

ORAL ARGUMENT HAS NOT BEEN SCHEDULED

=====

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

—————

No. 04-1347

—————

**CHEVRON NATURAL GAS, *et al.*,
PETITIONERS,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT**

—————

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

**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

—————

**JOHN S. MOOT
GENERAL COUNSEL**

**ROBERT H. SOLOMON
SOLICITOR**

**LONA T. PERRY
SENIOR ATTORNEY**

**FOR RESPONDENT
FEDERAL ENERGY REGULATORY
COMMISSION
WASHINGTON, D.C. 20426**

MAY 5, 2006

=====

CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties and Amici

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

B. Rulings Under Review

1. *Tennessee Gas Pipeline Company*, 99 FERC ¶ 61,017 (2002) (“Compliance Order”);
2. *Tennessee Gas Pipeline Company*, 104 FERC ¶ 61,063 (2003) (“Rehearing Order I”); and
3. *Tennessee Gas Pipeline Company*, 108 FERC ¶ 61,177 (2004) (“Rehearing Order II”).

C. 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.

Lona T. Perry
Senior Attorney

May 5, 2006

TABLE OF CONTENTS

	PAGE
STATEMENT OF THE ISSUE.....	1
STATUTES AND REGULATIONS.....	2
INTRODUCTION.....	2
STATEMENT OF FACTS.....	3
I. Events Leading To The Commission Orders.....	3
A. Order No. 636.....	3
B. Order No. 637.....	5
II. Tennessee’s Existing Penalty Structures.....	8
A. The Tennessee System.....	8
B. The Existing Penalties.....	10
III. The Challenged Orders.....	12
A. The Penalty Structure Approved In The Compliance Order.....	13
1. Elimination Of Imbalance Penalties And Adoption Of The Daily Imbalance Charge.....	13
2. Penalties For Violation Of Operational Flow Orders.....	15

TABLE OF CONTENTS

	PAGE
B. Indicated Shippers' Challenges.....	16
1. Substantial Evidence That The Daily Imbalance Charge Addressed Operational Integrity Issues.....	16
2. Comparison Of The Daily Imbalance Charge With The Daily Scheduling Variance Penalty.....	18
3. Overall Increase In Penalties.....	19
SUMMARY OF ARGUMENT.....	21
ARGUMENT.....	23
I. STANDARD OF REVIEW.....	23
II. THE COMMISSION REASONABLY ACCEPTED TENNESSEE'S PENALTY PROPOSAL AS IT FULLY COMPLIED WITH ORDER NO. 637.....	24
A. Tennessee's Restructuring Of Its Imbalance Penalties Was Consistent With Order No. 637.....	26
B. Tennessee's Addition Of Intermediate Operational Flow Order Levels Was Consistent With Order No. 637.....	28
III. TENNESSEE'S REVISED PENALTY STRUCTURE DOES NOT INCREASE PENALTIES IN CONTRAVENTION OF ORDER NO. 637.....	30

TABLE OF CONTENTS

	PAGE
A. Adoption Of The Daily Imbalance Charge Did Not Increase Penalties In Contravention Of Order No. 637.....	31
B. The Daily Imbalance Charge Is Not An Increase In Penalties In Contravention Of Order No. 637 Even Though It is Potentially Applicable Every Day.....	33
C. Addition Of Intermediate Operational Flow Order Levels Was Encouraged By Order No. 637, And Therefore Was Not An Increase In Penalties In Contravention Of That Order.....	35
IV. THE COMMISSION HAD SUBSTANTIAL EVIDENCE OF THE OPERATIONAL NEED FOR THE NEW PENALTIES.....	37
A. The Substantial Evidence Of The Operational Need For The New Penalties.....	37
B. Indicated Shippers’ Challenges To This Evidence Are Without Merit.....	41
CONCLUSION.....	48

TABLE OF CONTENTS

COURT CASES:	PAGE
<i>Amoco Production Co. v. FERC</i> , 158 F.3d 593 (D.C. Cir. 1998).....	4-5
<i>B&J Oil and Gas Co. v. FERC</i> , 353 F.3d 71 (D.C. Cir. 2004).....	41
<i>City of Waukesha v. EPA</i> , 320 F.3d 228 (D.C. Cir. 2003).....	41
<i>Columbia Gas Transmission Corp. v. FERC</i> , 750 F.2d 105 (D.C. Cir. 1984).....	23
<i>Consolidated Oil and Gas v. FERC</i> , 806 F.2d 275 (D.C. Cir. 1986).....	41
<i>East Texas Electric Cooperative, Inc. v. FERC</i> , 218 F.3d 750 (D.C. Cir. 2000).....	25-26
<i>Electricity Consumers Resource Council v. FERC</i> , 407 F.3d 1232 (D.C. Cir. 2005).....	44
<i>FERC v. Triton Oil & Gas Corp.</i> , 712 F.2d 1450 (D.C. Cir. 1983).....	26
<i>Florida Municipal Power Agency v. FERC</i> , 315 F.3d 362 (D.C. Cir. 2003).....	24
<i>FPL Energy Me. Hydro LLC v. FERC</i> , 287 F.3d 1151 (D.C. Cir. 2002).....	24

* Cases chiefly relied upon are marked with an asterisk.

TABLE OF CONTENTS

COURT CASES:	PAGE
<i>*Interstate Natural Gas Ass'n of America v. FERC</i> , 285 F.3d 18 (D.C. Cir. 2002).....	5, 26
<i>Koch Gateway Pipeline Co. v. FERC</i> , 136 F.3d 810 (D.C. Cir. 1998).....	4
<i>Natural Gas Clearinghouse v. FERC</i> , 108 F.3d 397 (D.C. Cir. 1997).....	25
<i>*Pennsylvania Office of Consumer Advocate v. FERC</i> , 131 F.3d 182 (D.C. Cir. 1997).....	4, 23, 39
<i>Sithe NewEngland Holdings, LLC v. FERC</i> , 308 F.3d 71 (1 st Cir. 2002).....	44
<i>*Southwest Gas Corp. v. FERC</i> , 145 F.3d 365 (D.C. Cir. 1998).....	23-25
<i>Tennessee Gas Pipe Line Co. v. FERC</i> , 400 F.3d 23 (D.C. Cir. 2005).....	23
<i>Transcontinental Gas Pipe Line Corp. v. FERC</i> , 54 F.3d 893 (D.C. Cir. 1995).....	23
<i>Transcontinental Gas Pipe Line Corp. v. FERC</i> , 922 F.2d 865 (D.C. Cir. 1991).....	23, 25, 26
<i>United Distribution Cos. v. FERC</i> , 88 F.3d 1105 (D.C. Cir. 1996).....	3

TABLE OF CONTENTS

ADMINISTRATIVE CASES:	PAGE
<i>Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, FERC Stats. & Regs. ¶ 30,939, on reh'g, Order No. 636-A, FERC Stats. & Regs. ¶ 30,950, on reh'g, Order No. 636-B, 61 FERC ¶ 61,272 (1992), reh'g denied, 62 FERC ¶ 61,007 (1993).....</i>	3-5
<i>*Regulation of Short-Term Natural Gas Transportation Service and Regulation of Interstate Natural Gas Transportation Services, Order No. 637, FERC Stats & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091, on reh'g, Order No. 637-A, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,099, on reh'g, Order No. 637-B, 92 FERC ¶ 61,062 (2000).....</i>	2, 5-8, 10-16, 18-22, 24-26, 28, 31-36, 45-47
<i>Tennessee Gas Pipeline Company, 99 FERC ¶ 61,017 (2002).....</i>	2, 7-13, 15-17, 20, 25, 27-30, 32-36, 39, 42-46
<i>Tennessee Gas Pipeline Company, 104 FERC ¶ 61,063 (2003).....</i>	2, 13, 16, 18-20, 26-32, 34-37, 39-41, 43-44, 46
<i>Tennessee Gas Pipeline Company, 108 FERC ¶ 61,177 (2004).....</i>	13, 16, 30
 STATUTE:	
Natural Gas Act:	
Section 19(b), 15 U.S.C. § 717r(b).....	23-24

