ORAL ARGUMENT IS SCHEDULED FOR APRIL 4, 2007

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IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Nos. 04-1166 and 06-1064 (consolidated)

PETAL GAS STORAGE, L.L.C. and
HIGH ISLAND OFFSHORE SYSTEM, L.L.C.,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

ON PETITIONS FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

BRIEF OF RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

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FEBRUARY 15, 2007

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CIRCUIT RULE 28(a)(1) CERTIFICATE

I. Parties and Amici

The parties before this Court are identified in the brief of Petitioners.

II. Rulings Under Review

1. *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005) ("HIOS Rate Order"), JA 1;

2. *High Island Offshore System, L.L.C.*, 112 FERC ¶ 61,050 (2005) ("HIOS Rehearing"), JA 81;

3. *High Island Offshore System, L.L.C.*, 113 FERC ¶ 61,280 (2005), JA 139;

4. *Petal Gas Storage, L.L.C.,* 97 FERC ¶ 61,097 (2001) ("Petal Certificate Order"), JA 151; and

5. *Petal Gas Storage, L.L.C.*, 106 FERC ¶ 61,325 (2004) ("Petal Rehearing"), JA 189.

III. Related Cases

This case has not previously been before this Court or any other court. Counsel is not aware of any other related cases pending before this or any other court.

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Lona T. Perry
Senior Attorney

February 15, 2007

TABLE OF CONTENTS

PAGE

STATEMENT OF THE ISSUES……………………………………………….1

STATUTORY AND REGULATORY PROVISIONS……………………….2

INTRODUCTION………………………………………………………….2

STATEMENT OF THE FACTS……………………………………………..3

I. HIOS FILES UNDER NGA § 4 FOR NEW RATES…….………3

II. THE COMMISSION REJECTS HIOS' PROPOSED SETTLEMENT WITH INDICATED SHIPPERS………………...3

III. THE COMMISSION'S DECISION ON THE MERITS OF HIOS' PROPOSED RATES………………………………………5

A. Depreciation……………………………………..……..5

B. Return on Equity……………………………………………9

1. The Selection of a Proxy Group………………………...9

a. The Commission's Selection of a Proxy Group Including Diversified Natural Gas Companies…..9

b. The Commission's Rejection of HIOS' Alternative Proxy Group Proposal……………….11

2. Placement of HIOS Within the Proxy Group…………..13

C. The Management Fee………………………………………14

IV. PETAL'S RETURN ON EQUITY……………………………….17

TABLE OF CONTENTS

PAGE

SUMMARY OF ARGUMENT……………………………………………20

ARGUMENT……………………………………………………………22

I. STANDARD OF REVIEW……………………………………...22

II. THE COMMISSION REASONABLY REJECTED HIOS' PROPOSED SETTLEMENT AS IT WAS NOT SHOWN TO BE IN THE PUBLIC INTEREST…………………………..23

III. THE COMMISSION REASONABLY ESTIMATED THE AVAILABILITY OF GAS RESERVES IN SETTING HIOS' DEPRECIATION EXPENSE……………………………………28

A. The Commission Reasonably Adopted Staff's Estimate of a 17.5 Year Economic Life……………………………………..31

B. The Commission Reasonably Rejected HIOS' Estimate of a Ten Year Economic Life..……………………………………35

IV. THE COMMISSION REASONABLY SET HIOS' RETURN ON EQUITY….…………………………………………………37

A. The Commission Reasonably Selected HIOS' Proxy Group…37

1. The Commission Reasonably Adopted Staff's Proposed Proxy Group of Diversified Natural Gas Companies With Significant Interstate Pipeline Operations……………………………………………38

2. HIOS Failed to Support Its Alternative Proposal To Include Master Limited Partnerships in the Proxy Group………39

TABLE OF CONTENTS

PAGE

2. The Commission Reasonably Relied On Evidence That Partnership Distributions Can Include a Return of Capital. ………………………………….…47

3. The Commission Consistently Applies Its Proxy Group Policy…………………………………………50

B. The Commission Reasonably Set HIOS' Return at the Median of the Range of Reasonable Returns……..…………54

V. THE COMMISSION REASONABLY SET HIOS' MANAGEMENT FEE…………………………………………56

VI. THE COMMISSION REASONABLY SET PETAL'S RETURN ON EQUITY………………………………………..63

CONCLUSION…………………………………………………………..67

TABLE OF AUTHORITIES

PAGE

COURT CASES:

B&J Oil and Gas v. FERC,
353 F.3d 71 (D.C. Cir. 2004) ……………………………………………35

City of Orrville, Ohio v. FERC,
147 F.3d 979 (D.C. Cir. 1998)……………………………………………65

California Public Utilities Comm'n v. FERC,
254 F.3d 250 (D.C. Cir. 2001)……………………………………………23

Deaf Smith County Grain Processors, Inc. v. Glickman,
162 F.3d 1206 (D.C. Cir. 1998)……………………………………….22

Florida Municipal Power Agency v. FERC,
315 F.3d 362 (D.C. Cir. 2003)………………………………….……..22

FLP Energy Me. Hydro LLC v. FERC,
287 F.3d 1151 (D.C. Cir. 2002)……………………………….………22

Memphis Light, Gas and Water Division v. FPC,
504 F.2d 225 (D.C. Cir. 1974)……………………………………………33

Mobil Oil Corp. v. FPC,
417 U.S. 283 (1974)…………………………………………………………24

NORAM Gas Transmission Co. v. FERC,
148 F.3d 1158 (D.C. Cir. 1998)………………………………………..24

Oxy USA v. FERC,
64 F.3d 679 (D.C. Cir. 1995)…………………………………………….22

Pennsylvania Office of Consumer Advocate v. FERC,
131 F.3d 182 (D.C. Cir. 1997)……………………………………………22

---

* Cases chiefly relied upon are marked with an asterisk.

TABLE OF AUTHORITIES

PAGE

COURT CASES: (con't)

Platte River Whooping Crane Critical Habitat Trust v. FERC,
876 F.2d 109 (D.C. Cir. 1989)……………………………………65

Sithe/Independent Power Partners, L.P. v. FERC,
165 F.3d 944 (D.C. Cir. 1999)……………………………………23

**South Dakota Public Utilities Commission v. FERC,*
668 F.2d 333 (8th Cir. 1981)…..……………………………………7, 9, 23

Tejas Power Corp. v. FERC,
908 F.2d 998 (D.C. Cir. 1990)……..………………………………25

Town of Norwood v. FERC,
962 F.2d 20 (D.C. Cir. 1992)………..………………………………23

Transcontinental Gas Pipe Line Corp. v. FERC,
54 F.3d 893 (D.C. Cir. 1995)……………………………………….22

Wisconsin Valley Improvement Co. v. FERC,
236 F.3d 738 (D.C. Cir. 2001)……………………………………23,36

ADMINISTRATIVE CASES:

Enbridge Pipelines (Kansas Pipeline Company),
100 FERC ¶ 61,260 (2002)………………………………………43, 47

EPGT Texas Pipeline L.P.,
99 FERC ¶ 61,295 (2002)……………………………………………43

Entrega Gas Pipeline, Inc.,
113 FERC ¶ 61,327 (2005) ………………………………………….65

Georgia Strait Crossing Pipeline LP,
98 FERC ¶ 61,271 (2002)……………………………………………66

Gulfstream Natural Gas System, L.L.C.,
105 FERC ¶ 61,052 (2003)…………………………………………..66

TABLE OF AUTHORITIES

PAGE

ADMINISTRATIVE CASES: (con't)

High Island Offshore System, L.L.C.,
107 FERC ¶ 63,019 (2004)…………………………..3, 5-9, 24, 28-30, 35-36, 41-42, 49

High Island Offshore System, L.L.C.,
110 FERC ¶ 61,043 (2005) ……………………………2, 4-19, 23-33, 35-39, 42-50, 53-62

High Island Offshore System, L.L.C.,
112 FERC ¶ 61,050 (2005) ………………………2, 4-19, 24-28, 31-46, 48-50, 53-54, 56-62

**Kern River Gas Transmission Co.,*
117 FERC ¶ 61,077 (2006), *reh'g pending*………………46, 52-53, 55

Mountain Fuel, Inc.,
28 FERC ¶ 61,196 (1984)…………………………………………43

North Baja Pipeline, LCC,
95 FERC ¶ 61,259 (2001)…………………………………………66

Petal Gas Storage, L.L.C.,
97 FERC ¶ 61,097 (2001).…………………………………………2

Petal Gas Storage, L.L.C.,
106 FERC ¶ 61,325 (2004) ……………………….,,,3, 9, 17-19, 63-66

SFPP, L.P.,
86 FERC ¶ 61,022 (1999)……………………………………..…..50

SFPP, L.P.,
113 FERC ¶ 61,277 (2005)……………………………………..….50

Stingray Pipeline Co.,
101 FERC ¶ 61,365 (2002) ……………………………………27-28

TABLE OF AUTHORITIES

PAGE

ADMINISTRATIVE CASES: (con't)

**Tarpon Transmission Co.,*
57 FERC ¶ 61,371 (1991)………………………14-15, 17, 56, 58, 60-62

**Texaco Refining and Marketing, Inc. v. SFPP, L.P.*,
117 FERC ¶ 61,285 (2006) ………………………………………...51

Trailblazer Pipeline Co.,
106 FERC ¶ 63,005 (2004)…………………………………………43

Trailblazer Pipeline Co.,
107 FERC ¶ 61,008 (2004)…………………………………………43

Trunkline Gas Company,
90 FERC ¶ 61,017 (2000) …………………………………………..37

Williston Basin Interstate Pipeline Co.,
87 FERC ¶ 61,264 (1999)…………………………………………..43

**Williston Basin Interstate Pipeline Co.,*
104 FERC ¶ 61,036 (2003)……………………..9-10, 18, 38-39, 64, 66

Wyoming Interstate Co., Ltd.,
96 FERC ¶ 63,040 (2001)…………………………………………..43

Wyoming Interstate Co., Ltd.,
101 FERC ¶ 61,343 (2002)…………………………………………43

STATUTES:

Natural Gas Act

Section 4, 15 U.S.C. § 717c………………………………………3

Section 19(b), 15 U.S.C. § 717r(b)...……………………………22, 64

TABLE OF AUTHORITIES

PAGE

REGULATIONS:

18 C.F.R. Part 201, Definition 12.B..…………………………….5

18 C.F.R. § 385.102………………………………………………4

18 C.F.R. § 385.602…….……………………………………4, 24-26

18 C.F.R. § 385.711…….……..…………………………………49

GLOSSARY

ALJ	Administrative Law Judge
FERC	Federal Energy Regulatory Commission
HIOS ALJ Order	*High Island Offshore System, L.L.C.,* 107 FERC ¶ 63,019 (2004)
HIOS Rate Order	*High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005)
HIOS Rehearing	*High Island Offshore System, L.L.C.*, 112 FERC ¶ 61,050 (2005)
NGA	Natural Gas Act
Petal Certificate Order	*Petal Gas Storage, L.L.C.,* 97 FERC ¶ 61,097 (2001)
Petal Rehearing	*Petal Gas Storage, L.L.C.*, 106 FERC ¶ 61,325 (2004)
Petitioners	Petitioners High Island Offshore System L.L.C. and Petal Gas Storage L.L.C.

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Nos. 04-1166 and 06-1064
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PETAL GAS STORAGE, L.L.C. and
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v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

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ON PETITIONS FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

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BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION

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STATEMENT OF THE ISSUES

1. Whether the Commission reasonably rejected the rate case settlement proposed by High Island Offshore System, L.L.C. (“HIOS”), where the settlement rates were substantially in excess of just and reasonable rates, and participating shippers would receive a special payment while non-participating shippers would be denied refunds for the period they paid rates in excess of the settlement rates.

2. Whether the Commission reasonably set HIOS' return on equity, management fee and depreciation allowance upon finding that HIOS had low financial and business risks and had ample access to abundant sources of new reserves in the Gulf of Mexico.

3. Whether the Commission reasonably set the return on equity for Petal Gas Storage, L.L.C. ("Petal") upon finding that Petal's business and financial risks similarly failed to justify the higher return on equity sought.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

INTRODUCTION

This matter concerns consolidated appeals of two natural gas pipeline rate-making proceedings. One set of challenged orders, *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005) ("HIOS Rate Order"), JA 1, *on reh'g*, 112 FERC ¶ 61,050 (2005) ("HIOS Rehearing"), JA 81, concerns Commission determinations weighing methodologies and evidence in setting rates on HIOS for firm and interruptible service, following the Commission's rejection of a proposed rate settlement that the Commission found had not been demonstrated to be in the public interest. The other set of challenged orders, *Petal Gas Storage, L.L.C.,* 97 FERC ¶ 61,097 (2001) ("Petal Certificate Order"), JA 151, *on reh'g*, 106 FERC ¶ 61,325

(2004) (“Petal Rehearing”), JA 189, concerns the determination of the return on equity to be applied in setting initial recourse rates for new facilities and service on Petal.

