UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Nora Mead Brownell, and Suedeen G. Kelly.

Algonquin Gas Transmission, LLC Docket No. RP06-31-001

ORDER DENYING REHEARING

(Issued April 19, 2006)

1. In this order the Commission will deny Direct Energy Services, LLC's (Direct Energy's) December 12, 2005, request for rehearing of the Commission's Letter Order dated November 10, 2005 in Docket No. RP06-31-000.[1] The November Order accepted tariff sheets that Algonquin Gas Transmission, LLC (Algonquin) filed to remove the cap on penalties to be assessed against shippers who violate the emergency situation, curtailment, or unauthorized contract overrun provisions of the General Terms and Conditions of its FERC Gas Tariff.

Background

2. Before Algonquin's filing in this case, section 31.2 of its General Terms and Conditions (GT&C) of its FERC Gas Tariff provided that if a customer takes unauthorized contract overrun gas and the unauthorized overrun threatens system integrity or deliveries to firm shippers, the customer must pay a penalty equal to three times a specified gas commodity index price, subject to a cap of $15 per Dth. The index price is the *Gas Daily* posting for the High Common price for the "AGT Citygate" on the day the violation occurred. Sections 24.6(e) and 24.8 of the GT&C provided for the same penalty in certain curtailment situations, but subject to a cap of $25 per Dth, rather than $15 per Dth. The section 24.8 penalty applies in situations where a customer takes quantities of gas in violation of a curtailment order issued by Algonquin. The section 24.6(e) penalty applies in situations where a customer was granted emergency relief from a curtailment order but then failed to provide Algonquin immediate notice of the cessation of the emergency situation which caused the customer to seek adjustment of the curtailment level.

[1] *Algonquin Gas Transmission, LLC*, 113 FERC ¶ 61,146 (November Order).

3. The Commission previously approved these penalty provisions in Algonquin's Order No. 637 compliance proceeding, finding that they complied with the requirement in section 284.12(b)(2)(v)[2] of the Commission's regulations that a pipeline may impose penalties "only to the extent necessary to prevent the impairment of reliable service." In its Order No. 637 compliance proceeding, Algonquin did not propose any cap on these index-based penalties. However, the Commission found that a 1999 settlement of an Algonquin rate case under section 4 of the Natural Gas Act[3] (NGA) prohibited Algonquin from increasing its penalties until after May 1, 2003. The Commission accordingly required that the penalties be capped at the existing penalty levels of $15 and $25.[4] On rehearing, Algonquin argued that the caps should be removed entirely on the theory that non-capped index-based penalties would have a better relationship to changing market conditions and prevent arbitrage. The Commission denied rehearing, reaffirming that the settlement prohibited any increase in penalties above their current levels and also stating that an increase in existing penalty levels would go beyond what was required to comply with Order No. 637.[5] However, the Commission did note that the moratorium on rate increases in the 1999 settlement had expired, and accordingly Algonquin would be free to file under NGA section 4 to propose an increase in the penalties.[6]

4. In the instant section 4 filing, Algonquin proposed to remove the $15 and $25 caps on the unauthorized overrun and curtailment penalties. In the November Order the Commission accepted Algonquin's proposal. The Commission found that the penalties at issue here were designed to provide an economic disincentive to shippers that might take actions which could threaten the operational integrity of the pipeline. Given the current increased gas prices, the Commission agreed that Algonquin's current penalties were capped at levels that may no longer act as a deterrent for actions that might threaten pipeline operations. Having accepted other tariffs providing for penalties equaling four times an index price with no cap,[7] and noting that the tariffs at issue involved penalties necessary to preserve the operational integrity of the pipeline, the Commission accepted Algonquin's proposal.

---

[2] 18 C.F.R. § 284.12(b)(2)(v) (2005).

[3] 15 U.S.C. § 717c (2000).

[4] *Algonquin Gas Transmission Co.*, 98 FERC ¶ 61,211 at 61,786 (2002).

[5] *Algonquin Gas Transmission Co.*, 104 FERC ¶ 61,118 at P 74-76 (2003).

[6] *Id*. at P 64.

[7] November Order at n.3.

Request for Rehearing

5. Direct Energy first argues that the Commission erred in granting Algonquin's request to remove the caps on penalties without considering evidence supporting the basis for the change or conducting a technical conference to gather information on the issue. According to Direct Energy, Algonquin's request is not supported by experience, as required by *Southern Natural Gas Company*, 76 FERC ¶ 61,303 (1996). Direct Energy characterizes the concerns related to the rising price of gas as "unsubstantiated" and argues that Algonquin was deficient because it "pointed to no mischief" and "failed to fully explain why $15 and $25 penalties . . . will not be sufficient to encourage proper behavior . . . ."[8]

6. Direct Energy also objects to the Commission's decision to not require a sunset provision to the cap removal. Relatedly, Direct Energy argues that the Commission failed to consider whether fluctuations in gas prices would result in higher penalties that could be applicable to suppliers of lower-priced gas in the future.