TABLE OF CONTENTS

REGULATIONS:	PAGE
18 C.F.R. § 284.12(b)(2)(iv).....	24, 29
18 C.F.R. § 284.12(b)(2)(v).....	6-7, 24

GLOSSARY

Compliance Order	<i>Tennessee Gas Pipeline Co.</i> , 99 FERC ¶ 61,017 (2002)
FERC or Commission	Federal Energy Regulatory Commission
Indicated Shippers	Petitioners Chevron Natural Gas, ExxonMobil Gas & Power Marketing, and Shell Offshore, Inc.
INGAA	<i>Interstate Natural Gas Association of America v. FERC</i> , 285 F.3d 18 (D.C. Cir. 2002)
Order No. 636	<i>Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol</i> , Order No. 636, FERC Stats. & Regs. ¶ 30,939, <i>on reh'g</i> , Order No. 636-A, FERC Stats. & Regs. ¶ 30,950, <i>on reh'g</i> , Order No. 636-B, 61 FERC ¶ 61,272 (1992), <i>reh'g denied</i> , 62 FERC ¶ 61,007 (1993), <i>aff'd in part, rev'd in part, United Distribution Cos. v. FERC</i> , 88 F.3d 1105 (D.C. Cir. 1996)
Order No. 637	<i>Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services</i> , Order No. 637, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091, <i>on reh'g</i> , Order No. 637-A, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,099, <i>on reh'g</i> , Order No. 637-B, 92 FERC ¶ 61,062 (2000); <i>aff'd in part, rev'd in part, Interstate Natural Gas Association of America v. FERC</i> , 285 F.3d 18 (D.C. Cir. 2002)
Rehearing Order I	<i>Tennessee Gas Pipeline Co.</i> , 104 FERC ¶ 61,063 (2002)
Rehearing Order II	<i>Tennessee Gas Pipeline Co.</i> , 108 FERC ¶ 61,177 (2002)

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

No. 04-1347

**CHEVRON NATURAL GAS, *et al.*,
PETITIONERS,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.**

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

**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

STATEMENT OF THE ISSUE

Whether the Federal Energy Regulatory Commission (“Commission” or “FERC”) reasonably approved, as consistent with applicable regulations and policy, proposed revisions by Tennessee Gas Pipeline Company (“Tennessee”) to the penalty provisions of its tariff in order to discourage shipper imbalances threatening the reliability of Tennessee’s pipeline system.

STATUTES AND REGULATIONS

The relevant statutes and regulations are contained in the Addendum to Petitioners' Brief.

INTRODUCTION

In the challenged orders, the Commission accepted revisions to Tennessee's penalty structure, intended to discourage shipper imbalances threatening the operational integrity of Tennessee's system, filed in compliance with regulations adopted in Order No. 637. *See Tennessee Gas Pipeline Company*, 99 FERC ¶ 61,017 (2002) ("Compliance Order"), JA 311; *Tennessee Gas Pipeline Company*, 104 FERC ¶ 61,063 (2003) ("Rehearing Order I"), JA 377; and *Tennessee Gas Pipeline Company*, 108 FERC ¶ 61,177 (2004) ("Rehearing Order II"), JA 412.

On appeal, petitioners Chevron Natural Gas, ExxonMobil Gas & Power Marketing, and Shell Offshore, Inc. (collectively "Indicated Shippers")¹ contend that the revised penalty structure violates Order No. 637 requirements. To the contrary, as the Commission found, the approved penalty revisions specifically meet Order No. 637's requirement that pipelines reassess their penalty structures: (1) to more narrowly focus penalties on system reliability concerns, and (2) to

¹ Anadarko Petroleum Corp., previously the lead plaintiff in this appeal, was granted leave by the Court on February 17, 2006 to withdraw its petition for review.

establish intermediate penalty levels to permit pipelines to more accurately and proportionately tailor penalties to the severity of the operational problem presented.

STATEMENT OF FACTS

I. Events Leading To The Commission Orders

A. Order No. 636²

The Commission's Order No. 636 rulemaking required pipelines to unbundle their sales service from their transportation service. Order No. 636 at 30,393-94. This unbundling created new operational problems for pipelines. Because the pipeline would be acting as a transporter, its ability to effectively manage its system would depend in part on shippers injecting gas into the mainline (packing the line) and into storage at the right place and time. *Id.* at 30,424. As this Court explained:

Order No. 636, and its “unbundled” regime, did not come without operational challenges to pipelines. Under the new regulatory regime, pipelines have reduced flexibility to adjust when customers unexpectedly deviate from their shipping schedules, and they cannot easily compensate for imbalances between volumes tendered to the pipeline and taken by a customer. Thus, a pipeline with a limited merchant function facing an overrun might be unable to sustain enough pressure (“line pack”) to provide efficient and reliable transportation service to its other customers. A customer might also arrange to have

² *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 636, FERC Stats. & Regs. ¶ 30,939, *on reh'g*, Order No. 636-A, FERC Stats. & Regs. ¶ 30,950, *on reh'g*, Order No. 636-B, 61 FERC ¶ 61,272 (1992), *reh'g denied*, 62 FERC ¶ 61,007 (1993), *aff'd in part, rev'd in part*, *United Distribution Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996).

tendered to the pipeline more gas than the customer ultimately takes within a specified time frame. In this scenario, if the pipeline lacks the ability to reduce tenders from other sources of supply or to deliver gas to other points, the pressure build up on the pipeline could threaten system integrity.

Pennsylvania Office of Consumer Advocate v. FERC, 131 F.3d 182, 184 (D.C. Cir. 1997) (citations omitted).

While the pipeline and its shippers might be able to achieve balance through cooperation, the Commission recognized that pipelines might need compulsory powers to dictate to shippers where and when to act by, for example, operational flow orders³ or penalties. Order No. 636 at 30,424. *See also Amoco Production Co. v. FERC*, 158 F.3d 593, 595 (D.C. Cir. 1998) (following Order No. 636 unbundling, pipelines seek to deter shippers from abusing the system by issuing operational flow orders and by imposing penalties).

Accordingly, as part of each pipeline's restructuring process, Order No. 636 required pipelines and their shippers to establish "reasonable, yet effective, methods such as penalties to deter shipper behavior inimical to the welfare of the system and other shippers." *Koch Gateway Pipeline Co. v. FERC*, 136 F.3d 810, 812 (D.C. Cir. 1998) (quoting Order No. 636 at 30,424). When a shipper takes

³Operational flow orders generally restrict service or require shippers to take particular action in response to operational concerns, including reducing tolerances for imbalances or instituting severe penalties.

more gas from the system than the maximum allowed volume under the shipper's contract, the pipeline imposes an unauthorized overrun penalty. *Amoco*, 158 F.3d at 595. Penalties are also imposed for violations of operational flow orders. *Id.*

Further, in order to control system operation, the Commission also recognized that pipelines may need to enter into agreements with gas suppliers to balance the injections of their shippers, and to predetermine allocations. Order No. 636 at 30,424. The Commission therefore encouraged pipelines to enter into “operational balancing agreements” with other gas merchants to allow such merchants to balance, in the aggregate, for all of their gas purchasers shipping on the pipeline. *Id.* at 30,428.

B. Order No. 637⁴

Order No. 636 permitted pipelines to enforce their contractual rights through penalties that applied whether or not the offending shipper's conduct caused any actual harm to system reliability. *INGAA*, 285 F.3d at 46. Subsequently, in its Order No. 637 rulemaking, the Commission concluded that this regime was

⁴*Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, Order No. 637, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091, *on reh'g*, Order No. 637-A, FERC Stats. & Regs, Regulations Preambles (July 1996-December 2000) ¶ 31,099, *on reh'g*, Order No. 637-B, 92 FERC ¶ 61,062 (2000); *aff'd in part, rev'd in part, Interstate Natural Gas Ass'n of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002) (“*INGAA*”).

ineffective in fulfilling the intended purpose of such penalties – deterring conduct that actually threatened the integrity of the pipeline system at critical times. *Id.* at 48 (citing Order No. 637 at 31,308; Order No. 637-A at 31,598, 31,607 & n. 152). Because penalty levels were not connected to threats to reliability, they did not offer incentives “in any way calibrated to those threats.” *Id.* The Commission concluded, therefore, that it should henceforth tie the imposition of penalties to behavior actually causing a threat to system integrity. *Id.* The rule also denied pipelines the right to retain revenues from penalties, instead requiring that penalties be credited to shippers. *Id.* at 47.