STATEMENT OF FACTS

I. HIOS FILES UNDER NATURAL GAS ACT § 4 FOR NEW RATES.

On December 31, 2002, HIOS filed revised tariff sheets proposing to increase its rates pursuant to § 4 of the Natural Gas Act, 15 U.S.C. § 717c. HIOS Rate Order P 5 & n. 4, JA 2. HIOS proposed to increase its rates for both firm and interruptible service from 12.44 cents per dekatherm to 16.16 cents for firm service and 17.59 cents for interruptible service. *Id.* P 6, JA 3.

On January 30, 2003, the Commission accepted and suspended the tariff sheets, subject to refund and the outcome of a hearing. *Id.* P 9, JA 3. On April 22, 2004, the Administrative Law Judge (“ALJ”) issued an Initial Decision setting a just and reasonable rate of 8.56 cents for both firm and interruptible service. *Id.* *See High Island Offshore System, L.L.C.*, 107 FERC ¶ 63,019 (2004) (“HIOS ALJ Order”), JA 200.

II. THE COMMISSION REJECTS HIOS’ PROPOSED SETTLEMENT WITH INDICATED SHIPPERS.

Following the ALJ’s determination, on August 5, 2004, HIOS submitted an offer of settlement supported by Indicated Shippers: BP Exploration & Production, Inc., Chevron Texaco Exploration and Production Company and Shell Offshore,

Inc. HIOS Rate Order P 10, JA 4. Under the settlement, HIOS would prospectively return its rates to their pre-existing level, 12.44 cents, and pay Indicated Shippers $3 million. *Id.* HIOS would make no refunds for the period during which the 16.16/17.59 cent rates were in effect. *Id.*

The settlement was contested by a firm shipper, ExxonMobil, and by Commission Staff. *Id.* Notwithstanding this opposition, HIOS contended that the settlement should be treated as uncontested because: (1) ExxonMobil pays a negotiated rate for its firm service and thus would be unaffected by the settlement rate for firm service; and (2) Commission Staff is only a participant in the rate proceeding, not a party.[1] *Id.* PP 19-20, JA 7.

The Commission determined that, even if the settlement were treated as uncontested, HIOS had not shown the settlement to be fair and reasonable and in the public interest, and thus did not satisfy the 18 C.F.R. § 385.602(g)(3) standard for approval of uncontested settlements. *Id.* PP 25, 31, JA 9, 11. The proposed settlement rates were substantially in excess of just and reasonable rates. *Id.* P 32, JA 11. Further, under the settlement, Indicated Shippers would receive special consideration of $3 million. *Id.* P 33, JA 12; HIOS Rehearing P 7, JA 84. Inactive parties, on the other hand, would receive no refunds for the period of about a year and half when HIOS' proposed new rates of 16.16/17.45 cents were in effect. *Id.*

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[1] Under 18 C.F.R. § 385.102(b)(2), FERC Staff is a "participant," not a "party," in proceedings set for hearing. HIOS Rate Order P 27, JA 9.

Staff estimated that the refunds would equal $15.6 million. HIOS Rate Order P 16, JA 5.

When the Commission approves an uncontested settlement, the Commission relies in part on the fact that the interests of active parties in the case generally are similar to the interests of inactive parties and consumers. *Id*. P 33, JA 12; HIOS Rehearing P 7, JA 84. Here, Indicated Shippers' demand for greater benefits than the settlement provided HIOS' other customers undercut any assumption that the Indicated Shippers were acting in the interest of other affected parties and consumers. HIOS Rate Order P 33 n. 15, JA 12; HIOS Rehearing P 17, JA 87. In these circumstances, the fact that Indicated Shippers were the only active litigants did not support this disparate treatment. HIOS Rehearing P 17, JA 87.[2]

III. THE COMMISSION'S DECISION ON THE MERITS OF HIOS' PROPOSED RATES.

A. Depreciation

Under the Commission's Uniform System of Accounts, depreciation includes "the exhaustion of natural resources." HIOS ALJ Order P 38, JA 210 (quoting 18 C.F.R. Part 201, Definition 12.B). The amount of the natural resource (gas) available to HIOS affects its economic life of production. *Id.* P 39, JA 210.

[2] The Commission did not consider approving the settlement for Indicated Shippers and severing the other parties because HIOS stated that such severance would constitute an unacceptable modification of the settlement. *Id*.

Accordingly, the depreciation expense for HIOS' facilities is determined by estimating the amount of gas reserves that will flow through HIOS in the future. *Id.* P 39, JA 210. The expert witnesses reached similar conclusions regarding the length of time existing wells connected to HIOS could be expected to produce gas. *Id.* P 42, JA 211. The experts differed widely, however, on the amount of additional gas reserves HIOS could potentially access in the future. *Id*. P 43, JA 211.

HIOS' facilities, consisting of over 200 miles of pipeline, are located mostly in the High Island area in the Gulf of Mexico. Exh. S-4, R. 355 at 10, JA 443. *See* Exh. S-5, R. 356, Schedule No. 3 (map), JA 467. HIOS receives gas mainly from the High Island area, but also from the East Breaks and West Cameron areas. Exh. S-4, R. 355 at 10, JA 443.

FERC Staff's expert, Mr. Pewterbaugh, determined HIOS had a 17.5-year life remaining as of June 30, 2003, the end of the test period. HOIS Rate Order P 63, JA 21 (citing Exh. S-4, R. 355, JA 433). Mr. Pewterbaugh used the Mineral Management Service's Western Planning Area of the Gulf of Mexico to represent the total area from which HIOS may receive throughput. HIOS Rate Order P 65, JA 22 (citing Exhs. S-4, R. 355, JA 433, and S-14, R. 365, JA 483); HIOS ALJ Order P 46, JA 212. *See* Exh. S-5, R. 356, Schedule No. 3 (map), JA 467.

Mr. Pewterbaugh obtained information on future resources from the Potential Gas Committee, an independent source of estimated levels of undiscovered gas,

Exh. S-4, R. 355 at 16-17, JA 449-50, and one of the most respected analysts in the natural gas industry. *South Dakota Public Utilities Commission v. FERC*, 668 F.2d 333, 344 (8th Cir. 1981). The Potential Gas Committee model utilizes factual regional data to estimate the potential supply to be found by wells expected to be drilled in the future. *Id.* at 338.

HIOS' expert, Mr. Jenkins, estimated a remaining economic life of the HIOS pipeline of ten years as of June 30, 2003. HOIS Rate Order P 63, JA 21 (citing Exh. HIO-76, R. 239, JA 385). In reaching this conclusion, he projected gas volumes from existing shallow and deepwater wells connected to HIOS, future completions in the shallow-water area, and deepwater wells expected to be completed and which may be connected to HIOS in the future. Exh. HIOS-76, R. 239 at 3, JA 387. The deepwater future volumes were derived from a proprietary El Paso data base. HIOS ALJ Order P 44, JA 211 (quoting Exh. HIO-76, R. 239 at 7, JA 391).

The Commission rejected HIOS' study as unpersuasive and unreasonable. HIOS Rate Order P 78, JA 26; HIOS Rehearing PP 31, 36, JA 91, 93. While the Potential Gas Committee provided a transparent and non-proprietary objective analysis of future reserves, the proprietary El Paso database used by HIOS was based on information that was not offered by HIOS and was not supported by the record. HIOS Rehearing P 36, JA 93; HIOS Rate Order P 68, JA 23; HIOS ALJ Order P 76, JA 219. The study moreover erroneously excluded potential production

from deep gas in the shallow Outer Continental Shelf waters and unleased prospects in the Gulf of Mexico that are not currently active or have not yet been discovered. HIOS Rehearing P 36, JA 93.

The Commission adopted Staff's recommended remaining life of 17.5 years based on Mr. Pewterbaugh's reserve study. HIOS Rate Order PP 67, 74, JA 23, 25; HIOS Rehearing P 27, JA 90. The record supported a reserve life based on the entire Western Planning Area. HIOS Rate Order P 75, JA 25. Although Mr. Jenkins claimed that the Western Planning Area was too large, *id*. P 77, JA 26, HIOS was receiving, or had the potential to receive, gas from approximately two-thirds of the Western Planning Area. *Id*.; HIOS Rehearing P 31, JA 91. In addition, as HIOS conceded, HIOS either actually accessed or could access gas supplies in each region of the Western Planning Area. HIOS Rate Order P 77, JA 26 (citing Exh. S-4, R. 355 at 16, 20, JA 449, 453).

Finally, the record showed that that the demand for gas is expected to rise from 22.3 trillion Btu in the year 1999 to 32.498 trillion Btu in the year 2020. HIOS Rate Order P 77, JA 26; HIOS Rehearing P 31, JA 91 (citing Exh. S-4, R. 355 at 26, JA 459). Rapid growth in demand for gas will cause producers increasingly to turn to Gulf Coast reserves to supply surging demand, and the higher prices will bring new sources of supply as higher-cost sources become economical. HIOS Rate Order P 68, JA 23; HIOS ALJ Order P 63, JA 216.

B. Return on Equity

Under long-standing Commission policy, the return on equity for gas pipelines is derived by use of a proxy group to set a range of reasonable returns. *See*, *e.g.*, Petal Rehearing P 25, JA 196. The Commission applied this approach in calculating HIOS' return on equity. HIOS challenged both the Commission's choice of proxy group, and the Commission's placement of HIOS at the median of that group. The Commission rejected both objections.

1. The Selection of a Proxy Group

a. The Commission's Selection of a Proxy Group Including Diversified Natural Gas Companies

Historically, the Commission has required that each company included in a gas pipeline proxy group be publicly traded, be recognized as a natural gas pipeline company with stock tracked by an investment information service, and have pipeline operations that constitute a high proportion of the company's business. HIOS Rehearing P 50, JA 98; HIOS Rate Order P 117, JA 40.

However, in recent years fewer and fewer companies meet these standards, because of mergers, acquisitions, and other changes in the natural gas industry. *Id*. In *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 at P 35 (2003), the Commission found that only three companies remained that met the Commission's traditional standards for inclusion in the proxy group. HIOS Rehearing P 50, JA 98; HIOS Rate Order P 117, JA 40. As a proxy group of three is too small, the

Commission approved using a proxy group based on nine companies listed in the Value Line Investment Survey's group of diversified natural gas companies that own Commission-regulated natural gas pipelines. *Id.*

The proxy group adopted here was based upon the same nine-member proxy group approved in *Williston Basin*, but eliminated five companies no longer appropriate for inclusion. HIOS Rehearing P 51, JA 98; HIOS Rate Order P 118, JA 41. HIOS agreed that one company selected, Kinder Morgan, Inc., should be included in the proxy group. *Id.* HIOS contested inclusion of the remaining three companies because a substantial portion of their business was gas distribution service. *Id.*

The Commission rejected this objection because, while the three companies did have distribution functions, they were not solely in the distribution business. HIOS Rehearing P 52, JA 99; HIOS Rate Order P 131, JA 46. Rather, all were listed in the Value Line Group of diversified natural gas companies whose business includes FERC-regulated natural gas pipelines. *Id.* While pipeline operations were not as high a percentage of the operations of these companies as the Commission historically had required, the Commission had no choice but to depart from its historical standards given that only one corporation (Kinder Morgan) continued to meet those standards. HIOS Rehearing PP 56-57, JA 100-01.

HIOS argued that the diversified natural gas companies have lower risk than HIOS given their operations in non-competitive franchised service territories. HIOS Rehearing P 59, JA 101. The Commission also rejected this claim because a substantial portion of each company's business involved operating natural gas pipelines subject to Commission jurisdiction. *Id.* (citing Exh. S-11, R. 362 at 11, JA 474; Exh. HIO-139, R. 302 at 2, JA 421). Further, these companies' business involving franchised service territories was not significantly less competitive than HIOS' transportation business. *Id.* (citing Exhs. S-11, R. 362 at 15, JA 475; Exh. IND-1, R. 314 at 12, JA 422). Virtually all of the gas moving on HIOS was captive to the system and has no direct alterative means of transportation. *Id.*

b. The Commission's Rejection of HIOS' Alternative Proxy Group Proposal

In lieu of the three challenged diversified natural gas companies, HIOS proposed including four pipeline master limited partnerships in the proxy group. HIOS Rate Order P 119, JA 41. The Commission recognized that, in theory, it might be appropriate to compare HIOS, a limited liability company owned by a master limited partnership, with other master limited partnerships whose business is made up primarily of pipeline operations. HIOS Rehearing P 53, JA 99; HIOS Rate Order P 125, JA 43. However, the Commission had never used a master limited partnership in a natural gas pipeline proxy group. HIOS Rehearing P 50, JA 98. Accordingly, before the Commission could consider including a master limited

partnership, the record would have to contain reliable financial data, comparable to that for corporations, that would permit the Commission to determine a return on equity for the master limited partnership under the discounted cash flow methodology. *Id*.

