

152 FERC ¶ 61,039  
UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

El Paso Natural Gas Company, L.L.C.

Docket No. RP08-426-017 and  
RP12-806-000

OPINION NO. 517-A  
ORDER ON REHEARING AND COMPLIANCE

Issued: July 16, 2015

## Table of Contents

|  | <u>Paragraph No.</u> |
|--|----------------------|
| I. Background .....  | <u>3.</u>            |
| II. Requests for Rehearing/Clarification of Opinion No. 517, Docket No. RP08-426-017 .....   | <u>9.</u>            |
| A. Procedural Matters .....  | <u>12.</u>           |
| B. Capital Structure .....   | <u>13.</u>           |
| 1. Requests for Rehearing .....  | <u>18.</u>           |
| 2. Commission Determination .....  | <u>26.</u>           |
| a. The Commission’s Ratemaking Precedent Addressing Loans to Shareholders and Undistributed Subsidiary Earnings Support the Equity Adjustment .....      | <u>28.</u>           |
| b. The Disputed Factual Evidence Fails to Justify Counting the Affiliate Loan in El Paso’s Capital Structure .....                                       | <u>54.</u>           |
| c. The Ratemaking Precedent Relied on in Opinion No. 517 Remains Good Law .....  | <u>101.</u>          |
| d. The Commission Affirms its Decision Not to Reopen the Record to Permit El Paso to Argue Purchase Accounting Precedent .....                           | <u>127.</u>          |
| e. El Paso’s Unadjusted Capital Structure is Not Representative of the Capital Invested in Regulated Activities and the Adjustment is Not Punitive ..... | <u>134.</u>          |
| f. El Paso Was Not Prejudiced by Its Inability to Cross Examine a Staff Witness on Capital Structure Issues .....  | <u>140.</u>          |
| g. El Paso Failed to Support a Working Capital Adjustment .....  | <u>143.</u>          |
| h. El Paso Failed to Demonstrate that the Adjusted Capital Structure is Inappropriate for Ratemaking Purposes .....                                      | <u>144.</u>          |
| C. Line 1903 .....   | <u>148.</u>          |
| 1. Request for Rehearing .....   | <u>151.</u>          |
| 2. Commission Determination .....  | <u>166.</u>          |
| 3. Accounting Matters .....  | <u>179.</u>          |
| D. Short-term Firm and Interruptible Rates .....   | <u>181.</u>          |
| E. Article 11.2 .....  | <u>201.</u>          |
| 1. Standard of Review .....  | <u>203.</u>          |
| 2. Just and Reasonable Review .....  | <u>226.</u>          |
| 3. Above-Cap Costs .....   | <u>248.</u>          |
| 4. Article 11.2(b) compliance .....  | <u>278.</u>          |
| III. Docket No. RP12-806-000 Compliance Filing .....   | <u>290.</u>          |
| A. Public Notice and Responsive Pleadings .....  | <u>291.</u>          |
| B. Procedural Matters .....  | <u>292.</u>          |
| C. Line 1903 .....   | <u>293.</u>          |
| D. Capital Structure and Article 11.2 .....  | <u>296.</u>          |
| E. Short-term Firm and Interruptible Rates .....   | <u>299.</u>          |
| F. Compliance Filing and Refund Report .....   | <u>303.</u>          |

Appendix

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UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Norman C. Bay, Chairman;  
Philip D. Moeller, Cheryl A. LaFleur,  
Tony Clark, and Colette D. Honorable.

El Paso Natural Gas Company, L.L.C.

Docket Nos. RP08-426-017  
RP12-806-000

OPINION NO. 517-A

ORDER ON REHEARING AND COMPLIANCE

(Issued July 16, 2015)

1. On May 4, 2012, the Commission issued an Opinion and Order on Initial Decision in Opinion No. 517 in Docket No. RP08-426-000, El Paso Natural Gas Company, L.L.C.'s (El Paso) general system-wide rate proceeding pursuant to section 4 of the Natural Gas Act (NGA).<sup>1</sup> On June 4, 2012, El Paso and a number of other parties filed requests for rehearing and/or clarification of Opinion No. 517 in Docket No. RP08-426-017. On June 8, 2012, El Paso filed, in Docket No. RP12-806-000, revised tariff records to comply with Opinion No. 517.

2. In this order, the Commission accepts El Paso's revised tariff records as consistent with the determinations in Opinion No. 517. In addition, the Commission grants limited rehearing to recognize that El Paso has demonstrated that it increased its outstanding debt in the relevant time frame by \$50 million through a 2007 debt issuance. As a consequence, the Commission agrees that El Paso should deduct this amount from its outstanding debt when it adjusts its capital structure to reflect a loan to its shareholding parent company, as ordered in Opinion No. 517. As discussed at the conclusion of this opinion, El Paso is directed to file such revised tariff records as are necessary to reflect the Commission's determination on rehearing within 30 days. El Paso is further required to provide refunds within 60 days and provide a report to the Commission consistent with section 154.501 of the Commission's regulations.

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<sup>1</sup> *El Paso Natural Gas Co.*, Opinion No. 517, 139 FERC ¶ 61,095 (2012), *rev'g*, 134 FERC ¶ 63,002 (2011) (ID or Initial Decision).

## I. Background

3. This proceeding began on June 30, 2008, when El Paso filed a general rate case pursuant to NGA section 4 to implement a number of changes to its tariff, including new services, a rate increase, and changes in certain terms and conditions of service (2008 Rate Case). The Commission accepted and suspended El Paso's primary tariff sheets, to become effective on January 1, 2009, subject to refund and conditions, and established procedures for a technical conference and hearing.<sup>2</sup>

4. On March 13, 2010, El Paso filed an uncontested settlement on the majority of the issues in this case (2010 Settlement). The settlement was approved by the Commission on April 28, 2010.<sup>3</sup> Article V of the 2010 Settlement sets forth the four issues the participants reserved for hearing and merits determination: (1) the amount to be included in El Paso's capital account for ratemaking and accounting purposes related to Line 1903; (2) the appropriate capital structure; (3) the appropriate rate design for the maximum recourse rate for interruptible transportation service (IT), interruptible parking and lending service (PAL), and short-term firm transportation rates; and (4) issues related to Article 11.2 of the 1996 Settlement. The 2010 Settlement provides that the resolution of the issues relating to capital structure and Line 1903 will not affect the settlement rates or revenues during the term of the 2010 Settlement, which will expire on April 1, 2011, the effective date for El Paso's subsequent rate case in Docket No. RP10-1398-000. Thus, the capital structure and Line 1903 determinations will only take effect on Commission acceptance of the ultimate rates in the subsequent 2011 Rate Case. The hearing on the four reserved issues commenced on May 18, 2010 and concluded on June 8, 2010.

5. On September 30, 2010, El Paso filed another general section 4 rate case in Docket No. RP10-1398-000 (2011 Rate Case). The Commission accepted and suspended the primary tariff records, to be effective April 1, 2011, subject to refund and conditions and the outcome of the hearing established in the order.<sup>4</sup> Thus, the rates determined in the Docket No. RP08-426-000 proceeding are effective only for a locked-in period from January 1, 2009 through March 31, 2011. As noted above, the Commission's determinations on capital structure and Line 1903 take effect only with the acceptance of

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<sup>2</sup> *El Paso Natural Gas Co.*, 124 FERC ¶ 61,124 (2008) (Suspension Order), *reh'g denied*, 133 FERC ¶ 61,129 (2010), *clarification and rehearing dismissed as moot*, 134 FERC ¶ 61,170 (2011).

<sup>3</sup> *El Paso Natural Gas Co.*, 131 FERC ¶ 61,077 (2010) (letter order).

<sup>4</sup> *El Paso Natural Gas Co.*, 133 FERC ¶ 61,104 (2010) (2011 Rate Case Suspension Order), *reh'g denied*, 133 FERC ¶ 61,253 (2010).

the rates in Docket No. RP10-1398-000. Furthermore, in Docket No. RP10-1398-000 the Commission accepted the proposed tariff records subject to the outcome of the hearing in Docket No. RP08-426-000 regarding the four reserved issues. El Paso moved its proposed primary tariff records into effect on April 1, 2011, and has been collecting revenues produced by the subject-to-refund rates since that date. The evidentiary hearing was conducted before an Administrative Law Judge from October 25 to December 16, 2011, and an Initial Decision was issued in Docket No. RP10-1398-000 on June 18, 2012.<sup>5</sup> The Commission issued Opinion No. 528, its opinion and order on that Initial Decision on September 17, 2013.<sup>6</sup>

6. On May 4, 2012, the Commission issued Opinion No. 517 in El Paso's 2008 Rate Case proceeding in Docket No. RP08-426-000. In Opinion No. 517, the Commission made the following findings: (1) El Paso's depreciable plant account should only include the \$10.5 million associated with El Paso's investment in Line 1903, and El Paso has not shown that it has booked accumulated depreciation and deferred income taxes assessed on the unused California segment that was purchased with Line 1903;<sup>7</sup> (2) El Paso's proposed capital structure should be adjusted to remove the \$615 million loan to its parent and the \$145 million in undistributed subsidiary earnings from equity capitalization for ratemaking purposes;<sup>8</sup> (3) El Paso's proposed short-term firm and interruptible rates are unjust and unreasonable;<sup>9</sup> and (4) the Article 11.2(a) rates remain just and reasonable, and El Paso may not reallocate to non-Article 11.2(a) shippers or contracts any shortfall arising as a result of Article 11.2(a) rates being lower than recourse rates.<sup>10</sup> The Commission required El Paso to file, within 30 days of the date of the order on initial decision, revised tariff records and rates, including proposed accounting and workpapers, reflecting the Commission's rulings. The Commission also required that within 30 days of a final order in this case, El Paso must refund amounts recovered in excess of the just and reasonable rates approved by the Commission.

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<sup>5</sup> *El Paso Natural Gas Co.*, Initial Decision, 139 FERC ¶ 63,020 (2012).

<sup>6</sup> *El Paso Natural Gas Co.*, Opinion No. 528, 145 FERC ¶ 61,040 (2013).

<sup>7</sup> Opinion No. 517, 139 FERC ¶ 61,095 at PP 51-52.

<sup>8</sup> *Id.* P 86

<sup>9</sup> *Id.* P 186.

<sup>10</sup> *Id.* PP 235, 290.

7. On June 4, 2012, El Paso and other parties filed requests for rehearing and/or clarification of Opinion No. 517 in Docket No. RP08-426-017. On June 8, 2012,<sup>11</sup> El Paso filed, in Docket No. RP12-806-000, revised tariff records to comply with Opinion No. 517 by reducing the short-term firm and interruptible rates for the locked-in period of January 1, 2009 through March 31, 2011.

8. On June 20, 2012, in Docket No. RP12-816-000, El Paso filed revised tariff records to voluntarily reduce the currently-effective short-term firm and interruptible rates that became effective April 1, 2011 in Docket No. RP10-1398-000. On July 20, 2012, the Commission accepted the proposed tariff records in partial compliance and directed El Paso to file revised tariff records in Docket No. RP12-816-000 to adjust the Docket No. RP10-1398-000 rates to reflect all the rulings in Opinion No. 517, in particular those related to capital structure, Line 1903, and Article 11.2.<sup>12</sup> On August 20, 2012, El Paso filed a request for rehearing of the July 20 order in Docket No. RP12-816-002 and a compliance filing in Docket No. RP12-816-001. The order on rehearing and compliance in Docket No. RP12-816-001, *et al.*, is issued concurrently with this order.

## **II. Requests for Rehearing/Clarification of Opinion No. 517, Docket No. RP08-426-017**

9. Requests for rehearing and/or clarification of Opinion No. 517 were filed by El Paso; Arizona Public Service Company (APS); the California Parties;<sup>13</sup> Gila River Power, L.P. (Gila River); New Harquahala Generating Company, LLC (New Harquahala); UNS Gas, Inc. (UNS); and jointly by the Rate Protected Shippers,<sup>14</sup> Salt River Project Agricultural Improvement and Power District, and Arizona Corporation Commission (jointly, Rate Protected Shippers, *et al.*). ConocoPhillips Company

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<sup>11</sup> On June 1, 2012, El Paso requested an extension of time of 14 days to comply with Opinion No. 517. No parties objected to the request.

<sup>12</sup> *El Paso Natural Gas Co.*, 140 FERC ¶ 61,063 (2012).

<sup>13</sup> The California Parties include the Public Utilities Commission of the State of California, Southern California Gas Company, San Diego Gas & Electric Company, Southern California Edison Company, and Pacific Gas and Electric Company.

<sup>14</sup> The Rate Protected Shippers are 15 El Paso shippers: the El Paso Municipal Customer Group (comprised of 10 members); Freeport-McMoRan Corporation; New Mexico Gas Company, Inc.; Southwest Gas Corporation; and UNS. ConocoPhillips withdrew from participation in the Rate Protected Shippers by agreement with El Paso.

(ConocoPhillips)<sup>15</sup> and Texas Gas Service Company (Texas Gas Service)<sup>16</sup> originally requested rehearing, but withdrew their pleadings by agreement with El Paso.

10. On June 12 and 19, 2012, respectively, UNS and APS each filed answers to El Paso's request for rehearing. On June 19, 2012, El Paso filed an answer to the requests for rehearing of the Rate Protected Shippers *et al.*, Texas Gas Service, and UNS. On June 26, 2012, El Paso filed an answer to APS's answer.<sup>17</sup> On July 11, 2012, APS filed an answer to El Paso's answer to APS's answer. On July 12, 2012, El Paso filed an answer to ConocoPhillips' answer.

11. El Paso filed for rehearing of a number of the Commission's rulings on all four issues: capital structure, Line 1903, short-term rates, and Article 11.2. The other parties requesting rehearing/clarification raised issues solely on Article 11.2. The requests are discussed below.

**A. Procedural Matters**

12. Section 385.713(d) of the Commission's regulations prohibits answers to rehearing requests. Therefore, we will reject the UNS, APS and El Paso answers to the requests for rehearing, and reject the answers to the answers as moot. To the extent the answers respond to requests for clarification, they have been considered by the Commission.

**B. Capital Structure**

13. In Opinion No. 517, the Commission affirmed the Presiding Judge's finding that El Paso's proposed capital structure should be adjusted to remove from outstanding equity (a) a \$615 million balance in its cash management account, which the Presiding Judge found was a loan its parent company, El Paso Corp., and (b) \$145 million in undistributed subsidiary earnings for ratemaking purposes. The Commission affirmed the Presiding Judge's findings that El Paso cannot count the cash management fund balance to calculate the equity ratio used to calculate its rates for jurisdictional services,

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<sup>15</sup> ConocoPhillips' April 15, 2015 notice of withdrawal reflected the termination of its rehearing and answer in this proceeding and membership in the Indicated Shippers and the Rate Protected Shippers. *See also* the Feb. 27, 2015 Letter Agreement in Docket No. RP15-583-000.

<sup>16</sup> *See* Texas Gas Service, August 7, 2014 notice of withdrawal, and July 1, 2014 settlement in Docket No. RP14-1088-000.

<sup>17</sup> ConocoPhillips' July 5, 2012 answer was withdrawn on April 15, 2015.

because the funds were loaned to its parent and are not available for jurisdictional purposes. The Commission rejected El Paso's argument that the subsidiary earnings and the loan to its parent of available earnings should be treated as investments made from commingled debt and equity issuances. The Commission also affirmed the Presiding Judge's finding that its cash management policies did not support ring fencing as an additional protective measure.<sup>18</sup>

14. The Commission affirmed the Presiding Judge's exclusion from equity capital of \$145 million in undistributed subsidiary earnings held by Mojave Pipeline Company (Mojave), consistent with the Commission's long-standing practice.<sup>19</sup> Following the approach approved in *Distrigas*, the Presiding Judge excluded a \$615 million balance in El Paso's cash management account from equity, finding that the balance was a loan to its parent that was not negotiated at arm's length and was not available for investment in jurisdictional activities.<sup>20</sup> The Commission relied on the finding in *Distrigas* that the

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<sup>18</sup> Ring fencing involves mechanisms intended to separate and protect the financial assets and ratings of a regulated utility from the business risks of other companies in a holding company. *FPA Section 203 Supplemental Policy Statement*, 120 FERC ¶ 61,060, at P 9 n.14 (2007). A ring fence is meant to protect the assets from inclusion in an investor's calculable net worth or to lower tax consequences and could prevent cross subsidization.

<sup>19</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 93 (citing *Southern California Edison Co.*, 3 FERC ¶ 63,033, at 65,203 (1978) (stating "undistributed earnings of subsidiaries are to be excluded from the common stockholder's equity in determining rate of return" but rejecting an adjustment for the remainder of the investments in non-utility subsidiaries absent connection to a specific stock or debt issue), *aff'd without discussion*, Opinion No. 62, 8 FERC ¶ 61,198 (1979) (*SoCal Ed.*); *Revisions in the Uniform System of Accounts, and Annual Reports Forms No. 1 and No. 2 to Adopt the Equity Method of Accounting for Long-Term Investments in Subsidiaries*, Order No. 469, 49 FPC 326 (1973) (*Equity Accounting Rule*); *Indiana & Michigan Electric Co.*, 10 FERC ¶ 61,238 (1980), *aff'g*, 4 FERC ¶ 63,039 (1978) (*Indiana-Michigan*); *Philadelphia Electric Co.*, 10 FERC ¶ 63,034, *aff'd and rev'd in part*, 13 FERC ¶ 61,057, at 61,118 n.3 (1980) (*Phila. Elec.*)).

<sup>20</sup> ID, 134 FERC ¶ 63,002 at PP 182 and 668 (Findings of Fact: "The balance in Account 123 represents \$615 million in unsecured, long-term notes receivable due from [El Paso's] non-investment grade parent, [El Paso Corp]"). *Distrigas of Massachusetts Corp.*, Opinion No. 291, 41 FERC ¶ 61,205, at 61,549 (1987) (rejecting argument that

(continued ...)

funds were not available for use in regulated activities because the regulated entity could not call on the funds at its discretion, due to the control that the corporate parent inevitably exercised over the regulated entity.<sup>21</sup> Insofar as equity costs more than debt financing, the result is a lower return on equity, as the proportion of equity used to calculate the rate of return is smaller.

15. The Commission, citing subsequent cases, rejected El Paso's suggestion that the *Transcontinental Gas Pipeline Corp.* opinions, Opinion No. 414, *et al.*,<sup>22</sup> established that the Commission would use a subsidiary's unadjusted capital structure, so long as the factors were met. On the contrary, the Commission noted that after Opinion No. 414 was issued, it had approved the use of a pipeline's own capital structure, while nevertheless ordering adjustments.<sup>23</sup>

16. The Commission affirmed the Presiding Judge's finding that including the amounts in the capital structure would artificially inflate El Paso's rates while providing no benefit to customers.<sup>24</sup> The Commission rejected El Paso's arguments that the subsidiary earnings and the loan should be treated similarly to investments in affiliates,

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cost-based adjustments transform a parent's actual capital structure into a hypothetical capital structure and approving use of the parent's actual, adjusted capital structure for ratemaking purposes).

<sup>21</sup> *Distrigas Mass. Corp. v. FERC*, 737 F.2d 1208, 1218 (1<sup>st</sup> Cir. 1984) (*Distrigas I*), *aff'g in pertinent part, Distrigas of Mass. Corp.*, Opinion No. 178, 23 FERC ¶ 61,416 (1983) (*Distrigas II*), *summarily aff'g in relevant part*, 18 FERC ¶ 63,036 (1982) (initial decision) (*Distrigas III*). *See also United Gas Pipeline Co.*, Opinion No. 99, 13 FERC ¶ 61,044, at 61,096 (1980) (*United Gas*) (excluding undistributed subsidiary earnings from equity because funds not available for investment in jurisdictional activities).

<sup>22</sup> *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414, 80 FERC ¶ 61,157, at 61,665 (1997), *order on reh'g*, Opinion No. 414-A, 84 FERC ¶ 61,084, at 61,415, *order on reh'g*, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998) (*Transco*).

<sup>23</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 91 (quoting Opinion No. 414-B, 85 FERC at 62,265: "many important cases were decided long before Opinion No. 414-A . . . but that does not diminish their value as precedent") and P 110 (citing *Iroquois Gas Transm. Sys., L.P.*, 84 FERC ¶ 61,086, at 61,448 (1998) (*Iroquois*), which applied Opinion No. 414 and required the use of an adjusted capital structure rather than hypothetical capital structure based on investor data).

<sup>24</sup> *Id.*, 134 FERC ¶ 63,002 at P 183.

where an adjustment to a company's equity capitalization requires tracing the funds used to make the investment to a specific equity issuance. In those cases where the source of funds for an investment could not be traced to a stock (or debt) issuance, the investment is imputed to be from the corporate hodgepodge, consisting of a mix of debt and equity financing in the same proportion as the existing capital structure. The Commission distinguished these and other cases cited by El Paso, because they addressed subsidiary investments, short-term receivables with affiliates, project-financed pipelines and accounting adjustments,<sup>25</sup> not loans to shareholders or subsidiary earnings.

17. The Commission ordered that El Paso's capital structure be adjusted for ratemaking purposes by subtracting the undistributed subsidiary earnings and loan balance from El Paso's equity calculation. The Commission rejected El Paso's proposed capital structure of approximately 60 percent equity and 40 percent debt, and estimated the just and reasonable adjusted capital structure at approximately 47 percent equity and 53 percent debt.<sup>26</sup> The Commission also affirmed the Presiding Judge's finding that El Paso's cash management policies did not require ring fencing as an additional protective measure, in light of its decision to make the adjustment to El Paso's capital structure.

### 1. Requests for Rehearing

18. On rehearing, El Paso contests the Commission's application of its precedent and policies providing for adjustments to a pipeline's capital structure for loans to parent corporations and undistributed subsidiary earnings. El Paso claims that the Commission should reject this precedent as no longer good law, or as inconsistent with other precedent governing adjustments to capital structure, for instance where accounting changes affect the capital structure on a pipeline's books or where a company raised capital and invested in affiliates or non-utility subsidiaries. Because the loan to the parent and Mojave subsidiary earnings cannot be traced to a specific debt or equity issuance (as the Commission requires to support an adjustment in the case of investment in subsidiaries), El Paso argues that these assets are "sourced" from debt and equity in the same proportion as El Paso's proposed capital structure, making any adjustment moot. El Paso states:

Given that this loan balance is a function of transfers of cash that fluctuate daily and have accumulated over time, it is clear that the source of the loan balance that existed at the end of

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<sup>25</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 95.

<sup>26</sup> *Id.* P 116.

the test period in this case cannot be isolated to equity and feasibly separated from [El Paso's] total capitalization within the meaning of *El Paso*. Rather, the funds loaned under the [Cash Management Program] were "intermingled" with all sources of funds received by [El Paso], or in the lexicon of the Fifth Circuit's *El Paso* opinion became part of the "corporate hodgepodge." In addition, in contrast to the evidence in *Distrigas* that [Distrigas] had never demanded repayment of the loan, there is evidence in this record that [El Paso] has in fact demanded and received payment of amounts owed to it under the [Cash Management Program].<sup>27</sup>

El Paso claims that the Commission failed to provide any grounds for attributing the loan to equity.<sup>28</sup>

19. El Paso suggests that earlier precedent supporting similar adjustments is no longer valid following the Commission's issue of the *Transco* orders, Opinion No. 414, *et al.* There, the Commission held that it would not look at evidence of financial control or a parent company's motivations in deciding whether to use a subsidiary pipeline's capital structure, instead of the parent's or a hypothetical capital structure. In *Transco*, the Commission determined that it will use the pipeline's capital structure if the pipeline (1) issues its own debt; (2) has its own separate bond rating; and (3) has an equity ratio that is not excessive in light of other equity ratios approved by the Commission and in comparison with the equity ratios of the proxy companies. El Paso argues that the *Transco* precedent requires the Commission to use a pipeline's unadjusted capital structure.

20. El Paso characterizes the effect of Opinion 517 as requiring "all assets on a pipeline's balance sheet that are not included in a pipeline's rate base must be deducted *solely* from equity capitalization for purposes of computing the pipeline's capital structure."<sup>29</sup> El Paso acknowledges as valid the regulatory objective of ensuring the pipeline's capital structure reflects the pipeline's investment in assets devoted to

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<sup>27</sup> El Paso Rehearing at 37, 46 (citing Ex. EPG-374 at 20: "Effectively [El Paso] 'demanded' and received the repayment of over \$300 million in cash over this period, varying in demand payments by certain months;" Tr. 1502).

<sup>28</sup> El Paso Rehearing at 38-39.

<sup>29</sup> El Paso Rehearing at 19.

jurisdictional service, but objects to a reduction in the pipeline's equity capitalization – “whenever a pipeline has capitalization that exceeds its rate base.”<sup>30</sup>

21. El Paso contests a number of factual findings, underpinning the Commission's action. El Paso argues that its participation in the Cash Management Program benefits ratepayers through greater liquidity and lower debt costs. In addition, El Paso argues that the resulting equity will be insufficient to cover its “rate base related assets and subsidiary investments.” El Paso states that the outstanding capital calculated after deducting the loan and the undistributed subsidiary earnings is not sufficient to fund \$2.7 billion in rate base related assets and subsidiary investments.<sup>31</sup>

22. El Paso argues that *United Gas* is no longer applicable, because the holding in *United Gas*, that a pipeline's capitalization should be representative of types of investments in rate base, suggests that all non-rate base assets should be excluded from capitalization.<sup>32</sup> According to El Paso, the Commission's rationale reflects an outdated notion that non-rate base assets, such as investments in subsidiaries (and by extension undistributed earnings of such subsidiaries), should not be included in a pipeline's capitalization because these investments are not necessarily representative of the capital structure funding the assets in rate base that are used to provide utility service.

23. El Paso claims that the Commission's determination of the appropriate capital structure for ratemaking purposes may affect its credit rating, because rating companies examine the debt/equity ratio and the Commission's decision will lower its rate of return and, consequently, its revenue. In addition, El Paso accuses the Commission of some inconsistency with cases where the Commission permitted a pipeline to adopt a hypothetical capital structure in the event that its own capital structure is “anomalous.”

24. El Paso requests “at a minimum” that the Commission recognize \$25 million in additional equity as working capital, as proposed by Commission Trial Staff witness,

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<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 60-62.

<sup>32</sup> *Id.* at 64 (citing Ex. EPG-374 at 36, Palazzari rebuttal testimony, which states that since no one calls for the other rate base assets to be excluded, undistributed subsidiary earnings should no longer be excluded, either).

Barlow.<sup>33</sup> At the same time, El Paso objects to the failure to strike Mr. Barlow's testimony, because he was unavailable for cross examination.

25. Finally, El Paso objects to the Commission's placing the onus on the pipeline to trace a portion of the loan balance to debt to avoid an adjustment to its equity ratio, claiming that this is a new obligation. However, El Paso cites testimony as demonstrating that a portion of the subsidiary earnings is in fact attributable to debt proceeds through a 2007 refinancing.<sup>34</sup> El Paso identifies a 2007 refinancing effort as providing \$50 million in unused debt proceeds when lenders did not accept early pay off.<sup>35</sup> El Paso states that the adjustment for the loan should reflect this additional debt as a source of the loan, and that \$50 million of the adjustment, at least, should be applied to outstanding debt instead of equity. El Paso seeks an additional adjustment to its outstanding debt to reflect that a portion of its subsidiary operations were financed with debt.<sup>36</sup>

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<sup>33</sup> Trial Staff calculated the \$25 million using the 45-day rule, which the Commission previously used to estimate a pipeline's working capital needs. El Paso provided no lead lag study as required by the Commission's regulations and did not attempt to support Trial Staff's projection with accounting data. *See* 18 C.F.R. § 154.306. *Revisions to the Filing Requirements for Changes in a Tariff, Executed Service Agreement or Part Thereof, Contained in Title 18 of the Code of Federal Regulations*, Order No. 383, FERC Stats. & Regs. ¶ 30,574 (1984) (requiring pipelines to file a lead-lag study to justify a cash working capital allowance greater than zero but no more than 1/8 of annual operating expenses in general rate cases, net of purchased gas costs and noncash items).

<sup>34</sup> El Paso Rehearing at 65.

<sup>35</sup> *Id.* at 65 (citing Ex. EPG-374 at 41).

<sup>36</sup> *Id.* El Paso cites the Initial Decision in *Arkansas-Louisiana Gas Co.* as holding that "if undistributed subsidiary earnings are removed from equity, debt traceable to non-jurisdictional business must also be eliminated." *Arkansas-Louisiana Gas Co.*, 19 FERC ¶ 63,008 at 65,057 (1982), *order on initial decision*, Opinion No. 160, 22 FERC ¶ 61,125 (1983) (*Arkla Gas*) (rejecting pipeline proposal that if undistributed subsidiary earnings are removed from equity, debt traceable to non-jurisdictional investments must also be eliminated due to the pipeline's failure to identify an investment traceable to a specific debt issuance).

## 2. Commission Determination

26. The Commission grants partial rehearing to the limited extent necessary to recognize a \$50 million 2007 debt issuance that funded part of the loan to El Paso Corp. and otherwise denies rehearing. In 2007, El Paso sought to refinance its debt and obtained alternative financing to do so. However, one note holder declined to accept early redemption in the amount of \$50 million. That is, El Paso took on \$355 million in additional debt, but only paid out \$305 million to retire old debt.<sup>37</sup> Consequently, El Paso has identified a debt issue that may reasonably be treated as a source for a portion of the loan to El Paso Corp. We agree that El Paso should deduct this amount from the debt component of its capital structure, rather than from equity.<sup>38</sup> El Paso should otherwise deduct from equity (a) the undistributed subsidiary earnings held by its subsidiary Mojave and (b) the balance of the loan that was not funded through the \$50 million of remaining 2007 debt proceeds.

27. On rehearing we affirm the Commission's direction in Opinion No. 517, that El Paso should remove the undistributed subsidiary earnings<sup>39</sup> and loan to its shareholding parent<sup>40</sup> from the equity portion of its capital structure because the funds used for such purposes are not available for investment in jurisdictional activities. These

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<sup>37</sup> *Id.* at 48 (citing Ex. EPG-374 at 29).

<sup>38</sup> Assuming the \$50 million proceeds, which were not invested in jurisdictional activities as part of the refinancing, were included in El Paso's outstanding debt, the Commission estimates the resulting capital structure as approximately 49.6 percent equity on combined debt and equity of \$2.216 billion. On compliance, El Paso shall submit its own calculations consistent with the Commission's determinations. *See also* Opinion No. 517, 139 FERC ¶ 61,095 at P 116 & n.188.

<sup>39</sup> *United Gas*, 13 FERC at 61,096; *see also SoCal Ed.*, 3 FERC at 65,203; *Indiana-Michigan*, 10 FERC ¶ 61,238, *aff'g*, 4 FERC ¶ 63,039; *Phila. Electric*, 10 FERC ¶ 63,034, *aff'd and rev'd in part*, 13 FERC at 61,118 n.3; *Equity Accounting Rule*, Order No. 469, 49 FPC 326. Undistributed Subsidiary Earnings are booked to Account No. 216.1, which is a stockholder's equity account under the Commission's Uniform System of Accounts. *See* Opinion No. 517, 139 FERC ¶ 61,095 at P 61.

<sup>40</sup> *Distrigas III*, Initial Decision, 18 FERC at 65,121 (excluding a pipeline's loan to its parent from equity "because the amount originated from internally generated funds – [the pipeline] had no debt or preferred stock issuances in either 1978 or 1979"); *summarily aff'd*, *Distrigas II*, 23 FERC ¶ 61,416 (affirming and adopting *Distrigas ID*), *aff'g in pertinent part*, *Distrigas I*, 737 F.2d 1208, 1218.

adjustments are supported by the Commission's precedent. Other than the \$50 million adjustment for the 2007 debt issuance, we reject El Paso's arguments on rehearing as discussed below.

a. **The Commission's Ratemaking Precedent Addressing Loans to Shareholders and Undistributed Subsidiary Earnings Support the Equity Adjustment**

28. An interstate natural gas pipeline is entitled to an opportunity to earn a just and reasonable rate of return on its rate base. Pipelines generally finance their rate base with a combination of debt and equity. Therefore, a pipeline's overall just and reasonable rate of return consists of (1) its embedded cost of debt capital and (2) its cost of equity, after taxes.<sup>41</sup> These two costs are weighted and applied to the rate base to derive the pipeline's return allowance in dollars.

29. Equity generally costs more than debt. Hence, ratepayers would be subjected to an excessive burden if their rates had to be set at a level high enough to compensate the pipeline for excessive equity in its capital structure. On the other hand, an increase in debt also makes the equity investors' stake less secure by increasing financial risk. Thus, the Commission must balance these two interests. The Commission's general policy is to do this "by finding a capital structure which is consistent with the sound financing of the pipeline in light of how the pipeline's risk profile would be perceived by investors."<sup>42</sup>

30. The effect of excluding particular dollar amounts from the pipeline's outstanding equity is to reduce equity's overall share of capitalization and thereby reduce the company's overall return on equity.<sup>43</sup> The Commission cited its reasoning as explained in *United Gas*, "The rate of return capitalization should, as nearly as possible, be representative of the types and relative amounts of capital invested in the pipeline's rate base to which the return is applied."<sup>44</sup>

31. In Opinion No. 517, the Commission applied its precedent and excluded from the equity portion of El Paso's capital structure Mojave's Undistributed Subsidiary Earnings

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<sup>41</sup> *Transcontinental Gas Pipe Line Corp.*, 71 FERC ¶ 61,305, at 62,192 (1995).

<sup>42</sup> *Id.* at 62,193.

<sup>43</sup> *Distrigas I*, 737 F.2d 1208 at 1217.

<sup>44</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 90 (citing *United Gas*, 13 FERC at 61,096).

consistent with *SoCal. Ed., et al.*,<sup>45</sup> and a long-term loan that El Paso made through its Cash Management Program to its parent company, El Paso Corp., consistent with the *Distrigas* line of orders.<sup>46</sup> In *SoCal Edison*, the Commission stated its policy succinctly and unambiguously, “[T]he undistributed earnings of subsidiaries are to be excluded from the common stockholder’s equity in determining rate of return.”<sup>47</sup> In the *Distrigas* precedent, the Commission excluded the balance of a loan to a parent company based on a finding that the funds advanced were not available to the pipeline for use in its regulated activities during the test year.<sup>48</sup> In *Distrigas*, the Commission affirmed an adjustment to outstanding equity for a loan to a shareholding parent, where the amount originated from internally generated funds and the regulated entity had no debt or preferred stock issuances in the relevant time frame.<sup>49</sup>

32. In *Distrigas v. FERC*, the court affirmed the finding that the funds in the loan were not available to the subsidiary, distinguishing between the practical realities inherent in an on-demand bank account and a demand note from a shareholding parent company:

One might reasonably believe that a right to call for money from a demand deposit with a bank depends solely on the will of the depositor, while the exercise of a similar right to call

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<sup>45</sup> Opinion No. 517, 139 FERC §61,095 at P 93; *SoCal Ed.*, 3 FERC at 65,203 (excluding Undistributed Subsidiary Earnings and discussing asset tracing as a requirement to exclude remainder of investments in non-utility subsidiaries or “businesses not required for efficient operation of the jurisdictional business”); *Indiana-Michigan*, 10 FERC ¶ 61,238, *aff’g*, 4 FERC ¶ 63,039 (applying policy established by the Commission’s predecessor, the Federal Power Commission, as reflected in the *Equity Accounting Rule*, Order No. 469, 49 FPC 326); *Phila. Electric*, 10 FERC ¶ 63,034, *aff’d and rev’d in part*, 13 FERC at 61,118 n.3.

<sup>46</sup> *Distrigas I*, 737 F.2d 1208, 1218; *Distrigas II*, 23 FERC ¶ 61,416; *Distrigas III*, 18 FERC ¶ 63,036.

<sup>47</sup> *SoCal Ed.*, 3 FERC at 65,203.

<sup>48</sup> *Distrigas I*, 737 F.2d 1208 at 1217.

<sup>49</sup> *Distrigas III*, 18 FERC at 65,121; *summarily aff’d and adopted, Distrigas II*, 23 FERC ¶ 61,416.

for money on deposit with a sole shareholder depends in large part, as a practical matter, on the desires of the shareholder.<sup>50</sup>

Based on the *Distrigas* precedent, as well as *Southern Natural*,<sup>51</sup> the Commission affirmed the Presiding Judge's determination that El Paso's \$615 million balance in the Cash Management Program should be excluded as a loan to El Paso's sole shareholding parent, El Paso Corp.

