123 FERC ¶ 61,057
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

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

Duke Energy Guadalupe Pipeline, Inc. Docket Nos. PR05-17-000
PR05-17-002
PR05-17-004

ORDER ON STAFF PANEL AND REHEARING

(Issued April 18, 2008)

1. On August 1, 2005, Duke Energy Guadalupe Pipeline, Inc. (Guadalupe) filed in Docket No. PR05-17-000 a petition for rate approval for firm and interruptible transportation services rendered under section 311 of the Natural Gas Policy Act of 1978 (NGPA).[1] An offer of settlement (Settlement) was accepted by the Commission on December 29, 2005.[2] However, on June 2, 2006, the Commission granted rehearing on its approval of the Settlement and instituted Staff Panel proceedings.[3] The Commission denied a subsequent request for rehearing in an order issued on July 21, 2006.[4] The Staff Panel was convened on July 26, 2006. As discussed below, the Commission by this order denies Guadalupe's request for rehearing of the July 21, 2006 Order, and reaffirms its rejection of the offer of settlement. The Commission resolves all issues necessary to determine Guadalupe's rates on the merits, except return on equity (ROE). The Commission will decide the ROE issue consistent with our contemporaneous policy

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[1] 15 U.S.C. § 3371 (2000).

[2] *Duke Energy Guadalupe Pipeline, Inc.*, 113 FERC ¶ 61,326 (2005) (December 29, 2005 Order).

[3] *Duke Energy Guadalupe Pipeline, Inc.*, 115 FERC ¶ 61,289 (2006) (June 2, 2006 Order).

[4] *Duke Energy Guadalupe Pipeline, Inc.*, 116 FERC ¶ 61,080 (2006) (July 21, 2006 Order).

statement on the composition of the proxy group.[5] Accordingly, this order establishes procedures to permit the parties to present views and evidence consistent with the *Proxy Group Policy Statement*.

I. Background

2. Guadalupe, a wholly owned subsidiary of Duke Energy Field Services, LLC (DEFS), operates approximately 500 miles of pipelines in Texas, extending from Waha in West Texas to Katy in the Gulf Coast area of Texas. Gas generally flows from west to east on Guadalupe's system.

3. In its August 2005 filing, Guadalupe proposed, among other things, a maximum system-wide base rate for firm and interruptible transportation service of $0.1906 per MMBtu, plus a 1.85 percent Fuel and Lost and Unaccounted For charge. Guadalupe also proposed to use the same $0.1906 per MMBtu rate as its maximum parking and lending rate.[6] Guadalupe proposed a total cost-of-service of $17,400,716,[7] based on its actual costs for the twelve months ending March 31, 2005, with certain adjustments. Guadalupe's proposed rate design volumes were based on its throughput for the same period, with a downward adjustment to account for base period discounts. Guadalupe states that its fuel charge was based on an engineering study of fuel use for the 12-month base period ending March 31, 2005.

4. Guadalupe explained that it was not proposing use of a two-part rate, with a reservation charge for firm service, because it does not believe one is justified at this time. Guadalupe elaborated by stating that it operates in one of the most competitive markets in the country, and that potential customers have numerous market options. Guadalupe stated that with only two exceptions, all of its gas is transported under interruptible contracts.

5. A settlement of the issues was reached by Guadalupe and the Commission staff, and Guadalupe filed the Settlement offer on November 18, 2005. The Settlement provided for a maximum system-wide base rate for firm and interruptible transportation

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

[6] Guadalupe proposed to eliminate its Power and Peaking Service (P&PS). It explained that it had only executed two contracts for that service, one of which has expired and the other of which is for intrastate service.

[7] *See* Exhibit B, Schedule 1 of Guadalupe's Request for Rate Approval in Docket No. PR05-17-000 filed August 1, 2005.

service and lending service of $0.1810 per MMBtu, plus the same 1.85 percent Fuel and Lost and Unaccounted For charge Guadalupe had proposed in its initial filing in this case.

6. Mewbourne Oil Co. (Mewbourne), a producer, filed comments opposing the Settlement. Mewbourne produces natural gas from wells located in southeastern New Mexico. It is not currently a direct customer of Guadalupe, but states that its gas can be shipped over Guadalupe to markets in central Texas.

7. In the December 29, 2005 Order approving the Settlement, the Commission stated that no party objected to the Settlement's maximum base rate of $0.1810 per MMBtu. However, the Commission stated that Mewbourne opposed the Settlement's fuel charge. Mewbourne pointed out that the Settlement's fuel charge exceeded the discounted fuel charge that Guadalupe recovers from its intrastate customers, and asserted that, as a result, the Settlement improperly required the interstate customers to subsidize the fuel use of the intrastate customers. The December 29, 2005 Order rejected this contention, on the ground that the record showed that Guadalupe had calculated the fuel charge in a manner that did not take into account the discounts given to the intrastate customers, and therefore Guadalupe would be solely at risk for any undercollection of fuel costs as a result of discounts offered to intrastate customers.

8. On rehearing, Mewbourne argued that the Commission erred in finding that no party objected to the Settlement's maximum base rate of $0.1810 per MMBtu, stating that its comments on the Settlement had opposed the Settlement's maximum base rate on the ground that that rate would provide Guadalupe an excessive return on equity. In the June 2, 2006 Order, the Commission granted rehearing of its approval of the Settlement. The Commission agreed that Mewbourne had opposed the Settlement's base rate, as well as the fuel charge. The Commission stated that, under Rule 602 of its Rules of Practice and Procedure,[8] the Commission may approve an uncontested settlement upon a finding that the settlement is fair and reasonable and in the public interest. However, where a settlement is contested the Commission must make an independent finding supported by substantial evidence on the record as a whole that the proposal will establish rates consistent with the statutory standard, here that the rate be "fair and equitable" under NGPA section 311(a)(2)(B). Therefore, the Commission found that, because the entire settlement was contested, including the Settlement's maximum base rate, the Commission could only approve the Settlement if the Commission could find on the merits that the overall $0.1810 per MMBtu settlement transportation rate is less than or equal to the fair and equitable transportation rate the Commission would approve based on a merits resolution of all issues concerning Guadalupe's cost of service and rate design volumes. The Commission found that the present record was insufficient to make such merits holdings. Accordingly, the Commission granted rehearing of its approval of

[8] 18 C.F.R. § 385.602(g)(3) (2006).

the Settlement and instituted a Staff Panel proceeding pursuant to section 284.123(b)(2)(ii) of its regulations.