Under the discounted cash flow methodology, return on equity equals dividend yield (dividends divided by stock price), plus the estimated constant growth in dividends. *Id*. However, partnerships make distributions to their partners, rather than pay dividends. HIOS Rehearing P 54, JA 99; HIOS Rate Order P 126, JA 43. Those distributions may include a share of the partnership's earnings, and, to that extent, the distribution may be comparable to a dividend. *Id*. However, unlike a dividend, distributions may also include a return of a portion of the partners' original investment. HIOS Rate Order P 126, JA 43 (citing Exh. IND-17, R. 330 at 4, JA 427). Use of a distribution payment that includes both earnings and a return of investment in the discounted cash flow analysis would skew the results, since the dividend yield would appear higher than it actually was. *Id*. Thus, the Commission would only consider including a master limited partnership in the proxy group if the record demonstrated that the distribution used as the "dividend" includes only a payment of earnings and not a return of investment. *Id*.

HIOS submitted evidence at hearing that purported to show each master limited partnership's annual dividend payments. *Id*. P 126, JA 44 (citing Exh. HIO-

135, R. 298, JA 418). However, it was not clear from that evidence that the "dividend" figures were comparable to the dividends used in the discounted cash flow analysis. HIOS Rehearing P 54, JA 99; HIOS Rate Order P 126, JA 44. The claimed dividend yields for the master limited partnerships were twice the yields of natural gas companies. HIOS Rate Order P 127, JA 44. Nothing in the record indicated whether the claimed dividend yields represented only payment of earnings or also included a return of investment. *Id.* Consequently, the Commission found that HIOS had not satisfied its burden under NGA § 4 to justify including master limited partnerships in the proxy group. *Id.*

2. Placement of HIOS Within the Proxy Group

In setting a pipeline's rate of return based upon a proxy group, the Commission assumes that the pipeline falls within a broad range of average risk, absent highly unusual circumstances. HIOS Rate Order P 154, JA 54. While parties may present evidence to support any return on equity within the zone of reasonableness, it is difficult for the Commission to make carefully calibrated adjustments to reflect the generally subtle differences in risk among pipelines. *Id.* Accordingly, unless a party makes a very persuasive case for an adjustment, the Commission sets the pipeline's return at the median of the range of reasonable returns. *Id.*

The Commission rejected HIOS' contention that it should have been placed at the higher end of the proxy group range. HIOS Rate Order P 158, JA 55; HIOS Rehearing PP 69, 70, JA 106. HIOS' financial risk is low as HIOS had recovered almost all of its initial pipeline investment, in comparison to the diversified natural gas companies in the proxy group, none of whom had recovered their investment. *Id*. HIOS' business risk was similarly low because its throughput, though largely interruptible, was shipped by captive shippers with no reasonable alternatives to move their product to market. *Id*. HIOS failed to show that its business risk exceeded that of the proxy group companies, all of whom have significant interstate pipeline business. *Id*.

C. The Management Fee

An ordinary pipeline rate case generally includes a return on the pipeline's rate base. HIOS Rate Order P 80, JA 27. However, here, HIOS had recovered essentially all of its investment in plant, and therefore had a negative rate base. *Id*. This raised the issue of calculating a management fee to be paid in lieu of the return on net rate base. *Id*.

In *Tarpon Transmission Co.,* 57 FERC ¶ 61,371 (1991), the Commission calculated the management fee of a pipeline with a negative rate base by applying the cost of capital to ten percent of the pipeline's historical average rate base. HIOS

Rate Order P 83, JA 28. Following *Tarpon*, the ALJ awarded HIOS a management fee of $680,802.[3] *Id*. P 84, JA 28.

HIOS argued that the *Tarpon* methodology was not appropriate here because it used the average rate base over the life of the pipeline. *Id*. P 100, JA 33. Tarpon's depreciation was constant over time, whereas HIOS had accelerated depreciation early in the project that skewed the average rate base. *Id*.

HIOS' own witness, Mr. Porter, computed an average rate base over the life of the project of $180 million, assuming that the depreciation occurred evenly over the project's life, as in *Tarpon*. HIOS Rate Order PP 113, 115, JA 38, 39 (citing Exh. HIO-64, R. 227 at 15, JA 375). Because of HIOS' unusual depreciation history, the Commission adopted the $180 million figure for the average historical rate base. *Id*. PP 105, 114, JA 35, 39. Using this figure, the Commission increased HIOS' management fee to $1,734,008. HIOS Rehearing P 72, JA 107.

HIOS maintained that this management fee was still too low, and proposed a "floor" to the rate base of twenty percent of HIOS' gross plant. HIOS Rate Order P 96, JA 32; HIO-64, R. 227 at 16, JA 376 (citing Exh. HIO-67, R. 230, JA 383). Twenty percent of HIOS' $385.5 million investment in plant was $77 million,

[3] HIOS' average rate base for the relevant period was $54,691,713. Ten percent of that figure is $5,469,171, which, multiplied by a 12.448 percent pretax rate of return, resulted in a total management fee of $680,802. *Id.*

which, multiplied by HIOS' proposed overall return of 12.08 percent, would produce a management fee of $9.3 million. HIOS Rate Order P 98, JA 33.

The Commission found that HIOS failed to show that the $9.3 million fee was just and reasonable, as it would amount to nearly one-third of HIOS' cost-of-service, and generate a margin of nearly fifty percent over HIOS' operating expenses. *Id*. PP 105, 108, JA 35, 36; HIOS Rehearing PP 73-74, JA 107.

HIOS argued, in the alternative, that the Commission should create a hypothetical positive rate base by either excluding supplemental depreciation or amortizing it over HIOS' service life. HIOS Rehearing P 47, JA 97; HIOS Request for Rehearing at 50, R. 115, JA 338 (citing Exh. HIO-92, R. 255, JA 402); Exh. HIO-91, R. 254 at 5, JA 401. HIOS witness Mr. Porter calculated that this would produce current positive net rate bases of $33 and $31 million, on which Mr. Porter calculated traditional returns of $3.2 million and $2.9 million, respectively. HIOS Rehearing P 47, JA 97 (citing Exhs. HIO-92, R. 255, JA 402; HIO-91, R. 254 at 5, JA 401).

The Commission rejected Mr. Porter's alternative proposals as inconsistent with *Tarpon*. *Id*. P 48, JA 97. The *Tarpon* methodology generates a management fee for a company which currently has a negative rate base, based on its actual average historical rate base during the period before its rate base became negative.

Id. Mr. Porter's alternative proposals instead would create a hypothetical current positive rate base, and thus would be inconsistent with *Tarpon*. *Id*.

Under *Tarpon*, a management fee should compensate the owners of the pipeline with a negative rate base for the risks of continuing to operate the pipeline. HISO Rate Order P 106, JA 35 (citing *Tarpon*, 57 FERC at 62,240). The Commission found the management fee it approved fully adequate for this purpose, given HIOS' low risks. *Id*. P 107, JA 36; HIOS Rehearing P 79, JA 109. HIOS, on the other hand, failed to show that the approved management fee was insufficient. HIOS Rate Order P 108, JA 36; HIOS Rehearing P 80, JA 109.

IV. PETAL'S RETURN ON EQUITY

On January 23, 2001, Petal filed an application for authority to construct pipeline and related facilities connecting an existing Petal storage facility to a Southern Natural Gas Company compressor station. Petal Rehearing P 4, JA 190; Petal Request for Rehearing, R. 46 at 3, JA 265. Petal proposed charging initial recourse rates based upon a fifteen percent return on equity, determined by reference to its parent, El Paso Energy, for which Petal calculated a 16.73 return on equity. Petal Rehearing P 23, JA 195.

The Commission rejected Petal's proposal because Petal's parent is engaged in many non-pipeline operations and Petal had not demonstrated that its risks are similar to that of its parent. *Id*. P 24, JA 196. Moreover, the Commission's long-

standing policy is to derive gas pipeline returns on equity by use of a proxy group. *Id*. P 25, JA 196. The Commission found this approach appropriate here. In reliance on the *Williston Basin* proxy group, the Commission found a range of equity returns from a low of 9.82 percent to a high of 13.76 percent, and approved a 12.48 percent return on equity at the median of the range. *Id*. P 27, JA 197.

Petal challenged the decision to place it at the median of the proxy group, contending that gas pipelines have higher risks than distribution companies. Petal Request for Rehearing, R. 46 at 13, JA 274. However, the Commission assumes that existing pipelines fall into a broad range of average risk, absent highly unusual circumstances. Petal Rehearing P 29, JA 197. Here, Petal did not make a sufficient showing that it is outside the broad range of average risk. *Id*. Petal is not a new entrant to the gas business; rather, it is an existing jurisdictional corporate entity engaged in providing jurisdictional storage services. *Id.* Constructing a new pipeline to transport gas from the Petal storage facilities to Southern's pipeline interconnection is simply an expansion of its existing jurisdictional business. *Id.*

Moreover, Petal proposed financing the pipeline internally through its parent, El Paso Energy, using a 50/50 debt/equity capitalization. *Id*. A review of the average capital structure of the *Williston Basin* proxy group shows it is comparable to Petal's capital structure, *i.e.*, 50/50 debt/equity capitalization. *Id*. This contrasts with highly leveraged, project-financed pipelines, where the Commission has

approved equity returns of up to 14 percent. *Id*. P 29 n. 21, JA 198. Under these circumstances, the Commission found Petal to be overall an average risk pipeline. *Id*. P 29, JA 198. Consequently, the Commission found Petal had not justified placement at the upper-end of the range. *Id*. P 30, JA 198.

SUMMARY OF ARGUMENT

HIOS

The Commission appropriately rejected HIOS' proposed rate case settlement, finding that HIOS had not shown the settlement to be fair and reasonable and in the public interest. The proposed settlement rates were significantly in excess of just and reasonable rates. Further, under the settlement, Indicated Shippers would receive special consideration of $3 million, while all non-participating shippers would receive no refunds for the period during which HIOS' proposed 16.16/17.59 cent rates were in effect.

On the merits of HIOS' rate proposal, the Commission found a rate of 9.2 cents to be just and reasonable. The Commission's determinations with regard to HIOS' cost of service issues, specifically the depreciation allowance, the return on equity and the management fee, all turned on the Commission's reasonable exercise of its discretion to choose between competing expert opinions and proposed methodologies, and to weigh proffered evidence, in reaching a conclusion on complex issues of rate-making and design. As the determinations made by the Commission were reasonable, no basis exists for overturning the Commission's decision in favor of competing opinions or methodologies, as HIOS urges.

Petal

The Commission reasonably rejected Petal's proposed equity return, determined by reference to its parent, because Petal's parent engages in many non-pipeline operations and Petal had not demonstrated that it and its parent have similar risks.

Moreover, the Commission's long-standing policy is to use a proxy group to derive the return on equity for gas pipelines. Accordingly, the Commission appropriately relied on a proxy group of diversified natural gas companies used in prior Commission orders to set Petal's return on equity. The Commission also reasonably placed Petal at the median of the proxy group returns because Petal failed to make a sufficient showing that it was outside the broad range of average risk.

ARGUMENT

I. STANDARD OF REVIEW

The Court must uphold FERC's orders unless they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Transcontinental Gas Pipe Line Corp. v. FERC*, 54 F.3d 893, 898 (D.C. Cir. 1995). Under the arbitrary and capricious standard, the Commission's action need only be *a* reasonable, not the best or most reasonable, decision. *Deaf Smith County Grain Processors, Inc. v. Glickman*, 162 F.3d 1206, 1215 (D.C. Cir. 1998). *See also Oxy, USA v. FERC*, 64 F.3d 679, 692 (D.C. Cir. 1995) (the Commission may approve a methodology if it is just and reasonable; it need not be the only reasonable methodology, or even the most accurate). Judicial scrutiny under the NGA is limited to assuring that the Commission's decisionmaking is reasoned, principled, and based upon the record. *Pennsylvania Office of Consumer Advocate v. FERC*, 131 F.3d 182, 185 (D.C. Cir. 1997). The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. NGA § 19(b), 15 U.S.C. § 717r(b).

