UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

High Island Offshore System, L.L.C.	)	**Docket No. RP03-221-000**

ORIGINAL

INITIAL BRIEF OF HIGH ISLAND OFFSHORE SYSTEM, L.L.C.

To: The Honorable Karen V. Johnson
Presiding Administrative Law Judge

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Pursuant to Rule 706 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.706 (2003), High Island Offshore System, L.L.C. ("HIOS") hereby submits its initial brief in this proceeding.

EXECUTIVE SUMMARY

This rate case involves six main issues: (1) HIOS's proposed management fee, including the appropriate rate of return and hypothetical rate base used to calculate the fee; (2) HIOS's operating expenses; (3) the proper depreciation rate as determined by the remaining useful life of HIOS's pipeline system; (4) the level of billing determinants used to calculate HIOS's rates; (5) whether to make two moderate rate design adjustments to recognize the benefits provided by firm services and to encourage efficient contracting; and (6) whether to prospectively change HIOS's Commission-approved mechanism for recovering for fuel and lost and unaccounted for gas ("LAUF"). As discussed in detail herein and summarized below, the record evidence and Commission

precedent strongly support HIOS's position on each of these issues and the other remaining issues in dispute.

Management Fee: Because HIOS has a negative rate base, HIOS and Staff agree that HIOS should receive a management fee in lieu of the rate of return allowance that a pipeline with a positive rate base would ordinarily receive. HIOS and Staff differ, however, on the amount of the management fee. This issue provides the Presiding Judge with an opportunity to send an important positive message to both natural gas pipelines and ratepayers, one that will advance the Commission's energy infrastructure policy.

The record supports the reasonableness of HIOS's proposed management fee of approximately $9.3 million. As documented by HIOS witnesses Richard W. Porter and J. Peter Williamson, HIOS's management fee provides the pipeline with sufficient cash flow to avoid insolvency and thereby fund the investments necessary to maintain the pipeline system. Consistent with the Commission's clear policy encouraging the development and maintenance of sufficient pipeline infrastructure to meet the nation's growing demand for natural gas, HIOS's proposal also provides the pipeline with the incentive to continue operating its facilities and, if economically justified, to make necessary expansions of those facilities. Furthermore, the record shows that, under HIOS's proposed management fee, HIOS would have the incentive to become even more efficient by continuing its vigorous efforts to minimize costs and increase throughput.

In contrast, Staff's proposed management fee of approximately $680,000 would violate fundamental ratemaking principles by failing to provide HIOS with revenues that are "sufficient to assure confidence in the financial integrity of the enterprise, so as to

maintain its credit and to attract capital."[1] Specifically, the record demonstrates that Staff's management fee would (1) threaten HIOS with insolvency and (2) *penalize* HIOS for making new investments necessary to provide safe and reliable pipeline service.

Staff relies heavily on a single, 1991 case -- *Tarpon Transmission Company*, 57 FERC ¶ 61,371 (1991) -- in which a small pipeline whose rates were investigated by the Commission under Section 5 of the Natural Gas Act ("NGA") applied for a management fee. HIOS will show why the *Tarpon* order should not dictate the amount of the management fee in the instant case in light of the extensive record developed here. To cite just one example, Staff failed to recognize that HIOS, unlike Tarpon, experienced a large amount of supplemental depreciation in its early years. Staff's failure to account for the impact this has on the rate base calculation it used to design its management fee actually punishes HIOS for a Commission-approved depreciation method that resulted in *lower* rates for its shippers over the entire life of HIOS's system. Correcting for that single error alone, though it would not cure all the problems with Staff's approach, would increase Staff's management fee to at least $3.2 million.

Finally, Staff's proposed management fee also is inadequate because it is based in part on a formula that includes a patently inadequate rate of return percentage. Staff generated that percentage largely by relying on the rates of return for gas *distribution* companies, which the record shows have much lower risks and thus much lower rates of return than gas *pipelines*, such as HIOS. In contrast, and in accordance with Commission precedent, HIOS properly relied on a proxy group consisting solely of natural gas pipelines to calculate the rate of return underlying its management fee.

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[1] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

Operating Expenses: After reviewing extensive documentation provided by HIOS in discovery, Staff agrees with HIOS, with one very minor exception, on the appropriate allowance for HIOS's operating expenses. In contrast, Indicated Shippers[2] seek to cut HIOS's operating expense allowance from approximately $19.7 million to approximately $14.4 million, based largely on a study of purported cost trends of *other* pipelines. However, as explained herein, Indicated Shippers' approach directly conflicts with Commission precedent. Moreover, as demonstrated by HIOS witness Gregory R. Schaller, Indicated Shippers' study ignores fundamental differences between HIOS and the pipelines in the study, and selectively disregards data that, if included, would undermine the study. In fact, after correcting for these and other errors, the study actually indicates that HIOS's operating costs are significantly *lower than* the operating costs of the other pipelines. The record also demonstrates, contrary to Indicated Shippers' conclusory allegations, that HIOS's costs are fully supported by, *inter alia*: (1) detailed historical cost data; (2) invoices specifically documenting HIOS's operating costs; and (3) FERC orders that approved many of the charges paid by HIOS and rejected similar theories advanced by Indicated Shippers in other rate cases.

Depreciation: HIOS's depreciation allowance is fully supported by the testimony of HIOS witness J. Scott Jenkins demonstrating the remaining useful life of the HIOS system. Mr. Jenkins, who has nearly thirty years of experience estimating gas reserves and forecasting gas production for HIOS and other pipelines, determined that HIOS has a remaining economic life of ten years from the end of the test period. Mr.

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[2] The Indicated Shippers are BP America Production, Inc., BP Energy Co., ChevronTexaco Exploration & Production Co. (a division of Chevron USA Inc.), and Shell Offshore Inc. *See* IND-1, at 3 n.1.

Jenkins reached his conclusion by examining the specific production fields and wells currently connected to HIOS, and those likely to be connected to HIOS in the future.

In contrast, Staff witness Kevin Pewterbaugh's 17.5 year estimate from the end of the test period gives no consideration to the economic feasibility or likelihood of attaching specific supplies to HIOS. Instead, Staff arbitrarily assumes that gas reserves are distributed uniformly throughout the entire Western Planning Area ("WPA") of the Gulf of Mexico and that every pipeline whose supply source consists of WPA gas reserves has exactly the same depreciable life. As Mr. Jenkins explained, HIOS cannot economically access many of the gas supplies in the WPA, thereby invalidating Mr. Pewterbaugh's conclusion. Staff apparently recognizes this as well, because Staff scrambled to rehabilitate Mr. Pewterbaugh at the end of the hearing by seeking to introduce into evidence an updated, yet even more flawed, estimate of gas reserves from a region even broader than the WPA. In short, the record compels the conclusion that HIOS's remaining economic life is ten years from the end of the test period.

Billing Determinants: Following established Commission precedent, HIOS derived its billing determinants for firm service by using the maximum daily quantities ("MDQs") for its only two firm shippers as of the end of the test period. HIOS then derived its billing determinants for interruptible services based on the established trend of steadily declining interruptible transportation ("IT") volumes and by including a representative level of interruptible overrun service. HIOS thus did not, as Staff contends, ignore overrun service in deriving its billing determinants.

In contrast, Staff disregarded clear Commission precedent that supports the use of *actual* MDQs for firm service billing determinants. Instead of using actual MDQs, and

contrary to the approach Staff witness Vladimir Ekzarkhov has consistently taken in numerous prior rate cases, Staff created *imputed* MDQs by adding interruptible overrun volumes to the actual firm MDQs. Staff's approach also conflicts with Commission precedent that logically requires overrun volumes, because they are interruptible in nature, to be accounted for in the billing determinants for interruptible services, not in the billing determinants for firm service.

Rate Design: HIOS, through the testimony of Mr. Porter, proposes two rate design changes. First, HIOS proposes to price the reservation charge for service under Rate Schedule FT-2 at 95 percent of the Rate Schedule FT reservation charge. This proposed change seeks to recognize the stable, incremental revenue contribution that FT-2 shippers make to HIOS's fixed costs. This contribution results in lower rates for all of HIOS's shippers.

Second, HIOS proposes to price the IT rate at 103.5 percent of the Rate Schedule FT rate. This proposal seeks to remedy a pricing inequity whereby interruptible shippers currently pay a significantly lower effective rate than firm shippers. This pricing disparity creates a disincentive for shippers to enter into firm contracts, even though the Commission has found that firm contracts provide significant benefits to pipelines and their shippers. HIOS's attempt to level the playing field between firm and interruptible services is a modest yet important step to encourage interruptible shippers, which comprise the clear majority of HIOS's throughput, to enter into firm contracts.

Staff contends that the Commission has previously expressed a preference for the 100 percent load factor rate design on which HIOS's IT rate was previously based. Although that may be true, Staff ignores the fact that the Commission has recently

endorsed the concept of pricing capacity held for a longer term, such as firm service, at a lower rate than capacity held for a shorter term, such as interruptible service. HIOS thus submits that its rate design proposals are consistent with the Commission's emerging policy in this area, and with the Commission's established policy of designing rates which foster economic efficiency.

Fuel/LAUF: HIOS's rate filing did not propose to change its Commission-approved mechanism for recovering the cost of fuel/LAUF. Instead, Indicated Shippers and Exxon proposed a change to the fuel/LAUF mechanism in their direct testimony. As a result, and as Exxon concedes, this issue arises under Section 5 of the NGA, meaning that any change can only be prospective and refunds are not permitted.

In its rebuttal case, HIOS responded by proposing a new fuel/LAUF mechanism that directly addresses the concerns expressed by its shippers. HIOS's proposal -- an annual redetermination of its fuel/LAUF charge based on the prior three years of actual experience -- will provide transparency, reduce volatility in the charge, and be simple to administer. Moreover, HIOS's proposal is consistent with the Commission's standard ratemaking methodology; in contrast, the Commission disfavors the "tracker" mechanisms proposed by Exxon and Indicated Shippers.

Finally, the suggestion by Indicated Shippers and Exxon that HIOS overcollected its fuel/LAUF should be rejected. Because the Commission's hearing order did not set that issue for hearing, that issue is well outside the scope of this case. Efforts to raise the issue here merely constitute an attempt by Indicated Shippers and Exxon to avoid initiating a separate complaint proceeding and thereby perform an end-run around the complaint process set forth in the Commission's regulations. In any event, the record

does not support the threadbare allegation that HIOS overcollected. Rather, the evidence strongly indicates that HIOS substantially *undercollected* its fuel/LAUF.

STATEMENT OF THE CASE

On December 31, 2002, HIOS filed revised tariff sheets proposing an increase in its transportation rates, based upon costs and revenues projected for the twelve months ending September 30, 2002, as adjusted for known and measurable changes through the test period which ended on June 30, 2003. The Commission accepted and suspended the proposed tariff sheets, subject to refund, pending the outcome of a hearing, and permitted the rate increase to become effective as of July 1, 2003. *High Island Offshore Sys., LLC*, 102 FERC ¶ 61,088, at ¶¶ 1-5, 17 (2003).

In its suspension order, the Commission set the following issues for hearing: (1) the proposed overall rate of return of 12.45 percent (including return on equity and capital structure); (2) the proposed change in HIOS's negative salvage allowance and depreciation rate; (3) HIOS's proposed management fee and associated taxes; (4) proposed adjustments to HIOS's billing determinants; (5) proposed changes in HIOS's rate design; and (6) the projected decrease in reservation and usage volumes. *Id.* at ¶ 14.

Subsequently, Staff and the parties conducted extensive discovery on HIOS regarding its proposed rate increase. After the participants filed several rounds of prepared testimony, an evidentiary hearing was held from November 17-21, 2003.

There have been two post-hearing motions since the conclusion of the evidentiary hearing. The first was an unopposed motion, filed by HIOS at the Presiding Judge's request, which sought to admit an exhibit (designated ALJ-1) containing corporate

organizational charts relating to HIOS. The Presiding Judge granted that motion on January 12, 2004. *See* "Order Admitting Exhibit," Jan. 12, 2004. The second motion, filed by the Commission Staff on December 29, 2003, sought to admit new evidence regarding Staff's position on the remaining economic life of HIOS's system. HIOS opposed this motion in a response filed on January 12, 2004. The Presiding Judge granted Staff's motion on January 29, 2004. *See* "Order Admitting Exhibits," Jan. 29, 2004.

ARGUMENT[3]

I. The Record Demonstrates That HIOS's Cost of Service Is Approximately $36.5 Million.

Record evidence submitted by HIOS and adduced at the evidentiary hearing in this proceeding demonstrates that HIOS's cost of service is $36,516,647. HIO-104, at 3; HIO-105. HIOS's cost of service is comprised of: (1) operating expenses of $19,698,676 (HIO-104, at 5; HIO-105); (2) a depreciation expense allowance of $1,611,641 (HIO-104, at 19); (3) a negative salvage allowance of $1,431,508 (HIO-104, at 20; HIO-110); (4) federal income taxes of $4,803,071 (HIO-104, at 22; HIO-105), and state ad valorem (property) taxes of $104,809 (HIO-75, at 18; HIO-105 (line 6)); (5) a management fee of $9,323,608 (HIO-105); and, (6) revenue credits (which are deducted from the gross cost of service) of $456,666 (HIO-104, at 23).

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[3] The issues in the following discussion are set forth in the same order as the issues listed in the Joint Statement of Issues that the parties provided to the Presiding Judge on November 3, 2003, with one minor change. HIOS has reversed the order of the management fee and rate of return issues, because the rate of return is actually a component of the management fee calculation, as will be explained *infra*.

In the following discussion, HIOS will explain why the record evidence fully supports each of the components of its cost of service.

A. HIOS's Operating Expenses Are Fully Supported.

1. Overview

HIOS's operating costs consist of three components: (1) the fixed monthly fee that it pays to GulfTerra Operating Company, LLC ("GTOC") for *routine* services performed by GTOC to operate, maintain and administer HIOS's pipeline system on a daily basis; (2) additional expenses paid to GTOC for *non-routine* operational and maintenance services; and (3) direct flow-through expenses, for services such as natural gas liquids separation, paid to parties other than GTOC. HIO-104, at 8-9; Tr. 428.

HIOS and Staff essentially agree on the proper level of HIOS's operating expenses. They disagree on only one issue, the proper level of HIOS's regulatory expense, which represents less than 0.5 percent of HIOS's cost of service. Thus, HIOS proposes an operating expense level of $19,698,676, whereas Staff proposes a slightly lower level of $19,638,018. *See* Joint Statement of Issues, at 2 (filed Nov. 3, 2003).