9. On July 21, 2006, the Commission issued an order[9] denying a request for rehearing by Guadalupe. Guadalupe asked the Commission either to reinstate the Settlement or, if it cannot approve the overall Settlement due to Mewbourne's objection, sever Mewbourne to litigate its concerns separately. Guadalupe also requested that the Staff Panel procedures be held in abeyance. The Commission stated that, since the Settlement was a black box settlement not reflecting any agreement as to the individual components of Guadalupe's cost of service, the Commission could not find the Settlement rates to be fair and equitable without addressing on the merits all issues concerning Guadalupe's cost of service and rate design volumes, and the Staff Panel was necessary for that purpose. However, the Commission stated that Guadalupe could raise the issue of severance at the Staff Panel. The Commission stated that severance could be an option if Mewbourne can transport all its production under its own contracts with Guadalupe. That would enable Mewbourne to obtain transportation at the litigated rate resulting from the Staff Panel procedures, leaving it unaffected by the Settlement. The Staff Panel was conducted on July 26, 2006.

10. On August 21, 2006, Guadalupe requested rehearing of the July 21, 2006 Order. Guadalupe renewed its request that the Commission sever Mewbourne from the Settlement and reinstate the Settlement for Guadalupe.

II. Discussion

11. The record developed as a result of the Staff Panel provides the Commission a sufficient basis to determine on the merits a fair and equitable rate for Guadalupe. For the reasons discussed below, we find that Guadalupe has failed to support several components of its proposed cost of service and has failed to support its proposed discount adjustment to its rate design volumes with respect to certain discounts given to an affiliate. We establish additional procedures to permit resolution of Guadalupe's ROE consistent with the *Proxy Group Policy Statement*. We hold that, even assuming approval of Guadalupe's proposed ROE, Guadalupe's proposed rates exceed a fair and equitable level and that the rates in the Settlement offer are also excessive. Finally, we reject Guadalupe's contention that we should sever Mewbourne from the Settlement and approve the use of the Settlement rates for all shippers other than Mewbourne.

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[9] *Duke Energy Guadalupe Pipeline, Inc*., 116 FERC ¶ 61,080 (2006) (July 21, 2006 Order).

A. **Cost of Service**

1. **O&M and A&G Costs**

12. Guadalupe's proposed $17,400,716 Cost of Service included O&M and A&G expenses of $8,790,701.[10] In its petition, Guadalupe provided two schedules in support of its O&M and A&G expenses. The first schedule, Exhibit B, Schedule 2, allocates O&M and A&G expenses by FERC account number and includes a footnote that states that the total expenses include adjustments for known and measurable changes. The second schedule, identified by Guadalupe as attachment 9(a), provides the itemized O&M and A&G expenses by FERC Account by month for the 12 month period ending March 2005, as adjusted. The schedule also includes support for Guadalupe's allocation of monthly A&G expenses from its parent, DEFS, based on the Massachusetts formula which is an allocation methodology used to allocate and book A&G expenses from a parent company.

13. In its written explanation of the second schedule, Data Response 9(a), Guadalupe states that the actual book amounts for O&M have been adjusted for known and measurable changes expected to be incurred throughout the remainder of 2005 and are reflected in column 14 [of attachment 9(a)]. The effect of the adjustments is to increase the annual amount of O&M by $1,266,843. There are no adjustments to A&G.

14. The Commission will reject Guadalupe's inclusion of costs that go beyond the twelve month actual period. In *Transok, Inc.*, the Commission stated that "… the Commission's regulations simply require that section 311 rates [be] 'cost-based,' and do not require a 'test-period' concept of ratemaking. Instead, the Commission's practice for section 311 ratemaking has been to use actual costs for a given 12-month period."[11] Since Guadalupe's O&M expenses have been adjusted upward outside the 12 month period by $1,266,843, we will require Guadalupe to remove this amount from its cost of service calculation.

2. **Rate Base**

15. Guadalupe included in its rate base a Total Plant Investment of $11,109,409, from which it subtracted Accumulated Depreciation, Depletion and Amortization (DD&A) of

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[10] *See* Exhibit B, Schedule 1 of Guadalupe's Request for Rate Approval in Docket No. PR05-17-000 filed August 1, 2005.

[11] *Transok, Inc.*, 70 FERC ¶ 61,177 (1995); *Mustang Fuel Corp.*, 31 FERC ¶ 61,265 (1985), *reh'g granted in part,* 36 FERC ¶ 61,001 (1986); *Lear Petroleum Corp.*, 42 FERC ¶ 61,015 (1988).

$633,306.[12] Guadalupe also included in rate base a cash working capital allowance of $1,226,313 for the period ending March 31, 2005.[13]

16. The Commission finds three errors in Guadalupe's proposed rate base. First, Guadalupe's Data Response 9(c) shows that it adjusted its Total Plant Investment for known and measurable changes expected to be incurred throughout the remainder of 2005. These adjustments increased its plant investment by $1,776,958. As discussed above, in NGPA section 311 rate proceedings, the Commission does not permit adjustments for changes that occur after the 12-month base period. Therefore, the $1,776,958 adjustment in plant must be removed from rate base.