The substantial evidence standard "'requires more than a scintilla, but can be satisfied by something less than a preponderance of the evidence.'" *Florida Municipal Power Agency v. FERC*, 315 F.3d 362, 365 (D.C. Cir. 2003) (quoting *FLP Energy Me. Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002)).

Under the substantial evidence standard, the relevant question is not whether record evidence supports petitioners' version of events, but whether it supports the Commission's conclusions. *Id.* at 368. The Commission's choice between "disputing expert witnesses" is entitled to deference. *Wisconsin Valley Improvement Co. v. FERC*, 236 F.3d 738, 746-47 (D.C. Cir. 2001).

"Because 'issues of rate design are fairly technical, and, insofar as they are not technical, involve policy judgments that lie at the core of the regulatory mission,' [the Court's] review of whether a particular rate design is 'just and reasonable' is highly deferential." *California Public Utilities Comm'n v. FERC*, 254 F.3d 250, 254 (D.C. Cir. 2001) (quoting *Sithe/Independence Power Partners, L.P. v. FERC*, 165 F.3d 944, 948 (D.C. Cir. 1999) and *Town of Norwood v. FERC*, 962 F.2d 20, 22 (D.C. Cir. 1992)).

II. THE COMMISSION REASONABLY REJECTED HIOS' PROPOSED SETTLEMENT AS IT WAS NOT SHOWN TO BE IN THE PUBLIC INTEREST.

In its December 31, 2002 rate filing, HIOS proposed to increase its rates from 12.44 cents to 16.16 cents for firm service and to 17.59 cents for interruptible service. HIOS Rate Order P 6, JA 3. The Commission accepted and suspended the tariff sheets subject to refund and set the proposed rates for hearing. *Id*. P 9, JA 3. In an Initial Decision issued on April 22, 2004, the ALJ determined that the just and

reasonable rate for both firm and interruptible service was 8.56 cents. *Id.* *See* HIOS ALJ Order, 107 FERC ¶ 63,019, JA 200.

Following the ALJ's decision, HIOS submitted an offer of settlement, supported by Indicated Shippers. HIOS Rate Order PP 10, 16, JA 4, 5. Under the proposed settlement, HIOS would pay $3 million to the Indicated Shippers, who collectively accounted for less then twenty percent of HIOS throughput. *Id.* P 10, JA 4. HIOS would reduce its rates to the pre-filing level of 12.44 cents for both firm and interruptible service, and would make no refunds for the period during which it had charged the 16.16/17.59 cent rates. *Id.* Staff calculated that those refunds would equal approximately $15.6 million. *Id.* P 16, JA 5.

Notwithstanding opposition to the settlement from Commission Staff and ExxonMobil, a firm shipper, *id.*, HIOS insisted that the settlement be considered uncontested. *Id.* P 19, JA 7. Even assuming that the settlement was uncontested, however, the Commission found that it must be rejected. *Id.* P 25, JA 9.

The Commission may approve an uncontested settlement only if it concludes, in its independent judgment, that the settlement is fair and reasonable and in the public interest. HIOS Rate Order P 30, JA 10; HIOS Rehearing P 7, JA 84. *See* 18 C.F.R. § 385.602(g)(3); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 314 (1974) (even if a settlement proposal enjoys unanimous support, the Commission must still consider the "general interest of the public" in approving it); *NORAM Gas Transmission Co.*

v. FERC, 148 F.3d 1158, 1165 (D.C. Cir. 1998) (even if pipeline's customers unanimously support settlement, the Commission still must "make an independent judgment as to whether the settlement is 'fair and reasonable and in the public interest.'"); *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1003 (D.C. Cir. 1990) (quoting 18 C.F.R. § 385.602(g)(3)). Thus, while Commission policy favors settlements, Br. 25, settlement approval is subject to this requirement of independent review. HIOS Rehearing P 14, JA 86.

Here, the HIOS settlement had not been shown to be "fair and reasonable and in the public interest." HIOS Rate Order PP 25, 31, JA 9, 11. The proposed 12.44 cent rate was substantially higher than the just and reasonable rate. HIOS Rehearing P 15, JA 86. While Indicated Shippers would receive a special payment of $3 million, the remainder of HIOS shippers – representing more than 80 percent of throughput – would receive *no* refunds for the year and a half period during which HIOS' rates of 16.16/17.59 cents were in effect, *id.*, causing them to forego their share of refunds of approximately $15.6 million. HIOS Rate Order P 16, JA 5.

When the Commission approves an uncontested settlement, it relies in part on the congruity of interests between the active parties and inactive parties and consumers. *Id.* P 33, JA 11; HIOS Rehearing P 7, JA 84. However, here, because Indicated Shippers would be receiving significantly better settlement terms than other shippers, Indicated Shippers' support for the settlement did not indicate that

the less favorable terms offered other shippers were fair and reasonable. HIOS Rehearing P 17, JA 87.

While acknowledging that the Commission assumed the HIOS settlement was uncontested for purposes of approval, Br. 27, HIOS contends that the Commission "effectively" treated the settlement as contested by considering Staff's comments and determining on the merits whether the settlement rates were just and reasonable. *Id*. 28. In essence, HIOS argues that the Commission is *precluded* from looking too deeply at an uncontested settlement.

However, while the Commission is not required in all cases to consider the merits if the settlement is uncontested, Br. 29, the Commission is required to independently judge whether the settlement is fair, reasonable and in the public interest. HIOS Rate Order P 30, JA 10; HIOS Rehearing P 7, JA 84; 18 C.F.R. § 602(g)(3). In making that judgment as to HIOS' proposed 12.44 cent rate here, the Commission was faced with the ALJ's determination that the just and reasonable rate was 8.56 cents. *See* HIOS Rate Order PP 9-10, JA 3-4. Moreover, the proposed settlement would require HIOS' inactive shippers to forego their share of $15.6 million in refunds, while Indicated Shippers would receive a $3 million special payment. *Id*. P 16, JA 5. Thus, ample cause existed for the Commission to question whether the settlement was in the public interest.

HIOS suggests that the inactive shippers were "sophisticated" parties who should be deemed to have waived any objection to the settlement. Br. 31. The Commission found the sophistication of inactive parties irrelevant to the issue of whether the settlement had been shown to be consistent with the public interest. HOIS Rehearing P 17, JA 87.

Further, NGA § 4 (b) prohibits a pipeline from maintaining any unduly discriminatory difference in rates. *Id*. HIOS attempts to justify the special payment to Indicated Shippers because they "shouldered the burden of litigation." Br. 30. However, in the circumstances of this settlement – where Indicated Shippers would receive a special $3 million payment, the proposed settlement rates were unjust and unreasonable, and inactive shippers would be afforded no refunds – the Commission found that the fact that Indicated Shippers were the only active litigants did not support the disparate treatment. HOIS Rehearing P 17, JA 87.

Although *Stingray Pipeline Co.*, 101 FERC ¶ 61,365 (2002), approved a settlement which provided for settlement rates, no refunds, and a payment to Indicated Shippers, *see* Br. 26-27, upon further reflection here, the Commission was increasingly concerned about the unduly discriminatory nature of such arrangements. HIOS Rate Order P 33, JA 12. Further, in *Stingray*, the settlement rates were slightly *lower* than the rate the ALJ found just and reasonable, whereas here the proposed rates were *substantially higher* than just and reasonable rates, and

the settlement would provide no refunds to other parties who had paid rates at twice the just and reasonable level for a significant period. *Id*. PP 32, 33, JA 11, 12; HIOS Rehearing P 7, JA 84.

HIOS claims its settlement provided *greater* ratepayer benefits than the *Stingray* settlement, because HIOS proposed to maintain its pre-existing rates, while the *Stingray* settlement rates exceeded its pre-existing rates. Br. 35. The fact that HIOS' pre-existing rates *substantially exceeded* just and reasonable rates, whereas the *Stingray* settlement rates were *lower* than just and reasonable rates, belies this contention. HIOS Rate Order P 32, JA 11.

The Commission did not "ignore" the fact that the settlement would provide some benefits, Br. 33, such as requiring that HIOS file a new rate case in three years and install certain metering facilities. HIOS Rehearing P 16, JA 86. Nevertheless, these benefits did not justify imposing a rate substantially above a just and reasonable level on all of HIOS' shippers and denying refunds to the inactive parties who had been paying excess charges. *Id*.; HIOS Rate Order P 34, JA 12.

III. THE COMMISSION REASONABLY ESTIMATED THE AVAILABILITY OF GAS RESERVES IN SETTING HIOS' DEPRECIATION EXPENSE.

Calculating the depreciation expense for HIOS' facilities requires the estimation of the availability of gas reserves to HIOS in the future. HIOS ALJ Order P 39, JA 210. HIOS' and Staff's experts reached similar conclusions

regarding the length of time existing wells connected to HIOS could be expected to produce, but differed widely on the amount of additional gas reserves HIOS could potentially access in the future. *Id*. PP 42-43, JA 211. At bottom, the issue boiled down to whether the Western Planning Area-wide reserve estimates used by Staff witness Mr. Pewterbaugh, or the HIOS-specific reserve estimates used by HIOS witness Mr. Jenkins, provided better evidence of HIOS' remaining life. HIOS Rate Order P 75, JA 25.

Mr. Pewterbaugh determined HIOS had a 17.5-year life remaining as of June 30, 2003, the end of the test period. *Id*. P 63, JA 21 (citing Exh. S-4, R. 355, JA 433). He used an area-wide approach to estimate the remaining and future reserves, based upon the Mineral Management Service Western Planning Area, taking into consideration, among other things, competition and the distance of the pipeline from reserves. *Id*. P 65, JA 22 (citing Exhs. S-4, R. 355 at 19-21, 27, JA 452-54, 460; S-14, R. 365 at 9-10, JA 492-93); HIOS ALJ Order P 46, JA 212. *See* Exh. S-5, Schedule No. 3 (map), JA 467. Mr. Pewterbaugh obtained information on future resources from the Potential Gas Committee, an independent source of estimated levels of undiscovered gas, Exh. S-4, R. 355 at 16-17, JA 449-50, and one of the most respected analysts in the natural gas industry. *South Dakota*, 668 F.2d at 344.

The Potential Gas Committee divides its estimates into proved (known) reserves and potential supply, which is the prospective quantity of gas yet to be

found or to be added to existing fields. *Id.* Potential supply is then divided into three categories: (1) probable – the most assured of new supplies resulting from the growth of existing fields; (2) possible – less assured supplies from new field discoveries in formations previously productive; and (3) speculative – potential gas supply associated with non-productive formations. *Id.* at 338-39. The Potential Gas Committee then provides three estimates for each category: minimum, maximum and "most likely." Exh. S-4, R. 355 at 18, JA 451. In his analysis, Mr. Pewterbaugh used only the probable and possible categories, excluding speculative entirely, and for each category used the "most likely" estimate. *Id.*

HIOS' expert, Mr. Jenkins, estimated a remaining economic life of the HIOS pipeline of ten years as of June 30, 2003. HIOS Rate Order P 63, JA 21 (citing Exh. HIO-76, R. 239, JA 385). He projected gas volumes from existing shallow and deepwater wells connected to HIOS, future completions in the shallow-water area, and deepwater wells expected to be completed and which may be connected to HIOS in the future. Exh. HIO-76, R. 239 at 3, JA 387. The deepwater future volumes were "derived from El Paso's proprietary database which has estimates on all *active* deepwater prospects in the Gulf of Mexico." HIOS ALJ Order P 44, JA 211 (quoting Exh. HIO-76, R. 239 at 7, JA 391) (emphasis added). Thus, Mr. Jenkins' estimates considered only *active* deepwater prospects, and assumed *no* future throughput from any deepwater prospects that are not active, or have not yet

been discovered. *See* Exh. S-14, R. 365, at 2, JA 485. Further, Mr. Jenkins did not consider the potential for additional deep gas from the shallow-water areas. Exh. S-4, R. 355 at 30, JA 463.