33. However, because the Commission makes its analysis on a case by case basis,<sup>52</sup> the Commission reviewed factual arguments touching on a number of factors weighed in *Distrigas*.<sup>53</sup> There, in addition to considering the fact that there was a loan to a shareholding parent, the Commission examined the source of the funds and found that El Paso accumulated the funds from "various business activities, including from ratepayers for services rendered,"<sup>54</sup> rather than a stock or debt issue. The Commission examined whether the loan was sufficiently related to regulated activities to justify inclusion in the pipeline's capital structure.

34. In Opinion No. 517, the Commission noted the evidence presented at hearing that El Paso had maintained a large balance in the Cash Management Account and that, by delivering the funds to its corporate parent, El Paso limited rather than expanded its own financial liquidity and flexibility.<sup>55</sup> In addition, the Commission noted its Staff's claim that the interest paid under the loan is inadequate to compensate El Paso for the risks it undertakes because it receives a short-term interest rate for an unsecured long-term loan to its below investment-grade parent.

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<sup>50</sup> *Distrigas I*, 737 F.2d 1208 at 1218.

<sup>51</sup> *Southern Natural Gas Co.*, Opinion No. 585, 44 FPC 567, 571-572 (1970) (*Southern Natural*).

<sup>52</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 95 (characterizing precedent as based on the facts in each case and demonstrating a case-by-case analysis whether the capital structure and resulting cost of capital is just and reasonable).

<sup>53</sup> *See Id.* PP 99-106 (arguing that Trial Staff and intervenors had raised concerns that required El Paso to justify including loan in capital structure, and weighing various factual arguments).

<sup>54</sup> *Id.* P 104 (citing El Paso's Brief on Exceptions at 24).

<sup>55</sup> *Id.* P 99.

35. Accordingly, the Commission deducted the undistributed subsidiary earnings and loan from El Paso's capital structure. The Commission's precedent is unambiguous that undistributed subsidiary earnings are to be deducted from a regulated entity's equity. El Paso has failed to convince us to change this policy in favor of a policy that treats all non-rate base assets as if they were sourced in identical proportion to the nominative capital structure.<sup>56</sup>

**i. Undistributed Subsidiary Earnings**

36. On rehearing, we affirm our decision to exclude the Undistributed Subsidiary Earnings and the loan to El Paso Corp. from the equity component of El Paso's capital structure. These exclusions are consistent with the Commission's precedent providing for capital structure adjustments for Undistributed Subsidiary Earnings and loans to shareholding parent companies.

37. With respect to Undistributed Subsidiary Earnings, the Commission has on several occasions excluded such earnings from a pipeline's capital structure – even in orders where the Commission rejects an additional adjustment to reflect the original investment in the subsidiary because the source of the funds for the investment could not be traced to debt or equity financing.<sup>57</sup> In fact, El Paso cites several orders on rehearing that make this distinction – deducting undistributed subsidiary earnings from a pipeline's capital structure, while rejecting a deduction for the remainder of the investment in the subsidiary for failure to trace the source of the investment to equity financing or a stock issue.<sup>58</sup> These cases demonstrate that the Commission treats Undistributed Subsidiary Earnings, which are derived from operations and not from debt or equity financing, differently from investments of funds obtained through such financings.

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<sup>56</sup> The Presiding Judge rejected El Paso's claim that *United Gas* was no longer good law, noting the Commission had more recently applied the case in the negative in *Golden Spread Elec. Coop., Inc.* 123 FERC ¶ 61,047 (2008) (*Golden Spread*). Opinion No. 517, 139 FERC ¶ 61,095 at P 61.

<sup>57</sup> *Arkla Gas*, 19 FERC at 65,057, *order on initial decision*, 22 FERC ¶ 61,125 (rejecting proposal that if undistributed subsidiary earnings are removed from equity, debt traceable to non-jurisdictional business must also be eliminated, absent tracing); *see also, United Gas*, 13 FERC at 61,096; *Phila. Elec.*, 13 FERC ¶ 61,057; *Indiana-Michigan*, 4 FERC at 65,312, *summarily aff'd*, 10 FERC ¶ 61,238; *SoCal Ed.*, 3 FERC ¶ 63,033, *aff'd*, 8 FERC ¶ 61,198.

<sup>58</sup> El Paso Rehearing at 26, 29, 40, 62-66.

38. El Paso complains that the Commission did not provide a justification for its policy to exclude Undistributed Subsidiary Earnings in its *Equity Accounting Rule*,<sup>59</sup> and therefore takes the opportunity to argue that a different result should apply in this instance. Initially, we note that the Commission's predecessor, the Federal Power Commission, did not adopt its policy in the *Equity Accounting Rule*, it merely referenced a long-standing policy. However, the Commission later provided its justification for the policy, in *United Gas*:

We do, however, adhere to the basic proposition that undistributed subsidiary earnings must be excluded from the pipeline's capitalization for rate of return purposes. We take this position for the reason that the rate of return capitalization should, as nearly as possible, be representative of the types and relative amounts of capital invested in the company's rate base to which the rate of return is applied. Since undistributed subsidiary earnings are not available to the pipeline for purposes of rate base investment and since the rate base therefore does not include investments which can be attributed to undistributed subsidiary earnings, those earnings must be excluded from the capitalization. Distributed subsidiary earnings, conversely, are available to the pipeline for rate base investment (or retirement of debts previously used for rate base investment) and are therefore properly includable in capitalization.<sup>60</sup>

39. Earnings are not typically generated by issuing debt or equity obligations, nor by making an investment in a subsidiary. As the Commission's ratemaking relies on cost-of-service principles, such activities would create equal and offsetting assets and liabilities, with the earnings to be gained from operations and other activities. Consequently, a requirement to trace subsidiary earnings to the initial debt or equity financing that supported the investment in the subsidiary would be futile.

40. Investments are typically either made using capital raised through debt and/or equity financing and may possibly be traced to a particular debt or equity issue. If an investment cannot be traced to an identifiable debt or equity issuance and is made from general company funds, the Commission assumes that the investments were made in the same proportion of the pipeline's outstanding capitalization. However, as explained in

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<sup>59</sup> Order No. 469, 49 FPC 326.

<sup>60</sup> *United Gas*, 13 FERC at 61,096.

Opinion No. 517, “[t]he Commission has only required a showing that an asset can be traced to a specific equity issuance when considering whether to exclude a pipeline’s investment in a subsidiary, as opposed to the undistributed earnings of that investment.”<sup>61</sup> Consequently, an adjustment to reflect an investment made using outstanding capital, raised through debt and equity financing, would be made in the same proportion as the outstanding capital elements and would not change the ratio of equity to debt. Such is not the case with earnings, which are raised through operations and not sourced to the original financing activities.

41. The Commission’s discussion in *United Gas* presents an additional factor that demonstrates the asset-tracing fact scenario is not appropriate in the case of Undistributed Subsidiary Earnings. There, the Commission noted that “capitalization should, as nearly as possible, be representative of the types and relative amounts of capital invested in the company’s rate base to which the rate of return is applied.”<sup>62</sup> The Commission notes further that “since undistributed subsidiary earnings are not available to the pipeline for purposes of rate base investment and since the rate base therefore does not include investments which can be attributed to undistributed subsidiary earnings, those earnings must be excluded from the capitalization.”<sup>63</sup> The *United Gas* discussion demonstrates that the Commission considers earnings to be a distinct source of capital. Once earned, these earnings are not part of the debt and equity capital that was invested in rate base. It is not merely that the funds were passively not available for investment, but also a consequence of the fact that the funds cannot have been used as a source of investment for the regulated rate base.

42. El Paso cites *Arkla Gas* and claims “if undistributed subsidiary earnings are removed from equity, debt traceable to non-jurisdictional business must also be

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<sup>61</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 94 (citing *Phila. Electric*, 13 FERC ¶ 61,057 (reversing exclusion of investments in subsidiary companies, where finances are managed on a consolidated basis, and subsidiary assets are pledged to obtain debt); *Indiana-Michigan*, 4 FERC ¶ 63,039, *aff’d*, 10 FERC ¶ 61,238 (rejecting exclusion of investment in nuclear power generating subsidiary as not traceable to equity)).

<sup>62</sup> *United Gas*, 13 FERC at 61,096.

<sup>63</sup> *Id.* (cited in Opinion No. 517, 139 FERC ¶ 61,095 at P 96); *see also Golden Spread*, 123 FERC ¶ 61,047 at P 120 (finding that undistributed subsidiary earnings “are only represented on paper, and not actually available for the utility to use. Once the subsidiary pays a dividend or the utility sells the subsidiary, the amount becomes available for the utility to use at its discretion”).

eliminated.”<sup>64</sup> However, El Paso fails to cite the actual holding in response to that quotation which rejected an additional adjustment for the portion of the investment that was funded through debt financing because such an adjustment would call for yet another adjustment for the portion of the investment funded through equity financing. The end result would be no change to the capital structure, since the investment could not be traced to debt or equity financing and the financing would be assumed to be proportionate to the existing equity-debt ratio. Thus, El Paso’s argument further underscores the fact that the Commission’s policy treats proposed adjustments for undistributed subsidiary earnings differently from those for investments in subsidiaries.

**ii. Loan to Parent Corporation**

43. Opinion No. 517 found that the Cash Management Program loan was not available for investment in jurisdictional activities, following *Distrigas* and *Southern Natural*. Following that precedent, the Commission excluded the loan from El Paso’s outstanding equity in calculating El Paso’s capital structure. Contrary to El Paso’s claim on rehearing, the Commission supplied substantial reasons for applying the adjustment to equity. First, the Commission found that the loan was sourced from operations and revenues from jurisdictional services. In Opinion No. 517, the Commission explained its justification for attributing the capital structure adjustment for the loan to equity:

El Paso has taken funds generated from general revenue and operations. Once earned, no debt issuance has any claim on these funds, but instead they represent additional equity available to the pipeline to dispose of at its discretion. In this instance, however, El Paso has chosen to dispose of these funds by delivering them to its corporate parent by way of the Cash Management Program. As such, they represent an asset that offsets the liability that it owes its shareholder parent by way of common stock.<sup>65</sup>

44. El Paso maintains that the most likely source of the \$615 million loan is not equity, but depreciation expense and deferred income tax.<sup>66</sup> However, the funds are not

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<sup>64</sup> *Arkla Gas*, 19 FERC at 65,057 (rejecting adjustment for investments in non-jurisdictional businesses that are not traceable to debt issuances, while removing subsidiary earnings from equity without tracing the original financing).

<sup>65</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 106.

<sup>66</sup> *Id.* P 105.

specifically earmarked as deferred income tax or accelerated depreciation, nor is the Commission aware of any requirement to do so. Nevertheless, El Paso's sourcing the funds to a rate component serves to demonstrate that the loan was made using internally-generated funds, namely revenues from customer rates over and above El Paso's costs. The Commission found that no debt issuance had any claim on these funds, which represented additional equity available to the pipeline to dispose of at its discretion (or as corporate dictates allowed). These facts mirror the *Distrigas* proceeding where the deduction was made to equity because the funds were internally generated and not raised from any debt or preferred stock issuances in the relevant time period.<sup>67</sup>

45. In this proceeding, the Presiding Judge followed the Commission's *Distrigas* precedent and correctly attributed the loan and earnings to equity. The source of the funds used to make the loan is cash accumulated from business activities, including payments from El Paso's ratepayers for services rendered.<sup>68</sup> Therefore, consistent with *Distrigas*, the Commission attributed the loan to El Paso's equity because the funds for the loan were made from internally generated funds which were delivered to the sole shareholding parent on a long-term basis, making the funds unavailable for investment in regulated activities.

46. Furthermore, the Commission in Opinion No. 517 found that El Paso's delivery of the funds to its corporate parent by way of the Cash Management Program represented an asset "that offsets the liability that it owes its shareholder parent by way of common stock."<sup>69</sup> The Commission considers this fact more important than simple accounting. El Paso Corp. is considered to have an investment in the pipeline equal to the outstanding

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<sup>67</sup> *Distrigas III*, 18 FERC at 65,121, *summarily aff'd and adopted*, *Distrigas II*, 23 FERC ¶ 61,416. As discussed elsewhere, El Paso has identified a \$50 million debt issue as a partial source for the loan, and the Commission is therefore applying a like portion of the required capital structure adjustment to debt.

<sup>68</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 104. El Paso suggests that the Commission has proposed a requirement that is "impossible" for it to meet, to trace the source of the loan to debt financing when the actual source was operations, and that such a requirement is arbitrary and capricious. *E.g.*, El Paso Rehearing at 23, 49. The Commission thinks that the better interpretation is that El Paso is attempting to apply the wrong precedent. *See Distrigas* and Undistributed Subsidiary Earnings cases. In our precedent, *Distrigas*, the record likewise reflects the loan was not made from equity or debt financing, and the loan was deducted from equity, because the loan was made using internally generated funds. *Distrigas III*, 18 FERC at 65,121.

<sup>69</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 106.

stock. By delivering a substantial cash outlay back to El Paso Corp., the pipeline has changed the underlying financial realities. While El Paso Corp. may nominally have the same amount invested in the pipeline, it has received funds from the pipeline for its own use.<sup>70</sup> Not only is it significant that El Paso Corp. has taken possession of cash for use in its broader business activities, but it is also significant that El Paso has prevented the funds from being used for pipeline operations.<sup>71</sup> Consequently, El Paso Corp. cannot, as the equity investor, expect to receive a regulated return on those funds, which should only receive what its unregulated operations will allow, minus debt costs to be paid to El Paso. Absent the adjustment, El Paso's stated equity figure is not representative of the amount that its parent corporation has at stake in El Paso, and thus the proposed capital structure does not represent the risks that the parent has undertaken through its investment, nor the parent's anticipated return on its investment.

47. The cost of capital is determined in order to provide a pipeline's investors with a fair rate of return, comparable to investments in similar activities. However, in this instance, El Paso's practice to maintain a large balance in the Cash Management Program ensures that those funds are not available for investment in jurisdictional activities. As such, they cannot earn a regulated rate of return. Therefore, it would be unjust and unreasonable and not representative of El Paso's risk to count those funds in El Paso's capital structure as if they were earning returns that would support a return on equity based on investors' expectations.

48. On rehearing, we affirm to the necessity of excluding from equity, funds generated from operations and paid by ratepayers when such funds are loaned to the shareholder parent possessing equity rights in the pipeline. Identifying the outstanding equity is one

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<sup>70</sup> El Paso describes the Cash Management Program in its SEC Form 10-K, Ex. EPG-382 at 12, as follows:

[El Paso Corp.] provides cash management and other corporate services for us. Pursuant to El Paso's cash management program, we transfer surplus cash to [El Paso Corp.] in exchange for an affiliated note receivable. In addition, we conduct commercial transactions with some of our affiliates. If [El Paso Corp.] or such affiliates are unable to meet their respective liquidity needs, we may not be able to access cash under the cash management program, or our affiliates may not be able to pay their obligations to us. However, we might still be required to satisfy affiliated payables we have established. Our inability to recover any affiliated receivables owed to us could adversely affect our financial position

<sup>71</sup> El Paso has maintained a substantial balance in the Cash Management Fund throughout the test period, and back through 2007 when the arrangement was formalized.

step in determining the cost of capital, that is, the cost to obtain the funds that are invested in jurisdictional activities. The funds for investment are typically generated through a mix of debt and equity. When the ratepayers pay for jurisdictional services, they pay a rate reflecting the cost of capital as determined through a weighted average in which the outstanding debt is multiplied by the historic cost of debt and the outstanding funds derived from equity financing are multiplied by the discount rate, which is calculated using the Commission's discounted cash flow methodology to represent the rate of return that investors require to invest in a firm – otherwise known as the market cost of equity capital.<sup>72</sup>

49. Using this methodology the pipeline determines the costs of the debt and the equity invested in the jurisdictional facilities to determine the rate that will provide the pipeline with a return of its costs – both the debt costs determined by the interest rates paid and the cost that investors seek to invest in the operations based on investments in comparable activities. When it accumulated the fund balances using funds raised through operations, *El Paso had already received payment at rates that accounted for the commingled costs of the debt and equity funds used to support regulated activities*. Then, once El Paso loaned the accumulated funds to its equity investing parent, the loan balance is used to support the non-jurisdictional activities of El Paso Corp.<sup>73</sup>

50. El Paso on rehearing again asks the Commission to recognize these funds as part of its capital structure, which we decline to do. To do so would imply that El Paso's parent, El Paso Corp., is entitled to a return on its "investment" in the Cash Management Program balance at a rate comparable to the rate that would be allowed if the funds were invested in jurisdictional pipeline activities (while retaining any return that it receives directly by using the funds for non-jurisdictional purposes (less interest).

51. In reality, El Paso Corp's outlay in the form of stock is offset by the return of capital through the loan. As an investor El Paso Corp. cannot expect to receive income from the equity capital returned in the form of the loan, because the return to El Paso is properly limited to the interest rate that it agreed to pay under the Cash Management Program. From El Paso Corp.'s perspective as an investor, this interest income "earned" by its subsidiary represents no earnings at all, due to the fact that it is paying the interest. Thus, we agree with the Presiding Judge that including the loan balance in El Paso's capitalization "artificially inflates its cost-of-service."<sup>74</sup> We also confirm the finding that

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<sup>72</sup> *National Fuel Gas Supply Corp.*, 51 FERC ¶ 61,122, at 61,337 n.68 (1990); *Ozark Gas Transmission Sys.*, 68 FERC ¶ 61,032, at 61,104 n.16 (1994).

<sup>73</sup> ID, 134 FERC ¶ 63,002 at P 185.

<sup>74</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 86; ID, 134 FERC ¶ 63,002 at P 185.

the failure to exclude the loan balance would result in a distorted cost of capital that is not based on the types of capital invested in regulated operations. An adjustment is needed to ensure that El Paso's cost of service is not increased because its unadjusted capital costs would include provision for an equity investment for which it is impossible to earn the rate of return on equity.

52. With the exception of the \$50 million of unused refinancing proceeds, the loan cannot be sourced to debt or equity capital. El Paso suggests that the Commission should nevertheless assume that the funds were "sourced" from debt and equity capital in equal proportion – resulting in no change to its capital structure. However, *United Gas* does not permit this, since the Commission does not treat adjustments for all sources of capital the same, and earnings raised from operations are treated differently from investments made from debt or equity proceeds.

53. In Opinion No. 517, the Commission applied the principles enunciated in *Distrigas*, where a loan to a parent company was excluded from equity "because the amount originated from internally generated funds" and the regulated entity had no debt or preferred stock issuances in the relevant time frame.<sup>75</sup> Despite the court's affirmance, El Paso argues that the *Distrigas* precedent is not determinative because the parties agreed that the issue hinges on whether or not the funds are available for use in regulated activities.<sup>76</sup> Nevertheless, the quote above indicates that the Commission did trace the origins of the funds used to make the loan in *Distrigas* – to internally generated funds, rather than externally generated debt or equity capital.<sup>77</sup> Accordingly, we affirm application of the adjustment for the loan to equity based on a straightforward application of our precedent in Opinion No. 178, which likewise identified "internally generated funds" as the source of the loan.<sup>78</sup>

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<sup>75</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 93 (citing *Distrigas III*, 18 FERC at 65,121, *aff'd*, *Distrigas II* 23 FERC ¶ 61,416).

<sup>76</sup> El Paso Rehearing at 36 (citing *Distrigas I*, 737 F.2d at 1217).

<sup>77</sup> See also, *Southern Natural*, 44 FPC 567, 571-572 (excluding \$29 million from equity representing dividends and proceeds from sale of subsidiary stock that were advanced to another subsidiary and citing *El Paso Natural Gas Co.*, Opinion No. 582, 44 FPC 73 (1970) (*El Paso I*), *aff'd El Paso Natural Gas Co. v. FPC*, 449 F.2d 1245 (5<sup>th</sup> Cir. 1971) (*El Paso II*)).

<sup>78</sup> *Distrigas II*, 23 FERC at 65,121.

**b. The Disputed Factual Evidence Fails to Justify Counting the Affiliate Loan in El Paso's Capital Structure**

54. The Participants in this proceeding argued a number of factual issues related to the proposed capital structure adjustments. These issues addressed whether the loan made El Paso more financially risky or increased its liquidity, whether the loan served to transfer risk or costs to ratepayers and whether the terms of the loan were appropriate. These factual issues were often discussed in the context of proposals to reform El Paso's cash management practices, which would have fundamentally altered El Paso's financial operations and relation with its affiliates. However, the proposals to revise El Paso's cash management practices were rejected and proponents of those revisions did not reargue their merits on rehearing.

55. In its rehearing request, El Paso discussed a number of factual issues relating to its Cash Management Program and financial position, such as whether El Paso has a need to maintain the accumulated funds in the cash management account, whether it has access to the funds and whether use of the Cash Management Program results in lower debt costs.

56. These factual issues do not directly relate to the central determination driving the Commission's decision, namely that the funds in the loan and undistributed subsidiary earnings were not available for use in regulated activities, and the funds were generally not raised through debt or equity financing. Moreover, consistent with the *Distrigas* precedent, the Commission may reject a capital structure adjustment, as appropriate, even when a particular transaction is for regulated activities.

57. El Paso disputes a number of the facts that the Commission weighed in Opinion No. 517, noting that the loan balance is not large in comparison to the deferred income tax balance, and claiming that the loan does not limit its liquidity.<sup>79</sup> El Paso claims that whether the loan expands or limits liquidity is irrelevant to the issue of how the funds were sourced, asserting that it can call on funds under the Cash Management Program at any time.<sup>80</sup>

58. El Paso contests the allegations that it does not receive sufficient compensation under the London Interbank based interest rate (LIBOR). In addition, El Paso disputes that ratepayers would be harmed due to the interest rate structure under the Cash

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<sup>79</sup> El Paso Rehearing at 46 (citing a Standard & Poor's report claiming that the Cash Management Program is a significant source of El Paso's liquidity needs. Ex. EPG-424 at 3; Tr. 464 and 1468-1470).

<sup>80</sup> El Paso Rehearing at 45-46.

Management Program because its loan is “not rate payer money and ratepayers have no claim to the interest that [El Paso] receives from loaning this money.”<sup>81</sup> El Paso states that it could be harmed by the Commission’s action because a change in capital structure could lead to a credit downgrade and higher debt costs. El Paso states that it could not have declared a dividend in the amount of the loan because the \$615 million loan balance exceeded its \$401 million test-year balance of retained earnings.

59. El Paso attributes the excess capitalization to deferred income taxes (DIT), which are customer payments representing taxes that are not paid until a later date.<sup>82</sup> El Paso suggests that it will need the funds at a later date to pay the tax or pay for improvements.<sup>83</sup> El Paso notes that, if a pipeline is to retain these funds, it will keep them in a “cash type balance sheet asset,” otherwise, the pipeline will raise debt or equity to pay the tax liability when it comes due.<sup>84</sup> El Paso defends having its capitalization greater than rate base, citing the Commission’s statement in Opinion No. 486-A indicating that a pipeline’s rate base is generally less than capitalization, due to other investments.<sup>85</sup>

60. We find all these points are disputed, however, and find El Paso’s claims speculative and largely unsupported. Because El Paso has failed to provide sufficient factual support for its claims, we reject these arguments as supporting its capital structure by demonstrating a need for the loan based on El Paso’s regulated activities, as discussed below.

61. While El Paso claims that it could not have paid a dividend in the amount of the loan, as it carried insufficient retained earnings, the Commission in *Distrigas* affirmed that it was sufficient for the funds to not be available as a result of the loan rather than be a surrogate dividend. The Commission’s precedent does not rely on the theory that the

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<sup>81</sup> *Id.* at 47.

<sup>82</sup> *Id.* at 23 (citing Ex. EPG-374 at 38).

<sup>83</sup> *Id.* at 41; Ex. EPG-329 at 4-13 (Lovinger rebuttal test.).

<sup>84</sup> El Paso Rehearing at 41

<sup>85</sup> *Kern River Gas Trans. Co.*, Opinion No. 486-A, 123 FERC ¶ 61,056, at P 27 (2008) (citing *Wyoming Interstate Company Ltd.*, 69 FERC ¶ 61,259, at 61,984-85 (1994)).

funds in question were a constructive dividend.<sup>86</sup> Instead, the fact that the funds are not available for investment in jurisdictional activities is sufficient to support the exclusion under our policies.<sup>87</sup> The Commission need not speculate on what other financial arrangements might have been possible had El Paso and Mojave not accumulated large cash balances in the Cash Management Program.

**i. The Commission's Holding in Opinion No. 517 Did Not Impose a New Burden**

62. El Paso takes issue with the Commission's statement that the Parties in this proceeding raised a legitimate concern as to the reasonableness of the use of the loan amount for capitalization purposes in this proceeding. The Commission cited the facts that (a) the loan balance is large, (b) the loan limited El Paso's own financial liquidity and flexibility rather than expanded it, and (c) El Paso received compensation for a short-term loan for an unsecured long-term loan to El Paso's below investment grade parent.<sup>88</sup> El Paso contests each of these factors and objects to the Commission's statement as imposing a new burden on it to justify its capital structure and demonstrate that the loan was sourced from debt financing.

63. We disagree that in merely applying established precedent, the Commission somehow imposed a new burden on El Paso. Following *Distrigas v. FERC*, the Commission excluded the loan from El Paso's capital structure, finding that the funds were not available to use in regulated activities, due to the control exercised by a shareholding parent corporation over a regulated subsidiary. In *Distrigas* and other cases cited in Opinion No. 517, the various relevant factors for considering capital structure adjustments were described, including whether funds are related to regulated activities, whether the funds were available in the near or long term, whether the source of the loan was from debt financing or "internally generated funds," and whether a transaction had a large or minimal effect on the capital structure. While the primary inquiry remains whether the funds are available to the regulated entity and form a portion of the capital used to finance pipeline activities, it is possible that other factors may nevertheless demonstrate that a transaction is for a regulated purpose, or not otherwise justified. We disagree that our weighing of these factors in the current proceeding imposed a new unfair burden on El Paso.

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<sup>86</sup> *Distrigas III*, Initial Decision, 18 FERC at 65,121 ("Whether the \$6.5 million in question is viewed as a 'constructive dividend' or a loan is not crucial").

<sup>87</sup> *Id.*

<sup>88</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 99.

ii. **The Record Supports the Finding that El Paso Corp. Controls the Cash Management Program**

64. In Opinion No. 517, the Commission disagreed with El Paso's suggestion that use of the Cash Management Program facilitated jurisdictional activities, such as by lowering debt costs or increasing liquidity. Instead, the Commission found, consistent with Trial Staff's assessment, that by lending the funds to the parent corporation, El Paso limited rather than expanded its own financial liquidity and flexibility.<sup>89</sup> Although El Paso contests this finding on rehearing, El Paso has failed to convincingly demonstrate that its contrary vision of additional liquidity is sufficiently credible so as to justify a different result on rehearing.

65. The facts in *Distrigas* largely parallel the facts in this proceeding. The court affirmed the Commission's assessment that the funds in the hands of the pipeline's sole shareholder were not available, since "[o]ne might reasonably believe that a right to call for money from a demand deposit with a bank depends solely on the will of the depositor, while the exercise of a similar right to call for money on deposit with a sole shareholder depends in large part, as a practical matter, on the desires of the shareholder."<sup>90</sup> Thus, absent other evidence, the *Distrigas* holding supports our finding that the funds here may not always be so freely available to the regulated subsidiary given the reality of the subsidiary-parent relationship.

66. According to El Paso, *Distrigas* is distinguishable due to the nature of the loan in that proceeding, and its arising before the advent of cash management arrangements.<sup>91</sup> El Paso claims that *Distrigas* featured a "demand note" system, while here El Paso uses the Cash Management Program to advance funds to its shareholding parent company. El Paso disputes the Commission's characterization of the funds entrusted to the Cash Management Program as a long-term loan, reasserting that the Program is more akin to a checking account in which funds are transferred in and out based on El Paso's needs (not El Paso Corp's).<sup>92</sup> El Paso asserts that the fact that the balance has remained in the same direction does not necessarily make the loan effectively long-term for regulatory purposes, any more than maintaining a balance in a short-term checking account makes it

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<sup>89</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 99.

<sup>90</sup> *Distrigas I*, 737 F.2d 1208 at 1218.

<sup>91</sup> *Regulation of Cash Management Practices*, Interim Rule, Order No. 634, FERC Stats. & Regs. ¶ 31,145, Final Rule, Order No. 634-A, FERC Stats. & Regs. ¶ 31,152.

<sup>92</sup> El Paso Rehearing at 51.

a long-term loan. We disagree, however, because while a depositor's rights to such funds may be clear, it is not so clear that control of cash management funds is in the subsidiary's hands and not the parent's.

67. In *Distrigas I*, the filing company argued that the parent company used a "demand note" system to manage its subsidiaries' cash efficiently and requested that the demand note should be treated in the same way as a bank account where no one would argue they were available for use.<sup>93</sup> Here, El Paso has maintained a large balance in El Paso Corp.'s Cash Management Program. The type of vehicle used to make the loan is less important than ultimate control over the funds. We therefore reject El Paso's comparison of the Cash Management Program to a checking account in which a regulated entity participates as the regulatory entity's checking account. In some ways it may be similar, but ultimately, the right to the money in the checking account is the depositor's and the disbursement of the funds in the cash management account is at the non-regulated parent's discretion, not the regulated company's demand. It is for this very reason that shortly after the Enron debacle, the Commission undertook a review of such cash management programs to ensure that ratepayers and regulated entities were not harmed by such programs.<sup>94</sup>

68. The record in this proceeding reflects El Paso's own characterization of the loan as non-current. Trial Staff characterizes El Paso as a "perpetual net lender" under the Cash Management Program.<sup>95</sup> While the practical truth of these characterizations may be somewhere in between, the Commission finds that the "perpetual net lender" description is not so ill-fitting a shoe that it does not fit. Though El Paso's witnesses speculate that many may treat cash management funds as current and a subsidiary could *request* the funds at any time, it has not been shown that this would always be the case in a crisis, when the non-regulated parent may desperately need these funds. Furthermore, the fact that the funds may be available in more normal circumstances does not change the fact that, by delivering the funds to the Cash Management Program, El Paso ensured that the money was not invested in jurisdictional activities in the relevant time period. Consequently, we affirm the adjustment ordered in Opinion No. 517.

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<sup>93</sup> *Distrigas I*, 737 F.2d 1208 at 1218.

<sup>94</sup> *Regulation of Cash Management Practices*, NOPR, FERC Stats. & Regs. ¶ 32,561 (2002); Order 634, Interim Rule, FERC Stats. & Regs. ¶ 31,145 at P 4, *as modified*, Order No. 634-A, Final Rule, FERC Stats. & Regs. ¶ 31,152.

<sup>95</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 113; Tr. 1214 (Palazzari test. stating that El Paso is a net lender since Cash Management Rule adopted).

69. El Paso's witness Palazzari claims to identify an "effective" demand on the cash management funds by El Paso, based on fluctuations from a high of \$941 million to the then-current \$615 million at the end of the test period. The witness cites Exhibit EPG-378, a statement of Cash Management Program balances, which merely reflects that El Paso's balance in the fund fluctuates over 36 months. Yet these fluctuations may reflect other variations of cash flows, including fluctuations in revenues or interest rates. In any event, the witness's statement in no way demonstrates that El Paso made (or could make) an affirmative demand for money against the wishes of its corporate parent, nor demonstrates that El Paso maintains a large balance of surplus cash in the Cash Management Program at its own direction.<sup>96</sup>

70. While the record reflects that El Paso does take cash from the account to pay for ongoing operations and meet payment needs, those transactions are naturally reflected in the fund balance. The amount remaining in the fund is not used by El Paso, and it is up to El Paso to justify maintaining such a large balance, which it characterizes, using the Commission's accounting system, as a non-current investment in its affiliates – not as cash or another current asset.<sup>97</sup>

71. The record in this proceeding reflects other possible motives for the declining balance. El Paso's SEC Form 10-K notes that in 2008 El Paso paid \$200 million in dividends to El Paso Corp. and settled \$40 million in deferred income tax, again with El Paso Corp., through the Cash Management Program.<sup>98</sup> These capital dispositions occurred in a year in which El Paso Corp. itself announced a \$300 million share repurchase and a dividend increase.<sup>99</sup>

72. El Paso's assertion of control over the disposition of funds in the account is in fact contradicted by other record evidence in this proceeding. In its Security Exchange Commission disclosures, El Paso confirms the Commission's understanding of the control that El Paso Corp. exercises over its subsidiary:

As an indirect wholly owned subsidiary of [El Paso Corp.],  
subject to limitations in our credit agreements and indentures,  
[El Paso Corp.] has substantial control over: **our payment of**

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<sup>96</sup> Ex. EPG-374 at 20; *see also* Ex. EPG-378.

<sup>97</sup> *See* FERC Account No. 123, Investment in Associated Companies.

<sup>98</sup> Ex. EPG-382 at 18, 40 (El Paso SEC 10-K filing).

<sup>99</sup> Ex. EPG-424 at 3 (consolidated Standard & Poor's rating).

**dividends; decisions on our financing and capital raising activities; mergers or other business combinations; our acquisitions or dispositions of assets; and our participation in [El Paso Corp's] cash management program.** [El Paso Corp.] may exercise such control in its interests and not necessarily in the interests of us or the holders of our long-term debt.<sup>100</sup>

Consequently, El Paso's own testimony supports the finding that El Paso Corp. exercises control over the pipeline's use of funds in the Cash Management Program.

73. As for El Paso's suggestion that the form of the loan is significantly different from that in *Distrigas*, we disagree. In upholding the Commission's finding to the contrary, the *Distrigas* court found it significant that the vehicle for managing the loan was chosen by the parent corporation.<sup>101</sup> The fact that the Cash Management Agreement is not an arm's length transaction also parallels this analytic focus in *Distrigas* and suggests that El Paso's choice is likewise limited.<sup>102</sup> Furthermore, the Commission's Cash Management Practices rule established a reporting requirement to allow prompt agency action if a regulated entity's access to funds becomes limited, but did not regulate or authorize participation in a Cash Management Program. Assessment of how to treat such funds for ratemaking purposes remains in the Commission's purview. Through its Cash Management Program, El Paso has maintained a significant balance in the possession of its shareholding parent, throughout the life of the program. The advent of that rule, in response to the Enron crisis, should not be interpreted as changing or undermining the Commission's established ratemaking policies regarding the treatment of advances or loans to affiliates.

74. In conclusion, we deny rehearing on this issue, as El Paso has failed to support a different treatment of the Cash Management Program funds from that prescribed in Opinion No. 517.

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<sup>100</sup> Ex. EPG-382 at 12 (emphasis added; internal bullet identifiers omitted); *see also* Ex. SWG-56 (debt prospectus).

<sup>101</sup> *Distrigas I*, 737 F.2d 1208, 1218.

<sup>102</sup> *See* Ex. SWG-6; Tr. 1452. Tellingly, the agreement is signed by the same person representing both sides.

iii. **El Paso's Claim of Enhanced Liquidity Is Unsupported and Fails to Support Recognizing the Loan in Capital Structure**

75. El Paso reiterates its disagreement with the Presiding Judge that the Cash Management Program was a loan, citing the fact that the balance accumulated over time. El Paso states that the Cash Management Program operates as a checking account in which funds are transferred every day between El Paso and El Paso Corp. "based on El Paso's cash needs" and states that the loan to the parent under the Cash Management Program is its primary source of liquid cash used to operate both its jurisdictional and non-jurisdictional assets.<sup>103</sup>

76. In Opinion No. 517, the Commission weighed the dispute between El Paso's claims that the Cash Management Program allows for greater financing flexibility, reduced borrowing and transactional costs, and increased liquidity against Trial Staff's representations that El Paso's status as a perpetual lender results in El Paso providing benefits in terms of liquidity and financing flexibility. The Commission found that El Paso had failed to adequately rebut the claims of the witnesses advocating an adjustment for the loan and had failed to explain why the outstanding equity that is used on a long-term basis for non-jurisdictional purposes should be reflected in its capital structure. Because the Commission found that El Paso had failed to support a finding that its actions in funding a large, long-term loan through the Cash Management Program were related to its regulated activities, it then fell to El Paso to support a smaller adjustment by demonstrating that the source of the loan was company debt, not capital raised from service revenues.<sup>104</sup>

77. El Paso attempts to rebut the Commission's finding in Opinion No. 517 (at P 99) that the Cash Management Program limited El Paso's liquidity citing a Standard & Poor's consolidated corporate credit rating for El Paso Corp., including its subsidiary El Paso, as identifying the Cash Management Program as a significant source of liquidity.<sup>105</sup>

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<sup>103</sup> El Paso Rehearing at 37.