In order to give shippers positive incentives, in lieu of penalties, to manage or prevent imbalances, Order No. 637 also required the pipelines to provide “imbalance management services” such as parking (*i.e.* temporary storage) and lending of gas, and greater information about the imbalance status of a shipper and the system as a whole. *Id.* at 47. New Section 18 C.F.R. § 284.12(c)(2)(v) established three general principles with respect to penalties: (1) penalties must be limited only to those necessary to ensure system reliability; (2) penalty revenues must be credited to shippers; and (3) imbalance and overrun information must be

disseminated promptly. Order No. 637 at 31,314-19.⁵ See Compliance Order P 146, JA 328.

The Commission's goal in Order No. 637, therefore, was not to discourage pipelines from imposing penalties at all, but rather to motivate them "to impose only necessary and appropriate penalties," and to develop non-penalty mechanisms to deal with imbalance problems. *INGAA*, 285 F.3d at 50 (quoting Order No. 637 at 31,316). Thus, FERC did not abandon "its existing penalty policy recognizing penalties as an important tool to protect system reliability," but, rather, "shifted its policy focus to place less reliance on penalties." Order No. 637-A at 31,607.

The Commission also required pipelines to adopt incentives and procedures that minimize the use and impact of operational flow orders. See Order No. 637 at 31,312. Among other things, the Commission required that pipelines examine their operational flow orders to determine whether they could establish different levels or

⁵Section 284.12(c)(2)(v) provides as follows:

A pipeline may include in its tariff transportation penalties only to the extent necessary to prevent impairment of reliable service. Pipelines may not retain net penalty revenues, but must credit them to shippers in a manner to be prescribed in the pipeline's tariff. A pipeline must provide to shippers, on a timely basis, as much information as possible about the imbalance and overrun status of each shipper and the imbalance of the pipeline's system.

degrees of severity of operational flow orders to correspond to different degrees of system emergencies the pipeline may confront. *Id.* at 31,313. For example, the Commission held that, while a large operational flow order penalty might be appropriate in a severe case, a small operational flow order penalty may be appropriate in others. *Id.*

The Commission implemented its new policies through individual pipeline compliance proceedings, which allowed 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. Accordingly, the Commission required each pipeline to propose *pro forma* tariff changes to implement Order No. 637, or to explain how its existing tariff and operating practices already complied with the new requirements. Order No. 637 at 31,309.

II. Tennessee’s Existing Penalty Structures

A. The Tennessee System

In providing transportation service, Tennessee contracts with three types of parties – a shipper who nominates the transportation, a receipt point operator and a delivery point operator. Compliance Order P 133, JA 327. Each party type has its own service agreement with Tennessee: the shipper has a transportation agreement

of some type; the receipt and delivery point operators have a Load Management Service-Pooling Area or Load Management Service-Market Area agreement, respectively.⁶ *Id.*

Shipper nominations are scheduled and allocated to the receipt and delivery point operators, and bills are sent to the shipper based on scheduled quantities. *Id.* Tennessee then separately determines the difference between scheduled quantities and the actual quantities for the receipt and delivery point operators. *Id.*

Reconciliation of the difference between scheduled volumes and actual volumes is performed through the operational balancing agreements. Compliance Order P 112, JA 324. Point operators have the ability to manage imbalances through various nominated services, “swing to storage” services,⁷ netting and trading, or cashing out the imbalance. *Id.* The point operator settles its imbalance position with Tennessee, and passes through the costs of settling the imbalance to shippers under the terms of the shippers’ agreement with the point operator. *Id.*

⁶In practical terms, the Service-Pooling Area agreement establishes an operational balancing agreement for receipt point operators, and the Service-Marketing Area agreement establishes an operational balancing agreement for delivery point operators. *Id.* P 112 n. 49, JA 324.

⁷The swing-to-storage service allows customers to use either their firm storage contract or a storage contract with a third party provider to resolve their daily imbalances.

B. The Existing Penalties

At the time of its Order No. 637 compliance filing, Tennessee's tariff provided three penalties triggered by imbalances that did not require the issuance of an operational flow order. These penalties were for: (1) daily scheduling variations greater than ten percent but less than the Maximum Allowed Volume⁸ (Daily Scheduling Variance Penalty); (2) unscheduled flow (Unscheduled Flow Penalty); and (3) exceeding the Maximum Allowed Volume of transportation contracts (Maximum Allowed Volume Penalty).

Daily Scheduling Variance Penalty: Section 7(b)(iv) of Rate Schedule Service-Market Area provided for a Daily Scheduling Variance Penalty of \$0.3936, per dekatherm that applied, upon eight hours notice, to daily netted scheduling variations greater than ten percent of scheduled volumes, but below the Maximum Allowed Volume. Compliance Order P 161 & nn. 63-64, JA 330. Section 5(c) of Rate Schedule Service-Pooling Area had a Daily Scheduling Variance penalty of \$0.1099 per dekatherm applicable under the same circumstances, with two days notice. *Id.*

⁸The Maximum Allowed Volume is essentially the maximum contract quantities of all transportation contracts under a particular operating balancing agreement.

Unscheduled Flow Penalty: Article III, § 8.2 of Tennessee's General Terms and Conditions imposed a penalty upon the responsible party (usually a point operator) for failure to correct unscheduled flow. Compliance Order P 213, JA 336. If a point operator failed to make corrective nominations, Tennessee purchased under-deliveries at fifty percent of an index price, and sold over-deliveries at one hundred and fifty percent of an index price. *Id.* Tennessee confiscated over-deliveries at a receipt point. If the operator failed to correct its nominations, Tennessee would also apply a penalty of fifteen dollars per dekatherm. *Id.*

Maximum Allowed Volume Penalty: Section 4 of Rate Schedule Service-Market Area provided a penalty of fifteen dollars per dekatherm plus the applicable regional daily spot price, upon eight hours notice, for all customers who exceeded by two percent or more their Maximum Allowed Volume. Compliance Order P 148, JA 328.

In addition to these imbalance penalties, Tennessee's tariff provided penalties for failure to comply with two levels of operational flow orders: (1) Action Alerts (Action Alert Penalty); and (2) Balancing Alerts (Balancing Alert Penalty).

Action Alert Penalty: An Action Alert is issued with forty-eight hours prior notice in the event of an ongoing or anticipated weather event, a known equipment problem, or anticipated continuation of a current system problem which threatens

system integrity or jeopardizes firm service. Compliance Order P 219, JA 336. Affected shippers are given thirty hours notice of the specific actions required. *Id.* The penalty for non-compliance with an Action Alert was twice the Daily Scheduling Variance Penalty for any volume of gas that deviated from the Action Alert tolerance (*i.e.* \$0.2198 per dekatherm for Rate Schedule Service-Pooling Area and \$0.7872 per dekatherm for Rate Schedule Service-Market Area). *Id.* P 237, JA 339.

Balancing Alert Penalty: A Balancing Alert is issued on eight hours notice if the operating problems are more severe than the circumstances referenced in the Action Alert. Compliance Order P 219, JA 336. The penalty for non-compliance with a Balancing Alert was \$15 plus the applicable daily regional spot price for each dekatherm of gas by which the non-conforming party deviated from the requirements of the operational flow order. *Id.* P 237, JA 339.

III. The Challenged Orders

On August 15, 2000, as modified in subsequent filings, *see* Initial Brief of Petitioners (“Br.”) at 12-13, Tennessee filed *pro forma* tariff sheets proposing, *inter alia*, changes in Tennessee’s penalty structure to comply with Order No. 637. Compliance Order P 1, JA 311. The challenged orders found that Tennessee’s proposed penalty structure, as modified, complied with Order No. 637. *Id.*

A. The Penalty Structure Approved In The Compliance Order

In the Compliance Order, the Commission approved a new penalty structure as follows:

1. Elimination Of Imbalance Penalties And Adoption Of The Daily Imbalance Charge.

Order No. 637 required that penalties be directed to the impairment of reliable service. *See* Order No. 637 at 31,314, Compliance Order P 146, JA 328. In compliance with this requirement, Tennessee proposed to eliminate all existing penalties that were triggered by imbalances irrespective of any adverse effect on system reliability. The penalties eliminated were: (1) the Maximum Allowed Volume Penalty, Compliance Order P 148, JA 328; (2) the Unscheduled Flow Penalty, Rehearing Order I P 184, JA 407; Rehearing Order II PP 59-60, JA 422; and (3) the Daily Scheduling Variance Penalty. Compliance Order P 162, JA 330.