In contrast, Indicated Shippers propose to slash HIOS's operating expense allowance. Based on Ms. Elizabeth H. Crowe's study of purported cost trends of pipelines other than HIOS, Indicated Shippers advocate an operating expense level of $14,367,838, more than $5 million lower than HIOS and Staff. However, as discussed below, Ms. Crowe's study is fatally flawed, as are Indicated Shippers' other allegations regarding HIOS's operating expenses.

2. Staff's Proposed Adjustment to HIOS's Regulatory Expenses Is Unsupported.

Because pipelines are actively regulated by the Commission, they incur costs associated with such regulation. In connection with rate case proceedings in particular, pipelines incur expenses for labor, travel, and hiring outside consultants and attorneys needed to defend the company's position. HIO-104, at 6. In its initial rate case filing in this case, HIOS proposed to recover regulatory expenses of $242,184, based on its past experience with the cost of prosecuting rate cases at the Commission. HIO-104, at 5.

Staff proposes to reduce HIOS's regulatory expense from $242,184 to $20,680, a reduction of over 90 percent. Staff achieves this substantial reduction by amortizing HIOS's test period actual regulatory expenses of $62,041 over a three-year period, resulting in an allowance of $20,680. HIO-104, at 7.

HIOS opposes Staff's proposed adjustment because it unrealistically assumes that HIOS will spend only $62,041 on this entire rate case. Rate cases represent a massive undertaking, requiring the company to prepare testimony for several witnesses and a detailed study of its cost of service as required by the Commission's regulations.[4] The company must also respond to extensive discovery requests, argue discovery motions, prepare for and participate in an evidentiary hearing, and write briefs for the Presiding Judge and, ultimately, the Commission. In view of the tremendous amount of work associated with a Section 4 rate case, the $242,184 that HIOS filed for regulatory expenses can reasonably be viewed as quite conservative and should be approved.[5]

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[4] *See* 18 C.F.R. §§ 154.301, 154.312 (2003); *see, e.g., Equitrans, L.P.*, 105 FERC ¶ 61,407 (2003) (rejecting pipeline rate case filing because it failed to include all the detail required by the Commission's regulations).

[5] Staff's proposal also conflicts with its basic approach regarding HIOS's operating expenses. Generally, Staff updated HIOS's operating expenses to actual test period levels. HIO-

3. Indicated Shippers' Proposed Adjustment to HIOS's Operating Expenses Should Be Rejected.

a. Indicated Shippers' Study of Cost Trends of Other Pipelines Is Fatally Flawed.

Indicated Shippers' witness, Ms. Crowe, derives her proposed operating expense allowance of $14,367,838 from a study she prepared that purports to document the cost trends of several other pipelines. According to Ms. Crowe, her study shows that HIOS's operating expenses have increased substantially over the period from 1996-2001, while operating expenses of the other pipelines have allegedly declined on average. IND-4. Ms. Crowe thus proposes to reduce HIOS's operating expense allowance by disallowing any expenses that exceed the level dictated by the average of five of the six other pipelines addressed in her study.[6]

Ms. Crowe's proposal, although certainly creative, suffers from numerous flaws. As an initial matter, her proposal ignores the fact that the Commission's regulations require a pipeline to file a rate case based on its own cost of service. *See* 18 C.F.R. § 154.303 (2003) (requiring rate case filing to be based on cost and revenue data reflecting what the pipeline itself actually experienced, as adjusted for known and measurable changes). Thus, in a similar context, the Commission stated:

> *The Commission's traditional, cost-based ratemaking method bases each natural gas pipeline's rates on its own cost-of-service.* The pipeline's cost-of-service is allocated among the pipeline's services and customers. Since different pipelines have different costs, offer different services, and have different customer profiles, their rates naturally vary. The

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104, at 7. However, for this one component of HIOS's operating costs, Staff proposes to amortize it over a three-year period instead of accepting the actual test period expenses. HIO-104, at 7.

[6] To reach this conclusion, Ms. Crowe summarily excluded the sixth pipeline, Venice, without explanation. Not surprisingly, Venice's costs increased substantially during the period covered by Ms. Crowe's study. IND-4; HIO-104, at 16.

> Commission rejects the notion . . . that there must be a zone-of-reasonableness created by comparing different pipelines' rates for [similar] services. *To determine one pipeline's rates based on other pipelines' costs would be contrary to the Commission's traditional method of determining cost-based rates for pipelines, where each pipeline's rates are determined based on its own costs.*

Mojave Pipeline Co., 79 FERC ¶ 61,347, at 62,485 (1997) (emphasis added).

The underlying logic of the regulations is that because one does not know the reasons for the cost increases or decreases on other pipelines, a comparison of different pipelines is problematic at best. *Id.* Moreover, if other pipelines experienced *increased* costs while HIOS's costs decreased, the regulations certainly would not permit HIOS to file a rate increase based on the other pipelines' higher costs. That principle applies with equal force here. Thus, even ignoring the numerous other flaws in Ms. Crowe's study, her proposal simply conflicts with the Commission's regulations.

In any event, Indicated Shippers ensured that the study produced a result to their liking by manipulating the data that formed the basis for the study. Amazingly, the study eliminates a major expense category of one pipeline (Sabine Pipeline) without any explanation. HIO-104, at 16; HIO-116. Adjusting the cost study to correct for this single error alone would increase Indicated Shippers' allowance for operating costs by approximately *$5 million*, an amount virtually equal to Indicated Shippers' entire reduction in operating expenses! HIO-104, at 16-17; HIO-112.

Moreover, and as just noted, Ms. Crowe reached her conclusion only by completely disregarding one of the six pipelines in the study, Venice, whose costs increased significantly during the period at issue. HIO-104, at 16. Inclusion of that pipeline in the study's conclusions, along with the inclusion of the Sabine costs arbitrarily excluded by the Indicated Shippers, results in a six-pipeline average in the $22 million to

$23 million range, well in excess of HIOS's approximately $19.7 million of operating expenses.[7]

In addition, Ms. Crowe's study is riddled with invalid "apples to oranges" comparisons that completely undermine the conclusions she draws from the study. For example, and as documented by HIOS witness Schaller, Ms. Crowe's study ignores material differences between HIOS and the other pipelines in terms of:

- The amount of *throughput* transported by each pipeline;
- The amount of *plant* in service for each pipeline;
- Whether the other pipelines, like HIOS, incur *liquids separation charges* that increase operating expenses;
- The number of *offshore platforms* on each pipeline system; and
- The *age* of each pipeline system.

For example, although Ms. Crowe asserted in discovery that Sea Robin Pipeline Company ("Sea Robin") and Stingray Pipeline Company ("Stingray") are "very similar" to HIOS in terms of plant and throughput levels, in fact those pipelines have plant and throughput levels that are very different from HIOS. Thus, HIOS has *30 percent more plant* than Sea Robin, *28 percent more plant* than Stingray, and *31 percent more throughput* than either pipeline. HIO-104, at 11-12. Ms. Crowe did not dispute these facts during cross examination. Tr. 597. Ms. Crowe also disregarded the fact that HIOS, unlike Sea Robin or Stingray, incurred substantial liquids separation charges that it must include in its operating expenses. These and other direct flow-through charges accounted for a large part (approximately 29 percent) of HIOS's operating expenses in this case.

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[7] *See* HIO-112 (six-pipeline cost average in the six-year study of $21,987,719; six-pipeline cost average in the five-year study of $23,057,341).

HIO-104, at 8. Importantly, when measured on a unit-of- throughput or unit-of-plant basis, and after eliminating direct flow-through charges (including Commission-approved ACA charges) to obtain a fairer comparison, the record shows that HIOS's operating expenses are actually *significantly lower than* either Sea Robin's or Stingray's operating expenses. HIO-104, at 12-13; HIO-113.

In addition, and as she acknowledged during cross examination, Ms. Crowe also ignored the age of the pipeline systems in her study and the number of offshore platforms each pipeline must operate. Tr. 598-99; HIO-104, at 14. The age of a pipeline system obviously can impact a pipeline's operating expenses significantly, as older pipelines such as HIOS require more maintenance expenditures than newer pipelines. HIO-104, at 14. Also, pipeline systems such as HIOS that have manned, offshore platforms incur significantly higher costs to maintain and operate those platforms than pipelines that do not have such platforms. HIO-104, at 14-15. HIOS operates two such platforms (HIO-104, at 15); there has been no showing that any of the other pipelines in Ms. Crowe's study operates even a single platform of this nature. The failure to account for these important factual differences between the pipelines at issue further undermines the conclusions that Ms. Crowe seeks to draw from the study.

In sum, Ms. Crowe's study of cost trends of other pipelines conflicts with the Commission's regulations and fails to produce a reliable, "apples to apples" comparison. When adjustments are made to produce a more reliable comparison, it is clear that HIOS's operating costs do not exceed, and in fact are probably significantly *lower than* the other pipelines in the study. Thus, properly analyzed, Ms. Crowe's study actually *supports* HIOS's proposed allowance for operating expenses.

b. The Record Rebuts Indicated Shippers' Conclusory Charge That HIOS's Operating Expenses Are Unsupported.

Indicated Shippers also attack HIOS's operating costs based on the conclusory accusation that such costs are unsupported or inflated. *See, e.g.*, IND-1, at 13-14. As will be seen, more than ample support exists for all of HIOS's operating costs.

i. Invoices Support HIOS's Operating Costs.

Indicated Shippers' charge, made in Ms. Crowe's direct testimony, that HIOS failed to provide support for its operating expenses was completely rebutted by the fact that HIOS provided Indicated Shippers with invoices or comparable documentation demonstrating the incurrence of all of the operating costs at issue. HIO-104, at 8; IND-24; Tr. 435. Ms. Crowe acknowledged during cross-examination that in discovery HIOS provided Indicated Shippers with invoices supporting all non-routine and direct flow-through expenses. Tr. 593-594. When one also considers the undisputed fact that many of the direct flow-through expenses have previously been approved by the Commission,[8] it is clear that there is no real dispute about the reasonableness of HIOS's non-routine and direct flow-through expenses, except insofar as Ms. Crowe would reduce HIOS's overall operating expense level through her flawed study of other pipelines' costs.

ii. The Fixed Fee Is Reasonable, Efficient and Fully Supported.

As for the other component of HIOS's operating expenses -- the fixed fee for routine operating services -- Indicated Shippers do not dispute that HIOS actually incurred the amounts it paid under the fixed fee arrangement. However, Indicated Shippers allege that the fixed fee provided for by HIOS's operating agreement with

GTOC is inflated because it is paid by one affiliate, HIOS, to another affiliate, GTOC. IND-1, at 13-14. This conclusory allegation ignores several facts which demonstrate that the fee is reasonable and fully supported.

First, contrary to Indicated Shippers' insinuation that the level of the fee was simply "pulled out of thin air," the fee is based on the historical cost of operating HIOS's system. In discovery, HIOS provided Indicated Shippers with a detailed schedule showing that the fee was fully cost justified when HIOS negotiated it in 1999. IND-24. In fact, the schedule demonstrates that the fee for routine operating services was initially set somewhat *below* the historical cost of providing those services.[9] Moreover, the record shows that the fee includes *no profit margin* for GTOC. Tr. 313, 366-69.

Second, when the fee was negotiated between HIOS and Leviathan Operating Company, L.L.C. ("LOC") in 1999, HIOS's ownership structure produced a strong incentive to negotiate the lowest possible fee. At that time, ANR Pipeline Company ("ANR") owned 50 percent of HIOS, while LOC, which was not affiliated with ANR at that time, owned the other 50 percent of HIOS. HIO-104, at 10; ALJ-1, at 1. Because fifty percent of the money paid by HIOS under the operating agreement effectively came directly out of ANR's pocket, ANR had a distinct interest in negotiating a reasonable fixed fee. HIO-104, at 10. Further, as a portion of the gas flowing through HIOS also flowed through ANR's pipeline system, ANR had a further incentive to keep HIOS's rates, and underlying cost structure, at a competitive level. Tr. 423, 427; IND-34. Thus, the fee is properly viewed as an arms-length transaction negotiated between ANR and

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[8] *See High Island Offshore Sys., LLC*, 62 FERC ¶ 61,080 (1993) (permitting ACA collection through base rates); Tr. 429-30, 435; Tr. 594.

LOC, two companies that were not affiliated with one another at that time. HIO-104, at 9-10. As such, the fee is entitled to a presumption of reasonableness.[10]

Third, the Indicated Shippers' attack on the fixed fee is undermined by the fact that GTOC could have increased the fee as early as January 2002, but did not do so until May 2003. Tr. 581. Section 3.3.2 of the HIOS operating agreement (S-21) is an inflation adjustment mechanism, under which, if a particular index of wage earnings published by the Department of Labor increased from calendar year 2000 to calendar year 2001, GTOC could have increased the fixed fee as of January 2002 by the amount of the percentage increase in the index, subject to a five percent cap. *See* S-21, at Section 3.3.2; HIO-143; HIO-144. During cross examination, Ms. Crowe agreed that the relevant index increased from 2000 to 2001. Tr. 583, 588. The fact that GTOC declined for more than a year to exercise its contractual right to increase the fixed fee further undermines the Indicated Shippers' unsupported allegation that HIOS and GTOC conspired to inflate the fee.

Fourth, the operating agreement unquestionably provides an efficient means of operating HIOS's system. In keeping with a common industry practice, GTOC provides operational services for several different pipelines, including HIOS. HIO-104, at 9-10. Even Ms. Crowe, who serves as a witness under a similar arrangement for the several companies that comprise the Indicated Shipper group, agreed that it is possible the operating agreement is a more efficient way of operating HIOS's system. Tr. 589.

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[9] IND-24, at 3 (showing annual routine operating expenses of $10,180,126, which on a monthly basis equal approximately $848,343, over $40,000 more than the fixed fee of $806,382).

[10] *See, e.g.*, Order No. 600, FERC Stats. & Regs. [Regulations Preambles 1996-2000] ¶ 31,066, at 30,722 (1998) (noting presumption); *Tennessee Gas Pipeline Co.*, 30 FERC ¶ 63,027, at 65,085 (1985) (presumption of reasonableness normally attaches to expenses produced by arms-length negotiations); *accord In re Portland Gen. Elec. Co.*, 1 FPC 161, 177 (1934).

Indeed, it is undisputed that HIOS has significantly reduced its operating expenses since its 1994 rate case (Tr. 303), consistent with HIOS's contention that the operating agreement and the fixed fee are an efficient means of providing for the operation of HIOS's system. The only other alternative -- Indicated Shippers never really provided one -- would be for HIOS to operate its own system, which would require HIOS to hire its own staff of operational, maintenance, and administrative employees. HIO-104, at 9-10. Obviously, that would sacrifice the efficiencies inherent in GTOC's operation of several pipelines and thereby *increase* HIOS's routine operating expenses well above the level represented by the fixed fee.