<sup>104</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 99.

<sup>105</sup> El Paso Rehearing at 37, 46 (citing Ex. EPG-424 at 3; Tr. 464, Vilbert testimony confirming El Paso benefitted by liquidity provided by the Cash Management Program).

78. To address the liquidity issue, El Paso only cites the Standard and Poor's credit rating which reflects that El Paso meets its liquidity needs through the Cash Management Program. The credit rating says nothing about whether the Cash Management Program enhances its liquidity as opposed to limits it by tying up El Paso's surplus cash to support unregulated affiliate activities.<sup>106</sup>

79. In its financial filings, El Paso describes its participation in the Cash Management Program as follows: "Pursuant to El Paso's cash management program, we transfer surplus cash to [El Paso Corp.] in exchange for an affiliated note receivable."<sup>107</sup> Furthermore, El Paso's accounting reflects the balance in the Cash Management Program as non-current investment in its associated companies.<sup>108</sup> El Paso does not account for the note as a current note, due on demand or within one year of the date of issue, nor as checking account or cash equivalent, for funds that are immediately available.<sup>109</sup>

80. El Paso attempts to explain away its accounting designation, stating, "The fact that [El Paso] classified the loan under the [Cash Management Program] as non-current for reporting purposes means only that [El Paso] had no firm plan at the time of that accounting closing period to demand repayment within a year. It does not mean that it could not demand repayment at any time should an unexpected need for cash arise, or that the loan would be considered long term by lenders for interest rate purposes."<sup>110</sup> In light of the inevitable control that a parent corporation exercises over a subsidiary, we find El Paso's explanation unconvincing. Taking El Paso at its word, we find that the \$615 million balance is a loan of surplus cash to an affiliate in exchange for a note receivable. El Paso's witness indicated that it has maintained the loan since the Commission's Cash Management Rules were adopted. El Paso's suggestion that it could demand repayment if a need arose underscores that El Paso has identified no current need to maintain the cash balance that relates to regulated activities.

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<sup>106</sup> All regulated participants in the Cash Management Program are net lenders. Tr. 1216.

<sup>107</sup> Ex. EPG-382 at 12 (SEC Form 10-K).

<sup>108</sup> See FERC Account No. 123, Investment in Associated Companies.

<sup>109</sup> See FERC Account No. 141, Notes receivable; Account No. 145 Notes Receivable from associated companies. El Paso states in its SEC 10-K filed March 2, 2009, "We do not intend to settle this note within twelve months and therefore classified it as non-current on our balance sheets." Ex. EPG-382 at 40.

<sup>110</sup> El Paso Rehearing at 47 (citing Tr. 1357).

81. Initially, we note that the Standard & Poor's credit rating identified cash flow from operations and the use of El Paso Corp's cash management account as providing El Paso with liquidity. El Paso Corp. was also identified as a "significant *potential* source of liquidity."<sup>111</sup> While the Cash Management Program is the vehicle through which El Paso measures outstanding balance in the inter-affiliate income and expenses accounting, its delivery of "surplus cash" to its parent corporation, becoming thereby a net lender under the Cash Management Program, arguably decreases rather than increases its liquidity.

82. The record in this proceeding reflects that in 2007 and 2008 El Paso made \$1 billion in loans to El Paso Corp's Cash Management Program.<sup>112</sup> During this time, Standard's & Poor's consolidated credit rating reflected that El Paso Corp. maintained \$498 million in cash and equivalents.<sup>113</sup> While, as a general matter, the Cash Management Program does provide El Paso whatever liquidity it is going to have, the record certainly does not reflect that El Paso's historical practice to contribute funds to the Cash Management Program increases its liquidity over maintaining its cash balances in some other sort of liquid asset, such as a demand account or commercial paper. In the latter accounts, it would have full control of the account, but it is the parent that has ultimate control of the cash management account.

83. More importantly, and as stressed above, El Paso has failed to demonstrate that parking its surplus cash in the Cash Management Program represents a use of the cash for regulated activities. The fact that the substantial cash balance remained unspent and uncommitted to any regulated activities suggests otherwise. El Paso suggests that, by placing \$760 million in the shared Cash Management Program, it has "enhanced" its liquidity and generally lowered its borrowing and transactional costs.<sup>114</sup> However, El Paso has failed to quantify these lowered costs. Furthermore, El Paso has failed to demonstrate that any such savings are comparable to the real costs that ratepayers will surely bear if the loan balance were included in its capital structure. The potential for

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<sup>111</sup> Ex. EPG-424 at 3 (emphasis added). However, El Paso has never borrowed under El Paso Corp's revolving credit facility. Tr. 1196 (Palazzari test.).

<sup>112</sup> Ex. EPG-382 at 18, 32 (describing practice under the Cash Management Program to advance cash to El Paso Corp. in exchange for an affiliated note receivable, due upon demand, with \$1.0 billion outstanding on Dec. 31, 2008).

<sup>113</sup> Ex. EPG-424 at 3 (describing March 2008 balance).

<sup>114</sup> Compare El Paso Rehearing at 45-46 ("because [El Paso] can call on the funds owed to it under the [Cash Management Program] at any time, its liquidity and flexibility are enhanced").

such savings is too attenuated to justify the increase in customer rates that would occur if the loan amount was reflected in El Paso's capital structure.

iv. **Accelerated Depreciation and Deferred Income Tax**

84. El Paso suggests another function for the Cash Management Program balance, reporting that the "most likely source" of funds for the loan was deferred income taxes and depreciation expense recovered through El Paso rates for services rendered.<sup>115</sup> El Paso notes that the ADITs represent a source of cash that will be needed in the future to satisfy El Paso's tax obligation, and claims that it is logical to contribute the funds to the El Paso Cash Management Program so that the funds would be available when needed to satisfy El Paso's future tax obligations.<sup>116</sup>

85. In addition, El Paso argues that it is inequitable to remove the loan balance from its equity capitalization because the funds have already been subtracted from El Paso's rate base as deferred income tax. El Paso suggests that it was natural for it to deliver funds representing deferred income tax to its shareholding parent because the tax liability would need to be paid eventually. However, nothing in the Commission's deferred tax policies assumes that a regulated entity would retain funds representing payments for deferred taxes for eventual disbursement by depositing those funds in an account controlled by its parent. Instead, the Commission's policies consider deferred taxes as an interest-free loan using funds paid by ratepayers,<sup>117</sup> and presumably such funds would be used for jurisdictional service purposes. El Paso nevertheless argues that, if the Commission does not reverse its ruling, the same source of cash, deferred income tax, will be effectively used to reduce rates in two different ways: first, as a reduction to rate

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<sup>115</sup> El Paso reports that it is generally required to deduct accumulated deferred income taxes (ADIT) from its rate base to compensate rate payers for the time value of this money until the deferred taxes become due and states that it has over \$400 million in ADIT. El Paso Rehearing at 41 (citing *Ozark Gas Transmission Co.*, 50 FERC ¶ 61,252, at 61,766 & n.15 (1990)).

<sup>116</sup> El Paso Rehearing at 42 (citing Ex. EPG-374 at 27).

<sup>117</sup> Deferred income tax is deducted from rate base to ensure that the company does not obtain such use at the expense of the ratepayers paying rates reflecting the tax; thus, rates reflect the time-value of the early payment. Order No. 486-A, 123 FERC ¶ 61,056 at P 267.

base; and second, as a reduction to El Paso's equity capitalization used to compute capital structure and that the Commission failed to address this issue in Opinion No. 517.<sup>118</sup>

86. Initially, we note that nothing in El Paso's analysis is inconsistent with the holding in *Distrigas* that a loan be excluded because the funds are not available for use in regulated activities. As for El Paso's claim that the cash management account is an asset with which to eventually pay the tax liability, the Commission's policies consider deferred taxes as an interest-free loan using funds paid by ratepayers.<sup>119</sup> The pipeline has a choice whether to reinvest funds collected for deferred taxes, maintain the balance in a manner in which it has control and serves jurisdictional purposes or put the money to some other use unrelated to jurisdictional activities.

87. The record reflects that El Paso forwarded funds that it attributes to deferred income tax to its parent company. El Paso states that it does not intend to request that the funds be returned in the next year. Furthermore, El Paso reports that, because El Paso Corp. files consolidated taxes and its books therefore reflect a measure of its impact on the overall tax burden, the deferred income tax themselves will most likely be payable to El Paso Corp. when due.<sup>120</sup> These facts do not suggest that the funds are being maintained in order to meet a future liability of the regulated entity. Instead, the facts support making the capital structure adjustment, because El Paso has advanced funds to its shareholding corporate parent that are now available for use in non-regulated activities, so long as a large positive balance is maintained over time.

88. If El Paso had chosen to invest funds generated from deferred income tax, then its rate base would have been increased by a like amount. In this case, however, El Paso has not invested or retained the funds for the benefit of its own jurisdictional service purposes, but has delivered the funds to its corporate parent and thereby made the funds de facto unavailable for investment in utility activities. The fact that El Paso has relayed the benefit of the prepayment of taxes to El Paso Corp. supports rather than counters the case for an adjustment to El Paso's capital structure.

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<sup>118</sup> El Paso Rehearing at 37.

<sup>119</sup> See *Distrigas I*, 737 F.2d 1208 at 1212 (describing the tax deferral as "highly advantageous" to regulated entities, noting that service providers "obtain the use of the 'saved tax' money until the time it falls due").

<sup>120</sup> Ex. EPG-382 at 40 (SEC Form 10-K). El Paso also reports that El Paso Corp. files consolidated tax returns, makes payments and charges or credits El Paso to the extent that it incurs a tax liability or supports a deduction that is reflected in the consolidated return. *Id.* at 31.

89. There is nothing inconsistent or unreasonable in applying both an adjustment to El Paso's capital structure and an adjustment to rate base for deferred income taxes. The Commission's policy to adjust rate base stems from the fact that tax rules may, in effect, defer payment for tax liabilities beyond the timing provided for in rates. The pipeline collects the customers' payment while obtaining the benefits of the tax deferral. To reflect the timing difference, the Commission requires the pipeline to deduct the deferred tax from rate base, with the effect that the customers need not pay in current rates the time value of the money previously paid.

90. We disagree that the two rate adjustments are based on the same transaction, as El Paso suggests. The rate base deduction is made to reflect that ratepayers have prepaid an expense that is to be paid at a later date. The capital structure deduction is to reflect the fact that El Paso has accumulated capital and disposed of the capital by effectively consigning the funds to the control of its parent company. El Paso's witness, Mr. Lovinger confirmed his understanding of this arrangement, describing deferred income tax as "cost-free funds" and confirming that ratepayers do not pay any return on these funds.<sup>121</sup> Thus, any "reduction" to rates from the rate base deduction is offset by the benefit to the pipeline of these cost-free funds. As confirmed by El Paso's witness, these offsetting facts are not considered a reduction in rates, nor a penalty to the pipeline.<sup>122</sup>

v. **El Paso's Claims that the Cash Management Program Lowered its Debt Costs are Unsupported**

91. As for El Paso's claims that the Commission's actions will cause its debt costs to rise, we find those claims speculative and largely abandoned by testimony of El Paso's witness. Consequently, we reject the theory that maintaining a balance in the loan benefitted customers through lower debt costs.<sup>123</sup>

92. El Paso maintains that participating in the Cash Management Program, and the pooling with its parent, results in a stronger financial position and an ability to obtain lower financing costs. In addition, El Paso speculates that adjusting its capital structure will result in higher capital costs, citing a business axiom that companies with higher debt ratios face higher debt costs. El Paso responds to Opinion No. 517's analysis that higher debt costs were not anticipated because the Commission's action did not change

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<sup>121</sup> Tr. 470.

<sup>122</sup> See Tr. 482.

<sup>123</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 98.

El Paso's financial characteristics, and creditors could independently weigh the risks of lending to El Paso, without the Commission's determination.<sup>124</sup> El Paso responds first that the Commission's action will lower its rates (from what they otherwise would have been), which is a factor that will be taken into account by ratings agencies and, second, that "it is theoretically unsound to make a change to one rate component without taking into account impacts to other rate components caused by such change."<sup>125</sup> El Paso cites Trial Staff's proposal to add back \$25 million representing working capital, in support of this latter claim.

93. We disagree with El Paso's assertion that the Commission is assuming that it has zero cash needs. Elsewhere in this order, we decline to credit El Paso for working capital needs, because El Paso did not file the required lead-lag study that would permit us to assess those needs. Consequently, we cannot say whether El Paso is correct in echoing Trial Staff's view that it should receive credit as would the case under our prior policy. There is simply no evidence in the record to support such a credit.<sup>126</sup>

94. On rehearing, El Paso makes a generalized claim that a company with a lower debt ratio will face lower debt costs than a company with a higher debt ratio.<sup>127</sup> El Paso claims that it did in fact quantify the higher debt costs, pointing to its witness Vilbert's statement "(i.e., 100 to 300 basis points) that could result if the credit agencies downgraded El Paso's credit rating due to the higher debt ratio caused by the reduction in [El Paso's] equity capitalization."<sup>128</sup> El Paso argues that its customers receive the benefit

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<sup>124</sup> *Id.* P 109 (citing *El Paso II*, 449 F.2d 1245, 1249-1250 (affirming Commission assumption "that a potential shareholder or lender-investor could determine the value of the regulated versus the non-regulated operations and calculate the sureness of his regulated return on the one and the commercial risk he assumes on the other").

<sup>125</sup> El Paso Rehearing at 59.

<sup>126</sup> It is of course entirely possible to have negative working capital needs, which would present a deduction from rate base. *Ozark Gas Transmission Sys.*, 39 FERC ¶ 61,142, at 61509 (1987). We make no attempt here to speculate as to what El Paso's circumstances would show, in the absence of a fully developed and reliable study.

<sup>127</sup> El Paso Rehearing at 57 ("No party in the case disputed the fact that reducing a company's equity capitalization and correspondingly increasing its debt ratio results in the company being viewed as more risky by financial analysts and lenders, which in turn increases the company's cost of debt").

<sup>128</sup> El Paso Rehearing at 58 (citing Vilbert rebuttal testimony, Ex. EPG-335 at 27-28, "There are a number of qualitative factors that are relevant as well, so it is not assured

of lower debt cost resulting from El Paso's actual (unadjusted) capital structure, and suggests that, with the equity adjustment, customers will avoid additional costs that should be allocated to them as a result of El Paso's lowering that debt level but not having the concomitant increase in equity recognized in the capital structure.<sup>129</sup>

95. Some parties argued in this proceeding whether the interest rate that El Paso receives in this proceeding is sufficient to compensate El Paso for the risks of making a loan to its below-investment grade parent. If the interest rate is too low, that would support removing the loan from El Paso's capital structure, as the evidence would show that the loan was not made for a sound business purpose, but to support non-regulated activities, at the direction of its shareholding parent corporation.

96. We find, consistent with Trial Staff's assessment, that El Paso's compensation under the Cash Management Program is inadequate. El Paso defends the interest rate as being comparable to the London interbank based interest rate (LIBOR) that El Paso Corp. negotiated for its revolving credit facility. The record reflects a number of reasons why the revolving credit financed by a consortium of lenders is not a comparable analog to the Cash Management Program. In particular, El Paso Corp. secured the bank loan using El Paso stock, whereas El Paso made a loan to its below-investment grade parent, without security. Consequently, we find El Paso failed to support its assertion that the interest rate is adequate through its comparison to the rate paid under El Paso Corp's revolving credit arrangement. Even if El Paso could demonstrate that the interest rate paid on the loan or that placing the funds in the Cash Management Program were advantageous to it, these facts would not address the fact that the funds represented in the loan were not used for regulated activities, and that the capital tied up in the loan was not used to invest in rate base.

97. In addition, we affirm the Commission's rejection of El Paso's claim that the Cash Management Program allowed it to obtain lower debt costs.<sup>130</sup> On rehearing, El Paso renews the claim of lower debt costs and cites its witness Vilbert's testimony as

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that the credit rating would not be affected by a dramatic reduction in equity. A reduction to 46-47 percent equity is substantial and could threaten a ratings downgrade").

<sup>129</sup> El Paso Rehearing at 60 (citing Tr. 433, El Paso witness Vilbert stating that he is troubled by Staff's proposal because "now ratepayers would have the benefit of the fact that the cost of debt is lower than it would be if it were to have the capital structure that is being recommended but they're not willing to pay the cost of getting the debt lower by having the equity recognized in the capital structure").

<sup>130</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 98.

quantifying the increased debt costs that “could” result if the credit agencies downgraded El Paso’s credit rating “due to the higher debt ratio caused by the reduction in [El Paso’s] equity capitalization.”<sup>131</sup> El Paso’s claim on rehearing is speculative. Furthermore, the claim assumes a reduction in El Paso’s equity capitalization. As the Commission noted in Opinion No. 517, it did not order El Paso to take any action to increase its debt. In a data response, El Paso’s witness confirmed that his analysis was based on an assumption that the intention was “to remove the amount of the loan and a corresponding amount of equity from the balance sheet, ” as opposed to merely deeming a different capital structure than El Paso’s actual capital structure.<sup>132</sup> The witness also reported that it was “purely speculative” whether El Paso would take steps to change its capital structure in response to the exclusion of the loan from El Paso’s capital structure.<sup>133</sup>

98. Furthermore, the witness clarified the claim on which El Paso seeks to rely, that interest rates could rise 100 to 300 points, as directed at a hypothetical company that experienced a credit downgrade. If the credit downgrade occurred, the hypothetical company’s debt costs could rise 100 points.<sup>134</sup> The hypothetical credit downgrade was also premised on a change to the company’s capital structure.<sup>135</sup> Because the witness acknowledged that merely deeming the company’s capital structure to be different was not the same as increasing debt capitalization that would prompt the increase in debt cost, we affirm that El Paso has failed to quantify the anticipated increase in debt costs.<sup>136</sup> In addition, El Paso has failed to quantify and compare those costs, in order to demonstrate that avoiding these potential costs could justify the immediate additional costs that

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<sup>131</sup> El Paso Rehearing at 58 (citing Ex. EPG-335 at 27-28). Again, “whatever the market rate would be for [El Paso’s] debt with a 40 percent debt ratio, it would be higher with a 54 percent debt ratio, which could result from the elimination of \$760 million from [El Paso’s] equity capitalization.” *Id.*

<sup>132</sup> Ex. SWG-48 at 2 (El Paso data response).

<sup>133</sup> Ex. EPG-335 at 25 (Vilbert Rebuttal test.).

<sup>134</sup> Tr. 379-380 (“I didn’t figure out how much it would be. I just gave you a benchmark that said if you go to BB [a lower credit rating], you can expect at least 100 basis points”).

<sup>135</sup> See Tr. 382 (Dr. Vilbert noting that downgrade may not occur but as a theoretical matter if you weaken the credit metrics a downgrade is more probable).

<sup>136</sup> See also Tr. 392 (listing how much debt as a credit rating factor, not ratio of debt to equity).

El Paso proposes its customers bear as a result of the higher cost of capital, absent the equity adjustment.

99. El Paso thus relies on a hypothetical in which a change in a company's capital structure results in a credit downgrade and higher debt costs. However, El Paso failed to demonstrate that El Paso's stated capital structure was one of the factors relied on by the credit agencies. On cross examination, Dr. Vilbert identified factors used in making a credit rating, listing the type of assets invested in, debt volume, net income, and depreciation.<sup>137</sup> Dr. Vilbert did not mention the ratio of debt to equity used in ratemaking as a credit factor.

100. To the extent that the Commission's action lowers El Paso's rates, we do not see this as prompting a credit rating revision. El Paso does not identify the need for higher transportation rates as a factor relied on by the credit ratings agencies. Furthermore, the ratings agency explanations suggest that El Paso's relationship with its parent is a primary driver.<sup>138</sup> In fact, Standard & Poor's provided a consolidated credit rating,<sup>139</sup> while Moody's engaged in a practice known as "notching," whereby "pipeline subsidiaries are rated one notch above the rating of the parent company, reflecting structural subordination for debt at the parent company level."<sup>140</sup> Based on this evidence that credit ratings are made on a consolidated basis, or derivative of El Paso Corp's financial situation, it is by no means clear that a change from El Paso's stated capital structure ratio would result in a change in El Paso's credit rating. Based on this record, it has not been shown that changes stemming from the Commission's actions in this case will necessarily lead to a credit downgrade for El Paso, with a resulting increase in debt costs. Consequently, we deny rehearing on this issue, and affirm our holding in Opinion No. 517 that El Paso has failed to establish that customers benefit from its maintaining a

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<sup>137</sup> Tr. 392 (characterizing use of the riskiest form of cash management program as "not the most important" rating factor).

<sup>138</sup> See Tr. 1224, Palazzari testimony (confirming "The parent rating becomes the primary determinant of a pipeline subsidiary's rating if cash flows are managed centrally and no significant ring-fencing exists" and discussing Ex. SWG-9, Moody's Rating Methodology). See also Standard & Poor's rating, Ex. EPG-424 at 2 (citing weak credit quality of parent El Paso Corp. and possibility that El Paso could be leveraged to support the parent as rating weaknesses).

<sup>139</sup> Ex. EPG-424 at 2

<sup>140</sup> Tr. 1225 (Palazzari test., reviewing Moody's rating methodology, Ex. SWG-9).

large balance in the Cash Management Program, or will be harmed by the Commission's ratemaking determination in this proceeding.

c. **The Ratemaking Precedent Relied on in Opinion No. 517 Remains Good Law**

101. El Paso cites a number of other holdings to support its claim that only assets sourced from equity may be deducted solely from equity for purposes of computing a pipeline's capital structure. El Paso claims that the Commission's "current policy" is "to assume that both rate base and non-rate base assets are sourced in the same proportion as total capitalization, absent a tracing of the source of the assets." This additional precedent reflects holdings taken from Commission opinions addressing project-financed pipelines, investments in subsidiaries, dispositions of revenues, receivables, subsidiary earnings and loans to parent corporations.

102. We disagree that these holdings represent a one-size-fits-all template for tracing the source of an investment or asset to equity financing, as El Paso suggests. As the Commission held in Opinion No. 517, the Commission's precedent represents a case-by-case analysis to ensure just and reasonable rates under the circumstances in each proceeding, based on the cost of providing jurisdictional service. As discussed below, we continue to find on rehearing that the holdings relied upon in El Paso's analysis are distinguishable and otherwise not applicable to the facts in this proceeding.

i. **Transco, Opinion No. 414, et al.**

103. El Paso claims that the Commission erred in applying the *Transco* orders in two regards. First, El Paso claims that the Commission's holding in *Transco* implicitly overrules its holdings in the proceedings addressing Undistributed Subsidiary Earnings and loans to shareholding parent companies. In addition, El Paso claims that *Transco* more directly relates to the facts in this proceeding because the Commission declined to make an adjustment to Transco's capital structure when the regulated company declined to issue dividends while it loaned money to its corporate parent.<sup>141</sup>

104. El Paso claims that Opinion No. 414 "renders irrelevant" the fact that El Paso's equity capitalization was higher than it would have been if it had paid a dividend, because the opinion "implicitly rejected" the theory that loans to a parent are constructive dividends. El Paso states that "the teaching of Opinion No. 414" is that, if the first two prongs of the standard are met, the Commission will determine whether the pipeline's actual capital structure is just and reasonable by comparing it to other approved

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<sup>141</sup> El Paso Rehearing at 53-54.

capital structures “and will not question how or why that actual capital structure was chosen by the company.”<sup>142</sup> According to El Paso, “After Opinion No. 414, the Commission stated its intention of no longer evaluating the motives of the pipeline or its parent in maintaining a loan balance in lieu of declaring dividends.”<sup>143</sup> El Paso states that the Commission’s refusal to evaluate the reason for maintaining the loan (presumably after Opinion No. 414) is highlighted by the Commission’s recognition in Order No. 634 that cash management programs are beneficial to both pipelines and ratepayers. According to El Paso, if the view in Opinion No. 517 was Commission policy, then in Opinion No. 414, the Commission would have ordered an adjustment to Transco’s equity capitalization for the loan in that proceeding.

105. We disagree.

106. Opinion No. 517 has already adequately addressed El Paso’s argument that Opinion No. 414 repudiated Commission precedent requiring adjustments to a pipeline’s capital structure. In Opinion No. 414, *et al.*, the Commission held that it would use a pipeline’s own capital structure for ratemaking purposes so long as the pipeline (1) issues its own debt; (2) has its own separate bond rating; and (3) has an equity ratio that is not excessive in light of other equity ratios approved by the Commission and in comparison with the equity ratios of the proxy companies. In Opinion No. 517, the Commission noted that the issue in the Opinion No. 414 series was whether to use a pipeline’s own capital structure, as El Paso proposes, or whether to use its parent’s capital structure.<sup>144</sup> Opinion No. 517 explained that the issue in Opinion No. 414 was not present in this proceeding, because no party proposed a hypothetical capital structure.<sup>145</sup> Further, the Commission explained that the issue in this proceeding is whether elements of El Paso’s

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<sup>142</sup> *Id.* at 54. El Paso provides no citation for its interpretation.

<sup>143</sup> *Id.* at 55. El Paso provides no citation for such statement and, following its precedent, the Commission did not rely in Opinion No. 517 on a “constructive dividend” theory, but based its finding on whether the funds were available for investment in jurisdictional activities. *Cf.*, *Distrigas III*, at 65,121 (rejecting reliance on constructive dividend characterization and excluding loan balance because funds were not available to support investment in jurisdictional facilities).

<sup>144</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 88.

<sup>145</sup> *Id.* at P 89.

own capital structure are not devoted to jurisdictional service and thus should be excluded.<sup>146</sup>

107. The Commission cited the statement in Opinion No. 414-B which took pains to affirm that “many important cases were decided long before Opinion No. 414-A . . . but that does not diminish their value as precedent.”<sup>147</sup> El Paso has raised no argument causing the Commission to question the value of this precedent and, on rehearing, we affirm the Commission’s holding that “Nothing in the Opinion No. 414 series of orders was intended to, or did, reverse the *United Gas* or *Distrigas* precedent.”<sup>148</sup>

108. Opinion No. 517 also cited the *Iroquois* opinion, which applied Opinion No. 414 to approve the use of a subsidiary’s capital structure, but only after making adjustments to that capital structure.<sup>149</sup> El Paso suggests that the Commission’s policy announced in Opinion No. 414, to use a pipeline’s own capital structure when the factors are met, was inconsistent with the adjustment ordered in this proceeding.<sup>150</sup> The fact that the Commission applied the Opinion No. 414 factors in *Iroquois* and directed a capital structure adjustment in the same proceeding refutes El Paso’s suggestion that there can be no adjustment to a company’s capital structure after the Opinion No. 414 factors are met.

109. On rehearing, El Paso quibbles with the Commission’s characterization of *Iroquois* as making an adjustment to correct “excess capitalization,” noting that the Commission made an out of test period adjustment to *Iroquois*’ capital structure to reflect cash reserves that were held for distribution after the test period. In Opinion No. 517, the Commission relied on the *Iroquois* opinion for the proposition that application of Opinion No. 414 did not preclude capital structure adjustments when appropriate to calculate a pipeline’s capital structure. It is immaterial, in the Commission’s view, whether the

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<sup>146</sup> *Id.* (citing Opinion No. 414, 80 FERC at 61,665 (rejecting suggestion that the Commission need only ascertain whether a pipeline issues its own debt); Opinion No. 414-B, 85 FERC at 62,266 (“the focus of the Commission’s analysis in all cases continues to be the reasonableness of the pipeline’s equity ratio”)).

<sup>147</sup> Opinion No. 414-B, 85 FERC at 62,265.

<sup>148</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 91.

<sup>149</sup> *Id.* P 91 (citing *Iroquois*, 84 FERC at 61,448 as applying Opinion No. 414 and adopting adjusted capital structure after excluding cash reserves that were held for distribution after the test period).

<sup>150</sup> El Paso Rehearing at 21, 40-41, 44, 52.

adjustment is based on an out of test period disbursement of accumulated capital or, as is the case in this proceeding, an adjustment for maintaining a long-standing balance of revenues generated from operations in a parent company's cash management account. In both cases, the adjustment appropriately corrects the capital structure to more accurately reflect the funds invested in jurisdictional activities.

110. El Paso further claims that the Commission's action in Opinion No. 517 is inconsistent with the treatment of intercompany loans in Opinion No. 414. El Paso notes that the pipeline in *Transco* was accused of increasing its equity ratio when it declined to pay dividends to its former parent corporation while loaning money to the parent. El Paso restates its interpretation of Opinion No. 414 that "the Commission will determine whether the pipeline's actual capital structure is just and reasonable by comparing it to other approved capital structures and will not question how or why that actual capital structure was chosen by the company." Based on this interpretation El Paso declares that the Commission's decision to eliminate the loan balance from equity in Opinion No. 517 is inconsistent with Opinion No. 414.<sup>151</sup>

111. *Transco's* loan to its parent company is distinguishable since it was repaid prior to the end of the test period in that case.<sup>152</sup> The loan in the *Transco* proceeding consisted of advances of accumulated retained earnings to the *former* owner of the pipeline, TEC. However, by the time of the rate case in question, TEC had been acquired by and merged into a new owner, TWC, who repaid the advances. The record in the *Transco* proceeding demonstrated that the repayment was part of a series of financial transactions intended to make the subsidiary pipeline more independent and to justify use of the pipeline's own capital structure. Because the loan had been repaid, the loans were presented as historic evidence of continuing control and manipulation by the parent over the subsidiary's capitalization (along with the repayment and concurrent redemption of premium stock). Thus, the rejected claim in *Transco*, that the parent company used timely loans and stock redemption schedules to maintain a higher equity ratio is different from the claim in this proceeding, that by returning a substantial sum to its parent company, El Paso has made its nominal capital structure unjust and unreasonable as not representing the mix of financing supporting jurisdictional activities. In *Transco*, the Commission found that the advance by the parent corporation to repay the loan and redeem stock did not make *Transco's* capital structure unjust or unreasonable, stating "we previously have recognized that subsidiaries commonly have close financial ties with their parent corporations, and the *one-time provision of funds* by *Transco's* corporate parent for repurchase of the preferred stock *had only a minor effect* — approximately two percent

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<sup>151</sup> El Paso Rehearing at 54 (citing *Transco*, 84 FERC at 61,420).

<sup>152</sup> *Transco*, 80 FERC at 61,666.

— on Transco’s equity ratio.”<sup>153</sup> In the instant proceeding, by contrast, the loan represents a substantial outstanding delivery of funds to the shareholding parent company.

112. Thus, the claim that the Commission rejected in *Transco* was whether the financial transactions between the parent corporation and the pipeline represented evidence of manipulation and control that would render the pipeline’s capital structure unreasonable. The *Transco* cases did not address the circumstance of a *current* outstanding loan to the shareholding parent corporation, representing capital that is not available for investment in regulated pipeline activities. Nothing in *Transco* indicated that the capital provided by the shareholding parent corporation did not represent an actual capital infusion at the time of the rate case. Indeed, the Commission cited the repayment of the advances to the former shareholding parent as demonstrating the independent financial footing necessary to support using the pipeline’s own capital structure.

113. While *Distrigas* and the *Transco* proceeding share some common elements, including parent control over a subsidiary, this limited nexus does not establish that Opinion No. 414 overturned *Distrigas* as precedent. The issue in *Transco* was whether the parent’s control, in combination with a history of cash transfers, demonstrated sufficient manipulation to call into question the pipeline’s current capital structure. The Commission found such common inter-affiliate transactions did not rise to the level of improper manipulation. In *Distrigas*, on the other hand, the issue was whether such parental control was a sufficient basis to support a Commission finding that placing funds with the parent through a demand note made those funds unavailable for investment in regulated activities, which is one element of the case in this proceeding. Based on that limited factual holding, we find no inconsistency between Opinion No. 414 and *Distrigas* and continue to find that *Distrigas* supports the equity adjustment in this proceeding.

ii. **Southern Natural and Subsidiary Investment Precedent**

114. El Paso suggests that it is “ironic” that the Commission cites *Southern Natural* for the proposition that funds need not be traced to equity to be excluded from equity capitalization, and quotes the statement that, if not excluded, capitalization would reflect “investment in properties not related to the jurisdictional business which we are

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<sup>153</sup> *Id.* (emphasis added) (citing *Williams Natural Gas Co.*, 77 FERC ¶ 61,277, at 62,191 (1996); *Panhandle Eastern Pipe Line Co.*, Opinion No. 404, 74 FERC ¶ 61,109, at 61,360 (1996)).

regulating.”<sup>154</sup> El Paso points out that *Southern Natural* is a proceeding where the Commission did exclude a non-rate base investment from equity because the funding for the asset could be traced to equity financing, specifically an issuance of stock. The Commission rejected a claim suggesting that the stock issue could nevertheless reflect unified financing and approved the adjustment.

115. The Commission finds that *Southern Natural* is a poor choice to show that in all cases the Commission must trace financing for an asset to equity before an adjustment may be made to equity. El Paso fails to acknowledge that the Commission addressed multiple adjustments in *Southern Natural*. In addition to the adjustment that was made for the investment made from funds generated from a specific stock issue, the Commission in *Southern Natural* also approved another adjustment to reflect funds advanced to one subsidiary using earnings and stock redemption proceeds related to a second subsidiary. The company in *Southern Natural* argued that the funds obtained from the first subsidiary were properly included in outstanding equity because the actual funds were used for company operations – to finance new construction and pay off notes. The Commission disagreed, citing the *El Paso* Opinion:

[W]e see no difference in substance between El Paso’s issuance of stock to acquire its subsidiaries, Southern’s issuance of stock to acquire South Georgia, and Southern’s advance [of] funds to Resources. In each of the three cases, if the appropriate deduction from equity were not made, the capitalization would reflect “investment in properties not related to the jurisdictional business which we are regulating.”<sup>155</sup>

116. The Commission attributed the advance to equity, noting that the size of the advance was comparable to the earnings and stock redemption proceeds. What is critical for this proceeding is that the Commission in *Southern Natural* did not trace the loan amount to equity financing, as was the case with the adjustment for the investment in the subsidiary pipeline. Thus, the *Southern Natural* opinion highlights the fact that the Commission treats loans to affiliates different from investments in affiliates made from stock issuances. The funds obtained from the subsidiary dividends and subsidiary stock repurchase were not considered part of the corporate hodgepodge, but were treated as a

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<sup>154</sup> El Paso Rehearing at 27 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 103; *Southern Natural*, 44 FPC 567, 571-72; *El Paso I*, 44 FPC 73)).

<sup>155</sup> *Southern Natural*, 44 FPC 567, 573.

separate source of capital from equity financing, as evidenced by the fact that the Commission traced the investment in the subsidiary to a specific stock issue.

117. Thus, in *Southern Natural*, the Commission distinguished its treatment of loans and investments. In either case, the Commission's goal is to ensure that capitalization reflects "investment in properties not related to the jurisdictional business which we are regulating."<sup>156</sup> However, as El Paso points out, the Commission's policy in *Distrigas* and *Southern Natural* is to exclude loans and advances to affiliates from a pipeline's capital structure. Nevertheless, the Commission has declined to do so in the case of investments in subsidiaries, absent a showing that the source of funds used to make the investment was equity financing.<sup>157</sup> El Paso nevertheless suggests that the Commission has failed to adequately distinguish or reconcile the two competing lines of precedent: cases addressing investments in subsidiaries, and cases addressing loans and undistributed subsidiary earnings.

118. On rehearing, the Commission notes two primary reasons for distinguishing the two lines of precedent. First, in the loan cases cited, the source of funds for the loans and earnings were generally shown to be operations, not financing. Therefore, a requirement to trace the source of the funds underlying the proposed adjustment to capital raised through debt or stock makes little sense.