These three penalties were replaced with the Daily Imbalance Charge, *id.*, which would be triggered only when the net system imbalance exceeded five percent, the point at which the imbalance can be expected to have operational consequences. *Id.* P 181, JA 333. Under the Daily Imbalance Charge, for each day on which the net pipeline imbalance position (the difference between the net quantities scheduled and actual flow) exceeds five percent of scheduled volumes, any balancing party with an imbalance in the same direction as the pipeline would

be charged: (1) nothing if the imbalance position is 0 to 10 percent; (2) two times the rate for Park and Loan Service if the imbalance position is more than ten percent or less than or equal to twenty percent; and (3) four times the rate for Park and Loan Service for imbalances in excess of twenty percent. *Id.* P 163, JA 330. This is a one-time charge for a particular day's imbalance. *Id.* For each day, all revenues collected from shippers with qualifying imbalances pursuant to this mechanism are credited, net of costs, to balancing parties with imbalances within five percent of scheduled volumes. *Id.* P 164, JA 330.

The Commission accepted the elimination of the three imbalance penalties, and the adoption of the Daily Imbalance Charge, as directed toward operational constraints consistent with Order No. 637. The Commission agreed that the revised penalty mechanism provided an innovative incentive for shippers to remain within a five percent tolerance to receive Daily Imbalance Charge revenues. *Id.* PP 179-181, JA 332-33.

2. Penalties For Violation Of Operational Flow Orders

Order No. 637 required pipelines to take all reasonable actions to minimize the issuance and impact of operational flow orders. Compliance Order P 217, JA 336. To this end, pipelines were required, among other things, to examine their operational flow orders to determine whether they could set forth standards for different levels or degrees of severity of operational flow orders to correspond to different degrees of system emergencies. *Id.* PP 217, 230, JA 336, 338.

In compliance with this directive, Tennessee proposed adding two intermediate operational flow order levels – Critical Days One and Two⁹ – between its already existing operational flow order levels Action Alert and Balancing Alert. *Id.* P 220, JA 337.¹⁰ The Commission accepted the addition of the Critical Days operational flow order levels and associated penalties as consistent with Order No. 637. *Id.* P 230, JA 338.

⁹ Tennessee will only call a Critical Day One for part or all of its system if customers contravene a capacity curtailment restriction, operational storage falls below ten percent or exceeds ninety percent of total storage balance, or there is a loss of or an inability to maintain line pack. Compliance Order P 220, JA 337. Critical Day Two will be called if Critical Day One fails to cure any of these conditions or if two or more of them exist simultaneously. *Id.* Both Critical Days One and Two will be called with a minimum of eleven hours notice. *Id.*

¹⁰ Tennessee proposed penalties for non-compliance with the Critical Days of the applicable regional daily spot price plus \$5 for Critical Day One and \$10 for Critical Day Two, for each dekatherm of gas that deviates from the requirements of the Critical Day. Compliance Order P 238, JA 339.

Tennessee also sought to increase the penalties for both Action Alerts and Balancing Alerts. Compliance Order P 246, JA 340; Rehearing Order I P 173, JA 405; Rehearing Order II P 94, JA 426. The Commission rejected the requested increases on the ground that Order No. 637 compliance filings were not intended to permit increases in existing penalties. *Id.*

B. Indicated Shippers' Challenges

1. Substantial Evidence That The Daily Imbalance Charge Addressed Operational Integrity Issues

Indicated Shippers argued Tennessee failed to provide substantial evidence that the new Daily Imbalance Charge was in fact tailored to address operational integrity issues, as required by Order No. 637. Rehearing Order I P 65, JA 387. The Commission rejected the argument, finding Tennessee had sufficiently demonstrated that it needed to address shipper imbalances on its system and the Daily Imbalance Charge was designed to focus on the points contributing most to Tennessee's system-wide imbalances. *Id.* P 74, JA 389. Tennessee provided evidence that a five percent system-wide imbalance represents its operational limit to manage imbalances, and presented data that showed its shippers were not making a sustained and consistent effort to stay in balance. *Id.*

While Tennessee had not yet experienced significant impairment of reliable service because of imbalances, Tennessee provided a year's worth of data showing

the imbalance problem on its system. Compliance Order P 177, JA 332. According to Tennessee, it should not be required to wait for actual system impairment to be allowed to take steps to assure system integrity and reliability. *Id.* The Commission agreed with Tennessee that setting the operational limit of imbalances involves a degree of prediction of future events and knowledge of how events may affect operations, and Tennessee should not have to demonstrate through experience that a five percent imbalance level is correct. *Id.* P 181, JA 333. The Commission found Tennessee's five percent figure reasonable. *Id.*

Indicated Shippers provided no evidence to dispute the operational evidence provided by Tennessee. Rehearing Order I P 74, JA 389. Rather, Indicated Shippers simply pointed to the fact that, in recent years, Tennessee had rarely employed operational flow orders, and had never imposed the Daily Scheduling Variance Penalty, as evidence that the new penalties were unnecessary. Compliance Order P 173, JA 331.

While Tennessee had not invoked the Daily Scheduling Variance Penalty, Tennessee had frequently invoked the significantly higher penalty for unauthorized overruns of the Maximum Allowed Volume, which Tennessee was eliminating. *Id.* P 182, JA 333. Without the Maximum Allowed Volume penalty, the Commission agreed that Tennessee must have a penalty tool to give customers an incentive to

bring their imbalances under control short of full-fledged operational flow orders.

Id. Further, Tennessee failed to implement Action Alerts routinely because the detrimental shipper behavior tended to occur quickly; accordingly, immediate relief was not possible under an Action Alert, which required 48 hours notice. *Id.* P 227, JA 338.

2. Comparison Of The Daily Imbalance Charge With The Daily Scheduling Variance Penalty

Indicated Shippers also contended that the new Daily Imbalance Charge was more stringent than the Daily Scheduling Variance Penalty it replaced, in contravention of Order No. 637's directive that compliance proceedings not be used to increase existing penalties. Rehearing Order I P 66, JA 388. The Commission also rejected this argument. *Id.* P 70, JA 388.

The Daily Imbalance Charge proposal was part of an overall reassessment of Tennessee's penalty structure, which included the elimination of several penalties, *i.e.* the Maximum Allowed Volume and Unscheduled Flow Penalties. *Id.* P 70, 72, JA 338-39. Further, the Daily Imbalance Charge applies only in the event that the net system imbalance exceeds five percent, and then only applies to balancing parties more than ten percent out of balance in the same direction as the pipeline. *Id.* PP 62, 72, JA 387, 389. The eliminated Daily Scheduling Variance Charge, in contrast, could be assessed at Tennessee's discretion without regard to the net

pipeline imbalance position. *Id.* P 61, JA 387. Unlike the Daily Imbalance Charge, the Daily Scheduling Variance Charge provided no credits to shippers who remain in balance. *Id.* P 71, JA 388. Tennessee also offers a number of imbalance management options that shippers may use to avoid the Daily Imbalance Charge. *Id.* P 73, JA 389.

Indicated Shippers also complained that no advance notice was provided of the Daily Imbalance Charge, and requested one-day notice prior to the application of the Charge. Rehearing Order I P 76, JA 389. The Commission rejected this proposal because a one-day notice for a penalty that is based on daily operational conditions would negate the penalty. *Id.* Nonetheless, the Commission agreed that shippers should be given reasonable notice that the system is entering conditions which may cause Tennessee to assess Daily Imbalance Charges. *Id.* While this notice would not tell shippers that they definitely will be subject to penalties, it would permit shippers to bring their performance within scheduled quantities or to make intra-day nominations to avoid imbalance penalties, as required by Order No. 637. *Id.*

3. Overall Increase In Penalties

Indicated Shippers argued that adoption of the new penalties increased Tennessee's operational flow order penalties from three to five, which Indicated

Shippers contend is an “increase” in penalties forbidden by Order No. 637.

However, as the Commission found, Order No. 637 encouraged pipelines to take all reasonable actions to minimize the issuance and impact of operational flow orders, including establishing different levels or degrees of operational flow orders to correspond to different degrees of system emergencies. Compliance Order P 217, JA 336. Tennessee’s addition of the new penalties as intermediate operational flow orders consequently was fully consistent with Order No. 637. *Id.* P 230, JA 338.