17. Second, in response to Staff Panel Data Request, Guadalupe filed in its Initial Brief a schedule to reconcile the accumulated depreciation from Guadalupe's prior rate filing in Docket No. PR02-21 with the Accumulated DD&A filed in the instant petition. The reconciliation provided by Guadalupe shows that the Accumulated DD&A as of March 2005 was actually $1,061,979, an increase of $428,673 from the $633,306 amount in Guadalupe's initial rate petition. The Commission will therefore require Guadalupe to subtract the March 2005 DD&A of $1,061,979 from its Total Plant Investment in its calculation of total Rate Base.

18. Third, Guadalupe has not sufficiently supported its cash working capital adjustment. The only justification Guadalupe provided is the cash working capital calculation shown on Exhibit B, Schedule 6 of its application. In that exhibit, Guadalupe calculated its proposed cash working capital allowance based on one eighth of its current operating expenses. Section 154.306 of the Commission's regulations, which applies to NGA rate cases, provides that any natural gas company that files a tariff change may not receive a cash working capital adjustment to its rate base unless such adjustments are accompanied by a fully developed and reliable lead-lag study. The Commission adopted this regulation after finding that the one-eighth of current operating expenses methodology overstated the lag in pipelines' recovery of expenses. Although Part 154 of our regulations does not apply here, the rationale for this policy is to ensure that all of a pipeline's cost and revenue timing differences are accounted for in developing an appropriate cash working capital allowance. This underlying policy is equally applicable to the appropriate design of a fair and equitable rate under the NGPA. Amounts must be adequately supported and the calculations demonstrated before the Commission will allow the amounts to be imputed. Here, Guadalupe has neither provided a lead-lag study

[12] *See* Exhibit B, Schedule 6 of August 1, 2005, Petition for Rate Approval.

[13] *Id.*

nor provided any other support for its cash working capital allowance.[14] Therefore, we will require Guadalupe to remove the working capital allowance of $1,226,313 from its calculation of rate base.

B. Rate of Return

1. Initial Comments

19. In its August 1, 2005 filing, Guadalupe requested a 14 percent return on equity. Guadalupe submitted a discounted cash flow (DCF) study based on January to June 2005 data for nine firms. Guadalupe states that it selected the nine firms from the Value Line Investment Survey's "Natural Gas (Diversified)" industry group, but excluded firms which are either major energy merchants or primarily involved in oil and gas exploration and production. The nine selected firms include six corporations and three master limited partnerships (MLPs). The ROE results of Guadalupe's DCF study are as follows:

Enterprise Products	MLP	14.1
Kinder Morgan Inc.	Corp.	13.4
TEPPCO Partners	MLP	13.0
KM Energy Partners	MLP	12.1
Equitable Resources	Corp.	11.1
Western Gas Res.	Corp.	10.4
ONEOK Inc.	Corp.	10.0
Questar	Corp.	9.3
National Fuel Gas	Corp.	9.1

20. The median of the 9.1 to 14.1 percent range of returns established by Guadalupe's DCF study is 11.1 percent. Guadalupe requests that its return be set at the top of the range at 14.1 percent, arguing that its risk is higher than average. Among other things, Guadalupe argues that the proxy group includes corporations with significant local distribution activities which are less risky than Guadalupe's pipeline business.

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[14] In Order No. 383, the Commission found that due to computerization and other improvements in billing procedures, business practices established in recent decades have reduced the time necessary for billing and payment. As the Commission stated in Order No. 383, lead-lag studies have failed to support the claimed one-eighth cash working capital allowance. In fact, studies performed by the Commission resulted in leads or negative allowance. According to Order No. 383, the current practice is a presumption of zero unless a lead-lag study demonstrates otherwise. *Revisions to the Filing Requirements for Changes in a Tariff*, Order No. 383, 49 Fed. Reg. 24,880, FERC Stats. & Regs., Regulations Preambles 1982-1985 ¶ 30,574 at 30,990 (1984).

21. Mewbourne, the only other party in the proceeding, has not presented any DCF study of its own, or objected to Guadalupe's DCF study. However, it argues that Guadalupe's risk is relatively low, and therefore its ROE should be set below the 11.1 median of Guadalupe's DCF study, at 10.6 percent.

2. Commission Determination

22. The Commission determines a pipeline's ROE by performing a Discounted Cash Flow (DCF) analysis of a proxy group of publicly traded firms with corresponding risks. Under the constant growth DCF formula used by the Commission, the cost of capital is equated with the dividend yield (dividends divided by market price) plus the estimated constant growth in dividends. The Commission determines dividend growth by averaging short-term and long-term growth estimates, giving two-thirds weight to the short-term growth projection and one-third weight to the long-term growth estimate.[15] The DCF results for the proxy group companies produce a zone of reasonableness within which the pipeline's rate may be set based on specific risks.

23. In NGPA section 311 rate cases, the Commission generally uses the same proxy group to determine return on equity as has been used in recent NGA section 4 rate cases.[16] Since *Williston Basin Interstate Pipeline Co*.,[17] the Commission has based the proxy group on corporations listed among the Value Line Investment Survey's group of diversified natural gas companies that own Commission-regulated natural gas companies. However, in the contemporaneous *Proxy Group Policy Statement*, the Commission has reexamined its proxy group policy in light of the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Petal Gas Storage, LLC v. FERC*,[18] and current trends in the gas and oil pipeline industry. As a result, the Commission is modifying its policy to permit MLPs to be included in the proxy group. However, the *Proxy Group Policy Statement* finds that the DCF analysis of MLPs should use a long-term growth projection of 50 percent of GDP, instead of the long-term growth projection equal to GDP used for corporations.

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[15] The Commission uses the five-year Institutional Broker's Estimate System (IBES) growth projections as the short-term growth projection and the growth rate of the Gross Domestic Product (GDP) as the long-term growth projection.