119. Second, we find that the cases of an investment in a subsidiary are distinguishable from cases involving a loan to a shareholding parent, because an investment would not generally change the pipeline investor's underlying risks and rewards in the way that a return of capital to a shareholding parent does. As explained elsewhere, the Commission's goal in developing a cost of capital is to balance the relative costs of debt and equity and arrive at a weighted average of such costs to apply to rate base. The rate of return on equity is calculated to represent an investor's expected return on its investment, based on rates of return for investments sharing comparable risk characteristics. However, when a pipeline returns a substantial sum to the investing parent corporation, the nominative capital structure does not reflect the amount of funds the parent has at risk in pipeline operations, nor the returns that the parent can expect, because only a portion of the funds counted as outstanding capital are invested in regulated activities. This would not be the case, however, with respect to the proceedings

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<sup>156</sup> *Id.*, 44 FPC at 571-572 (citing *El Paso I*, 44 FPC 73).

<sup>157</sup> *E.g.*, *Indiana-Michigan*, 4 FERC at 65,312, *summarily aff'd*, 10 FERC ¶ 61,238; *SoCal Ed.*, 3 FERC ¶ 63,033, *aff'd without discussion*, 8 FERC ¶ 61,198; *Phila. Elec.*, 10 FERC ¶ 63,034, *aff'd and rev'd in part*, 13 FERC ¶ 61,057; *Southern Natural Gas Co.*, 44 FPC 567 (1970) (*Southern Natural*).

addressing investments in subsidiaries. This is because the parent corporation could expect the indirect subsidiaries to produce comparable returns as the regulated pipeline, assuming that the investments were made on a financially rational basis.<sup>158</sup>

120. El Paso seeks to rely on a number of additional opinions where the Commission has rejected a capital structure adjustment, including opinions addressing project-financed facilities using the so-called *Ozark* methodology or featuring levelized rates. Rates calculated using a levelized methodology and project-financed facilities, funded solely by debt, present special ratemaking issues and El Paso has failed to demonstrate how the issues in those proceedings relate to this proceeding. Consequently, those orders represent the exception to the Commission's policies, and we decline to adjust our general ratemaking policies to reflect the outcomes in those proceedings.

### iii. Mountain Fuel

121. El Paso contests the Commission's rejection in Opinion No. 517 of the *Mountain Fuel* precedent.<sup>159</sup> As with Opinion No. 414, El Paso cites *Mountain Fuel* (Opinion No. 214) as a proceeding where the Commission has applied an asset tracing requirement to a proposed equity adjustment for a loan made to a corporate parent. El Paso points out that the Commission in *Mountain Fuel* affirmed a presiding judge's refusal to exclude "loans to affiliates" from equity, "because there [was] no basis in the record for tracing this amount directly to equity."<sup>160</sup> El Paso questions the Commission's dismissal of *Mountain Fuel* as not involving a long-term investment, claiming that the Commission in *Mountain Fuel* did not base its ruling on the term of the loan or the account in which it was recorded. According to El Paso, the Commission rejected an equity adjustment because the "loan balance" could not be traced to equity.

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<sup>158</sup> These financial expectations also distinguish Commission opinions rejecting an adjustment for an investment based on the theory that revenues and long-term capital accumulation may be mixed in the corporate hodgepodge. While investments made in subsidiaries may not call for an adjustment, other transactions using funds in an ongoing operation may nevertheless result in a capital structure adjustment when appropriate. See *Southern Natural*. In contrast, in this proceeding the funds were mixed into the parent company's corporate hodgepodge, not the hodgepodge of the pipeline whose capital structure is being examined.

<sup>159</sup> *Mountain Fuel Resources, Inc.*, Initial Decision, 22 FERC ¶ 63,102, at 65,372-73 (1983), *aff'd*, Opinion No. 214, 27 FERC ¶ 61,171, at 61,315 (1984) (*Mountain Fuel*).

<sup>160</sup> *Mountain Fuel*, Opinion No. 214, 27 FERC ¶ 61,171 at 61,315; Initial Decision, 22 FERC ¶ 63,102 at 65,372-73.

122. To respond, we affirm Opinion No. 517's statement that to justify an adjustment to a pipeline's equity calculation, there must be some basis to attribute the adjustment to equity. Nevertheless, we reject El Paso's reliance on *Mountain Fuel* as demonstrating a policy under which the basis must always be that the loan was made using funds generated from equity financing. In the *Mountain Fuel* Opinion No. 214, the Commission did reject an adjustment for loans to affiliates because the record failed to provide a basis to trace the amount in question to equity. However, the record in *Mountain Fuel* reflects that an adjustment based on loans to affiliates was not presented at hearing, but only presented after the initial briefs.<sup>161</sup> Consequently, the record in *Mountain Fuel* failed to provide any factual basis to support a capital structure adjustment based on a loan to the parent company, let alone a basis of funds traced directly to equity financing.<sup>162</sup>

123. We note that the Court of Appeals opinion affirming the Commission in *Distrigas* was issued in the same year as the *Mountain Fuel* opinion.<sup>163</sup> Consequently, we are faced with the *Distrigas* precedent, which traced the source of the loan to internally-generated funds and not to any stock issue,<sup>164</sup> in conjunction with the *Mountain Fuel* precedent which fails to provide any factual record, because the issue was dismissed by the presiding judge on largely procedural grounds. Moreover, the overarching goal of the Commission in the subject El Paso case is to achieve a just and reasonable result, and to achieve that result the Commission can explain departures from precedent where appropriate. Because *Mountain Fuel* was decided largely on procedural and evidentiary

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<sup>161</sup> 22 FERC ¶ 63,102 at 65,372-73 (affirming adjustment based on Account 123 – Investments in Subsidiary Companies, and noting that Staff's proposal to make an adjustment for loans to affiliates was originally argued as an adjustment for funds due via Account 146, Accounts Receivable—Associated Companies).

<sup>162</sup> *Id.* at 65,372 (noting “there is no evidence to support” staff's proposed adjustment based on accounts receivable).

<sup>163</sup> *Distrigas II*, 23 FERC ¶ 61,416 was issued in 1983, with *Mountain Fuel*, 27 FERC ¶ 61,171, issued in 1984.

<sup>164</sup> *Distrigas III*, Initial Decision, 18 FERC at 65,121 (noting claim that the regulated entity had earnings and additional cash stemming from a recent cash-infusion from the parent corporation).

grounds, we do not see the holding as supporting a change in our policy concerning the treatment of loans to affiliates.<sup>165</sup>

124. The Commission understands *Mountain Fuel* as confirming there is no assumption that a loan is automatically derived from equity financing. A proponent of a capital structure adjustment must provide some basis to attribute an affiliate loan to equity. Such a basis could be by identifying stock issued that generated the source for the loan, as implied by *Mountain Fuel*. In the alternative, a basis may be demonstrated in the larger factual context, as was the case in *Distrigas* (and as is the case in this proceeding) by demonstrating that internally-generated funds were returned to the shareholding parent. Thus, although the Commission rejected an adjustment in *Mountain Fuel* and cited the lack of evidence tracing the source of the affiliate loans in that proceeding to equity financing, we do not find that the holding establishes that equity financing is the only basis for attributing a capital structure adjustment for a loan to equity.

125. Moreover, in *Mountain Fuel*, the adjustment was ultimately rejected based on a failure to follow procedure and a lack of evidence. In *Distrigas*, the Commission did trace the source of the loan and, based on the record, found that the loan was not sourced from debt or equity financing. Instead, the record in *Distrigas* reflected that the loan was derived (as here) from revenues from operations, a separate source of capital.

126. Based on these facts, the Commission is satisfied that the holding in *Mountain Fuel*, which was based on a lack of record evidence and highlighted one line of precedent which was not met, does not impair the policy established in *Distrigas*. The policy represented in *Distrigas* was applied to facts based on a fully developed record, a record which justified an adjustment to equity based on a loan which could not be sourced to debt or equity.<sup>166</sup>

**d. The Commission Affirms its Decision Not to Reopen the Record to Permit El Paso to Argue Purchase Accounting Precedent**

127. El Paso seeks rehearing of the Commission's rejection of its supplemental brief arguing that a purchase accounting adjustment should not trigger a capital structure adjustment if it has not been shown that the accounting treatment distorted the capital

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<sup>165</sup> In addition to the rejected \$1.4 million adjustment attributed to accounts receivable or affiliate loans, the presiding judge adopted a \$3.7 million adjustment for an investment in a subsidiary.

<sup>166</sup> *Distrigas III*, Initial Decision, 18 FERC at 65,121.

structure.<sup>167</sup> The Commission affirmed the Presiding Judge's rejection of its supplemental brief, noting that the supplemental brief was untimely and no purchase accounting adjustment is present in this proceeding.

128. El Paso contests this ruling, claiming that the treatment of purchase accounting adjustment is relevant, because it is a "balance sheet asset" that was not included in the company's rate base, but rather resulted in total capitalization exceeding rate base.<sup>168</sup> El Paso seeks to rely on the Commission's order in *SFPP*, which rejected a capital structure adjustment because parties failed to demonstrate that the accounting "distorted" the company's capital structure.<sup>169</sup> El Paso claims that a similar requirement should apply in this proceeding and that the facts are generally similar, stating that the SFPP purchase accounting adjustment is like the loan balance and subsidiary earnings at issue in this case because it is "a balance sheet asset that was not included in the company's rate base, but rather resulted in total capitalization exceeding rate base." El Paso states "Clearly, the capital supporting the PAA, like the debt and equity associated with the non-rate base assets at issue in this case, was not available for investment in . . . jurisdictional operations."<sup>170</sup> El Paso argues that failure to consider the *SFPP* proceeding is error because other parties cited other *SFPP*-related cases involving purchase accounting adjustments as relevant and supporting an equity adjustment.<sup>171</sup>

129. We deny rehearing, since in this proceeding, there is no adjustment proposed to reflect a purchase accounting adjustment.<sup>172</sup> Consequently, there is no issue in this

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<sup>167</sup> *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,121, at PP 153-154 (2011).

<sup>168</sup> El Paso Rehearing at 31.

<sup>169</sup> In *SFPP*, the pipeline proposed an accounting adjustment to reflect the value it paid for an asset; however, no acquisition premium was permitted in rate base to reflect the fact that the pipeline paid a higher price than depreciated book value – consequently, the additional purchase price was accounted for outside of the value permitted for rate base.

<sup>170</sup> El Paso Rehearing at 31.

<sup>171</sup> El Paso Rehearing at 32 (citing Initial Brief of Southwest Gas Corporation, Salt River Agricultural and Improvement Power District and Arizona Corporation Commission at 24-25 (discussing Commission's discount adjustment policy)).

<sup>172</sup> An acquisition premium is an issue with respect to the cost treatment sought for Line 1903, but no Participant has proposed any adjustment to El Paso's capital structure to reflect the rejected acquisition premium or based on El Paso's accounting thereof.

proceeding whether a pipeline distorted its capital structure when it accounted for the difference between the acquisition cost and the original depreciated book cost. The Commission may waive the time for filing exceptions for good cause shown or reopen the record to address changes in law.<sup>173</sup> Because the issue addressed in Opinion No. 511 is not present in this proceeding, there is no error in failing to apply such precedent. On rehearing, we affirm our decision not to reopen the record, based merely on El Paso's general equation of the facts in the two proceedings, or to attempt to apply our purchase accounting adjustment precedent to the loan or the undistributed subsidiary earnings at issue in this proceeding.

130. El Paso suggests some unfairness, insofar as other Participants cited earlier Commission precedent involving an SFPP accounting adjustment. Opinion No. 511 did not represent a change in law, but simply applied earlier precedent requiring that an accounting adjustment to reflect the removal of an acquisition premium from rate base be shown to distort the capital structure before any adjustment is made.<sup>174</sup> El Paso has suffered no unfairness, because the precedent supporting the Commission's holding was available and could have been argued before the Commission issued Opinion No. 511. In sum, El Paso's supplemental brief was properly rejected as untimely and there is no purchase accounting adjustment issue that relates to El Paso's capital structure in this proceeding.

131. Assuming the Commission were to consider the *SFPP* precedent, it arguably supports the Commission's findings in Opinion No. 517. While it is true that an investment in a non-rate base asset or an internal accounting entry may fail to change the mix of capital invested in rate base (or the reporting of that capital ratio), the Commission specifically found to the contrary for El Paso in Opinion No. 517. In returning funds generated from operations to its shareholding parent on a long term basis, El Paso offset the equity investment made by the parent corporation.<sup>175</sup>

132. Opinion No. 517 properly determined that El Paso's proposed capital structure was not just and reasonable, because in including capital not available for investment in rate base, it subjected the ratepayers to higher capital costs over and above the cost of the

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<sup>173</sup> 18 C.F.R. § 385.711(a)(3), 385.716(c).

<sup>174</sup> Opinion No. 511, 134 FERC ¶ 61,121 at P 168 (comparing holdings from *Texaco Refining and Marketing, Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285, at P 32 (2006) (*SFPP Sepulveda Order*); *SFPP, L.P.*, 113 FERC ¶ 61,277, at PP 64-65 (2005)).

<sup>175</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 106.

capital needed to provide jurisdictional services.<sup>176</sup> Therefore, consistent with the *SFPP* opinions, an adjustment *is appropriate here* because El Paso's financial realities caused its stated capital structure ratio to differ from the mix of funds that were invested in rate base.

133. Opinion No. 511 fails to support El Paso's broader claim that the source of an asset must be traced to equity. In Opinion No. 511, the Commission rejected an equity adjustment because the accounting treatment did not change the equity ratio. However, the Commission did not reject the adjustment based on a failure to trace the source of the purchase accounting adjustment to equity financing. The source of funds for the purchase accounting adjustment in Opinion No. 511, as well as in the two prior orders cited in that opinion, was the capital used to acquire the assets used to provide service. While the Commission declined to direct an adjustment in two of those orders, Opinion No. 511 and the *SFPP Sepulveda Order*, it directed an adjustment in the third.<sup>177</sup> However, no effort was made in those proceedings to trace the source of financing for the acquisitions in those proceedings. Thus, the opinions do not support El Paso's premise that it is necessary to trace the source of an asset to equity.

e. **El Paso's Unadjusted Capital Structure is Not Representative of the Capital Invested in Regulated Activities and the Adjustment is Not Punitive**

134. El Paso argues that the Commission's actions were punitive when it applied its policies to remove Undistributed Subsidiary Earnings and the loan from the equity component of its capital structure. According to El Paso, this is because the Commission might have approved a capital structure higher than the adjusted capital structure calculated in this proceeding if the Commission adopted a hypothetical capital structure. El Paso provides an example, suggesting that if it had been financed 100 percent by equity, it would have been better off, because a hypothetical capital structure might have been adopted.<sup>178</sup> Such a hypothetical capital structure would have been based on the average capital structure of the proxy group companies, if both the pipeline's and its parent's capital structure were found to be anomalous. El Paso states that, if the Commission does not reconsider its rulings on rehearing, it should adopt a policy that adjustments to capital structure would not lower a pipeline's capital structure below a

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<sup>176</sup> *Id.* P 113.

<sup>177</sup> 113 FERC ¶ 61,277 at P 65.

<sup>178</sup> *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 143 (2005).

hypothetical capital structure consisting of the average of the proxy group capital structures.

135. We disagree. First, we note that El Paso's claim is procedurally defective. As reflected in Opinion No. 517, no Party advocated the use of a hypothetical capital structure in this proceeding.<sup>179</sup> Permitting El Paso to make this argument for the first time on rehearing would be unfair to the other Parties and permitting such arguments is disfavored by the Commission.<sup>180</sup>

136. Were the Commission to address El Paso's arguments on the merits, we find El Paso's proposal to be inconsistent with Commission policy. In *Iroquois*, the Commission rejected a request to adopt a hypothetical capital structure based on an average of its corporate investors' capital structures.<sup>181</sup> However, the Commission found use of a hypothetical capital unnecessary, finding that the pipeline's own capital structure, "as adjusted," was reasonable when compared to the equity ratios of the proxy companies and to other equity ratios approved by the Commission. The Commission stated, "most importantly," that it was "satisfied that Iroquois' own adjusted capital structure will produce just and reasonable rates." Thus, *Iroquois* demonstrates that use of an adjusted capital structure may be appropriate, and it is likewise appropriate to compare the adjusted capital structure to the proxy group.

137. Furthermore, El Paso has failed to demonstrate that either its proposed capital structure or the adjusted capital structure adopted in Opinion No 517 is anomalous when compared to the proxy group. At hearing, El Paso argued against the use of a hypothetical capital structure.<sup>182</sup> In doing so, El Paso argued that its proposed equity

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<sup>179</sup> See Opinion No. 517, 139 FERC ¶ 61,095 at P 89.

<sup>180</sup> *Transmission Relay Loadability Reliability Standard*, Order No. 733, 130 FERC ¶ 61,221 (2010), *order on reh'g and clarification*, Order No. 733-A, 134 FERC ¶ 61,127, *order on reh'g and clarification*, Order No. 733-B, 136 FERC ¶ 61,185, at P 57 (2011) (stating that the Commission looks with disfavor on parties raising issues for the first time on rehearing because other parties are not permitted to respond to a request for rehearing).

<sup>181</sup> *Iroquois*, 84 FERC at 61,448 (applying Opinion No. 414, and adopting adjusted capital structure after excluding cash reserves that were held for distribution after the test period).

<sup>182</sup> El Paso Initial Brief at 14-15 (comparing adjusted capital structure to use of hypothetical capital structure, which is contrary to the Commission's preference to use the pipeline's actual capital structure).

ratio was reasonable, as being within the range of the equity ratios of the proxy group and other equity ratios approved by the Commission.<sup>183</sup> El Paso submitted testimony asserting that El Paso's proposed 60 percent equity ratio was "not unusual" given a sample ranging from 37 to 75 percent book value equity, or 37 to 80 percent market value equity.<sup>184</sup> Thus, El Paso's own exhibits refute any finding that either El Paso's proposed capital structure (60 percent) or the adjusted capital structure (estimated on rehearing at 49 percent) are anomalous.

138. As discussed earlier, the Commission's goal in assessing a pipeline's capital structure is to calculate a rate of return that is representative of the types and relative amounts of capital invested in the pipeline's rate base.<sup>185</sup> In Opinion No. 517, the Commission proposed adjustments to El Paso's proposed capital structure to reflect the fact that the original amount reflected funds that were not available for investment in rate base. The funds were not available either because they were generated by El Paso's subsidiary, Mojave, and not forwarded to El Paso, or had been left in the control of El Paso's shareholding parent corporation.<sup>186</sup> On rehearing, we affirm these findings, with the implication that El Paso's capital structure as adjusted is a better reflection of the composition of the capital invested in rate base.

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<sup>183</sup> Brief on Exceptions at 14 ("the record clearly demonstrates that [El Paso's] actual equity ratio is within the range of the equity ratios of the proxy group and other equity ratios approved by the Commission," citing Ex. EPG-335 at 21-23, EPG-374 at 15-17, EPG-376 and EPG-377). See Ex. EPG-376 (El Paso supported its claim with data from Form No. 2 comparing capital structures for 25 companies, with equity ratios ranging from 19 to 82 percent and averaging 56 percent).

<sup>184</sup> Ex. EPG-335 at 21-22 (Vilbert rebuttal test.).

<sup>185</sup> *United Gas*, 13 FERC at 61,096 ("the rate of return capitalization should, as nearly as possible, be representative of the types and relative amounts of capital invested in the company's rate base to which the rate of return is applied").

<sup>186</sup> Mojave's cash revenues from operations are held by an operating company affiliate that participates in the Cash Management Program. Mojave carries a substantial balance with the operating company, over and above the amount of the Undistributed Subsidiary Earnings. See Mojave's FERC Form No. 2 at page 122.8 (April 20, 2009) (reporting \$371.8 million balance in Account 146, Accounts Receivable from Associated Companies, at the December 31, 2008 end of the test period). No party raised an issue on rehearing whether the balance above Undistributed Subsidiary Earnings could represent an additional, indirect loan to El Paso Corp.

139. As for El Paso's suggestion that the Commission instead adopt a new policy to use a hypothetical capital structure whenever an adjustment that causes a company's capital structure to fall below average, we decline to adopt such a policy on this record and will continue to apply existing policies which are based on achieving a just and reasonable result after assessing, among other things, the financial circumstances of each pipeline seeking approval for its rates. The Commission's use of a hypothetical structure is intended to be the exception, as the Commission prefers to use a pipeline company's own capital structure.<sup>187</sup> The Commission examines a proposed capital structure in relation to the range of capital structures represented by the proxy group. El Paso would have the Commission compare the proxy structure to the proxy group average. The appropriate comparison is to the range of capital structures in the proxy group to determine whether the capital structure being considered is so far from the norm to fall outside the range of comparable companies that are represented in the proxy group. Absent such a determination, the average is not examined. We conclude that, were we to consider the issue, the record in this proceeding fails to support the use of a hypothetical capital structure. El Paso's capital structure is market tested and, as adjusted, a just and reasonable reflection of the mix of capital invested in regulated activities.

f. **El Paso Was Not Prejudiced by Its Inability to Cross Examine a Staff Witness on Capital Structure Issues**

140. In its Rehearing, El Paso copies its objection to the Presiding Judge's admittance of Trial Staff witness Barlow's testimony, despite the fact that Mr. Barlow became ill and was not available for cross examination.<sup>188</sup> On rehearing, El Paso faults the Presiding Judge's decision and the Commission's failure to address its exceptions on this issue.<sup>189</sup>

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<sup>187</sup> *Williams Natural Gas Co.*, 80 FERC ¶ 61,158, at 61,683 (1997) (“Traditionally, the Commission has preferred to utilize the applicant's own capital structure and will continue to do so if the applicant issues its own non-guaranteed debt and has its own bond rating. But the Commission will utilize an imputed capital structure (most often that of the corporate parent) if the record in a particular case reveals that the pipeline's own equity ratio is so far outside the range of other equity ratios approved by the Commission and the range of proxy company equity ratios that it is unreasonable”).

<sup>188</sup> El Paso Rehearing at 19.

<sup>189</sup> *Id.* at 19 n.1. In its Brief on Exceptions, El Paso argued that the Presiding Judge's decision to reject a Staff stipulation (designed to prevent a denial of due process) and admit Mr. Barlow's testimony without cross-examination was error. At 11 n.1.

141. Initially, we note that El Paso fails to identify how it was prejudiced by the error, if any, in admitting Mr. Barlow's testimony. In making its claim, El Paso states that the theory adopted by the Commission was "advanced primarily" by Trial Staff witness Barlow. Elsewhere, El Paso gives another witness the credit, describing Joint Parties' witness Lesser as the "primary proponent" for adjusting the equity capitalization figure.<sup>190</sup> The fact that El Paso was able to fully question Dr. Lesser mitigates its inability to question Mr. Barlow.

142. Regardless, the theory adopted by the Commission was established in its long-standing precedent. Furthermore, although El Paso seeks to strike Mr. Barlow's testimony arguing in favor of the equity adjustment, elsewhere El Paso seeks to rely on a portion of Mr. Barlow's testimony.<sup>191</sup> We find that El Paso has failed to demonstrate that it was prejudiced by the failure to exclude Mr. Barlow's testimony. The testimony that El Paso seeks to strike largely addresses a policy issue. This issue was addressed and was thoroughly argued on brief and rehearing. Consequently, we find that El Paso has had ample opportunity to address the underlying policy issues and the Commission rejects its request for rehearing on the admittance of Mr. Barlow's testimony and failure to stipulate conditions as to its use.

**g. El Paso Failed to Support a Working Capital Adjustment**

143. Referring to the testimony of Staff Witness Barlow, El Paso argues that it should be permitted to offset any equity adjustment by adding back \$25 million to represent working capital.<sup>192</sup> Staff witnesses proposed the add-back to represent cash liquidity needs, based on the Commission's so called 45-day rule, which historically determined working capital based on an approximation of cash needs for 45 days, estimated as 1/8 of operations and maintenance expense. However, El Paso's proposal is inconsistent with the Commission's policy that requires a gas company claiming a cash working capital allowance greater than zero to support it with a lead-lag study.<sup>193</sup> In Order No. 383, the Commission confirmed that computerization and other improvements in billing procedures resulted in a reduction of collection times which made the 45-day rule unreliable. Similarly, the *Distrigas* proceeding demonstrates difficulty with the 45-day

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<sup>190</sup> El Paso Rehearing at 24.

<sup>191</sup> *Id.* at 59.

<sup>192</sup> *Id.* (citing Ex. S-9 at 12; Ex. S-1 at 33-35).

<sup>193</sup> 18 C.F.R. § 154.306 (Cash Working Capital); Order No. 383, FERC Stats. and Regs. ¶ 30,574 at 30,989-93.

rule, because billing practices permitted collection of payment in advance, which would undercut the basis for the adjustment. Neither El Paso, nor the Trial Staff testimony on which it relies, provides a lead-lag study to support the \$25 million figure, or any other figure. Consequently, we deny rehearing as to the \$25 million adjustment for working capital.

**h. El Paso Failed to Demonstrate that the Adjusted Capital Structure is Inappropriate for Ratemaking Purposes**

144. On rehearing, El Paso reiterates its position that the capital structure adjustment is flawed because it would reduce El Paso's total capitalization below El Paso's capital needs. El Paso states that the \$760 million adjustment leaves approximately \$2.2 billion in capitalization, which is insufficient to fund \$2.7 billion in "rate base related assets" and subsidiary investments, before deduction of deferred income tax liabilities.<sup>194</sup> El Paso cites its witness's position that it is unsound to reduce a pipeline's capitalization below the level needed to fund its gross assets.<sup>195</sup> El Paso claims that the adjustment should not include \$25 million in working capital or \$415 to \$427 in deferred income tax.<sup>196</sup>

145. El Paso objects to the Commission's statement that the adjustments are for ratemaking purposes, stating that rates simply cannot be based on capitalization that is insufficient to fund the company's gross balance sheet assets.<sup>197</sup> El Paso acknowledges the Commission's reliance on *Williston Basin Interstate Pipeline Co.*, 84 FERC ¶ 61,081, at 61,378 (1998) for the proposition that no adjustments are needed when capitalization falls below rate base. However, El Paso states that *Williston* "has no bearing on the validity of an adjustment reducing a pipeline's total capitalization below the amount needed to fund its assets" and characterizes the case as "refusing to impute short-term debt because rate base exceeded capitalization."<sup>198</sup> El Paso asserts that "the appropriate

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<sup>194</sup> El Paso Rehearing at 60 (not including cash or liquid assets).

<sup>195</sup> *Id.* (citing Ex. EPG-329 at 4).

<sup>196</sup> *Id.* at 60 n.59.

<sup>197</sup> *Id.* at 61 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 110).

<sup>198</sup> *Id.* at 61 n.61.

comparison” is its capitalization with its “net plant and other cash assets on its balance sheet,” not rate base.<sup>199</sup>

146. On rehearing El Paso provides no new argument to support its position. We therefore affirm the Commission’s holding on these matters in Opinion No. 517.

147. El Paso’s arguments remain unconvincing, primarily because El Paso, by its own admission, fails to provide a full accounting. That is, although El Paso argues that the \$2.2 billion in adjusted capitalization is insufficient to fund \$2.7 billion in “rate base related assets and subsidiary investments,” El Paso’s tally fails to include an asset representing the loan itself. By El Paso’s accounting, even if the adjustment were not made, El Paso’s \$2.9 billion in unadjusted capitalization would be insufficient to support the rate base related assets, subsidiary investments and loans to affiliates including the \$2.7 billion identified capital needs, the \$615 million loan and some provision for the \$145 million in undistributed subsidiary earnings. A more complete analysis would incorporate other sources for funding assets, such as deferred income tax and other liabilities. Such an analysis would more accurately mirror El Paso’s financial affairs and better reconcile its outstanding financial obligations and needs.<sup>200</sup> Accordingly, we deny rehearing on this issue.

### C. Line 1903

148. El Paso contests the Commission’s rejection of its request to roll-in an additional \$25.7 million for the 88-mile Line 1903, which was converted to jurisdictional gas transportation service and placed in service in 2005.<sup>201</sup> El Paso reports that Line 1903 was purchased in 2000 as part of an acquisition of All American Pipeline oil pipeline assets that ran through El Paso’s service territory.<sup>202</sup> El Paso reports that it originally

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<sup>199</sup> El Paso calculates \$2.7 billion in assets, excluding construction work in progress, the loan to parent, receivables and other non-cash related assets, “system encroachments” and assets that may be funded by the deferred income taxes. *See* Ex. EPG-374 at 47.

<sup>200</sup> *See* Ex. EPG-331 at 2-5 (El Paso’s 2008 FERC Form No. 2, comparative balance sheet); *see also* Joint Parties Brief Opposing Exceptions at 42 (providing accounting breakdown based on Form No. 2 data).

<sup>201</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 49 (approving roll in of \$10.5 million as acquisition cost of Line 1903).

<sup>202</sup> In 2000, El Paso purchased the 785-mile pipeline (later named Line 2000) beginning in Texas and extending to Ehrenberg, Ariz., along with a connecting 303-mile

(continued ...)

sought to purchase the 785-mile Line 2000 segment for \$125 million. However, El Paso claims that it agreed to pay an additional \$4 million for 303 miles of oil pipeline, including the portion of Line 1903 extending from Ehrenberg, Ariz. to Cadiz, Cal. and the remaining 215-mile segment of oil pipeline in California. El Paso claims that the seller insisted on selling the entire 1,088-mile All American Pipeline.<sup>203</sup> El Paso nevertheless allocated only \$93.1 million of the \$129.3 million purchase price as the acquisition cost for Line 2000 when it was placed in service in 2002.<sup>204</sup>

149. In Opinion No. 517, the Commission accepted \$10.5 million as the Line 1903 acquisition cost, based on the per-mile allocation of the total purchase price, and rejected recovery of additional costs associated with the California segment as not being “used or useful.”<sup>205</sup> The Commission cited its holding in the Line 1903 Certificate Order, as limiting the section 7 rate predetermination of rolled-in rate treatment “to the costs associated with the 87.8 mile portion,” or \$10.5 million, and deferred the issue of the costs related to the California segment (\$25.7 million) to this rate case.<sup>206</sup> In Opinion No. 517, the Commission rejected El Paso’s proposal that the remaining costs be allocated to Line 1903 because the unconverted California segment had no value. The Commission accepted the Presiding Judge’s finding that the mileage-based methodology

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section of All American’s facilities in California, running through Cadiz, Cal. and ultimately terminating at the Emidio pumping station near Bakersfield, Cal. ID, 134 FERC ¶ 63,003 at P 30.

<sup>203</sup> ID, 134 FERC ¶ 63,003 at PP 47, 51; Opinion No. 517, 139 FERC ¶ 61,095 at P 47 n.53.

<sup>204</sup> *El Paso Natural Gas Co.*, 95 FERC ¶ 61,176 (2001) (Line 2000 Certificate Order); El Paso Dec. 12, 2000 Data Response No. 2 submitted in Docket No. CP00-422-000 (stating that El Paso paid \$93.1 million to its wholly-owned subsidiary for Line 2000 and that El Paso allocated the \$129 million total acquisition costs for the All American assets between the California and non-California portions based on miles of pipe).

<sup>205</sup> Opinion No. 517, 139 FERC ¶ 61,095 at PP 46, 49. *See also El Paso Natural Gas Co.*, 111 FERC ¶ 61,408, at P 42 (*Line 1903 Certificate Order*), *reh’g denied*, 113 FERC ¶ 61,183 (2005) (*Line 1903 Rehearing Order*), *reh’g denied*, 115 FERC ¶ 61,083 (2006) (affirming ratepayer benefits from contract extensions).

<sup>206</sup> Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 42; Line 1903 Rehearing Order, 113 FERC ¶ 61,183 at P 9 (“the June 16 Order determined that El Paso had included the cost of acquiring all 303 miles of Line 1903, rather than the 87.8-mile long segment of Line 1903 that El Paso proposed to acquire in its application”).

provides the only credible evidence of El Paso's original valuation of Line 1903,<sup>207</sup> noting the Commission's requirement that gas plant be valued and recorded at actual cost.<sup>208</sup> The Commission also rejected El Paso's theory that it should recover additional funds, based on a showing that benefits exceeded costs. The Commission instead found a showing of benefits irrelevant to determining the acquisition costs.<sup>209</sup>

150. Finally, the Commission found that El Paso had failed to provide sufficient documentation on the record in this proceeding to support an adjustment to its depreciable plant accounts to reflect the exclusion of \$25.7 million.<sup>210</sup>

### 1. Request for Rehearing

151. On rehearing, El Paso again reasserts its position, stating that it had agreed to pay \$125 million for the 785-mile Line 2000 segment of the All American Pipeline in 2000, but agreed to raise its initial offer by \$4 million, to acquire Line 1903 and the remaining unused California segment, when the seller insisted on selling the whole line.<sup>211</sup> El Paso seeks to increase the \$10.5 million sales cost amount, which was the amount approved in the certificate proceeding for Line 1903, to \$36.2 million, arguing that the California segment never had any value,<sup>212</sup> that the Line 1903 project would have cost more than \$36.2 million to build as new construction, and that ratepayers benefit because revenues from the pipeline exceed the \$36.2 million.

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<sup>207</sup> ID, 134 FERC ¶ 63,003 at PP 47, 51 (noting that El Paso's witness did not participate in sale negotiations and provided no evidence to support his assertion that All American insisted that El Paso assume ownership of all All American assets).

<sup>208</sup> 18 C.F.R. Pt. 201, Gas Plant Instruction Nos. 2, Gas plant recorded at cost and 5, Gas plant purchased or sold.

<sup>209</sup> Trial Staff estimated a \$4 million decrease in the cost of service when \$10.5 million is used for Line 1903. Ex. S-4 at 14 (Radel testimony).

<sup>210</sup> Because the 2010 Settlement establishes "black box rates," the adjustments for depreciable plant would not affect rates in this proceeding. ID, 134 FERC ¶ 63,002 at PP 48, 50.

<sup>211</sup> El Paso Rehearing at 68.

<sup>212</sup> El Paso Rehearing at 69.

152. El Paso argues that, because the cost of purchasing the entire All American oil pipeline was less than it would have cost to construct Line 1903 alone, it should recover the full purchase price.<sup>213</sup> El Paso claims that permitting recovery of only the amount approved in the certificate ignores other factors related to the All American Pipeline purchase. According to El Paso, it would have cost approximately \$180 million to build a new Line 1903, while the entire capital cost of the Line 1903 conversion project was only about \$74 million. Consequently, El Paso uses this comparison to claim customer savings of over \$100 million in capital costs compared to the hypothetical new construction. El Paso suggests that unless it is allowed to recover all it seeks on rehearing, this may spur pipelines to build entirely new, more expensive facilities instead of converting existing pipeline infrastructure to new uses.

153. El Paso notes the Commission's reference to *Enbridge Pipelines (KPC)*, which reflects the Commission's policy to record jurisdictional pipeline assets at net book value, subject to increasing this amount up to the purchase price upon a showing of tangible benefits through an acquisition premium.<sup>214</sup> Although El Paso objects to the Commission's reliance on the acquisition premium analysis, El Paso claims that it fulfilled the requirements for an acquisition premium because the pipeline is being placed in jurisdictional service for the first time and provides substantial benefits in the form of savings over the hypothetical new construction.

154. El Paso also notes that shippers entered into \$46 million in contracts over paths that include Line 1903. El Paso argues that this figure exceeds Line 1903's \$31.1 million cost of service, even if the \$36.2 million it seeks is included in rate base.<sup>215</sup> On that basis, El Paso claims a direct benefit to El Paso's customers of \$15 million, based on the fact that the contract revenues exceed its claimed costs (\$46 million - \$31 million). El Paso claims that ratepayers directly benefit because additional Line 1903 revenues mean that fewer system costs must be recovered from other services.

155. El Paso also argues that it has demonstrated system benefits under the Commission's roll-in analysis, noting that, in the Line 1903 certificate proceeding, the Commission found that the Line 1903 capacity would provide increased system

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<sup>213</sup> El Paso Rehearing at 70-71 (citing new construction cost estimate of about \$2 million per mile; Ex. EPG-83 at 33).

<sup>214</sup> *Enbridge Pipelines(KPC)*, 100 FERC ¶ 61,260, at P 48 (2002).