The Commission further found that the introduction of the Daily Imbalance Charge, Critical Day One and Critical Day Two as new intermediate operational flow order levels benefited Tennessee’s customers. Rehearing Order I P 93, JA 394. The intermediate penalties did not increase the level of the highest penalty, the Balancing Alert. *Id.* Rather, increased operational flow order levels give pipelines a greater range of tools to keep operational flow orders closely proportioned with the operational problem. *Id.* Thus, Tennessee’s customers will not have to go immediately from the Action Alert penalty to the much more stringent Balancing Alert penalty. *Id.* Introducing additional levels below the strictest operational flow order level reduces the probability that the strictest operational flow order would be issued. Rehearing Order I P 94, JA 394.

SUMMARY OF ARGUMENT

Tennessee proposed revisions to the penalty structure of its tariff to encourage its customers to avoid imbalances that threaten the operational integrity of the pipeline system. The Commission reasonably accepted the revised penalty structure as supported by substantial evidence and consistent with FERC policy and requirements – particularly those in Order No. 637.

Order No. 637 required pipelines: (1) to offer imbalance management services so that shippers can avoid imbalances; (2) to establish positive incentives for shippers to avoid imbalances; and (3) to establish only those penalty structures and levels necessary to protect system reliability. Consistent with these requirements, Tennessee eliminated three penalties that were not tied to operational concerns, and replaced them with one penalty triggered only by imbalances threatening system reliability, which provided credits to in-balance shippers as a positive incentive to remain in balance.

Order No. 637 also encouraged pipelines to establish different levels of severity of operational flow orders to correspond to different degrees of system emergencies the pipeline may confront. In compliance with Order No. 637, Tennessee established intermediate levels of operational flow order penalties for situations that do not require the use of the highest operational flow order penalty.

Indicated Shippers contend that these tariff changes “increased” Tennessee’s penalties, contrary to the Commission’s general policy that pipelines should not use Order No. 637 compliance proceedings to increase existing penalties or make them more stringent. However, as these changes were fully consistent with and encouraged by Order No. 637, the Commission reasonably did not find them to be penalty “increases” prohibited in an Order No. 637 compliance filing.

Moreover, the tariff changes did not increase Tennessee’s penalties. Rather, as intended by Order No. 637, the penalty changes more narrowly tailored Tennessee’s penalty structure to focus on system reliability and to match more closely the severity of the penalty with the severity of the operational condition encountered.

Indicated Shippers also contend the Commission lacked substantial evidence for finding that Tennessee’s proposed penalty revisions addressed operational concerns. Tennessee, however, provided evidence of aggregate imbalance swings and individual customer imbalance swings to support the need to address imbalances on its system. Tennessee also provided data showing that net pipeline imbalances of five percent or more severely threaten its system reliability. In these circumstances, the Commission reasonably found substantial evidence to support approval of Tennessee’s penalty revisions.

ARGUMENT

I. STANDARD OF REVIEW

The Court reviews FERC's orders to assure they are not "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).

Judicial scrutiny under the Natural Gas Act is limited to assuring that the Commission's decisionmaking is reasoned, principled, and based upon the record.

See, e.g., Pennsylvania Office of Consumer Advocate, 131 F.3d at 185. The

“breadth of agency discretion is, if anything, at [its] zenith when the action relates primarily . . . to the fashioning of policies, remedies and sanctions.” *Tennessee*

Gas Pipe Line Co. v. FERC, 400 F.3d 23, 25 (D.C. Cir. 2005) (quoting *Columbia*

Gas Transmission Corp. v. FERC, 750 F.2d 105, 109 (D.C. Cir. 1984)). *See also*

id. at 27 (the Court “properly defers to policy determinations invoking the

Commission’s expertise in evaluating complex market conditions.”).

“[A]n agency’s interpretation of the intended effect of its own orders is controlling unless clearly erroneous.” *Southwest Gas Corp. v. FERC*, 145 F.3d 365, 370 (D.C. Cir. 1998) (quoting *Transcontinental Gas Pipe Line Corp. v. FERC*, 922 F.2d 865, 871 (D.C. Cir. 1991)). The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. Natural Gas Act § 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 *FPL Energy Me. Hydro LLC v. FERC*, 287 F.3d 1151, 1160 (D.C. Cir. 2002)).

II. THE COMMISSION REASONABLY ACCEPTED TENNESSEE’S PENALTY PROPOSAL AS IT FULLY COMPLIED WITH ORDER NO. 637.

Indicated Shippers correctly recognize that this case turns upon whether the penalty structure approved by the Commission in Tennessee’s Order No. 637 compliance proceeding in fact complied with Order No. 637 and the regulations implemented thereunder. *See* Br. 33. Further, Indicated Shippers recognize, as they must, that the Commission’s regulations permit penalties that are necessary to prevent impairment of reliable service, *id.* 35 (citing 18 C.F.R. § 284.12(b)(2)(v)), and require pipelines to take all reasonable actions to minimize the issuance and adverse impacts of operational flow orders. *Id.* (citing 18 C.F.R. § 284.12(b)(2)(iv)).

The penalty structure changes accepted in this proceeding in fact were fully consistent with and encouraged by Order No. 637 and the cited regulations. Tennessee tailored its penalty structure to system reliability concerns by eliminating

three penalties that were not tied to operational concerns, and replacing them with one penalty triggered only by imbalances threatening system reliability. Further, to minimize the adverse impact of operational flow orders, Order No. 637 encouraged pipelines to establish different levels of severity of operational flow orders to correspond to different degrees of system emergencies the pipeline may confront. Order No. 637 at 31,313; Compliance Order PP 217, 230, JA 336, 338. In compliance, Tennessee established two new intermediate levels of operational flow orders, Critical Day One and Critical Day Two.

Accordingly, the Commission reasonably concluded that Tennessee's proposed revisions to its penalty structure were consistent with and encouraged by Order No. 637. Therefore, the Commission orders should be affirmed. “[I]t is well established that an agency’s interpretation of the intended effect of its own orders is controlling unless clearly erroneous.” *Southwest Gas Corp.*, 145 F.3d at 370 (quoting *Transcontinental*, 922 F.2d at 871) (rejecting arguments questioning the Commission’s interpretation of the breadth of prior orders as petitioner failed to show interpretation was clearly erroneous). *See also East Texas Electric Cooperative, Inc. v. FERC*, 218 F.3d 750, 754 (D.C. Cir. 2000) (the Court defers to the Commission's interpretation of its own orders); *Natural Gas Clearinghouse v. FERC*, 108 F.3d 397, 399 (D.C. Cir. 1997) (same).

This “traditional duty to defer,” moreover, is enhanced in cases that are technical and complex. *Transcontinental*, 922 F.2d at 871. *See also FERC v. Triton Oil & Gas Corp.*, 712 F.2d 1450, 1462 (D.C. Cir. 1983). Thus, the Commission’s reasonable interpretation of its own orders, not Indicated Shippers’ contrary interpretation, is due substantial deference. *East Texas Electric*, 218 F.3d at 754; *Natural Gas Clearinghouse*, 108 F.3d at 399.

A. Tennessee’s Restructuring Of Its Imbalance Penalties Was Consistent With Order No. 637.

As this Court has recognized, the Commission’s goal in Order No. 637 was not to discourage pipelines from imposing penalties at all, but to motivate them to impose only “necessary and appropriate” penalties and to develop non-penalty mechanisms to deal with imbalance problems. *INGAA*, 285 F.3d at 50 (quoting Order No. 637 at 31,316). *See* Rehearing Order I P 73, JA 389. In compliance, Tennessee offered a number of imbalance management options to aid shippers in remaining in balance. *Id.* Tennessee also revised its penalty structure to eliminate three penalties (Maximum Allowed Volume, Unscheduled Flow, and Daily Schedule Variance Penalties) that were triggered by shipper imbalances without regard to the effect of the imbalance on system reliability. *See* Rehearing Order I PP 59-60, JA 386-87.

Tennessee still needed, however, a penalty tool to give customers an incentive to bring their imbalances under control without having to issue an operational flow order. Compliance Order P 182, JA 333. Tennessee showed that shippers on its system were systematically not staying within balance or even within ten percent of scheduled volumes. *Id.* P 166, JA 330. Data on individual shipper scheduling variances showed some shippers were extremely abusive of the ability to run scheduling variances above the ten percent tolerance. *Id.* P 168, JA 331. As system imbalances of only five percent place Tennessee's ability to provide service at risk, these extreme individual shipper imbalances place the whole system at risk of failure. *Id.* PP 166-68, JA 330-31; Rehearing Order I P 74, JA 389.