Finally, it should be noted that the Indicated Shippers and Ms. Crowe have an unsuccessful history at the Commission of attacking pipeline operating costs such as the fixed fee based on conclusory allegations that such costs are unsupported. For example, in *Koch Gateway Pipeline Company*, 74 FERC ¶ 61,088 (1996), Indicated Shippers and Ms. Crowe alleged that Koch had failed to support labor costs for services provided and billed directly to Koch by its parent. Specifically, they argued that Koch had provided only one sheet of paper showing the actual expenses billed by the parent to Koch. *Id.* at 61,273. Koch disputed Ms. Crowe's argument, contending that some functions that Koch previously performed were now performed by the parent, and that this was an accepted and widely-used method of achieving efficiencies in labor and overhead costs. *Id.*

Rejecting the Indicated Shippers' challenge to the costs at issue, the Commission held that Koch had provided sufficient support for the expenses, in the form of internal invoices billing Koch directly for the services rendered. *Id.* According to the Commission, Indicated Shippers merely alleged that the costs billed by the parent to

Koch were too high. *Id.* at 61,274. The Commission held that in the absence of specific evidence questioning the prudence of the costs, Indicated Shippers' conclusory allegation provided no basis for eliminating the costs. *Id.*

The Indicated Shippers and Ms. Crowe experienced a similar result in *Mojave Pipeline Co.*, 81 FERC ¶ 61,150 (1997), *reversing* 77 FERC ¶ 63,021 (1996). In *Mojave*, as in this proceeding, Ms. Crowe maintained that the pipeline had failed to support costs billed to it by an affiliate for services rendered. 77 FERC at 65,123. The ALJ concluded that Ms. Crowe's general allegation was sufficient in light of the Indicated Shippers' argument that Mojave bore the burden of proof. *Id.* However, the Commission reversed the ALJ, holding that "in the absence of a credible challenge" to the pipeline's proffer, the pipeline's costs should be accepted. 81 FERC at 61,678.

These precedents bear directly on the issue here. Indicated Shippers merely allege that the fixed fee is too high; they have failed, however, to offer any specific evidence to question its prudence. Thus, Indicated Shippers have provided no basis to eliminate or reduce the fixed fee included in HIOS's cost of service. For all the foregoing reasons, the Presiding Judge should reject Indicated Shippers' challenge to this component of HIOS's operating expenses.

B. The Record Supports HIOS's Proposed Depreciation Expense Allowance of Approximately $1.6 Million, Which Is Based on an Economic Life Ending June 30, 2013.

Two experts performed reserve studies for use in determining the remaining life of HIOS: Mr. Scott Jenkins on behalf of HIOS and Mr. Kevin Pewterbaugh for Staff. Both experts agree that the economic life of HIOS (as opposed to its physical life) is the controlling factor. Tr. 630-31. Mr. Jenkins concluded that a 10-year remaining life from

the end of the test year (June 30, 2003) is warranted, while Mr. Pewterbaugh opined that HIOS's reserves will support operations through December 31, 2020 -- an economic life 7.5 years longer than Mr. Jenkins' determination.[11] For the reasons set forth below, the Presiding Judge should adopt the depreciable life conclusion reached by Mr. Jenkins.[12]

1. HIOS Witness Jenkins Correctly Determined HIOS's Economic Life By Examining Specific Fields That Are Now, Or Likely Will Be, Connected to the Pipeline.

In order to determine the remaining economic life of HIOS, Mr. Jenkins, El Paso Field Services' ("EPFS") Manager of Reservoir Engineering, undertook a study of present and expected future gas supplies that can be transported through HIOS. Mr. Jenkins has nearly thirty years of reserve-related experience, dating back to 1974 when he received a Bachelor of Science degree in Geology. His first work efforts involved estimating gas reserves and forecasting gas production for ANR, the original operator of HIOS. By 1986, he was named Director of the Reserves and Availability Department of ANR and tasked with overseeing all reservoir engineering and geological studies relating to ANR gas supply. HIO-76, at 1-2.

After ANR merged into El Paso in 2001, Mr. Jenkins became Manager of Reservoir Engineering at EPFS where he is in charge of professionals who forecast gas

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[11] Tr. 630. Ms. Crowe on behalf of Indicated Shippers submitted very limited depreciation testimony, summarily concluding that 2.5 years should be added to the depreciable life conclusion reached by Mr. Pewterbaugh, but she offered no independent depreciation study of her own. *See* IND-7, at 4-6.

[12] Although the level of depreciation expense is based in large part on HIOS witness Scott Jenkins' recommended economic life of 10 years, it is also based on HIOS's depreciable plant, which HIOS and Staff agree should be updated to the end of test period level. HIO-104, at 21. HIOS's end of test period plant level is approximately $13.4 million. HIO-106. In addition, it is undisputed that Ms. Crowe did not update depreciable plant to the end of the test period, and offered no explanation in support of her position. HIO-104, at 21. Ms. Crowe also erred by applying her proposed 20-year depreciable life for transmission plant to all categories of HIOS's

and oil supplies for all assets operated and managed by EPFS or GTOC, including HIOS. HIO-76, at 2. In addition, for some twenty years, Mr. Jenkins has held various positions on the Potential Gas Committee ("PGC"), an organization that publishes estimates of "potential" gas reserves in the United States. HIO-76, at 2. Unquestionably, Mr. Jenkins is eminently qualified to offer an estimate of HIOS's remaining life.[13]

Mr. Jenkins undertook his study based on the premise that "[t]he economic or depreciable life of HIOS is completely dependent upon the gas supplies that can be economically transported through HIOS in the future." HIO-119, at 3. *See also Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,054 (2000) (quoting *South Dakota Pub. Utils. Comm'n v. FERC*, 668 F.2d 333, 345 (8th Cir. 1981) (the Commission "must estimate the potential *recoverable* natural gas reserves available to pipeline companies" (emphasis supplied))). The "economically transported" qualifier is a necessary, and very important, factor in any realistic analysis of reserve availability. Total gas supplies that, solely in a physical sense, could be transported through a pipeline do not matter. What counts are reserves that can be transported economically, that is, profitably. For example, while there may be many trillions of cubic feet ("Tcf") of gas under the deep waters of the Gulf of Mexico, due to costs of production and/or costs of operating an associated pipeline many of those reserves may not be economically recoverable. HIO-76, at 8-9.

In the case of reserves related to HIOS, the limiting factor is the cost of operating HIOS. If HIOS cannot recover at least its operating costs, it makes no sense to operate the pipeline. Based on HIOS's filed annual operating expense amount of $18.2 million,

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plant, including intangible and general plant categories, and subcategories that require different depreciable lives. HIO-104, at 21.

Mr. Jenkins calculated that the "economic limit" on operation of HIOS will be 273 million cubic feet of gas per day (MMcf/d).[14] That is, 273 MMcf/d is the average volume that must be transported by HIOS at the proposed transportation rate in order for the pipeline to recover its annual operating costs.

Importantly, no party or witness challenged Mr. Jenkins' calculation of the economic limit. Indeed, Staff witness Pewterbaugh used the very same 273 MMcf/d economic limit factor in his depreciation study. S-4, at 21-22. Because his economic limit calculation was unchallenged and because there is no alternate calculation in the record, Mr. Jenkins' economic limit factor must be adopted and used in determining HIOS's depreciable life.[15] Indeed, that factor is conservative as it does not reflect the $1.5 million increase in operating expense experienced by HIOS during the test period (or HIOS's proposed management fee). *See* HIO-105. Had that increase been considered, the economic limit would have been set at a higher volume and would have yielded a lower remaining depreciable life.

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[13] Mr. Jenkins is also a Certified Petroleum Geologist of the American Association of Petroleum Geologists. HIO-76, at 2.

[14] $18.2 million divided by the 17 cent transportation rate advocated by HIOS and adjusted for the average Btu content of 1075 Btu/Mcf yields the result. HIO-76, at 3.

[15] While admitting that "I have not performed a study of reserves that are attached or accessible to HIOS," Ms. Crowe nonetheless offered up a one-sentence conclusion that "the studies performed by HIOS's own witnesses indicate that the reserves available to HIOS's system will not be depleted for twenty years." IND-1 at 9. Although she did not identify what "studies" she was referring to, presumably Ms. Crowe had in mind HIO-77, which graphically sets forth annual gas production through the year 2022. However, that same exhibit has the 273 MMcf/d economic limit line superimposed on it, and clearly shows that production declines below that level in the year 2013. Ms. Crowe's disagreement with the economic limit concept (IND-1, at 9) defies common sense. No for-profit entity would continue to produce reserves at an economic loss. In any event, Ms. Crowe has no credentials that suggest that either her disagreement with the economic limit concept or her unsupported 20-year life conclusion should be given any weight. *See* Tr. 554, where Ms. Crowe acknowledged that she has no training in geology or petroleum engineering, and has never testified as an expert on either of those subjects; *see also*

Using that 273 MMcf/day factor, Mr. Jenkins performed a study that examined four categories of gas reserves that can reasonably be expected to be transported through HIOS in the future. These four categories of gas are all physically located within a portion of the WPA of the Gulf of Mexico, which is delineated on HIO-123. As can be seen by examining HIO-123 and HIO-128 (which plots pipelines in the WPA), the WPA is very large (approximately 300 miles by 200 miles),[16] and already contains many pipelines. Hence, Mr. Jenkins' study did not rely on estimates of reserves for the whole WPA, but rather studied only the portion of the WPA accessible to HIOS. HIO-119, at 6.

The four categories of gas reserves analyzed by Mr. Jenkins are:

- Existing Outer Continental Shelf ("Shelf") wells now connected to HIOS;
- New expected Shelf wells that may be connected to HIOS;
- Existing deepwater wells now connected to HIOS via the East Breaks Gathering System ("EBGS"); and
- New expected deepwater wells that may be connected to HIOS.

HIO-76, at 3. The already produced and expected future volumes of gas associated with each such category are depicted on HIO-77.

Existing and Expected Shelf Wells. To calculate Shelf reserves, Mr. Jenkins and his staff examined all existing Shelf wells currently connected to HIOS and performed what is called a "vintaging" study.[17] All wells were grouped by year of first production, or vintage. Using data going back to 1978, he examined:

Trailblazer Pipeline Co., 106 FERC ¶ 63,005, slip op. at ¶ 52 & n.10 (2004) (concluding Ms. Crowe is not qualified to testify as an expert on gas supply and remaining economic life issues).

[16] Tr. 632-33. HIO-128 has a mileage scale that can be used to measure the various WPA dimensions.

[17] Mr. Pewterbaugh took no issue with Mr. Jenkins' vintaging approach:

i) the number of wells added per year;
ii) reserves for each vintage;
iii) the start production rate for each vintage; and
iv) the decline factor for each vintage.

HIO-76, at 5. *See also* HIO-81. Production from each vintage was plotted (for historic years) and forecast (for future years). Through his examination, Mr. Jenkins determined that the first category -- existing Shelf wells -- had a depreciable life of 2 years beyond 2002, taking into account the 273 MMcf/d economic limit. HIO-76, at 5.

Mr. Jenkins also used the same vintaging process to determine the second category -- new expected Shelf wells. By using historical vintage data from the existing Shelf wells, Mr. Jenkins was able to forecast with reasonable certainty future vintages of new expected Shelf wells. He estimated that these wells would add another 2 years to HIOS's depreciable life, again recognizing the 273 MMcf/d economic limit. HIO-76, at 5-6.

Existing and Expected Deepwater Wells. Mr. Jenkins' study also examined two categories of gas reserves in Gulf of Mexico deepwater areas, that is, gas in waters greater than 1000 meters deep. The first such category reflects already existing deepwater wells that are now being produced into EBGS which, in turn, connects into HIOS.[18] Mr. Jenkins forecast future deliveries from these existing wells, which serve

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Q Is the technique of vintaging a technique that you have any conceptual quarrel or dispute with?

A No.

Q Is it an accepted, to your knowledge, technique in the natural gas industry?

A Yes.

Tr. 642.

[18] EBGS is a non-jurisdictional pipeline that transports gas from a platform that sits in 4500 feet of water and is 80 miles from HIOS. HIO-76, at 6.

four different fields. He concluded that approximately 3 additional years of production would come from the existing wells before the economic limit is reached.[19]

Finally, Mr. Jenkins also estimated production from the most speculative of the categories -- future expected deepwater wells that may be accessible to HIOS. To make that estimate, he examined all active deepwater prospects in the Gulf of Mexico and forecast the resource potential of each such prospect. Then risk components such as distance from HIOS, competition from other pipelines, and the chance of a wildcat well finding commercial reserves were factored in by means of downward adjustments to the unrisked resource potential.[20] While, as Mr. Jenkins acknowledged, this approach can be inaccurate as to individual well or field estimates, on a portfolio basis it provides a good approximation of total future supplies. He concluded that these future expected deepwater gas prospects could add approximately four years to the accessible reserve total, thus allowing HIOS to operate through mid-2013 when the economic limit factor is reached. HIOS-76, at 7.

As Mr. Jenkins further testified, his economic life conclusion is conservative because his analysis also supports an economic life conclusion of as little as seven years, rather than the ten years he ultimately recommends, from the June 30, 2003 end-of-test period date. This is because a seven-year life would reflect all the reserves associated with the first three categories, but not the quite speculative fourth category involving deepwater wells. As explained by Mr. Jenkins, individual deepwater wells cost between

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[19] *See* HIO-76, at 6. The 7-year total depreciable life number referenced on that page reflects 4 years' additional production from existing and new expected Shelf wells and 3 years' production from existing deepwater wells.

[20] Mr. Pewterbaugh had no quarrel with an estimating methodology that takes into account factors such as distance and competition. Tr. 644-45.

$15 and $30 million each and production systems range from $50 million up to $1 billion. HIO-76, at 7; HIO-76, at 2, 4. Pipelines in such waters typically cost a million dollars per mile to construct. HIO-76, at 7. The high risk of commercial failure and high exploration costs dictate that only prospects with large potential will be drilled. Once a commercial discovery is made it takes two to ten years to develop. HIO-76, at 7.

Further, the geology of the deepwater area is complex, including structural, stratigraphic and combination traps influenced by salt movements and faulting. Even though improved seismic technology has helped to image these potential traps prior to drilling, the technology still lacks detail sufficient to reduce the risk of drilling in the deepwater area, especially near salt bodies typically associated with the larger prospects. HIO-76, at 7. In short, given the speculative nature of forecasts of volumes from undrilled deepwater prospects and the high costs involved, Mr. Jenkins would have been justified in excluding entirely this category of gas from his study and concluding that HIOS's economic life will end in mid-2010.

