ORAL ARGUMENT IS NOT YET SCHEDULED

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

Nos. 04-1250, *et al.*

THE INDUSTRIALS, *ET AL.*,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

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

BRIEF FOR RESPONDENT FEDERAL ENERGY REGULATORY COMMISSION

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WASHINGTON, DC 20426

MAY 3, 2005

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties:

All parties appearing before the Commission and this Court are listed in Petitioners' Rule 28(a)(1) certificate.

B. Rulings Under Review:

The rulings under review appear in the following orders issued by the Federal Energy Regulatory Commission:

1. *Northern Natural Gas Co.*, 105 FERC ¶61,172 (2003); and
2. *Northern Natural Gas Co.*, 107 FERC ¶61,252 (2004);

C. Related Cases:

This case has not previously been before this Court or any other court. FERC counsel are not aware of any related cases pending in this or any other court.

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May 3, 2005

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GLOSSARY

EFM	Northern's real time metering system
MIP	monthly index price
NGA	Natural Gas Act
Northern	Northern Natural Gas Company
October 31 Order	*Northern Natural Gas Co.*, 105 FERC ¶61,172 (2003)
Order No. 637	*Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091 (Order No. 637), *order on reh'g*, Order No. 637-A, FERC Stats. & Regs, Regulations Preambles (July 1996-December 2000) ¶ 31,099, *order on reh'g*, Order No. 637-B, 92 FERC ¶ 61,062 (2000); *aff'd in pertinent part and remanded in nonpertinent part*, *Interstate Natural Gas Association of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002).
Rehearing Order	*Northern Natural Gas Co.*, 107 FERC ¶61,252 (2004)
SLA	Northern's System Levelized Account, which records the monthly dollar effects of its imbalance resolution mechanism
Texas Gas	Texas Gas Transmission Corporation
Transco	Transcontinental Gas Pipe Line Corp.

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

BRIEF FOR RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION

STATEMENT OF THE ISSUE

Whether the Commission appropriately approved as just and reasonable Northern Natural Gas Company's ("Northern") Natural Gas Act ("NGA") § 4 proposal to change its gas imbalance resolution rate mechanism to eliminate incentives for arbitrage and the harm arbitrage causes all pipeline customers.

STATUTES AND REGULATIONS

Pertinent sections of the NGA are set out in the Addendum to this brief.

STATEMENT OF THE CASE

I. NATURE OF THE CASE, COURSE OF PROCEEDINGS, AND DISPOSITION BELOW

Gas imbalances occur on a pipeline's system when a shipper delivers to or takes from a pipeline more or less gas than the volumes nominated and confirmed for shipment on the system. As net monthly imbalances can cause pipelines to under-recover costs and adversely affect system reliability, pipelines seek to reduce monthly imbalances and their harmful effects first by offering services (*e.g.*, parking) that allow shippers to avoid imbalances, and then by charging shippers for net monthly imbalances that do occur.

In May 2003, Northern filed an NGA §4, 15 U.S.C. § 717c, rate proposal that, in pertinent part, modified the index price component of its tiered imbalance cash-out mechanism.[1] R. 1 at Statement of Nature, Reasons and Basis For Filing pp. 6-7, JA 63-64; R. 1 at Seventh Revised Tariff Sheet No. 267-78, JA 65-72; R. 1 at Seventh Revised Tariff Sheet No. 267-78 (redline version), JA 73-80. Northern's index price had been set at the average monthly gas price but, because that methodology provided an incentive for shippers to engage in price arbitrage,

[1] To calculate a shipper's monthly imbalance charge, Northern multiplies the shipper's net monthly imbalance volumes by an index price. In addition, net monthly shipper imbalances above three percent are subject to a tiered penalty multiplier, *i.e.*, the penalty multiplier increases as the shipper's imbalance percentage increases. R. 1 at Seventh Revised Tariff Sheet No. 267-78, JA 65-72; R. 1 at Seventh Revised Tariff Sheet No. 267-78 (redline version), JA 73-80.

Northern proposed to set the index price at the highest or lowest of five weekly prices. The five weeks would include the four weeks during the month when the imbalances occurred and the first week of the following month.

Order No. 637[2] had determined that pipelines could modify their imbalance cash-out mechanisms if necessary to remove the incentive for arbitrage. Rehearing Order at P 13, JA 37 (citing Order No. 637-A at 31,607-08). Thereafter, the Commission approved other pipelines' similar proposals to cash-out imbalances using weekly high/low index price penalty mechanisms to eliminate the incentive for arbitrage. *Northern Natural Gas Co.*, 105 FERC ¶ 61,172 at P 80 (2003) ("October 31 Order"), JA 22, *order on reh'g*, 107 FERC ¶ 61,252 at P 20 (2004) ("Rehearing Order"), JA 40-41. The challenged orders approved Northern's proposal as consistent with this precedent and policy. October 31 Order, JA 1-32, Rehearing Order, JA 33-61.

[2] *Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) &31,091 (Order No. 637), *order on reh'g*, Order No. 637-A, FERC Stats. & Regs, Regulations Preambles (July 1996-December 2000) &31,099, *order on reh'g*, Order No. 637-B, 92 FERC &61,062 (2000); *aff'd in pertinent part and remanded in nonpertinent part*, *Interstate Natural Gas Association of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002).

II. STATEMENT OF FACTS

A. Events Leading to the Challenged Orders

1. Order No. 637

Prior to Order No. 637, pipelines' tariff provisions for remedying monthly shipper net gas input and output imbalances allowed shippers to cash-out net monthly imbalances using an average monthly price. In Order No. 637, the Commission found this procedure:

> invite[d] shippers to game the system within the month. For example, a shipper may take more than it delivers when gas prices are higher than cash-out prices, and deliver more than it needs when gas prices are lower than cash-out prices. To the extent that pipelines rely on additional storage capacity to accommodate these imbalances, the arbitrage activity imposes costs on all shippers on the system through higher transportation rates that include more storage costs. In addition, at peak, arbitrage behavior may imperil systemwide reliability . . . .

Order No. 637 at 31,308. The Commission determined that pipelines should "revise the level and structure of their penalty provisions to minimize the opportunity for arbitrage," Order No. 637-A at 31,607, and "change the methods by which they cash-out imbalances to eliminate the incentives for shippers to borrow gas from the pipeline because the cash-out price is less than the market price for gas," Order No. 637 at 31,314; *see also* Order No. 637-A at 31,607 (same).

