

123 FERC ¶ 61,059
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

Petal Gas Storage, L.L.C.

Docket No. CP01-69-009

ORDER ON REMAND
ESTABLISHING SETTLEMENT PROCEDURES

(Issued April 18, 2008)

1. On August 7, 2007, the United States Court of Appeals for the District of Columbia Circuit issued its decision in *Petal Gas Storage v. FERC (Petal v. FERC)*,¹ remanding to the Commission two proceedings involving the use of proxy groups for purposes of establishing allowed rates of return on equity, *i.e.*, *High Island Offshore System, L.L.C (HIOS)*² and *Petal Gas Storage, L.L.C.*³ Specifically, in the October 25 Order, the court remanded to the Commission its decision regarding the composition of the proxy group and the placement of Petal Gas Storage, L.L.C. (Petal) within the proxy group in terms of risk. As discussed below, on remand, the Commission will refer this proceeding to a settlement judge to determine whether, due to the changed circumstances since the issuance of the Commission's prior orders, the parties can reach a settlement in this proceeding.

Background

2. In determining just and reasonable rates for a pipeline company, the Commission considers the pipeline's costs, including its cost of capital, and establishes a reasonable rate of return for the pipeline. Most gas pipelines are wholly-owned subsidiaries and their stock is not publicly traded. Therefore, in establishing a reasonable rate of return,

¹ 496 F. 3d 695 (D.C. Cir. 2007).

² 110 FERC ¶ 61,043 (2005), *reh'g denied*, 113 FERC ¶ 61,280 (2005).

³ 97 FERC ¶ 61,097 (2001) (October 25 Order), *reh'g*, 106 FERC ¶ 61,325 (2004). The Commission is issuing an order on remand in the *HIOS* proceeding is being issued contemporaneously with this order.

the Commission uses a proxy group of firms with risks corresponding to those of the pipeline to set a range of reasonable returns for natural gas companies. The Commission then assigns the pipeline a place within that zone or range to reflect the specific risk of the pipeline as compared to risk of the proxy group companies.

3. On January 23, 2001, Petal, an existing natural gas storage company, filed an application pursuant to section 7(c) of the Natural Gas Act for authority to construct and operate 59 miles of pipeline and compression and appurtenant facilities commencing at the terminus of Petal's storage header facility near Hattiesburg, Mississippi and terminating adjacent to Southern Natural Gas Company's (Southern) compressor station near Enterprise, Mississippi. In the application, Petal's proposed initial cost-based recourse rates for firm and interruptible transportation services over the proposed pipeline facilities⁴ under Rate Schedules FTS and ITS were derived using a 15 percent rate of return (ROE), an 8.75 percent cost of debt, an 11.875 percent overall rate of return, and a capital structure comprised of 50 percent debt and 50 percent equity.⁵

4. In the October 25 Order, the Commission issued a certificate of public convenience and necessity to Petal authorizing the construction and operation of the pipeline facilities described above. However, the October 25 Order rejected Petal's proposed 15 percent ROE. While Petal claimed that its cost of equity was derived from its parent company, El Paso Energy Partners, L.P. (El Paso Energy),⁶ the Commission determined that Petal failed to provide the calculations that support its proposed ROE.⁷

⁴ For its storage services, the Commission accepted Petal's proposal to continue charging market-based rates. October 25 Order, 97 FERC ¶ 61,097 at 61,521 (2001). See also *Petal Gas Storage Co.*, 64 FERC ¶ 61,190 (1993), *Petal Gas Storage Co.*, 86 FERC ¶ 61,224 (1999), and *Petal Gas Storage Co.*, 92 FERC ¶ 61,220 (2000).

⁵ On June 19, 2001, Petal filed an amendment to its application in which, among other things, Petal revised its proposed recourse rates to depreciate the pipeline facilities over a 40 year life (using a 2.5 percent annual depreciation accrual rate), in lieu of the 20 year life originally proposed. However, Petal made no changes to the capital structure or ROE reflected in its original application.

⁶ El Paso Energy is the parent of Crystal Gas Storage, which is the parent of Petal.

