

UNITED STATES OF AMERICA 90 FERC ¶ 61,128
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: James J. Hoecker, Chairman;
William L. Massey, Linda Breathitt,
and Curt Hébert, Jr.

Certification of New Interstate
Natural Gas Pipeline Facilities

Docket No. PL99-3-001

ORDER CLARIFYING STATEMENT OF POLICY

(Issued February 9, 2000)

On September 15, 1999, the Federal Energy Regulatory Commission (Commission) issued a Statement of Policy (Policy Statement) revisiting its policy for certificating new construction not covered by the optional or blanket certificate authorizations. The purpose of the Policy Statement was to provide the industry with guidance as to the analytical framework the Commission will use to evaluate proposals for certificating new construction.

The Policy Statement sets out the analytical steps the Commission will use. It provides that when a certificate application is filed, the threshold question applicable to existing pipelines is whether the project can proceed without subsidies from their existing customers. The next step is to determine whether the applicant has made efforts to eliminate or minimize any adverse effects the project might have on the existing customers of the pipeline proposing the project, existing pipelines in the market and their captive customers, or landowners and communities affected by the route of the new pipeline. If the proposed project will not have any adverse effect on the existing customers of the expanding pipeline, existing pipelines in the market and their captive customers, or the economic interests of landowners and communities affected by route of the new pipeline, then no balancing of benefits against adverse effects would be necessary. The Commission would proceed to a preliminary determination or a final order. If residual adverse effects on the three interests are identified, after efforts have been made to minimize them, then the Commission will proceed to evaluate the project by balancing the evidence of public benefits to be achieved against the residual adverse effects. The Policy Statement sets forth in detail the considerations that the Commission

will apply to each of these steps. At the end of the analysis, the Commission will approve an application for a certificate only if the public benefits from the project outweigh any

adverse effects. This policy approach strives to advance development of a sustainable energy infrastructure that supports economic growth, environmental protection and other social benefits over the life of the projects.

Twelve parties sought rehearing or clarification of the Policy Statement. The issues raised by these parties include application of the Policy Statement to optional certificates, the application of the threshold no-subsidy requirement, issues relating to some of the factors to be considered in the balancing test, and the application of the policy to projects preceding its issuance. These issues are discussed in turn below.

I. Application of Policy Statement to Optional Certificates

The Policy Statement indicated that this policy does not apply to construction authorized under 18 CFR Part 157, Subparts E and F (optional and blanket certificates).

The Coastal Companies request that the Commission clarify that the Policy Statement will apply the public interest balancing factors to pipeline projects that are filed under the optional certificate regulations. The Coastal Companies contend that this clarification is necessary to ensure that there is no major policy gap in the Commission's administration of section 7 of the NGA between traditional and optional certificate applicants, and that both types of applicants will be entitled to a certificate of public convenience and necessity only to the extent that such applicants clearly demonstrate that the project's benefits exceed its economic and social costs.

Public Service Company of Colorado (PSCO) and El Paso concur that the Policy Statement should apply to projects filed under the optional certificate regulations, as well as to traditional applicants. It notes that the overarching standard applicable to all requests for certificate authority under NGA section 7, regardless of whether the certificate is sought under traditional or optional certificate procedures, is the requirement that a certificate applicant show that its proposal is required by the present or future public convenience and necessity.

Enron requests that the Commission either require that optional certificates make the same showing of public benefits and mitigation of adverse effects that is required of traditional section 7(c) applicants, or eliminate this requirement for traditional certificates.

The optional certificate regulations establish procedures whereby an eligible applicant may obtain, for the purposes of providing new service, a certificate authorizing: the transportation of natural gas; sales of natural gas; the construction and operation of natural gas facilities; the acquisition and operation of natural gas facilities; and

conditional pre-granted abandonment of such activities and facilities. If an applicant complies with the requirements set forth in the Commission's regulations for optional certificates, it is presumed, subject to rebuttal, that the proposed new service is or will be required by the present or future public convenience and necessity.

The optional certificate procedures were established to provide expedited treatment of applications for service under section 7 of the NGA. A certificate and pre-granted abandonment are available under the optional certificate procedures to allow any applicant to institute jurisdictional service and to construct and operate facilities for such services. To qualify, the applicant must agree to comply with certain terms and conditions, the most important of which is that the applicant must accept the full risk of the proposed venture. The applicant's willingness to assume the full risk of the project is critical to the presumption that the project is in the public interest.

In the Policy Statement, the Commission explained that as the natural gas marketplace has changed, the Commission's traditional factors for establishing the need for a project, such as contracts and precedent agreements, may no longer be a sufficient indicator that a project is in the public convenience and necessity. The Commission, therefore, changed its policy regarding the pricing of construction projects so that market decisions by pipelines and shippers, as opposed to regulatory tests, would better reveal whether there is sufficient support for the project and whether the project is financially viable. The Commission established a threshold requirement that the pipeline must be prepared to financially support the project without subsidy from its existing shippers. This will usually mean that the pipeline would have to price the project using incremental rates in which the full costs of the project are recovered solely from the shippers subscribing to the new capacity. Under this policy, the pipeline and its expansion customers could share the risks of the project, but they could not shift any of those risks onto existing customers.