A. The Commission Reasonably Adopted Staff's Estimate of a 17.5 Year Economic Life.

The Commission reasonably adopted Mr. Pewterbaugh's 17.5 year study results, finding that the record supported a reserve life based on the entire Western Planning Area. HIOS Rate Order P 75, JA 25. HIOS complains the Western Planning Area is too large an area to consider, *see* Br. 36-38, given that HIOS currently accesses only parts of the Western Planning Area, specifically High Island, East Breaks and West Cameron. Exh. S-4, R. 355 at 10, JA 443. *See* Exh. S-5, R. 356, Schedule No. 3 (map), JA 467. However, HIOS either was receiving, or had the potential to receive, gas from a much larger area, including the Alaminos Canyon, Keathley Canyon, Galveston and Garden Banks areas, which represent approximately two-thirds of the Western Planning Area. HIOS Rate Order P 77, JA 26; HIOS Rehearing P 31, JA 91.

HIOS conceded that it either actually accessed or could access gas supplies in each region of the Western Planning Area. HIOS Rate Order P 77, JA 26 (citing Exh. S-4, R. 355 at 16, 20, JA 449, 453). Also, HIOS identified over 57 drilling prospects in various stages of development that could be connected to HIOS, and conceded that six prospective gas supplies are within the Western Planning Area

and some supply areas extend beyond the Western Planning Area. *Id.*; HIOS Rehearing P 31, JA 91. In fact, HIOS attached 16 new supply sources throughout the Western Planning Area to its system during just the base and test periods. HIOS Rehearing P 31, JA 91 (citing Exh. IND-1, R. 314 at 12, JA 422). HIOS also has the ability to attach significant new reserves to its 200-mile, multi-pronged system such as the increased throughput provided by its East Breaks lateral. HIOS Rate Order P 77, JA 26; HIOS Rehearing P 31, JA 91 (citing Exh. S-4, R. 355 at 22, JA 455).

Based on these factors, the Commission found that HIOS could obtain gas supplies from the entire Western Planning Area region, including both potential production from deep gas in the shallow waters and unleased deepwater prospects that are not currently active or have not yet been discovered, which were excluded from Mr. Jenkins' study. HIOS Rate Order P 78, JA 26; HIOS Rehearing P 31, JA 91.

HIOS asserts that it is improper to consider areas beyond HIOS' identified prospects and potential East Breaks reserves. Br. 38-39. However, while the Commission's decision specifically relied on the location of HIOS' facilities, it was not limited to considering only reserves physically connected to HIOS, as HIOS proposes. HIOS Rehearing P 30, JA 91. Rather, the Commission properly

considered gas supplies currently beyond the reach of HIOS' pipeline that are reasonably forecasted to be available to the pipeline in the future. *Id*.

As the Commission's finding was premised upon HIOS' particular location, circumstances and facilities, *see id*., HIOS' assertion that this analysis is equally applicable to any pipeline in the Western Gulf of Mexico, regardless of its location or size, *see* Br. 38, is patently incorrect. Rather, the Commission fully complied with the directives of *South Dakota,* 668 F.2d at 337, and *Memphis Light, Gas & Water Division v. FPC*, 504 F.2d 225, 231 (D.C. Cir 1974), to consider '"the extent and location of reserves that the utility may utilize.'" *See* Br. 37 (quoting *South Dakota*, 668 F.2d at 337). The Commission found that adopting a reserve estimate that includes gas supplies reasonably forecasted to be available to the pipeline in the future was fully consistent with these court rulings. HIOS Rehearing P 30, JA 91.

HIOS asserts that fifty percent of present deepwater gas production in the Western Planning Area comes from only one-eighth of the leased area, Mississippi Canyon and Viosca Knoll. Br. 37 (citing Exh. HIO-119, R. 282 at 6, JA 403). However, Mississippi Canyon and Viosca Knoll are not in the Western Planning area. Exh. S-14. R. 365 at 3, JA 486. Mr. Pewterbaugh adjusted the Potential Gas Committee data, which includes data for the entire Gulf of Mexico, to eliminate estimated undiscovered gas in deep water *outside* of the Western Planning Area. HIOS Rehearing P 33, JA 92. Because HIOS will not receive gas from the entire

Gulf of Mexico, but only the Western Planning Area, Mr. Pewterbaugh used only twenty-five percent of the Potential Gas Committee's estimate for this category of deep water gas to account for the portion of the potential available to HIOS. *Id.* (citing Exh. S-4, R. 355 at 20-21, JA 453-54). *See also* Exh. S-14, R. 365 at 3, JA 486.[4] Thus, Mr. Pewterbaugh's study allowed for seventy-five percent of deepwater production to be from areas *outside* the Western Planning Area and *not* accessible to HIOS. That allowance would include production from Mississippi Canyon and Viosca Knoll. The Commission found that HIOS failed to explain why this assumption was unreasonable. HIOS Rehearing P 33, JA 92.

Contrary to HIOS' assertions, *see* Br. 38, the Commission found that Mr. Pewterbaugh fully considered competition and reasonably concluded that competition will not shorten HIOS' supply life. HIOS Rehearing P 32, JA 92 (citing Exh. S-4, R. 355 at 27-28, JA 460-61). Although most of the gas moved on HIOS is interruptible, according to HIOS' data request responses none of this gas has a ready alternative path to market. *Id.* (citing Exh. S-4, R. 355 at 27-28, JA 460-61). Further, HIOS held a superior competitive position because it already has an

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[4] To adjust the data, Mr. Pewterbaugh looked at active deepwater leases in the greater than 1000 feet category and compared the number of discoveries in HIOS' potential supply area to total discoveries. Exh. S-4, R. 355 at 21, JA 454. Twenty-nine percent of the total fields occurred in HIOS' potential supply area. *Id.* *See* Exh. S-5, R. 365, Schedule No. 9, JA 470. Mr. Pewterbaugh used twenty-five percent of the Potential Gas Committee's total estimate for this category to estimate the portion of potential gas available to HIOS. Exh. S-4, R. 355 at 21, JA 454.

avenue into the deepwater area through the East Breaks Gathering System, and is well situated in the High Island area to transport shallow-water deep gas. Exh. S-4, R. 355 at 27, JA 460. Also, HIOS had an advantage over future pipeline projects because a new project would have to recover 100 percent of the investment, whereas HIOS already has recovered essentially all of its investment. *Id.*

Finally, the record showed that the demand for gas is expected to rise from 22.3 trillion Btu in the year 1999 to 32.498 trillion Btu in the year 2020. HIOS Rate Order P 77, JA 26; HIOS Rehearing P 31, JA 91 (citing Exh. S-4, R. 355 at 26, JA 459). While HIOS asserts that increased demand is not germane to the volume of supply available to it, Br. 39, rapid growth in demand for gas will cause producers to turn increasingly to Gulf Coast reserves, and the resulting higher prices will bring new sources of supply as higher-cost sources become economical. HIOS Rate Order P 68, JA 23; HIOS ALJ Order P 63, JA 216.

B. The Commission Reasonably Rejected HIOS' Estimate of a Ten Year Economic Life.

As demonstrated above, the Commission's finding of 17.5 years as HIOS' useful life was well supported by substantial evidence. *See, e.g., B&J Oil and Gas v. FERC*, 353 F.3d 71, 77 (D.C. Cir. 2004) ("This data-rich evidentiary record easily satisfies our 'more than a scintilla, less than a preponderance' standard. Moreover, FERC's decision rests on just the type of highly technical evidence that this court is least equipped to second guess.").

Further, the Commission's choice between "disputing expert witnesses" is entitled to deference. *Wisconsin Valley*, 236 F.3d at 746-47. Here, the Commission reasonably rejected HIOS' study as unpersuasive and unreasonable. HIOS Rate Order P 78, JA 26; HIOS Rehearing PP 31, 36, JA 91, 93. While the Potential Gas Committee provided a transparent and non-proprietary objective analysis, the proprietary El Paso database used by HIOS was based on information that was neither proffered by HIOS nor supported by the record. HIOS Rehearing P 36, JA 93; HIOS Rate Order P 68, JA 23; HIOS ALJ Order P 76, JA 219.

HIOS' study, moreover, erroneously excluded potential production from deep gas in the shallow Outer Continental Shelf waters and unleased deepwater prospects in the Gulf of Mexico that are not currently active or have not yet been discovered. HIOS Rehearing P 36, JA 93. The study thus disregarded the recent award of numerous High Island leases, which indicate substantial interest in development of deep shelf gas, and the estimate of the Potential Gas Committee that there is more than 42,000 Bcf of gas in the "most likely" category in water depths of more than 1000 meters. HIOS ALJ Order PP 68-69, JA 217 (citing Exh. S-14, R. 365 at 11, JA 494; Exh. S-4, R. 355 at 18-19, 451-52). Accordingly, the record did not support the finding that HIOS will not be able to access gas supplies after 2013, the economic end-life proposed by HIOS. HIOS Rehearing P 36, JA 93.

Contrary to HIOS' claims, Br. 39-40, the Commission's decision was fully consistent with *Trunkline Gas Company*, 90 FERC ¶ 61,017 (2000). HIOS Rehearing P 28, JA 90. Under *Trunkline,* the reserve estimate must be based on reserves that a pipeline can reasonably attach in the future based on long-term forecasts of supplies over large areas. *Id*. P 29, JA 90 (citing *Trunkline*, 90 FERC at 61,055). The Commission's use of the entire Western Planning Area in determining the reserve life for HIOS readily met this standard. *Id.*

IV. THE COMMISSION REASONABLY SET HIOS' RETURN ON EQUITY.

The Commission's long-standing policy is to use a proxy group to derive the return on equity for gas pipelines because most gas pipelines are wholly-owned subsidiaries and their stock is not publicly traded. *See*, *e.g.,* Petal Rehearing P 25, JA 196. The Commission applied this approach in calculating HIOS' return on equity. Here, HIOS challenges both the Commission's choice of proxy group, and the Commission's placement of HIOS within that group. Neither objection has merit.

A. The Commission Reasonably Selected HIOS' Proxy Group.

Historically, in selecting proxy groups in natural gas pipeline rate cases, the Commission had required that each company be publicly traded, be recognized as a natural gas pipeline company and have a high proportion of its business in pipeline operations. HIOS Rehearing P 50, JA 98; HIOS Rate Order P 117, JA 40. In recent

years, however, fewer and fewer companies met these standards because of mergers, acquisitions, and other changes in the natural gas industry. *Id.*

Here, only one corporation, Kinder Morgan, Inc., met the Commission's historical proxy group standards. HIOS Rehearing P 56, JA 100. The Commission accordingly had no choice but to depart from its historical proxy group standards for natural gas pipelines. *Id.* P 57, JA 100. Thus, the Commission had to identify a reasonable alternative to the now-unavailable historical methodology. Following *Williston Basin*, 104 FERC ¶ 61,036 (2003), FERC Staff proposed using diversified natural gas companies whose pipeline operations were not as significant as the Commission historically required. HIOS Rehearing P 57, JA 100. HIOS proposed using master limited partnerships. *Id.*

1. The Commission Reasonably Adopted Staff's Proposed Proxy Group of Diversified Natural Gas Companies With Significant Interstate Pipeline Operations.

The Commission reasonably adopted the proxy group proposed by Staff, consisting of Kinder Morgan, Inc., and three diversified natural gas companies, Equitable Resources, Inc., National Fuel Gas Company, and Questar. HIOS Rehearing P 51, JA 98; HIOS Rate Order P 118, JA 41. Petitioners and Intervenor Interstate Natural Gas Association challenge the inclusion of the three diversified natural gas companies, arguing that they are distribution companies with much lower risks than HIOS. *See, e.g.*, Br. 42-49; Intervenor Br. 11-13; HIOS Request for

Clarification, Rehearing and Stay, R. 115 at 33-35, JA 333-35. However, the Commission concluded that, while the three challenged companies were not pure transmission companies, they were the best available proxies on the current record. HIOS Rehearing P 52, JA 99; HIOS Rate Order P 131, JA 46.

First, the three challenged companies were not purely distribution companies, but rather were diversified companies with a significant portion of their business in operating Commission-jurisdictional natural gas pipelines. HIOS Rehearing PP 58-59, JA 101-02 (citing Exh. S-11, R. 362 at 11, JA 474; Exh. HIO-139, R. 302 at 2, JA 421). In *Williston Basin*, 104 FERC ¶ 61,036, the Commission approved a proxy group including the same diversified natural gas companies as here -- Questar, National Fuel and Equitable. HIOS Rehearing P 52, JA 99; HIOS Rate Order P 131 & n. 120, JA 46. While pipeline operations were not as high a percentage of the operations of the three companies as the Commission historically had required, the Commission had no choice but to depart from that standard where only one corporation, Kinder Morgan, satisfied the historical standard. HIOS Rehearing PP 56-57, JA 100-01.