⁷ In the June 6, 2001 response to the May 17, 2001 Staff Data Request No. 7, Petal indicated that the current capital structure of El Paso Energy was 53 percent debt and 47 percent equity, with a 9.27 percent cost of debt, a 15 percent ROE, and an 11.963 percent overall rate of return; however, Petal did not support or propose to use this updated capital structure in its June 19, 2001 amendment to its original application.

5. In the October 25 Order, the Commission, using the discounted cash flow (DCF) methodology for establishing the ROE, selected eleven companies, including some electric utilities, to use as a proxy group in developing the ROE for Petal. The proxy group included CMS Energy, Duke Energy, El Paso Energy, Equitable, Kinder Morgan, MDU Resources, National Fuel Gas Company, NiSource, Questar Corp., Reliant Energy, and The Williams Companies. Based on the dividend yields and growth rate estimates for these proxy group companies, this methodology resulted in a range of equity costs between 10.31 percent and 15.52 percent with a median of 12.60 percent.

6. The Commission stated in the October 25 Order that absent highly unusual circumstances indicating an exceptionally high or low risk as compared to other pipelines, the assumption is made that a pipeline faces average risks. The Commission then noted that Petal did not justify placement at the upper-end of the zone of reasonableness. Consequently, the Commission concluded a reasonable ROE for Petal was the median of the range of the above-described proxy group, i.e., 12.60 percent. Petal was required to revise its FTS and ITS recourse rates and accordingly to make a restatement filing at the end of its first three years of actual operation to justify its existing recourse rates.⁸

7. Petal and the Interstate Natural Gas Association of America (INGAA) sought rehearing of the October 25 Order, claiming that the Commission inappropriately lowered Petal's requested ROE without explanation or justification. Specifically, Petal claimed that the Commission adopted an unprecedented group of proxy companies for purposes of setting Petal's return on equity, and placed Petal in the middle of the range of return indicated by the proxy group, without any examination of the relative risks of Petal compared to the proxy group. INGAA also asserted that the October 25 Order's proxy group substantially diverged from the proxy group and proxy group approach approved in Opinion No. 414-A.⁹

8. Petal requested that the Commission accept Petal's proposed 15 percent equity return based on the cost of equity capital for El Paso Energy, Petal's publicly traded parent company or, alternatively, utilize a group of proxy companies comparable to those approved in Order No. 414-A and evaluate Petal's risk relative to the risks of the companies comprising the new proxy group, and place Petal within the range of equity returns for that proxy group.

⁸ Petal's pipeline facilities went into service on July 1, 2002.

⁹ *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-A, 84 FERC ¶ 61,084 (1998), *reh'g denied*, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998), *petition for review denied*, *North Carolina Utilities Commission v. FERC*, D.C. Cir. Case No. 99-1037 (February 7, 2000) (*per curiam*).

9. Petal also objected to the Commission's placing Petal at the median of the range of required returns derived from the selected proxy group, which comprised a mixed group of pipeline, local distribution companies (LDC) and electric companies, instead of a conventional pipeline company proxy group. According to Petal, LDCs and others in the proxy group selected by the Commission had lower risks of loss than interstate pipelines. Therefore, Petal argued that it was arbitrary for the Commission to assume that Petal would have average risk within that group in the absence of record evidence.

10. On rehearing, the Commission affirmed its finding that it would not be appropriate to approve Petal's proposed 15 percent equity return based on the claimed cost of equity capital for its parent, El Paso Energy. First, the Commission noted that El Paso Energy is engaged in many non-pipeline operations and Petal had not demonstrated that its risks are similar to the risks of its parent. In addition, the Commission held that Petal's reliance on *System Energy Resources, Inc.*¹⁰ to support the use of its parent's cost of equity was misplaced, since that case involved the Commission's ROE policy for an electric utility, and the Commission developed approaches that distinguish between electric utilities and natural gas pipelines in establishing return on equity.