Upon further review of the issue, the Commission concludes that the policies set forth in the Policy Statement have converged with the policies underlying the optional certificate program. Specifically, both the Policy Statement and the optional certificate procedures are intended to place the risk of a new project on the pipeline and the customers for the new project and to protect existing customers from bearing the risk of a project that was not designed for their benefit. Accordingly, the Commission is issuing a notice of proposed rulemaking in Docket No. RM00-5-000 contemporaneously with this order that proposes to remove the optional certificate procedures from the Commission's regulations. Pending a final rule on that issue, however, the Commission concludes that the balancing outlined in the Policy Statement should apply to any new applications for optional certificates.

Section 157.104(c) of the Commission's Regulations provides:

(c) *Presumption.* If an application complies fully with the requirements of §157.102 and §157.103, it is presumed, subject to rebuttal, that:

- (1) The applicant is qualified to perform all the activities for which certificate authorization is requested;
- (2) The applicant is willing and able to perform acts and provide service, as proposed, and to comply with the Natural Gas Act and any applicable regulations thereunder; and
- (3) The proposed new service is or will be required by the present or future public convenience and necessity.

Until the Commission issues a rule in Docket No. RM00-5-000, applications for optional certificates filed after the issuance of this order will continue to have the regulatory presumption. However, if the record shows that under the Policy Statement analysis, the adverse effects of the proposed project outweigh the benefits of the project, then the presumption that the proposed new service is or will be required by the present or future public convenience and necessity will be deemed to have been rebutted and the certificate will not issue.

II. The Threshold Requirement of No Financial Subsidies

The Policy Statement changed the Commission's previous policy of giving a presumption for rolled-in rate treatment for pipeline expansions. The Commission found that rolled-in pricing sends the wrong price signals by masking the true cost of capacity expansions to the shippers seeking the additional capacity. Sending the wrong price signals to the market can lead to inefficient investment and contracting decisions which can cause pipelines to build capacity for which there is not a demonstrated market need. Such overbuilding, in turn, can exacerbate adverse environmental impacts, distort competition between pipelines for new customers, and financially penalize existing customers of expanding pipelines and customers of the pipelines affected by the expansion.

The Commission noted, however, that its new policy would not eliminate the possibility that some or all of a project's costs could be included in determining existing shippers' rates. The Commission stated that rolled-in pricing could still be appropriate when initial costly expansion results in cheap expansibility. The Commission indicated that project expansion costs could still be included in existing shippers' rates when

construction projects are designed to improve service for existing customers. The Commission also stated that a form of rolled-in pricing could be applied as shippers exercise their right of first refusal, although the Commission did not describe specifically the process that would be followed.¹

While the new policy initially places the pipeline at risk for the financial consequences of an expansion decision, expansion customers may agree to share the risk with the pipeline by specifying what will happen to rates under certain circumstances, such as anticipated volumes that do not develop or cost overruns. The Commission encouraged pipelines not to rely on standard "Memphis clauses,"² but to reach agreement with new shippers concerning specific elements of risk.

Requests for rehearing and clarification were filed with respect to a number of these issues: the adoption of the no-subsidy test for pricing expansions, the pricing of capacity during the right of first refusal, and the policy regarding Memphis clauses.

A. Adoption of the No-Subsidy Test

American Forest and Paper Association (AFPA), Indicated Shippers, and Paiute Pipeline Company (Paiute) sought rehearing and clarification regarding the adoption of the no-subsidy test for pipeline expansion projects. They contend the Commission should continue to apply its current policy permitting rolled-in pricing, particularly in situations when the increase in price to existing customers will not amount to a greater than 5%

¹Under the right of first refusal, a shipper is entitled to continue service by matching the highest bid for that capacity up to the maximum rate.

²A "Memphis clause" refers to an agreement between a shipper and a pipeline providing that the pipeline may change a rate during the term of the contract by making a rate filing under section 4 of the NGA. See *United Gas Pipeline Co. v. Memphis*, 358 U.S. 103 (1958).

increase in their rates. AFPA and Indicated Shippers contend that the Commission's prior policy is correct because under this policy existing shippers' rates increase only when they receive some benefit from the construction project. They also contend that permitting rolled-in pricing sends accurate price signals and avoids discrimination because rolled-in pricing ensures that all customers receiving the same transportation service pay the same rates for that service. AFPA maintains that rolled-in pricing will better promote competition by ensuring a level playing field among competitors purchasing natural gas supplies. AFPA and Paiute maintain that incremental pricing is not needed to protect against overbuilding because the Commission can exercise its oversight role to ensure that there is sufficient market need for a project.

AFPA and Paiute argue that if the Commission does not retain its current pricing policy, it should at least modify that policy. AFPA and Paiute argue that the Commission should not establish the no-subsidy criteria as a threshold test, but consider a proposal for rolled-in rates in the context of the second prong of the test in which the Commission weighs all the benefits of the construction and the adverse impacts. As another alternative, AFPA argues the Commission could adopt a commensurate benefits test in which rolled-in pricing is permitted when the increase in rates to existing customers is commensurate with the benefits they receive.