Additionally, concerned that pipelines did not offer services to allow shippers to keep their gas input and output in balance, and therefore, avoid net imbalance penalties, the Commission required pipelines to provide imbalance management services, such as a parking and lending, "to make it easier for shippers to remain in balance in the first instance." Order No. 637 at 31,308-09. "[R]equiring pipelines to provide imbalance management services, to the extent operationally feasible, is a key step in creating a policy that focuses more on providing flexible service options, minimizing the need for . . . penalties." Order No. 637 at 31,311. Moreover, "[m]oving towards a system where customers pay directly for imbalance management services will impose the costs of those services on those shippers needing the service, minimizing the impact on other customers that require less flexibility. Thus, it should shift costs that are now collected from all shippers through general transportation charges to those shippers that most require the needed flexibility." Order No. 637 at 31,311.

"Since the penalty system [was] being used by shippers to indirectly gain needed flexibility, and [to] engage in behavior that may be harmful to the system as a way to obtain such flexibility, the Commission [found] that a general shift in Commission policy [was] warranted so that penalties are imposed only when needed to protect system integrity." Order No. 637 at 31,308. This did not mean, however, that penalties could be imposed only to protect system integrity during

critical reliability periods. Order No. 637-A at 31,608. Rather, "whether penalties may be imposed during non-critical periods needs to be determined in the pipelines' compliance filing proceedings and cannot be determined in the abstract." Order No. 637-A at 31,608. Individual compliance filing proceedings allow the Commission to "evaluate how the proposed imbalance management services . . . and penalty structures all work together, as an overall program of system management." Order No. 637-A at 31,609. Individual review makes sense, as the "goal of the Commission's new policy on penalties is to encourage pipelines to rely less on penalties and more on non-penalty mechanisms, such as imbalance management services, and to design and impose only necessary and appropriate penalties." *Id.*

2. *Texas Gas*

In 2001, the Commission approved, as consistent with Order No. 637, Texas Gas Transmission Corporation's ("Texas Gas") NGA § 4 proposal to change its imbalance cash-out methodology to minimize the incentive for arbitrage. *Texas Gas Transmission Corporation*, 95 FERC ¶ 61,093 at 61,273, *order after technical conference*, 96 FERC ¶ 61,318 at 62,218, *order on reh'g*, 97 FERC ¶ 61,349 (2001). Texas Gas previously used an average monthly price methodology to determine cash-out amounts. *Texas Gas*, 95 FERC at 61,273; *see also Texas Gas*, 96 FERC at 62,217 and n.3. Specifically:

> [w]hen the imbalance was less than five percent of the customer's total deliveries to the system, then the index price [was] the average weekly price for the month . . . . When the imbalance [was] greater than five percent and the customer took too much gas, then the index price used to determine the customer's payment [was] the highest average weekly price for the month. By contrast, when the imbalance [was] greater than five percent and the customer took too little gas, the index price used to determine Texas Gas' payment [was] the lowest average weekly price for the month.
>
> All imbalances less than five percent [were] paid for based on 100 percent of the average weekly price for the month. However, as the imbalances increase[d] above five percent of the customer's overall deliveries for the month, the payments [were] adjusted based on increasing or decreasing percentages of the relevant index price, depending on whether the customer took too much or too little gas.

Texas Gas, 95 FERC at 61,273.

The average monthly price methodology provided an incentive for shippers to engage in price arbitrage as they could calculate towards the end of the month what the likely cash-out price would be. *Texas Gas*, 97 FERC at 62,630, 62,632. For example, if prices were rising during a month, shippers could be fairly certain that end-of-month gas prices would be higher than the average cash-out imbalance price, creating an incentive for shippers to take gas from the pipeline in excess of their nominated and confirmed amounts, sell the excess for the relatively higher prices, and repay the pipeline for that excess (imbalance) gas at the lower average cash-out price. *Texas Gas*, 97 FERC at 62,630. On the other hand, if prices were declining over a month, shippers had an incentive to take less gas from the

pipeline's system than their nominated and confirmed volumes, and obtain the higher average cash-out price for the difference.

To minimize such arbitrage, Texas Gas first proposed to replace the average cash-out index price with a daily high/low index price. *Texas Gas*, 97 FERC at 62,632. The Commission rejected this proposal because it went "beyond what is necessary to minimize arbitrage. All that is needed is a mechanism that minimizes the incentive to game Texas Gas' system without unnecessarily removing a customer's flexibility . . . ." *Texas Gas*, 97 FERC at 62,633; *see also Texas Gas*, 96 FERC at 62,218.

Moreover, the Commission found that a daily high/low index price would inappropriately penalize customers in contravention of Order No. 637, as "a customer's net overtakes of gas over the course of a month are the result of its overall transportation volumes for the month, and cannot necessarily be attributed to an overtake on any particular day during the month, let alone the day when prices were at their highest. . . . Thus, requiring a customer to pay the pipeline the high daily price could easily cause the customer to pay more than the cost of the particular gas it took." *Texas Gas*, 97 FERC at 62,632-33; *Texas Gas*, 96 FERC at 62,219-20 (citing *Southern Natural Gas Co.*, 74 FERC ¶ 61,230 (1996), *reh'g denied*, 78 FERC ¶ 61,164 (1997)).

Texas Gas' subsequent proposal, to use a weekly high/low index price, by contrast, was appropriate and consistent with Order No. 637. *Texas Gas*, 97 FERC at 62,633, 62,637; *see also Texas Gas*, 96 FERC at 62,218 ("to the extent that Texas Gas' [proposed tiered cash-out imbalance] charges are necessary to remove the incentive for arbitrage, they are appropriate under Order No. 637.") Under that proposal, the cash-out index price for customers who took more or less gas than they put on the system would be the highest or lowest, respectively, of the weekly prices in any of the four weeks during that month and the first week of the following month. *Texas Gas*, 97 FERC at 62,633, 62,635. This would eliminate the opportunity for arbitrage.

> During the last week, customers should not have any degree of certainty that the cashout price will be higher (or lower) than market prices on the day in question. In the example where prices increase during the month, the lower prices in the earlier part of the month will no longer be reflected in the price the customer must pay the pipelines for overtakes of gas. Thus, during the last week of the month, the price for cashing out overtakes will either be based on the high prices in effect during the last week or the perhaps still higher prices that might occur during the first week of the following month. Therefore, the customers could have no certainty that they could take gas from the pipeline during the last week and sell it for a higher price than they would have to pay the pipeline for cashing out the resulting imbalance.