<sup>215</sup> El Paso Rehearing at 73.

flexibility and increased system reliability.<sup>216</sup> El Paso notes that the Commission found in the Line 1903 Rehearing Order that “the Line 1903 project provides enhanced reliability for all shippers through a new north-south interconnect and decreased reliance on displacement, new service to the expansion shippers, and a way for the extension shippers to use their north system capacity to access their markets directly.”<sup>217</sup>

According to El Paso, the Commission also found that the Line 1903 capacity increased access to low-cost Rocky Mountain gas supplies and reduced gas supply costs for El Paso’s customers, claiming that Rockies supplies have typically been priced lower than San Juan or Permian supplies since Line 1903 was placed in service.<sup>218</sup> El Paso estimates that Line 1903 saved \$24 million annually in fuel costs.<sup>219</sup> El Paso states that the Commission should consider jointly the benefits of the Line 1903 and Line 2000 projects, because together they represent the aggregate benefits of the All American purchase, claiming substantial benefits from Line 2000.<sup>220</sup> In addition, the Line 2000 Power-Up project added another 320 MMcf/day to serve the converting full requirements shippers, and provided similar benefits to all shippers on the system.<sup>221</sup>

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<sup>216</sup> *Id.* at 74 (citing Line 1903 Certificate Order, 111 FERC ¶ 61,408 at PP 39-40, 56. *See also* Line 1903 Rehearing Order, 113 FERC ¶ 61,183 at PP 10, 28-29. *Certification of New Interstate Natural Gas Pipeline Facilities*, 88 FERC ¶ 61,227, at 61,746 (1999) (Certificate Policy Statement)).

<sup>217</sup> *Id.* (quoting Line 1903 Rehearing Order, 113 FERC ¶ 61,183 at P 29).

<sup>218</sup> *Id.* at 75 (citing Ex. EPG-368 at 16-20).

<sup>219</sup> *Id.* (citing Ex. EPG-372, Westhoff test.).

<sup>220</sup> El Paso Rehearing at 75-76 (citing Ex. EPG-368 at 18-20; Line 2000 Certificate Order, 95 FERC at 61,573).

<sup>221</sup> *Id.* at 76 (citing *El Paso Natural Gas Co.*, 103 FERC ¶ 61,280 (Power-Up Project Certification Order), *order denying reh’g and granting clarification*, 105 FERC ¶ 61,202 (2003)). El Paso argues additional benefits from the projects insofar as the projects added capacity to the California border even though the additional capacity rights were allocated to East of California locations. Therefore, the capacity downstream of the East of California locations was available to provide gas for customers in California, to operationally facilitate hourly and daily variations in East of California areas (or EOC), and to be used on an alternate delivery basis. Citing Line 2000 Certificate Order, 95 FERC at 61,573; Ex. EPG 374 at 52.

156. In sum, El Paso claims ratepayer benefits of \$100 million (compared with a new pipeline), additional net revenues of approximately \$15 million, and fuel savings of approximately \$24 million as a direct and proximate result of the All American Pipeline acquisition. El Paso concludes that these benefits alone justify inclusion of the remaining purchase price in rate base, whether under the acquisition premium or the roll-in standard.

157. El Paso attempts to address the Commission's point that project benefits do not establish plant acquisition costs, stating that it never contended the Line 1903 project's benefits establish the original cost of Line 1903.<sup>222</sup> Furthermore, El Paso challenges the Commission's conclusion that El Paso misconstrued the Certificate Policy Statement to suggest that system benefits justify the roll-in of costs other than original acquisition costs, claiming that the Commission's assertion begs the question of what the original acquisition costs are. According to El Paso, the original acquisition costs are determined by the price paid for the All American Pipeline, not in the later certificate proceedings.

158. El Paso contests the Commission's reliance on the mileage-based methodology that was used in the Line 2000 certificate proceeding as the only credible evidence of the cost-basis of the used-and-useful portion of its original valuation of the All American assets including the Line 1903 segment and the unconverted California segment, noting that the filing occurred about six months after the acquisition.<sup>223</sup> El Paso faults the Commission for failing to consider relevant El Paso's claim in this proceeding that it had no wish to purchase the Line 1903 and California segments of the All American Pipeline. El Paso cites the rebuttal testimony of its witness, Rexford D. Adams, of his understanding that El Paso initially offered to purchase only the portion located east of California, which was converted to gas service as Line 2000, and that, to complete the purchase, it agreed "at the seller's insistence" to purchase what would become Line 1903 and the California segment for an additional \$4 million.<sup>224</sup>

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<sup>222</sup> *Id.* (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 49).

<sup>223</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 47.

<sup>224</sup> El Paso Rehearing at 78 (citing Ex. EPG-83 at 32-33, Adams direct test. stating: "As the negotiations were nearing their conclusion, the All American negotiators threw in all of the California assets for an additional \$4 million. Reviewing the original purchase with backwards looking vision and clarity, since the Line 1903 assets and the Line 2000 assets are included in this rate case and are rolled-in to costs in determining rates, it is fair that the entire purchase cost be included as well.").

159. El Paso essentially insists that the Commission should have used other evidence of the valuation of the property, rather than concluding that the mileage-based utility methodology provides the best reasonable and credible evidence of valuation for the acquired All American Pipeline assets. According to El Paso, “the only evidence in the record about how [El Paso] originally valued the California portion of the line is that [El Paso] valued it at no more than \$4 million, since that is the additional amount [El Paso] agreed to pay when the seller insisted [El Paso] buy the California portion in addition to the east of California portion that [El Paso] originally sought to purchase.”<sup>225</sup> According to El Paso, this contradicts the Commission’s finding that a mileage-based allocation methodology provides the original valuation. El Paso argues it is “more accurate” to say it agreed to pay \$4 million more for the East of California pipeline, which became Line 2000, and continued to place no value on the portion of the pipeline that included Line 1903 and the unused California segments.<sup>226</sup> Nevertheless, El Paso argues that this does not mean it should be limited to rolling in only \$4 million for the Line 1903 project; rather, it asserts that the additional \$4 million is more appropriately attributed to Line 2000, not to the Line 1903 California portion. El Paso suggests that, because it may not have allocated enough costs to the Line 2000 project, then rolling in the additional costs is justified because the Commission acknowledged that Line 2000 provided benefits for ratepayers.<sup>227</sup> According to El Paso, these Line 2000 benefits justify rolling in \$125 million of the purchase price -- or even \$129 million -- while Line 1903 benefits justify rolling-in any remaining amount.

160. El Paso defends its reliance on value rather than mileage of pipe utilized to assign costs to assets purchased in a group, citing its witness Lovinger’s testimony that the cost assigned to each asset should be based on the fair value of each asset.<sup>228</sup> El Paso notes that the Commission considers Financial Accounting Standards Board (FASB) statements authoritative and relies on them to interpret the Uniform System of Accounts. El Paso defends allocating \$36.2 million to Line 1903 as fully consistent with the Fair Value

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<sup>225</sup> *Id.*

<sup>226</sup> *Id.* at 79.

<sup>227</sup> El Paso Rehearing at 78-79 (citing Line 2000 Certificate Order, 95 FERC at 61,573-76).

<sup>228</sup> *Id.* at 80 (citing Ex. EPG-329 at 20, Lovinger rebuttal test.). El Paso reports that valuing Line 1903 should comply with Financial Accounting Standard Board’s (FASB) Statement No. 157 (SFAS No. 157), which provides three approaches to value an asset: market, income and cost.

Measurement concept SFAS No. 157, including under the cost valuation approach.<sup>229</sup> El Paso contests the Commission's failure to accept SFAS No. 157 because it was not issued until 2006, after El Paso purchased the pipeline, claiming that SFAS No. 157 reflects the Commission's methodology for valuing assets purchased as a group.<sup>230</sup> According to El Paso, even though such methodology was codified and issued after the purchase, and El Paso could not have relied upon it, the Commission should nevertheless have used it.<sup>231</sup>

161. El Paso also repeats its prior arguments below that the oil pipeline purchase should be treated similar to the case when a utility acquires more land than is needed for gas utility purposes.<sup>232</sup> According to El Paso, the purchase price used for utility purposes is reduced by the fair market value of the land not used for utility purposes, unless the Commission permits the cost of the entire lot to be included in rates when the value of the useful land is equal to the full purchase price.

162. Applying its rationale, El Paso proposes to allocate some or the entire additional \$4 million to the unused California segment, and deduct that allocation from the \$25.7 million in remaining unallocated costs.<sup>233</sup> El Paso contests the Commission's core conclusion, to use a mileage-based measure of utility for cost recovery, which El Paso states only permits the recovery of "what the Commission views as the original acquisition cost of Line 1903."<sup>234</sup> El Paso believes this is unreasonable because it did not want to acquire the California portion of the line when it acquired the All American

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<sup>229</sup> Citing Ex. EPG-329 at 18, 23.

<sup>230</sup> El Paso Rehearing at 81.

<sup>231</sup> *But see* Ex. EPG-382 at 30 (SEC Form 10-K, noting El Paso's election to adopt SFAS No. 157 "in measuring the fair value of financial assets and liabilities in the financial statements" but deferring adoption "for certain of our non-financial assets and liabilities until January 1, 2009").

<sup>232</sup> *E.g.*, 18 C.F.R. pt. 201, Gas Plant Instruction No. 7(G) (land and land rights).

<sup>233</sup> El Paso Rehearing at 82. In short, El Paso proposes to add the \$25.7 million associated with the purchase of the unused California segment to the \$10.5 million already approved for roll-in the certificate predetermination, less a figure representing some portion of the additional \$4 million paid to acquire all the California assets, including Line 1903.

<sup>234</sup> El Paso Rehearing at 82.

assets. El Paso suggests that the original book value of the unused Cadiz-to-Emidio segment should be considered to be zero or, at most, an appropriate portion of the \$4 million paid for the California facilities, instead of the \$25.7 million that the Commission determined was the original cost of the unused Cadiz-to-Emidio Line.

163. El Paso argues the market value of the Cadiz-to-Emidio segment is negligible, citing failed open seasons for natural gas service and attempts to sell the pipeline for other product services.<sup>235</sup> El Paso concludes that allocating the entire remaining \$36.2 million purchase price to Line 1903, and \$0 to the remaining segment running from Cadiz, Cal. to the Emidio Pumping Station near Bakersfield, is more consistent with the “Fair Value Measurement” concept under SFAS No. 157, whether an original cost or current market value approach to valuation is used.

164. Finally, El Paso requests rehearing of the Commission’s finding that it had failed to support an adjustment to its depreciable plant accounts to exclude \$25.7 million.<sup>236</sup> According to El Paso, it recognized depreciation on the disputed \$25.7 million purchase price which it booked to Account No. 101 since December 31, 2005. El Paso asserts that the booked ADIT reflects the difference between such recognized book depreciation and tax depreciation. El Paso notes that the resolution of this issue does not affect the rates in this proceeding, which were settled. El Paso states that, if the entire \$36.2 million is not included in El Paso’s rates, the actual depreciation, depletion and amortization (DD&A) reserves and DITs to be excluded will be determined in El Paso’s next rate case.

165. El Paso reports that it also booked accumulated depreciation and deferred income taxes associated with the purchase price attributed to the Cadiz-to-Emidio segment. Accordingly, to be consistent with the Commission’s exclusion of the \$25.7 million, El Paso seeks to adjust its accounts by eliminating the accumulated depreciation and DITs associated with that \$25.7 million. El Paso seeks clarification that no decision on this accumulated depreciation, and related deferred taxes issue in this proceeding will

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<sup>235</sup> *Id.* at 83. El Paso reports that the Cadiz-to-Emidio Line currently is in what is called a nitrogen blanket, to preserve the pipe for future use, and touts its restraint in that it has not sought to recover in its natural gas transportation rates an additional \$9.2 million in preservation and right-of-way costs related to the inoperative crude oil pipeline. Ex. EPG-368 at 10. El Paso’s witness Adams also describes an El Paso proposal to credit rate payers for any sales proceeds for the unused segment up to the allocated purchase price less interim costs.

<sup>236</sup> The Commission found that El Paso failed to demonstrate that it booked accumulated depreciation and deferred income taxes based on California segment costs. Opinion No. 517, 139 FERC ¶ 61,095 at P 51.

“prejudice” the issue of the appropriate book entries for accounting purposes in compliance with Opinion No. 517. El Paso states there are no rate consequences in the instant proceeding, but that it is required to maintain its books and records for accounting and reporting purposes in compliance with the accounting principles and Commission orders.

## 2. Commission Determination

166. The Commission clarifies the impact of its holding on El Paso’s accounting to reflect the reclassification of costs relating to Line 1903, as discussed more fully below. Otherwise, the Commission denies rehearing and affirms its holding that El Paso’s rates should reflect the \$10.5 million in per-mile acquisition costs associated with Line 1903. El Paso should exclude the remainder of the unallocated costs arising from its acquisition of the All American Pipeline assets.

167. Opinion No. 517 reasonably rejected El Paso’s proposal to roll-in and recover in its cost of service the full remaining cost of the All American Pipeline (\$36.2 million) as the value of the Line 1903 segment. The Commission explained that rolling-in the remaining \$36.2 million would allow the recovery of \$25.7 million of costs for facilities that were never “used or useful” namely the costs of the unused California segment. The Commission affirms its disallowance of costs related to the acquisition of the unused California segment. Although there may be various methods of evaluating costs and the utility of an acquisition for recovery in rates, the method used in Opinion No. 517 for Line 1903 was reasonable in the circumstances, notwithstanding El Paso’s arguments to the contrary.

168. Under the used and useful doctrine, customers’ rates are generally limited to the costs of facilities devoted to jurisdictional service. The Commission employs a balancing test to determine whether a pipeline may include costs of facilities not devoted to jurisdictional service, weighing customers’ interest in fair rates against the pipeline’s interest in “maintaining financial integrity and access to capital markets.”<sup>237</sup> El Paso’s purchase of the All American Pipeline assets does not present the typical case where a planned plant is cancelled before being devoted to jurisdictional services, but instead involves the acquisition of facilities that were devoted to another service and were never devoted to jurisdictional service (and, according to El Paso, are not likely to be). Thus, as El Paso indicates, this case also presents the issue of dividing the purchase price between Line 1903 and the unused California facilities. On rehearing, we affirm that El Paso has failed to support its proposal to roll in the additional \$25.7 million in acquisition costs.

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<sup>237</sup> *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987); *Town of Norwood, Mass. v. FERC*, 80 F.3d 526 (D.C. Cir. 1996).

For less than that amount it would not be inconceivable for a large shipper to construct a bypass to serve itself. It is not reasonable to allocate these costs to shippers at this late juncture, contrary to the allowance originally granted in the certificate proceeding, and El Paso's decision to pay for the entire All American Pipeline was its own (sellers may insist on certain conditions of offer, but the buyer need not accept).

169. In Opinion No. 517, the Commission rejected El Paso's attempt to allocate \$0.00 to the unused California segment, citing the Uniform System of Accounts requirement that gas plant be valued and recorded at actual cost.<sup>238</sup> El Paso has simply failed to support replacing the mileage-based cost allocation with a different allocation based on El Paso's subsequent valuation of the pipeline. The mileage-based cost allocation methodology has a reasonable basis in the circumstances, and there is no clear basis for replacing it as El Paso seeks. The Commission again confirms the Presiding Judge's finding that the mileage-based methodology credibly reflects El Paso's original valuation of the All American assets and rationally supports the original valuation of Line 1903 and the California segment.<sup>239</sup>

170. El Paso asks that no costs at all should be attributed to the unused California segment and that any such cost should be attributed to the facilities that were placed in service. This allocation is unreasonable, as there was certainly some cost for each portion of the All American Pipeline that made up its entirety. El Paso claims the seller insisted that it take the entire pipeline from Texas to Bakersfield, Cal., whereas El Paso wished to purchase only the section from Texas to Ehrenberg, Ariz. However, El Paso need not have accepted, but did, and, in any event, its scenario as an "unwilling" buyer was not clearly proven at hearing. There, the Presiding Judge weighed the evidence and found that El Paso had failed to support its justification for the sale.<sup>240</sup> We find the Judge's finding adequately supported. In the Initial Decision, the Presiding Judge noted that El Paso's witness was not present at the negotiations; furthermore, we note that El Paso's witness provided his "understanding" in rebuttal testimony delivered in summer 2009 for the hearing.<sup>241</sup> Earlier, in testimony accompanying the June 30, 2008 rate filing, the

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<sup>238</sup> 18 C.F.R. pt. 201, Gas Plant Instruction No. 2, Gas plant recorded at cost and Gas Plant Instruction No. 5, Gas plant purchased or sold).

<sup>239</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 47 n.53 (citing ID, 134 FERC ¶ 63,003 at PP 47, 51).

<sup>240</sup> ID, 134 FERC ¶ 63,003 at PP 47, 51 (noting that El Paso's witness did not participate in sale negotiations and provided no evidence to support his assertion that All American insisted that El Paso assume ownership of the California facilities).

<sup>241</sup> Ex. EPG-368 at 11.

witness testified that the seller “*threw in* all of the California assets” for an additional \$4 million.<sup>242</sup> Thus, the initial description of the negotiations might even suggest that it was the opportunity for a bargain, not the seller’s insistence, that motivated El Paso’s acquisition. In any event, whether El Paso was reluctant to buy unusable assets or not, it did in fact do so. El Paso deferred the issue whether it was justified in recovering the cost of acquiring the California assets as a cost of acquiring the useful assets until this section 4 rate case.<sup>243</sup> Permitting El Paso to claim various cost assessments for Line 1903 based on different circumstances is inconsistent with the Commission’s policy to review cost and accounting at the time of an acquisition.<sup>244</sup> At this juncture, there is no basis to allow recovery of any more of the original purchase cost than what has been used and useful.

171. El Paso does not address the disparate justifications for the sale and, at any rate, has already abandoned pursuing an acquisition cost of \$4 million based on the sales negotiations. Instead, El Paso adopts some portion of the \$36.2 million figure remaining from the Line 2000 acquisition, based on the miles of pipe methodology, albeit for both the remaining segments, Line 1903 and the unused California segment. The evidence in this proceeding supports finding that \$10.5 million provides a credible accounting of

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<sup>242</sup> Ex. EPG-83 at 33 (Adams test.). At that time, the witness did not characterize the cost to acquire the additional California facilities as a cost to acquire the remaining used and useful facilities, but provided only a tepid defense of its proposal: “Reviewing the original purchase with backwards looking vision and clarity, since the Line 1903 assets and the Line 2000 assets are included in this rate case and are rolled-in to costs in determining rates, it is fair that the entire purchase cost be included as well.” *See also* El Paso Dec. 3, 2004 answer in Docket No. CP05-2-000 at 17 (“El Paso had offered in negotiations \$125 million for the portion of the All American Pipeline from McCamey, Texas to the California border and only purchased the segment from the California border to roughly Emidio when the All American sellers offered this additional mileage for a small additional cost of \$4 million, or a total purchase cost of \$129 million.”).

<sup>243</sup> Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 42.

<sup>244</sup> The record reflects that El Paso paid an increase of approximately \$4 million for Line 1903 and the California segment. Thereafter, the Commission accepted an allocation of \$93.1 for Line 2000 on a per mile basis, leaving \$36.2 as the cost for both Line 1903 and the California segment. In this proceeding, El Paso proposes to rely on a third valuation and seeks to reject the per mile basis for Line 1903 and claim \$0 for the California segment.

El Paso's acquisition costs.<sup>245</sup> In any event, El Paso's recounting would justify only recognition of the \$4 million additional funds expended to close the deal as the cost to acquire both Line 1903 and the unused California segment. Thus, the \$10.5 million in costs for Line 1903 would already reflect an accounting adjustment over El Paso's original acquisition cost. Of course, El Paso seeks more than that—namely the difference between the approximately \$36 million valuation it now seeks, and the \$10.5 million based on the previously-allowed methodology.

172. El Paso's attempts to justify its proposal, by claiming variously that the unused California segment is of no value or that roll-in of the remaining acquisition costs is justified based on benefits provided by Line 2000, are post-hoc rationalizations for changing to a methodology that now presents this unexpected "bill" for payment. Yet the existing mileage-based allocation method for cost recovery has not been shown to be unreasonable or unjust. In Docket No. CP00-422-000, the Commission permitted El Paso to roll in \$93.1 million as the cost that it purchased Line 2000 from its affiliate, based on the miles of pipe methodology.<sup>246</sup> The decision to roll in costs is made at the certificate phase to "enable existing and potential new shippers to make appropriate decisions pre-construction to protect their interests either in the certificate proceeding or in their contracts with the pipeline."<sup>247</sup> El Paso does not attempt to argue a change in circumstances to suggest that we revisit the certificate determination.

173. The Commission's policies, including original cost accounting and the used and useful doctrine, serve to balance investor interests in obtaining an adequate return on investment with ratepayers' interest in fair rates. Ratepayers generally are not required to pay for facilities that are of no use to jurisdictional service, or to subsidize non-regulated,

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<sup>245</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 47 n.53 (citing ID, 134 FERC ¶ 63,003 at PP 47, 51).

<sup>246</sup> El Paso Dec. 12, 2000 Data Response No. 2 submitted in Docket No. CP00-422-000 (stating that El Paso paid \$93.1 million to its wholly-owned subsidiary for Line 2000 and that El Paso allocated the \$129 million total acquisition costs for the All American assets between the California and non-California portions based on miles of pipe).

<sup>247</sup> Certificate Policy Statement, 88 FERC at 61,746-47; *Cheyenne Plains Gas Pipeline Co., LLC*, 131 FERC ¶ 61,002, at P 17 (2010).

competitive enterprises. Appropriately using an original cost methodology serves to protect ratepayers from speculative investments or pipelines overpaying for facilities.<sup>248</sup>

174. In this case, El Paso proposes that no costs at all be attributed to acquiring the unused California facilities and that all the cost of acquisition should be treated as a cost of acquiring the smaller segment of pipe that was placed in service. El Paso supports its zero value notion for the unused California segment because it has been unable to sell the unused facilities for non-natural gas product services and it held failed open seasons. El Paso claims that these failures demonstrate that the facilities are not valuable to it for natural gas services. We do not find that these circumstances justify allocation of additional costs to Line 1903. Even though ratepayers benefited from lower fuel costs and extended contract terms due to its placing the new Line 1903 cross-over into service, El Paso fails to make a credible case that all acquisition costs should be allocated solely to Line 1903, and none should be allocated to the majority of the converted pipeline that remains unused. Nor has it been shown that the status of the remaining capacity is more reflective of current conditions in the natural gas markets with new sources of supply competing with old sources, or whether the lack of utility existed at the time of purchase. This is all the more reason not to change the existing cost-recovery allowance for Line 1903 as established in the certificate proceeding.

175. El Paso contests the Commission's approval of the Presiding Judge's finding that the \$10.5 million miles-of-pipe figure represents the only credible evidence of El Paso's original valuation of Line 1903. El Paso cites its claim that it originally sought to purchase the All American Pipeline assets located east of California for \$125 million, but ultimately purchased the entire 1,088 mile pipeline ending in Bakersfield for \$129 million. As noted above, according to El Paso, the seller "insisted" that it take the remaining 303 miles of California facilities for \$4 million when it purchased the All American Pipeline assets in 2000. However, the Presiding Judge questioned whether El Paso had proven even this assertion, since its witness did not participate in the sales negotiations and provided no evidence to support his assertion that All American insisted that El Paso assume ownership of the California assets. Furthermore, El Paso and All

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<sup>248</sup> *E.g., Northern Border Pipeline Company v. FERC*, 129 F.3d 1315, at 1318 (D.C. Cir. 1997) (approving original cost for accounting purposes: "The concept of original cost accounting is a bedrock principle of the Uniform System [of Accounts]. Absent original cost accounting, 'all that pipelines would have to do to raise rates and obtain greater income would be to buy utility properties from another at a higher price than original cost and in this very simple way increase the cost of service to consumers[;]'" quoting *Arkla Energy Resources a Division of Arkla, Inc., and Mississippi River Transmission Corp.*, 61 FERC ¶ 61,004, at 61,038 (1992)).

American did not establish values for Line 2000, Line 1903 or the unused California segment in their negotiations in 2000. Indeed, El Paso itself declined to rely on these negotiations to establish its acquisition costs, instead adopting the miles of pipe methodology when it sought to establish the cost of the Line 2000 facilities. That is, El Paso did not purchase Line 2000 from its affiliate for the \$129 million that would have been suggested by the negotiations with All American, but instead used \$93 million based on its miles of pipe methodology. El Paso provides no evidence that it differentiated the costs associated with acquiring the California assets as it now suggests should be done: zero cost for non-used miles of pipe and entire cost for used miles of pipe.<sup>249</sup> Instead, when asked for its accounting relating to the Line 1903 acquisition, it simply provided a composite exhibit that was made for litigation.<sup>250</sup>

176. In 2001, El Paso used a “miles of pipe” methodology to allocate the total \$129 million paid between Line 2000 and the remaining All American Pipeline assets located in California, including Line 1903 and the unconverted California segment. Based on this methodology, El Paso paid its wholly-owned subsidiary \$93.1 million for Line 2000, leaving \$36.2 in acquisition costs on the subsidiary’s books for the California segment.<sup>251</sup> Ultimately, El Paso’s claim of \$36 million as the acquisition price for Line 1903 relies on a series of affiliate transactions, insofar as it uses as the acquisition cost the amount remaining on its affiliate books when it dissolved the affiliate, that portion of the All American acquisition price that was left over when it purchased Line 2000. Because El Paso’s accounting ignores the unused California segment, we cannot accept it as providing a reasonable valuation of that segment or an accounting of acquisition costs between the two segments.

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<sup>249</sup> Ex. S-5 at 12 (data response reporting that El Paso did not maintain separate accounts for Line 1903); Ex. S-4 at 13 (Trial Staff witness Radel stating that Staff has been unable to determine the actual costs of Line 1903 and that El Paso has not kept separate records for Line 1903 that isolate its costs or revenues). *See also* Tr. 893 (Dougherty cross: “because we have composite plant, composite depreciation on plant, we don't have specific identification of all our assets”). In 2001, El Paso dissolved the subsidiary that actually acquired the facilities and transferred \$36.2 million in remaining costs to its books for all of the California assets. *See* El Paso’s Oct. 4, 2004 certificate application in Docket No. CP05-2-000, Exhibit S, Accounting.

<sup>250</sup> Ex. EPG-370 at 6.

<sup>251</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 18; El Paso Dec. 12, 2000 Data Response No. 2 submitted in Docket No. CP00-422-000.

177. El Paso complains that the unused California assets have no value based on failed open seasons and attempts to sell the pipeline for non-gas services.<sup>252</sup> But the reasons for this inability may simply reflect market forces, as noted above. Moreover, inability to sell an illiquid asset does not mean it lacks any value, nor does it serve to justify allocation of all the costs of these unused assets to ratepayers. Even assuming shifts in the natural gas markets have an unquantified impact, El Paso's self-described sales efforts may bear fruit in the future. Consequently, we cannot say that El Paso convincingly demonstrates that absolutely no value should be ascribed to the remaining unused California segment, as El Paso is free to continue to make efforts to dispose of the remaining facilities. El Paso's valuation is especially problematic in light of El Paso's attributing costs and benefits from Line 2000 to the project.<sup>253</sup> El Paso recognizes the potential for value in the remaining facilities, proposing to credit back to rate base an amount up to the allocated purchase price.<sup>254</sup> Thus, El Paso would ask shippers to bear the cost to acquire the facilities, with any profits to be retained by shareholders. For this reason, the original cost recovery allowance for Line 1903 appears more reasonable than the change that El Paso proposes on rehearing.

178. In sum, the evidence in this proceeding supports a finding that El Paso acquired the California facilities for future use or investment, without perhaps a clear intention of what to do with the facilities, and on terms agreeable to it. El Paso subsequently reevaluated its position with respect to acquiring the Line 2000 facilities calculating its acquisition costs at \$93 million on a miles-of-pipe basis. Because El Paso proposes to

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<sup>252</sup> Ex. EPG-83 at 32.

<sup>253</sup> El Paso cites "several open seasons" and attempts to negotiate with "various parties to purchase the facilities for other product pipeline uses," Ex. EPG-83 at 32. A survey of trade literature indicates El Paso's continuing sales and development efforts: Cadiz, Inc.: press release, *Cadiz Advances Plans to Convert 300 miles of Natural Gas Pipelines for Water Conveyance* (Feb. 29, 2012) (noting option to purchase El Paso facilities for \$10 to \$40 million for conversion to water transportation); Kinder Morgan, investor presentation: *Natural Gas Pipelines* at 35 (Jan. 30, 2013) (indicating plans to reconvert Line 2000 and Line 1903 to oil transportation service by 2017).

<sup>254</sup> Adams rebuttal test, Ex. EPG-368 at 10-11 ("if, in the future, [El Paso] is able to sell or find a use for the Cadiz to Emidio facilities, [El Paso] would be willing to credit its rate base with the net revenues up to \$25.7 million from any sale of the facilities, to address any concerns that the Commission, its staff, or [El Paso]'s shippers may have about over recovery"). Adams explains that the revenues would be net of \$9 million in preservation costs associated with the unused facilities.

allocate more than the original depreciated cost to Line 1903, it is appropriate to consider the Commission's acquisition premium criteria. Given the lack of a valuation provided by arms length bargaining and El Paso's own varying valuation of the California facilities, the Commission finds that El Paso has failed to support an alternate objective measure for the acquisition costs, other than the per mile cost-valuation methodology accepted in the certificate proceeding. To do otherwise runs the risk that El Paso's shippers would, almost 15 years after the regulatory framework established in the certificate proceeding, bear an unreasonable and unexpected portion of El Paso's possibly risky purchase transaction and subsidize El Paso's ultimate use or sale of the facilities.

### 3. Accounting Matters

179. The Commission clarifies its finding in Opinion No. 517 that El Paso's depreciable plant balance should reflect its actual book amounts, adjusted to include only the \$10.5 million associated with El Paso's investment in Line 1903.<sup>255</sup> As El Paso indicates, its books should also reflect accumulated depreciation and deferred income tax entries that reflect \$10.5 million in plant cost associated with Line 1903 (along with the cost of additional plant devoted to jurisdictional service), consistent with the facts established in the Commission's orders. Although the parties agreed that there would be no rate impact in the settlement limiting the hearing to the four issues addressed in Opinion No. 517, El Paso's books should accurately reflect the depreciation and deferred income tax associated with its plant in service and its rate calculations should reflect the updated balances.<sup>256</sup>

180. In its August 20, 2012 compliance filing in Docket No. RP12-816-001, El Paso proposed to reclassify \$25,645,000 in cost, which it originally proposed to book to Line 1903, from utility plant recorded in Account 101, Gas Plant in Service, to Account 121, Nonutility Property. However, it also proposes to reverse the accumulated depreciation and related accumulated deferred income taxes recorded on this amount. Under the Uniform System of Accounts, when property is transferred from one plant account or function to another the related accumulated depreciation is also reclassified.<sup>257</sup> As

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<sup>255</sup> Opinion No. 517, 139 FERC ¶ 61,095 at PP 51-52.

<sup>256</sup> See also Opinion No. 528, 145 FERC ¶ 61,040 at P 167.

<sup>257</sup> Uniform System of Accounts, Gas Plant Instruction No. 12, Transfers of Property, and Account 108, Accumulated provision for depreciation of gas utility plant, paragraph (d). Based on the numbers presented, El Paso should record the \$3,802,299 of accumulated depreciation transferred from Account 108, Accumulated Provision for Depreciation of Gas Utility Plant, to Account 122, Accumulated Provision for Depreciation and Amortization of Nonutility Property. Additionally, El Paso should

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discussed below, the Commission accepts El Paso's proposed accounting adjustments, subject to the changes discussed herein.

#### **D. Short-term Firm and Interruptible Rates**

181. El Paso proposed a maximum rate for short-term firm service, interruptible (IT) service, park and loan (PAL) service, and authorized overrun service equal to 250 percent of the maximum reservation component of the recourse rate applicable to long-term firm service, plus the applicable commodity component. Long-term service includes seasonal contracts (seven-month summer or five-month winter) and contracts with terms of one year or more. El Paso proposed a revenue crediting mechanism to prevent over-collection in which 90 percent of short-term revenues in excess of the 100 percent long-term firm rate would be credited once El Paso collects its annual cost-of-service. El Paso proposed that the revenue crediting mechanism would be effective if (1) El Paso collects any revenues resulting from short-term firm rates that exceed the related long-term firm rates and (2) revenues exceed the annual cost of service established in this rate case. El Paso argued that it proposed to implement these short-term value-based services consistent with Order No. 637<sup>258</sup> to more properly recognize the value of short-term services, assign the appropriate prices to those services, and encourage long-term firm contracting in response to the market's growing reliance on short-term service and the need to discount services to retain load.<sup>259</sup>

182. Opinion No. 517 affirms the Presiding Judge's finding that El Paso's short-term firm and interruptible rate proposal does not comport with Commission policy and is not just and reasonable. The Commission found that El Paso's proposal met neither the clear parameters for designing peak/off-peak and term-differentiated rates set forth in Order

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reclassify the \$3,651,694 of accumulated deferred income taxes recorded in Account 282, Accumulated Deferred Income Taxes-Other Property, to Account 283, Accumulated Deferred Income Taxes-Other, which is a nonutility deferred income tax account.

<sup>258</sup> *Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services*, Order No. 637, FERC Stats. & Regs. ¶ 31,091, *clarified*, Order No. 637-A, FERC Stats. & Regs. ¶ 31,099, *reh'g denied*, Order No. 637-B, 92 FERC ¶ 61,062 (2000), *aff'd in part and remanded in part sub nom. Interstate Natural Gas Ass'n of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002), *order on remand*, 101 FERC ¶ 61,127 (2002), *order on reh'g*, 106 FERC ¶ 61,088 (2004), *aff'd sub nom. American Gas Ass'n v. FERC*, 428 F.3d 255 (D.C. Cir. 2005).

<sup>259</sup> El Paso, June 30, 2008 transmittal letter, Docket No. RP08-426-000, Statement of the Nature, the Reasons, and the Basis for the Proposed Changes, at 5-6.

No. 637 nor the fundamental principle of ratemaking that a pipeline must design its rates to recover the costs properly allocated to that service.<sup>260</sup>

183. While Order No. 637 sets forth parameters for designing either peak/off-peak or term-differentiated rates, the Commission concluded that El Paso proposed a hybrid of the two that fails to meet either set of requirements but instead uses the most favorable aspects of each. El Paso proposed a maximum peak rate that is available every day of the year, but does not designate any lower off-peak rates, thus contravening the Order No. 637 requirement that increases in peak rates must be offset by decreases in off-peak rates to prevent over-recovery of its annual revenue requirement. Likewise, El Paso proposed the 250 percent rate for short-term service of less than one year (excluding five-month winter or seven-month summers seasonable service), yet does not propose any gradation in rates based on length of contract, in contravention of the requirements for term-differentiated rates.

184. The Commission found that El Paso failed to justify its proposed rate and did not prepare or provide studies to support the choice of 250 percent as the rate multiplier or to compare the use and impact of the 250 percent rate versus some other rate. Order No. 637 stated that the Commission will “consider any reasonable method of implementation that is consistent with the general principles discussed in this section [of Order No. 637], but the pipeline will have the burden of proof to show that its proposed method is just and reasonable.” The Commission further found that the cases cited by El Paso did not support its proposal.

185. The Commission affirmed the Presiding Judge’s finding that El Paso’s proposed revenue crediting mechanism was insufficient to act as a substitute for the failure to project revenues and properly allocate costs. Order No. 637 contemplated that a revenue crediting mechanism would only be necessary for peak/off-peak rates proposed in a *pro forma* tariff filing in between rate cases because the pipeline would not be able to reallocate costs among services in the *pro forma* tariff filing. In addition, revenue crediting was not contemplated for term-differentiated rates, for a general reallocation of revenue responsibility among customer classes would be done for all customers simultaneously in a general section 4 rate filing. The Commission found that a revenue crediting mechanism is not designed to provide an immediate benefit to off-peak or long-term shippers and that El Paso’s shippers may never benefit from revenue crediting because it is not triggered until El Paso recovers its cost of service and short-term revenues exceed the costs allocated to the services. Furthermore, El Paso’s proposal to

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<sup>260</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 177 (citing 18 C.F.R. §§ 284.10(b) and 284.10(c)).

retain 10 percent of the revenues ensures that it will over-recover its revenue requirement if revenue crediting is triggered.

186. The Commission further affirmed the Presiding Judge's holding that interruptible service is not properly included within the 250 percent rate proposal, contrary to long-standing Commission policy that the rate for interruptible service should be designed on a 100 percent load factor basis.