The Commission concludes that, in the current market, its threshold requirement that pipeline expansions should not be subsidized by existing customers is necessary to enable a finding of a market need for a project. There are three different types of projects: an expansion project to provide additional service, a project to improve service to existing customers by replacing existing facilities, improving reliability, or providing additional flexibility, and a project that combines an expansion for new service with improvements for existing customers.³ Under the Commission's no-subsidy policy, existing shippers should not have the rates under their current contracts changed because the pipeline has built an expansion to provide service to new customers. Existing customers' rates can be increased for projects that improve their service. And, as explained below, where a project combines an expansion with improvements to existing services, a pipeline can file to increase existing customers' rates when the pipeline can demonstrate that the new facilities are needed to improve service to existing customers.

³The term expansion as used here includes the extension of existing facilities to serve new customers.

The Commission has a two-step process for determining whether the market finds an expansion project economically viable. The first step, which occurs prior to the certificate application, is for the pipeline to conduct an open season in which existing customers are given an opportunity to permanently relinquish their capacity.⁴ This first step ensures that a pipeline will not expand capacity if the demand for that capacity can be filled by existing shippers relinquishing their capacity. The open season policy was not changed by the recent Policy Statement. The second step is that the expansion shippers must be willing to purchase capacity at a rate that pays the full costs of the project, without subsidy from existing shippers through rolled-in pricing.

The removal of the subsidy is necessary to ensure that the market finds the project is viable because either the pipeline or its expansion shippers are willing to fully fund the project. Having lower prices subsidized by existing customers can lead to overbuilding as new customers are willing to subscribe to the capacity only because the price of the capacity is subsidized.

This no-subsidy requirement also is needed to ensure existing pipelines do not receive unfair advantage in competition for new construction projects with new entrant pipelines. The new entrant, by virtue of having no existing customers, must fully support a proposed project. In contrast, if the existing pipeline can receive a partial subsidy from its existing customers, this would create a bias favoring the expansion of existing facilities even where the pipeline of the new entrant would be more efficient. A rolled-in subsidy paid by the customers of the existing pipeline, therefore, may result in potential shippers favoring the less efficient project over the more efficient one.

AFPA and Paiute contend that the Commission need not rely on incremental pricing to establish market need, but can continue to rely upon its current regulatory requirements, such as relying on executed long-term contracts or binding precedent agreements for the capacity. But, as the Commission found in the Policy Statement, reliance on contractual agreements cannot be a substitute for reliance on proper pricing

⁴Pricing Policy for New and Existing Facilities Constructed by Interstate Natural Gas Pipelines, 71 FERC ¶ 61,241, at 61,917 (1995), reh'g denied, 75 FERC ¶ 61,105 (1996).

signals. A pipeline, for instance, may be able to provide precedent agreements for 100% of a project when it offers new shippers rolled-in rates subsidized by existing shippers. But that level of support could well disappear if the subsidy were removed and the new shippers had to fully support the costs of the project.

Indicated Shippers, AFPA, and Paiute contend that incremental pricing creates price discrimination because the existing and expansion shippers are paying different rates for the same service. Indicated Shippers maintain that all shippers should pay the same rate because both existing and expansion shippers are responsible for the demand creating the need for the expansion. Indicated Shippers quotes Southeastern Michigan Gas Company v. FERC, to the effect that:

Because every shipper is economically marginal the costs of increased demand may equitably be attributed to every user, regardless when it first contracted with the pipeline.⁵

There are legitimate bases for charging existing and expansion shippers different rates. One of the Commission's regulatory goals is to protect captive customers from rate increases during the terms of their contracts that are unrelated to the costs associated with their service. The existing shippers sign long-term contracts with the pipelines with the expectation that increases in their rates will be related to the costs and usage of the system for which they subscribe and not based on construction needed to serve other shippers. One of the benefits generally associated with long-term contracts is that they reduce the buyer's risk by providing greater price certainty. Raising the rates of existing shippers during the term of their long-term contracts in order to subsidize expansions for new shippers reduces rate certainty and increases contractual risk. Existing shippers, therefore, should not be subject to increases in rates during the term of their existing contracts to reduce the rates faced by new shippers subscribing to expansion capacity.

It is not necessarily true, as AFPA suggests, that all companies should pay the same prices for the same good or service regardless of when they contract for the good or service. In an unregulated market, an established firm may be able to lock-in a low price for goods or services through a long-term contract when demand is weak relative to available supply, while a new entrant contracting for the same good or service at a later time when supply and demand conditions have changed, may have to pay higher prices.⁶

⁵133 F.3d 34, 41 (D.C. Cir. 1998).

⁶By the same token, during periods when demand is greater relative to available supply, customers may enter into high priced contracts for the future, while customers

Moreover, charging expansion customers rolled-in prices at the onset of a project is not, as AFPA and Indicated Shippers suggest, the most efficient pricing solution because rolled-in pricing may result in undervaluing the costs of the expansion, which, in turn, results in overbuilding. An alternative to the approach adopted in the Policy Statement would be for the Commission to revamp its current pricing system so that all shippers pay incremental prices or prices based on replacement as opposed to historic costs. Such an approach would avoid the pricing distortions that accompany rolled-in pricing for new facilities while charging both expansion and existing shippers the same rate. But moving to such a pricing system would require a complete reevaluation of the Commission's current ratemaking method, which the Commission is not prepared to make at this point. Indeed, neither AFPA nor Indicated Shippers support such an approach, and AFPA, in fact, objects to any approach that would permit a pipeline to overrecover its cost-of-service based on historic costs. Thus, while no ratemaking policy is perfect, the Commission concludes that, within the confines of the existing ratemaking policy, the no-subsidy policy is superior to the use of rolled-in pricing in establishing the proper pricing signals for new construction, without creating undue discrimination between pipeline customers.

entering the market later when conditions have changed pay lower prices.