Data supplied by HIOS' expert, Dr. Williamson, Br. 45 & n. 14, supported the Commission's findings. HIOS Rehearing P 58 n. 55, JA 101 (citing Exh. HIO-139, R. 302 at 2, JA 421). The data showed that the three companies had significant interstate pipeline operations (25 percent (Questar); 25 percent (National Fuel) and

10 percent (Equitable Resources)); were subject to Commission jurisdiction; and were included in the Value Line group of diversified natural gas companies. *Id*. Further, these data showed that the companies were not purely distribution entities, as distribution constituted 26 percent (Questar); 22 percent (Equitable Resources); and 41 percent (National Fuel), respectively, of the companies' total business. *Id*.

Second, HIOS itself had low risk, and therefore its risk was comparable to that of the diversified natural gas companies. *Id*. P 59, JA 101. HIOS had almost no financial risk as it had recovered virtually all of its initial investment in the pipeline, whereas the diversified natural gas companies had not recovered their original investment. *Id*. PP 69, 70, JA 106-07. Likewise, HIOS did not show that its business risk exceeded that of the proxy group companies, all of whom have significant interstate pipeline business. *Id*. Even though large volumes of interruptible transportation move on HIOS, which would seem to increase its business risk, those volumes are shipped by captive shippers who have no alternative means of transportation to bring their gas to market. *Id*.

The evidence supported this conclusion. *Id*. P 59, JA 101 (citing Exhs. S-11, R. 362 at 15, JA 475; IND-1. R. 314 at 12, JA 422). Indicated Shippers' witness Elizabeth Crowe testified that, while a local distribution company has a legal franchise over a service territory, *see* Intervenor Br. 12-13, HIOS has a practical franchise over its service territory by virtue of the natural monopoly it holds over

almost all the gas attached to its system. Exh. IND-1, R. 314 at 12, JA 422. Likewise, Staff witness Rodney Manganello testified that a large number of HIOS' shippers have no transportation alternatives and there are high costs of hookups for shippers that do have alternatives. Exh. S-11, R. 362 at 15, JA 475.

HIOS argues that its risks are higher than those of the proxy group because it purportedly has not been able economically to access new sources of gas and its throughput is declining. Br. 47. However, the evidence showed that HIOS had ample access to gas, and its throughput had increased as well as decreased in the past, and would likely increase in the immediate future. HIOS Rehearing P 59, JA 101.

As to access, HIOS had attached 16 new supply sources to its system during the base and test periods in this case, and had identified over 57 drilling prospects in various stages of development that potentially could be connected to HIOS in the future. *Id*. (citing Exh. IND-1, R. 314 at 12, JA 422). HIOS potentially had access to gas reserves throughout the Western Planning Area and, among other things, HIOS' arguments overlooked the significant growth in estimates of reserves in the Gulf of Mexico. *Id*. (citing HIOS ALJ Order P 54, JA 214).

Likewise, HIOS' throughput was not constantly declining. HIOS Rehearing P 59, JA 101; HIOS ALJ Order P 54, JA 214; Exh. S-14, R. 365 at 7, JA 490. As Staff witness Pewterbaugh testified, throughput in some years increased relative to

the preceding year. HIOS ALJ Order P 54, JA 214 (citing Exh. S-14, R. 365 at 7, JA 490). For example, a decline in throughput in 1999 was followed by two years of increasing throughput (from 271 million MCF in 1999 to 305 million MCF in 2000 and 343 million MCF in 2001). *Id.* See Exh. S-15, R. 366, Schedule No.4, JA 502. Although HIOS' throughput declined in 2002 (to 253 million MCF), no trend of future declines could be predicted from that fact. Exh. S-14, R. 365 at 7, JA 490; Exh. S-15, R. 366, Schedule No. 4, JA 502. Rather, Staff witness Ekzarkhov testified that near-term future trends predicted increased throughput. HIOS Rehearing P 59, JA 101 (citing HIOS ALJ Order P 54, JA 214); Exh. S-9, R. 360 at 14, JA 471; Exh. S-10, R. 361 at 4-5, JA 472-73.

Thus, Intervenor errs in suggesting that the Commission elevated organizational structure over relative risk. Intervenor Br. 15-16. Rather, instead of relying on generic assumptions about particular types of businesses, the Commission looked at the characteristics of the pipelines at issue and determined that, given their low risk profiles, the diversified natural gas companies were the best option for inclusion in HIOS' proxy group.

HIOS contends that this decision is inconsistent with pre-*Williston* precedent. Br. 43-45. That precedent is inapposite now due to the significant changes in the natural gas industry that made it necessary to revise Commission policy on proxy groups. HIOS Rehearing P 61, JA 102; HIOS Rate Order P 132, JA 46. For

example, the proxy groups in *Williston Basin Interstate Pipeline Co*., 87 FERC ¶ 61,264 at 62,007 (1999), *EPGT Texas Pipeline L.P.*, 99 FERC ¶ 61,295 at 62,250 (2002), and *Kansas Pipeline Co*., 96 FERC ¶ 63,014 at 65,084-87 (2001), consisted of those companies traditionally used, which are no longer available. HIOS Rehearing P 61, JA 102; *Williston*, 87 FERC at 62,007; *Enbridge Pipelines (Kansas Pipeline Company)*, 100 FERC ¶ 61,260 P 236 (2002), *on reh'g*, 102 FERC ¶ 61,310 (2003). *Mountain Fuel, Inc.*, 28 FERC ¶ 61,195 at 61,369-370 (1984), did not reject gas companies with distribution functions as such as HIOS contends, Br. 43, but declined to include companies which appeared to be arbitrarily proposed. HIOS Rehearing P 61, JA 102; HIOS Rate Order P 132, JA 46.[5]

HIOS argues that the Commission's selection of diversified natural gas companies as proxy group members is inconsistent with the Commission's rejection of Indicated Shippers' proposal to include eight distribution companies in the proxy group. Br. 47-48. However, Indicated Shippers' proposed companies were rejected because: (1) they did not have significant interstate pipeline operations; (2) they were not regulated by FERC; and (3) they were outside the diversified natural gas

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[5] The ALJ initial decisions in *Wyoming Interstate Co., Ltd*., 96 FERC ¶ 63,040 (2001) and *Trailblazer Pipeline Co*., 106 FERC ¶ 63,005 (2004), *see* Br. 43 n. 12, were never considered by the Commission as the issue was moot. *See Wyoming Interstate Co., Ltd*., 101 FERC ¶ 61,343 (2002); *Trailblazer Pipeline Co*., 107 FERC ¶ 61,008 (2004).

group. HIOS Rehearing P 60, JA 102. Thus, those eight companies did not meet the Commission's criteria for inclusion in a pipeline-oriented proxy group.

2. HIOS Failed to Support Its Alternative Proposal To Include Master Limited Partnerships in the Proxy Group.

The Commission reasonably concluded that HIOS failed to support its proposal to include master limited partnerships in the proxy group. HIOS Rehearing P 51, JA 98; HIOS Rate Order P 118, JA 41. While, in theory, it might be appropriate to compare HIOS, a limited liability corporation owned by a master limited partnership, with other master limited partnerships, HIOS Rehearing P 53, JA 99; HIOS Rate Order P 125, JA 43, the Commission had always used corporations for natural gas pipeline proxy groups, never master limited partnerships. HIOS Rehearing P 50, JA 98. Thus, in proposing to use master limited partnerships, HIOS knew it was seeking a change in Commission policy. *Id.* P 67, JA 105. The record would have to contain reliable financial data, comparable to that for corporations, for use in the discounted cash flow analysis. *Id.* P 50, JA 98.

Under a discounted cash flow analysis, return on equity is considered to equal dividend yield (dividends divided by stock price), plus the estimated constant growth in dividends. *Id.* P 62, JA 103. However, partnerships make distributions to their partners, rather than pay dividends. *Id.*; HIOS Rate Order P 126, JA 43-44. If partnership distributions consist solely of earnings, they may be comparable to

dividends. *Id*. However, unlike dividends, distributions may also include a return of capital. *Id*. (citing Exh. IND-17, R. 330 at 4, JA 427).

HIOS submitted evidence purporting to show annual dividends for its proposed proxy group members, but it was not clear that the "dividend" figures provided were comparable to corporate dividends. *Id*. P 54, JA 99; HIOS Rate Order P 126, JA 43. The dividend yields for the master limited partnerships, which ranged from 3.2 percent to 7.88 percent, were twice the yields for natural gas companies, which ranged from 1.59 percent to 4.70 percent. HIOS Rate Order P 127, JA 44 (citing Exh. HIO-135, R. 298 at 1, JA 418; Exh. S-12, R. 363, Schedule A at 2, JA 478). Nothing in the record demonstrated that the "dividends" of the master limited partnerships represented only earnings. *Id*.

HIOS asserts that it provided evidence showing that master limited partnership distributions are the "functional equivalent" of corporate dividends, Br. 51 (citing R. 296, Exh. HIO-133, R. 296 at 21-23, JA 415-17). However, as HIOS itself states later in its brief, the referenced exhibit pages are rebuttal testimony of HIOS witness Dr. Williamson addressing "the argument that *tax-related differences* disqualified [master limited partnerships] from inclusion in the proxy group." Br. 56 n. 23 (emphasis added). The testimony does not address whether distributions, unlike dividends, may include a return of capital. Accordingly, the Commission found that HIOS had not satisfied its burden under NGA § 4 to justify its proposal to

include master limited partnerships in the proxy group. HIOS Rate Order P 127, JA 44.

HIOS also asserts that master limited partnerships and gas pipeline corporations have similar risks as evidenced by the fact that its four proposed master limited partnership proxy group members had returns on equity nearly identical to the 15.35 percent return for Kinder Morgan, Inc. -- the one agreed-upon corporate member of the proxy group -- whereas the diversified natural gas companies in the Staff proxy group had much lower returns. Br. 52-53. This argument disregards the Commission's express finding, based on the record, that HIOS itself has low risk, and therefore its risk is more comparable to that of the diversified natural gas companies. HIOS Rehearing PP 59, 69, 70, JA 101, 106.

Indeed, in *Kern River Gas Transmission Co*., 117 FERC ¶ 61,077 at PP 144-150 (2006), *reh'g pending*, the Commission distinguished HIOS from Kern River because, *inter alia*, HIOS had low risk due to its large number of captive customers, whereas Kern River had fewer captive customers and a much greater degree of competition from competing pipelines. The Commission found Kern River, unlike HIOS, to be more similarly situated to Kinder Morgan, and its higher risk profile, than to the lower-risk diversified natural gas companies. *Id*. P 173. Nevertheless, the Commission still did not set Kern River's return on equity at Kinder Morgan's

level, which was then 13.62 percent; rather, Kern River's return on equity was set at 11.20 percent. *Id*. P 175.

Thus, even as to natural gas pipeline companies, Kinder Morgan is an "outlier" in terms of risk and rate of return, which explains why its rate of return approaches that of the master limited partnerships. *See, e.g*., *Enbridge Pipeline*, 100 FERC ¶ 61,260 P 236 (finding that the traditional proxy group of natural gas pipeline companies, composed of Coastal, Columbia Energy, El Paso, Enron, and Williams, had rates of return ranging from 10.12 percent to 13.28 percent, with a median value of 11.83 percent). Even Kern River, which the Commission found to be of significantly higher risk than HIOS, received a rate of return of 11.20 percent, comparable to those of the diversified natural gas companies. *See* chart at Br. 52. No basis exists for assuming that HIOS' return should approach that of Kinder Morgan.

3. The Commission Reasonably Relied On Evidence That Partnership Distributions Can Include a Return Of Capital.

The Commission reasonably relied upon evidence showing that partnership distributions can include a return of investment. HIOS Rate Order P 126, JA 44 (citing Exh. IND-17, R. 330, at 4, JA 427). Exh. IND-17 demonstrated that, over the period 2001-2003, two of the master limited partnerships that HIOS proposed to include in its proxy group had distributions averaging a 301.3 percent payout ratio,

which indicates that two-thirds of their payout distributions are a return *of* capital and not a return *on* capital. *Id*. n. 112, JA 44 (citing IND-17, R. 330 at 3-4, JA 426-27). In comparison, the payout ratios for the gas pipeline companies over the same period averaged 73.78 percent, demonstrating that their dividends were a return *on* capital and not a return *of* capital. *Id*. While Intervenor points out that, at times, the dividends of the natural gas companies may exceed their earnings, *see* Intervenor Br. 18, that does not change the fact that, on average, natural gas pipeline dividends were *below* earnings, while master limited partnerships on average returned *multiples* of their earnings to their partners. Neither HIOS nor the Intervenor provided a credible alternative explanation for this discrepancy.