[16] *EPGT Texas Pipeline, L.P.*, 99 FERC ¶ 61,295, at 62,250-1 (2002) (*EPGT*). *Bay Gas Storage Co*., 111 FERC ¶ 61,345, at P 31-32 (2005). *Cranberry Pipeline Corp*., 112 FERC ¶ 61,268, at P 26-27 (2005).

[17] 104 FERC ¶ 61,036 at P 35 (2003).

[18] 496 F.3d 695 (D.C. Cir. 2007) (*Petal v. FERC*).

24. The *Proxy Group Policy Statement* requires parties proposing to include particular firms in a proxy group to provide as much information about the nature of the firm's business activities including their recent annual SEC filings and investor service analyses of the firms. This information will enable the Commission to determine whether the interstate natural gas pipeline business is a primary focus of the firm and whether investors view an investment in the firm as essentially an investment in the gas pipeline business. The *Proxy Group Policy Statement* concludes that permitting appropriate MLPs to be included in the proxy group should render the proxy group more representative of the business risks of natural gas pipelines, and thus reduce the need to make adjustments for differences in risk. Finally, the *Proxy Group Policy Statement* states that the new proxy group policy should govern all rate proceedings that are now before the Commission.

25. Accordingly, we will apply the new policy in this case. Therefore, the Commission reopens the record in this case for a paper hearing in order to give all parties an opportunity to submit additional evidence as to (1) which specific MLPs and corporations should be included in the proxy group consistent with the policy statement, (2) the appropriate DCF analysis of each entity proposed for inclusion in the proxy group, including its projected short and long-term growth rates, and (3) where Guadalupe's ROE should be set in the resulting range of reasonable returns. The parties' initial briefs in the paper hearing will be due within 60 days after this order issues. Reply briefs are due 90 days after this order issues and rebuttal briefs are due 105 days after this order issues. The parties' presentations in their initial, reply, and rebuttal briefs should separately state the facts and arguments advanced by the party and include any and all exhibits, affidavits, and/or prepared testimony upon which the party relies.

C. Discount Adjustment

1. Initial Comments

26. Guadalupe proposes to reduce the volumes it uses to design its rates to reflect its discounts of its maximum rate. In support for the discount adjustment, Guadalupe's application contained a schedule for the 12 month period April 2004 through March 2005 showing the different transportation rates that customers were charged.[19] During that period, Guadalupe's maximum rate for NGPA section 311 firm or interruptible service was $0.1726 per MMBtu.[20] The discounted rates charged by Guadalupe for this time

[19] Data Request 8 to Staff Standard Data Request.

[20] By Letter Order dated December 19, 2002, the Commission approved a Stipulation and Agreement establishing a maximum fair and equitable rate of $0.1726 per MMBtu for NGPA section 311 system-wide transportation service. 101 FERC ¶ 61,302 (2002).

period ranged from a low of $0.0060 per MMBtu to $0.1670 per MMBtu. In its original filing, Guadalupe noted that none of the discounts were given to affiliates. However, it subsequently provided information that during the six months of the base period it provided discounted service to an affiliate, under two interruptible contracts executed in June 2000 before the two companies were affiliated. One contract covers backhaul transportation and the other covers forward haul transportation. Guadalupe states it negotiated discounted rates with its affiliate each month for November 2004 through January 2005. Guadalupe then entered into a one-year discounted rate agreement with the affiliate to provide service at the same transportation rate that had been provided for the prior three months.[21]

27. In this case, the parties' contentions concerning the appropriateness of Guadalupe's proposed discount adjustment focus primarily on the discounts given to its affiliate. Guadalupe argues that it was appropriate to include the affiliate's volumes in the discount adjustment due to competitive circumstances surrounding pricing of transportation by Guadalupe.[22] Guadalupe, citing Commission precedent in *EPGT*[23] argues that the Commission has stated that it is the burden of the pipeline to show that its discounts to affiliates were required by competition, to provide information concerning how the level of discounts to its affiliates was determined and why it was necessary to grant those discounts.

28. Guadalupe states that: (1) the affiliate has numerous alternatives for sending its gas to market; (2) Guadalupe has never collected its maximum rate on the transportation segments used by the affiliate; and (3) the discounts granted to the affiliate during the base period are comparable to discounts granted to other non-affiliated customers for similar service.[24]

29. Finally, Guadalupe states that it has no financial incentive to offer discounts to the affiliate that are not required by competition. The transportation rates paid by the affiliate have a direct financial impact on both Guadalupe and the affiliate and both parties have an incentive to negotiate the best deal for their respective companies.[25]

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[21] The overall rates for these transactions, including fuel costs, are found in Appendix, Attachment 1 to the initial brief and are identified as privileged.

[22] Guadalupe Initial Brief at 10.

[23] *EPGT,* 99 FERC ¶ 61,295, at 62,255 (2002); *Koch Gateway Pipeline Company,* 84 FERC ¶ 61,143, at 61,780, *reh'g denied*, 85 FERC ¶ 61,426 (1998).

[24] Guadalupe Initial Brief at 11.

[25] Guadalupe Initial Brief at 13.

30. Mewbourne opposes any discount adjustment for the discounts given to Guadalupe's affiliate. Mewbourne argues that Guadalupe has failed to show that its discounts to its affiliate were required by competition. It points out that in *EPGT* the Commission found that the mere fact the pipeline gave deeper discounts to non-affiliates than to its affiliates is insufficient to show that the discounts to the affiliate were required by competition, and in any event Mewbourne claims that Guadalupe's discounts to its non-affiliate were not as deep as some of its affiliate discounts.[26]

31. Mewbourne further states that some of Guadalupe's agreements do not require the shipper to reimburse Guadalupe for fuel, but impute an unspecified part of the transportation fee in $/MMBtu to represent fuel reimbursement. Mewbourne states that these provisions constitute a material deviation from Guadalupe's approved rates. Mewbourne contends that, as a result, these agreements must be treated as negotiated rate agreements which under Commission policy are not eligible for a discount adjustment.[27] Mewbourne also argues that in some cases the overall $/MMBtu rate paid by the shipper did not cover Guadalupe's average cost of fuel per MMBtu transported, thus indicating that Guadalupe had discounted below its variable costs. Mewbourne contends that Guadalupe should be required to bear the costs of such discounts and thus be denied any discount adjustment with respect to discounts below its variable costs.