### 1. Request for Rehearing

187. El Paso argues that the Commission's rejection of its proposed short-term rates was unreasonable, failed to acknowledge that El Paso's proposal will achieve Order No. 637's policy objectives, and dismissed evidence that such rates were achieving those policy goals by encouraging shippers to contract for seasonal service. To the extent that El Paso's proposal encourages shippers to contract for long-term service even though they prefer to use peak month service, El Paso submits this was contemplated by Order No. 637. El Paso argues that Order No. 637 held that pipelines are free to adopt whatever methods are best suited to the characteristics of their systems.<sup>261</sup>

188. El Paso argues that the Commission focuses instead on one aspect of its proposal that is inconsistent with the approach discussed in Order No. 637: designing peak/off-peak or term-differentiated rates in advance to meet its annual revenue requirement. El Paso argues that it chose to apply the higher short-term rate throughout the year to capture the higher values whenever they occur, and not exceed the annual revenue requirement through an after-the-fact revenue crediting mechanism.<sup>262</sup>

189. El Paso contends that the Commission mischaracterized the evidence when it said that "El Paso's system may experience two peak periods throughout the year."<sup>263</sup> El Paso claims that the evidence shows that peaks can and do occur throughout the year on El Paso's system based on market conditions.<sup>264</sup> El Paso argues that the Commission should address the evidence that its proposal is designed to capture the higher value of its capacity from short-term shippers on any day of the year when value exceeds the 100 percent load factor rate, thereby maximizing allocative efficiency.

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<sup>261</sup> El Paso Rehearing at 92-93.

<sup>262</sup> *Id.* at 93.

<sup>263</sup> *Id.* at 94 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 179).

<sup>264</sup> *Id.* at 93 (citing Ex. EPG-337 at 3-4).

190. El Paso further argues that the Commission should have acknowledged that El Paso's revenue crediting method provides customers better protection against over-recovery than attempting to allocate costs and design higher peak and lower off-peak rates in advance, given the difficulty of projecting when demand will be high enough for El Paso to capture higher prices. In sum, El Paso argues that its proposal is consistent with Order No. 637's objective of improving allocative efficiency, providing better price signals, equitably allocating costs between short- and long-term shippers, and encouraging long-term contracting. On rehearing, El Paso objects to the rejection of its proposal, which it asserts would produce these benefits, merely because it included a revenue crediting mechanism instead of a pre-allocation of costs.<sup>265</sup>

## 2. Commission Determination

191. The Commission denies rehearing. El Paso's proposed peak/off-peak rates are not consistent with Order No. 637 and do not provide the required safeguards against the exercise of monopoly power. The Commission affirms its finding in Opinion No. 517 that by selectively complying with certain aspects of Order No. 637, while ignoring others, El Paso's proposal is not just and reasonable.

192. In Order No. 637, the Commission revised its regulatory framework to improve the efficiency of the market and provide captive customers with the opportunity to reduce their cost of holding long-term pipeline capacity while continuing to protect them against the exercise of market power. Order No. 637 revised the Commission's pricing policy to enhance the efficiency of the market by waiving price ceilings for short-term released capacity and permitting pipelines to file for peak/off-peak and term-differentiated rate structures. The Commission stated that it would permit peak/off-peak rates for short-term services "as one possible method of promoting allocative efficiency that is consistent with the goal of protecting customers from monopoly power."<sup>266</sup> In Order No. 637-A, the Commission found that the relaxation of cost-of-service regulation for short-term capacity release transactions was justified by the continuation of regulation for primary pipeline services. The cornerstone of Order No. 637's peak/off-peak rate program was that lower off-peak rates would offset higher peak rates so as to act as "a check on the ability of the pipelines to propose extraordinarily high rates during peak periods because any rate increase for peak periods must be matched by a rate decrease during the off-peak periods."<sup>267</sup>

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<sup>265</sup> *Id.* at 94-95 (citing Tr. 816-17, 802-03, 18).

<sup>266</sup> Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,287.

<sup>267</sup> *Id.* at 31,290.

193. Order No. 637 set forth the parameters for implementing peak/off-peak rates, explaining that “value-based peak/off-peak rates are just and reasonable cost-based rates” and that “[t]he sum of the daily or monthly rate, multiplied by the quantity used or reserved, still must not exceed the pipeline’s annual revenue requirement, and thus, *any increases in rates at peak must be offset by decreases in off-peak rates.*”<sup>268</sup> The Commission stated that “there is more than one reasonable way to implement peak/off-peak rates based on value of service concepts.”<sup>269</sup> Order No. 637 set forth specific parameters and processes for implementing peak/off-peak rates, allowing pipelines flexibility in choosing a method of implementation to fit the unique circumstances of their systems, but only if they could demonstrate the proposed methods were just and reasonable and consistent with the general principles of Order No. 637.<sup>270</sup>

194. The Commission thus established a framework for pipelines to propose peak/off-peak rates that relied on lower off-peak rates to serve as a check against the pipeline’s ability to propose extraordinarily high peak rates. El Paso’s proposal would remove that check. El Paso’s peak rates would apply on any day of the year and would not be offset with lower off-peak rates. In this respect, El Paso’s proposed peak rates are similar to market-based rates capped at 250 percent of the FT-1 rate. El Paso would be able to charge any rate up to the 250 percent cap on any day it determined it could command a peak rate. There would be no designated off-peak periods, other than long-term contracts

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<sup>268</sup> *Id.* (emphasis added) and further explaining that “[l]ike uniform maximum rates, peak/off-peak rates would be established by taking the pipeline’s annual revenue requirement and deriving from it a daily or monthly rate. The difference in developing peak/off-peak rates and the current uniform maximum rate is that instead of dividing the annual revenue requirement by 365 to obtain a daily rate, different daily or monthly rates will be developed for peak and off-peak periods using one of several possible methods of measuring the value of capacity at peak and off-peak. In other words, if a shipper paid the peak and off-peak rate for the same volume of transportation every day of the year, the amount it paid annually for service would be no more than if it had paid the uniform maximum daily rate for the same transportation volume based on the same revenue requirement.”

<sup>269</sup> Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,291. The Commission listed various methods of implementing peak/off-peak rates based on value of service concepts. All the methods focused on ways to measure the value of capacity at peak and off-peak times, either by ratios of load factors, compressor usage, price differentials or similar methods to tailor the rates.

<sup>270</sup> *Id.*

(seasonal or one-year contracts or longer). This result is inconsistent with Order No. 637's dual goals of promoting allocative efficiency while also protecting customers from monopoly power.

195. El Paso counters that the Commission offered pipelines flexibility in choosing a reasonable method for implementing peak/off-peak rates, but a closer reading of Order No. 637 shows that the Commission was referring to flexibility in the method of devising the peak and off-peak rates to ensure that aggregate annual revenues did not exceed the annual revenue requirement.<sup>271</sup> Order No. 637 did not give pipelines flexibility in complying with the general principles, such as offsetting off-peak rates to lower the costs to long-term customers and serve as a check against market power. Order No. 637 states that "the courts have permitted the Commission to institute flexible pricing to improve market efficiency so long as the overall regulatory scheme protects against price gouging."<sup>272</sup>

196. El Paso argues that Order No. 637 permits a pipeline to adopt whatever pricing methodology is best suited to the characteristics of its system, but the resulting rate structure must still be just and reasonable. El Paso fails to support its 250 percent multiplier as just and reasonable or to show that use of the 250 percent rate, without offsetting off-peak rates, will provide its customers protection against its exercise of monopoly power. El Paso argues that the Commission made the unsupported statement that "El Paso's system may experience two peak periods throughout the year" and thus failed to acknowledge that peaks can and do occur throughout the year based on market conditions. The fact that El Paso's system has multiple peaks does not relieve it of the obligation to offset peak rates with lower off-peak rates such that the aggregate revenues are not designed to exceed El Paso's revenue requirement.

197. El Paso argues that the Commission ignores the evidence that El Paso's peak rates, while they were in effect subject to refund, achieved the allocative efficiency goals of Order No. 637 by encouraging short-term customers to shift to long-term contracts. However, Order No. 637 does not promote shifting customers to long-term contracts as a

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<sup>271</sup> *Id.* (listing methods proposed by commenters such as "using a ratio of the prices for capacity release and IT on a system to develop a ratio, looking at usage of compression to develop a ratio, looking at peak/off-peak volumes/load factors to develop a ratio, developing a ratio based on historic price differentials between receipt and delivery point prices, or allowing a shaping of prices to try to capture the value of the capacity, and tailoring of contract demand levels during the year." (footnotes omitted)).

<sup>272</sup> *Id.* at 31,284 (citing *Environmental Action v. FERC*, 996 F.2d 401, 410 (D.C. Cir. 1993)).

stand-alone goal. Order No. 637 states that peak/off-peak pricing for short-term services could remove one of the biases favoring short-term contracts, but also that it could lower the share of costs allocated to long-term transportation customers.<sup>273</sup> Order No. 637 states that the Commission is “seeking to lower the rates to long-term customers in recognition of the additional risks they take by signing long-term contracts.”<sup>274</sup> El Paso thus has selectively chosen certain Order No. 637 goals (such as increasing allocative efficiency, sending better price signals, and encouraging long-term contracting), while ignoring other important policy goals (such as creating a more equitable cost allocation between short-term and long-term rates, preventing price gouging, and lowering costs allocated to long-term rates). Order No. 637 thus permits value-based short-term rates if they are offset by lower long-term rates in order to protect against pipeline monopoly power. El Paso’s peak/off-peak proposal does not provide this essential balance.

198. Order No. 637 anticipates that peak/off-peak rates will generate more short-term service revenue for the pipeline and that the process for implementing peak/off-peak rates must take into account the increased revenues.<sup>275</sup> One method would be to file an NGA section 4 general rate case and reduce the long-term rates in recognition of the fact that the pipeline could be expected to recover more revenues from short-term services. The other method would be to file a *pro forma* tariff filing and implement a revenue crediting mechanism until the subsequent cost and revenue study is addressed by the Commission.<sup>276</sup> El Paso, however, has chosen to mix the two options in such a fashion that it provides the benefits of neither.

199. El Paso offers revenue crediting as an alternative to lowering off-peak rates through a pre-allocation of costs to peak/off-peak rates. However, Order No. 637 specifically limits the use of revenue crediting for peak/off-peak rates. Order No. 637 sets forth two separate processes for implementing peak/off-peak rates: (a) if proposed in a rate case, peak/off-peak rates would be allocated costs so that off-peak rates would offset peak rates and the sum would not exceed the annual revenue requirement; and

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<sup>273</sup> *Id.* at 31,288.

<sup>274</sup> *Id.* at 31,292.

<sup>275</sup> Order No. 637, FERC Stats. & Regs. ¶ 31,091 at 31,291 (stating that because market prices for off-peak services are less than maximum short-term rates, a pipeline will likely reduce its off-peak rate to approximate its discount history. Thus, the pipeline might see little or no reduction in off-peak revenues, but it could realize higher peak revenues if it adopts peak/off-peak rates).

<sup>276</sup> *Id.* at 31,291-292.

(b) if proposed in between rate cases, Order No. 637 allows a limited NGA section 4 *pro forma* filing with a revenue crediting mechanism followed by a mandatory cost and revenue study within 15 months. Order No. 637 did not contemplate that revenue crediting would be a permanent part of a pipeline's peak/off-peak rate design. The Commission intended revenue crediting to serve as a short-term method of benefiting long-term contracts until such time as the Commission could act on a complete cost and revenue study in a general rate case to determine whether the rates should be adjusted.

200. El Paso's suggestion that the Commission rejected its short-term rate proposal "merely because it included a revenue crediting mechanism instead of a pre-allocation of costs" mischaracterizes the Commission's findings on this issue. It is the unsupported 250 percent multiplier, the lack of off-setting off-peak rates, and the failure to meet the parameters and processes set forth in Order No. 637, including the required use of revenue crediting only as a temporary measure, that make the proposal unreasonable and require its rejection. On rehearing, El Paso has offered no new arguments to counter the Commission's finding that El Paso's proposal is inconsistent with Order No. 637 and has not been shown to be just and reasonable. The Commission therefore denies rehearing on this issue.

#### **E. Article 11.2**

201. In Opinion No. 517, the Commission found that Article 11.2(a) rates remain just and reasonable but that El Paso may not reallocate to non-Article 11.2(a) shippers or contracts any shortfall arising as a result of Article 11.2(a) rates being lower than recourse rates. The Commission further found that Article 11.2(b) was not triggered because El Paso had met the presumption that at least 4,000 MMcf/d of firm capacity was subscribed at the rate cap level or above. Requests for rehearing and/or clarification on this issue were filed by El Paso, APS, the California Parties, Gila River, New Harquahala, the Rate Protected Shippers, and UNS.<sup>277</sup>

202. As discussed more fully below, the Commission denies rehearing and affirms its holdings that (1) Article 11.2 rates remain just and reasonable, and El Paso may not reallocate to non-Article 11.2(a) shippers or contracts any shortfall arising as a result of Article 11.2(a) rates being lower than recourse rates; and (2) Article 11.2(b) was not triggered because El Paso met the presumption that at least 4,000 MMcf/d of capacity was subscribed at or above the rate cap level. The Commission also confirms that Opinion No. 517 reflects the Presiding Judge's finding that the 4,000 MMcf/d threshold equals 4,068 MDth/d.

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<sup>277</sup> As noted above, ConocoPhillips and Texas Gas Service filed for rehearing but later withdrew their pleadings.

## 1. Standard of Review

### a. Requests for Rehearing

203. El Paso argues that a central issue in this case is whether a provision that the Commission and all parties have agreed was designed to meet a problem that effectively disappeared (i.e., addressing the economic consequences of significant turn-backs of capacity in the 1990s) can still serve the public interest when applied to costs stemming from the capacity shortage that replaced it. El Paso argues that the Commission's application of Article 11.2 instead functions to allow a favored group of historical customers to avoid the costs of investments made in large part to meet their expanded needs. El Paso concludes that termination of Article 11.2 of its 1996 Settlement is required even under standards laid down in *Mobile-Sierra* and other relevant cases.<sup>278</sup>

204. Other parties disagree with the Commission's finding that the *Mobile-Sierra* public interest standard applies in determining whether the Article 11.2 rates remain in effect, are just and reasonable, and should not be eliminated in light of changes to the El Paso system. Gila River, New Harquahala, and the California Parties argue that the Commission erred in confirming that Article 11.2(a) requires El Paso to propose rates consistent with the rate cap, and that to find those rates not just and reasonable, the Commission must overcome the *Mobile-Sierra* presumption.<sup>279</sup> El Paso and Gila River argue that Opinion No. 517 erred by assuming that Article 11.2(a) establishes a *Mobile-Sierra* fixed rate contract.<sup>280</sup>

205. The California Parties argue that the Commission's analysis conflates El Paso's obligation to propose Article 11.2(a) rates using the rate cap formula with the Commission's obligation to determine whether those rates as proposed are just and reasonable.<sup>281</sup> El Paso, the California Parties, Gila River, and New Harquahala argue that El Paso is not barred from collecting rates that are higher than the rate cap if the Commission finds that the proposed rates are unjust and unreasonable.<sup>282</sup> El Paso and

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<sup>278</sup> El Paso Rehearing at 165-67.

<sup>279</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 234.

<sup>280</sup> El Paso Rehearing at 153; Gila River Rehearing at 21.

<sup>281</sup> California Parties Rehearing at 4.

<sup>282</sup> El Paso Rehearing at 147-160; California Parties Rehearing at 6; Gila River Rehearing at 21-22; New Harquahala Rehearing at 29.

Gila River argue that if the settling parties wanted to ensure that El Paso would never be permitted to collect a rate any higher than the rate cap, the settlement would have said so, but didn't.<sup>283</sup>

206. El Paso and Gila River further argue that a corrected version of Article 11.2 was filed with the Commission later in the same day that the initial version of the 1996 Settlement was filed, which included a proviso barring El Paso from collecting a rate higher than the rate cap until August 31, 2006.<sup>284</sup> Gila River argues that, under the principle of *expressio unius est exclusio alterius*, the absence of any such provision applicable to the period after August 31, 2006, demonstrates the parties intended to permit El Paso to collect more than the rate cap if so ordered by the Commission after August 31, 2006.<sup>285</sup> Gila River argues that even though this proviso was not ultimately approved, the existence of both versions shows the parties understood how to limit the Commission's NGA section 5 power to prevent El Paso's collecting a higher rate, but elected not to do so for the referenced period. New Harquahala explains that, while El Paso and the parties agreed that this proviso need not go in the re-filing of the 1996 Settlement in 1997, the parties nonetheless contemplated that later shippers might object to disparate treatment caused by Article 11.2.<sup>286</sup> El Paso and Gila River argue that Opinion No. 517's failure to acknowledge the possible efficacy of this proviso, which would militate against application of a public interest standard of review for possible future changes to Article 11.2, contravenes fundamental principles of contract interpretation: "We assume that the parties intended for every part of the agreement to have meaning; interpretations that would render a portion of the agreement ineffective or mere surplusage are traditionally disfavored by courts."<sup>287</sup> While Opinion No. 517 states

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<sup>283</sup> El Paso Rehearing at 150, Gila River Rehearing at 22.

<sup>284</sup> El Paso Rehearing at 155-56 (citing Ex. EPG-432; the proviso states: "provided, however, that during the period January 1, 2006, through August 31, 2006, El Paso shall not be entitled to collect from any Shipper to which this paragraph 11.2 applies any rate higher than the rate required to be proposed pursuant to this subparagraph 11.2(a) irrespective of the Commission's decision regarding such proposal.").

<sup>285</sup> Gila River Rehearing at 26 (citing *Leatherman v. Tarrant City Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 168 (1993)); see also El Paso Rehearing at 156-158.

<sup>286</sup> New Harquahala Rehearing at 29.

<sup>287</sup> El Paso Rehearing at 156-157, Gila River Rehearing at 27 (citing *Aka v. Washington Hospital Center*, 156 F.3d 1284, 1302 (D.C. Cir. 1998): "We assume that

that there were “many shippers testifying that they did not view the language as providing for a waiver of the public interest standard,” Gila River notes that only the hearing testimony of one Article 11.2 shipper witness is cited.<sup>288</sup> El Paso states that it never argued for such a waiver, but instead is arguing that Mobile-Sierra does not apply and does not prevent Commission-ordered, just and reasonable changes to the proposed Article 11.2(a) rates under NGA section 5.<sup>289</sup>

207. Gila River and El Paso argue that the *Mobile-Sierra* presumption does not apply because there is no proposal to change the terms of Article 11.2(a).<sup>290</sup> El Paso argues that the Commission failed to address this argument.<sup>291</sup> Gila argues that Article 11.2(a) does not prevent the Commission from acting under NGA section 5 “to replace not only rates that are contrary to the public interest but also rates that are unjust, unreasonable, or unduly discriminatory or preferential,” even if to do so would be “to the detriment of the contracting purchaser.”<sup>292</sup> El Paso and Gila River argue that the Commission stated that, “as the courts have indicated, the Commission has every right to expect contracting parties to express clearly their intentions and not require the Commission to read into their agreements what is not spelled out there.”<sup>293</sup>

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the parties intended for every part of the agreement to have meaning; interpretations that would render a portion of the agreement ineffective or mere surplusage are traditionally disfavored by courts;” Farnsworth on Contracts § 78.11 (1990)); *Conoco Inc. v. NLRB*, 91 F.3d 1523, 1526 (D.C. Cir. 1995): “[P]arties ought not be presumed to have included in their agreement a meaningless provision.”).

<sup>288</sup> Gila River Rehearing at 28 n.414. In Opinion No. 517, the Commission cited the testimony of Southwest Gas witness, Jordan, who participated in a coalition of Article 11.2 shippers in the negotiations leading to the 1996 Settlement. P 255; Tr. 1563. Due to a typographical error, this was presented as being the testimony of many shippers. El Paso did not provide a witness who was involved in the negotiations.

<sup>289</sup> El Paso Rehearing at 157-58.

<sup>290</sup> El Paso Rehearing at 151; Gila River Rehearing at 23.

<sup>291</sup> El Paso Rehearing at 147.

<sup>292</sup> Gila River Rehearing at 23-24 (citing *Papago Tribal Utility Authority v. FERC*, 723 F.2d 950 (D.C. Cir. 1983)); *see also* El Paso Rehearing at 158.

<sup>293</sup> El Paso Rehearing at 154; Gila River Rehearing at 25 n.45 (each citing *Sea Robin Pipeline Co., LLC*, Opinion No. 516, 137 FERC ¶ 61,201, at P 107, 127(2011): “it

(continued ...)

208. El Paso argues that the Commission appears to have erroneously assumed there are only two types of contracts: fixed rate contracts and contracts that preserve the pipeline's right to file unilateral rate changes under NGA section 4. El Paso argues that the courts have recognized a third type of contract which leaves the Commission free to make changes under the just and reasonable standard of section 5 without meeting the *Mobile-Sierra* public interest standard.<sup>294</sup> El Paso contends that Article 11.2(a) is a variation of this third type of contract, where Article 11.2(a) restricts El Paso's right to file unilateral changes under section 4 of the NGA, but does not specify that the Commission must approve the rate proposed by El Paso. El Paso asserts that numerous customers in virtually every rate zone have argued that the Article 11.2(a) rates are unjust, unreasonable and unduly discriminatory and should be rejected.<sup>295</sup> El Paso states that in Opinion No. 517, however, the Commission has read into Article 11.2(a) terms that are not spelled out there and have thereby converted Article 11.2(a) into a fixed rate contract when it is not. By failing to give meaning to the phrase "propose to" language, the Commission has rendered it superfluous, contrary to long-standing rules of contract interpretation.<sup>296</sup>

209. The second document that El Paso argues corroborates its position is a document El Paso circulated to the parties prior to settlement explaining its reasons for refusing to accept a proposed change to add language stating that El Paso could not "collect" a rate higher than the rate cap. El Paso suggests that the document rejected such language because it was recognized the Commission had the authority in the future to require rates that differ from the Article 11.2(a) rates, such as a change in cost allocation that could cause some rates to exceed the Article 11.2(a) rate caps.<sup>297</sup>

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is a reasonable interpretation device to conclude that what someone has not said, someone has not meant.")

<sup>294</sup> El Paso Rehearing at 151-52 (citing *Papago Tribal Utility Authority v. FERC*, 723 F.2d 950 (D.C. Cir. 1983): "Third, the parties may contractually eliminate the utility's right to make immediately effective rate changes under Sec. 205 but leave unaffected the power of the Commission under Sec. 206 to replace not only rates that are contrary to the public interest but also rates that are unjust, unreasonable, or unduly discriminatory or preferential to the detriment of the contracting purchaser.").

<sup>295</sup> *Id.* at 153.

<sup>296</sup> *Id.* at 154 (citing *Pacific Gas Transmission Co.*, 73 FERC ¶ 61,276, at 61,760 (1995)).

<sup>297</sup> *Id.* at 159 (citing Ex. EPG-433, point 14).

210. Gila River and New Harquahala argue that the 1996 Settlement does not contain any mention of the public interest standard; only the just and reasonable standard is referred to, in Article 16.6, stating that the parties waived any right “to challenge the level of settlement rates provided for herein or any other provision of this Stipulation and Agreement as being unjust, unreasonable, or unduly discriminatory[.]”<sup>298</sup> They argue that it makes sense that the standard waived by those parties during the settlement would be the appropriate standard for them to challenge after. They contend that the Commission came to the same conclusion in an earlier El Paso rate case settlement, finding that because the settlement provided for an NGA section 5 hearing with no reference to the *Mobile-Sierra* standard, it is clear that the parties contemplated a section 5 proceeding with the normal just and reasonable burden of proof. They conclude that it would be wrong to interpret the 1996 Settlement under a standard that was never mentioned in the settlement.<sup>299</sup>

211. Gila River next argues that the public interest standard (if it is applicable) is not “practically insurmountable;” it suggests the Commission has explained that a more relaxed, flexible application of the standard is appropriate to protect non-parties to contract.<sup>300</sup> Gila River and New Harquahala maintain that the Commission erred in not using the ordinary just and reasonable standard to determine whether to terminate Article 11.2 in order to protect non-parties.<sup>301</sup> Gila River argues that Opinion No. 517 misapplies the March 20, 2006 Order where the Commission states that if El Paso or any other party desired additional modifications to the 1996 Settlement, it would have to meet the *Mobile-Sierra* standard.<sup>302</sup> Gila River explains that the “other party” refers to other

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<sup>298</sup> Gila River Rehearing at 28-29; New Harquahala Rehearing at 29.

<sup>299</sup> Gila River Rehearing at 34-35 (citing *El Paso Natural Gas Co.*, 26 FERC ¶ 61,016, at 61,025 (1984)); New Harquahala Rehearing at 8-9.

<sup>300</sup> Gila River Rehearing at 32-33 (citing *Florida Power & Light Co.*, 67 FERC ¶ 61,141, at 61,399 (1994)).

<sup>301</sup> Gila River Rehearing at 33; New Harquahala Rehearing at 7.

<sup>302</sup> *El Paso Natural Gas Co.*, Order on Post [1996] Settlement Issues, 114 FERC ¶ 61,290, at P 37 (2006) (March 20 Order), *reh’g denied*, 124 FERC ¶ 61,227 (2008) (September 5 Order), *reh’g denied*, 132 FERC ¶ 61,155 (2010) *aff’d sub nom.*, *Freeport-McMoRan Corp. v. FERC*, 669 F.3d 302 (D.C. Cir. 2012) (*Freeport*).

settling parties, not non-parties like Gila. Gila River and New Harquahala argue that the Commission never ruled on what standard should apply to non-parties.<sup>303</sup>

212. Gila River and New Harquahala argue that while the Supreme Court in *Maine PUC* determined that certain non-parties can be bound to contracts, this case is distinguishable because (1) Gila River and New Harquahala did not exist in 1996 and could not have participated in the settlement; (2) the *Maine PUC* settlement provided an auction with generally applicable rules, whereas Article 11.2 created a preferred class of shippers; (3) the *Maine PUC* settlement expressly provided that *Mobile-Sierra* would apply but the 1996 Settlement does not mention *Mobile-Sierra*; and (4) the *Maine PUC* settlement had a 2.5 year term while Article 11.2 has no termination save by subsequent agreement.<sup>304</sup>

213. Gila River and New Harquahala argue that the Commission clarified, in *Devon Power LLC* that the public interest presumption only applies to contract rates, not tariff rates and that Article 11.2 rates are not contract rates because they are set forth in section 37 of the tariff and involve service under FT-1. They state that *Devon* made clear that rates stemming from a settlement are not necessarily contract rates, and there is no evidence that the El Paso parties would have agreed to the 1996 Settlement if the public interest standard was included.<sup>305</sup>

214. El Paso argues that, instead of addressing El Paso's arguments directly, the Commission sets up, mischaracterizes, or rebuts arguments El Paso never made. El Paso states that in applying the *Mobile-Sierra* standard, the Commission contends that the evidence does not show that Article 11.2 leads to revenue shortfalls that impair El Paso's financial stability or its ability to provide service. The Commission further states that El Paso "seeks an opportunity to recover its costs, suggesting that it does indeed make a costs shortfall argument." El Paso argues, however, that it has never made this argument, but rather has argued that Article 11.2 was never intended to be subject to the *Mobile-Sierra* standard, or prevent El Paso from recovering the prudently incurred costs of its Post-1995 Expansion facilities, even if its financial stability would not be imperiled by a

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<sup>303</sup> Gila River Rehearing at 36-37; New Harquahala Rehearing at 10.

<sup>304</sup> Gila River Rehearing at 39-40; New Harquahala Rehearing at 11-12 (citing *Maine Pub. Util. Comm'n. v. FERC*, 520 F.3d 464, 477-78 (D.C.Cir.2008)).

<sup>305</sup> Gila River Rehearing at 40-41; New Harquahala Rehearing at 13 (citing *Devon Power LLC*, 134 FERC ¶ 61,208 (2011), *reh'g denied*, 137 FERC ¶ 61,073, at P 21 (2011)).

denial of such recovery.<sup>306</sup> El Paso argues that having previously said that Article 11.2 was not an issue in the Capacity Allocation Proceeding, it is arbitrary and capricious for the Commission now to assert in Opinion No. 517 that Article 11.2 was in fact addressed there and to conclude that El Paso is simply restating arguments that the Commission previously rejected there.<sup>307</sup>

215. El Paso argues that the instant case is the first time El Paso and the parties have had the opportunity to litigate the *Mobile-Sierra* issue, because after the Commission set the *Mobile-Sierra* issue for hearing in the 2005 rate case, the parties ultimately settled all rate issues. Having set the issue for hearing in this proceeding, the Commission erred, in El Paso's view, in finding that El Paso's public interest showing in this case is a reargument of its prior claims in the 2005 rate proceeding, where El Paso did not raise the issue of *Mobile-Sierra* but instead argued that Article 11.2(a) was no longer binding as a matter of contract law.<sup>308</sup>

216. El Paso maintains that the Commission wrongly conflates the issues in this case with the issues in the Capacity Allocation Proceeding and the 2005 Rate Case proceeding. El Paso suggests that the Commission gave it the opportunity to make a factual record to support its position that Article 11.2 is no longer in the public interest and then largely ignored the extensive evidentiary showing presented by El Paso. El Paso maintains that the need for a public interest analysis was first announced in the March 20 Order, when the Commission, according to El Paso, was not even confronted with the *Mobile-Sierra* issue.<sup>309</sup> El Paso contends that it is therefore wrong for the Commission to suggest that El Paso's public interest argument here is merely a rerun of arguments advanced and adjudicated in the 2005 Rate Case.<sup>310</sup>

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<sup>306</sup> El Paso Rehearing at 167-68.

<sup>307</sup> *Id.* at 168-69 (citing Opinion No. 517, 139 FERC ¶ 61,095 at PP 239, 240, "the factors cited appear to have all been present in the Capacity Allocation Proceeding, where we did not find abrogation of Article 11.2(a) supported;" *Freeport*, 669 F.2d 302 at 308, citing March 20 Order, 114 FERC ¶ 61,290 at P 15).

<sup>308</sup> *Id.* at 169-70 (citing March 20 Order, 114 FERC ¶ 61,290 at PP 20, 33, 37).

<sup>309</sup> March 20 Order, 114 FERC ¶ 61,290, *reh'g denied*, September 5 Order, 124 FERC ¶ 61,227.

<sup>310</sup> El Paso Rehearing at 171 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 240).

217. El Paso asserts that, if the Commission is suggesting Article 11.2 is not against the public interest because any problems associated with recovering Post-1995 Expansion costs are of El Paso's own making, because it was El Paso that decided to build the expansions, that suggestion is incorrect. El Paso contends finally that the *Freeport* decision of the U.S. Court of Appeals for the District of Columbia Circuit recognized that El Paso was not required to absorb its expansion costs.<sup>311</sup>

**b. Commission Determination**

218. Some parties argue that the Commission erred in affirming its prior determinations that the *Mobile-Sierra* public interest standard applies in determining whether the Article 11.2 rates remain in effect, are just and reasonable, and should not be eliminated in light of changes to El Paso's system. We disagree.

219. As stated in Opinion No. 517, the Commission's decision to apply the *Mobile-Sierra* public interest standard to changes to the 1996 Settlement is final and not subject to review. In the Capacity Allocation Proceeding, the Commission found that any changes to the 1996 Settlement must be justified under the *Mobile-Sierra* standard,<sup>312</sup> and the court upheld the Commission's decision.<sup>313</sup> On rehearing of the Commission's Order on Post-Settlement Issues in the 2005 Rate Case, the Commission held that "the Commission's decision to apply *Mobile-Sierra* to changes in the 1996 Settlement is final and not subject to review here. Despite El Paso's contention, there is no justifiable reason to make an exception for changes to Article 11.2, while holding the rest of the 1996 Settlement to the standard of review under *Mobile-Sierra*."<sup>314</sup>

220. Article 11.2(a) of the 1996 Settlement provided that rates for capacity then under contract by eligible shippers would be capped, subject to an annual inflation adjustment, and that the rate cap would continue to apply until the termination of those shippers' service agreements. The Commission's finding that the Article 11.2(a) rates are just and reasonable relies on a determination that the Article 11.2(a) rates proposed by El Paso are consistent with the 1996 Settlement. To find otherwise would require modification or abrogation of the 1996 Settlement based on a finding that Article 11.2 of the 1996

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<sup>311</sup> *Id.* at 174-75 (citing Opinion No. 517 at P 242; *Freeport*, 669 F.3d 302 at 312; *Arizona Corp. Comm'n v. FERC*, 397 F.3d 952 at 956 (D.C. Cir. 2005) (ACC)).

<sup>312</sup> *El Paso Natural Gas Co.*, 99 FERC ¶ 61,244, at 62,005 (2002).

<sup>313</sup> *See ACC*, 397 F.3d 952.

<sup>314</sup> *September 5 Order*, 124 FERC ¶ 61,227 at P 41; *aff'd*, *Freeport*, 669 F.3d 302.

Settlement no longer meets the *Mobile-Sierra* public interest standard. No party in this proceeding has yet met the *Mobile-Sierra* public interest standard to support such a change.

221. The parties are correct that the Article 11.2(a) requires El Paso to “propose” Article 11.2(a) rates that the Commission could subsequently determine were not just and reasonable. However, because the Article 11.2 rates are set forth in the 1996 Settlement, a finding that those rates are just and reasonable rests solely on whether the rates proposed are consistent with the terms of the 1996 Settlement. The Commission may only find that the Article 11.2(a) rates are not just and reasonable if a change to the 1996 Settlement which sets those rates is justified by an application of the *Mobile-Sierra* public interest standard of review.

222. Similarly, parties argue that the Commission fails to give effect to the existence of a “corrected” version of Article 11.2 which was filed later in the same day as the initial version of the 1996 Settlement on March 18, 1996. We disagree. When El Paso refiled the settlement agreement with modifications and corrections on June 10, 1997, the “corrected” version of Article 11.2 was not included. The 1997 filed settlement agreement is the document that the Commission, El Paso, and the parties have relied on since 1997.<sup>315</sup> El Paso included the text of the 1997 version of Article 11.2 in the Stipulation and Agreement filed in the instant proceeding. Thus, El Paso’s introduction of the “corrected” version as an unsponsored cross-examination exhibit revealed only at hearing does not persuade us to reverse our consistent holding that the *Mobile-Sierra* standard applies to any changes in the 1996 Settlement.

223. Parties argue that the *Mobile-Sierra* standard does not apply because no changes to the 1996 Settlement have been proposed. However, a request to modify or eliminate Article 11.2(a) rates, or to find that those rates are not just and reasonable, is certainly the functional equivalent of a proposed change to the 1996 Settlement. As explained above, approving an Article 11.2(a) rate higher than the fixed contract rate set forth in the 1996 Settlement would be inconsistent with the 1996 Settlement and would constitute a change to the 1996 Settlement that must be supported under the public interest standard of the *Mobile-Sierra* doctrine.

224. Gila River and New Harquahala argue that the Commission erred in finding that non-contracting parties as well as contracting parties and the Commission can be bound

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<sup>315</sup> See RPS/Salt River/ACC Brief Opposing Exceptions at 44-46 (stating that the Article 11.2 text from the 1997 filing has been reprinted in the March 20 Order, 114 FERC ¶ 61,290 at P 20 and El Paso’s Offer of Settlement and Explanatory Statement, Docket No. RP08-426-000, Stipulation and Agreement, App. U).

by the *Mobile-Sierra* public interest standard. They argue that the Commission's reliance on *NRG* was in error, because Gila River and New Harquahala were not even in existence when the 1996 Settlement was approved. We affirm our reliance on *NRG*. In *NRG*, the U.S. Supreme Court rejected the argument that the public interest standard should not apply to shippers that are not parties to the contract.<sup>316</sup> We do not read *NRG* as exempting new companies from that requirement.<sup>317</sup>

225. El Paso argues that the Commission has read into Article 11.2(a) terms that are not spelled out there and has thereby converted Article 11.2(a) into a fixed rate contract which it is not. We disagree. Article 11.2(a) rates are rates capped by the 1996 Settlement and adjusted annually by an inflation adjustment. No other adjustment to the Article 11.2(a) rates is allowed, absent a *Mobile-Sierra* public interest showing.