Discussion

7. The Commission will affirm its decision to accept Algonquin's request to remove certain limitations on penalty charges in recognition of the fact that gas prices may rise to a level at which an index-based penalty with a cap will lose its effectiveness.

8. Order No. 637 revised the Commission's regulations to provide that "[a] pipeline may include in its tariff transportation penalties only to the extent necessary to prevent the impairment of reliable service."[9] In Order No. 637, the Commission explained that "by requiring that all penalties be necessary to prevent the impairment of reliable service, the Commission is requiring pipelines to narrowly design penalties to deter only conduct that is actually harmful to the system."[10] Under the statutory scheme in the NGA, pipelines have the initiative through a section 4 filing to propose rates, terms, and conditions for the service it provides. If the pipeline's proposal is reasonable, the Commission will accept it, regardless of whether other rates, terms, and conditions may

[8] Req. for *reh'g* at 3.

[9] Order No. 637 at 31,314.

[10] Order No. 637 at 31,314.

be reasonable.[11] Consistent with this scheme, Algonquin took the initiative to propose appropriate penalty levels to deter conduct harmful to its system, and the Commission will accept its proposal so long as it is consistent with the policy set forth in Order No. 637.

9. The Commission has already found in Algonquin's Order No. 637 proceeding that the penalties at issue here are narrowly tailored to apply only in situations where the shipper's conduct may impair reliable service. The unauthorized overrun penalty by its terms only applies when the overrun "threatens system integrity or deliveries to firm shippers." The curtailment penalties apply only when Algonquin has issued a curtailment order. Section 24 of the GT&C provides that Algonquin may issue a curtailment order in such circumstances as when necessary to maintain the operational integrity of its system, or when necessary for Algonquin to meet its firm service obligations.

10. The only change Algonquin has proposed in this case is to remove the caps on these penalties, so that the penalties will always be three times the applicable daily index price. Until last year, gas commodity prices were generally low enough that the caps rarely came into play. As a result, the actual penalties incurred by shippers were generally equal to three times the index price, rather than at the cap. The effect of Algonquin's proposal to remove the caps is simply to ensure that the penalties continue to bear the same proportionate relationship to current gas commodity prices, as they have in the past. The Commission continues to believe that this proposal is reasonable.

11. In its filing, Algonquin pointed out that, as of October 11, 2005, the NYMEX futures closing price for January 2006 was $14.40. It stated that if daily cash prices along the Algonquin pipeline system reached or exceeded the penalty caps, Algonquin's system could be severely compromised in a curtailment or unauthorized overrun situation. It argued that, if a customer has a choice between incurring the penalty by taking excess gas versus purchasing gas at any price above the penalty charge, an economically rational customer will generally choose the penalty.

12. Direct Energy does not contest Algonquin's contention that, if daily spot prices reach or exceed the penalty caps, shippers would have an incentive to incur the penalty rather than purchase gas at a higher price than the penalty. However, it points out that gas prices were in excess of $10 starting in August 2005, and Algonquin pointed to no "mischief"[12] on its pipeline during that period or during the winter of 2004-2005 when it admits prices were lower. Direct Energy's argument that Algonquin's proposal is deficient because it lacks examples of "mischief" seems to be based on the proposition

---

[11] *Western Resources, Inc. v. FERC*, 9 F.3d 1568, 1578 (D.C. Cir. 1993).

[12] Direct Energy rehearing request at 3.

that a pipeline cannot propose and the Commission cannot accept changes in penalties that are meant to deter illicit behavior until after that behavior has occurred. However, this is certainly not Commission policy.[13] Algonquin made its filing in anticipation that, if commodity prices continued to rise as was predicted at the time of its filing, the deterrent effect of the subject penalties would be seriously eroded, with the potential for serious operational problems. The Commission finds it entirely appropriate for pipelines to anticipate problems and take action to forestall them, rather than waiting until such problems actually occur.

13. Moreover, the Commission required Algonquin to cap these penalties in its Order No. 637 proceeding, because a settlement in Algonquin's previous rate case prohibited Algonquin from proposing increased penalties at the time Algonquin made its Order No. 637 compliance filing. The Commission made no finding in Algonquin's Order No. 637 compliance that section 284.12(b)(2)(v) of its regulations required the subject penalties to be capped. In fact, the Commission pointed out that Algonquin could propose to increase these penalties, after the settlement moratorium on rate increases expired. Since Order No. 637, the Commission has approved other pipeline proposals for uncapped penalties, based on multiples of price indices.[14] The Commission's primary concern with respect to penalties such as those at issue here, which apply only to conduct that is harmful to the system is that the penalties be high enough to act as an effective deterrent to the harmful conduct. Since such conduct risks harm to other customers as well as the pipeline, the Commission believes that significant penalties for such conduct are appropriate. Thus, Algonquin presented a sufficient record which the Commission carefully considered in finding that the increase in penalties is justified.