32. Finally, Mewbourne states that Guadalupe obtained revenues in excess of its maximum section 311 rate of $0.1726 under certain agreements, and those excess revenues should be credited against the discount adjustment.[28]

2. <u>Reply Comments</u>

33. Guadalupe argues that Mewbourne misconstrues the Commission's negotiated rate policy by suggesting that the negotiated rate policy, which applies to interstate pipelines that transport under Part 284 of the Commission's regulations, also applies to an intrastate pipeline acting under NGPA section 311. As far as fuel reimbursement is concerned, Guadalupe argues that Mewbourne is incorrect in alleging that Guadalupe discounted below its variable costs in certain transactions. Guadalupe states that the transportation rate information provided in Standard Data Response Nos. 6, 7, 8, and 11 represent only the transportation component of the rate. Any dollar amounts related to the Fuel Charge were not included in the rates listed. Guadalupe states that for transactions that did not have a separately stated fuel rate, Guadalupe determined the transportation component of the rate on a monthly basis. For backhaul transactions

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[26] Mewbourne Initial Brief at 4-5.

[27] *Id*. at 5-6.

[28] *Id*. at 7.

Guadalupe states that no fuel was used.[29] Finally, Guadalupe states that since the Fuel Charge is not included in the transportation rates listed in Data Response No. 8, the Commission should disregard Mewbourne's argument that Guadalupe did not recover the cost of fuel.

34. In response to Mewbourne's assertion that Guadalupe should credit revenues that were collected above the maximum rate, Guadalupe states that those transactions were intrastate transactions not subject to the NGPA section 311 maximum rate and there is no provision for crediting intrastate revenues that were above the maximum rate.

3. <u>Commission Determination</u>

35. The Commission has consistently held that, to the extent a pipeline was required during the test period to give discounts either to attract or retain load, it need not design its rates on the assumption that such discounted volumes would flow at maximum rates. Otherwise, there would be a disincentive to pipelines' discounting their rates to capture marginal firm and interruptible business. The Commission has held that such discounts benefit all customers by allowing a pipeline to maximize throughput and thus spread fixed cost recovery over more units of service.

36. The Commission has also stated that the pipeline has the ultimate burden of proving that all discounts reflected in its discount adjustment were appropriate and that its throughput projections are reasonable. However, the Commission has distinguished between discounts to non-affiliates and discounts to affiliates. It has stated that with respect to discounts to non-affiliates:

> it is a reasonable presumption that a pipeline will always seek the highest possible rate from non-affiliated shippers, since it is in its own economic interests to do so.[30]

37. Accordingly, once the pipeline has explained generally the basis for its discounts to non-affiliated customers and thus met an initial burden of demonstrating that the discounts were proper, those opposing a discount adjustment have the burden of demonstrating that the discounts to non-affiliates were discriminatory, i.e., were not justified by competition.

38. The Commission also permits discounts to affiliates to be included in the discount adjustment. However, the Commission carefully scrutinizes discounts to affiliates, since

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[29] Guadalupe Reply Brief at 6, n.10.

[30] *Southern Natural Gas Co*., 65 FERC ¶ 61,347, at 62,831 (1993), *order on reh'g,* 67 FERC ¶ 61,155 (1994).

pipelines have incentives to offer affiliates discounts not required by competition. There is a much heavier burden on the pipeline to justify that its discounts to affiliates were required to meet competition.

39. Thus, under established Commission policy, Guadalupe has the burden in this case of showing that its discounts to affiliates were required by competition. Guadalupe must provide information concerning how the level of the discounts to affiliates was determined and why it was necessary to grant those discounts, for example, by identifying the transportation and/or fuel alternatives available to the affiliated customer that gave rise to the decision to discount or by showing that it was routinely unable to collect its maximum rate on a particular segment, so that the affiliate merely received the same level of discount granted to its nonaffiliated shippers.[31]

40. Guadalupe has failed to meet this burden. Guadalupe has sought to show that the discounts to its affiliate were required by competition by asserting that it offered similar discounts to non-affiliated shippers for similar service. In order to support this assertion, it relies on Attachment 1 to Appendix B to its initial brief, showing the rates paid per MMBtu by the affiliate and the rates paid by non-affiliates in certain allegedly similar transactions. The rates shown in that exhibit are based on the entire dollar amount paid by each shipper, including any cash payments for fuel use. However, including cash payments for fuel distorts the analysis, because Guadalupe recovers fuel costs from interstate customers through an in-kind fuel reimbursement percentage, while recovering fuel costs from at least some intrastate customers through cash payments. It thus appears that the rates shown on Attachment 1 to Appendix B include the entire amount some shippers paid for service on Guadalupe, including both the base transportation rate and the fuel charge, but only include the base transportation rates paid by other shippers. Such an apples to oranges comparison does not provide a reliable basis for determining whether Guadalupe offered similar discounts to both its affiliate and its non-affiliated customers.