## 2. Just and Reasonable Review

### a. Requests for Rehearing

226. El Paso argues that because the bargain under Article 11.2 was not intended to apply to Post-1995 Expansion costs and because the Article 11.2 shippers benefit from the expansions just like other customers, the Article 11.2 rates do not make the Article 11.2 shippers uniquely situated compared with other shippers regarding cost responsibility for expansion costs. While El Paso agrees with the Commission's statements that the Article 11.2(a) shippers pay for some expansion costs in their recourse rate contracts, and that some of them hold contracts that include capacity attributable to Line 2000 and Power-up Expansion projects, the implication that El Paso is fully recovering its expansion costs is incorrect. El Paso concludes that Article 11.2 causes the allocation and recovery of Post-1995 Expansion costs to be impermissibly and unfairly

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<sup>316</sup> *NRG Power Marketing, LLC v. Maine PUC*, 130 S. Ct. 693, 700-01 (2010) (*NRG*) (finding *Mobile-Sierra* doctrine "is not limited to challenges to contract rates brought by contracting parties. It applies, as well, to challenges initiated by third parties"); *reversing and remanding Maine PUC v. FERC*, 520 F.3d 464, 478 (D.C. Cir. 2008).

<sup>317</sup> *Id.*, 130 S. Ct. at 701 ("A presumption applicable to contracting parties only, and inoperative as to everyone else – consumers, advocacy groups, state utility commissions, elected officials acting *parens patriae* – could scarcely provide the stability *Mobile-Sierra* aimed to secure").

skewed in favor of Article 11.2(a) contracts and against non-Article 11.2(a) recourse rate contracts.<sup>318</sup>

227. The California Parties argue that the Commission erred in not separately evaluating whether the Article 11.2 rates are just and reasonable in the current factual context and failing to rule that the Article 11.2 rates are not just and reasonable because they do not include costs of post-1995 facilities that are utilized to serve the Article 11.2 shippers and were constructed at their urging.<sup>319</sup> Gila River argues that Opinion No. 517 refuses to recognize that Article 11.2 rates do not reflect the costs of all the pipeline facilities they use. Gila River does not dispute that some Article 11.2(a) shippers also hold recourse rate contracts, but argues that does not absolve them from paying an Article 11.2(a) rate that also reflects El Paso's actual cost of providing the service.<sup>320</sup>

228. El Paso argues that recovery of Post-1995 Expansion costs from all shippers, including Article 11.2 shippers, is appropriate. El Paso argues that the March 20 Order clearly provided that El Paso should recover its expansion costs from "all shippers" and that it is appropriate to recover the Above-Cap costs (which are entirely Post-1995 Expansion costs) from all recourse rate contracts, including those held by Article 11.2 shippers.<sup>321</sup> El Paso contends that allocating those costs to all shippers is also appropriate because the Article 11.2(a) shippers supported El Paso's construction of those facilities. El Paso argues that it is well established that cost responsibility should be aligned with cost causation; it necessarily follows that, since Article 11.2(a) shippers (along with other customers) urged El Paso to construct expansions whose costs have become part of the Article 11.2 issues in this case, all recourse rate contracts should bear an equal portion of the Above-Cap costs.<sup>322</sup>

229. Gila River argues that, contrary to Opinion No. 517 at P 236, a detailed analysis does exist to establish that Article 11.2 rates are unduly discriminatory and provide a competitive advantage to Article 11.2 shippers. (G 42) Gila River states that, in *Energy Transfer*, the Commission stated that "[t]o prove the existence of undue discrimination or undue preference it must be shown that: (1) two classes of customers are treated

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<sup>318</sup> El Paso Rehearing at 176-77.

<sup>319</sup> California Parties Rehearing at 6.

<sup>320</sup> Gila River Rehearing at 29-30.

<sup>321</sup> El Paso Rehearing at 127-128.

<sup>322</sup> *Id.* at 130.

differently; and (2) that the two classes of customers are similarly situated.”<sup>323</sup> Gila River argues that El Paso provides service to all shippers, including Article 11.2, under Rate Schedules FT-1 and FTH, and that the quality, terms and conditions of service are identical for Article 11.2 shippers, except for the rates.

230. El Paso argues that the Commission failed to recognize the unduly discriminatory impact of Article 11.2, which the Supreme Court has held is one way of showing a contract is against the public interest.<sup>324</sup> El Paso argues that it is beyond any reasonable dispute that El Paso’s recourse rates exceed the Article 11.2(a) rates because of the cost of the Post-1995 Expansion facilities, even without the additional safety-related costs. In other words, without the Post-1995 Expansion costs, El Paso’s recourse rates would not exceed the Article 11.2(a) rates. El Paso argues that, because all of its shippers including the Article 11.2 shippers wanted El Paso to incur the Post-1995 Expansion costs, and because all shippers benefit from the Post-1995 Expansion costs, both recourse rate shippers and Article 11.2(a) shippers are similarly situated (since they asked for the expansion) and therefore Article 11.2 shippers should bear an equal share of the Post-1995 Expansion costs.<sup>325</sup> Because a number of recourse rate contracts are held by non-Article 11.2 shippers, El Paso maintains that similarly situated shippers are treated differently without justification, which is an unduly discriminatory outcome that conflicts with the public interest under the *Mobile-Sierra* line of cases.<sup>326</sup>

231. Gila River and New Harquahala argue that while Opinion No. 517 might permit such discrimination as not undue, because the 1996 Settlement was an exchange of risk sharing payments for a share of future revenue from remarketing capacity, risk sharing was not unique to El Paso. They contend that, the language of the 1996 Settlement notwithstanding, the risk sharing amounts should not be considered a prepayment for perpetual rate preferences; 80 percent of the risk sharing amounts were paid by shippers not seeking Article 11.2 protection. They argue that it is wrong for Article 11.2 shippers,

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<sup>323</sup> Gila River Rehearing at 42-43 n.92 (citing *Energy Transfer Partners, L.P.*, 120 FERC ¶ 61,086, at P 169 (2007) (footnote omitted)).

<sup>324</sup> El Paso Rehearing at 172 (citing *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County, Washington*, 554 U.S. 527, 533 (2008)).

<sup>325</sup> *Id.* at 173 (citing Ex. EPG-374 at 58; EPG-289A).

<sup>326</sup> *Id.* at 174 (citing March 20 Order, 114 FERC ¶ 61,290 at P 36; *Northeast Utilities Service Co. v. FERC*, 55 F.3d 686, 690 (1<sup>st</sup> Cir. 1995), *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956); *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956)).

who paid only 7 percent of the total capacity turnback costs, to seek permanent rate reductions under the 1996 Settlement.<sup>327</sup> Gila River argues that Opinion No. 517 was wrong to find that the 1996 Settlement was a bargain to share unknown risks, because it provided significant rate relief, and the settlement rates, even including the risk sharing amounts, were lower than prior rates.<sup>328</sup> Gila River and New Harquahala argue that the payment of the risk sharing amount was not an assumption of an unknown risk, as Opinion No. 517 stated, but a reduction of a known risk.<sup>329</sup> Gila River asserts that the point is not that the bargain turned out better for some but that the 1996 Settlement confers an undue preference on Article 11.2 shippers; if that 1996 Settlement benefit were eliminated, all shippers would be on a level playing field according to Gila River, who maintains Article 11.2 shippers have already received an undue windfall.<sup>330</sup>

232. Gila River states that Opinion No. 517 essentially characterizes the 1996 Settlement as a *quid pro quo*, but Gila River suggests it really allows some to get something for nothing, a *quid pro nihil*. Gila River estimates that four of the Article 11.2 shippers (APS, Conoco, Freeport, and Southwest Gas) would receive more than \$62 million in rate reductions by the end of 2019 compared to their risk sharing payments of \$2 million.<sup>331</sup>

233. Gila River and New Harquahala argue that Article 11.2 produces a competitive advantage for Article 11.2 shippers such as APS and Salt River who buy and transport natural gas to generate electricity and who compete with Gila River for sales in the wholesale power markets. They argue that Opinion No. 517 should have analyzed the economic impact from the difference between the rates, before affirming the legality of Article 11.2. They argue that Article 11.2(a) alone reduces APS' total reservation charges by about \$3.7 million per year while increasing the cost to transport gas to other power suppliers by \$1.4 million, and the rate disparity has grown over time and will continue to increase.<sup>332</sup>

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<sup>327</sup> Gila River Rehearing at 44-46; New Harquahala Rehearing at 15-17.

<sup>328</sup> *Id.* at 46.

<sup>329</sup> *Id.* at 47; New Harquahala Rehearing at 28.

<sup>330</sup> Gila River Rehearing at 48-49.

<sup>331</sup> Gila River Rehearing at 49-51; New Harquahala Rehearing at 20-21 (showing similar analysis of five shippers, adding Salt River).

<sup>332</sup> Gila River Rehearing at 51-53; New Harquahala Rehearing at 21-22.

234. Gila River contends that APS has exploited Article 11.2 by building new facilities and increasing its billing determinants to 88,023 Mcf/d from its risk sharing amount of 66,042 Mcf/d. Gila River argues that Article 11.2 vests APS with dual competitive advantages over Gila River; it lowers APS' generation costs which (1) protects APS' units from competition from Gila River; and (2) allows APS to bid lower prices in the electric energy markets thereby capturing more sales. Gila River contends that Freeport has also reaped a windfall from Article 11.2 by selling a substantial amount of power through its subsidiaries.<sup>333</sup>

235. Gila River and New Harquahala argue that, because the cost to transport gas is incremental to a marginal power sale, El Paso's transportation rates impact the sales price of power and competition. They argue that, to the extent that Article 11.2 shippers, which own older, less efficient facilities, can continue operating at artificially lower costs, they squeeze newer, more efficient generators who were not around in 1996 out of the market and discourage unprotected newer, more efficient generators from entering the market.<sup>334</sup> New Harquahala asserts that Article 11.2 creates absurd results in today's energy markets: (1) Salt River retained only 15 dth/d of an Article 11.2(a) contract to retain Article 11.2(b) protection for all of its contracts; and (2) El Paso has a greater incentive to sign a maximum rate firm contract in a low rate zone such as New Mexico (to count toward the 4,000 MMcf/d threshold) than to sign discounted contracts to deliver to California in order even though the latter would provide greater revenue.<sup>335</sup>

236. Gila River argues that Opinion No. 517 failed to recognize that, absent termination, Article 11.2(a) rate discrimination will continue in perpetuity. Opinion No. 517 does not consider under what conceivable conditions Article 11.2(a) rates could possibly become higher than recourse rates, contrary to its statement in Opinion No. 517, P 254.<sup>336</sup> Gila River argues that the perpetual continuation of Article 11.2 would be contrary to the Commission's goal that transportation rates merge over time, not diverge.<sup>337</sup> Gila River and New Harquahala argue that continuation of Article 11.2 would

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<sup>333</sup> Gila River Rehearing at 57-59.

<sup>334</sup> Gila River Rehearing at 60-61; New Harquahala Rehearing at 23.

<sup>335</sup> New Harquahala Rehearing at 24.

<sup>336</sup> Gila River Rehearing at 61-62.

<sup>337</sup> Gila River Rehearing at 63 (citing *Certification of New interstate Natural Gas Pipeline Facilities*, 90 FERC ¶ 61,128, at 61,394-395 (2000)).

promote divergence not just in one rate case, but in perpetuity.<sup>338</sup> New Harquahala argues that the Commission's policy is buttressed by the economic "law of one price," which provides that in an efficient market, all identical goods must have only one price;" the subsidy required to continue the 1996 Settlement's Article 11.2 bargain leads to a violation of the "law of one price" and in turn promotes economic inefficiency.<sup>339</sup>

237. El Paso argues that the Commission should find it is just and reasonable, and not unduly discriminatory, for Article 11.2(a) contracts in this case to pay the same rate that shippers pay under maximum recourse rate contracts.<sup>340</sup> El Paso argues that the Article 11.2(a) shippers, as well as other shippers, demanded that El Paso install the Post-1995 Expansion facilities, and the Commission found that the facilities were needed to provide reliable service to these shippers, who are currently relying on these facilities.<sup>341</sup> El Paso contends that all \$12.8 million of the annual Above-Cap costs are comprised of Post-1995 Expansion costs and that while Article 11.2(a) shippers pay for a portion of those costs in their recourse rate contracts, the \$12.8 million of Post-1995 Expansion costs that exceed the Article 11.2(a) rate cap would be shifted away from the Article 11.2(a) contracts to either recourse rate contracts or to El Paso. El Paso argues that the lower rates for Article 11.2(a) contracts are not warranted because Article 11.2 shippers are equally responsible for and benefit from the Post-1995 Expansion costs to the same degree as other El Paso shippers and are thus similarly situated, notwithstanding their 1996 Settlement status.<sup>342</sup>

238. El Paso argues that it is irrelevant that Article 11.2 shippers negotiated for and obtained the Article 11.2 protections. Insofar as the Commission has confirmed the 1996 Settlement was never intended to address Post-1995 Expansion costs or prevent El Paso from seeking to recover those costs, El Paso argues this supports making Article 11.2(a) contract holders pay the same rates as paid under non-Article 11.2 recourse rate contracts.<sup>343</sup> El Paso also argues that the Commission erred by not authorizing a

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<sup>338</sup> Gila River Rehearing at 63; New Harquahala Rehearing at 26.

<sup>339</sup> New Harquahala Rehearing at 26 n.80.

<sup>340</sup> El Paso Rehearing at 160.

<sup>341</sup> *Id.* at 160-161 (citing Line 2000 Certificate Order, 95 FERC ¶ 61,176 ; Power-Up Project Certification Order, 103 FERC ¶ 61,280 at P 1; Line 1903 Certificate Order, 111 FERC ¶ 61,408 at P 39).

<sup>342</sup> El Paso Rehearing at 161-62.

<sup>343</sup> *Id.* at 162-63 (citing March 20 Order, 114 FERC ¶ 61,290 at PP 68, 69).

surcharge. While the Commission stated that “if El Paso feels the circumstances warrant, it may propose and seek to justify a surcharge, consistent with our policies and precedent under the NGA,” El Paso argues that deferring the surcharge issue to a future proceeding is inappropriate and unreasonable.<sup>344</sup> El Paso argues that in order to provide just and reasonable, and not unduly discriminatory rates for all shippers in this case, Article 11.2(a) shippers should pay the same amounts for El Paso service as recourse rate shippers, either through an upward adjustment to Article 11.2(a) base rates or through a rate surcharge in addition to Article 11.2(a) rates. El Paso suggests that even if the Commission adheres to a *Mobile-Sierra* analysis and declines to adjust the Article 11.2(a) base rates upward, the Commission could grant rehearing and authorize a surcharge that would recover the \$12.8 million of annual Above-Cap costs from the Article 11.2(a) contracts.<sup>345</sup>

**b. Commission Determination**

239. The parties argue that the Commission ignored evidence that Article 11.2 was not just and reasonable in the current factual context and failed to rule that Article 11.2(a) rates are not just and reasonable because they do not include post-1995 costs used to serve Article 11.2 shippers through facilities constructed at their urging. Parties raise cost causation arguments, arguing that the Article 11.2 shippers demanded that El Paso build the post-1995 facilities, that the Commission approved the roll-in of the costs of post-1995 facilities to all shippers, that Article 11.2 shippers are provided service using post-1995 facilities, and that the Article 11.2 shippers bear a cost responsibility for their share of the costs of post-1995 facilities.

240. These arguments attempt a re-assessment of the Article 11.2 rates under the ordinary application of the just and reasonable standard. As explained above, however, changes to the Article 11.2 rates are subject to the *Mobile-Sierra* public interest standard. Unless it can be shown that it is in the public interest to modify those rates under the *Mobile-Sierra* doctrine, the cost causation issues raised by certain parties are insufficient to support a change to find the Article 11.2 rates are no longer just and reasonable.

241. Opinion No. 517 affirmed the Presiding Judge’s finding that El Paso and the other parties requesting termination of Article 11.2 have failed to carry their burden of showing extraordinary circumstances that merit abrogation of Article 11.2. The Presiding Judge determined that “the record in this proceeding does not demonstrate, with sufficient ‘detailed analysis,’ that continuation of Article 11.2 will impair the financial ability of

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<sup>344</sup> *Id.* at 163.

<sup>345</sup> El Paso Rehearing at 164-165.

[El Paso] to provide service, impose excessive burdens on third parties, or be unduly discriminatory such that the public interest is seriously harmed, as *Mobile-Sierra* requires.”<sup>346</sup> That is precisely so.

242. Several parties filed evidence in the hearing purporting to support a finding that the Article 11.2 rates are unduly discriminatory and not in the public interest. They assert that (1) the Article 11.2 shippers are similarly situated to certain non-Article 11.2 shippers who compete in the same market but did not exist at the time of the 1996 Settlement; (2) the Article 11.2 shippers benefit from the lower Article 11.2 rates even though their facilities may be older and less efficient than those of their non-Article 11.2 competitors; and (3) they pay millions more each year yet receive the same service as the Article 11.2 shippers. Gila River argues that APS exemplifies how the Article 11.2 shippers have gained a competitive advantage, alleging that APS has exploited Article 11.2 to gain a competitive advantage by using its Article 11.2(a) contracts to transport natural gas to any of its generation facilities, including those constructed after 1996.<sup>347</sup>

243. As stated in Opinion No. 517, the Commission reviewed that evidence and found that the record is insufficient to support a finding that the competitive advantages held by Article 11.2 shippers resulted in unequivocal actual harm to the general public, as opposed to predictions of possible future harm. The non-Article 11.2 shippers are not similarly situated with the Article 11.2 shippers because the Article 11.2 shippers bargained for the benefits in the 1996 Settlement. The existence of a rate differential between recourse rates and Article 11.2(a) rates is therefore not unduly discriminatory, and not a sufficient basis to find harm to the general public necessitating contract modification under *Mobile-Sierra*.<sup>348</sup> Furthermore, the Article 11.2(a) rates are higher than many of the discounted rates to non-Article 11.2 shippers.<sup>349</sup> As for the allegations that APS is exploiting Article 11.2, the contracted amount of service to APS under

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<sup>346</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 232; ID, 134 FERC ¶ 63,002 at PP 506-07.

<sup>347</sup> Gila River Rehearing at 53-56.

<sup>348</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 189 (citing March 20 Order, 114 FERC ¶ 61,290 at P 35, itself citing *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000); *Cities of Bethany v. FERC*, 727 F.2d 1131, 1139 (D.C. Cir. 1984); *United Mun’l Distribs. Group v. FERC*, 732 F.2d 202 (D.C. Cir. 1984)).

<sup>349</sup> See ID, 134 FERC ¶ 63,002 at PP 485, 487 (summarizing Participants’ statements identifying discounts for California and non-Article 11.2 shippers and resulting revenue impacts).

Article 11.2 rates has not increased; instead, APS is availing itself of the contract right provided every shipper to change receipt and delivery points. As the Presiding Judge found, the claims of undue, distorted competitive effects of Article 11.2 due to disparity of rates were not proven.<sup>350</sup>

244. Parties also argue that the Commission should modify or abrogate Article 11.2 because the Article 11.2 shippers received a better bargain than they should have. Those parties estimate that the Article 11.2 shippers have received benefits, in the form of revenue sharing payments and savings from low rates, that far exceed the risk sharing payments they made, resulting in an unjust and unreasonable or unduly discriminatory rate differential between Article 11.2 shippers and non-Article 11.2 shippers. Gila River and New Harquahala argue that Article 11.2 effects a lasting competitive advantage for Article 11.2 shippers such as APS and Salt River, who buy gas for fuel to generate electricity and compete with Gila River in the wholesale power market.

245. Whether the 1996 Settlement bargain turned out to be more favorable to Article 11.2 shippers than expected is not in itself an indicia that automatically justifies negating the perduring Article 11.2 Settlement obligations. Merely comparing risk sharing payments with revenue sharing receipts is not sufficient to change the contracted Article 11.2 rates as no longer in the public interest. Likewise, the fact that the Article 11.2 rates exceed the recourse rates is not in and of itself an indication of unduly discriminatory rates. While Article 11.2 rates may give Article 11.2 shippers a competitive advantage, so do many discounted and negotiated rates. On El Paso's system, many of the discounted rates are lower than Article 11.2 rates. The record in this case does not support a clear finding that this rate disparity has caused a dysfunctional market. Furthermore, while Commission-approved settlement provisions with no finite termination date are not common, the 1996 Settlement was a complex balancing of risks and rewards that the Commission approved, has interpreted over the years in various orders, and which the courts have generally upheld.

246. At the time of the Settlement, it was not a foregone conclusion that the Article 11.2 rates will be "perpetually lower than recourse rates," and no party has provided sufficient evidence to support such a conclusion going forward. The Article 11.2 rates have increased annually by at least one percent through the inflation adjustment mechanism, while the existing facilities have depreciated.<sup>351</sup> In addition, the universe of Article 11.2(a) contracts has also been decreasing, as shippers reduce or terminate their

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<sup>350</sup> *Id.* P 511.

<sup>351</sup> *See Id.* P 483 (customer suggesting that inflation could make Article 11.2 rates approach recourse rates over time).

contracts, and as El Paso has negotiated with a good number of shippers to replace Article 11.2 contracts with new contracts that are not subject to Article 11.2.<sup>352</sup> Thus, the overall impact of Article 11.2 is diminishing over time. Of particular note, the two shippers identified by Gila River as competitors, APS and Salt River, are no longer subject to Article 11.2 as of May 30, 2013 and December 12, 2013, respectively.

247. El Paso argues that the Commission sets up and rebuts a series of arguments that El Paso never made regarding whether El Paso supported a *Mobile-Sierra* public interest showing. Yet El Paso's arguments against what it perceives as a *Mobile-Sierra* strawman highlight the Commission's and El Paso's differing views on what demonstration would be needed to support any change to the 1996 Settlement. The Commission did not ignore the factual record that El Paso claims supports its position, but rather concluded that El Paso's arguments did not support a public interest finding. El Paso is arguing that Article 11.2 is not in the public interest because it prevents El Paso from fully recovering the costs of Post-1995 expansions which the Article 11.2 shippers use and demanded to be built. As the Commission pointed out, the U.S. Court of Appeals for the D.C. Circuit agreed that, rather than constructing the expansion capacity at the urging of its former full requirements customers or because those customers demanded it, El Paso was already obligated under its full requirements contracts to meet those customers' full requirements, and the Capacity Allocation Proceeding merely implemented a reasonable way to do

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<sup>352</sup> To date, El Paso has negotiated with APS (*El Paso Natural Gas Co., L.L.C.*, 143 FERC ¶ 61,187 (2013)), Tucson Electric (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP13-1230-000 (Aug. 23, 2013) (delegated letter order)), UNS (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP13-1231-000 (Aug. 23, 2013) (delegated letter order)), Salt River (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP14-206-000 (Dec. 12, 2013) (delegated letter order)), Texas Gas Service (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP14-1088-000 (July 30, 2014) (delegated letter order)); ConocoPhillips (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-583-000 (March 25, 2015) (delegated letter order)), Arizona Electric Power Coop. (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-615-000 (March 25, 2015) (delegated letter order)), and 10 Rate Schedule FT-2 customers (*El Paso Natural Gas Co., L.L.C.*, Docket No. RP14-1260-000 (Oct. 2, 2014) (delegated letter order); *El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-123-000 (Nov. 25, 2014) (delegated letter order); *El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-213-000 (Dec. 10, 2014) (delegated letter order); *El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-277-000 (Jan. 9, 2015) (delegated letter order); and *El Paso Natural Gas Co., L.L.C.*, Docket No. RP15-395-000 (Feb. 19, 2015) (delegated letter order)).

so.<sup>353</sup> After the initial term of the 1996 Settlement expired, those former full requirements shippers using expansion capacity began paying recourse rates for that capacity. Thus, the former full requirements shippers have not improperly avoided paying for expansion capacity, since those receiving service on expansion capacity are paying the full recourse rate for such capacity.<sup>354</sup>

### 3. Above-Cap Costs

#### a. Requests for Rehearing

248. El Paso argues that a central element of the 1996 Settlement was that El Paso could recover the costs for which it bore the risk of recovery from new business that it developed, so it is antithetical to that notion for the Commission now to bar El Paso from designing its rates to recover the Above-Cap costs even from new shippers.<sup>355</sup> El Paso argues that the Commission has effectively added more risk than existed in the 1996 Settlement, requiring El Paso to bear more costs than it agreed to bear.<sup>356</sup> El Paso also points to the March 2006 Order, where the Commission stated that “there is nothing in the Settlement that prevents El Paso from proposing to price its services so that it could recover its costs from other shippers to the extent that the Article 11.2 rates would not recover its costs of service.”<sup>357</sup>

249. El Paso argues that it has remarketed a large amount of capacity that was turned back by California shippers in the 1990s and the subject of the risk-sharing agreement in

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<sup>353</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 244 (citing *Freeport*, 669 F.3d 302 at 309).

<sup>354</sup> *Id.* (citing *Freeport*, 669 F.3d at 312, approving Commission finding that Article 11.2 does not apply to expansion capacity).

<sup>355</sup> The new shippers are shippers who began to take service after Article 11.2 became effective. Because the Commission has held the discounts granted according to the complex 1996 Settlement were not shown to have been granted solely to meet competition. Opinion No. 517, 139 FERC ¶ 61,095 at P 292. Thus, El Paso cannot utilize a “discount adjustment” in its rate case, to recover such costs that go unrecovered under the Article 11.2 rate caps from post-1996- Settlement new shippers, because it does not meet the parameters for such a “discount adjustment.”

<sup>356</sup> El Paso Rehearing at 98-99.

<sup>357</sup> *Id.* at 99-100 (citing March 20 Order, 114 FERC ¶ 61,290 at P 92).

the 1996 Settlement.<sup>358</sup> El Paso argues that the suggestion that it needed to include a provision affirmatively reserving its right to recover any future Above-Cap costs from new shippers, i.e., a provision addressing the rights and obligations of customers who did not exist at the time of the Settlement, is contrary to well-established contract law.<sup>359</sup>

250. El Paso argues that this aspect of Opinion No. 517 also conflicts with Commission and court precedent concerning the law of waiver. El Paso states that the Commission has held that “[r]elinquishment of a known claim or right must be clearly established and will not be inferred from doubtful or equivocal acts or language.”<sup>360</sup> Thus, because the 1996 Settlement contains no express waiver or limitation regarding cost recovery from new shippers, the Settlement must be read to permit El Paso to design its recourse rates to recover any Above-Cap costs from new shippers. In addition, Section 18.2 of the Settlement, Matters Not Addressed, provides that “no party waives any claim or right which it may otherwise have with respect to any matters not expressly provided for or referred to herein.” El Paso concludes that the Settlement preserves its right to recover Above-Cap costs.<sup>361</sup>

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<sup>358</sup> *Id.* at 100-01 (citing Ex. EPG-141).

<sup>359</sup> *Id.* at 101 (citing *Johnson Bank v. George Korbakes & Co., LLP*, 472 F.3d 439, 441 (7<sup>th</sup> Cir. 2006) (Posner, J.) (“Parties to contracts are naturally reluctant to empower a third party to enforce their contract, so *third-party beneficiary status ordinarily is not inferred from the circumstances but must be express.*”) (emphasis added); *Mirant Kendall, LLC*, 110 FERC ¶ 61,272, at P 12 (2005) (“The Commission has found that ‘[t]hird parties are not beneficiaries unless the contracting parties have clearly expressed their intention that the third parties have rights conferred upon them.’”) (quoting *Power Authority of the State of New York, et al. v. Long Island Lighting Co.*, 60 FERC ¶ 61,069 at 61,236 (1992)); see also *Verosol V.V. v. Hunter Douglas, Inc.*, 806 F. Supp. 582 (E.D. Va. 1992) (“Under well established principles of contract law, a stranger to a contract ordinarily has no rights under the contract and cannot sue to enforce it.”)).

<sup>360</sup> El Paso Rehearing at 102 (citing *Sithe/Independence Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 76 FERC ¶ 61,285, at 62,458 (1996) (fn. Omitted), remanded on other grounds, 165 F.3d 944 (D.C. Cir. 1999); see also *So. Cal. Edison Co.*, Opinion No. 289, 41 FERC ¶ 61,188, at 61,491 & nn.17-19 (1987) (“It is horn book law that a waiver is an intentional abandonment or relinquishment of a known right or advantage which, but for such waiver, the party would have enjoyed.... A waiver must be clearly established and will not be inferred from doubtful or equivocal acts or language.”). See also Williston on Contracts § 39.28 (4<sup>th</sup> Ed. 2000)).

<sup>361</sup> El Paso Rehearing at 103.

251. El Paso argues that the Commission disregarded court precedent reversing the Commission on this point. El Paso argues that, in *Mid Louisiana Gas Co., v. FERC*, the Court reversed the Commission for concluding that, because the pipeline did not specifically reserve its right to reprice certain production should it prevail in pending litigation, the pipeline “must by law be deemed to have given up that right.” The Court concluded that because the repricing issue and the pending litigation over that issue were not addressed in the settlement, they were not resolved by the settlement, despite the absence of any express reservation of the pipeline’s right to reprice its gas. The Court also observed that the general reservations clause, similar to El Paso’s Section 18.2, further supported “the non-global nature of the settlement” and refused to deem the pipeline’s silence as a waiver of its right to reprice the gas at issue.<sup>362</sup> El Paso concludes that the Commission has acknowledged that the vehicle provided by the 1996 Settlement for El Paso to recover its Above-Cap costs is remarketing and that the Settlement is otherwise silent on the rights of non-parties after 2005.<sup>363</sup>

252. El Paso argues that the Commission and the settling parties have treated the Article 11.2(a) rates as vintage, maximum rates for purposes of capacity release and scheduling, not discounted rates; El Paso posts the Article 11.2 rates on its EBB as maximum rates. El Paso contends that it was thus unreasonable for the Commission to require El Paso to show such rates were discounts required by competition, effectively denying El Paso the ability to recover the Above-Cap costs.<sup>364</sup>

253. El Paso states that the Commission discusses two cases in which the Commission denied a pipeline’s request for a discount adjustment because the pipeline failed to show the discounts were granted to meet competition. El Paso argues that these cases are clearly distinguishable and inapplicable here because there was no dispute that the rates at issue were discounts, unlike the situation on El Paso’s system.<sup>365</sup>

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<sup>362</sup> El Paso Rehearing at 103-105 (citing *Mid Louisiana Gas Co. v. FERC*, 780 F.2d 1238 (5<sup>th</sup> Cir. 1986) (“FERC would thrust the burden on the regulated entity, in settling a section 4 rate case, to make provision for everything, including safeguards against every unknown, but conceivable, contingency. That, however, is not the nature of a settlement. See *Texas Eastern Transmission*, 306 F.2d at 357”).

<sup>363</sup> *Id.* at 106.

<sup>364</sup> *Id.* at 107-10.

<sup>365</sup> *Id.* at 110-11 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 295 n.453).

254. El Paso maintains that, even assuming arguendo the Article 11.2(a) rates are discounts, the Commission erred by concluding that those rates were not negotiated to meet competition. El Paso asserts the dire competitive situation it faced in 1996 was well known to the Commission and its customers and is enough evidence to justify a discount adjustment for the Article 11.2(a) rates, even though El Paso disagrees with the Commission's premise that the Article 11.2(a) rates are discounts per se, not maximum rates.<sup>366</sup> El Paso argues that it was negotiating the entire settlement under intense competitive pressure and did not have a choice but to apply Article 11.2 to all shippers. El Paso argues that the central purpose of the 1996 Settlement was to meet this competitive threat, reduce and stabilize rates, and retain load. The Settlement allowed El Paso to retain load for the benefit of all remaining firm shippers on the system, just as the Discount Policy Statement contemplates. Even if the Commission's finding that the Article 11.2 rates constitute discounts were correct (and it is not), the Commission should nonetheless approve a discount-type adjustment for any Above-Cap costs associated with the ConocoPhillips California contract. The Commission's failure to address this issue and grant such a discount adjustment was arbitrary and capricious.<sup>367</sup>

255. El Paso also argues the Commission erred by failing to address El Paso's detailed analysis of competition in the East of California area. El Paso contends that it provided un rebutted evidence of actual, contemporaneous competition as well as customer-specific competitive analysis which the Commission should have weighed.<sup>368</sup> El Paso argues that the record also shows that major East of California firm customers had the right to terminate their El Paso contracts in the near term shortly after 1995. The Commission erred in focusing on the customers' alleged reasons for seeking termination rights instead of why El Paso granted those rights. El Paso argues that the evidence reinforces the presumption that El Paso obtained the highest possible rates in Article 11.2(a) to avoid losing volumes, thus justifying a discount adjustment.<sup>369</sup> El Paso asserts that these "captive customers" were not captive at all.<sup>370</sup> El Paso contends that, by suggesting that El Paso must show what was in the minds of the individuals who negotiated the settlement, the Commission is imposing a requirement never contemplated by its Discount Adjustment Policy. The question of whether competition made the rate

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<sup>366</sup> *Id.* at 131-33.

<sup>367</sup> *Id.* at 133-37.

<sup>368</sup> *Id.* at 137-40 (citing sources).

<sup>369</sup> *Id.* at 140.

<sup>370</sup> *Id.* at 141.

necessary is an objective matter in El Paso's view, which El Paso has fully proven in the record in this case.<sup>371</sup>

256. El Paso argues such evidence was disregarded when Opinion No. 517 focused instead on the lack of evidence, in that El Paso "fail[ed] to present any witness who participated in the settlement negotiations to demonstrate how such concerns affected its negotiations."<sup>372</sup> El Paso states that such a standard is unrealistic and penalizes El Paso for not knowing in 1996 that the Article 11.2 rates would be required to meet competition ten years later. El Paso argues the Commission should have considered its discount-adjustment evidence, even if in a typical discount adjustment case it might not be considered. El Paso argues that this case "presents a unique set of facts and circumstances, with rate provisions that, while not discounts per se, are analogous to pre-approved discounts that did not become applicable until ten years after they were negotiated, and which certain customers claim last indefinitely."<sup>373</sup>

257. El Paso argues that the Above-Cap costs are part of El Paso's overall cost of service and should be recoverable from maximum recourse rate shippers under the Commission's ratemaking rules by spreading its entire projected cost of service, including any Above-Cap costs, over its maximum recourse rate billing determinants, after deducting costs recovered from other contracts, including Article 11.2(a) maximum rate contracts and discounted contracts. El Paso asserts that it has two vintages of maximum rates: (1) Article 11.2(a) maximum rates, which can be no higher than rates computed using a vintage 1995 cost of service and (2) maximum recourse rates for non-Article 11.2(a) contracts, which are based on El Paso's total current cost of service, including both 1995 and Post-1995 costs.<sup>374</sup>

258. El Paso states that Opinion No. 517 found El Paso's vintage rate analogy inapposite, because "the decision whether to design rates according to vintage or use a roll-in approach is made in the certificate proceeding, not post-hoc in a rate case. El Paso has chosen to roll in the expansion and safety costs into its recourse rates, and we need not revisit that decision here."<sup>375</sup> El Paso states, if the Commission is characterizing the

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<sup>371</sup> *Id.* at 142-43.

<sup>372</sup> *Id.* at 142 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 293).

<sup>373</sup> *Id.* at 146.

<sup>374</sup> *Id.* at 112 (citing 18 C.F.R. § 284.10(c)(2) (2011); Ex. EPG-374 at 87-88).

<sup>375</sup> *Id.* at 112-13 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 300).

Article 11.2(a) rates as “recourse rates,” that is inconsistent with its holding that such rates are discounted rates. But if the Commission did not intend to characterize the Article 11.2(a) rates as recourse rates, it follows that El Paso has only rolled the expansion costs into its non-Article 11.2(a) maximum recourse rate contracts. El Paso argues that the Article 11.2(a) rates were designed solely to recover El Paso’s 1995 system costs, not Post-1995 Expansion and other system costs. Even though the Commission rejected El Paso’s “vintage rate” analogy, El Paso again argues that Article 11.2 rates are similar to vintage rates on other pipelines.<sup>376</sup> El Paso argues that the discussion of vintage rates in Opinion No. 517 is inconsistent with prior Commission orders that recognize that the 1996 Settlement rates were based solely on the 1995 system costs and were designed to recover only 1995 costs.<sup>377</sup>

259. El Paso argues it never agreed to roll-in expansion costs to both of its vintages of maximum rates, including its Article 11.2(a) rates, or to forego recovery of any expansion costs that exceed the Article 11.2(a) rate caps. To the contrary, El Paso states it has consistently sought to recover all of its Post-1995 Expansion costs in an appropriate rate case. El Paso maintains the Commission orders certifying those expansions did not require El Paso to absorb the Above-Cap costs.<sup>378</sup> Furthermore, El Paso argues that the Commission is incorrect in stating that vintage rates are only established in certificate proceedings. El Paso cites *Transcontinental Gas Pipe Line Corp.*, where the Commission approved “bifurcated rates” for a storage service based on concessions made by customers in a settlement.<sup>379</sup>

260. El Paso argues that the 1996 Settlement itself established two different rate vintages: for 1995 contracts and for post-1995 contracts. Because the 1996 Settlement required all customers, old and new, to pay rates that included a risk sharing component, but only required El Paso to credit revenues from remarketed capacity to the settling parties, customers with post-1995 contracts paid higher rates than customers with 1995 contracts. El Paso claims that the Commission failed to address this argument.<sup>380</sup>

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<sup>376</sup> *Id.* at 113-14 (citing Ex. EPG-69 at 48; Ex. EPG-374 at 87).