Accordingly, Tennessee adopted one new imbalance penalty (Daily Imbalance Charge) that is specifically tied to system reliability. It applies only when the net system imbalance exceeds five percent -- which is the point at which system reliability is threatened -- and is chargeable only to balancing parties that are themselves more than ten percent out of balance in the same direction as the system, and are therefore exacerbating the system imbalance. Compliance Order P 179, JA 332. Further, Tennessee credits the Daily Imbalance Charge proceeds to parties that stay within a five percent swing tolerance, which provides an innovative

positive incentive for parties to stay in balance without increasing penalties or decreasing tolerances. *Id.* P 180, JA 332-33.

Thus, Tennessee's revised imbalance penalty structure, focusing both on overall system conditions and individual balancing party behavior, was reasonably designed to prevent the impairment of reliable firm service. It more clearly focused penalties on point operators causing system imbalances, and reduced the number of point operators that would violate the tolerance. Compliance Order P 183, JA 333; Rehearing Order I P 74, JA 389. Moreover, consistent with Order No. 637, balancing parties have ample opportunity to avoid imposition of the new imbalance penalty (Daily Imbalance Charge) through use of a number of imbalance management options offered by Tennessee. Rehearing Order I P 73, JA 389.

The Commission therefore reasonably concluded that Tennessee's changes to its imbalance penalty structure fully complied with Order No. 637. Compliance Order PP 180, 183, JA 332-33; Rehearing Order I P 74, JA 389.

B. Tennessee's Addition of Intermediate Operational Flow Order Levels Was Consistent With Order No. 637.

Order No. 637 required that pipelines take all reasonable actions to minimize the issuance and adverse impacts of operational flow orders. Compliance Order P 217, JA 336. *See* Br. 35. Among other things, pipelines were encouraged to design standards for different levels or degrees of severity of operational flow orders to

correspond to different degrees of system emergencies the pipeline may confront. Compliance Order P 217 & n. 82, JA 336 (citing 18 C.F.R. § 284.12(b)(2)(iv)); *Id.* P 230, JA 338. The Commission found, for example, that, while a large operational flow order penalty may be appropriate in severe cases, a small operational flow order penalty may be appropriate in others. Order No. 637 at 31,313.

In compliance with this directive, Tennessee added to its operational flow order penalties two new intermediate levels (Critical Day One and Critical Day Two), falling between the existing Action Alerts and Balancing Alerts. The Commission found that Tennessee's revised operational flow order penalty structure complied with Order No. 637's directive that pipelines assess adoption of graduated levels of operational flow orders. Compliance Order P 230, JA 338. Additional operational flow order levels give pipelines a greater range of tools to keep operational flow orders closely proportioned with the operational problem. Rehearing Order I P 93, JA 394. Additional operational flow order levels also benefit Tennessee's balancing parties as they will not go immediately from the Action Alert penalty to the much more stringent Balancing Alert Penalty. *Id.*

III. TENNESSEE’S REVISED PENALTY STRUCTURE DOES NOT INCREASE PENALTIES IN CONTRAVENTION OF ORDER NO. 637.

Order No. 637 compliance proceedings were designed to examine whether existing pipeline penalties remain just and reasonable because they are necessary and appropriate to protect against system reliability problems. Compliance Order P 246, JA 340. Accordingly, the Commission has held that these compliance proceedings should not be used by pipelines as an opportunity to “increase penalties or make their penalty provisions more stringent.” *Id.* Indeed, in these proceedings, the Commission denied Tennessee’s requests to increase the existing Action Alert and Balancing Alert penalties precisely because compliance proceedings are not the proper fora for penalty increases. Compliance Order P 246, JA 340; Rehearing Order I P 181, JA 406; Rehearing Order II P 94, JA 426.

Indicated Shippers contend that the new Daily Imbalance Charge is an “increased” penalty over the eliminated Daily Scheduling Variance Charge, because the former applies without prior notice, and its per dekatherm penalty level exceeds that of the latter. Br. 38, 46. Indicated Shippers also argue that the addition of the three new penalties – Daily Imbalance Charge and Critical Days One and Two – expanded Tennessee’s categories of penalties and therefore also constituted an

“increase” in penalties prohibited under Order No. 637. Br. 37, 43, 46-47. These arguments are mistaken.

A. Adoption Of The Daily Imbalance Charge Did Not Increase Penalties In Contravention Of Order No. 637.

Indicated Shippers contended that the new Daily Imbalance Charge was an “increase” in Tennessee’s penalties because it was allegedly more stringent than the existing Daily Scheduling Variance Penalty. Rehearing Order I P 69, JA 388. The Commission rejected this argument, finding that Tennessee’s penalty restructuring, including adoption of the new Daily Imbalance Charge, did not increase Tennessee’s penalties and was beneficial to shippers. *Id.* P 72, JA 389.

First, Tennessee’s restructuring eliminated several imbalance penalties (*i.e.* the Maximum Daily Volume Penalty and the Unauthorized Overrun Penalty), *id.* P 70, JA 388, which carried stiff penalties of fifteen dollars per dekatherm plus the applicable regional daily spot price. *See id.* P 71, JA 388. Accordingly, the penalties imposed under the new Daily Imbalance Charge could not simply be compared with the Daily Scheduling Variance Penalty. *Id.* P 70, JA 388.

Further, the differing designs of the new Daily Imbalance Charge and the eliminated Daily Scheduling Variance Penalty precluded direct comparison of their respective “costs.” *Id.* While both the Daily Variance Scheduling Penalty and the Daily Imbalance Charge employ tolerance levels of ten percent of scheduled

quantities, the old Daily Scheduling Variance Penalty could be charged for all variances regardless of overall system conditions and regardless of whether individual shipper imbalances were in the same or opposite direction of the pipeline's imbalance. *Id.* P 71, JA 388.

In contrast, the new Daily Imbalance Charge can only be collected when the pipeline's operational integrity is in peril, and only when a shipper's imbalance is in the same direction (*i.e.* contributes to) the net system-wide imbalance. *Id.* This change in the application of the tolerance reduces the potential number of point operators that would violate the tolerance. Compliance Order P 183, JA 333. Further, revenues from the Daily Imbalance Charge are credited to parties who stay within a five percent swing tolerance, which provides a financial incentive for parties to stay more in balance. Rehearing Order I P 71, JA 388. Such a positive incentive was not part of the old system. *Id.*

Additionally, Tennessee could impose the old Daily Scheduling Variance Penalty at will, whenever it determined that assessment of the charge would avoid jeopardizing existing system integrity or a threat to its ability to provide firm service. *Id.* The new Daily Imbalance Charge removes Tennessee's discretion, and therefore removes Tennessee's ability to impose an imbalance penalty in a discriminatory fashion. *Id.* P 71 n. 44, JA 388.

B. The Daily Imbalance Charge Is Not An Increase In Penalties In Contravention Of Order No. 637 Even Though It Is Potentially Applicable Every Day.

Order No. 637 required pipelines to disseminate timely imbalance information, in order to give shippers a reasonable opportunity to avoid penalties. Compliance Order P 127, JA 326; Order No. 637 at 31,317. At the time of its compliance filing, Tennessee provided information regarding imbalances within one business day following the production day, and “stood behind” the data on the third full business day. Compliance Order P 127, JA 326. In compliance with Order No. 637, Tennessee improved its notice to shippers, agreeing to “stand behind” the data on the first full business day following the production day, and to provide continuous notice of the system’s net imbalance position, which is the data that drives the new Daily Imbalance Charge. *Id.*

Indicated Shippers contend that the lack of advance notice that the Daily Imbalance Charge is being applied is contrary to Order No. 637. Br. 46. To the contrary, the Commission found that the notice provided, combined with the multiple imbalance management services that Tennessee offers and hourly nominations, offer point operators and shippers enhanced means to effectively manage imbalances and avoid penalties, consistent with Order No. 637’s objectives. Compliance Order PP 127, 186, JA 326, 333.