---

[13] *See, e.g.*, *Tennessee Gas Pipeline Co.*, 83 FERC ¶ 61,063 at 61,335 (1998).

[14] *See, e.g.*, *Northwest Pipeline Corp*., 100 FERC ¶ 61,347 P77 (2002) (approving a tariff containing an OFO penalty equal to the greater of $10.00/Dth or four times the highest absolute price reflected in the local daily price survey with no tolerance bands). The Commission has also approved OFO penalties per Dth equal to three times the midpoint of the range of prices reported for a published index price location in *Midwestern Gas Transmission Co.*, 112 FERC ¶ 61,345 (2005) and *Viking Gas Transmission Co.*, 112 FERC ¶ 61,098 (2005). Additionally, the Commission has approved index price based OFO penalties for other pipelines, *e.g.*, *Paiute Pipeline Co.*, 111 FERC ¶ 61,107 (2005); *Southern Star Central Gas Pipeline, Inc.*, 107 FERC ¶ 61,071 (2004); and *Gulf South Pipeline Co., LP*, 104 FERC ¶ 61,160 (2003).

14. In attacking Algonquin's proposal, Direct Energy cites *Stingray Pipeline Co.*,[15] and *Southern Natural Gas Co.*,[16] cases in which the Commission concluded that the pipelines had not provided sufficient evidence to support their proposals. However, in both of these cases, the pipelines had proposed to revise their procedures for cashing out net monthly imbalances. Those procedures apply to all imbalances, regardless of whether the imbalances caused operational problems. The purpose of the proposals in those cases was to reduce shippers' incentive for incurring imbalances for the purpose of arbitraging the cashout mechanism, because such arbitrage could cause the pipeline to underrecover its costs of operating the cash-out mechanism. These proposals were thus primarily economic, and applied even in circumstances where the arbitrage caused no operational problems. In such cases, where a penalty will apply regardless of operational problems, the Commission is more concerned that the penalties not unnecessarily restrict shipper flexibility. Thus, the Commission has carefully analyzed such proposals to ensure that they do not go beyond what is necessary to prevent the price arbitrage they are intended to discourage.[17] By contrast, when operational issues are at stake, the overriding concern is to discourage behavior that would physically threaten the system by imposing effective penalties. It is just this scenario, rather than mere economic concerns that Direct Energy cites, that Algonquin's proposal seeks to address.

15. Direct Energy also makes the claim that gas prices fluctuate and expresses concern that in the future higher penalties could be applicable to suppliers of lower-priced gas. However, since the penalties at issue here are a multiple of the index price on the day that the violation occurs, if gas prices decrease in the future, the penalties will also decrease.

16. The Commission has recognized that setting penalties is "not a matter for scientific calculation. Penalty charges are not cost-based, and their essential purpose is to deter undesirable shipper behavior."[18] The penalty level necessary to accomplish that

---

[15] 75 FERC ¶ 61,061 (1996).

[16] 76 FERC ¶ 61,303 (1996).

[17] *See The Industrials v. FERC*, 426 F.3d 405 (D.C. Cir. 2005), *affirming Northern Natural Gas Co*. 105 FERC ¶ 61,172 (2003), *order on reh'g*, 107 FERC ¶ 61,252 (2004). As the court pointed out, the Commission has approved the use of high/low weekly index prices for cashing out imbalances, including the addition of a fifth week, to minimize incentives for arbitrage, as in the orders affirmed by the court. But the Commission has rejected proposals to require cash-out of imbalances measured over periods of less than a month as unnecessary to minimize incentives for arbitrage, as in *ANR Pipeline Co.*, 103 FERC ¶ 61,252 (2003), *order on reh'g*, 105 FERC ¶ 61,236 (2003).

[18] *See Northern Natural Gas Co.*, 77 FERC ¶ 61,282 at 62,235-37 (1996), *reh'g denied*, 78 FERC ¶ 61,355 at 62,494 (1997). *See also, e.g., Trunkline Gas Go.*, Opinion No. 441, 90 FERC ¶ 61,017 at 61,078 (2000).

purpose is a matter of judgment. Furthermore, the pipeline lacks an incentive to choose an unreasonably high penalty because it is not permitted to keep penalties it collects.[19] Given the current increased gas prices and the potential for prices to continue rising, Algonquin reasonably concluded that its currently capped penalties may no longer act as an effective deterrent to actions that might threaten its pipeline operations. Accordingly, the Commission is satisfied that Algonquin's proposed penalties are just and reasonable.

The Commission orders:

Direct Energy's Request for Rehearing is denied.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.

[19] *See, e.g.*, Order No. 637 at 31,309.