11. However, addressing Petal's argument that it should be permitted to rely on the Commission's long-standing policy regarding proxy groups in Opinion No. 414-A or any successor policy developed on the basis of a record in a rate case, the Commission did grant rehearing of the October 25 Order's eleven-company proxy group for purposes of setting Petal's return on equity. Specifically, the Commission stated that subsequent to the October 25 Order, in *Williston Basin Pipeline Company (Williston Basin)*,¹¹ the Commission recognized that changing conditions in the natural gas industry have resulted in fewer companies qualifying for use in the proxy group under the standards set forth in Opinion No. 414-A. The Commission accordingly modified its policy to include in the proxy group companies listed among the Value Line group of diversified natural gas companies that own FERC-regulated natural gas pipelines, without regard to what portion of the company's business comprises pipeline operations. However, the Commission rejected proposals to include electric utilities in the proxy group. In *Williston Basin*, the Commission performed a DCF analysis using a proxy group including nine companies based on the new criteria. The result of that analysis was a range of equity returns from a low of 9.82 percent to a high of 13.76 percent and approval of a 12.48 percent ROE at the median of the range for Williston Basin. On rehearing of the October 25 Order, the Commission found it appropriate to rely on the *Williston Basin* proxy group to establish an ROE for Petal.

¹⁰Opinion No. 446-A, 96 FERC ¶ 61,165 (2001).

¹¹ 104 FERC ¶ 61,036 (2003).

12. With regard to the appropriate placement of Petal in the *Williston Basin* proxy group, the Commission restated that its risk analysis for a particular existing pipeline is conducted with the presumption that it falls into a broad range of average risk, absent highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines. The Commission then reaffirmed its determination in the October 25 Order that Petal did not make a sufficient showing that it is outside the broad range of average risk. Specifically, the Commission found that Petal is not a new entrant to the gas business, rather it is an existing jurisdictional corporate entity simply proposing in this proceeding to expand its existing jurisdictional services. In addition, Petal proposed financing the pipeline internally through its parent, El Paso Energy, using a 50/50 debt/equity capitalization,¹² the same as the average 50/50 debt/equity capital structure of the *Williston Basin* proxy group. The Commission, therefore, required Petal's initial rates for its expansion to be calculated using the median return of 12.48 percent of the proxy group used in *Williston Basin*.

13. On review in *Petal v. FERC*, the court vacated and remanded the Commission's decision in October 25 Order on the return on equity issue. The court accepted the Commission's statement that changes in the gas pipeline industry compel a new approach to proxy groups and further stated that it accepted, for the sake of argument, that it was appropriate for the Commission to include local distribution companies. Nonetheless, the court stated that nothing in the Commission's decision explained why the companies selected by the Commission for inclusion in the proxy group are risk-comparable to Petal. The court stated that when the goal is a proxy group of comparable companies, it is not clear that natural gas companies with highly different risk profiles should be regarded as comparable.

14. The court further questioned the Commission's placing Petal in the middle of the proxy group in terms of return on equity, since the Commission expressly relied on the assumption that interstate pipelines generally fall into a broad range of average risk as compared to other interstate pipelines. The court explained that this assumption is valid only if the given proxy group is composed of other interstate pipelines. If local distribution companies generally face lower risk than interstate pipelines,¹³ a risk-appropriate placement would be at the high end of the group. For these reasons, the court

¹² This contrasts with highly leveraged, project financed pipelines, for which the Commission has approved equity returns of up to 14 percent. *See, e.g., Gulfstream Natural Gas System, L.L.C.*, 105 FERC ¶ 61,052 (2003) and 91 FERC ¶ 61,119 (2000), *Georgia Strait Crossing Pipeline LP*, 98 FERC ¶ 61,271 (2002), *North Baja Pipeline, LLC*, 95 FERC ¶ 61,259 (2001).

¹³ The court noted that local distribution companies likely are subject to lower risks than interstate pipelines.

found that the Commission erred by failing to explain how its proxy group arrangements were based on the principle of relative risk.

15. Therefore, the court vacated and remanded the Commission's order with respect to the proxy group issue. The court explained that it was not requiring any particular proxy group arrangement, but that the overall arrangement must make sense in terms of an interstate pipeline's relative risk and in terms of the Commission's statutory mandate to set just and reasonable rates that are commensurate with returns on investments in other enterprises having corresponding risks.