Likewise, the Commission rejected Indicated Shippers' request for a one-day notice requirement, *see* Br. 38, finding that requiring one-day notice for a penalty that is based on daily operational conditions would negate the penalty. Rehearing Order I P 76, JA 389. Nonetheless, the Commission agreed that balancing parties should be given reasonable notice that the system is entering conditions (*i.e.* when the net system imbalance is approaching five percent), which may cause Tennessee to assess Daily Imbalance Charges. Rehearing Order I P 76, JA 389. The notice would not tell shippers that they definitely would be subject to penalties – that is a function of the final daily imbalance position of the point operator the shippers deliver to or receive from, and their agreements with the point operators. *Id.* However, such notice would allow shippers to bring their performance within scheduled quantities or to make intra-day nominations to avoid imbalance penalties. *Id.*

Thus, the new Daily Imbalance Charge was designed to encourage shippers to use the many imbalance management tools available to stay in balance and to discourage extreme imbalances, in order to keep the system as a whole within reasonable levels. Compliance Order PP 169, 176, JA 331-32; Tennessee April 6, 2001 Tariff Filing, R. 194 at 8, JA 196. Tennessee offers extensive options to avoid imbalances and the Daily Imbalance Charge. Compliance Order P 184, JA 333;

Rehearing Order I P 73, JA 389. If customers choose not to avail themselves of these imbalance management services, and the system comes under stress, the Commission found that additional financial incentives for shippers to bring themselves into balance are appropriate. Compliance Order P 184, JA 333.

C. Addition Of Intermediate Operational Flow Order Levels Was Encouraged By Order No. 637, And Therefore Was Not An Increase In Penalties In Contravention Of That Order.

Indicated Shippers contend that the addition of intermediate operational flow order penalties increased Tennessee's penalties in contravention of Order No. 637. Br. 43, 46-47. However, in claiming that Tennessee's penalties went from three to five, *see* Br. 37 (referencing chart at Br. 23), 46, Indicated Shippers fail to take into account the elimination of the Maximum Allowed Volume and Unscheduled Flow Penalties. *See* Rehearing Order I P 73, JA 389.

In any event, Order No. 637 encouraged pipelines to introduce graduated levels of operational flow order penalties in order to reduce the impact of operational flow orders and tailor them more narrowly to the severity of the operational conditions experienced. Compliance Order PP 217, 230, JA 336, 338; Order No. 637 at 31,313. Thus, adoption of graduated levels of penalties can scarcely contravene Order No. 637. As Order No. 637 itself encouraged the

adoption of intermediate penalty levels, those intermediate levels cannot be prohibited “increases” in penalties within the meaning of Order No. 637.

To the contrary, additional intermediate levels of penalties are not designed to make operational flow order penalties higher or more stringent, *see* Br. 43, 47, but rather to permit pipelines to more closely tailor operational flow order penalties to the system impact, and therefore keep the penalty proportionate to the operational problem. Compliance Order PP 217, 230, JA 336, 338; Rehearing Order I P 93, JA 394; Order No. 637 at 31,313. The additional levels benefit Tennessee’s balancing parties because they will not go immediately from the Action Alert penalty to the much more stringent Balancing Alert penalty, Rehearing Order I P 93, JA 394, and they will allow Tennessee to impose the Balancing Alert penalty less often. *Id.* PP 73, 94, JA 389, 394.

Thus, the Critical Day One and Critical Day Two penalties do not, as Indicated Shippers argue, “empower Tennessee to impose greater restrictions on shippers by allowing Tennessee to impose substantial penalties on previously unpenalized conduct.” Br. 38-39. Rather, the revised penalty scheme, approved by the Commission, permits Tennessee to more accurately and proportionately tailor its penalties to the severity of the operational problem presented.

IV. THE COMMISSION HAD SUBSTANTIAL EVIDENCE OF THE OPERATIONAL NEED FOR THE NEW PENALTIES.

Indicated Shippers contend that the Commission did not have substantial evidence to support a threat to system integrity or reliable firm service that would support the new penalties. *See* Br. 39, 43. This contention is mistaken.

A. The Substantial Evidence Of Operational Need For The New Penalties.

The Commission found substantial evidence of the operational need for the new penalties.

Operational flow orders and their penalties are necessarily driven by operational concerns. Rehearing Order I P 94, JA 394. The purpose of operational flow orders is to permit pipelines to take actions necessary to prevent serious operational difficulties on their systems. Rehearing Order II P 8, JA 413. Article VIII, Section 2 of Tennessee’s Tariff General Terms and Conditions provides that operational flow orders will be issued to alleviate conditions which threaten the safe operation or system integrity of Tennessee’s system, or to maintain operations required to provide efficient and reliable firm service. Rehearing Order I P 94, JA 394. Accordingly, Tennessee’s operational flow orders (Action Alerts, Critical Days One and Two, Balancing Alerts) necessarily are based on the operational needs of the pipeline. Penalties for violations of operational flow orders are, by

their nature, directed at encouraging proper shipper behavior when adverse operational conditions exist. *Id.*

As for the new Daily Imbalance Charge, Indicated Shippers assert that the Commission “accepted on faith” Tennessee’s “generalized assertion” that if Tennessee’s system “becomes five percent out of balance as a whole, the retained operational storage injection and withdrawal levels have been vastly exceeded.” Br. 39 (quoting April 6, 2001 Compliance Filing, R. 194 at 5, JA 193).

However, in support of its need to restrain imbalances, Tennessee submitted hard empirical evidence, not simply broad generalities. In its August 15, 2000 tariff filing, R. 62, JA 1, as well as at a series of conferences,¹¹ Tennessee provided operational data supporting the need to rein in daily imbalances on Tennessee’s system. Compliance Order PP 166, 181, JA 330, 333. The data showed that, notwithstanding many imbalance management options on Tennessee’s system, shippers were not making any consistent and sustained attempts to stay in balance. *Id.* P 166, JA 330. Rather, shippers were systematically not staying within balance or even within ten percent of scheduled volumes. *Id.* Aggregated data on imbalances at all delivery points on Tennessee’s system from July 1999 through

¹¹ A series of technical and/or settlement conferences were held on November 14, 2000, December 13, 2000, January 23 and 24, 2001, and March 6, 2001. *See* April 6, 2001 Tariff Filing, R. 194 at 2 n.3, JA 190.

June 2000 demonstrated extreme swings: the net system imbalance in one month is minus forty percent of scheduled volumes, and the next month the net system imbalance is twenty percent of scheduled volumes in the opposite direction. August 15, 2000 Tariff Filing, Appendix B, Statement of Nature, Reasons and Basis, R. 62 at 15, JA 15. Swings were not limited to the winter heating period, but occurred throughout the year and were unpredictable. *Id.* Similarly, sample data on four customers over four representative shoulder months showed swings as large as 300 to 400 percent of scheduled volumes. *Id.*

Tennessee also presented data showing that a system imbalance of only five percent places Tennessee's ability to provide firm service at risk. Compliance Order PP 166, 177, JA 331-32; Rehearing Order I P 74, JA 389. Tennessee has inadequate storage injection and withdrawal capability to accommodate system imbalances of that magnitude. April 6, 2001 Tariff Filing, Letter to Secretary Boergers, R. 194 at 5, JA 193. As this Court has recognized, following unbundling, pipelines have "reduced flexibility to adjust when customers unexpectedly deviate from their shipping schedules, and they cannot easily compensate for imbalances between volumes tendered to the pipeline and taken by a customer." *Pennsylvania Office of Consumer Advocate*, 131 F.3d at 184. A pipeline with a limited merchant function facing an overrun might be unable to

sustain enough pressure in its line to provide reliable transportation service. *Id.* On the other hand, if customers tender more gas than scheduled, pipelines may lack the ability to reduce tenders from other sources of supply or to deliver gas to other points to avoid a pressure build up on the pipeline that could threaten system integrity. *Id.*

For example, on an average injection season day, Tennessee may have a daily system throughput of 4 billion cubic feet. April 6, 2001 Tariff Filing, Letter to Secretary Boergers, R. 194 at 5, JA 193. If the system is five percent out of balance, then Tennessee must inject 400,000 dekatherms of gas into storage to regain system balance. *Id.* However, the total (customer and retained) system injection capability is only 535,000 dekatherms per day. *Id.* See May 1, 2001 Reply Comments and Answer of Tennessee Gas Pipeline Company, R. 224 at 4-8, JA 271-75 (explaining calculation). If customers are injecting gas in excess of 135,000 dekatherms, there is nowhere for the excess gas to go. April 6, 2001 Tariff Filing, Letter to Secretary Boergers, R. 194 at 5, JA 193.