Texas Gas, 97 FERC at 62,632.

Additionally, unlike use of a daily high/low index price, use of a weekly high/low index price more appropriately matches imbalance costs with cash-out

obligations because it better represents the highs and lows that occur over the monthly imbalance netting period. *Texas Gas*, 97 FERC at 62,633, 62,635, 62,637. Thus, Texas Gas' proposal "balance[d] the goals of deterring arbitrage, while not imposing an unnecessarily high penalty on the customers." *Texas Gas*, 97 FERC at 62,633.

Finally, the Commission found, a pipeline does not have to show that imbalances are actually causing operational problems on its system before modifying its cash-out methodology to remove the incentive for price arbitrage.

> When price arbitrage occurs, the pipeline is, in essence, required to sell gas to its customers at below market levels and buy gas from them at above-market levels. As demonstrated by Texas Gas' situation, this can lead to the pipeline incurring a substantial underrecovery of costs. There is no reason to make the correction of such a problem contingent on a showing that the imbalances are causing operational problems. It is not just and reasonable to require pipelines to underrecover their costs, and . . . the Commission did not require such a thing in Order No. 637.

Texas Gas, 97 FERC at 62,634-35; *see also Texas Gas*, 96 FERC at 62,218-19.

The Commission also has approved, as consistent with Order No. 637, other pipelines' similar tiered imbalance cash-out methodologies intended to minimize the incentive for price arbitrage on their systems. *E.g.*, *Guardian Pipeline, LLC*, 102 FERC ¶ 61,081 (2003) (approving proposal to substitute weekly high/low index prices for average index prices in pipeline's tiered imbalance cash-out mechanism); *Gulf South Pipeline Co.*, 97 FERC ¶ 61,069 (2001), *order on reh'g*,

98 FERC ¶ 61,068 (2002) (approving proposal to calculate the index price for its tiered imbalance cash-out mechanism based on high/low prices reported for each week of the month in which the net imbalance occurred and the price from the first week of the following month); *Transcontinental Gas Pipe Line Corp.*, 96 FERC ¶ 61,352 (2001), *order on reh'g*, 98 FERC ¶ 61,213 (2002) ("Transco") (same); *Black Marlin Pipeline Co.*, 101 FERC 61,087 (2002) (approving implementation of weekly high/low index prices and tiered imbalance cash-out mechanism); *Enbridge Pipelines (KPC)* ("KPC"), 99 FERC ¶ 61,208 (2002) (approving continuation of pipeline's tiered imbalance cash-out mechanism).

3. Northern's Proposal to Modify Its Tiered Cash-Out Mechanism To Remove The Incentive For Shippers To Engage In Price Arbitrage

On May 1, 2003, Northern filed an NGA §4 rate proposal, in pertinent part, to modify the methodology it uses to determine the index price component of its tiered imbalance cash-out mechanism. R. 1 at Statement of Nature, Reasons and Basis For Filing p. 6-7, JA 63-64; R. 1 at Seventh Revised Tariff Sheet No. 267-78, JA 65-72; R. 1 at Seventh Revised Tariff Sheet No. 267-78 (redline version), JA 73-80. Northern's existing methodology used an average monthly index price. R. 1 at Statement of Nature, Reasons and Basis For Filing p. 6-7, JA 63-64; R. 1 at Seventh Revised Tariff Sheet No. 267-78 (redline version), JA 73-80.

To remove the incentive for price arbitrage inherent in that methodology, Northern proposed an index price methodology that averages several industry index prices for each of the weeks during the month when the imbalances occurred and the first week of the following month. When a customer takes more gas from the system than it puts on during a month, it will reimburse Northern for the difference based on the highest of the five weekly average prices. If a customer takes less gas from the system than it puts on, Northern will purchase the difference based on the lowest of the five weekly average prices. Northern justified its proposed modification:

> The existing imbalance resolution mechanism appeared to have been initially effective in reducing imbalances on Northern's system. However, imbalance levels are now escalating, indicating that shippers may be discovering ways to arbitrage the current [monthly index price ("MIP")] calculation. The current mechanism, which includes an averaging for a month's worth of pricing data, is destined to understate the cash-out price during rising prices and overstate the cash-out price during falling prices, providing shippers with an incentive to over or underdeliver depending on the daily cash price versus the average monthly index price. Northern's proposal for weekly pricing of imbalances will result in MIPs that more accurately reflect any price volatility occurring within the month and will give shippers additional incentives not to create imbalances solely for financial gain. By [continuing to] valu[e] imbalances in a tiered manner and [beginning to] cash[]-out imbalances accumulated over a month period based on weekly high/low prices, Northern [will] mitigate[] the economic incentive for shippers to create imbalances within a given month.

R. 1 at Statement of Nature, Reasons and Basis For Filing p. 7, JA 64; *see also* R. 5 at Ex. Nos. NNG-14 pp 46-51 (JA 82-87), NNG-20 through 22 (JA 88-90); R. 111 at 11-12, JA 301-02; R. 131 at 35-36, JA 550-51.[3]

The Commission accepted, subject to a five month suspension, Northern's proposed rate changes, and directed that a technical conference be held regarding, among other things, the proposed imbalance cash-out mechanism modifications. *Northern Natural Gas Co.*, 103 FERC ¶ 61,266 at PP 22, 30, Ordering P (D) (2003). The technical conference was held on July 29 and 30, 2003. October 31 Order at P 2, JA 1.

Northern's comments after the technical conference pointed out that the:

> proposed weekly high/low mechanism is similar to the imbalance provisions previously accepted by the Commission, which are based on high/low weekly average prices and include tiering mechanisms.[[4]] Like such other pipelines, Northern proposes to cash out imbalances due Northern at the highest weekly price index and imbalances due Northern's customers at the lowest weekly price index and continue its tiering mechanism with modifications. Northern's use of five weeks instead of four weeks to calculate the applicable MIP will

[3] While Northern also initially proposed to "revis[e] its existing tiering structure by reducing the tolerance level from 3% to 2%," R. 1 at Statement of Nature, Reasons and Basis For Filing p. 6, JA 63, it later withdrew that proposal, R. 131 at 3, JA 518; *see also* October 31 Order at P 70, JA 19. The Commission rejected Northern's proposal to add a new tier for imbalances greater than 25 percent, R. 1 at Statement of Nature, Reasons and Basis For Filing p. 6, JA 63, because Northern had not justified the need for another level of imbalance tolerance, October 31 Order at P 84, JA 23.