Several of the comments raise questions about the application of the Commission's policy to expansion projects which may provide some benefit to existing customers. AFPA contends that rolled-in pricing should be permitted if the existing customer receives some benefit from the project. Paiute similarly contends that integrated expansions generally provide a positive benefit to all shippers and, therefore, should be priced on a rolled-in basis. Indicated Shippers contends that rolled-in pricing creates no subsidy when existing shippers bear a portion of the expansion costs reflective of the benefits they receive from the expansion. Indicated Shippers, in particular, contend that the construction of supply laterals should qualify for rolled-in pricing, because supply laterals frequently benefit all shippers on a system by providing access to new gas supply sources. Amoco⁷ asks the Commission to clarify what constitutes a subsidy. Amoco maintains there may be some projects, such as the addition of compression, that have the effect of both expanding system capacity and also improving the reliability of and flexibility to existing customers at a cost lower than could be achieved without the capacity expansion.

⁷Amoco Energy Trading Corporation, Amoco Production Company, and Burlington Resources Oil & Gas Company.

The Commission's no-subsidy policy recognizes that existing customers should pay the costs of projects designed to improve their service by replacing existing capacity, improving reliability, or providing additional flexibility. An example of the application of that policy is Great Lakes Gas Transmission,⁸ in which the Commission permitted the pipeline to raise rates for all customers for a looping project where the pipeline demonstrated that the project provided increased reliability and flexibility and was not tied to the provision of service to specific customers. But this approach does not justify rolling-in the entire costs of an expansion simply because the existing customers receive "some benefit from the construction of the new facilities," as AFPA suggests⁹ or because shippers receive some positive benefit as Paiute recommends. Nor is there a presumption favoring rolled-in rates. Pipelines can file to include additional costs in calculating the rates charged existing customers if the facilities are needed to improve service for existing customers, the increase in rates is related to the improvements in service, and raising existing customers' rates does not constitute a subsidy of an expansion by the existing customers.

B. Right of First Refusal

Process Gas Consumers,¹⁰ Florida Cities,¹¹ and Amoco raise questions about the statement in the Policy Statement which would permit a form of rolled-in pricing when the contracts of existing shippers expire and they seek to exercise their right of first refusal (ROFR). Process Gas Consumers and Florida Cities maintain that the Commission cannot legally permit a pipeline to change the maximum rate for ROFR in a policy statement and that such an action must take place through either a rulemaking or a section 4 filing. Both Florida Cities and Process Gas Consumers request clarification that pipelines cannot incorporate the ROFR policy sua sponte without making a general section 4 rate filing.

⁸80 FERC ¶ 61,105 (1997).

⁹AFPA Rehearing, at 6.

¹⁰Process Gas Consumers Group, American Iron and Steel Institute, Georgia Industrial Group, United States Gypsum Company, and Alcoa, Inc.

¹¹Orlando Utilities Commission, Cities of Lakeland and Tallahassee, Florida, City of Gainesville d/b/a Gainesville Regional Utilities, Jacksonville Electric Authority, and Florida Gas Utility.

Florida Cities further contends that charging shippers whose contracts expire a rate higher than the current maximum rate for that capacity fails to provide sufficient protection to existing shippers. They contend that an existing shipper is no less an existing shipper when its contract expires and that it should, accordingly, be entitled to the same rate protection. Florida Cities also contends that raising existing shippers' rates upon contract renewal would run afoul of an existing rate settlement on Florida Gas. If the Commission determines to continue with its policy, Florida Cities proposes that existing shippers should not be subject to the policy until they have had at least one opportunity to recontract for capacity at their existing rate so that they can choose a contract term with full appreciation for the pricing risks attendant to signing a short-term contract.

While supporting the policy, Amoco requests clarification of the rate that existing customers would have to match. Amoco maintains that existing shippers should not have to match a bid up to the highest incremental rate, but instead should be required to pay no more than the system-wide rolled-in rate in order to prevent the pipeline from overrecovering its cost-of-service.

In the Policy Statement, the Commission did not fully describe how the ROFR process would operate but will clarify that process here. The Commission's ROFR regulations provide that a shipper whose contract is expiring is entitled to renew that contract by matching the highest bid made for the capacity up to the maximum rate.¹² The Commission clarifies that under the policy described in the Policy Statement, a shipper exercising its ROFR could be required to match a bid up to a maximum rate higher than the historic maximum rate applicable to its capacity in certain limited circumstances: when a pipeline expansion has been completed and an incremental rate exists on the system; the pipeline is fully subscribed; and there is a competing bid above the maximum pre-expansion rate applicable to existing shippers.¹³ To adjust the maximum rate applicable to shippers exercising their ROFR in these circumstances, the pipeline would have to establish a mechanism for reallocating costs between the historic and incremental rates so all rates remain within the pipeline's cost-of-service.¹⁴ The

¹²18 C.F.R. § 284.221(d) (1999).