The Commission therefore concluded that Tennessee had sufficiently demonstrated the need to address shipper imbalances on its system, and sufficiently supported the use of five percent net system imbalance as a trigger point, so that it had adequately justified use of the Daily Imbalance Charge. Rehearing Order I P

74, JA 389 (replying on “operational evidence provided by Tennessee” to support need for revised penalties to prevent impairment of reliable service on Tennessee system resulting from shipper imbalances). *See also B&J Oil and Gas Co. v. FERC*, 353 F.3d 71, 76 (D.C. Cir. 2004) (agency is entitled to an “extreme degree of deference” when it is evaluating complex scientific or technical questions) (quoting *City of Waukesha v. EPA*, 320 F.3d 228, 247 (D.C. Cir. 2003)).

B. Indicated Shippers’ Challenges To This Evidence Are Without Merit.

Indicated Shippers attempt to dismiss the evidence in support of the operational need for the new penalties as “paltry.” Br. 40. *See also* Br. 39, 43. However, they offer no contrary operational evidence on brief to refute it, and provided no such evidence to the Commission. Rehearing Order I P 74, JA 389. *See Consolidated Oil and Gas v. FERC*, 806 F.2d 275, 280 (D.C. Cir. 1986) (FERC reliance on undenied assertions satisfies the substantial evidence test).

Instead, Indicated Shippers only point to the fact that, for several years prior to the instant Order No. 637 compliance proceeding, Tennessee operated its system without resort to frequent operational flow orders or Daily Scheduling Variance Penalties. Br. 40, 41-42, 44. This “fact” does not, however, demonstrate that the new penalties are unnecessary.

Although Tennessee had not invoked the Daily Scheduling Variance Penalty, Tennessee had frequently invoked the significantly higher Maximum Allowed Volume Penalty, that is now eliminated. Compliance Order P 182, JA 333. Indeed, during the year for which data was provided, Tennessee had the Maximum Allowed Volume penalty in place for much of the peak winter period, which acted to reduce individual shipper imbalances. May 1, 2001 Reply Comments and Answer of Tennessee Gas Pipeline Company, R. 224 at 5, JA 272.

Further, Tennessee was able to manage system imbalances in excess of five percent in the two prior heating seasons because the winters were moderate, and therefore Tennessee's customer balances had not been depleted so customers did not need their full injection capabilities. April 6, 2001 Tariff Filing, Letter to Secretary Boergers, R. 194 at 5, JA 193. This excess injection capability helped to manage net system imbalances in excess of five percent. *Id.* Tennessee cannot, however, operate its system in reliance on mild winters and customers not needing their full injection capabilities. *Id.* Indeed, the data established that, even where these circumstances exist, maintaining a five percent system imbalance level has started to put at risk the provision of firm service for all customers. *Id.*

Tennessee failed to implement Action Alerts routinely because the detrimental shipper behavior tended to occur quickly and in the same direction, and

immediate relief was not possible under an Action Alert, which required 48 hours advance notice. Compliance Order P 227, JA 338. Where immediate action was required, Tennessee was compelled to issue high penalty Balancing Alerts, which can now be avoided by implementation of intermediate Critical Days penalty layers. Tennessee May 4, 2001 Reply Comments, R. 224 at 17 & n. 32, JA 284. The Commission accepted an eleven hour notice requirement for Critical Days operational flow orders in recognition of the fact that Tennessee may face detrimental behavior requiring immediate action to maintain operational integrity. Rehearing Order I P 88, JA 391. The Action Alert with its 48-hour notice provision was retained, however, to permit Tennessee to give shippers more advanced notice where circumstances permit. *Id.*

Thus, while Tennessee had not actually experienced significant impairments to reliable service because of imbalances, the Commission agreed that Tennessee need not demonstrate through experiencing actual system impairment that the five percent tolerance employed in the Daily Imbalance Charge is the proper level. Compliance Order P 181, JA 333. Similarly, Tennessee is not required to experience operational impairments before designing operational flow orders. Compliance Order P 230, JA 338; Rehearing Order I P 85, JA 391.

Rather, penalties are to deter future conduct rather than merely react to past problems, and most operational flow order conditions involve a degree of prediction of future events and knowledge of how these events may affect operations. *Id. See Electricity Consumers Resource Council v. FERC*, 407 F.3d 1232 (D.C. Cir. 2005) (Court defers to Commission’s predictive judgment as long as Commission articulates reasons for its judgment and responds to objections). As Tennessee’s tariff describes it, an operational flow order may be called when “action is necessary to *avoid* a situation in which the system integrity is jeopardized or [the pipeline’s] ability to render firm service is threatened. . . .” Compliance Order P 230 & n. 89, JA 338 (quoting Tennessee’s FERC Gas Tariff, 5th Revised Volume No. 1, Substitute 1st Revised Sheet No. 359, Article VIII, § 2.4) (emphasis added by Commission).

Tennessee’s proposal to implement intermediate operational flow order levels was a clear statement that Tennessee could identify operational situations that may impair service that do not require the full power of a Balancing Alert operational flow order and related fifteen dollar per dekatherm penalty. Rehearing Order I P 94, JA 394. Operational flow order penalties are appropriate to encourage proper shipper behavior when these adverse operational conditions exist. *Id. See, e.g., Sithe New England Holdings, LLC v. FERC*, 308 F.3d 71, 77-79 (1st Cir. 2002)

(upholding, as explained and supported, FERC approval of penalties designed to encourage behavior that will assure adequate capacity).

Indicated Shippers fault the Commission for failing to consider whether a non-penalty approach relying on positive incentives could effectively address any perceived problems. Br. 41. At the same time, however, they contend that, with the data provided, it was “simply impossible to know” whether “a more incentive-oriented approach would work more effectively.” *Id.* In any event, Indicated Shippers ignore the fact that shippers do have a positive incentive to avoid stresses on the Tennessee system under the Tennessee penalty structure, in that in-balance parties share in the penalty revenue collected from parties not in balance.

The Commission rejected contentions that Tennessee failed to offer alternatives to its imbalance penalty. Tennessee offered an extensive list of imbalance management options, which it expanded as part of its Order No. 637 compliance proceeding. Compliance Order P 184, JA 333. *See id.* PP 116-18, JA 325 (listing options). Further, Tennessee converted its Maximum Allowed Volume penalty to the equivalent of an authorized overrun service. *Id.* If customers chose not to avail themselves of these services, and the system starts to come under stress, the Commission found that additional financial incentives for shippers to bring themselves into balance are appropriate. *Id.*

Indicated Shippers also contend that the Commission failed to consider the cumulative effect of Tennessee's proposals in affirming the new penalty provisions. Br. 41, 48. The Commission found to the contrary that it had in fact considered the combined impact of all of Tennessee's penalty provisions. Rehearing Order I P 79, JA 390. The Commission pointed to its discussion in the Compliance Order PP 244-46, JA 340, finding that Tennessee had created a graduated level of penalties in full compliance with Order No. 637. Rehearing Order I P 79, JA 390. The fact that the Commission discussed the proposed penalties individually did not mean that the Commission failed to consider their combined impact. *Id.*

Indeed, the Commission expressly considered the Tennessee penalty structure as a package in concluding that it complied with the Order No. 637 goals of introducing more imbalance management services and penalty structures focused on operational integrity. Rehearing Order I P 73, JA 389. The package as a whole is beneficial to shippers because it eliminated the Maximum Allowed Volume and Unscheduled Flow Penalties, and added additional operational flow order tiers, which permit penalties to more closely match actual system conditions and individual contributions to those conditions. *Id.* Further, while the Daily Imbalance Charge was required by the operational needs of Tennessee's system, *id.* P 74, JA

389, it could be avoided by use of one of Tennessee's numerous imbalance management options. *Id.* P 73, JA 389.

For all these reasons, the Commission was justified in concluding, based on Tennessee's representations and evidence, that its proposed revisions to its penalty structure were just and reasonable under the requirements of the Natural Gas Act and Order No. 637.

CONCLUSION

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

Respectfully submitted,

John S. Moot
General Counsel

Robert H. Solomon
Solicitor

Lona T. Perry
Senior Attorney

Federal Energy Regulatory
Commission
Washington, D.C. 20426
TEL: (202) 502-6600
FAX: (202) 273-0901

May 5, 2006

CERTIFICATE OF COMPLIANCE

In accordance with Fed. R. App. P. 32(a)(7)(C)(i), I certify that the Brief of Respondent Federal Energy Regulatory Commission contains 9948 words, not including the tables of contents and authorities, the glossary, the certificates of counsel and the addendum.

Lona T. Perry
Attorney for Federal Energy
Regulatory Commission