2. Staff Witness Pewterbaugh Incorrectly Determined the Economic Life By Examining Aggregate Reserve Data From the Entire Western Planning Area.

In contrast to the detailed field-by-field analysis done by Mr. Jenkins, Mr. Pewterbaugh relied upon published aggregate reserve data for the entire WPA. As just noted, the WPA is quite large -- some 300 miles by 200 miles -- and Mr. Pewterbaugh readily agreed that HIOS does not receive gas from all areas of the WPA.[21] Many other pipelines receive reserves from wells located in the WPA waters. HIOS-128. As

[21] Tr. 635. When asked why he did not utilize reserve data for the whole Gulf of Mexico, Mr. Pewterbaugh said because there are areas where HIOS does not receive gas. Tr. 635. Of course, his answer applies equally to the WPA, but when pressed as to why he did not use

concluded by Mr. Jenkins, the WPA is simply too large and too diverse geologically to serve as a reasonable proxy for HIOS. HIO-119, at 4-6.

In addition to this flawed aggregate data approach, Mr. Pewterbaugh's methodology and study contain multiple weaknesses:

- His methodology would give the same economic life result for every pipeline in the WPA that receives all its reserves from WPA wells (Tr. 633-35);
- His methodology thus implicitly assumes HIOS is like every other pipeline in the WPA (Tr. 635);
- His methodology departs from his own 1993 depreciation study for HIOS wherein he based his economic life conclusion largely on data for individual fields serving HIOS (Tr. 637-38);
- He did have available to him and did examine production data for fields serving HIOS, but then chose not to use it in reaching his economic life conclusion (Tr. 648-50);
- His methodology does not take into account pipeline-specific depletion rates, competition, or distance from reserves -- factors Mr. Pewterbaugh testified can or should be examined in reaching an economic life conclusion (Tr. 641; 644-45);
- His methodology creates a wide lower and upper limit for the remaining economic life, from which Mr. Pewterbaugh subjectively made his economic life choice (S-15, at 1); and
- His methodology assumes production occurs beyond the economic limit point even though Mr. Pewterbaugh agreed with the economic limit concept. *See* S-15, at 2.

See Tennessee Gas Pipeline Co., 25 FERC ¶ 61,020, at 61,098-99 (1983) (Opinion No. 190) (rejecting Staff's reserve modeling approach because it was based upon "unsupported assumptions" relating to future reserve "attachment" rates and the likelihood of attaching reserves that are near other pipeline facilities).

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subareas of the WPA he simply replied that "I decided that this would be representative of HIOS's economic life." Tr. 636.

Importantly, as noted above, the methodology utilized by Mr. Pewterbaugh stands in strong contrast to the methodology he used in an earlier 1993 HIOS rate case. There he estimated the remaining economic life primarily by examining the individual fields serving HIOS (Tr. 637-38), just as Mr. Jenkins did here. Mr. Pewterbaugh then adjusted his life to take into account reserves not then connected to HIOS. When asked why he did not use in his 2003 testimony the same methodology he used in 1993, Mr. Pewterbaugh first said that was because "just using the fields that are attached [to HIOS] would not give a complete picture of what the remaining life would be." Tr. 638. After being shown that his 1993 estimate of reserves also included a component for reserves not then serving HIOS, he agreed. Tr. 640. In the end, the witness's reason for choosing to use the whole WPA was simply his own arbitrary determination that the WPA was sufficiently representative of HIOS's economic life to be utilized. But, as explained earlier, Mr. Jenkins' testimony shows otherwise.

One of Mr. Pewterbaugh's own exhibits provides a strong indication of why he jettisoned the field-specific analysis technique in this proceeding, and retreated to using aggregated WPA data. As part of his direct testimony, Mr. Pewterbaugh included a section entitled "Extrapolatory Historical Production and Determining the Remaining Life of Each Field." S-4, at 13-16. In that section, as the title suggests, Mr. Pewterbaugh extrapolated historical production data into the future for each field serving HIOS to determine how long the existing fields could support HIOS's operation. His conclusion? That as of December 31, 2002, "the existing fields will last from zero to up to eleven more years." S-4, at 15. The exhibit supporting that statement lists 38 fields. S-5, at Schedule 4. As observed by Mr. Jenkins, 33 of those fields, that is, 87 percent, have a

life of 8 years or less. HIO-119, at 5. That data is entirely consistent with Mr. Jenkins' conclusion that, excluding expected new deepwater wells, HIOS has a remaining life of just seven years from June 20, 2003.

Notwithstanding his analysis of those 38 fields, Mr. Pewterbaugh entirely disregarded the field-specific data in reaching his depreciable life recommendation in the instant case: "They did not work their way into the endpoint of my analysis." Tr. 650. While it is apparent why that is so, the Presiding Judge should take note of the consistency of Mr. Pewterbaugh's own field-specific data with the conclusion reached by Mr. Jenkins.[22]

C. Negative Salvage

The record supports HIOS's proposed negative salvage allowance of $1,431,508. HIO-104, at 20. Negative salvage represents the cost of removing HIOS's facilities when HIOS retires those facilities, after deducting the salvage value of the facilities. HIO-75, at 16; *see Enbridge Pipelines*, 100 FERC ¶ 61,260, at ¶ 295 (2002).

The negative salvage allowance is a function of two factors: (1) HIOS witness Robert C. Byrd's negative salvage study, which concluded that $27,504,881 is a

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[22] Further, as Mr. Jenkins pointed out, even assuming Mr. Pewterbaugh's aggregated WPA-wide approach is valid, standard engineering calculations can be made to estimate HIOS's remaining life using Mr. Pewterbaugh's own numbers from his exhibits. Rather than supporting a 17.5 year life from the end of the test period, Mr. Pewterbaugh's numbers support only a 13.9 year life from that point. HIO-119 at 5-6; HIO-120.

Also of importance is the fact that, while accepting the economic limit concept, Mr. Pewterbaugh ignored it when it actually came to estimating the upper limit of HIOS's economic life. This can readily be seen by comparing S-15, at 1 with S-15, at 2. On the former, Mr. Pewterbaugh calculated a "Total Gas Reserves" amount of 18.061 Bcf. On cross-examination, he agreed that that figure represents the point at which the reserves serving HIOS are exhausted. Tr. 656-57. Yet, on S-15 at 2, Mr. Pewterbaugh shows reserve production continuing through to

reasonable estimate of HIOS's negative salvage costs; and (2) the remaining economic life of HIOS's facilities. (These two factors produce a negative salvage rate of 0.39 percent. HIO-104, at 20; HIO-110.) As to the first factor, Staff witness Taylor has accepted Mr. Byrd's estimated cost of negative salvage, which is not contested by any party.[23] As to the second factor, HIOS maintains that the remaining economic life of its system from the end of the test period is ten years, for the reasons discussed *supra* in Section B and in the testimony of Mr. Scott Jenkins.[24]

D. Federal Income Taxes[25]

HIOS, Staff and Indicated Shippers agree that HIOS's federal income tax allowance should be determined by multiplying the federal income tax rate by either the management fee (as proposed by HIOS and Staff) or the return allowance (as proposed by Indicated Shippers) that is adopted by the Presiding Judge. HIO-104, at 22; S-1, at 10-11; IND-1, at 6. Using HIOS's proposed management fee, the 34 percent tax rate proposed by Staff results in a federal income tax allowance of $4,803,071.[26]

2044. This is because he set a decline rate (2.59 percent) that is far too low, resulting in reserves that are far from exhausted when 18.061 Bcf have been produced.

[23] HIO-104, at 19; S-7, at 5. Staff witness Pewterbaugh adopted the testimony of retired Staff witness James S. Taylor. S-7; Tr. 628-20.

[24] HIO-76. In addition, HIOS opposes Ms. Crowe's recommended negative salvage allowance of $698,147 because she failed to base that allowance on the depreciable plant balances at the end of the test period. HIO-104, at 21.

[25] HIOS does not incur any state income taxes, and thus has not applied for a state income tax allowance. HIO-75, at 17. In addition, it is undisputed that HIOS incurred state ad valorem (property) taxes of $104,809. HIO-75, at 18; HIO-105 (line 6).

[26] HIO-104, at 22; HIO-105. If HIOS's taxable income is determined to exceed $10 million, then a 35 percent tax rate would apply. HIO-104, at 22; S-1, at 11.

E. Management Fee

1. HIOS Requires a Management Fee Because It Has a Negative Rate Base.

A threshold issue is whether HIOS should receive a management fee or a traditional return on equity. Although differing as to the level of the management fee, HIOS, Staff, and Exxon all agree that HIOS should receive a management fee in lieu of a return because it has a negative rate base.[27] Indicated Shippers alone take the position that HIOS should receive a nominal return on equity, rather than a management fee. To support this minority position, Indicated Shippers manufacture a small positive rate base by crediting only half of the negative salvage reserve against the undepreciated plant balance. IND-1, at 6; HIO-91, at 13-14.

The Presiding Judge should reject Indicated Shippers' approach. It is well established that a pipeline's net plant is determined by crediting *100 percent* of the negative salvage reserve against any undepreciated plant. HIO-91, at 14; HIO-75, at 7; HIO-2 (line 8); S-7; *see, e.g., Kansas Pipeline Co.*, 96 FERC ¶ 63,014, at 65,101 (2001) (J. Dowd) (practice of deducting negative salvage accruals from rate base takes into account the fact that negative salvage expenses are being collected in advance of the time at which facility retirement costs are incurred), *aff'd in pertinent part*, 100 FERC ¶ 61,260 (2002). Indicated Shippers' witness Ms. Crowe cited no authority, ratemaking theory or accounting principle to support her proposal to credit only half of the negative salvage reserve and to simply ignore the remaining half. The creation of a small positive

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[27] HIO-64; at 7-8; S-11, at 21; EM-1, at 26. HIOS has a negative rate base because its negative salvage reserve and accumulated deferred income taxes exceed, and are credited against, HIOS's small remaining undepreciated plant balance, yielding a negative rate base. HIO-68; HIO-75, at 5.

rate base represents an arbitrary approach designed solely to produce a predetermined, unreasonably low rate, and should be rejected. HIO-91, at 13-14.

2. HIOS's Proposed Management Fee Is Reasonable.

The management fee proposed by HIOS is intended to provide: (1) an incentive for the owners to continue to operate and maintain the pipeline, including an incentive for the owners to invest in existing or new facilities; and (2) sufficient cash flow to cover fluctuations in revenues and expenses, thereby preventing insolvency. HIO-64, at 7-8; HIO-85, at 23-26; HIO-140, at 1-2. HIOS has calculated its proposed management fee using a floor of 20 percent of HIOS's gross plant.[28] Under this approach, HIOS would receive a management fee equal to the difference between its return on rate base (assuming it achieves a positive rate base in the future) and a return on the 20 percent of gross plant. Because HIOS has a negative rate base, the management fee would be based entirely on the rate of return approved by the Presiding Judge, multiplied by 20 percent of HIOS's gross plant. HIO-64, at 16. HIOS's formula produces a pre-tax management fee of approximately $9.3 million.[29] For several reasons, this fee strikes a reasonable balance between the conflicting interests of shippers and owners.

First, the floor concept effectively eliminates any disincentive to invest in new facilities. As explained more fully in the next section, under Staff's approach, HIOS

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[28] In contrast, the *Tarpon* method, by calculating a management fee based on 10 percent of a pipeline's *average* rate base, is roughly equivalent to calculating a return on roughly 5 percent of the pipeline's gross plant investment. HIO-64, at 11. And, by ignoring the significant impact of supplemental depreciation on HIOS's average plant balance, *see infra* Section E.3.c., Staff's proposal essentially calculates a return on far less than 5 percent of HIOS's gross plant investment. *See* HIO-92.

[29] HIO-105 (showing management fee of $9.3 million, which is the product of HIOS's proposed rate of return of 12.08 percent times $77.1 million, which is 20 percent of HIOS's gross plant of approximately $385.5 million).

would face a substantial risk of losing its management fee if it invests in new facilities that create a small positive rate base. But under HIOS's proposed management fee, HIOS could invest far more ($15 million) before it would lose its entire management fee. HIO-91, at 7. This is because the creation of a positive rate base reduces the management fee to the extent of the return yielded by the positive rate base, but does not completely eliminate the management fee unless HIOS invests in facilities that create a rate base that exceeds twenty percent of gross plant. Because this methodology would not cause HIOS to suffer a reduction in profit, HIOS would have the incentive to continue to make necessary capital additions, which have been $3.7 million annually over the past three years. *Id.* at 8. Thus, HIOS's proposed management fee promotes the Commission's vital goal of encouraging investment in the pipeline infrastructure needed to meet the market's growing demand for natural gas. HIO-140, at 3-4. *See, e.g., In re Midwest Energy Infrastructure Conference*, AD02-22-000 (Nov. 13, 2002) Tr. 3-4 (statement by Chairman Wood that "having a sufficient energy infrastructure is a crucial part of what FERC's mission is"); Federal Energy Regulatory Commission, *Strategic Plan for Fiscal Years 2003-2008*, Sept. 2003, at 3, 6 (stating Goal 1 of FERC's strategic plan as promoting infrastructure, and that "A robust natural gas pipeline infrastructure is critical for the reliability of the Nation's energy supply").[30]

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[30] *See also In re Northeast Energy Infrastructure Conference*, AD02-6-000 (Jan. 31, 2002) Tr. 4 (statement by Chairman Wood that the primary goal of FERC "is to ensure a high quality, secure and environmentally responsible energy infrastructure"); *Testimony of Chmn. Pat Wood III, Federal Energy Regulatory Commission, before the Subcomm. on Energy Policy, Natural Resources, and Regulatory Affairs of the House Comm. on Gov't Reform*, Oct. 16, 2001, at 2 (FERC's "central role in the natural gas industry is to serve the growing demand for natural gas by enabling the construction and use of that pipeline infrastructure at just and reasonable rates, terms and conditions of service, and without undue discrimination."); Federal Energy Regulatory Commission, News Release: "Commission Approves Natural Gas Pipeline Expansion Under Pre-filing Process; Increased Infrastructure Will Meet Demand in West," July 17, 2002 (pipeline "will

Second, HIOS's proposed management fee also would help to prevent HIOS from becoming insolvent -- something in the obvious interest of both HIOS and its ratepayers. HIO-85, at 23-26. HIOS requires sufficient cash flow to cover (1) its annual maintenance capital expenditures (which are approximately $3.7 million annually),[31] (2) increases in operating expenses (*e.g.*, $1.5 million increase during the pendency of the test period),[32] and (3) decreases in revenues, which occurred during the base and test period (by approximately $900,000 in the base period alone[33]) and are virtually certain to continue declining in the future as HIOS's throughput continues its steady decline. HIOS's management fee would provide it with an improved cash flow level, thereby aiding its ability to deal with fluctuations in costs and revenues. However, the record shows that even with its proposed management fee HIOS would still have a relatively high risk of insolvency.[34]

Third, HIOS's proposed management fee will continue, not reduce (as contended by Staff), the company's incentive to operate efficiently by minimizing costs and increasing throughput. In any rate case, a pipeline receives an opportunity to earn a return on its investment, based on assumed levels of costs and revenues. Yet every pipeline also retains the incentive, between rate cases, to earn additional profit by

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provide much needed additional infrastructure to the western markets"); Federal Energy Regulatory Commission, News Release: "Commission Approves Pipelines on West Coast, Adding to Region's Energy Infrastructure," Apr. 24, 2002 (similar).

