a utility is given the ability to charge market-based rates, we are really just removing regulatory controls on its ability to set its own prices and, instead, relying on market forces to provide price discipline. Accordingly, market-based rates are normally only in the public interest when adequate competition is present. When adequate competition is present, anyone trying to raise their price too high will risk having competitors take away their customers by charging less. In the absence of adequate competition, a party can raise its price without worrying about losing customers to competitors because there essentially are no competitors. Absent this competitive discipline on market-based rates, customers will be forced to pay more than they would in a competitive market and, accordingly, the public interest is not served.

Nevertheless, in the Energy Policy Act of 2005 Congress stated that, despite the lack of adequate competition, market-based rates might be in the public interest anyway if a storage project was needed and could not otherwise be built using either traditional or negotiated cost-based rates (and, importantly, if customers were protected by something other than the missing competition or cost-based rate regulation). It is our task under new NGA section 4(f) to determine whether these requirements have been met in each case.

Regarding the public interest requirement in Order No. 678, I believe the open season process here proves that market-based rates are not needed for this storage project and, accordingly, that market-based rates are not in the public interest in this case. First, we can expect that Northern designed the floor that it imposed on open season bidders to be somewhere above its current estimate of what it will cost to perform the expansion.[1] In other words, this floor can be expected to be no less than an initial cost-based rate for purposes of determining customer interest through precedent agreements. Bidders nevertheless requested more storage capacity than was offered and most of their bids were in fact above the floor. This indicates not only strong demand at a price level no less than the initial cost-based rate level would have been, but at even higher price levels as well. In the face of this, there does not appear to be strong evidence that customer objections would have prevented the use of a traditional cost-based rate.

This contrasts sharply with the situation in *Red Lake*,[2] where the applicant argued that there was inadequate customer interest at cost-based rates to justify

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[1] In fact, given Northern's extensive discussion of the risks of this expansion project, one can assume that the proposed floor is set well above Northern's current cost estimate, in order to provide some leeway in case of unforeseen expenses.

[2] *Red Lake Gas Storage, L.P.*, 102 FERC ¶ 61,077, *reh'g denied*, 103 FERC ¶ 61,277. (*Red Lake*)

construction of the project,[3] and that it faced a currently "soft" market where it would be forced to discount below cost-based rates to make sales without the "possibility of making up this loss during tight markets."[4] Clearly, there is more than enough current customer interest in Northern's proposed expansion and this abundant interest demonstrates a "tight" market rather than a "soft" one. A situation like that in *Red Lake* is better suited to application of new NGA section 4(f) than the situation here.[5]

The Commission's alternative negotiated rate program could also have been used and might well have resulted in the same negotiated rates. However, the difference would have been that customers would be protected in their negotiations by the cost-based recourse rate, which was absent here.

It is interesting to note that, while Northern's application indicates that market-based rates are necessary for this project, even if we denied such market-based rates, Northern has reserved the option through its draft precedent agreement to go forward with the project under cost-based rates (see P 2 of the draft precedent agreement attached to Northern's filing). Indeed, given the robust customer interest at the proposed rate levels, it seems unlikely that Northern would forego exercising this contractual option to move forward with the project under cost-based rates that would include a Commission-approved ROE commensurate with the risks of the aquifer storage expansion project. In summary, while the applicant supported the need for the expansion, it has not supported the need for market-based rates.

I also do not believe that the applicant supported its claim of adequate customer protection. First, Northern claims that expansion customers are protected because this proposal gives them rate certainty over a 20-year period by shifting the risk of cost increases to Northern. However, unlike the situation for customers who are bound by the terms of the precedent agreements they signed, there appear to be two contractual provisions that give Northern the ability to back out of the expansion if it wants to for economic reasons.

The first one is in P 4(b) of the draft precedent agreement and states that "[i]f the final costs determined by Northern require higher rates than set forth in the precedent agreements, Northern will notify customers that it will not execute the precedent agreements and will hold another open season." The second, even broader "out" is in P 7(b) of the draft precedent agreement and states that "Northern shall have the right *at any time* to terminate this Precedent Agreement *and any resulting FDD Agreement* and to withdraw any requests or application for regulatory

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[3] Red Lake argued on rehearing that its open season resulted in highly contingent precedent agreements covering only 61 percent of its proposed capacity. See 103 FERC ¶ 61,277 at P 30.

[4] Id.