41. Guadalupe has only sought a discount adjustment with respect to its discounts of its base transportation rate, not including fuel charges. Thus, as Guadalupe itself points out, the discounted rates it has used to calculate its discount adjustment, which are shown in Standard Data Response No. 8 attached to its initial application, all exclude any cash payments for fuel use. Therefore, for purposes of analyzing whether Guadalupe's discounts to its affiliate were similar to its discounts to non-affiliates, the relevant comparison should be to the base transportation rates paid by each shipper, with any cash payments for fuel excluded. Guadalupe has not identified which of the transactions shown in Standard Data Response No. 8 were with affiliates and which were with non-affiliates. However, a comparison of the volumes shown for the affiliated transactions

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[31] *EPGT*, 99 FERC ¶ 61,295 at 62,255.

listed in Appendix B, Attachment 1 to the volumes shown for the transactions listed in Standard Data Response No. 8 suggests that some of the deepest discounts shown in Standard Data Response No. 8 were given to the affiliate. In any event, Guadalupe has not presented sufficient evidence to show that its affiliate merely received the same level of discount as offered to its non-affiliates as to its affiliate.

42. Moreover, Guadalupe has not provided any specific information about each discount offered to the affiliate to show how the level of each discount to the affiliate was determined and why it was necessary to grant those discounts. While Guadalupe has pointed out that there were other pipelines on which its affiliate could have transported its gas, Guadalupe has failed to provide any information as to the rates available to the affiliate on other pipelines for the transactions in question. Thus, there is no evidence showing that the level of discounts Guadalupe provided to the affiliate was necessary to retain it as a customer.

43. There is no doubt that there is competition on the Guadalupe system. However, Guadalupe has not proven that the discounts that were given to its affiliate were reasonable and not unduly discriminatory. Therefore, we will disallow the discount adjustment to the volumes of gas transported for its affiliate.

44. We reject Mewbourne's other objections to Guadalupe's proposed discount adjustment. Mewbourne's assertion that Guadalupe's proposed discount adjustment reflects improper discounts of its fuel charges is incorrect. As previously discussed, Guadalupe's proposed discount adjustment is based on the discounted rates shown in its response to Standard Data Request No. 8, and all charges for fuel have been excluded from the discounted rates shown in that exhibit. Thus, that exhibit only shows Guadalupe's discounts of its base transportation rate. In addition, to the extent Guadalupe received cash reimbursement for fuel use, rather than in-kind reimbursement, it appears that occurred in intrastate transactions not governed by Guadalupe's NGPA section 311 rates. Thus, such cash payments do not represent a deviation from Guadalupe's approved interstate rates.

45. We will also reject Mewbourne's request to have the revenues for those volumes in which shippers paid greater than the maximum rate credited against the discount adjustment. The volumes of gas associated with those transactions are intrastate transactions for which the Commission has no jurisdiction.

D. Fuel Charge

1. Initial and Reply Comments

46. In this rate case, Guadalupe proposed to continue its existing postage stamp rate design, including a single system-wide fuel retention percentage to recover its costs of fuel and lost and unaccounted for gas. Guadalupe states that it derived its fuel charge

based on the same engineering study it did in its prior rate case in Docket No. PR02-21. Guadalupe states that the engineering study used in the instant filing was based on system operations for the 12 month period ending March 31, 2005 and reflects actual fuel consumed, losses of gas and throughput for the system for that period. Guadalupe states that this system-wide fuel recovery mechanism based on an engineering study, was approved as fair and equitable in Guadalupe's prior rate case.

47. Mewbourne argues that the Commission should require Guadalupe to restate its fuel charges by denoting separate fuel charges for each operational segment of the pipeline. Mewbourne argues that this is necessary in order to enable NGPA section 311 shippers to compete with Guadalupe's intrastate shippers for sales to markets in Texas via Guadalupe's pipeline on a not unduly discriminatory basis. Mewbourne points out that the Commission has accepted in *EPGT*, a recent NGPA section 311 rate case, a matrix that assesses fuel charges according to costs incurred to move gas from each receipt point to each delivery point on the system.[32]

48. Guadalupe responds that *EPGT* is distinguishable. Guadalupe argues that the Commission did not require a particular fuel charge in *EPGT,* but merely approved the fuel matrix proposed by EPGT Texas Pipeline, L.P. (EPGT) itself.[33] Further Guadalupe states that EPGT is 6200 miles long where on the other hand Guadalupe is only 500 miles long and 90 percent of the gas transported on Guadalupe travels the entire length of the pipeline from Waha to Katy. Guadalupe states that Mewbourne's position amounts to no more than a claim that because the Commission approved a distance based methodology in *EPGT*, it should do so here, without regard to the differences between the two systems, the fact that no customer of Guadalupe has ever objected, or that system wide rates have been approved in other cases.

2. Commission Determination

49. The Commission will reject Mewbourne's arguments to require Guadalupe to adopt distance sensitive fuel charges. Since Guadalupe has proposed to continue the existing design of its fuel charge, Mewbourne has the burden of showing that the existing system-wide mechanism is not fair and equitable. Mewbourne has not satisfied that burden. Mewbourne's rationale for its arguments is that because the Commission approved distance sensitive fuel charges on one pipeline, EPGT, it should do so here. However, there are important distinctions between Guadalupe and EGPT. Guadalupe is a 500 mile pipeline with approximately 90 percent of its throughput being transported the entire length of its system from Waha to Katy. EPGT, on the other hand, is a 6200 mile pipeline that includes gathering and transmission lines. In addition, the Commission

[32] *Id*.

[33] *EPGT*, 99 FERC ¶ 61,295 at 62,256.

required EPGT to maintain its distance sensitive base transportation rate methodology in developing it maximum rates in its last rate proceeding.[34] Since EPGT was required to maintain its distance sensitive base transportation rates, it is logical that it should also maintain distance sensitive fuel charges. Here Guadalupe is proposing, and Mewbourne does not oppose, a postage stamp base transportation rate for Guadalupe's system. We see no basis to require Guadalupe to adopt a different rate design for its fuel costs.