[4] Citing *Texas Gas*, 95 FERC ¶61,093, 96 FERC ¶61,318, 97 FERC ¶61,349; *Black Marlin*, 101 FERC ¶61,087; and *Guardian*, 102 FERC ¶61,081.

> inject additional uncertainty as to the calculation of such MIPs . . . . By using average weekly index prices and a tiered structure, Northern is attempting to remove the incentive for shippers to create imbalances within a given month.

R. 111 at 13, JA 303; *see also* R. 131 at 26-41, JA 541-56.

In addition, Northern noted that, to address concerns expressed at the technical conference, it revised its:

> imbalance to storage provisions to allow for resolution of imbalances via a shipper's storage account as opposed to dollar valuation and cashout of the entire imbalance. In this way, shippers will be able to transfer their imbalances to storage . . . before the cashout provisions go into effect, thereby mitigating the impact of the cashout provisions on shipper imbalances. Thus, the imbalance to storage provisions, plus the existing imbalance trading provisions, provide shippers with the tools to manage their imbalances on Northern's system before the cashout provisions are applied.

R. 111 at 14, JA 304.

Northern further explained that "parties that actually benefit the system by having a position in the opposite direction of the net monthly imbalance" can "trade their imbalances and thereby avoid either paying the highest weekly price to Northern or receiving the lowest weekly price from Northern," as "[o]nly the net imbalances after trades of all shippers will be charged the high/low price." R. 131 at 31, JA 546.

B. The Challenged Orders

After carefully considering the entire record and applicable precedent, the Commission approved Northern's NGA § 4 proposal because "Northern

satisfactorily show[ed] that its use of a high/low index price is just and reasonable." Rehearing Order at P 12, JA 37. First, Northern's proposal to modify its index price methodology to remove the prior methodology's incentive for arbitrage was consistent with precedent. October 31 Order at P 80, JA 22; Rehearing Order at PP 13-15, 20-21, JA 37-38, 40-41.

"The Commission in Order No. 637 recognized a need to minimize arbitrage on pipelines' systems and determined that, to the extent that changes to a cash-out mechanism are necessary to remove the incentive for arbitrage, a pipeline could implement such changes." Rehearing Order at P 13, JA 37 (citing Order No. 637-A at 31,607-08). Since then, the Commission has approved other pipelines' proposals to cash-out imbalances using a weekly high/low index price penalty mechanism as a means to eliminate the incentive for arbitrage. October 31 Order at P 80, JA 22; Rehearing Order at P 20, JA 40-41 (citing *Texas Gas*, 95 FERC ¶ 61,093, 96 FERC ¶ 61,318, 97 FERC ¶ 61,349; *Guardian Pipeline*, 102 FERC ¶ 61,081; *Gulf South*, 97 FERC ¶ 61,069, 98 FERC ¶ 61,068; *Transco*, 96 FERC ¶ 61,352, 98 FERC ¶ 61,213; *Black Marlin*, 101 FERC ¶ 61,087; *Enbridge (KPC)*, 99 FERC ¶ 61,208).

"[P]recedent does not require that a pipeline show that arbitrage has actually occurred on the system or has caused operational problems before permitting a pipeline to modify its cash-out mechanisms." Rehearing Order at P 14, JA 37-38;

cf. October 31 Order at P 80, JA 22. Rather, in *Texas Gas*, 97 FERC at 62,634, and *Transco*, 98 FERC at 61,814, FERC found that, "when price arbitrage occurs, the pipeline is, in essence, required to sell gas at below market levels and buy gas from them at above-market levels," and "that it was not just and reasonable to require pipelines to give their customers such an opportunity, particularly since this can lead to the pipeline incurring a substantial underrecovery of costs." Rehearing Order at P 14, JA 37-38.

Moreover, because a pipeline does not have ready access to information about why a shipper incurred an imbalance,[5] "if 'the current system provides obvious opportunities and incentive to game the system' . . . it is reasonable to assume that there is a danger of such gaming occurring and to permit [the pipeline] to modify its cash-out mechanism to eliminate that opportunity." Rehearing Order at P 15, JA 38 (quoting *Gulf South*, 98 FERC at 61,180).

The Commission noted that a 2002 uncontested Northern settlement attempted to prevent arbitrage on its system and the rate increases it can cause for all shippers by creating a ten-day lag in determining the imbalance cash-out index price. Rehearing Order at P 16, JA 38-39. Prior to the settlement, Northern cashed out imbalances based on the average gas price for the month in which the

[5] "For example, when a customer takes more gas from the system than it put on the system, the pipeline would not ordinarily know what the customer did with the excess gas it took, *i.e.*, whether the customer sold that gas for a price higher than the cash-out index price." Rehearing Order at P 15, JA 38.

imbalances were incurred. *Id.* Under the settlement methodology, Northern calculated the average monthly price for a period beginning on the eleventh day of the month in which the imbalances occurred and continuing through the tenth day of the following month. *Id.*

Despite that change, the Commission found "a continuing problem with imbalances on Northern's system, leading to an under recovery of costs." Rehearing Order at P 17, JA 39.

> Even with the 10-day lag in the calculation of the average monthly price used for cashing out imbalances, shippers can still predict toward the end of the month with reasonable accuracy whether the cash-out price is likely above or below market prices toward the end of the month. About two thirds of the daily prices used in calculating the average price are already known.

Rehearing Order at P 17, JA 39. Thus, while the ten-day lag initially appeared to reduce imbalances on Northern's system, the evidence showed that, after a short period, imbalances again increased. Rehearing Order at P 16, JA 38-39 (citing R. 131 at 27-29, JA 542-44). The balance in Northern's System Levelized Account ("SLA"), which records the monthly dollar effects of its imbalance resolution mechanism, increased from $40,814,178 in April 2002, when the settlement became effective, to $55,708,918 on April 30, 2003, and increased to approximately $60 million by December 1, 2003. Rehearing Order at P 16, JA 38-39 (citing R.131 at 28, JA 543 and R. 194 at 2, JA 729).

Consequently, the Commission found it was "reasonable to conclude that the likelihood of gaming occurring on Northern's cash-out mechanism exists[,] which ultimately leads to an underrecovery of costs that Northern will shift to other customers. Accordingly, it [was] also reasonable, given the policies and precedent discussed above, to permit Northern to modify its cash-out mechanism to reduce the incentive for shippers to engage in such actions." Rehearing Order at P 17, JA 39. Unlike the prior monthly average system, the proposed high/low weekly system will significantly reduce the opportunity for arbitrage because the high/low prices may well result from prices unknown even at the end of the month in which the imbalances are incurred. Rehearing Order at P 17, JA 39.