On rehearing, HIOS objected to Exh. IND-17, but the Commission found HIOS' objection too late for consideration. HIOS Rehearing PP 64-65, JA 104-05. HIOS failed to object when IND-17 was admitted as evidence, *id*. P 65, JA 105 (citing Transcript of Hearing, R. 67 at 552, JA 282), and failed to object when Staff and Indicated Shipper relied on IND-17 in their filings before the ALJ. *Id*. (citing Staff Reply Br., R. 83 at 23-24, JA 299-300); Initial Brief of Indicated Shippers, R. 80 at 29-30, JA 297-98. These filings further belie HIOS' and Intervenors' claim that the IND-17 argument "was not advanced by any party in this proceeding," Br. 53; *see also* Intervenor Br. 16-17.

Moreover, the ALJ adopted Staff and Indicated Shippers' arguments in her Initial Decision rejecting HIOS' proxy group, citing specifically to Exh. IND-17 and Indicated Shippers' Initial Brief. HIOS Rehearing P 65, JA 105; HIOS ALJ Order P 126, JA 232. Nevertheless, HIOS still raised no issues regarding Exh. IND-17 in its Brief on Exceptions to the Initial Decision. HIOS Rehearing P 65, JA 105. Thus, the Commission found that HIOS waived its right to object to Exh. IND-17 or findings based on it. *Id*. (citing 18 C.F.R. § 385.711(d)(2)).

HIOS requested in the alternative that the Commission either reopen the record to accept a new affidavit from Dr. Williamson, or remand the case to the ALJ. *Id*. P 66, JA 105. The Commission observed, however, that, while Dr. Williamson stated he did not "believe" there was any return of investment in the distributions he used in his evidence, he also testified he knew of no way to match earnings with distributions. *Id*. (citing HIOS Request for Clarification, Rehearing and Stay, R. 115, Affidavit of J. Peter Williamson at P 12, JA 345). Dr. Williamson also conceded that, in the Value Line reports he attached as exhibits to his affidavit, the reports for the Kaneb, Lakehead, and Northern Border Partners partnerships acknowledged that a part of each distribution was a "return of capital." *Id*. *See* Williamson Affidavit Appendix Exhibit A at 3, JA 349.

Thus, the Commission reasonably rejected HIOS' request to reopen the record. HIOS Rehearing P 67, JA 105. There had already been a full hearing before

an ALJ, with all sides given an opportunity for discovery and presentation of evidence. *Id.* In proposing to include master limited partnerships in the proxy group, HIOS was aware that it was seeking a change in Commission policy. *Id.* Further, the issue of the comparability of distributions and dividends could hardly have surprised HIOS or Dr. Williamson, particularly since Dr. Williamson had proposed a similar proxy group in the Trailblazer proceeding and, as shown by Exh. IND-17, Staff had challenged that proposal in the Trailblazer proceeding and again here. *Id.* In any event, once IND-17 was submitted, HIOS had an opportunity to present the evidence it belatedly proffered on rehearing. *Id.* As HIOS failed to take any action to present further evidence on this issue until rehearing, the Commission reasonably declined to delay resolution of this proceeding by reopening the record for further presentation of evidence. *Id.*

4. The Commission Consistently Applies Its Proxy Group Policy.

HIOS contends that the Commission's determination here "fundamentally conflicts with its established policy of using oil pipeline [master limited partnerships] in oil pipeline cases." Br. 50 (citing *SFPP, L.P.,* 86 FERC ¶ 61,022 at 61,099 (1999)). *See also* Intervenor Br. 14 (citing a subsequent oil pipeline case, *SFPP, L.P.*, 113 FERC ¶ 61,277 at P 77 n. 104 (2005)). HIOS is incorrect.

The oil pipeline orders are inapposite. In oil pipeline cases, master limited partnerships are the only available companies for use in the proxy group without

going outside the oil pipeline industry altogether, since all publicly traded oil pipeline companies are master limited partnerships. HIOS Rehearing P 63, JA 104; HIOS Rate Order P 129, JA 45. In contrast, the choice here is not between using natural gas pipeline master limited partnerships or using companies that are not engaged in the natural gas pipeline industry at all. HIOS Rehearing P 63, JA 104. Rather, all four companies selected by the Commission for the proxy group were engaged in the transportation of natural gas and own and operate natural gas interstate pipelines subject to the Commission's NGA jurisdiction. *Id.* In these circumstances, the Commission reasonably found the chosen proxy group preferable to using master limited partnerships whose "dividend" data had not been shown to be comparable to the corporate dividends upon which the discounted cash flow methodology is premised. *Id.*

Further, although master limited partnerships must be used in oil pipeline cases, the Commission nevertheless addresses in oil cases the issue raised here concerning the composition of the master limited partnership distributions. For example, in the recent decision in *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006), the Commission approved a proxy group of five oil pipeline master limited partnerships only after finding that those partnerships raised no "HIOS" concerns for the test years at issue, because their distributions had the characteristics of corporate dividends. *See id.* P 28. The Commission rejected

one master limited partnership as a proxy group member because its distributions exceeded per unit income for the years at issue, and that disparity increased significantly in the last year. *Id*.

Thus, there has been no change in Commission policy regarding the use of master limited partnerships in proxy groups. *See* Intervenor Br. 19. This is evident from the recent natural gas pipeline case, *Kern River*, 117 FERC ¶ 61,077. *Kern River* followed the HIOS orders in rejecting the use of master limited partnerships in a gas pipeline proxy group, finding significant differences between corporate dividends and partnership distributions. *Id*. P 149. Corporations pay dividends to distribute earnings to their stockholders, and typically reinvest some earnings to provide for future growth of earnings and thus dividends. *Id.* Since the return on equity awarded in a rate case is intended to permit pipeline investors to earn a profit on their investment and provide funds to finance future growth, the use of dividends in the discounted cash flow analysis is entirely consistent with the purpose of that analysis. *Id*. In contrast, partnership distributions may include a return of invested capital. *Id*. P 150.

To the extent partnership distributions include a return of capital, they are not comparable to corporate dividends, and the use of a distribution payment that includes both earnings and return of investment would inflate the dividend yield of a master limited partnership in comparison to the pipeline at issue and the corporate

members of the proxy group. HIOS Rehearing P 54, JA 99. This would skew the discounted cash flow results, since the dividend yield would appear higher than it actually was. *Id*. P 62, JA 103; HIOS Rate Order P 126, JA 44.

HIOS argues that distributions including return of capital would not skew the discounted cash flow analysis, since investors value the investment by the amount, not the composition, of the distribution. Br. 53-55. *See also* Intervenor Br. 20. It should be noted that HIOS' support for this argument was the supplemental affidavit of Dr. Williamson offered on rehearing, *see* Request for Rehearing, R. 115 at 38, JA 337, which the Commission reasonably rejected as untimely. HIOS Rehearing P 67, JA 105. *See* Section IV(A)(3) *supra*. As HIOS acknowledges, Br. 55, the rejected supplemental affidavit also included HIOS' purported demonstration that companies offering higher yields, such as master limited partnerships, are associated with lower growth rates. *Cf. Kern River*, 117 FERC ¶ 61,077 P 151 (finding evidence offered in that case did not support the contention that the master limited partnerships had lower growth rates).

In any event, while the level of a partnership's distributions may be a significant factor in the unit holder's decision to invest, the discounted cash flow analysis is used solely to determine the pipeline's return *on* equity. *See Kern River*, 117 FERC ¶ 61,077 P 150. Return *of* invested capital is provided through a separate depreciation allowance. *Id*. For this reason, partnership distributions that include a

significant return of investment would tend to cause an overstatement of the return on equity because the "dividend" would be inflated by return of capital, thereby overstating the earnings the dividend stream purports to reflect. *Id*.

The Commission has made no generic determination that master limited partnerships cannot, in the future, be included in proxy groups if a proper evidentiary showing is made. *Id*. P 147. Here, however, HIOS failed to meet its burden of showing that master limited partnerships are appropriate for inclusion in a proxy group used to set natural gas pipeline rates. HIOS Rate Order P 127, JA 44.

B. The Commission Reasonably Set HIOS' Return at the Median of the Range of Reasonable Returns.

In setting a pipeline's rate of return based upon a proxy group, the Commission generally presumes that pipelines fall into a broad range of average risk, absent highly unusual circumstances. HIOS Rate Order P 154, JA 54. While parties may present evidence to support any return on equity within the zone of reasonableness, the tools available to the Commission for determining the return on equity to be awarded a particular pipeline are blunt, making it difficult to make carefully calibrated adjustments to reflect the generally subtle differences in risk among pipelines. *Id*. Accordingly, unless a party makes a very persuasive case in support of the need for an adjustment, the Commission sets the pipeline's return at the median of the range of reasonable returns. *Id*.

HIOS contends that it should have been placed at the higher end of the proxy group range because its risks, as a "small, offshore pipeline that is more than two-thirds empty," were higher than those of the proxy group members. Br. 59-60. The Commission reasonably rejected this contention. HIOS Rate Order P 158, JA 55; HIOS Rehearing PP 69-70, JA 106-07. Again, HIOS' financial risk is low as it had recovered almost all of its initial pipeline investment, while none of the diversified natural gas companies in the proxy group had recovered their original investment. *Id.* HIOS' business risk was similarly low because its throughput, though largely interruptible, was shipped by captive shippers with no reasonable alternatives to move their product to market. *Id.* HIOS thus failed to show that its business risk exceeded that of the proxy group companies, all of whom have significant interstate pipeline business. *Id.* Accordingly, the Commission reasonably affirmed the ALJ's placement of HIOS at the median of the proxy group returns on equity. *Id.*

The Commission based this finding not on generic assumptions about the comparability of pipelines and diversified natural gas companies that perform distribution functions, but rather on HIOS' own circumstances in comparison to those of the proxy group companies. As evidence of this, in *Kern River*, 117 FERC ¶ 61,077 P 176, the Commission distinguished placing HIOS at the median of the proxy group returns from the result reached for Kern River because, *inter alia*, HIOS had a large number of captive customers whereas Kern River had fewer

captive customers and a much greater degree of competition from competing pipelines.

V. THE COMMISSION REASONABLY SET HIOS' MANAGEMENT FEE.

In a natural gas pipeline rate case, the rates set ordinarily include a return on the pipeline's rate base. HIOS Rate Order P 80, JA 27. However, here, HIOS had recovered essentially all of its investment in plant, and therefore it had a negative rate base. *Id*. Thus, the Commission turned to its precedent to calculate a management fee to be used in lieu of the return on rate base. *Id*. P 92, JA 31 (citing *Tarpon*, 57 FERC ¶ 61,371 at 62,240).

In *Tarpon*, the Commission calculated the management fee by multiplying ten percent of the pipeline's historical average rate base by the pipeline's cost of capital. *Id*. P 83, JA 28. Following the *Tarpon* formula, the ALJ awarded HIOS a management fee of $680,802. *Id*. P 84, JA 28.

On exceptions, HIOS argued that the *Tarpon* method of calculating the substitute rate base was not appropriate here. As *Tarpon* used straight-line depreciation, Tarpon's average rate base was approximately 50 percent of gross investment, resulting in a management fee roughly equal to a return of five percent on the pipeline's original investment. *Id*. P 112, JA 38 (citing 57 FERC ¶ 61,371 at 62,241). HIOS, however, used a high initial depreciation rate in the early years of the project, and applied supplemental depreciation, resulting in a negative rate base

starting in 1998. *Id*. P 113, JA 38. As a result, under the *Tarpon* methodology, HIOS would have an average rate base of $54.7 million, ten percent of which is only $5,469,171, which is only slightly more than one percent return on HIOS' original investment. *Id*.

The unique historical circumstances of HIOS' depreciation of plant investment over the life of the project persuaded the Commission to adjust upward the management fee awarded by the ALJ. *Id*. P 114, JA 39. The Commission found that differences in the timing of the pipeline's past recovery of its original investment, resulting in a negative rate base, should not have a major effect on a fee whose purpose is to provide the pipeline modest compensation for future activities. *Id*. Having found that a management fee equal to a return on about five percent of the original investment was appropriate in *Tarpon*, the Commission saw no reason to limit HIOS to a significantly lower management fee. *Id*.

HIOS' own witness, Mr. Porter, calculated that HIOS' average rate base would equal $180,625,854 million, assuming that HIOS had been depreciated on a uniform, straight-line basis over HIOS' 24-year life. *Id*. PP 113, 115, JA 38, 39 (citing Exh. HIO-64, R. 227 at 15, JA 375); HIOS Rehearing P 72, JA 107. *See also* HIO-66, R. 229, JA 382. The Commission adopted this average rate base calculation. HIOS Rate Order P 105, JA 35.