<sup>377</sup> El Paso Rehearing at 114-15 (citing March 20 Order, 114 FERC ¶ 61,290 at P 81-83, *El Paso Natural Gas Co.*, 104 FERC ¶ 61,045 at PP 103-104).

<sup>378</sup> *Id.* at 116.

<sup>379</sup> *Id.* at 117 (citing *Transcontinental Gas Pipe Line Corp.*, 130 FERC ¶ 61,043 (2010)).

<sup>380</sup> *Id.* at 118-19.

261. El Paso argues that requiring it to absorb above-cap costs effectively denies it an opportunity to recover its expansion costs, contrary to prior FERC orders that held El Paso should be permitted to recover such costs from all shippers. El Paso suggests that some of Opinion No. 517 appears not to require El Paso to absorb Post-1995 Expansion Costs; as an example, El Paso points to where the Commission states that the Article 11.2(a) shippers are paying for expansion capacity pursuant to “separate, fully allocated rates.”<sup>381</sup>

262. El Paso further argues that the Above-Cap costs are comprised entirely of post-1995 expansion costs which Opinion No. 517 forces El Paso to absorb, even though such costs had nothing to do with the 1996 risk-sharing arrangement.<sup>382</sup> El Paso asserts that but for the expansion facilities added since 1995, El Paso’s recourse rates would not exceed the Article 11.2(a) rates and the level of discounted and unsubscribed capacity would be much smaller.<sup>383</sup> El Paso explains that more than half its cost of service is associated with facilities constructed after 1995.<sup>384</sup> El Paso argues that it is able to recover an allocable share of its 1995 costs from its Article 11.2(a) maximum rates, but because the Post-1995 Expansion costs are so large, it is unable to recover a fully allocable share of those costs from the Article 11.2(a) rates. Thus, El Paso concludes the entire amount of Above-Cap costs is comprised exclusively of Post-1995 Expansion Costs. El Paso contends that the Commission erred by assuming that El Paso is fully recovering its expansion costs given that Opinion No. 517 has effectively required El Paso to absorb \$12.8 million of Post-1995 Expansion costs.<sup>385</sup>

263. El Paso argues that Article 11.2(b) only protects shippers from 1995 costs, and that El Paso did not agree to bear or absorb any costs incurred after 1995. El Paso argues that Article 11.2 contravenes the public interest because forcing it to absorb \$12.8 million annually of Above-Cap, Post-1995 Expansion costs will create a significant disincentive to make future discretionary investments in the El Paso system. El Paso contends that this will be particularly true with flexibility projects that typically do not generate new contracts.

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<sup>381</sup> *Id.* at 119-20 (citing Opinion No. 517, 139 FERC ¶ 61,095 at PP 251, 243).

<sup>382</sup> *Id.* at 120.

<sup>383</sup> *Id.* at 120-21 n.141 (citing Ex. EPG-69 at 42-43; Ex. EPG-374 at 120).

<sup>384</sup> *Id.* at 121 (citing Ex. EPG-374 at 89; Tr. 2601).

<sup>385</sup> *Id.* at 123.

264. El Paso argues that the Commission erred in rejecting the “disincentive to construct” argument as speculative because El Paso had failed to produce evidence that any significant system improvements were not built due to Article 11.2.<sup>386</sup> El Paso argues that common sense and basic economics compel the conclusion that El Paso will not invest in new discretionary facilities if it is required by Article 11.2 to absorb a portion of their costs. El Paso further contends that the reason Article 11.2 has not created this disincentive until now is due to the fact that El Paso has not had to absorb any Above-Cap costs until this proceeding, since the 2005 Rate Case settlement deferred this issue to the instant rate case. El Paso argues that the Commission erred by ignoring the likely consequence of continuing disproportionate increases in non-Article 11.2 rates, which would likely be a disincentive for new shippers to contract for service on El Paso’s system.<sup>387</sup>

265. El Paso argues that the Commission erred in finding that the increased revenue from the Article 11.2 inflation adjustments may be applied to system improvements.<sup>388</sup> El Paso states that the Commission has previously found that the inflation adjustment only provides for an increase in the Operations and Maintenance (O&M) and Other Taxes portion of the Article 11.2(a) rates and thus does not provide any revenue for expansions.<sup>389</sup> El Paso argues that its annual inflation adjustment is too small to overcome its disincentive to invest in new facilities created by the 1996 Settlement. El Paso disputes the suggestion in Opinion No. 517 that the inflation adjustment permitted by Paragraph 3.2(b) of the 1996 Settlement was intended to compensate El Paso for the cost of additional facilities. El Paso argues that the Commission rejected this argument in an earlier order when it found that nothing in the inflation adjustment provision leads to the conclusion that the parties intended to apply the rate cap to major expansion projects.<sup>390</sup>

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<sup>386</sup> *Id.* at 178-79 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 252, Ex. EPG-374 at 64-65).

<sup>387</sup> *Id.* at 181.

<sup>388</sup> El Paso Rehearing at 181-82 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 248).

<sup>389</sup> *Id.* at 181-82 (citing September 5 Order, 124 FERC ¶ 61,227 at P 79; March 20 Order, 114 FERC ¶ 61,290 at P 82).

<sup>390</sup> *Id.* at 115-16, n.133 (citing September 5 Order, 124 FERC at P 79).

266. El Paso argues that the Commission erred in endorsing the Presiding Judge's finding that the impact of El Paso's discounts to California and other shippers exceeds the impact of the Article 11.2(a) rates.<sup>391</sup> El Paso states this ignores a key difference between the California discounts and the Article 11.2(a) rates, namely that El Paso has not been required to absorb any costs it cannot recover from discounted contracts because recourse rate discounts to meet competition are recoverable in a subsequent discount adjustment to throughput in a following rate case.

267. Finally, El Paso contends that it has installed new discretionary facilities since 1995 that have helped reduce its fuel rates by approximately 50 percent, saving shippers (including Article 11.2(a) Shippers) approximately \$100 million annual in reduced fuel costs. El Paso argues that it is unfair to allow Article 11.2 shippers to receive the benefit of the fuel savings from new facilities while shielding them from the facilities' costs.<sup>392</sup>

**b. Commission Determination**

268. El Paso presents a number of arguments purporting to support its ability to shift the costs resulting from the difference between Article 11.2 and recourse rate revenues. El Paso argues that the Above-Cap costs are essentially related to the post-1995 expansion projects, including safety and pipeline enhancement projects.

269. El Paso argues that the Commission erred by not authorizing a surcharge to recover Post-1995 projects, yet El Paso did not propose such a surcharge, despite Commission statements that El Paso had that option. By choosing to challenge the justness and reasonableness of Article 11.2, and to propose that the Above-Cap costs be recovered from non-Article 11.2 shippers, El Paso has not given the Commission and the other parties the opportunity to argue the merits of a surcharge. El Paso cannot on rehearing here seek yet another bite of the apple, once it has chosen to pursue a very different cost recovery avenue in this proceeding. After failing to support elimination of Article 11.2 and then its proposal to shift the Above-Cap costs to non-Article 11.2 shippers, El Paso is now arguing that the Commission should use its section 5 authority to approve a surcharge that has neither been proposed by El Paso nor litigated in the hearing. If El Paso chooses to pursue a surcharge proposal, it may do so by making a section 4 filing pursuant to the Commission's cost recovery policy statement.<sup>393</sup>

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<sup>391</sup> *Id.* at 183 (citing Opinion No. 517, 139 FERC ¶ 61,095 at P 251).

<sup>392</sup> *Id.* at 184 (citing Ex. EPG-374 at 63).

<sup>393</sup> *See Cost Recovery Mechanisms for Modernization of Natural Gas Facilities*, Policy Statement, 151 FERC ¶ 61,047 (2015).

270. The Commission has not implicitly found that El Paso's recovery of the Post-1995 expansion costs was subject to unstated conditions, as El Paso alleges. Article 11.2 allowed the capped rates to extend beyond the initial 10-year term of the 1996 Settlement for eligible shippers with only one allowed adjustment: an annual inflation adjustment. It is entirely reasonable to expect that El Paso and the parties understood that any other actions undertaken by El Paso would be pursued in light of the restrictions of the 1996 Settlement.

271. El Paso argues that the 1996 Settlement contains no express waiver or limitation regarding cost recovery from new shippers and thus the Settlement must be read to permit El Paso to design its recourse rates to recover any Above-Cap costs from new shippers. We disagree. The 1996 Settlement cannot be read to allow El Paso to increase the Article 11.2 rates for any future expansions without modifying the 1996 Settlement. To do otherwise would nullify the core purpose of Article 11.2 which is to prevent any non-inflation adjustments to the Article 11.2 rates. El Paso argues that court precedent reverses the Commission on this point. We disagree, finding that *Mid Louisiana Gas Co., v. FERC* is not on point. That case did not concern the allocation of costs to transportation rates, but the repricing of a pipeline's own natural gas production. In that case, the court found that where there was pending litigation over that issue, and where a settlement did not address the issue, this did not amount to a waiver of the pipeline's right to reprice its own gas, despite the absence of any express reservation in the settlement of the pipeline's right to reprice its gas. In the case of the 1996 Settlement, however, the issue of allocating the costs of future expansion costs to non-parties was not a matter of current dispute when the 1996 Settlement was executed and approved, and the waiver analogy is inapposite.

272. El Paso argues that the Commission erred in requiring El Paso to show that the Article 11.2 rates are discount rates required by competition before it could recover costs through a so-called "discount adjustment" to reduce throughput estimates in its next rate case. El Paso's first tack is to argue that the Article 11.2 rates have been treated as vintage, maximum rates for purposes of capacity release and scheduling, and thus are not discounted rates. El Paso then appears to concede that the traditional discount analysis should apply, and argues that, if the Commission requires a discount analysis, the record shows that the Article 11.2 rates were justified by competitive concerns.

273. The Commission has addressed the issue of how El Paso could show that it should be allowed to reallocate to non-Article 11.2(a) shippers or contracts any shortfall arising as a result of Article 11.2(a) rates being lower than recourse rates. In prior orders on the 2006 Rate Case, the Commission stated that the parties may address whether "the other shippers on [El Paso] should be allocated, through a discount adjustment, costs associated

with the rate cap.”<sup>394</sup> The Commission did not, however, pre-decide that the Article 11.2(a) rates were eligible discounted rates nor did it guarantee that El Paso would meet the discount adjustment criteria. Thus, notwithstanding the fact that El Paso has not treated the Article 11.2(a) rates as discounted rates, the Commission did not bar El Paso from proposing to recover a revenue shortfall through a discount adjustment. It is this language that El Paso highlights to allege inconsistent treatment by the Commission.

274. Contrary to El Paso’s assertions, the Commission allowed El Paso to make its showing, reviewed the record, including the analysis and evidence provided by El Paso and other parties, and then reached its decision to affirm the Presiding Judge’s conclusion that El Paso has not met its burden to show that the discounts were required to meet competition. El Paso has not provided any new arguments on rehearing to change that conclusion. El Paso argues that the Commission imposed an impossible standard on El Paso by faulting it for not knowing in 1996 that the Article 11.2 rates would be required to meet competition ten years later. El Paso’s argument only highlights the point that the Article 11.2 rates are not easily characterized as discounted rates that qualify for a discount adjustment, but instead are *sui generis* settlement contract rates that were applied to all shippers on the system, many of whom were captive customers, as part of a risk-sharing agreement, and are not eligible for a discount adjustment, because they were not primarily agreed to for competitive reasons.

275. El Paso again raises other arguments to justify recovery of the Article 11.2 shortfall, such as (1) labeling them vintage rates; (2) contending that the Commission’s decision to allow El Paso to roll-in the expansion facility costs into system rates requires that El Paso be allowed to recover the Article 11.2 shortfall; and (3) asserting that the shortfall is comprised exclusively of post-1995 expansion costs that benefit the Article 11.2(a) shippers and that El Paso did not agree to bear or absorb any of those expansion costs that are not recovered from Article 11.2(a) shippers. As Opinion No. 517 explained and as the Commission has again made clear on rehearing – while it allowed El Paso to make its showing, and while it anticipated review of El Paso’s proposal under the established Discount Adjustment Policy, it did not thereby signal any pre-approval, or give tacit encouragement or approval of novel theories to justify recovery of the shortfall should a “discount adjustment” be disallowed.<sup>395</sup> El Paso’s arguments on rehearing are not new and continue to be non-persuasive. The core of El Paso’s argument is that the Commission has effectively denied El Paso full recovery of the costs that it allowed El Paso to roll-in to system rates. Yet there is no guarantee that a pipeline will fully

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<sup>394</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 289 (citing March 20 Order, 114 FERC ¶ 61,290 at P 27; September 5 Order, 124 FERC ¶ 61,227 at P 120).

<sup>395</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 299.

recover its costs if rolled-into system rates. A Commission finding that rolling in the rates is reasonable gives the pipeline the opportunity to recover its costs, not a guarantee. Many factors affect the ability of a pipeline to fully recover its costs, including whether the new capacity is fully subscribed, whether the contracts are discounted, and whether the system is operated efficiently. As the Presiding Judge noted, “the impact of El Paso’s discounts to California and other shippers exceeds the impact of Article 11.2(a) rates.”<sup>396</sup> In addition, El Paso made the decisions to roll-in the post-1995 expansion costs years after the 1996 Settlement was approved and with full knowledge of Article 11.2.

276. While El Paso argues that the Commission ignored a key difference between the discounts and Article 11.2 rates (that recourse rates are adjusted by a discount adjustment, but not to recover the shortfall), the reality is that discount adjustments serve to widen the gap between recourse and Article 11.2 rates. Without the discount adjustment, the difference between the two would decrease significantly.

277. El Paso argues that the Commission erred by refusing to find that Article 11.2 creates a significant disincentive to construct necessary facilities, including flexibility projects and facilities that improve energy efficiency. We disagree. El Paso has a variety of options to recover costs, including incremental rates and pipeline integrity surcharges.<sup>397</sup> In addition, any perceived disincentive has been mitigated to a degree by El Paso’s own laudable efforts to negotiate with Article 11.2 shippers to reduce the contracts subject to Article 11.2.

#### **4. Article 11.2(b) compliance**

##### **a. Requests for Rehearing**

278. El Paso supports the Commission’s conclusion that no rate reduction under Article 11.2(b) is required in this case but reiterates its arguments that the potential for this provision to exacerbate the discriminatory effects of Article 11.2 cannot be ignored. El Paso argues that Article 11.2(b) provides a further basis for finding here that Article 11.2 is not in the public interest and should be terminated.<sup>398</sup>

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<sup>396</sup> *Id.* P 251 (citing ID, 134 FERC ¶ 63,002 at P 507).

<sup>397</sup> *See Cost Recovery Mechanisms for Modernization of Natural Gas Facilities*, 151 FERC ¶ 61,047.

<sup>398</sup> El Paso Rehearing at 185-88.

279. Rate Protected Shippers/Salt River/ACC seek clarification that the Commission affirmed the Initial Decision finding that the 4,000 MMcf/d threshold equals 4,068 MDth/d. They argue that no party took exception to this finding and the Commission did not reverse the Presiding Judge on this finding, but there is no explicit finding in Opinion No. 517.<sup>399</sup>

280. APS argues that the Commission erred in allowing El Paso to rely on non-forward haul capacity to demonstrate compliance with Article 11.2(b). APS contends that inclusion of non-forward haul capacity is contrary to the plain language of Article 11.2(b). APS argues that Article 11.2(b) does not protect *capacity* from cost shifting; instead it protects the *rates for service to eligible customers* from being allocated costs of 1995 forward haul capacity that becomes unsubscribed or sold at a discount.<sup>400</sup>

281. APS argues that the purpose of the threshold is to ensure that “at risk” costs (i.e., costs of 1995 capacity to deliver gas on a forward haul basis that is unsubscribed or sold at a discount) are not included in El Paso’s rates in violation of Article 11.2(b). APS argues that Article 11.2(b) was never intended to address non-forward haul capacity because there was no issue in the 1995 rate case concerning the turnback or allocation of costs of eastflow or backhaul capacity. APS argues that if El Paso is not at risk for the cost of non-forward haul capacity sold at discounted rates, then the subscription of such capacity at maximum rates should not be relevant to whether El Paso has met the threshold.<sup>401</sup>

282. APS argues that the 4,000 MMcf/d threshold is based on the 1995 forward-haul capacity and does not include the east flow capacity. APS argues that Article 11.2(b) protects both forward haul and east flow shippers from being shifted costs of forward haul capacity that is unsubscribed or sold at a discount. While forward haul capacity is utilized to provide service to most of the Article 11.2 shippers, a small amount of service to such eligible shippers is provided on east flow capacity.<sup>402</sup>

283. APS thus requests that the Commission require that only forward haul capacity be counted towards the threshold. In this case, the non-forward haul capacity was 437 MMBtu/d (as calculated by APS witness Bishop); the removal of this amount would

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<sup>399</sup> Rate Protected Shippers/Salt River/ACC Rehearing at 3.

<sup>400</sup> APS Rehearing at 2-9.

<sup>401</sup> *Id.* at 5 n.14, 7.

<sup>402</sup> *Id.* at 4-5 n.13.

leave El Paso with 3,648 MMBtu/d of firm, forward haul capacity, resulting in a shortfall of 420 MMBtu/d. Non-forward haul capacity consists of 168 MDth/d of eastflow and 269 MDth/d of short haul of less than 100 miles, which is considered by El Paso to be non-forward haul for fuel purposes.<sup>403</sup>

284. APS and Rate Protected Shippers/Salt River/ACC agree that the Article 11.2(b) threshold was not met. Rate Protected Shippers/Salt River/ACC request that the Commission clarify its threshold calculation, which they agree appears to show that the Commission counted 4,085 MDth/d toward the threshold, which is 17 Dth/d more than the threshold.<sup>404</sup>

285. Rate Protected Shippers/Salt River/ACC request that the Commission affirm the Initial Decision and clarify that only subscribed maximum rate firm capacity and CRNs count toward the threshold. They argue that this finding is implicit in Opinion No. 517's findings, but clarification is necessary to prevent future litigation. Rate Protected Shippers/Salt River/ACC further request that the Commission confirm that El Paso's peak month analysis cannot be used to inflate the capacity eligible for the threshold calculation.<sup>405</sup>

286. The California Parties request that the Commission clarify that Opinion No. 517 does not reach the issue of whether the termination of the sole supplier obligation under El Paso's former full requirements contracts terminates or otherwise affects El Paso's obligation under Article 11.2(b). They argue that the actions of several former full requirements shippers in contracting for capacity on Transwestern's Phoenix Lateral should not be rewarded with lower rates under Article 11.2(b).<sup>406</sup>

#### **b. Commission Determination**

287. Several parties argue that the Commission erred in finding that El Paso need not reduce any rates pursuant to the 1996 Settlement, since it has met the 4,000 MMcf/d presumption threshold and therefore fulfilled the Article 11.2(b) requirements to avoid triggering a reduction in rates. APS argues that the Commission erred in determining that the Initial Decision incorrectly excluded non-forward haul contracts from the calculation

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<sup>403</sup> *Id.* at 8-9 n.28.

<sup>404</sup> RPS/SRP/ACC Rehearing at 4.

<sup>405</sup> *Id.* at 5-6.

<sup>406</sup> California Parties Rehearing at 7.

of the presumption. We disagree. “Forward haul” capacity defines the scope of 1995 capacity that is protected from cost-shifting, not the services that can be counted toward compliance with Article 11.2(b).<sup>407</sup> The presumption calls for a determination that El Paso has contracts for at least 4,000 MMcf/d (the approximate capacity of El Paso’s system in 1995) that are priced at or above the Article 11.2 rate in order to comply with Article 11.2(b).

288. For purposes of the threshold calculation, all firm contracts that are priced at or above the Article 11.2(a) rate (including CRNs<sup>408</sup>) count toward the 4,000 MMcf/d threshold, for that approximates what would be generated by contracts associated with the 1995 capacity. As long as there are sufficient contracts at that level, it is presumed that El Paso has not shifted the cost of unsubscribed or discounted capacity onto the Article 11.2 shippers. Whether those contracts are forward haul, backhaul, short haul, east flow, or production area contracts is immaterial, as long as those contracts are priced at or above the Article 11.2 rate. We affirm that all firm contracts priced at or above the Article 11.2 rates, and CRNs, count toward the threshold calculation.

289. The California Parties request that the Commission clarify that Opinion No. 517 does not reach the issue of whether the termination of the sole supplier obligation under El Paso’s former full requirements contracts terminates or otherwise affects El Paso’s obligation under Article 11.2(b). Because we find that the Article 11.2(b) rate reduction threshold is not triggered in this proceeding, the subsidiary issues regarding Article 11.2(b), including those raised by the California Parties, are moot and were not addressed by Opinion No. 517. Similarly, because the Commission found that an excess of the threshold volumes to prevent a rate reduction was achieved in this case, we need not address whether El Paso’s peak month analysis would show compliance with Article 11.2(b).

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<sup>407</sup> Opinion No. 517, 139 FERC ¶ 61,095 at P 325.

<sup>408</sup> CRNs (daily capacity reservation nomination capacity) reflect the capacity El Paso reserves for hourly services under Rate Schedule FTH. The Commission found that El Paso provided evidence that it must set aside capacity to accommodate the hourly variations provided under the FTH service in addition to the contract demand (CD) contract established by the FTH contracts. That capacity is excluded from the operationally available capacity El Paso posts on its EBB and is therefore not “unsubscribed.” *See* Opinion No. 517, 139 FERC ¶ 61,095 at P 328.

**III. Docket No. RP12-806-000 Compliance Filing**

290. On June 15, 2012, El Paso submitted a filing in Docket No. RP12-806-000 to comply with the Commission's directives in Opinion No. 517 regarding the four issues set for hearing in that proceeding, as described below.

**A. Public Notice and Responsive Pleadings**

291. Public notice of El Paso's June 15 filing was issued on June 18, 2012, allowing protests to be filed on or before June 27, 2012. Pursuant to Rule 214 (18 C.F.R. § 385.214 (2014)), all timely filed motions to intervene and any unopposed motion to intervene out-of-time filed before the issuance date of this order are granted. Granting late intervention at this stage of the proceeding will not disrupt the proceeding or place additional burdens on existing parties. The Indicated Shippers filed a protest,<sup>409</sup> and Texas Gas Service filed a protest, which was withdrawn.<sup>410</sup> Indicated Shippers filed a protest arguing that El Paso did not comply with Opinion No. 517, because it failed to revise the currently-effective rates under review in the 2011 Rate Case proceeding, which were accepted subject to the outcome the 2008 Rate Case determinations. On July 9, 2012, El Paso filed an answer to the protests. On July 13, 2012, Joint Parties<sup>411</sup> filed a limited answer to El Paso's answer, to clarify the record with respect to one sentence contained in El Paso's answer. On July 20, 2012, El Paso filed an answer to the Joint Parties' limited answer.

**B. Procedural Matters**

292. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure prohibits an answer to a protest or answer unless otherwise ordered by the decisional authority. We are not persuaded to accept El Paso's answer and will, therefore, reject it. Consequently,

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<sup>409</sup> With ConocoPhillips' withdrawal, the Indicated Shippers are Shell Energy North America (US), L.P.

<sup>410</sup> See Texas Gas Service's August 7, 2014 notice of withdrawal in Docket No. RP12-806-000.

<sup>411</sup> For the purposes of this pleading, Joint Parties are: the El Paso Municipal Customer Group; New Mexico Gas Company, Inc.; UNS Gas, Inc.; Tucson Electric Power Company; Freeport-McMoRan Corporation; Apache Nitrogen Products, Inc.; and the Salt River Project Agricultural Improvement and Power District (as noted above, Texas Gas Service and ConocoPhillips filed motions withdrawing from the joint pleading).

we reject the remaining answers filed subsequent to El Paso's answer as moot. To the extent the answers respond to requests for clarification, they have been considered by the Commission. The Commission will address issues with regard to El Paso's currently-effective rates in its orders addressing the 2011 Rate Case proceeding.<sup>412</sup>

**C. Line 1903**

293. In Opinion No. 517, the Commission found that (1) El Paso's depreciable plant account should only include the \$10.5 million associated with El Paso's investment in Line 1903, and (2) El Paso has not shown that it has booked accumulated depreciation and deferred income taxes assessed on the unused California segment that was purchased with Line 1903. In its compliance filing, El Paso states that it understands Opinion No. 517 to require El Paso to adjust its Account No. 101 to include only approximately \$10.5 million for accounting purposes. El Paso states that, because Opinion No. 517 essentially finds that El Paso erroneously recorded the additional approximately \$25.7 million in Account No. 101 from the time El Paso first recorded it, El Paso therefore must adjust that account to remove that amount retroactively. El Paso further states that now is the appropriate time to make any necessary related accounting entries. El Paso states that ordering paragraph (C) of Opinion No. 517 requires El Paso to file proposed accounting entries and workpapers. El Paso therefore filed accounting entries and supporting workpapers to ensure that its FERC books and records (as well as Commission accounting required reports such as Form 2 and Form 3Q) are accurate given the directives of Opinion No. 517.

294. El Paso states that it recorded the \$36,120,000 in Account No. 101 on the in-service date of the Line 1903 project, December 31, 2005, consistent with Commission requirements. El Paso states that it has provided accounting entries in Appendix B to this filing that reflect an adjustment from December 31, 2005 through May 31, 2012 to "reverse" \$25,645,000 from Gas Plant in Service – Account No. 101 and record that amount in Non-Utility Property – Account No. 121. El Paso further states that the Commission requires amounts in Account No. 101 to be depreciated beginning when the facilities are placed in service, and that amounts for accumulated deferred income taxes be recorded when there is a difference for depreciation rates for book and tax purposes. Thus, El Paso states that it began depreciating the \$25,645,000 and recording deferred taxes associated with that amount on December 31, 2005, and continuously after. To ensure the accuracy of El Paso's accounting books and records, El Paso provided accounting entries in Appendix B that "reverse" the amounts previously recorded in association with the \$25,645,000 for depreciation in Account No. 108 and deferred

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<sup>412</sup> *E.g.*, Docket No. RP12-816-001 (where Indicated Shippers filed a similar protest) and Docket No. RP10-1398-000.

income taxes in Account No. 282 through May 31, 2012. The accounting entries in Appendix B show that El Paso (1) “reversed” \$3,802,299 in Accumulated Provision for Depreciation of Gas Utility Plant – Account No. 108, and recorded that amount in Depreciation Expense – Account No. 403 and (2) “reversed” \$3,651,694 in Accumulated Deferred Income Taxes – Other Property – Account No. 282 and recorded that amount in Provision for Deferred Income Taxes – Credit, Utility Operating Income – Account No. 411.1.

### **Commission Determination**

295. El Paso proposes to reclassify the \$25,645,000 cost of Line 1903 from utility plant recorded in Account No. 101, Gas Plant in Service, to Account No. 121, Nonutility Property. However, it also proposes to “reverse” the accumulated depreciation and related accumulated deferred income taxes recorded on this amount. Under the Uniform System of Accounts, when property is transferred from one plant account or function to another, the related accumulated depreciation is also reclassified.<sup>413</sup> El Paso acknowledges that an adjustment to its depreciation accounts is necessary, but incorrectly proposes to “reverse” the amounts recorded in Account Nos. 108 and 282 and record those amounts in Account Nos. 403 and 411.1, respectively, which are income accounts rather than balance sheet accounts. El Paso’s proposal would inappropriately increase net income and stockholders’ equity. Therefore, El Paso must record the \$3,802,299 of accumulated depreciation transferred from Account No. 108, Accumulated Provision for Depreciation of Gas Utility Plant, to Account No. 122, Accumulated Provision for Depreciation and Amortization of Nonutility Property. Additionally, El Paso must reclassify the \$3,651,694 of accumulated deferred income taxes recorded in Account No. 282, Accumulated Deferred Income Taxes – Other Property, to Account No. 283, Accumulated Deferred Income Taxes – Other, which is a nonutility deferred income tax account. Accordingly, we accept El Paso’s proposed accounting adjustments, subject to the changes discussed above.

#### **D. Capital Structure and Article 11.2**

296. El Paso states that, pursuant to Paragraph 5.2 of the 2010 Settlement, El Paso’s capital structure for rate purposes in subsequent rate case(s) will be subject to the Commission’s order on the reserved issues. Thus, El Paso states that the Commission’s directives in Opinion No. 517 with regard to capital structure do not affect the Docket No. RP08-426-000 locked-in rates and no conforming accounting changes or accounting workpapers associated with this issue are required.

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<sup>413</sup> See Gas Plant Instruction No. 12, Transfers of Property, and paragraph (d) to Account No. 108.

297. Similarly, El Paso states that all issues related to Article 11.2 as they pertain to recourse rates in effect for the locked-in Docket No. RP08-426-000 period were agreed upon in the 2010 Settlement. Therefore, El Paso concludes that no tariff changes are required due to the determinations in Opinion No. 517. Pursuant to Articles 6.7 and 15.5 of the 2010 Settlement, El Paso will make any required refunds (with associated interest) related to the Article 11.2 issues within 60 days following a final Commission order.

### **Commission Determination**

298. The Commission's directives in Opinion No. 517 regarding capital structure and Article 11.2 do not apply to the Docket No. RP08-426-000 locked-in rates; thus, El Paso's compliance filing appropriately contains no revised tariff records on these two issues. Indicated Shippers' protest regarding currently-effective rates filed in the 2011 Rate Case proceeding will be addressed in orders relating to those proceedings.

#### **E. Short-term Firm and Interruptible Rates**

299. In Opinion No. 517, the Commission found that El Paso's proposal to charge a maximum rate for short-term firm, IT, PAL, and authorized overrun service equal to 250 percent of the daily reservation rate applicable to long-term firm service was unjust and unreasonable.

300. El Paso proposes to change the short-term firm and interruptible rates in the Docket No. RP08-426-000 locked-in period to be equal to the long-term firm reservation rates, in compliance with the Commission's rejection of El Paso's use of 250 percent of the long-term firm reservation rate as the basis for the design of such rates. El Paso states that it has not proposed to eliminate the short-term service provisions in its tariff at this time. El Paso explains that elimination would require Passport system<sup>414</sup> updates to the internal programming logic that differentiates short-term and long-term service identification that would be extensive, time-consuming, and potentially costly. El Paso states that reducing the short-term rates as required but leaving in place the service identification structure complies with the Opinion No. 517 directives. El Paso notes that its pending rate case in Docket No. RP10-1398-000 includes rate levels identified and differentiated as short-term, long-term, and ten-year term rates. El Paso thus proposes to leave in place all tariff references to short-term rates until system programming modifications are necessary for the Docket No. RP10-1398-000 proceeding.

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<sup>414</sup> El Paso states that Passport is an internet-based computer system that enables its customers to transact business activities with the pipeline, including but not limited to, contracting, nominations, flowing gas, capacity release, and imbalance management.

301. El Paso states that, for the Docket No. RP08-426-000 locked-in period, it has recomputed rates for IT service using a 100 percent load factor derivative of the long-term firm Rate Schedule FT-1 rate in each applicable zone of delivery. El Paso has also recomputed rates for its Rate Schedule PAL and ISS services using 100 percent load factor derivatives of its settlement system average rates. El Paso states that, pursuant to the 2010 Settlement at paragraphs 2.1(c) and 5.4, the interruptible IHSW rates are not subject to the determination set forth in Opinion No. 517 and are therefore not modified.

### **Commission Determination**

302. We find that El Paso's revised rates as shown on the tariff records, listed in the Appendix, are in compliance with Opinion No. 517 and are accepted, effective January 1, 2009. Those tariff records adjust the short-term firm and interruptible rates for the Docket No. RP08-426-000 locked-in period. The Commission notes that El Paso selected tariff record priority numbers lower than those in effect at the time. As a result, the proposed tariff records are deemed superseded by the tariff records containing rates the Commission has found not to be just and reasonable. Below, the Commission requires these compliance tariff records be refiled with priority numbers greater than the tariff records that have been found not to be just and reasonable.

### **F. Compliance Filing and Refund Report**

303. Within 30 days of the issuance of this order, El Paso must file revised tariff records and rates, to be effective January 1, 2009, reflecting the Commission's rulings in this order for the locked-in period. Within sixty days, El Paso is required to provide refunds and provide a report to the Commission consistent with section 154.501 of the Commission's regulations.<sup>415</sup>

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<sup>415</sup> 18 C.F.R. § 154.501 (2014). The locked-in period of January 1, 2009 through March 31, 2011 includes the date on which the Commission changed its electronic tariff system. Within this locked-in period, there were several intervening tariff changes on the subject tariff sheets and records. El Paso is not required to file revised electronic tariff sheets in the FASTR format, as the Commission no longer maintains that system. For the period of January 1, 2009 through April 30, 2010, El Paso is required to file a rate summary tariff sheet document with content similar to the Statement of Rates in El Paso's FERC Gas Tariff, Second Revised Volume No. 1A. In the same compliance filing, El Paso is required to file tariff records for the period of May 1, 2010 through March 31, 2011. Docket No. RP08-426-000 predates the change in the Commission's electronic tariff filing procedures. As a result, El Paso created a new docket number in this proceeding when it filed its compliance tariff records, effective January 1, 2009 in Docket No. RP12-806-000. To prevent the proliferation of docket numbers, El Paso is

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304. The Commission is accepting El Paso's proposed accounting adjustment relating to the revaluing of Line 1903. El Paso is directed to include in the compliance filing to this order a report that reflects its compliance with these accounting adjustments.

305. As discussed above, the Commission is granting rehearing to permit El Paso to reflect that \$50 million was raised through a 2007 debt issue, and that it may therefore attribute that amount to outstanding debt when adjusting its capital structure. Pursuant to the 2010 Settlement, Commission determinations on the capital structure and Article 11.2 issues are to be applied prospectively. As a result, the Commission expects that El Paso shall reflect those findings in its future compliance filings in Docket No. RP10-1398-000, when those compliance filings are made.

The Commission orders:

(A) Rehearing is granted to permit El Paso to make a change to the adjustment to its capital structure ordered in Opinion No. 517, to attribute certain debt proceeds to its outstanding debt, as discussed above.

(B) The remaining requests for rehearing of Opinion No. 517 are otherwise denied as discussed above; to the extent a rehearing request is not mentioned in this order, the request should be considered denied.

(C) Within 30 days of the issuance of this order, El Paso must file revised tariff records and rates, effective January 1, 2009, and a report reflecting the proposed accounting and workpapers, reflecting the Commission's rulings in this order.

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required to use Type of Filing Code (TOFC) 580 for its compliance tariff filing and TOFC 670 for its refund report, and both of these filings should be associated with Docket No. RP12-806-000. The compliance tariff filing's Filing Title should include "Docket No. RP08-426 Compliance Filing."

(D) Within 60 days of the issuance of this order, El Paso must refund amounts recovered in excess of the just and reasonable rates calculated pursuant to Ordering Paragraph (C) and file a refund report consistent with section 154.501 of the Commission's regulations.

By the Commission.

( S E A L )

Nathaniel J. Davis, Sr.,  
Deputy Secretary.

Appendix

El Paso Natural Gas Company, L.L.C.  
FERC NGA Gas Tariff  
EPNG Tariffs  
Accepted Effective January 1, 2009

[Part II: Stmt. of Rates, Section 1.1 - Production Area Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.2 - Texas Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.3 - New Mexico Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.4 - Arizona Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.5 - Nevada Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.6 - California Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.7 - Lateral, System-wide Balancing & Storage Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.8 - Firm Small Shipper Service Rates, 4.0.0](#)

[Part II: Stmt. of Rates, Section 1.9 - Interruptible and PAL Rates, 4.0.0](#)