31 HIO-91, at 9.

32 *See* HIO-105.

33 *See* HIO-24 (Schedule G-1) (revenues declined from approximately $3.3 million in October 2001 to approximately $2.4 million in September 2002).

34 HIO-85, at 24-25 (Williamson); HIO-69. The average operating expense ratio of the offshore pipelines included in HIO-70 results in a return requirement of approximately $10.1 million, compared to HIOS's requested management fee of approximately $9.6 million. HIO-64, at 21.

reducing costs and by increasing revenues (with additional throughput) compared to the cost and revenue levels assumed by the Commission in establishing the pipeline's rates in the prior rate case. HIO-140, at 2; Tr. 221-22. Basic economic theory dictates that a profitable company will take steps to increase profits even further if it is possible to do so; indeed, a company's management has a duty to its shareholders to maximize profits through all legal means available. *See, e.g., Transwestern Pipeline Co.*, 36 FERC ¶ 61,175, at 61,446 (1986) (noting pipeline's "duty to its shareholders to maximize profits"). It therefore is not reasonable to suggest -- as Staff witness Manganello does -- that HIOS's proposed management fee would deprive it of the incentive to earn additional revenue by operating more efficiently.

Fourth, HIOS's significant business risks also justify its proposed management fee. Such risks include steadily declining throughput, much of which is interruptible, not firm. Indeed, as of the end of the test period, only five percent of HIOS's capacity was contracted on a firm basis. HIO-91, at 21. HIOS's risks also include a lack of economically accessible gas reserves, regardless of HIOS's vigorous efforts to compete. HIO-64, at 21-24. HIOS's management fee, which serves the same role that a rate of return does for a pipeline with a positive rate base, is required in order to reflect the significant risks HIOS must address in continuing to operate its pipeline system.

HIOS further submits that the Presiding Judge should consider the distinct circumstances of the *Tarpon* case relied upon by Staff and the policy ramifications the instant case will have for pipelines and their shippers. A review of *Tarpon* reveals an extremely unique set of facts, including:

- A pipeline with a unique *"cost of service" tariff* that completely insulated Tarpon against fluctuations in throughput or costs, depriving Tarpon of any incentive for efficient operations (57 FERC at 62,230); and

- A pipeline that effectively received additional profits through extraordinarily high salaries for its executives, who were also the owners of the company, and through unusually high travel expenses and other "perks" included in the pipeline's operating expenses (*Id.* at 62,242-43).

It is perhaps not surprising that in light of these uncommon facts the Commission used a restrictive formula to establish Tarpon's management fee. But none of those unique facts applies to HIOS. To the contrary, the record shows that HIOS has significantly reduced its operating expenses in prior years,[35] has operating expenses that are in line with or are significantly *lower than* other offshore pipelines (*see supra* Section I.A.3.a.), and competes aggressively for new throughput. HIO-64, at 23. The record also reflects that HIOS's management fee is needed to prevent insolvency -- an issue that did not concern the owners of Tarpon. HIO-133, at 24. In short, it would be legal error to reject HIOS's proposed management fee because of a failure to consider the unique circumstances at issue in *Tarpon.*

Perhaps more importantly, the impact of the instant case on future investment in the natural gas pipeline industry cannot be ignored. The challenge for the Presiding Judge and the Commission in this proceeding is to establish a management fee that encourages sufficient future investment in pipeline infrastructure. An insufficient management fee may serve the short-term interests of those who advocate lower rates here, but would establish an extremely misguided policy that in the long-term punishes ratepayers at large by discouraging critically needed investment. For all these reasons,

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[35] Tr. 303.

HIOS respectfully submits that the Presiding Judge should accept its proposed management fee.

3. Staff's Proposed Management Fee Is Unreasonable.

As noted, Staff claims to base its proposed management fee of $680,802 on the formula used in *Tarpon*. S-18, at 2. In *Tarpon*, the Commission derived a management fee by multiplying the pre-tax cost of capital by 10 percent of the pipeline's historical average rate base. 57 FERC at 62,241. The Commission has not had another occasion to decide how to derive an appropriate management fee in a pipeline rate case, either prior to or since *Tarpon*. In the following discussion, HIOS will show why Staff's interpretation of the *Tarpon* formula would establish a dangerous precedent for gas pipelines and their customers.

a. Staff's Approach Would Create a High Risk That HIOS Would Become Insolvent.

The stark reality is that Staff's management fee creates an unacceptably high risk that HIOS would become *insolvent*. A typical pipeline can absorb short-term increases in operating expenses or decreases in revenues while still paying its bills for operating expenses because its allowances for depreciation expense and return give it a cash "cushion" to manage such fluctuations. In simple terms, if the pipeline's revenues go down or its expenses increase, it typically can absorb the revenue/expense "hit" without going insolvent simply by taking fewer profits in the short-run. However, with Staff's management fee, HIOS would not have that ability, because it would have only a minimal management fee (and a very small depreciation allowance), and, thus, a dangerously small cash cushion. *See* HIO-64, at 6-7; HIO-85, at 24-26.

The evidence shows that the risk of insolvency is concrete, not merely theoretical. Staff's proposed management fee and depreciation allowance would provide HIOS with a cash cushion of only $1.8 million (approximately $0.7 million for the management fee, and $1.1 million for depreciation). HIO-91, at 10. But HIOS's operating expenses increased sharply during the nine-month test period by $1.5 million, from $18.2 million to $19.7 million. HIO-105; *see also* S-1, at 7. Had Staff's management fee been in effect during the period when this increase in costs occurred, HIOS would have been left with only about $300,000 to cover any decrease in revenue due to a decline in throughput. In addition, the record shows that HIOS's revenue declined by approximately $900,000 during the base period, including a sharp drop of almost $500,000 during the last two months of the base period alone. *See* HIO-24 (Schedule G-1). Declining revenues can be expected to continue as a result of declining throughput, which the evidence shows has steadily occurred for several years and is likely to continue in the future. HIO-72.

Even assuming *arguendo* that HIOS would have any remaining cash on hand after experiencing the types of decreases in revenues and increases in expenses that it experienced in the base and test periods, such cash would also be required to fund any necessary maintenance on the HIOS system. But unrebutted evidence shows that HIOS spends approximately $3.7 million per year on capital expenditures needed to maintain its system in order to continue providing safe and reliable service. HIO-91, at 9. Given the revenue reductions and cost increases it recently experienced and can be expected to experience in the future, HIOS's remaining cash balance would probably be insufficient

to cover necessary maintenance. Thus, in all likelihood *Staff's approach would not provide sufficient cash flow for HIOS to remain solvent or maintain its system.*[36]

Staff's main response to this impending financial train wreck is to suggest that HIOS can avoid these problems merely by filing a new Section 4 rate case to cover any increased costs or decreased revenues.[37] Staff's proposed solution is no solution at all. Both Mr. Manganello and Ms. Crowe conceded that it takes a substantial amount of time to prepare a rate case; also, a rate case typically does not go into effect for six months as a result of the suspension and notice procedures set forth in Section 4. Tr. 576-77; Tr. 702. In the meantime, while preparing its rate case and waiting for its proposed rate increase to go into effect, HIOS would have insufficient cash funds to maintain its system and pay its bills, and may well be unable to continue to operate. HIO-133, at 24-25; HIO-64, at 6-7.

Nor could HIOS manage a cash flow problem by obtaining additional equity investment or a loan. As Professor Williamson testified, owners and lenders would have no incentive to make investments in or loans to HIOS to cover HIOS's operating expenses, because the normal ratemaking process does not permit pipelines to receive a return on or of investments made to meet operating expenses rather than to establish new rate base. HIO-85, at 24. In other words, due to the rule against retroactive ratemaking, HIOS would have no clear legal right to recover the cost of loans or investments needed

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[36] The same conclusion applies with even greater force to Indicated Shippers' approach, which would provide HIOS with a small return allowance that is even less than Staff's inadequate management fee. HIO-91, at 13-14.

[37] S-1, at 9. As noted by Professor Williamson, Staff's witness on the management fee issue, Mr. Manganello, did not address the risk of insolvency at all in his testimony. HIO at 133, at 24.

to cover cash flow problems.[38] In that situation, no rational person would have any incentive to invest in or loan money to HIOS. HIO-85, at 24.

Ms. Crowe attempted to respond, but only indirectly. She did not dispute that HIOS would be unable to attract new equity or debt capital. Instead, she alleged that HIOS has other sources of cash that would allow it to avoid insolvency. For example, she said the "most obvious source" of funds to cover cash flow problems is HIOS's $13 million reserve for negative salvage. This idea, however, is just as bankrupt as the suggestion that HIOS could obtain a loan to solve the problem. If HIOS were to follow Ms. Crowe's suggestion and tap its negative salvage reserve to cover cash flow shortfalls, it ultimately would lack the funds required to retire the HIOS system. HIO-91, at 10. Obviously, that is not a viable option.

Indicated Shippers also suggest that HIOS's cash flow concerns are not legitimate because it made a cash distribution of $17 million to its owners in 2001. IND-1, at 8. Indicated Shippers thus appear to argue that the owners of HIOS should return to HIOS the cash distributions they have received in the past, should HIOS need cash in the future. That suggestion, however, ignores the fact that HIOS's distributions of cash in 2001 and in prior years were completely legal and appropriate: just as the rule against retroactive ratemaking bars pipelines from filing to recover past losses, the same rule bars ratepayers from seeking to require HIOS's owners to return or sacrifice revenues that they lawfully received in the past. *See, e.g., Tarpon*, 57 FERC at 62,234. As Mr. Manganello

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[38] "Under [the retroactive ratemaking] doctrine, the Commission is prohibited from adjusting current rates to make up for previous over- or undercollections of costs in prior periods. The retroactive ratemaking doctrine is thus a logical outgrowth of the filed rate doctrine, prohibiting the Commission from doing indirectly what it cannot do directly. The Commission may not allow a utility to 'recoup past losses.'" *Transwestern Pipeline Co.*, 73 FERC ¶ 61,091,

acknowledged, Section 5 of the NGA provides for prospective relief only, even assuming prior rates are found to be unjust and unreasonable.[39]

In addition, it should be recognized that the *Tarpon* case did not consider the type of insolvency problem faced by HIOS. As noted in unrebutted testimony provided by Professor Williamson, who was himself a rate of return witness for Tarpon in that proceeding, insolvency was not a concern of Tarpon's owners. HIO-133, at 23-24. In fact, the *Tarpon* order indicates that Tarpon had a unique operating agreement with Trunkline, the operator of Tarpon's system, that at that time did not expose Tarpon to the full cost of operating its pipeline system. 57 FERC at 62,244-45. In contrast, HIOS's operating agreement with GTOC requires HIOS to pay all of the operating expenses of running HIOS's system, including non-routine and direct flow-through operating expenses that constitute a large portion of HIOS's overall operating costs (HIO-104, at 8) and that can fluctuate significantly, thereby creating the potential for significant cash flow problems not faced by Tarpon.

Finally, there can be no doubt that a management fee that causes a substantial risk of insolvency would violate the Commission's obligation to establish just and reasonable rates. As Mr. Manganello acknowledges, the U.S. Supreme Court has established several

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at 61,279 (1995) (quoting *Associated Gas Distribs. v. FERC*, 898 F.2d 809, 810 (D.C. Cir. 1990) (Wald, concurring).

[39] *Id.*; Tr. 703. Staff and Ms. Crowe briefly offer a handful of other arguments regarding the insolvency issue, but those arguments fare no better than their other arguments discussed above. *See* HIO-91, at 10-12. For example, Ms. Crowe asserts that HIOS has $4 million in its cash-out tracker; however, it is undisputed that such funds must be used to replace gas that was taken from but never delivered to HIOS by its customers. Thus, the cash-out revenues are not a source of funds. HIO-91, at 11. In addition, Staff contends HIOS could have filed a lead-lag study to justify a working capital allowance; however, that allowance merely provides a return on the cash deficiency, and does not fund the deficiency itself. HIO-91, at 11. *See Canyon Creek Compression Co.*, 56 FERC ¶ 61,140, at 61,515-16 (1991) (explaining function of cash working capital allowance).

criteria for judging the reasonableness of a pipeline's allowed return on investment. Among other things, the Commission must establish a return that allows the pipeline to maintain credit, assure financial integrity, and attract capital. S-11, at 5 (citing *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923), and *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944)). Mr. Manganello agreed that a management fee, which is intended to substitute for a fair return, must achieve the same objectives. Tr. 692. As shown above, however, Staff's proposed management fee falls far short of meeting each of these criteria.

b. Staff's Approach Creates a Disincentive for HIOS and Other Similarly-Situated Pipelines To Invest in Facilities, and an Incentive To Abandon Operations Entirely.

Even assuming that a pipeline with a major risk of insolvency actually *could* make the investments necessary to expand or continue operations, Staff's management fee proposal would eliminate any incentive to make such investments. By discouraging investments in needed infrastructure, Staff's proposal would have major negative implications for the gas pipeline industry as a whole and the shippers that rely on it.

Under Staff's proposed management fee, the creation of *any* positive rate base would potentially cause HIOS to lose its management fee. HIO-91, at 6-7. If HIOS, which currently has a negative rate base, were to make new investments in facilities that caused its rate base to become positive, there would be, at a bare minimum, a substantial risk that HIOS would lose its management fee because its rate base had turned marginally positive.[40] In this situation, depending on the level of new investment, HIOS would receive a return allowance that would be *lower than* the management fee it forfeited.

[40] Staff's witness agreed with this proposition at the evidentiary hearing. Tr. 689, 690.