¹³Under this procedure, the pipeline cannot require the existing shipper to pay a rate higher than that of the competing bidder. For example, if the historic maximum rate is \$1/MMBtu, the maximum rate the existing shipper has to match is \$2/MMBtu, and the competing bid is \$1.50/MMBtu, the pipeline must sell the capacity to the existing shipper if it is willing to match the \$1.50 bid.

¹⁴Cf. Viking Gas Transmission Company, 89 FERC ¶ 61,204 (1999) (rejecting

mechanism can be established either through a general section 4 rate case or through the filing of pro forma tariff sheets which would provide the Commission and the parties with an opportunity to review the proposal prior to implementation. The Commission would review the proposed mechanism to determine how well it achieves the following objectives: capacity pricing that permits as efficient an allocation of capacity as is possible under cost-of-service ratemaking; protection against the exercise of market power by the pipeline (through withholding of capacity, for example, or the potential for skewed bidding); protection against the pipeline's overrecovery of its revenue requirement; and equity of treatment between shippers with expiring contracts and new shippers to the system seeking comparable service.

Application of this approach could lead to rates for shippers exercising their ROFR that are higher than their existing vintaged rate. But this will occur only if the preconditions are met -- the pipeline is full and there is a competing bid higher than the pre-expansion rate so that a higher rate is needed to allocate available capacity -- and the Commission has accepted the pipeline's mechanism for determining rates as just and reasonable.

The Commission recognizes there is tension between sending efficient pricing signals to expansion customers and to customers whose contracts are expiring, while remaining within the pipeline's revenue requirement. There may be a number of ways to recompute rates to effectively balance these interests. Amoco, for example, has suggested that the maximum matching rate for shippers exercising a ROFR should be the system average rate. The Appendix to this order provides two examples of potential approaches to the recomputation of rates, one in which the expansion rate is recomputed to establish the maximum matching rate and the other where the system average rate is used as the matching rate. Under these approaches, as contracts of existing shippers expire, the costs and contract demand represented by these contracts are reallocated between the existing and expansion service without changing the pipeline's overall revenue requirement.

tariff filing to raise matching rates under a ROFR where the filing did not readjust existing and expansion rates and was inconsistent with a rate settlement).

The rehearing requests question the appropriateness of requiring an existing customer to pay a rate higher than its historic rate to continue service beyond the term of its contract. As discussed above, there is a reasonable basis for not having existing shippers subsidize expansion projects during the remaining term of their current contracts. However, when the existing customer's contract expires, the existing customer could be treated similarly to new customers for pipeline capacity, who face rates higher than the pre-expansion historic rate.¹⁵ Under the policy conditions established by the Commission (fully subscribed expansion, at least one bid above the existing rate, and a rate mechanism established in advance), there would be insufficient capacity to satisfy all the demands for service on the system. When insufficient capacity exists, a higher matching rate will improve the efficiency and fairness of capacity allocation, within the limits imposed by cost-of-service ratemaking, by allowing new shippers who place greater value on obtaining capacity than the existing shipper to better compete for the limited capacity that is available.

The Commission does not agree with Florida Cities that an existing customer must be provided with one opportunity to renew at its current maximum rate. When there is insufficient capacity to satisfy all demands for capacity, an efficient system of capacity allocation would award the capacity to the shipper placing the greatest value on obtaining capacity. Adoption of Florida Cities' proposal for a one-time mandatory renewal would conflict with that policy by permitting the existing shipper to continue service at a rate less than the highest rate bid.

Process Gas Consumers maintains that the restructuring of rates should be implemented in a general section 4 rate case in which the Commission could examine all the pipeline's costs and revenues. A full section 4 rate case is one option a pipeline can use to establish the reallocation mechanism. However, a full section 4 rate case can be a cumbersome way of implementing this mechanism because it examines cost and revenue items and other issues unrelated to the more limited cost allocation and rate design changes needed to readjust rates at contract expiration. Pipelines, therefore, also can establish the reallocation mechanism by filing pro forma tariff sheets, which will provide the Commission and the parties with sufficient opportunity to review the filing prior to implementation. Once the review is completed, the pipeline can then implement the mechanism through a limited section 4 rate filing. Issues regarding case-specific

¹⁵ Cf. PG&E Gas Transmission, Northwest Corporation, 82 FERC ¶ 61,289, at 62,124-26 (1998), affirmed, Washington Water Power Co. v. FERC, No. 98-1245 (D.C. Cir., February 1, 2000). (for permanent releases of capacity taking place after an expansion, the replacement shippers should pay the same rate as the expansion shippers).

settlement conditions, such as those referenced by Florida Cities, can be addressed in the section 4 rate case or pro forma tariff proceeding.

C. Memphis Clause

El Paso Energy Corporation Interstate Pipelines (El Paso) requests clarification of the Commission's policy towards the use of Memphis clauses. Under the Policy Statement, the pipeline is responsible for financially supporting the project unless it contracts with new customers to share that risk. Similarly, the risks of construction cost overruns would rest with the pipeline unless apportioned between the pipeline and the new customers by contract. In apportioning such risks, the Commission stated that pipelines should not rely on standard Memphis clauses which would permit the pipeline to change the rate during the term of a contract by making a new rate filing under section 4 of the NGA. Instead, the Commission stated that pipelines should reach more explicit agreements with new shippers concerning who will bear the risks of underutilization of capacity and cost overruns and the rate treatment for cheap expansibility.¹⁶

El Paso requests clarification that the Commission's comment on Memphis clauses does not signify that Memphis clauses will no longer be considered a viable contractual method to allocate risk between pipelines and shippers. El Paso maintains that a Memphis clause evidences the customer's agreement to an increase in rates, but only if the pipeline can satisfy the burden of showing that the increase is just and reasonable.