The petitions for review followed.

SUMMARY OF ARGUMENT

The Commission appropriately approved Northern's proposed imbalance resolution rate mechanism to eliminate incentives for arbitrage on its system. Arbitrage can cause a pipeline to substantially underrecover costs and adversely affect system reliability. Accordingly, Commission precedent, beginning with Order No. 637, permits a pipeline to restructure its imbalance cash-out penalty mechanism to eliminate incentives for shippers to engage in arbitrage without showing that arbitrage actually has occurred, and has caused reliability problems, on its system, so long as the pipeline offers imbalance management services that

allows shippers to minimize the possibility of incurring imbalances, shippers are permitted to run imbalances during the whole month, and the tiered penalties are imposed only on net monthly imbalances. Northern's proposal met all those criteria.

Application of the high/low weekly index price to all monthly imbalances (after netting and trading) on Northern's system was appropriate because imbalances of up to three percent can occur for the purpose of arbitrage just as greater imbalances can occur for that purpose. Thus, the goal of minimizing arbitrage justifies applying the high/low index price to all imbalances, not just those in excess of three percent.

Whether other pipelines' imbalance provisions are less stringent than Northern's is of no import. A pipeline has the initiative under NGA § 4 to propose rates, terms, and conditions for the services it provides. If the pipeline shows that its proposal is just and reasonable, as Northern did here, the Commission must accept it, regardless of whether other rates, terms and conditions may be just and reasonable as well. Shippers are not entitled to a penalty-free tolerance zone, but only to an overall just and reasonable rate, which they received here.

Additionally, imbalance management services do not provide pipelines a windfall. Rather, Order No. 637 found that pipelines must provide imbalance management services because they are a necessary and appropriate means for

shippers to remain in balance, and would properly assign the costs of imbalances services to those needing them.

Finally, as Petitioners did not raise on rehearing their assertion on appeal that the October 31 Order is internally inconsistent because it approved Northern's proposal to modify its cash-out mechanism's index price, but rejected Northern's proposal to add a 25 percent imbalance tier to that mechanism, the Court does not have jurisdiction to address it. In any event, there is no inconsistency. Northern showed that its proposal to apply the weekly high/low index price to all net imbalances was necessary to remove the existing mechanism's incentive to engage in arbitrage, but did not make that same showing regarding its proposal to add the 25 percent imbalance tiering level.

ARGUMENT

I. Standard of Review

The Court reviews FERC orders under the Administrative Procedure Act's arbitrary and capricious standard. *E.g.*, *Florida Municipal Power Agency v. FERC*, 315 F.3d 362, 365 (D.C. Cir. 2003). Under that standard, the Commission's decision must be reasoned and based upon substantial evidence in the record. For this purpose, the Commission's factual findings are conclusive if supported by substantial evidence. 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*, 315 F.3d at 365 (quoting *FPL Energy Me. Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002)). Moreover, the Court defers to the Commission's interpretation of its own orders. *East Texas Electric Cooperative, Inc. v. FERC*, 218 F.3d 750, 754 (D.C. Cir. 2000); *Natural Gas Clearinghouse v. FERC*, 108 F.3d 397, 399 (D.C. Cir. 1997).

As explained below, the Commission's determination was well-reasoned, supported by substantial evidence, and consistent with precedent. Accordingly, the challenged orders must be upheld.

II. The Commission Appropriately Approved Northern's Proposed Imbalance Resolution Rate Mechanism To Eliminate Incentives For Arbitrage

In Petitioners' view, Order No. 637 allows a pipeline to restructure its penalty mechanism in order to eliminate the incentives for shippers to engage in arbitrage *only if* the pipeline establishes that arbitrage is actually occurring on its system and is affecting system reliability. Br. at 16-37. FERC found otherwise:

> Order No. 637 recognized a need to minimize arbitrage on pipelines' systems and determined that, to the extent that changes to a cash-out mechanism are necessary to remove the incentive for arbitrage, a pipeline could implement such changes. Specifically, in Order No. 637, the Commission stated that pipelines could "change the methods by which they cash out imbalances to eliminate the incentives for shippers to borrow gas from the pipeline because the cash-out price is less than the market price for gas."

Rehearing Order at P 13, JA 37 (quoting Order No. 637 at 31,314-15 and citing Order No. 637-A at 31,607-08).

Furthermore, precedent establishes that if a pipeline's existing cash-out penalty mechanism provides an incentive to game the system through arbitrage, the pipeline does not have to show that arbitrage has actually occurred on its system (Br. at 35-37) and has caused reliability problems (Br. at 34-35) to restructure that mechanism to remove the gaming incentive. October 31 Order at P 80, JA 22; Rehearing Order at P 14, JA 37-38. Because arbitrage forces a pipeline to sell gas to shippers at below market levels and to buy gas from them at above-market levels, which can cause substantial cost underrecovery, it would be unjust and unreasonable to require a pipeline to retain a cash-out mechanism that allows its shippers to engage in arbitrage. Rehearing Order at P 14, JA 37-38 (citing *Texas Gas*, 97 FERC at 62,634, and *Transco*, 98 FERC at 61,814). A system that provides opportunities and incentives for arbitrage creates a danger that arbitrage will occur. Rehearing Order at P 15, JA 38 (citing *Gulf South*, 98 FERC at 61,180). The Commission found that its precedent allows a pipeline to modify its cash-out mechanism to eliminate that danger. Rehearing Order at P 15, JA 38 (citing *Gulf South*, 98 FERC at 61,180). FERC's reasonable interpretation of its own orders, not Petitioners' contrary interpretation, is due substantial deference. *East Texas Electric*, 218 F.3d at 754; *Natural Gas Clearinghouse*, 108 F.3d at 399.

Thus, the answer to Petitioners' "fundamental issue" -- "whether FERC, in the orders under review, has eviscerated the Order No. 637 requirements

concerning the circumstances under which penalties may be imposed without adequate evidentiary support or explanation," Br. at 16, *see also* Br. at 23-24, 34-37 -- is a resounding "no." Since Order No. 637, pipelines have been able to change their imbalance cash-out mechanisms where necessary to remove the incentive for arbitrage without showing that arbitrage actually has occurred on their systems. *See Texas Eastern Transmission, LP*, 102 FERC ¶ 61,198 at P 101 (2003) (explaining that "Order No. 637 articulated a number of policies and goals with respect to imbalance management services, penalties, cash-out mechanisms, and arbitrage" including "discouraging or reducing the possibility of arbitrage"). The challenged orders, therefore, do not abandon the policies enunciated in Order No. 637, as Petitioners posit (Br. at 24, 26), but further them. As no change in policy occurred in the challenged orders, no evidentiary support or explanation for a change was necessary.