And, to make matters even worse, HIOS would only earn a return on the portion of its investment that exceeded its negative rate base. As acknowledged at the hearing by both Ms. Crowe and Mr. Manganello, HIOS would earn absolutely nothing on the portion of its investment that would be offset by its negative rate base.[41] Although Mr. Manganello cavalierly asserted that he would still invest in facilities under these circumstances (Tr. 689), his opinion is divorced from market reality; it is clear that no rational pipeline or investor would make the same choice. HIO-91, at 6-9.

As with the potential for insolvency, the disincentive to invest created by Staff's proposal is real, not merely theoretical. The evidence shows that if HIOS made plant additions of up to $15.0 million, it would earn a return on rate base that would be significantly *less* than the forfeited management fee. HIO-91, at 7-8 (discussing HIO-93). The evidence also shows that if Staff's management fee is adopted in this case, and assuming *arguendo* that HIOS continues to make average maintenance capital additions of $3.7 million annually, HIOS would face a loss of up to $4.8 million because it would potentially lose its management fee. HIO-91, at 8-9 (discussing HIO-94).

Staff's management fee, if adopted, would thus force HIOS to make a stark choice: either discontinue operations altogether or accept the fact that it would not earn a return on a large portion of investments needed to safely and reliably operate the pipeline system. HIO-91 at 8-9; Tr. 214-15, 240. Indicated Shippers try to minimize the possibility that HIOS would seek to abandon service, pointing to the fact that HIOS operated profitably in the years preceding this rate case. IND-1, at 8. However, the fact that HIOS was profitable in the past is completely irrelevant: the question here is

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[41] HIO-64, at 8; Tr. 571-73; Tr. 690.

whether HIOS's owners will have any incentive to continue operations in the future. Without the opportunity to earn a reasonable management fee in the future, the incentive to continue operating the system is eliminated, regardless of what profits HIOS made in the past. Tr. 239-40. In short, what pipeline would continue to operate in the long-run knowing that it may lack the opportunity to earn a reasonable return on future investments needed to provide safe and reliable service? Neither Staff nor Indicated Shippers provides any answer to this fundamental question.

Staff's proposal also ignores the significant opportunity cost associated with its proposal. As Ms. Crowe acknowledged, the "economically rational" choice for a pipeline, as for any other business, would be to deploy its capital on projects that yield the highest profit. Tr. 567. A significant amount of human capital is required to operate a pipeline; in HIOS's case, this human capital is represented by the approximately $19.7 million of operating expenses required to operate the system on a daily basis. HIOS's owners must choose whether to continue to deploy this human capital on an investment like HIOS or on other, more profitable investments, including investments that can earn unregulated returns. *See* HIO-140, at 4.

It also should be recognized that Section 7(b) of the NGA permits pipelines to file to abandon their jurisdictional facilities. 15 U.S.C. § 717f(b). HIOS thus would have to obtain Commission abandonment authorization prior to ceasing operations. However, and although Ms. Crowe found the idea intriguing (Tr. 575), it is beyond reasonable dispute that the Commission cannot require pipelines to continue operating as non-profit organizations or when they have no real opportunity to make a reasonable profit on their

investments. *FPC v. Hope Natural Gas Co.*, 320 U.S. at 603; *Bluefield Water Works & Improvement Co.*, 262 U.S. at 690.

Staff's draconian management fee proposal would not only establish the wrong precedent, it would do so at the worst possible time. It is widely recognized that the demand for natural gas in the U.S. is growing rapidly, due in part to the addition of a massive amount of new gas-fired electric generation facilities.[42] At the same time, the Commission, other policymakers, and many large natural gas consumers have serious concerns about the industry's ability to supply enough natural gas to meet growing demand. HIO-140, at 3. Thus, the maintenance and development of the infrastructure necessary to transport this natural gas to the market is critical. *Id.* at 3-4 (noting that the Commission's 2003 Natural Gas Market Assessment found a "need for expanded natural gas transmission capacity"). Any rate mechanism, such as Staff's proposed management fee, that would encourage pipelines to abandon their facilities or discourage them from making additional investments directly conflicts with the Commission's recognition of the need for a substantial amount of investment in additional pipeline infrastructure.

c. Staff's Approach Penalizes HIOS for Accelerated Depreciation That Resulted in Lower Rates for HIOS's Customers in Prior Years.

Staff has also ignored the fact that HIOS, unlike Tarpon, experienced a significant amount of supplemental depreciation in its early years. As stated by HIOS witness Porter, the existence of the supplemental depreciation skews the average rate base calculation that underlies the *Tarpon* formula. HIO-64, at 14-15. Nothing in the *Tarpon*

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[42] *See, e.g.*, Scott Miller & Jeff Wright, "Southeast Energy Infrastructure Conference," May 9, 2002, *available at* <http://www.ferc.gov/industries/infrastructure/05-09-02-1.pdf> at 5, 7 (identifying significant growth of gas-fired electric generation).

order suggests that Tarpon had anything remotely resembling HIOS's supplemental depreciation, or that the Commission considered how to design an appropriate management fee in this unique situation. As demonstrated by HIO-92, correcting for Staff's failure to account for HIOS's supplemental depreciation would increase Staff's proposed management fee to at least approximately $3.2 million (assuming *arguendo* that the Presiding Judge adopts Staff's proposed rate of return). *See* HIO-91, at 5; HIO-92.

The Commission approved HIOS's supplemental depreciation in its orders certificating the HIOS project. HIO-91, at 5. HIOS was required to credit to its accumulated provisions for depreciation all revenues attributable to (1) interruptible overrun service and (2) volumes transported above the level used to design HIOS's commodity rates. HIO-91, at 5-6. Thus, HIOS depreciated its plant much faster as a result of the supplemental depreciation. This has a huge impact under Staff's version of the *Tarpon* formula, because it results in lower plant balances over the life of the HIOS project, thereby yielding a much lower average rate base that Staff then uses to derive the management fee. HIO-91, at 4-5.

Perversely, Staff's approach actually penalizes HIOS for the fact that its supplemental depreciation resulted in *significantly lower rates* for HIOS's shippers over the life of the project. Because of this unique supplemental depreciation method, HIOS did not receive a return on investment in its transportation rates for the amount of the supplemental depreciation. HIO-91, at 6. It is undisputed that this resulted in *lower* rates for HIOS's shippers. When asked by counsel (and again by the Presiding Judge) about the impact of HIOS's supplemental depreciation, Mr. Manganello acknowledged that the

rates to HIOS's customers were "lower than they would have been" without the supplemental depreciation. Tr. 699; *see* Tr. 705-06.

Staff's response to this key fact is to assert that HIOS benefited from the supplemental depreciation, thereby implying that HIOS, by arguing that the supplemental depreciation should be excluded from the *Tarpon* calculation, is seeking some sort of improper double recovery of the supplemental depreciation. While it is true that the supplemental depreciation allowed HIOS to recover the cost of its investment faster, Staff's response ignores the more salient fact that the supplemental depreciation benefited HIOS's shippers through lower rates. Yet Staff's approach would unreasonably penalize HIOS for that fact.

Staff's approach also appears to conflict with the intent of *Tarpon*; at a minimum, Staff's approach is by no means compelled by the language of that case, assuming *arguendo* that *Tarpon* applies here. In *Tarpon*, the Commission calculated the management fee based on "10 percent of the historical average rate base." 57 FERC at 62,241. In adopting this method, it appears the Commission assumed that the pipeline's plant was depreciated in a relatively constant manner over time, *i.e.*, the Commission evidently assumed *Tarpon* had been depreciated on a straight-line basis, instead of on an accelerated or supplemental basis. HIO-64, at 14; *cf. Enbridge Pipelines*, 100 FERC ¶ 61,260, at ¶ 253 (noting that "[t]he Commission generally uses straight line depreciation which assumes that the amount of depreciation is the same every year"). That assumption, however, obviously does not apply to HIOS. HIO-91, at 14.

In addition, and because HIOS's rate base turned negative in 1998, Staff's approach is also distorted because it uses a negative rate base balance for four years in its

calculation of the average rate base. HIO-64, at 14; HIO-65. Staff's approach will lead to increasingly absurd results; indeed, as a result of the continued accumulation of its negative salvage balance, at some point in the future HIOS will have a *negative average rate base*. At that point, Staff's version of the *Tarpon* method would result in a *negative management fee*, whereby HIOS's investors would receive no profit whatsoever. HIO-64, at 15. Although this cannot possibly be what the Commission intended in *Tarpon*, Staff's approach, if continued, would lead eventually to that absurd result.

F. Rate of Return

Notwithstanding that HIOS has applied for a management fee instead of the traditional rate of return allowance received by pipelines that have positive rate bases, the rate of return issue still has relevance to this case. Assuming the Presiding Judge agrees that HIOS should receive a management fee, it will then be necessary to determine the appropriate rate of return because that is one component of the management fee formula. The management fee would be determined by multiplying either HIOS's or Staff's proposed method of determining the hypothetical rate base (*see supra* Section E) by the appropriate overall rate of return.[43] For the reasons discussed below, HIOS submits that the Presiding Judge should adopt a cost of debt of 8.04 percent, a return on equity ("ROE") of 15.25 percent, and an overall rate of return -- based on a capital structure of 44 percent debt and 56 percent equity -- of 12.08 percent.

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[43] HIO-64, at 9-10. Alternatively, if the Presiding Judge decides to accept Indicated Shippers' arbitrary method of creating a small positive rate base, it would then be necessary to multiply that hypothetical rate base by the appropriate rate of return to determine HIOS's return allowance.

1. Cost of Debt

HIOS, Staff and Indicated Shippers have all agreed to use 8.04 percent as HIOS's cost of debt, as this reflects the cost of debt of GulfTerra Energy Partners L.L.C., HIOS's parent company, as of the end of the test period. HIO-133, at 4; S-11, at 9; IND-18, at 1.

2. Return on Equity

In contrast to the unanimity among the parties on the issue of cost of debt, HIOS, Staff and Indicated Shippers do not agree on the issue of return on equity. Professor Williamson supports an ROE of 15.25 percent, Mr. Manganello supports an ROE of 11.22 percent, while Ms. Crowe advocates an ROE of 10.5 percent. As discussed below, these divergent views on the ROE issue stem principally from a dispute about which companies to include in the proxy group used to derive the ROE using the Commission's discounted cash flow ("DCF") analysis.

a. Proxy Group

As a result of recent developments in the natural gas pipeline industry, the issue of the appropriate proxy group in pipeline rate cases has become less certain. For a number of years, the proxy group consisted of several large, stable pipeline companies. For example, in the Commission's oft-cited Opinion No. 414-A, *Transcontinental Gas Pipeline Corp.*, 84 FERC ¶ 61,084 (1998), the proxy group consisted of six companies: Coastal Corporation ("Coastal"); El Paso Energy (now El Paso Corporation); Enron Corp. ("Enron"); Panhandle Energy ("Panhandle"); Sonat Inc. ("Sonat"); and The Williams Companies, Inc. ("Williams"). However, since that time, Enron Corp. has declared bankruptcy, and, as a result of mergers and acquisitions, Coastal, Panhandle and Sonat have ceased to exist as publicly traded companies. HIO-85, at 8.

The remaining two pipeline companies in the Opinion No. 414-A proxy group, El Paso and Williams, have encountered serious problems that prevent their use as proxy companies. Because of energy trading and liquidity problems, the stock prices and dividends for these companies have dropped precipitously. HIO-85, at 9. Indeed, the record shows that El Paso and Williams have a combined *negative* cost of equity. HIO-133, at 9; HIO-138. Both Professor Williamson and Mr. Manganello agree that these companies' financial difficulties make them unrepresentative and unsuitable for use in the in the Commission's DCF analysis. HIO-133, at 7. Although Ms. Crowe proposed to include El Paso and Williams in the proxy group (IND-1, at 11), she did not explain why she disagreed with Professor Williamson's reasoning on this point, and thus offered no basis for including these companies in the proxy group.

The record thus shows that, as a result of mergers and financial difficulties, none of the six pipeline companies from the Opinion No. 414-A proxy group can or should be used in the proxy group here. The issue thus becomes what alternative to use. As discussed below, the Presiding Judge should use the proxy group chosen by Professor Williamson, who advocates a proxy group made up of five natural gas pipelines that have emerged and grown in recent years, including one corporation and four master limited partnerships ("MLPs"). HIO-133, at 6; HIO-135. In contrast, despite the fact that this is a natural gas pipeline rate case, Mr. Manganello proposes a proxy group consisting of three *gas distribution* companies and only one gas pipeline company. Mr. Manganello also opposes the use of MLPs in the proxy group. Ms. Crowe advocates a proxy group comprised of four gas pipelines and *twelve* gas distribution companies.

i. Natural Gas Pipelines, Not Natural Gas Distributors, Should Be Used as Proxies for HIOS.

Historically, the Commission has rejected the use of distribution companies as proxies for natural gas pipelines. The reason is that distributors have significantly lower risks than gas pipelines, largely because distributors, unlike gas pipelines, have franchised service territories where they face no competition in both retaining customers *and* adding new customers. HIO-133, at 10. Thus, in *Williston Basin Interstate Pipeline Company*, 87 FERC ¶ 61,264, at 62,007 (1999), the Commission concluded:

> The Commission does not consider it appropriate to include any of these four companies, which have focused primarily on gas distribution and are thus not recognized as being truly representative of the gas transmission business.

See also Mountain Fuel Res., Inc., 28 FERC ¶ 61,195, at 61,370 (1984), (finding that gas distributors are not comparable to gas pipelines and therefore refusing to use them in a proxy group); *EPGT Texas Pipeline, L.P.*, 99 FERC ¶ 61,295, at 62,250 (2002) ("Commission policy in natural gas cases has been to use a proxy group consisting solely of companies operating natural gas pipelines. The companies should be publicly traded, engaged largely in natural gas transmission and own natural gas pipelines regulated by the Commission.").

In accordance with the Commission's policy, ALJ Harfeld stated in *Wyoming Interstate Company Ltd.*, 96 FERC ¶ 63,040 (2001):

> The flaw in BP's position is that the proxy group advocated by it is heavily influenced by several *distribution companies that are less risky than a transmission company* such as WIC. The Commission has rejected the use of such companies in a proxy group because *"distribution companies . . . are not really comparable* to [pipeline companies]." [citing *Mountain Fuel, supra*] Gas distribution companies typically have franchised service areas and do not face direct competition in their core

> markets. WIC and other interstate pipelines do not have such a competitive advantage.