Discussion

16. Since the issuance of the Commission's prior decisions in this proceeding, circumstances have changed. The Commission approved Petal's initial cost-based recourse rates for firm and interruptible transportation service in 2001. At that time, Petal had only one shipper which had reserved the entire 700 MMcf per day (MMcf/d) of capacity on Petal's 59-mile pipeline for a twenty-year term. The shipper and Petal agreed to a negotiated rate lower than the recourse rate.¹⁴ On March 7, 2005, in Docket No. CP04-424-000, the Commission issued an order authorizing the increase in capacity of its mainline pipeline, from 700 MMcf/d to 1.3 Bcf per day.¹⁵ Petal executed contracts to provide 10 MMcf/d to one shipper for a three-year term, and with another shipper to provide 50 MMcf/d of firm transportation for a five-year term. Both of these contracts contained rates discounted below Petal's recourse rates. At the time the expansion order was issued, Petal stated it planned to hold an open season for up to 500 MMcf/d of the remaining expansion capacity, but had no marketing plans on the remaining 40 MMcf/d of expansion capacity. Since Petal expanded its pipeline capacity in 2005, new shippers have come on board, and any new shipper that pays the recourse rate may have an interest in participating in settlement discussions. In order to afford shippers such an opportunity, the Commission will direct that any existing expansion shippers, as well as other interested parties, shall be permitted fifteen days from the date of this order to file a motion to intervene in this proceeding.

17. Because of the passage of time since the issuance of the prior orders in this proceeding and the changed circumstances, the Commission believes that the parties should be given an opportunity to settle the issues related to Petal's initial recourse rates for firm and interruptible transportation services over Petal's facilities. If a settlement of

¹⁴ Petal's pipeline connects to its gas storage facility from which it provides storage services at market-based rates.

¹⁵ *Petal Gas Storage, L.L.C.*, 110 FERC ¶ 61,260 (2005).

these issues cannot be reached, the Commission will establish additional procedures to address the proxy group issues on remand consistent with the Commission's contemporaneous Policy Statement in *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, Docket No. PL07-2-000. The Commission encourages parties to resolve disputes through settlement, and believes that the circumstances here make the initial recourse rate issues appropriate for settlement.

18. To aid the parties in their settlement efforts, we will direct that a settlement judge be appointed, pursuant to Rule 603 of the Commission's Rules of Practice and Procedure. The Commission also directs that its litigation staff participate in the settlement discussion. If the parties desire, they may, by mutual agreement, request a specific judge as the settlement judge in the proceeding; otherwise, the Chief Judge will select a judge for this purpose. The settlement judge shall report to the Chief Judge and the Commission within 30 days of the date of the appointment of the settlement judge, concerning the status of settlement discussions. If settlement discussions continue, the settlement judge shall file a report at least every sixty (60) days thereafter, informing the Commission and the Chief Judge of the parties' progress toward settlement.

The Commission orders:

(A) Pursuant to Rule 603 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.603 (2005), the Chief Administrative Law Judge is hereby directed to appoint a settlement judge in this proceeding within fifteen (15) days of the date of this order. Such settlement judge shall have all powers and duties enumerated in Rule 603 and shall convene a settlement conference as soon as practicable after the Chief Judge designates the settlement judge. If the parties decide to request a specific judge, they must make their request to the Chief Judge within five (5) days of the date of this order.

(B) Within thirty (30) days of the appointment of the settlement judge, the settlement judge shall file a report with the Commission and the Chief Judge on the status of the settlement discussions. Based on this report, the Chief Judge shall provide the parties with additional time to continue their settlement discussions or, if appropriate, refer the matter back to the Commission for further action. If settlement discussions continue, the settlement judge shall file a report at least every sixty (60) days thereafter, informing the Commission and the Chief Judge of the parties' progress toward settlement.

(C) As discussed in the body of this order, any person wishing to intervene in this proceeding shall file a motion to intervene within fifteen (15) days of the date of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.