Memphis clauses can continue to be used in expansion contracts if the pipelines and shippers choose to use this method for allocating risk. While Memphis clauses may be an acceptable means of allocating the risks of difficult to predict events, the Commission does not find them a good method of allocating the risks of anticipated events such as cost overruns, underutilization of capacity, and cheap expansibility. The parties are in the best position to allocate these risks at the time of contracting, rather than leaving such issues for litigation at the Commission.¹⁷ The Commission strongly

¹⁶Cheap expansibility refers to the fact that pipeline construction projects sometimes make further expansion relative inexpensive, for instance, because all that is needed to create extra capacity is the addition of greater compression.

¹⁷See, e.g., El Paso Natural Gas Company, 79 FERC ¶ 61,028, reh'g denied, 80 FERC ¶ 61,084 (1997), remanded Southern California Edison Company v. FERC, 162 F.3d 116 (D.C. Cir. 1999); Natural Gas Pipeline Company of America, 73 FERC ¶ 61,050, at 61,128-29 (1995)(whether it is just and reasonable to allocate costs of underutilized capacity to existing shippers).

encourages pipelines and shippers to specifically provide in their contracts for the allocation of such anticipated risks even if they choose to include a Memphis clause to deal with unanticipated risks.

III. Factors to Balance in Assessing Public Convenience and Necessity

After satisfaction of the threshold no-subsidy requirement, the Commission will determine whether a project is in the public convenience and necessity by balancing the public benefits against the adverse effects of the project. The public benefits could include, among other things, meeting unserved demand, eliminating bottlenecks, access to new supplies, lower costs to consumers, providing new interconnects that improve the interstate grid, providing competitive alternatives, increasing electric reliability, or advancing clean air objectives. Among the adverse effects the Commission will consider are the effects on existing customers of the applicant, the interests of existing pipelines and their captive customers, and the interests of landowners and the surrounding community, including environmental impacts. The Commission will approve a project where the public benefits of the project outweigh the project's adverse impacts.

Several requests for rehearing raise issues relating to some of the factors to be considered in the balancing process: the consideration of effects on existing pipelines and their captive customers, the timing of the consideration of environmental impacts, and the ability of an applicant to acquire the necessary rights-of-way without the need to use eminent domain to obtain rights from landowners.

A. Impacts on Competing Pipelines and Customers

In the Policy Statement, the Commission listed as one factor to be balanced in assessing public convenience and necessity the impact of the project on existing pipelines and the captive customers of these pipelines. The Commission stated that its focus is not on protecting incumbent pipelines from the risks of competition, but that the impact on existing pipelines and their shippers is one factor that should be taken into account in balancing all the relevant interests.

Indicated Shippers maintain the Commission should not take the financial effect on existing pipelines into consideration because such a policy is at odds with the Commission's goal of allowing the market to decide whether an expansion is necessary and would have the effect of reducing competition and maintaining pipelines' market power. Indicated Shippers maintains that taking into account the effect on competing pipelines would harm, rather than help, captive customers because competition from alternative pipelines may be the only way to provide such shippers with alternatives that would free a customer from reliance on a single pipeline. AFPA agrees with the

Commission that the impact of the expansion on captive customers should be taken into account, but it contends that the impact of a project on the revenue of an existing pipeline should not be part of the consideration.

The effect of a project on an existing pipeline and its customers is only one factor to be considered in assessing need and will not be dispositive. As the Commission explained in the Policy Statement, it will be employing a proportional approach in which the quantum of evidence necessary to establish need will depend on an overall assessment of all relevant factors. In this analysis, the creation of greater competition would be considered a positive benefit. For example, as the Commission explained in the Policy Statement, a project that has negative impacts on an existing pipeline and its shippers may still be approved if it has positive public benefits, such as increasing competitive alternatives or lowering rates, that outweigh the negative impacts. Generally, this means that construction of a pipeline whose rates are unsubsidized will not be considered to have an adverse effect on an existing pipeline. The purpose of examining the effect of projects on existing pipelines is not to protect incumbent pipelines from competition, but to evaluate all relevant factors to determine if a project is needed. However, there may be cases in which service on an existing pipeline is an alternative to construction and the cumulative adverse impacts on an existing pipeline and its customers as well as on landowners and the environment are significant enough that the balance would tip against certification.

AFPA asks for clarification as to whether the Commission's balancing policy will apply to pipeline projects that bypass LDCs or other pipelines. AFPA contends that bypass enhances competition and that the Commission should not consider the adverse effects on customers of the existing or expanding pipeline in determining whether to approve the bypass. AFPA recognizes, however, that the Commission previously has permitted an LDC being bypassed to reduce its contract demand on the bypassing pipeline so that the pipeline is not collecting twice for the same contract demand.¹⁸

The same public convenience and necessity test applies to bypass construction as to other construction, and, therefore, the same basic balancing test should be applied to bypass cases. The Commission will need to weigh whether the benefits of a bypass, including enhanced competitive options, outweigh potential adverse effects of the bypass. It may well be that in many bypass projects, the amount of construction is minimal with little impact on landowners or the environment which would militate in favor of permitting the construction project if it provided additional competition or lower prices.