Id. at 65,262-63 (emphasis added); *see Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005, slip op. at ¶ 94 (Jan. 21, 2004) (Birchman, J.) (accepting Professor Williamson's position and rejecting Ms. Crowe's "inclusion of LDCs in her proxy group because they face less risk than a pipeline"); *Kansas Pipeline Co.*, 96 FERC ¶ 63,014, at 65,088 (2001) (Dowd, J.) (refusing to include distributor in proxy group because it "deviates from the Commission's prior decisions to focus on gas pipeline companies.").

Although Mr. Manganello acknowledged that the Commission has not overruled these precedents, Tr. 674-75, he points to *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036 (2003), which relied on a nine-member proxy group that included three gas distributors -- Equitable Resources, National Fuel Gas, and Questar. Staff now seeks to make those three distributors part of the proxy group here. S-11, at 12. Staff's treatment of *Williston*, however, omits a key fact: the issue of whether to include distributors in the proxy group was *not litigated* in *Williston*. Instead, both Williston and Staff agreed to use the nine companies in the proxy group, including the three distributors. Thus, the Commission in *Williston* was never asked to consider the major differences between pipelines and distributors. HIO-133, at 13-15. Staff's reliance on *Williston* is, therefore, misplaced.

The fact remains that the only pipeline rate cases where this issue has been litigated at the Commission have *rejected* the inclusion of gas distribution companies. *See EPGT*, 99 FERC at 62,250; *Williston*, 87 FERC at 62,007; *Mountain Fuel Res., Inc.*, 28 FERC at 61,370. Indeed, in a prior Williston case where the issue was actually litigated, the Commission rejected Williston's proposal to use Questar and Equitable

Resources, two of the distributors selected by Mr. Manganello, precisely because they were primarily gas distributors, not gas pipelines. *See Williston*, 87 FERC at 62,007.

The record here dictates the same result. Unrebutted evidence demonstrates that Mr. Manganello's three distribution companies have little in common with the gas pipelines that the Commission typically includes in the proxy group. For example, the EBIT[44] of Equitable Resources' distribution segment is more than twice the EBIT of its pipeline segment. HIO-133, at 12. Similarly, the net income of National Fuel Gas from distribution is far more than its net income from pipelines. *Id.* And pipelines contributed only a small fraction of Questar's total operating income, which was largely made up of income from its distribution segment. *Id.* Thus, the record confirms that Equitable, National Fuel, and Questar are properly considered gas distributors, not gas pipelines. Indeed, Mr. Manganello acknowledged at the hearing that it was incorrect to refer to these three distributors as "natural gas pipelines." Tr. 681. Similarly, the record shows that the cost of equity for Ms. Crowe's twelve gas distributors is much lower than the cost of equity for natural gas pipelines, reflecting the much lower risks experienced by gas distributors. HIO-133, at 8. In sum, the record supports only one conclusion: gas distributors should not be included in the proxy group of this gas pipeline rate case.

ii. HIOS's Proxy Group Correctly Includes Only Natural Gas Pipelines, Including Partnerships.

HIOS's proposed proxy group includes five gas pipelines: GulfTerra Energy, Kinder Morgan Energy Partners, Kinder Morgan Inc., Northern Border Partners, and Enterprise Products Partners. HIO-133, at 6. Kinder Morgan Inc. is a corporation, while the other four pipelines are MLPs. Mr. Manganello also includes Kinder Morgan Inc. in

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[44] EBIT means "earnings before interest and taxes".

his proxy group. However, he opposes the use of the four gas pipeline MLPs in order to force the use of lower-risk gas distribution companies in the proxy group as a last resort.[45]

Although the Commission has not decided this issue in a natural gas pipeline rate case (HIO-141, at 3), there is no logical reason not to include gas pipeline MLPs in the proxy group.[46] Mr. Manganello himself has made use of a set of MLPs as proxy companies in oil pipeline rate cases. HIO-133, at 16. Apparently, Mr. Manganello opposes the use of MLPs in this case on the ground that the Commission has expressed a "preference" to use proxy groups that have the same ownership structure as the entity whose return is being set.[47]

As explained by Professor Williamson, however, no such preference exists. HIO-133, at 18-19. Indeed, in a 1999 case Mr. Manganello himself proposed the use of MLPs, *in combination with natural gas pipeline corporations*, in the same proxy group. *Id.*; Tr. 671-72. In that case, Opinion No. 435, *SFPP, L.P.*, 86 FERC ¶ 61,022 (1999), the Commission ultimately concluded that that there were now a sufficient number of oil

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[45] In her direct testimony, Ms. Crowe did not object to HIOS's use of MLPs, perhaps because she herself included MLPs in a proxy group she proposed in another pending gas pipeline rate case. HIO-133, at 16. Curiously, however, in her surrebuttal testimony she appeared to agree implicitly with Mr. Manganello in opposing the use of MLPs as proxy companies. HIO-141, at 4. To the extent that she changed her position and now opposes the use of MLPs, Ms. Crowe is incorrect for the same reasons Mr. Manganello is incorrect, as explained herein.

[46] Mr. Manganello also objected to HIOS's use of GulfTerra Energy in the proxy group because it has a bond rating of BB+. S-18, at 5. However, the Commission has never disqualified a pipeline from being a proxy company because of its bond rating. HIO-141, at 2.

[47] Tr. 668-72. Mr. Manganello also contended that the Commission has stated a preference for using proxy companies in the same industry as the entity whose rates are being set. However, the record shows that the Commission has indeed used gas pipelines to set the rate of return in oil pipeline cases. Tr. 671. In any event, based on his updated analysis of gas pipeline companies, Professor Williamson is not proposing to include any oil companies in his proposed proxy group, and thus the point is moot. HIO-133, at 6.

pipeline MLPs so that it could rely on a proxy group made up solely of those MLPs, whereas before it had been necessary to rely on proxy groups consisting of both oil pipeline MLPs and gas pipeline corporations. 86 FERC at 61,099; *see* HIO-133, at 18-19. Nowhere in Opinion No. 435 is there any suggestion that it is inappropriate to use MLPs to set the rate of return for a company that is not itself an MLP,[48] a fact conceded by Mr. Manganello. Tr. 673. In fact, in several cases the Commission has accepted the use of corporations as proxies to set the rate of return for partnerships.[49]

Moreover, Mr. Manganello's own logic would require the use of MLPs in the proxy group in this case. Mr. Manganello testified that the Commission did in fact mix ownership structures in prior cases because in his view there were insufficient alternatives in those cases. Tr. 668, 674. At present, mergers and financial distress have reduced the number of suitable gas pipeline corporations. HIO-85, at 8-9; HIO-133, at 17. And Mr. Manganello conceded that if the Commission adhered to its precedent of excluding distribution companies from gas pipeline proxy groups, there probably would not be enough gas pipeline corporations to form a proxy group. Tr. 675. Consequently, even under Mr. Manganello's view of Commission policy, it would now be appropriate to include MLPs in a proxy group to set the return for non-MLPs.

Mr. Manganello also now asserts that MLPs have "unique" features that make them unsuitable for use as proxy companies. However, not only does the Commission's

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[48] In addition, as Professor Williamson has indicated, HIOS itself is a limited liability company, which is treated for income tax purposes as a partnership. HIO-85, at 12. For this reason alone, the use of MLPs in a proxy group used to set HIOS's return would be appropriate even under Mr. Manganello's theory.

[49] *See Kuparuk Transp. Co.*, 45 FERC ¶ 63,006 (1988), *aff'd and modified in part*, 55 FERC ¶ 61,122 (1991); *EPGT Texas Pipeline, L.P.*, 99 FERC ¶ 61,295 (2002); *Enbridge Pipelines*, 100 FERC ¶ 61,260 (2002) discussed by Professor Williamson at HIO-141, at 3. *See also* Tr. 673-74, 676-80.

reliance on MLPs as proxies in oil pipeline cases conflict with Mr. Manganello's position, the record demonstrates that Mr. Manganello's position is incorrect. Mr. Manganello himself acknowledged during cross examination that the Commission has stated that "partnerships have been around now long enough to have credibility to use them in a proxy group." Tr. 669.

As Professor Williamson also explained in his rebuttal testimony, the clear majority of the features associated with MLPs are neither unique nor relevant. HIO-133, at 20. Although MLPs feature different tax treatment than corporations, Professor Williamson (who Staff counsel correctly observed is an "expert in these matters, there is no doubt about it," Tr. 471) demonstrated that for many investors "there is little or no tax advantage in an MLP." HIO-133, at 22. To the extent tax differences exist between MLPs and corporations, the market accounts for such differences, as illustrated by Professor Williamson in Exhibit HIO-135. This exhibit shows that the cost of equity of the gas pipeline MLPs in HIOS's proposed proxy group is almost identical to, and in fact is slightly *lower than*, the cost of equity of Kinder Morgan Inc., the gas pipeline company that both HIOS and Staff include in their proxy groups. The record, therefore, indicates that MLPs have a cost of equity that is materially the same as gas pipeline companies, and that HIOS's use of gas pipeline MLPs actually benefits ratepayers by causing a downward bias in the cost of equity. Tellingly, although Mr. Manganello filed surrebuttal testimony on the MLP issue, he did not dispute Professor Williamson's testimony on any of these points.[50]

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[50] *See* S-18, at 5. It should be noted that the ALJ in *Trailblazer Pipeline Co.*, 106 FERC ¶ 63,005 (2004), rejected the use of Kinder Morgan Inc. because it was redundant in view of the fact that he accepted the inclusion of Kinder Morgan Energy Partners (and the three other partnerships advocated by Professor Williamson) in the proxy group in that case. *See Trailblazer*,

b. HIOS Has Significant Business Risks That Are Substantially Higher Than the Business Risks Facing the Distribution Companies Included in the Staff and Indicated Shipper Proxy Groups.

The selection of a proxy group yields a range of returns on equity. The Commission selects a return on equity within that range depending on the risks faced by the pipeline. In Opinion No. 414-A, the Commission held that unless a pipeline has atypical risks relative to other gas pipelines, a pipeline will be placed in the "broad middle" of the range and will receive the median return on equity. 84 FERC at 61,426.

The record shows that HIOS has significant business risks, including: (1) a low load factor and a steady decline in volumes in recent years, despite HIOS's vigorous efforts to compete; (2) a throughput mix characterized mostly by interruptible volumes and a dearth of firm transportation contracts (other than HIOS's two FT-2 shippers);[51] (3) substantial barriers to attaching new gas supplies, largely because of a lack of accessible gas reserves within HIOS's geographic market; and (4) a unique degree of regulatory risk due to whether HIOS will qualify for a reasonable management fee now and in the future, which creates uncertainty that inhibits HIOS's ability to make the investments necessary to compete for new gas supplies. HIO-64, at 21-24. As explained *supra*, these risks support HIOS's requested management fee. Despite these significant risks, HIOS has

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slip op. at ¶¶ 88, 97. Even if Kinder Morgan Inc. were also eliminated from HIOS's proposed proxy group in the instant case, it would have no material impact because the median ROE would still be higher than HIOS's proposed ROE of 15.25 percent. *See id.*, slip op. at p. 30; HIO-135, at 1.

51 *Cf. Indicated Shippers v. Sea Robin Pipeline Co.*, 79 FERC ¶ 61,072, at 61,358 (1997) (citing the fact that the pipeline was "unusually dependent on interruptible throughput for fixed cost recovery" as justification for concluding that the pipeline had higher than average business risks and providing the pipeline with an ROE above the median).

taken a conservative approach by requesting a 15.25 percent ROE that is below the median ROE calculated by Professor Williamson. HIO-135, at 1.

Although Mr. Manganello and Ms. Crowe do not agree with the specific aspects of HIOS's risk assessment, they agree that HIOS's risks place it within the "broad middle" of gas pipelines in general, citing Opinion No. 414-A, and thus recommend the median ROE.[52] HIOS would merely note that the recommendations by Staff and Indicated Shippers contain a serious disconnect, as they contend that HIOS has average risk compared to other gas *pipelines*, and yet they rely on proxy groups that predominately contain lower-risk gas *distributors*. Obviously, the Commission's preference for assuming that most *pipelines* have average risk, as reflected in Opinion No. 414-A, was premised on the assumption that the proxy group consists *solely of gas pipelines, not gas distributors*. As discussed *supra*, the record shows that HIOS's risks are much greater than the risks of gas distributors. *See, e.g.*, HIO-133, at 9 (gas distributors' cost of equity is four to five percentage points lower than cost of equity for gas pipelines). Thus, if the Presiding Judge or the Commission were to err and adopt a proxy group that includes gas distributors, HIOS would require an ROE at or even above the high end of the range of returns calculated by either Staff or Indicated Shippers.

3. Capital Structure

In determining the appropriate capital structure to use in its the rate of return analysis, the Commission prefers to use the capital structure of the pipeline itself. 84 FERC at 61,411. If the pipeline has an unsuitable capital structure, the Commission will

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[52] S-11, at 16-17; IND-1, at 13. Mr. Manganello, however, did acknowledge during cross examination that factors that indicate a pipeline has higher risk relative to other pipelines include: declining throughput; a low level of firm contracts; and, uncertainty regarding the proper management fee due to the lack of precedent on the subject. Tr. 665, 667.

next look to the capital structure of the company that does the financing for the pipeline, which is often the parent company.[53]

Neither of these options works in the instant case. HIOS has no debt and thus has an actual capital structure of 100 percent equity. Because of the unusual nature of that capital structure, the Commission has refused to rely on it in its rate of return analysis.[54]

In addition, the capital structure of HIOS's parent company, GulfTerra, cannot be used for two reasons. First, it is undisputed that GulfTerra does not provide any debt financing for HIOS. HIO-133, at 3. Thus, the predicate for using the parent's capital structure is not present in this case. Second, all of GulfTerra's debt is devoted to financing GulfTerra's non-regulated activities. HIO-133, at 3. Accordingly, the use of GulfTerra's capital structure would be inappropriate.

When neither the pipeline's nor the parent company's capital structure is a viable option, the Commission has utilized a hypothetical capital structure.[55] In following that approach here, Professor Williamson initially proposed a capital structure of 60 percent equity and 40 percent debt by reviewing the 2001 Form 2 filed at FERC by each of the 61 gas pipelines that filed a Form 2 by July 20, 2002. HIO-85, at 21. He then determined the median capital structure for the 14 pipelines (of the 61) that had long-term bond ratings and thus could be considered to be "market-tested". HIO-85, at 21; HIO-88. In his rebuttal testimony, he then updated his analysis based on the most recent data, from Form 2s for 2002 filed in 2003. HIO-133, at 4. Professor Williamson's study shows a

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[53] 84 FERC at 61,412; *Enbridge Pipelines*, 100 FERC ¶ 61,260, at ¶ 185.

