

123 FERC ¶ 61,058
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.

High Island Offshore System, L.L.C.

Docket No. RP03-221-011

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*,¹ remanding to the Commission two decisions in proceedings pursuant to the Natural Gas Act (NGA) involving issues regarding use of a proxy group, *i.e.*, *High Island Offshore System, L.L.C (HIOS)*² and *Petal Gas Storage, L.L.C (Petal)*.³ Specifically, in *HIOS*, the court remanded to the Commission its decision regarding the composition of the proxy group and the placement of High Island Offshore System, L.L.C. (HIOS) 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.

¹ 496 F. 3d 695 (D.C. Cir. 2007).

² 110 FERC ¶ 61,043 (2005), *order on reh'g*, 112 FERC ¶ 61,050 (2005), *order on reh'g*, 113 FERC ¶ 61,280 (2005).

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

Background

2. In determining just and reasonable rates for pipeline companies, 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, 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 December 31, 2002, HIOS filed revised tariff sheets pursuant to section 4 of the NGA proposing to increase its firm and interruptible transportation rates. On January 30, 2003, the Commission issued an order⁴ accepting and suspending the tariff sheets to be effective July 1, 2003, subject to refund and the outcome of a hearing. A hearing was held before an Administrative Law Judge (ALJ) and the ALJ issued the Initial Decision on April 22, 2004.⁵ The Initial Decision addressed numerous issues regarding HIOS's proposed rates, including the appropriate rate of return for HIOS. In determining the just and reasonable rate of return, the ALJ selected a proxy group to establish a range of returns, and then placed HIOS in the middle of that range.

4. Specifically, the ALJ selected a proxy group consisting of four companies, Kinder Morgan, Inc., Equitable Resources, Inc., National Fuel Gas Company, and Questar Pipeline Company. HIOS filed exceptions to the ALJ's selection of this proxy group, and argued that the three companies other than Kinder Morgan should not be included in the proxy group because they earn more from their LDC operations than from their pipeline operations. HIOS asserted that instead of these companies, the Commission should include four master limited partnerships (MLPs) in the proxy group.⁶

5. In its order on the initial decision, the Commission rejected HIOS's argument. The Commission explained that, historically, it had required that each company included in the proxy group be publicly traded, be recognized as a natural gas pipeline company with its stock tracked by an investment information service, and have pipeline operations

⁴ *High Island Offshore System, L.L.C.*, 102 FERC ¶ 61,088 (2003).

⁵ *High Island Offshore System, L.L.C.*, 107 FERC ¶ 63,019 (2004).

⁶ The four master limited partnerships that HIOS argued should be included in the proxy group are GulfTerra Energy, Kinder Morgan Energy Partners, Northern Border Partners, and Enterprise Products Partners.

constitute a high proportion of the company's business. However, the Commission further explained, in recent years, fewer and fewer companies have met these standards because of mergers, acquisitions, and other changes in the natural gas industry. Therefore, the Commission stated, in *Williston Basin Interstate Pipeline Co.*,⁷ it had relaxed this requirement and approved a proposal to use a proxy group based on the corporations listed in the Value Line Investment survey's list of diversified natural gas firms that own Commission-regulated natural gas pipelines, without regard to what portion of the company's business comprises pipeline operations. The Commission stated that the companies that the ALJ included in the proxy group are all companies listed in the Value Line Group of diversified natural gas companies whose business includes FERC-regulated natural gas pipelines and, thus, the companies are not solely in the distribution business. The Commission stated that these diversified gas companies were the best available proxies on the current record on which to base the Discounted Cash Flow (DCF) analysis.