Transcontinental Gas Pipe Line Corporation, 91 FERC ¶ 61,004 at 61,018 (2000), does not, as Petitioners assert (Br. at 19), buttress their interpretation of Order No. 637. FERC did not reject Transco's 1999 proposal to modify its existing tiered cash-out mechanism as contrary to Order No. 637 because no actual arbitrage was shown. Rather, unlike the instant case, "Transco ha[d] proposed to tighten penalty levels, resulting in significant immediate overrecoveries, without offering to provide any new imbalance management tools to help shippers avoid

imbalances and the associated penalties." *Transco*, 91 FERC at 61,018. The Commission approved, as consistent with Order No. 637, Transco's subsequent proposal to modify its tiered cash-out imbalance mechanism to calculate the index price based on weekly prices for five, rather than four, weeks and to offer shippers a number of tools that would enable shippers to manage imbalances and, thus, avoid imbalance charges. *Transco*, 96 FERC at 62,311, 62,313.

Texas Eastern Transmission, LP, 98 FERC ¶ 61,215 at P 127 (2002), *order on reh'g*, 102 FERC ¶ 61,198 at PP 97-106 (2003), does not help Petitioners either. While, as Petitioners state (Br. at 19-20), the Commission rejected Texas Eastern's proposed changes to its imbalance cash-out mechanism because it found that "the pipeline had failed to make the requisite demonstration of operational harm," that requirement did not derive from Order No. 637, but from a settlement that prohibited Texas Eastern from making its penalties more stringent unless required to do so by the Commission. *Texas Eastern*, 102 FERC at PP 95, 96, 104-05. As "Order No. 637 did not *require* pipelines to make any changes to their cash-out mechanisms," a pipeline could do so only under NGA § 4. *Id.* at PP 101, 102 and n. 68. "Since Texas Eastern agreed in its settlement not to strengthen or increase its penalty provisions, the Commission . . . would require Texas Eastern to show that arbitrage is so detrimental to its system that it creates such significant operating difficulties that the Commission needs to intervene in order to ensure

adequate service to all of its customers. . . . Texas Eastern has not made such a showing in this proceeding." *Id.* (citation omitted).

Petitioners' reliance (Br. at 20) on *Columbia Gas Transmission Corporation*, 100 FERC ¶ 61,084 at P 204 (2002), *order on reh'g*, 104 FERC ¶ 61,168 (2003), fails as well. The Commission rejected Columbia Gas' proposal to increase its imbalance penalty levels not "because the new penalty levels were 'found to lack a relationship to the operational harm caused by shipper behavior,'" Br. at 20, but because the proposal inappropriately was made as part of Columbia Gas' Order No. 637 compliance filing rather than as an NGA § 4 filing. *Columbia Gas*, 100 FERC at P 204; *cf. Columbia Gas*, 104 FERC at P 75 ("we reiterate our policy of not allowing pipelines to use their proceedings to comply with the Section 5 requirements of Order No. 637 [*i.e.*, to add, or justify the existing, imbalance management services offered in their tariffs] as an opportunity to increase their penalties or make the tolerances more stringent."). Order No. 637 established an NGA § 5 proceeding to review the justness and reasonableness of pipelines' imbalance services and existing penalty provisions. While Columbia Gas could not include a proposal to increase its imbalance penalties as part of its Order No. 637 NGA § 5 compliance filing, it could make an NGA § 4 filing to do so. *Columbia Gas*, 100 FERC at P 204. As Northern's instant proposal was made as an NGA § 4 filing, *Columbia Gas* is inapposite.

Williams Gas Pipelines Central, Inc., 100 FERC ¶ 61,232, *order on reh'g*, 102 FERC ¶ 61,119 (2002) and *ANR Pipeline Co.*, 103 FERC ¶ 61,252, *order on reh'g*, 105 FERC ¶ 61,236 (2003) (Br. at 20, 24-25) are distinguishable as well. Rehearing Order at n.10, JA 37. Imbalance penalties normally are not imposed unless a shipper incurs net monthly imbalances, but the pipelines in those cases proposed to penalize imbalances incurred during periods of less than a month (daily for Williams; five day periods for ANR). Northern, by contrast, did not propose any intra-monthly imbalance penalties. Rehearing Order at n.10, JA 37. As the Commission explained in *ANR*, monthly resolution fits with monthly imbalance charges:

> The Commission recognizes that it has permitted pipelines to continue tiered mechanisms to cash out monthly imbalances without a showing that imbalances are causing operational problems, so long as the pipeline offers an imbalance management service that allows shippers to minimize the possibility of the shippers incurring imbalances. However, in all those cases, shippers were permitted to run imbalances during the whole month, and the tiered penalties were only imposed on the net monthly imbalances. As the Commission stated in [*ANR*, 103 FERC at P 13 and n.6 (citing *Williams*, 100 FERC at 61,823-24)], we have not approved any pipeline tariff provision requiring resolution of imbalances during the course of a month, at least during non-critical periods. . . . ANR's proposal, like the one in *Williams*, would clearly reduce the flexibility shippers now have to run imbalances during a month, subject only to penalties for the overall monthly imbalance. Consistent with Order No. 637, the Commission would only permit such a reduction in flexibility where the pipeline could make a convincing case that it was necessary to prevent impairment of reliable services.

105 FERC ¶ 61,236 at P 19 (footnotes omitted).

Petitioners err in asserting that "the Order No. 637 policy and its application have been abundantly clear [that] penalties – including penalties on imbalances such as those proposed by Northern here – can only be imposed where necessary to prevent the impairment of reliable services and to protect system integrity." Br. at 21, *see also* Br. at 22, 34-35. Rather, as the Commission explained in Order No. 637, it evaluates a pipeline's imbalance management services and penalty mechanisms in tandem as part of an overall approach to managing imbalances. Order No. 637-A at 31,608-09. Accordingly, consistent with Order No. 637, the Commission "has permitted pipelines to continue tiered mechanisms to cash out monthly imbalances without a showing that imbalances are causing operational problems, so long as the pipeline offers an imbalance management service that allows shippers to minimize the possibility of the shippers incurring imbalances[,] shippers [a]re permitted to run imbalances during the whole month, and the tiered penalties [a]re only imposed on the net monthly imbalances. *ANR*, 105 FERC ¶ 61,236 at P 19. Northern's proposal met those criteria and, therefore, FERC's approval of that proposal was consistent with precedent.