¹⁸ AFPA cites to Paiute Pipeline Company, 68 FERC ¶ 61,064 (1994).

There also may be other means, such as measures taken by the LDC or state regulatory agencies to mitigate the effect of a bypass on the bypassed pipeline or LDC.

B. Environmental Review of Projects

The Policy Statement set forth the analytical steps the Commission will use to balance the public benefits against the potential adverse consequences of an application for new pipeline construction. In discussing the role that the environmental analysis of a project plays in the Commission's evaluation of proposals for certificating new construction, the Policy Statement stated that "[o]nly when the benefits outweigh the adverse effects on economic interests will the Commission then proceed to complete the environmental analysis where other interests are considered."¹⁹ This statement has given rise to confusion about the timing of the Commission's environmental review of projects.

Enron is concerned that the Policy Statement may suggest that the environmental review process for traditional certificate applications will not commence with the filing of the application. El Paso likewise requests clarification that the environmental and economic reviews will proceed concurrently, as in current practice, and that the NEPA process will not be postponed until the Commission reaches a resolution of the balance of benefits and effects. Paiute too is concerned that the Commission will delay its initiation of its environmental review until after economic tests are met. Paiute proposes merging the various steps for review and processing pipeline construction applications that are outlined in the Policy Statement to avoid delays.

Raising a different issue, AF&PA states that in considering the potential adverse environmental impact of a project, the Commission should take into account the overall benefits to the environment of natural gas consumption, particularly when, as a result of the new facilities, natural gas will displace fuels that are more harmful to the environment.

As has been the Commission's practice, the Commission will begin its environmental review at the time an application is filed with the Commission; environmental and economic review of a proposed project will continue to proceed concurrently. The Policy Statement does not alter this process. The quoted statement from the Policy Statement was only intended to indicate that if the economic analysis

¹⁹Policy Statement at 19.

concluded that the adverse effects outweighed the benefits then there would be no need to complete the environmental analysis.

Similarly, in considering the potential adverse environmental impact of a project, the Commission will continue to take into account as a factor for its consideration the overall benefits to the environment of natural gas consumption.

C. Eminent Domain Considerations

The Policy Statement notes that, as part of its environmental review of projects, the Commission will work to take landowners' concerns into account, and to mitigate adverse impacts where possible and feasible.

AFPA states that whether, and to what extent, new facilities may affect the property of landowners on the proposed route are significant factors for the Commission to consider in weighing public benefits against adverse impacts. Noting, however, that if eminent domain proceedings are necessary to obtain rights-of-way, the landowners will receive proper compensation for such rights-of-way, AFPA concludes that the compensation that a landowner would receive in such a proceeding should be considered by the Commission in its analysis of the economic impacts on the landowners that would result from the construction of new pipeline facilities.

The Policy Statement encouraged project sponsors to acquire as much of the right-of-way as possible by negotiation with the landowners and explained how successfully doing so influences the Commission's assessment of public benefits and adverse consequences. The Policy Statement nonetheless recognized that, under section 7(h) of the NGA, a pipeline with a Commission-issued certificate has the right to exercise eminent domain to acquire the land necessary to construct and operate its proposed new pipeline when it cannot reach a voluntary agreement with the landowner. Even though the compensation received in such a proceeding is deemed legally adequate, the dollar amount received as a result of eminent domain may not provide a satisfactory result to the landowner and this is a valid factor to consider in balancing the adverse effects of a project against the public benefits.

VI. Retroactive Application of the Policy

Northern Border, Texas Eastern, and Enron assert that the Policy Statement may not be applied to proposals filed before the date it issued. The Commission disagrees. It is within the Commission's discretion to determine to apply its current policies in certificate orders when it acts.

PSCO, while concluding that the Policy Statement should not be applied retroactively where construction has begun or where a pipeline applicant has undertaken financial commitments necessary to proceed with construction, contends that the Policy Statement should be applied in situations where the certificate has expired and a pipeline is requesting an extension of the certificate. This approach could have harsh results depending on the circumstances. Therefore, the Commission will address such matters as they arise based on the facts of the individual case.

El Paso requests clarification that the Policy Statement does not constitute a significantly changed circumstance that deprives certificate holders of predeterminations of rolled-in pricing in subsequent rate cases. The Commission clarifies the intent of the Policy Statement, as requested by El Paso. Issuance of the Policy Statement will not constitute "changed circumstances" for projects that were previously given a predetermination that rolled in rates would be appropriate.

The Policy Statement is clarified in accordance with the discussion herein.

By the Commission. Commissioner Hébert concurred with a separate statement attached.

(S E A L)

Linwood A. Watson, Jr.,
Acting Secretary.