6. The Commission also rejected, based on the record in this case, HIOS's proposal to include MLPs in the proxy group. The Commission explained that partnerships make distributions to their partners, rather than pay dividends to stockholders.⁸ The Commission further stated that a distribution payment that includes both earnings and a return of investment as an MLP's "dividend" is not comparable to the dividend used by the Commission in its DCF analysis⁹ and would skew the DCF results. Thus, the Commission stated that it would not consider including an MLP in the proxy group unless the record demonstrated that the distribution used as the "dividend" includes only a payment of earnings and not a return of investment. The Commission concluded that the record in this proceeding was inadequate to make that determination. On rehearing, the Commission affirmed its decision.

7. With regard to the appropriate placement of HIOS in the proxy group, the ALJ found that HIOS had not supported an adjustment of its risk level to above average, and placed HIOS at the median of the proxy group, resulting in a return on equity of 11.22 percent. On exceptions, HIOS argued that the ALJ failed to recognize that its

⁷ 104 FERC ¶ 61,036 (2003).

⁸ As the Commission explained, those distributions may include payment to the partners of a share of the partnership's earnings and that to that extent the distribution is comparable to corporate dividend payments. However, the distributions may also include a return of a portion of the partners' original investment, unlike a corporate dividend.

⁹ Under the DCF analysis, return on equity is considered to equal dividend yield (dividends divided by stock price), plus the estimated constant growth in dividends.

business risks are greater than those faced by the companies in the proxy group. The Commission upheld the ALJ's decision. The Commission stated that its risk analysis assumes that pipelines generally fall into a broad range of average risk, absent highly unusual circumstances that indicate an anomalously high or low risk as compared to other pipelines. The Commission found that HIOS had not shown that its business risk exceeds the business risk of the diversified natural gas companies that are in the proxy group. The Commission also stated that HIOS has recovered almost all of its initial investment in the pipeline, and thus has no financial risk. On rehearing, the Commission affirmed these holdings.

8. On review of the Commission's decision in *Petal Gas Storage v. FERC*, the court affirmed the Commission's holdings on various issues not related to HIOS's return on equity.¹⁰ However, the court vacated and remanded the Commission's decision 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 reject the inclusion of MLPs in the proxy group on the ground that they issue distributions rather than dividends and to include gas 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 HIOS. 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.

9. The court further stated that in placing HIOS in the middle of the proxy group in terms of return on equity, the Commission expressly relied on the assumption that pipelines generally fall into a broad range of average risk as compared to other pipelines. However, the court stated, this assumption is decisive only given a proxy group composed of other pipelines. If gas distribution companies generally face lower risk than gas pipelines,¹¹ a risk-appropriate placement would be at the high end of the group. The court stated that the Commission erred by failing to explain how its proxy group arrangements were based on the principle of relative risk.

10. Therefore, the court vacated the Commission's order with respect to the proxy group issue. The court stated that on remand, it did not require any particular proxy group

¹⁰ HIOS argued to the court that the Commission should have approved its settlement in this proceeding, should have selected a faster depreciation rate, and should have awarded HIOS a higher management fee. The court rejected all three claims and upheld the Commission's decision in these issues.

¹¹ The court noted that this seems likely.

arrangement, but stated that the overall arrangement must make sense in terms of the relative risk and in terms of the statutory command to set just and reasonable rates that are commensurate with returns on investments in other enterprises having corresponding risks.

Discussion

11. Since the issuance of the Commission's prior decisions in this proceeding, the circumstances on HIOS have changed, and the rates at issue in this proceeding are no longer in effect on HIOS's system. New rates went into effect on HIOS effective June 1, 2007 pursuant to an uncontested settlement approved by the Commission.¹² Therefore the rates to be resolved in this proceeding were in effect only for a past locked-in period from July 1, 2003 to June 1, 2007.

12. Because of the passage of time since the issuance of the prior orders in this proceeding and the changed circumstances on HIOS, the Commission believes that the parties should be given an opportunity to settle the rate issues for the locked-in period. If the parties are unable to reach a settlement, 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 rate issues for the locked-in period appropriate for settlement. 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. 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 (2007), 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

¹² *High Island Offshore System, L.L.C.*, 120 FERC ¶ 61,150 (2007).

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.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.