[5] Indeed, in addressing the requirement for an applicant to show why market-based rates are necessary to encourage the construction of storage capacity, Order No. 678 specifically stated that "one way that the applicant could make such a showing is to present evidence that it offered its capacity at cost-based rates through an open season and was unable to obtain sufficient long-term commitments at those cost-based rates." Order No. 678 at P 129. Accordingly, unlike Northern, it appears that Red Lake would have met this requirement.

approvals if Northern determines, *in its sole discretion*, that the FDD Expansion, or portion thereof, has become uneconomical for Northern to pursue."(emphasis added) Because Northern will not even present FDD Agreements to its customers until after its cost studies are complete and it has signed the precedent agreements, this appears to let Northern cancel the expansion even after it has committed to it by signing the precedent agreements that bind its customers. That does not seem to be consistent with the idea that Northern is accepting the risks of the project. Rather, the customers who signed precedent agreements are bound by them but Northern is never bound, even after it moves to the FDD Agreement stage. When one side can extract a much better deal for itself than the other side is able to get, that constitutes a text-book example of exercising market power and is not consistent with customer protection.

Moreover, Northern claims that its customers prefer this proposal because of the rate certainty it allegedly provides them. However, the customers who sought desperately needed capacity from the incumbent storage provider were forced to sign away their right to protest the proposal as part of the precedent agreement (see P 10 of the draft precedent agreement) so we don't have unbiased feedback from the customers. Even Xcel's very brief comments in support of the filing are prefaced by a statement that the precedent agreement they signed requires them to support the filing. At best we can say that customers desperately want storage from a monopoly provider but we can't say that they support market-based rates for that provider just because they signed the precedent agreements. The monopolist forbid them from commenting honestly on the issue as a condition of service they can't get without winning the monopolist's good favor.

Turning to the order's rationale for why customers are protected, I disagree that Northern's open season provided the needed protection. The order cites (at footnote 19) to certain court cases for the proposition that rates resulting from an auction *with the characteristics of the one that Northern held*, reflect competitive prices rather than the exercise of market power. However, while those cases involved auctions with some of the characteristics of the Northern open season, the deciding auction characteristic in those cases is not present here. Those cases reviewed the Commission's decision to eliminate a cap on *term*-length when the customers were protected by the existence of a cost-based maximum rate. The court's ultimate decision to affirm the Commission's contract term length findings specifically turned on the existence of Commission-regulated cost-based rates. Here, there is no cost based rate to protect customers and, while the proposal does contain term caps of 20 years, those term caps are long enough that, in the absence of a cost-based rate, they would still trigger the concerns that were raised by the court in an earlier phase of that proceeding.[6] These court cases, thus, do not speak to the relevant issue of market-based rates in an auction and do not support the draft order's contention that Northern's auction process protected customers, either from a rate or term length perspective.

Further, P 20 of the draft includes the following statement: "In Order No. 678, the Commission recognized that a storage operator cannot exert market power as long

[6] The court initially found that the Commission had not adequately supported its decision to approve a Tennessee Gas Pipeline proposal to increase its term cap to 20 years. See 336 U.S. App. D.C. 162; 177 F.3d 995 (*Process Gas I*).

as it does not withhold its capacity and offers a reasonable reserve price." Again, there was no reserve price, let alone a "reasonable" reserve price, in Northern's open season.

Further, as both FERC and the courts have recognized, monopoly pipelines can exert market power even without withholding capacity or raising price. The court's initial concerns in the *Process Gas I* case cited above involved the potential for the pipeline to exert market power by requiring customers to sign up for longer terms of service than they otherwise would in a truly competitive market. In fact, while the Commission found (and the court ultimately agreed) that this term-based concern was not relevant to new expansion customers *protected by cost-based rates*, with the court's approval the Commission retained a term cap for the expiring contracts of existing customers with a right of first refusal, finding that those customers should continue to be protected from this form of market power abuse.[7]

In the absence of a cost-based rate cap, the term cap in Northern's auction does not address the term-based market power concerns discussed in *Process Gas I* and *Process Gas II*. Neither are the rate-based market power concerns that underlie the entire NGA, including new section 4(f), addressed by the proposed term cap or the proposed non-cost-based bid caps to which the customers are bound but to which the provider is never truly bound, as explained above. Therefore, the proposal does not meet the customer protection requirement of new section 4(f) or Order No. 678.

Having determined that this proposal fails to meet two key requirements of Order No. 678 and NGA section 4(f), I respectfully dissent from this order authorizing the proposal."

[7] See 352 U.S. App. D.C. 127; 292 F.3d 831 (*Process Gas II*).