E. Unbundling

1. Initial Comments

50. Mewbourne argues that in determining a fair and equitable NGPA section 311 rate for Guadalupe, the Commission should require Guadalupe to unbundle from its cost of service those costs that are properly allocable to functions that are separate from gas transmission, such as gathering costs and costs allocable to the provision of market hub services at Guadalupe's Waha and Katy headers. Mewbourne argues that Guadalupe's NGPA section 311 shippers who bring gas onto Guadalupe's pipeline from off-system sources, and DEFS southeastern New Mexico system producers, like Mewbourne, whose gas sales prices are in some cases calculated by deducting DEFS's transportation costs from DEFS's sales proceeds, should not have to pay for costs more properly allocable to gathering services and/or market hub services. Mewbourne contends that the Commission should require Guadalupe to remove such costs from its transmission cost of service.

2. Reply Comments

51. Guadalupe argues that Mewbourne has not identified costs or services that it thinks are inappropriate for inclusion in Guadalupe's section 311 rates, and that its arguments are merely unsupported conclusory demands. Guadalupe notes that Mewbourne did not cite to any precedent to support its position. Lastly, Guadalupe argues that no Commission policy or any other argument requires unbundling whatever minimal costs are associated with the Waha and Katy Headers.

3. Commission Determination

52. We decline to unbundle any cost or service that is included in Guadalupe's section 311 rates. Mewbourne has failed to specify which particular costs or service should be unbundled or to provide supporting arguments, and has failed to demonstrate that inclusion of any specific cost or service in Guadalupe's rates causes a result that is not fair and equitable. In addition, it is not clear that the costs which Guadalupe has recorded as gathering would be considered gathering costs under the Commission's

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[34] *Id.*

primary function test. Guadalupe states that these costs include an upgrade at the Katy Header compression station, an upgrade to an Emergency Shut Down system, and a delivery point interconnect.[35] Guadalupe states that these items would not be classified as gathering under Commission policy because they are downstream of or interconnected with transmission facilities. On the present record, we have no way of finding that any of these costs constitute gathering costs that are not necessary for the provision of mainline transportation service.

III. Reconsideration of the Settlement and Severance

A. Guadalupe's Request for Rehearing and Initial Comments

53. Guadalupe argues in its request for rehearing of the July 21, 2006 Order and its initial comments that Mewbourne's opposition to the settlement should be disregarded and the Settlement should be reinstated. Guadalupe argues that Mewbourne has no demonstrable interest in the rates that Guadalupe charges because Mewbourne had never transported any gas on Guadalupe. Guadalupe further argues that despite the theoretical possibility that some of Mewbourne's gas could get to Guadalupe if Mewbourne was willing to pay for transportation on intervening pipelines, it has not expressed any interest in shipping its gas on Guadalupe. Guadalupe also argues that Mewbourne has produced no substantive evidence to support its claim that its gas may be transported on Guadalupe by third parties.

54. Guadalupe argues that if the Commission does not reinstate the Settlement, the Commission should sever Mewbourne from the settlement and address Mewbourne separately. Guadalupe argues that the Commission erred in the July 21, 2006 Order when it required that Mewbourne be able to transport all of its production on Guadalupe as a condition for severing Mewbourne's interest from the Settlement. Guadalupe notes that the Commission stated in *Trailblazer I* that "[u]nder the Commission's regulations, if the contesting parties are appropriately severed, then the settlement is treated as an uncontested settlement for the consenting parties, and is reviewed under the fair and

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[35] Guadalupe Initial Comments at Appendix A, p. 5.

equitable standard of Rule 602(g)."[36] Guadalupe argues that the Commission has already found the Settlement to be fair and equitable, and contends that consistent with the rationale in *Trailblazer I* and with the Commission's longstanding policy favoring settlements, the Commission should find that with Mewbourne's interests severed, the Settlement is fair and equitable on the same basis stated in the December 29, 2005 Order.

55. Mewbourne argues that it is inconsistent with established precedent for the Commission to approve a contested settlement and then sever Mewbourne's claims and permit Guadalupe to proceed under the Settlement with other shippers.[37] Mewbourne argues that its arguments concerning, among other things, the discount adjustment and the proposed rate or return on equity, have substantial merit. Mewbourne further argues that because the Settlement as a whole represents a bargain only for Guadalupe, the Commission may not approve it as providing an overall just and reasonable result.

56. Mewbourne further argues that it should not be severed because it has a substantial interest in the transportation rates charged by pipelines its production can readily access. Mewbourne states that its gas, most of which is gathered by the Empire gathering system and delivered to the El Paso interstate pipeline, can access the Waha market hub operated by Guadalupe, where El Paso can deliver up to 500,000 Mcf of gas per day. Mewbourne contends that its interest cannot be characterized as "attenuated" for any purpose.

B. Reply Comments

57. Guadalupe argues that Mewbourne's claims that it has significant quantities of gas that could potentially access Guadalupe's system are insufficient to establish a sufficient interest in this proceeding. Guadalupe asserts that there is no evidence that any of Mewbourne's gas has ever been shipped on Guadalupe. Guadalupe states that Mewbourne is incorrect that its interest in Guadalupe's system is as strong as Amoco's stake was in the *Trailblazer* proceeding. Guadalupe states that Amoco had shipped gas directly and indirectly through its marketers on Trailblazer's system, and contends that Mewbourne has not established any interest in shipping on Guadalupe's system beyond vague claims that it might do so in the future. Guadalupe adds that Mewbourne ignores the fact that in *Trailblazer*, the Commission approved the settlement and determined that Amoco's claims should be severed.

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[36] Guadalupe Request for Rehearing at 8-9 (citing *Trailblazer I*, 88 FERC ¶ 61,168, at 61,564 (1999)).

[37] Mewbourne Initial Brief at 12 (citing *Trailblazer Pipeline Company*, 85 FERC ¶ 61,345 (1998), *order on reh'g*, 87 FERC ¶ 61,110 (1999)).