Next, Petitioners complain that Northern's imbalance cash-out mechanism does not include a penalty-free tolerance zone because the high/low weekly index

price applies to each Mcf of imbalance gas.[6] Br. at 10, 22-23, 30, 33, 38-40. Even assuming a high/low weekly index price is a penalty, the Commission found its application to all net monthly imbalances on Northern's system appropriate.

> [A] primary purpose of Northern's high/low proposal is to minimize arbitrage and the continuing increase in the SLA balance, which ultimately hurts all of Northern's customers. Shippers may incur imbalances in the 0 to 3 percent range for the purpose of arbitrage, just as they can incur greater imbalances for that purpose. Thus, the goal of minimizing arbitrage supports the use of the high/low pricing method for all imbalances, not just those in excess of a tolerance level such as three percent. For that reason, the Commission approved the use of the high/low pricing method for all imbalance tolerance levels for other pipelines, including Guardian and Black Marlin.

Rehearing Order at P 23, JA 42.

The fact that Texas Gas' mechanism resolves imbalances in its first imbalance tier on an in-kind basis, rather than by using the high/low index price it applies to higher imbalance levels, does not undercut Northern's use of its high/low index price for imbalances up to three percent, as Petitioners assert, Br. at 30, 33. Rehearing Order at PP 24-25, JA 42-43. In approving Texas Gas' tiered imbalance proposal, "the Commission expressly noted that there could be other methods of addressing the resolution of imbalances that would also be just and

[6] Under the approved Northern tiered cash-out imbalance mechanism, a penalty multiplier applies only if net shipper imbalances exceed three percent. Thus, for net imbalances up to three percent, a shipper pays or receives the high/low index price without a tiered penalty adder or reduction. Rehearing Order at P 19, JA 40 ("All that is being modified here is the index price used to cash out the imbalances, not the tolerances that trigger penalties through the use of cash out prices that are more or less than 100 percent of the applicable index price.").

reasonable." Rehearing Order at P 20, JA 40-41 (citing *Texas Gas*, 97 FERC at 62,634).

Furthermore, "Texas Gas uses that approach not as a means of mitigating the effect of its high/low proposal as suggested by [Petitioners], but because it believed that even the high/low pricing mechanism could be insufficient to prevent gaming in the 0 to 3 percent range." Rehearing Order at P 24, JA 42. When a shipper is required to replace imbalance gas in-kind, the price it pays for the replacement gas may be significantly higher than the price of gas was when the imbalance occurred. Rehearing Order at P 25, JA 42-43. Just as some imbalances will cause pipelines to incur losses that are equal to the high/low index price and some will not, some imbalances will cause pipelines to incur losses that are equal to the in-kind replacement price and some will not.[7] Thus, despite Petitioners' claims to the contrary (Br. at 30, 33), if Texas Gas' in-kind resolution of its first tier imbalances

[7] As the Commission has recognized, "use of the weekly high/low index price . . . may not exactly reflect the cost of the gas involved in a customer's takes from the pipeline," but it "balances the goals of deterring arbitrage, while not imposing an unnecessarily high penalty on the customers." *Texas Gas*, 97 FERC at 62,633. "[I]n the context of cashing out net monthly imbalances, it is difficult to make the cashout price exactly equal the cost of the extra gas taken. The only way to truly match the cashout price with the cost of the extra gas taken would be to shift from a monthly imbalance resolution to a daily mechanism, but that would be more burdensome on customers, since they would not be able to net out imbalances over a month." *Texas Gas*, 97 FERC at 62,637.

in order to prevent arbitrage is not a penalty, neither is Northern's application of the index price to first tier imbalances to prevent arbitrage.

Whether other pipelines "have imbalance tariffs that are far less stringent and that provide a penalty-free tolerance zone" (Br. at 32, *see also* Br. at 28-29), even if true, is of no import. As the Commission explained:

> A pipeline has the initiative under NGA section 4 to propose rates, terms, and conditions for the services it provides.[[8]] If the pipeline shows that its proposal is just and reasonable, the Commission must accept it, regardless of whether other rates, terms and conditions [may] be just and reasonable.[[9]] Here, Northern satisfactorily shows that its use of a high/low index price is just and reasonable.

Rehearing Order at P 12, JA 37. Shippers are not "entitled" to a penalty-free tolerance zone as Petitioners posit, Br. at 32, but only to an overall just and reasonable rate, which the Commission found they received here.

Petitioners contend "FERC ignored the fact that the Northern proposal it approved immediately hurts all of Northern's customers by imposing penalties on every Mcf of imbalance gas, regardless of whether or not the shipper was gaming the system, the shipper's imbalance was helping the system, or the shipper was provided information concerning its imbalances at a time when the shipper could

[8] Citing *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956); *ANR Pipeline Co. v. FERC*, 771 F.2d 507, 513 (D.C. Cir. 1985).

[9] Citing *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1578 (D.C. Cir. 1985).

take steps to remedy the situation." Br. at 39 (emphasis omitted); *see also* Br. at 23, 37-38. Petitioners are wrong on all counts.

Before approving Northern's imbalance cash-out mechanism, the Commission assured, as required by Order No. 637, that Northern provides its customers sufficient imbalance services to permit them to avoid incurring imbalances in the first place.[10] Rehearing Order at PP 18-19, JA 39-40. Thus, shippers can avoid imbalance penalties altogether by subscribing to Northern's imbalance management services.

Although Petitioners view imbalance management services as providing a windfall to pipelines, Br. at 39, Order No. 637 required pipelines to provide such services because they are a necessary and appropriate means for shippers to remain in balance, and would properly assign the costs of imbalance services to those needing them. Order No. 637 at 31,308-09 (requiring pipelines to provide imbalance management services "to make it easier for shippers to remain in

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[10] Northern's imbalance services include: (1) imbalance netting and trading (which allows shippers to net out their individual imbalances and trade their remaining imbalances with other shippers); (2) an imbalance-to-storage option (a monthly in-kind balancing mechanism, provided through delayed delivery from storage); (3) Preferred Deferred Delivery Service; (4) a PowerPak option (which is similar to a form of park and loan service or a no-notice service); and (5) an Auto-Balancing Option (in which a shipper may request Northern to automatically schedule volumes into or out of its deferred delivery account as necessary to balance receipts and deliveries). Rehearing Order at P 18, JA 39-40 (citing *NorthernNatural Gas Co.*, 101 FERC ¶61,203 at PP 69-145 (2002); *Northern Natural Gas Co.*, 105 FERC ¶61,174 at PP 104-134 (2003)).

balance in the first instance"); Order No. 637 at 31,311 ("Moving towards a system where customers pay directly for imbalance management services will impose the costs of those services on those shippers needing the service, minimizing the impact on other customers that require less flexibility. Thus, it should shift costs that are now collected from all shippers through general transportation charges to those shippers that most require the needed flexibility.").