Applying the *Tarpon* formula, the Commission concluded that the substitute rate base to be used in determining the management fee would be ten percent of the average rate base of approximately $180,625,854. *Id*. P 115, JA 39. Multiplying this by the overall return of 9.6 percent determined by the Commission increased the management fee allowed by the ALJ from $680,802 to approximately $1.7 million.[6] *Id.* PP 164-66, JA 57; HIOS Rehearing P 72, JA 107.

HIOS nevertheless maintained that this management fee was still too low, and proposed a "floor" to the rate base of twenty percent of HIOS' gross plant. HIOS Rate Order P 96, JA 32; Exh. HIO-64, R. 227 at 16, JA 376 (citing Exh. HIO-67, R. 230, JA 383). Twenty percent of HIOS' $385.5 million investment in plant was $77 million, which, multiplied by HIOS' proposed overall return of 12.08 percent, produced a proposed management fee of $9.3 million. HIOS Rate Order P 98, JA 33.

The Commission reasonably found that HIOS failed to satisfy its burden under NGA § 4 to show that the $9.3 million fee was just and reasonable, as it would generate a margin of nearly fifty percent over operating expenses, and

[6] The Commission's calculation of the $1.7 management fee was lower than the $2.2 million fee HIOS calculated under the *Tarpon* formula, *see* HIOS Rate Order P 113, JA 38 (citing HIO-64, R. 227 at 15, JA 375), because the calculations used different overall rates of return.

amount to nearly one-third of HIOS' cost-of-service. HIOS Rate Order PP 105, 108, JA 35, 36; HIOS Rehearing PP 73-74, JA 107-08.

HIOS argued in the alternative that the Commission should create a hypothetical positive rate base for HIOS by either excluding supplemental depreciation or amortizing it over HIOS' service life. HIOS Rehearing P 47, JA 97; HIOS Request for Rehearing, R. 115 at 50-51, JA 338-39 (citing Exh. HIO-92, R. 255, JA 402). *See also* Exh. HIO-91, R. 254 at 5, JA 401. HIOS witness Mr. Porter calculated that these assumptions would produce current positive net rate bases of $33 and $31 million, which would result in traditional returns of $3.2 million and $2.9 million, respectively. HIOS Rehearing P 47, JA 97.

On brief, HIOS contends that the Commission erred: (1) in relying on Mr. Porter's calculation of the $180 million average rate base under the *Tarpon* methodology; and (2) in rejecting Mr. Porter's alternative management fee methodologies. Br. 60-66. Neither objection has merit.

HIOS contends that the Commission's reliance on Mr. Porter's $180 million average rate base calculation was "not rational" as that calculation were intended merely to "demonstrate[] the unreasonableness of the $680,802 fee" and was not proposed as an appropriate method of calculating a management fee. Br. 61-62; 64-65. However, Mr. Porter himself testified that his calculation "assume[d] HIOS' average cost of facilities as a simplified calculation of average rate base at the

midpoint of the pipeline's useful life as assumed in *Tarpon*." Exh. HIO-64, R. 227 at 15, JA 375 (discussing Exh. HIO-66, R. 229, JA 382); HIOS Rehearing P 45, JA 96. He then used his calculation of the average rate base to develop a management fee calculated in accordance with the *Tarpon* methodology. Exh. HIO-64, R. 227 at 15, JA 375. Thus, in following the *Tarpon* methodology, the Commission reasonably employed the average rate base figure developed by HIOS' own witness to apply that methodology. HIOS Rehearing P 46, JA 96.

The Commission reasonably rejected HIOS' alternative management fee proposals as inconsistent with *Tarpon*. HIOS Rehearing P 48, JA 97. The *Tarpon* methodology generates a management fee for a company which currently has a negative rate base, based on its average historical net rate base during the period before its rate base became negative. *Id*. Mr. Porter's alternative proposals did not calculate a historical rate base, but instead created a hypothetical positive rate base based upon a different method of depreciation. *Id*. In other words, under the Commission's methodology, HIOS still had a negative rate base, but, to eliminate the overly negative effect of HIOS' front-loaded supplemental depreciation, the Commission assumed the negative rate base was reached through even depreciation over HIOS' life as it was in *Tarpon*. *See* Exh. HIO-66, R. 229, JA 382. Mr. Porter's alternative proposals, on the other hand, changed the depreciation

assumptions to generate a fictional positive rate base on which to apply a return. *See* Exhs. HIO-91, R. 254 at 5, JA 401; HIO-92, R. 255, JA 402.

Accordingly, while both the Commission's and HIOS' methodology assume the absence of HIOS' supplemental depreciation, Br. 65, HIOS' methodology, inconsistent with *Tarpon*, also relies on a non-existent positive rate base. As the *Tarpon* methodology is designed to compensate owners of a pipeline with a negative rate base, the Commission reasonably concluded that, rather than adopt a management fee based on a hypothetical positive rate base, it would adhere to the principle – established in its precedent – of using the average historical rate base during the period when the pipeline had a positive rate base. HIOS Rehearing P 48, JA 97.

Moreover, as the Commission determined, the management fee awarded was sufficiently large to serve its intended purpose. HIOS Rate Order P 106, JA 35. Under *Tarpon*, a management fee should compensate the owners of the pipeline with a negative rate base for the risks of continuing to operate the pipeline. *Id.* (citing *Tarpon*, 57 FERC ¶ 61,371 at 62,240). The management fee should be high enough to encourage the pipeline to take actions to prevent a loss of throughput and to minimize costs, but not so high that it would be equivalent to a monopoly return unavailable to a firm operating under competitive conditions. *Id.*

Given HIOS' low risks, the approved management fee would fully compensate HIOS' owners for the risks of continuing to operate the pipeline. *Id*. P 107, JA 36; HIOS Rehearing P 79, JA 109. HIOS, on the other hand, failed to show that the approved management fee was insufficient. HIOS Rate Order P 108, JA 36; HIOS Rehearing P 80, JA 109. HIOS' operating costs, depreciation and negative salvage totaling over $20 million were already included in the allowed cost of service and should provide sufficient cash flow. *Id*. Additionally, about $3.6 million of that $20 million represented non-current expenses over and above the actual operating and maintenance expenses requested by HIOS. HIOS Rehearing P 80, JA 109. Such expenses do not represent actual payments that HIOS must make on a current basis and thus including these amounts in HIOS' cost of service contributes to an operating margin above actual current expenses. *Id*.

In any event, it is the responsibility of prudent management to maintain cash on hand necessary to weather downturns in its business, and HIOS had made distributions to its partners of $23.2 million in 1998, $15.3 million in 1999, $23.9 million in 2000, and $25 million in 2001, for a total of $87 million. *Id*. P 81 & n. 78, JA 110. Accordingly, the Commission reasonably applied the *Tarpon* methodology here, having determined that it resulted in a management fee sufficient to meet the purposes of the fee, and no showing having been made that any higher fee was required.

VI. THE COMMISSION REASONABLY SET PETAL'S RETURN ON EQUITY.

In connection with proposed pipeline construction and new service, Petal requested rates based upon a 15 percent return on equity, derived from the return of equity of Petal's parent, El Paso Energy. Petal Rehearing P 23, JA 195. In Petal's view, the parent was an appropriate proxy because it was publicly traded, engaged in the natural gas transmission business, and owned Petal. *Id*

In the Petal Certificate Order, the Commission rejected Petal's 15 percent return on equity because Petal had failed to provide the calculations to support it. Petal Rehearing P 6, JA 191. Instead, the Commission selected eleven companies to use as a proxy group. *Id*. P 7, JA 191. Based on the dividend yields and growth rate estimates for these proxy group companies, the discounted cash flow method resulted in a range of equity costs between 10.31 percent and 15.52 percent with a median of 12.60 percent. *Id.*

On rehearing, Petal derived a 16.73 percent return on equity for El Paso Energy to support Petal's proposed 15 percent return. *Id*. P 23, JA 195. The Commission again rejected Petal's reliance on its parent for its proposed equity return. *Id*. P 24, JA 196. Although petitioners assert there was no analysis associated with this decision, Br. 49, the Commission found the parent an inappropriate choice because it was engaged in many non-pipeline operations and

Petal did not demonstrate that its risks were similar to that of its parent. Petal Rehearing P 24, JA 196.

Petal also sought rehearing as to the selection of the eleven proxy group members, arguing that the group included only two companies used in prior natural gas pipeline proxy groups; only one company, Kinder Morgan, would satisfy the Commission's historical criteria for inclusion in the proxy group; and other companies were electric utilities and distribution companies. Petal Request for Rehearing, R. 46 at 6-10, JA 267-71. The Commission granted rehearing of the eleven-company proxy group, and adopted instead a *Williston Basin* proxy group of companies listed among the Value Line group of diversified natural gas companies that own FERC-regulated natural gas pipelines. Petal Rehearing P 26, JA 196. In reliance on the *Williston Basin* proxy group, the Commission found a range of equity returns from a low of 9.82 percent to a high of 13.76 percent, and approved a 12.48 percent return on equity at the median of the range. *Id*. P 27, JA 197.

Petal now asserts that the Commission does not employ the discounted cash flow analysis to calculate returns on equity in a certificate proceeding. Br. 49-50. As Petal never raised this argument on rehearing, the Court lacks jurisdiction to hear it. NGA § 19(b), 15 U.S.C. § 717r(b) ("[n]o objection to the Order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is

reasonable ground for failure to do so."). *See also City of Orrville, Ohio v. FERC*, 147 F.3d 979, 990 (D.C. Cir. 1998) (court lacks jurisdiction to hear arguments not made on rehearing); *Platte River Whooping Crane Critical Habitat Trust v. FERC*, 876 F.2d 109, 113 (D.C. Cir. 1989) (same). Indeed, to the contrary, Petal stated on rehearing that "[t]he Commission's Order correctly notes that its longstanding practice has been to utilize a [discounted cash flow] methodology to establish a rate of return for natural gas pipeline companies." Petal Request for Rehearing, R. 46 at 5, JA 266.

Likewise, *Entrega Gas Pipeline, Inc*., 113 FERC ¶ 61,327 at PP 34-36 (2005), does not support Petal's position. *See* Br. 49. Both the opponent and proponent of the selected rate of return in *Entrega* argued that their position was supported under the discounted cash flow analysis. *Entrega*, 113 FERC ¶ 61,327 PP 34-35. The fact that the Commission considered the return on equity in relation to other recently-awarded rates of return as a check on reasonableness, *see id*. P 36, does not constitute a rejection by the Commission of the discounted cash flow methodology.

Petitioners also challenge Petal's placement in the middle of the proxy group. Br. 59. Contrary to petitioners' claims, the Commission did not ignore, but rather rejected, the contention that Petal had above-average risk. Petal Rehearing P 29, JA 197. Like HIOS, Petal failed to make a sufficient showing that it was outside the

broad range of average risk. *Id.* Petal was not a new entrant into the gas business, but rather an existing corporate entity engaged in providing jurisdictional storage services. *Id.* The newly certificated service -- constructing a new pipeline to transport gas from Petal's storage facilities to Southern's pipeline interconnection -- was simply an expansion of Petal's existing jurisdictional business. *Id.*

Moreover, Petal proposed financing the pipeline internally through its parent, El Paso Energy, using a 50/50 debt equity capitalization. *Id.* This contrasted with highly leveraged, project-financed pipelines, where the Commission had approved equity returns of up to fourteen percent. *Id.* P 29 n. 21, JA 198 (citing *Gulfstream Natural Gas System, L.L.C.*, 105 FERC ¶ 61,052 (2003), *Georgia Strait Crossing Pipeline LP*, 98 FERC ¶ 61,271 (2002), and *North Baja Pipeline, LLC*, 95 FERC ¶ 61,259 (2001)). The average capital structure of the proxy group used in *Williston Basin* was comparable to Petal's capital structure, *i.e.* 50/50 debt/equity capitalization. *Id.* P 29, JA 198.

Under these circumstances, the Commission reasonably concluded that Petal had average business and financial risks, and overall was an average risk pipeline. *Id.* Consequently, the Commission appropriately found that Petal had not justified placement at the upper-end of the range, and therefore approved use of the median 12.48 percent return on equity. *Id.* P 30, JA 198.

CONCLUSION

For the reasons stated, the Commission's orders should be affirmed in all respects.

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CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 28(d)(1), and this Court's order of August 4, 2006, setting a word limit for Respondent's Brief of 18,000 words, I hereby certify that this brief contains 15,661 words, not including the tables of contents and authorities, the certificate of counsel, the glossary, this certificate and the addendum.

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