C. Commission Determination

58. The Commission has an obligation under NGPA section 311 to ensure fair and equitable rates for intrastate pipelines. In addition, in order to approve a settlement, the Commission must find, in its independent judgment, that the settlement is in the public interest, even if the settlement is uncontested.[38] Here, we find that the settlement was not in the public interest, and reject it.

59. The settlement offer would reduce Guadalupe's proposed $0.1906 per MMBtu base transportation rate by about 5 percent to $0.1810. However, in the discussion above, we have found that Guadalupe's rate proposal overstated various components of its cost-of-service. In addition, we have found that Guadalupe's proposed rate design volumes are too low, since Guadalupe included a significant discount adjustment with respect to its affiliate discounts, which it has failed to support. We estimate that, even if we were to accept Guadalupe's proposed ROE, the combined effect of our rulings in this order will reduce Guadalupe's proposed base transportation rate below the settlement rate. It is thus clear that the Settlement's $0.1810 maximum base transportation rate exceeds a fair and equitable level.

60. Guadalupe asserts that we should nevertheless approve the Settlement without regard to Mewbourne's opposition, or at least sever Mewbourne so that the lower rate determined on the merits in this order would only apply to the extent that Mewbourne contracts directly for service on Guadalupe, and all other shippers would be subject to the higher Settlement maximum base transportation rate. Having found on the merits that the Settlement rate is excessive, the Commission sees no reason in the circumstances of this case to approve that rate for any shipper on the Guadalupe system.

61. Guadalupe seeks to have us approve the settlement under one of the two approaches described in *Trailblazer I*[39] which the Commission has held can permit it to approve a settlement, even though the Commission has not found that the settlement satisfies the statutory standard applicable to contested settlements, here the NGPA's fair and equitable standard. Under the first of those approaches, the Commission may approve a settlement "where (1) it determines that the contesting party's interest is

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[38] *Tejas Power Corporation v. FERC*, 908 F.2d 998 (D.C. Cir. 1990). Section 385.602(g) of the Commission's settlement rules provides that the Commission may approve an uncontested settlement upon a finding that the settlement is "fair and reasonable and in the public interest." *See also Petal v. FERC,* 496 F.3d at 701 (holding that "the Commission may adopt an uncontested settlement only after finding it "fair and reasonable and in the public interest"; that is, the Commission has a duty to disapprove uncontested settlements that are unfair, unreasonable or against the public interest").

[39] 85 FERC at 62,343-5.

sufficiently attenuated that the settlement can be analyzed under the fair and reasonable standard applicable to uncontested settlements and (2) the Commission satisfies its *Tejas* obligation to make an independent finding that the settlement benefits the directly affected settling parties."[40] Under the second approach, the Commission would "preserve the settlement for the consenting parties by severing the contesting parties, and approving the settlement as uncontested for the consenting parties. This permits the contesting parties to obtain a litigated result on the merits, while consenting parties receive the benefits of their bargain."[41]

62. The Commission finds that neither of these approaches is appropriate in this case, regardless of the extent of Mewbourne's interest in Guadalupe's rates.[42] The cases where the Commission has used either of these approaches involve situations where the pipeline has negotiated, and agreed to, a settlement directly with at least some of its customers. The settlement thus represents a contract between the pipeline and the settling customers, which is filed for the Commission's approval. In such situations, where the Commission finds that the settlement agreement provides significant benefits to the settling customers, for example by providing rate certainty through a rate moratorium or avoiding significant litigation costs, the Commission may seek to give the consenting customers the benefit of their bargain, either by finding that the contesting parties' affected interests are too attenuated to stand in the way of approving the settlement or by severing the contesting parties for a separate merits decision.

63. However, in the instant case, unlike in *Trailblazer* or subsequent cases following the *Trailblazer* precedent, the underlying settlement is not a contract Guadalupe negotiated with any of its customers. It represents at most an agreement between Guadalupe and Commission staff. In this situation there is no contract to preserve between Guadalupe and its customers. Moreover, we see no basis to make the findings required by *Trailblazer* that approval of the settlement will benefit Guadalupe customers. The settlement does not include any rate moratorium that would provide the customers

[40] *Id*. at 62,343.

[41] *Id*. at 62,344.

[42] The Commission finds that Mewbourne does have at least some interest in Guadalupe's rates. Most of Mewbourne's southeastern New Mexico spot market wells connect at or near the wellhead with the gas gathering facilities of Enterprise Products. Mewbourne's spot market volumes comprise the single largest source of gas per day into the Enterprise system and represent an important part of El Paso's Permian Basin system supply. Once on El Paso's pipeline, Mewbourne's gas can access the Waha market hub operated by Guadalupe. Mewbourne Initial Brief at 13. Also, Mewbourne's primary gas marketer, BP Energy Co., regularly ships gas on El Paso and has become a significant source of gas for Guadalupe's system. *Id*. at 14.

rate certainty. Nor does it enable any customer to minimize litigation costs. All that approving the settlement would appear to accomplish is to approve a maximum base transportation rate for Guadalupe that is significantly in excess of a fair and equitable level. Accordingly, we reaffirm our rejection of the settlement.

The Commission orders:

(A) The request for rehearing is denied.

(B) The Commission establishes a paper hearing on the issue of the composition of the return on equity proxy group, the DCF analysis of the firms included in the proxy group, and related issues of risk, as more fully described herein. The Commission directs interested parties to file initial briefs within 60 days after this order issues. Reply briefs are due 90 days after this order issues and rebuttal briefs 105 days after this order issues. Each party's presentations in its initial, reply, and rebuttal briefs should separately state the facts and arguments advanced by the party and include any and all exhibits, affidavits, and/or prepared testimony upon which the party relies. The statements of facts must include citations to the supporting exhibits, affidavits and/or prepared testimony. All materials must be verified and subscribed as set forth in 18 C.F.R. § 385.2005 (2007).

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.