Moreover, despite Petitioners' claims to the contrary, Br. at 23, 37-39, under Northern's proposal, shipper imbalances that benefit the system are not subject to penalties. Northern shippers can net out their own monthly imbalances and trade any remaining monthly imbalances with other shippers whose imbalances run in the opposite direction. Rehearing Order at P 18, JA 39-40; R. 131 at 31, JA 546. Only imbalances remaining after netting and trading are subject to imbalance penalties. *See Northern Natural Gas Co.*, 101 FERC ¶ 61,203 at PP 87-105 (2002), *order on reh'g*, 105 FERC ¶ 61,174 (2003).

Petitioners' next contention, that they may not receive imbalance information at a time when they could take steps to remedy the situation (Br. at 23, 39), was raised by Petitioners and rejected in Northern's Order No. 637 compliance proceeding. Rehearing Order at P 21, JA 41 (citing *Northern*, 105 FERC at PP 118-22); *see also Northern*, 101 FERC at PP 62-71. Consistent with Order No. 637, Northern provides information on a monthly basis and charges

monthly penalties. Rehearing Order at P 21, JA 41; *see also Northern*, 105 FERC at P 119. Moreover, even shippers without real time metering[11] can continually monitor their imbalances as the nomination process notifies all shippers throughout the month of scheduled volumes. Rehearing Order at P 21, JA 41; *see also Northern*, 105 FERC at P 120 ("even those customers who do not have [real time metering ("EFM")] are notified by Northern of scheduled volumes through the confirmation process at each nomination cycle. This should be sufficient to allow the non-EFM shippers to determine their imbalances throughout the month.").

Although Petitioners persist in pointing out that three of the six pipelines cited in the October 31 Order as using a weekly high/low cash out mechanism do not use that mechanism, Br. at 22, 27-28, FERC acknowledged this on rehearing, but found its determination unaffected.

> Parties are correct that three pipelines – [Natural Gas Pipeline Company of America, Enbridge Offshore Pipelines (UTOS) LLC, and High Island Offshore System, LLC] – were inadvertently cited as pipelines cashing-out imbalances on a weekly high/low index price. However, KPC and Guardian do, in fact, use the weekly high/low mechanism, as do other pipelines including Texas Gas, Transco, Gulf South and Black Marlin . . . .

Rehearing Order at P 20, JA 40-41.

[11] Northern already had real time metering for 93 percent of the volumes delivered into and out of its system and was continuing to add real time metering to its system. *Northern*, 101 FERC at P 70.

Petitioners contend that KPC's, Guardian's, and Centerpoint Energy – Mississippi River's ("Centerpoint") use of weekly high/low index prices does not support FERC's approval of Northern's use of such an index price because two of those pipelines are smaller than Northern and the third uses a weekly high/low index price in accordance with a settlement and cashes out imbalances up to 1,000 Dth at monthly average prices. Br. at 28-29, 31. These proffered distinctions, however, do not undermine the challenged finding that "Northern's tariff would be *consistent with*" KPC's, Guardian's, and Centerpoint's tariffs. October 31 Order at P 80, JA 22 (emphasis added). Northern's weekly high/low index price mechanism need not be identical to other pipelines' weekly high/low index price mechanisms to be consistent with them.[12] Rehearing Order at PP 24-25, JA 42-43. Pipelines' different NGA § 4 proposals intended to minimize arbitrage can all be just and reasonable. Rehearing Order at PP 12, 20, JA 37, 40-41. Additionally, pipeline size is irrelevant to whether a proposed imbalance mechanism lowers the incentive to engage in arbitrage.

Petitioners attempt to distinguish *Texas Gas* from the instant case by contending that, while "Texas Gas *did* demonstrate that it faced or would face credible threats of arbitrage," Northern "did not present any evidence of actual

[12] Likewise, FERC did not have to "discuss the specifics" of Transco's, Gulf South's and Black Marlin's tariffs, Br. at 32, in order to note that they include a weekly high/low index price mechanism, Rehearing Order at P 20, JA 40-41.

arbitrage on its system . . . ." Br. at 30 (emphasis in original), *see also* Br. at 33. Even if that distinction existed[13] it would not matter, as a pipeline does not have to show that arbitrage actually has occurred on its system, but only that the incentive to engage in arbitrage exists, to modify its cash-out mechanism. October 31 Order at P 80, JA 22; Rehearing Order at P 14, JA 37-38.

Finally, Petitioners assert, for the first time on appeal, that "FERC's Initial Order in this case is internally inconsistent" because it approved Northern's proposal to modify its cash-out mechanism's index price, but rejected Northern's proposal to add a 25 percent imbalance tier to that mechanism. Br. at 25-26. Petitioners did not raise that assertion in their petitions for rehearing (R. 189, 190, 193, JA 653-79, 680-714, 715-27), and, therefore, the Court does not have jurisdiction to address it. NGA §19(b); *Intermountain Municipal Gas Agency v. FERC*, 326 F.3d 1281, 1285 (D.C. Cir. 2003).

In any event, the October 31 Order's holdings are not inconsistent. While Northern showed that its proposal to apply the weekly high/low index price to all net imbalances was necessary to remove the existing mechanism's incentive to engage in arbitrage, Northern did not make that same showing for its proposal to add a tiering level.

[13] The Commission found the increasing balance in Northern's SLA account showed it was likely that arbitrage was occurring on Northern's system. Rehearing Order at PP 16-17, JA 38-39.

CONCLUSION

For the foregoing reasons, the petitions for review should be denied.

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The Industrials,, et al. v. FERC **Docket No. RP03-398**
D.C. Cir. No. 04-1250, ***et al.***

CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 28(d)(1), I hereby certify that this brief contains 8,908 words, not including the tables of contents and authorities, the certificate of counsel, this certificate and the addendum.

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