APPENDIX

Two Possible Methods for Reallocating Costs
Between Existing and Expansion Service

Method 1 -- Recomputation of the Expansion Rate as the Matching Rate

Under this method, the pipeline would recompute the expansion rate by applying the contract demand of the expiring contract and the costs represented by that demand to the expansion rates, thus reducing the expansion rates so the pipeline remains within its overall revenue requirement. Under this approach, the pipeline would add the expiring shipper's contract demand and its cost-of-service (in an amount proportionate to the contract demand) to the expansion cost-of-service to create a new expansion rate. Correspondingly, the contract demand and cost-of-service allocated to existing customers would be decreased proportionately, so the historic rate would be unchanged. Because the cost-of-service allocated to the expiring contract is less on a per unit basis than the incremental cost-of-service, this approach will reduce the expansion rate, but, due to the larger amount of contract demand allocated to the expansion rate, the pipeline's revenue requirement remains the same. The following example shows how this method would work where a contract for 20,000 MMBtu of existing contract demand (CD) expires resulting in a reduction to the expansion rate (from \$25 to \$22) while the rate for existing customers remains the same (\$10) and the pipeline recovers the same revenue requirement.

	Existing Service	Expansion Service	Revenue Requirement
COS	\$1,000,000	\$2,000,000	\$3,000,000
CD (MMBtu/Year)	100,000	80,000	
Rate/MMBtu/Year	\$10	\$25	
New CD (MMBtu/Year)	80,000	100,000	
New COS	\$800,000	\$2,200,000	\$3,000,000
New Rate/MMBtu/Year	\$10	\$22	

Other details, such as the applicable rates for capacity release and interruptible transportation would be established as part of the pipeline's filing.

Method 2 -- System-Wide Cost-of-Service as the Matching Rate

Under this approach, the existing shipper would have to match a bid only up to the system-wide average rate. The added revenue derived from the higher system average

rate would reduce the expansion rate, with no change to the pipeline's revenue requirement. Using the same numbers as Method 1, this approach would result in the existing shipper whose contract is expiring having to match a rate no higher than \$16.67. The expansion rate would decline (from \$25 to \$23.33), but less than what would occur under Method 1 (\$22), and the pipeline would remain within its cost-of-service.

	Existing Service	Expiring Contract	Expansion Service	System Average Rate	Revenue Requirement
COS	\$1,000,000		\$2,000,000	\$3,000,000	\$3,000,000
CD (MMBtu)	100,000		80,000	180,000	
Rate/MMBtu/Year	\$10.00		\$25.00	\$16.67	
New CD (MMBtu)	80,000	20,000	80,000		
New COS	\$800,000	\$333,333	\$1,866,667		\$3,000,000
New Rate/MMBtu/Year	\$10.00	\$16.67	\$23.33		

The rates paid by new shippers to the system as well as the rates for capacity release and interruptible transportation would have to be addressed as part of the filing.

The following charts show that both methods eventually would converge in a system-wide average rate. The difference between the two is the maximum rate the shipper exercising its ROFR has to pay and how quickly the expansion service rate

declines as contracts expire.

Certification of New Interstate Natural
Gas Pipeline Facilities

Docket No. PL99-3-001

(Issued February 9, 2000)

HÉBERT, Commissioner, *concurring*

I write separately to explain briefly my position on one of the issues presented in this proceeding.

In the Policy Statement – which I supported – the Commission stated explicitly that its policy on pipeline certification does not apply to optional certificates. 88 FERC at 61,737 & n.3. In today’s clarifying order, however, the Commission reverses course and decides that its policy does indeed apply to optional certificates. Specifically, the Commission explains that it will apply the provisions of the Policy Statement to any “applications for optional certificates filed after the issuance of this order” and “until the Commission issues a rule in Docket No. RM00-5-000.” Slip op. at 4. (In a notice of proposed rulemaking, issued contemporaneously with this order in Docket No. RM00-5-000, the Commission proposes to remove the optional certificate procedures from the Commission’s regulations.)

My preference would be to stick with our earlier decision and to confine the Policy Statement to traditional applications for pipeline certification filed under section 7 of the Natural Gas Act. I do not view the policies underlying the Commission’s optional application procedures as entirely redundant to, and entirely subsumed by, the policies underlying the Commission’s Policy Statement. As today’s order recognizes, the optional regulations do not provide for consideration and weighing of public interest factors. (And for similar reasons, my preference would not be to proceed immediately to a rulemaking that proposes to abandon altogether the Commission’s optional regulations.)

But my concerns are mitigated by the Commission’s decision to pursue a cautious approach as to the applicability of the Policy Statement to applications for optional certificates. Pending application for optional certificates will continue to be processed under the Commission’s existing optional regulations. And the Commission continues to remain receptive – at least for the time being – to applications for optional certificates. The Commission explains, slip op. at 4, that it will continue to presume that an application for an optional certificate satisfies all of the Commission’s requirements, and that the Policy Statement is limited only to the purpose of rebutting that presumption.

In light of this limitation, I do not view the Commission's action today as effectively eliminating, without prior notice, the ability of pipelines to apply for optional certificates.

(As a final matter, I add that the optional certificates used to be commonly known as optional "expedited" certificates. Presumably, the promised speed of Commission action on applications for optional certificates – at least in comparison to the slower pace of Commission action on traditional applications – once provided much of the motivation to pipeline certificate applicants, filing under optional procedures, that were confident that there was a market for additional capacity. Alas, as the Commission explains in its proposed rulemaking in a related docket, optional certificates today provide none of the expedition contemplated at the time of promulgation of optional certificate regulations in 1985. This is because "[e]nvironmental review is the driving force in total processing time, and environmental review requirements are the same under either program." Hopefully, there will not be a delay in the future.)

Therefore, I respectfully concur.

Curt L. Hébert, Jr.
Commissioner