[54] *See, e.g., Riverside Pipeline Co., L.P.*, 48 FERC ¶ 61,309, at 62,017 (1989); *Tarpon Transmission Co.*, 41 FERC ¶ 61,044, at 61,138 (1987).

median capital structure of 56 percent equity and 44 percent debt.[56] As this evidence demonstrates, HIOS's proposed capital structure is plainly consistent with the capital structure of gas pipelines generally, including those with long-term bond ratings.

In determining a hypothetical capital structure, the Commission has stated that it also "will compare the applicant's capital structure with those approved by the Commission for other pipelines."[57] HIOS's proposed capital structure compares favorably with those that the Commission has approved previously. For example, in *Williams Natural Gas Company*, 86 FERC ¶ 61,232 (1999), the Commission accepted Williams' capital structure of approximately 64 percent equity and 36 percent debt, describing that capital structure as "not anomalous when compared to other equity ratios approved by the Commission." 86 FERC at 61,856; *see also Northwest Pipeline Corp.*, 92 FERC ¶ 61,287, at 62,005 (2000), and *Transcontinental Gas Pipeline Corp.*, 90 FERC ¶ 61,279, at 61,926 (2000) (quoting the same language from *Williams, supra*).[58]

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[55] *See, e.g., Natural Gas Pipeline Co. of Am., Panther Interstate Pipeline Energy, LLC*, 105 FERC ¶ 61,383, at ¶ 16 (2003); *B-R Pipeline Co.*, 105 FERC ¶ 61,025, at ¶¶ 16, 38 (2003); *Kansok Partnership*, 71 FERC ¶ 61,340, at 62,338 (1995).

[56] HIO-133, at 4; HIO-134. *See also* Exhibit HIO-88, showing that the 14 pipelines with long-term bond ratings had a median capital structure of approximately 61 percent equity and 35 percent debt, and that the 61 pipelines as a whole had a median capital structure of approximately 69 percent equity and 31 percent debt. As noted in HIO-88, median percentages do not always add to 100 percent because the median used to determine the equity percentage is not always the same as the median company used to determine the debt percentage.

[57] HIO-141, at 2 (citing *Transcontinental Gas Pipe Line Corp.*, 84 FERC at 61,415).

[58] In contrast, Ms. Crowe's proposal to use the capital structure of HIOS's parent, GulfTerra, should be rejected. HIO-133, at 3. Ms. Crowe has made no showing that GulfTerra's capital structure of 37 percent equity and 63 percent debt is within the acceptable range of Commission-approved capital structures. Moreover, a review of Professor Williamson's Exhibit No. HIO-134 shows that only one of fourteen pipeline companies with a long-term bond rating has an equity ratio below the 37 percent proposed by Ms. Crowe. *Cf. Trailblazer, supra*, slip op. at ¶ 74, where the ALJ found that the capital structure of Trailblazer's parent, Kinder Morgan Energy Partners, of 52 percent equity and 48 percent debt, was within the range of Commission-approved capital structures, and should be used.

Although the Commission also has approved capital structures with less equity than that proposed by HIOS, HIOS's proposed capital structure is firmly within the range of what the Commission has approved for other pipelines.[59] For these reasons, the Presiding Judge should adopt HIOS's proposed capital structure of 56 percent equity and 44 percent debt.

G. Revenue Credits

The final cost of service issue is the proper level of revenue credits. Although HIOS primarily transports natural gas, HIOS also receives a small amount of revenues for the transportation of liquids through its system. HIOS credits those revenues to its gross cost of service, thereby reducing HIOS's overall cost of service for jurisdictional transportation. HIOS, Staff and Indicated Shippers all support the use of revenue credits of $456,666. HIO-104, at 23; S-9, at 22; IND-18, at 1.

II. Billing Determinants and Rate Design

A. The Billing Determinants Used to Establish the Charges for Firm Service Should Be Based on End of Test Period Actual Firm Contract Demand Levels, Adjusted to Reflect the 80 Percent Minimum Bills, Not on Imputed Contract Demand Levels That Include Interruptible Overrun Volumes and Assume a 100 Percent Load Factor.

One of the major issues in this rate case is the appropriate level of billing determinants to be used to establish demand and commodity rates (otherwise referred to

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[59] Like Professor Williamson, Staff witness Manganello also used a hypothetical capital structure. S-11, at 9. However, Mr. Manganello based his proposed capital structure on the companies in his proxy group, which of course included gas distribution companies. S-11, at 9. Because HIOS is a gas pipeline whose risks are materially greater than those of the gas distributors relied on by Mr. Manganello, HIOS's proposed capital structure, relying solely on

as reservation and usage charges, respectively) for firm service on HIOS's system. In basic terms, this issue is about what number should be used in the denominator of the formula used to determine the firm rates in this case.[60]

As explained below, HIOS witness Porter followed Commission precedent in designing firm rates by proposing to use an MDQ of 95,200 Dth/day and firm usage volumes of 34,748,000 Dth/day. In contrast, Staff witness Ekzarkhov unquestionably departed from that precedent by including interruptible overrun volumes in the number used in the denominator, and thereby proposing to use 187,941 Dth/day and 68,598.374 Dth/day of MDQ and usage volumes, respectively. He cited not a single case supporting his approach, and he did not even explain the rationale behind his departure from Commission precedent. One can only infer that his novel approach to HIOS's billing determinants was prompted by a desire to deal with the relatively high volume of interruptible overrun shipped over HIOS. But that hardly justifies jettisoning Commission precedent by including interruptible volumes in the design of firm transportation rates.

Commission precedent on how to derive the billing determinants for firm rates is clear. "It is established Commission policy to base rates on *contract demands* in effect on the last day of the test period." *Iroquois Gas Transmission Sys. L.P.*, 81 FERC ¶ 63,012, at 65,110-11 (1997) (emphasis added) *(citing Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109, at 61,389 (1996)); *see also Northwest Pipeline Corp.*, 87 FERC ¶

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evidence of gas pipeline capital structures, is clearly more appropriate than that proposed by Staff. HIO-133, at 3.

[60] Essentially, rates are determined by dividing the pipeline's costs (the numerator in the equation) by the pipeline's billing determinants (the denominator). Naturally, the process becomes somewhat more complex as one designs different rates for different services, but that is the basic framework.

61,266, at 62,079 & n.353 (1999). The Commission uses *actual* end-of-test period contract demand ("CD") levels -- also known as MDQs -- to design firm rates because such billing determinants "reflect the latest best evidence of what will exist for the pipeline once the rates go into effect."[61] In addition, the Commission's policy is to make a downward adjustment to a pipeline's actual CDs to reflect any discounts that the pipeline has provided to its firm shippers, absent a showing that the discounts were not justified.[62]

HIOS's proposal, as described in the testimony of Mr. Porter, follows these well-established rate design principles to the letter. As a starting point for designing firm rates, Mr. Porter utilized HIOS's actual end-of-test period Rate Schedule FT-2 CDs, or MDQs, of 119,000 Dth/day.[63] He then adjusted the actual MDQs to reflect the fact that under HIOS's FT-2 Rate Schedule, shippers pay for service on a volumetric basis, provided that their throughput during the production month and the preceding two months is at least 80 percent of their contractual MDQ. HIO-91, at 24; HIO-90, at 4; HIOS Tariff, Section 4.1. Both Mr. Porter and Mr. Ekzarkhov agree that this provision

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61 *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,084 (2000). Although the Commission sometimes uses a 12-month average of the test period MDQs (or an average based on some time period other than 12 months) when that produces a more representative projection than end-of-test period MDQs, *see Williston Basin Interstate Pipeline Co.*, 87 FERC ¶ 61,264, at 62,013 (1999), the Commission typically relies on end-of-test period MDQs. In either case, the Commission relies on *actual* MDQs, not *imputed* MDQs.

62 *See, e.g., Indicated Shippers v. Sea Robin Pipeline Co.*, 81 FERC ¶ 61,146, at 61,656-57 (1997); *Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109 at 61,404 (1996); *Southern Natural Gas Co.*, 65 FERC ¶ 61,347, at 62,829-30 (1993), *order on reh'g*, 67 FERC ¶ 61,155, at 61,456-57 (1994); *see also Koch Gateway Pipeline Co.*, 84 FERC ¶ 61,143, at 61,779-80 (1998) (competitive "discounts benefit all customers by allowing a pipeline to maximize throughout and thus spread fixed cost recovery over more units of services").

63 *See* HIO-91, at 22; HIO-140, at 5. Although HIOS currently offers firm service pursuant to two FERC rate schedules, no shipper currently subscribes to firm service under Rate Schedule FT. S-9, at 6.

can be viewed as a minimum throughput level obligation. S-9; at 11; HIO-91, at 26. As a result of this minimum bill, FT-2 shippers are obligated to pay for only 80 percent of HIOS's fixed costs, and prudent rate design dictates that HIOS's FT-2 rates be based on this minimum level of cost responsibility. *Id.*; HIO-140, at 5-6.

Mr. Porter's proposed rate design adjustment to take this 80 percent minimum bill into account is supported by the record. The actual historical load factor of HIOS's FT-2 shippers indicates that they have been and will continue to be billed on a volumetric basis reflecting the 80 percent minimum bill.[64] Thus, in order to design rates that reflect what the FT-2 shippers are obligated to pay, HIOS utilized 80 percent of the actual MDQs, or 95,000 Dth/day, to design firm reservation rates. HIO-91, at 26. In addition to matching cost allocation to cost responsibility, this adjustment is analogous to a discount adjustment, *see* HIO-140, at 5-6, and thus is supported by the Commission's policy of accounting for discounts in rate design. *See, e.g., Indicated Shippers v. Sea Robin, supra* n.62.

In stark contrast to HIOS's proposed billing determinants, the proposal advanced by Staff Witness Ekzarkhov conflicts directly with the Commission's policy of using *actual* end-of-test period contract demand levels as adjusted for discounts or similar mechanisms (such as the 80 percent minimum bill present in the instant case).[65] Instead of using actual contract demand levels to design firm rates, Mr. Ekzarkhov relied on an *imputed* or hypothetical contract demand level. Mr. Ekzarkhov achieved this imputed

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[64] The average load factor for FT-2 services has been 83 percent. *See* HIO-140, at 6; HIO-98.

[65] *See* HIO-91, at 20. The same criticism applies equally to Ms. Crowe's proposed billing determinants. *See* IND-1, at 15.

MDQ by using a 12-month average of all throughput by FT-2 shippers, including not only throughput within the shippers' firm MDQs, but also including *interruptible overrun* volumes that exceeded the shippers' firm MDQs. *See* S-10, at 7; S-17, at 7; *see also* IND-1, at 15. Staff thus proposes to design rates based on imputed FT-2 MDQs of 187,941 Dth/day. HIO-91, at 21.

As explained by Mr. Porter, unlike interruptible services, firm FT-2 shippers have a specified MDQ stated in their contracts and there is no need to resort to throughput levels to impute an MDQ. The MDQ in firm contracts represents the level of service that a shipper can demand from the pipeline and the amount of capacity that a pipeline is obligated to provide to the shipper. HIO-91 at 22. The fact that FT-2 shippers pay a volumetric rate if they qualify for such a rate under the FT-2 Rate Schedule does not change HIOS's contractual obligation to stand ready to serve shippers' contractual entitlements, as reflected in their MDQs. HIO-91, at 24.

Furthermore, Mr. Ekzarkhov's decision to include overrun volumes in the calculation of firm rates conflicts with Commission precedent regarding the appropriate treatment of overrun volumes in rate design. For example, in another Section 4 rate case, the Commission squarely held: "Authorized overrun is an interruptible service that is associated with a firm service contract. The service rendered is indistinguishable from any other interruptible service. As such, the Commission traditionally considers authorized overrun and interruptible services as identical." *CNG Transmission Corp.*, 81 FERC ¶ 61,346, at 62,592 (1997). Similarly, in *Northern Natural Gas Co.*, 101 FERC ¶ 61,203 (2002), the Commission stated that "overrun service is a form of interruptible service." *Id.* at ¶ 198; *see also National Fuel Gas Supply Corp.*, 63 FERC ¶ 61,291, at

63,024 (1993) (same); *Tennessee Gas Pipeline Co.*, 64 FERC ¶ 61,020, at 61,228 (1993) (same). For that reason, the Commission requires pipelines to allocate costs to overrun service separately from firm service.[66]

As these precedents demonstrate, firm rates must be designed based on firm contract obligations, not on interruptible overrun volumes. Commission policy does *not* factor overrun volumes into the design of rates for firm services. Yet Mr. Ekzarkhov's approach does exactly that, by relying on interruptible overrun volumes for the purpose of calculating an imputed MDQ level for HIOS's FT-2 shippers.

Further illustrating that Staff erred by including overrun volumes in its firm billing determinants, Mr. Ekzarkhov acknowledged during cross examination that overrun volumes are considered to be the same as IT volumes under the curtailment provisions of HIOS's Commission-approved tariff. Tr. 715. Thus, HIOS's tariff provides for overrun and IT volumes to be curtailed before FT-2 volumes in the event shipper nominations exceed HIOS's available capacity. Tr. 715 (discussing Second Revised Sheet No. 114 of HIOS's tariff). Given the undisputed fact that overrun volumes are treated essentially the same as IT volumes under HIOS's tariff, Mr. Ekzarkhov's proposal to treat overrun volumes as part of the FT-2 shippers' firm MDQs for rate design purposes is simply incorrect. Indeed, as the tariff demonstrates, HIOS's obligation to provide *firm* service to its FT-2 shippers is defined solely by the FT-2 shippers' MDQs; HIOS has no firm obligation to provide overrun service. HIO-91, at

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[66] *See, e.g., Great Lakes Gas Transmission L.P.*, 64 FERC ¶ 61,017, at 61,163 (1993) ("In addition, we note that Great Lakes has not allocated any cost to its interruptible or overrun transportation services. Section 284.7(d)(2) [now 284.10(c)(3)] of our regulations requires that rates for open-access services be designed on projected units of service. In keeping with our decisions in other restructuring cases, we will require Great Lakes to revise its filing to make a

27-28. Inexplicably, Staff's proposal imputes significantly more units (and thus allocates significantly more costs) to FT-2 service than the FT-2 shippers have a right to demand on a firm basis. Accordingly, Staff's erroneous treatment of overrun volumes renders its rate design proposal unsalvageable.

Not only does Mr. Ekzarkhov improperly use throughput levels, including IT volumes, to design firm rates, Mr. Ekzarkhov's approach also conflicts with the Commission's goal of "reflecting the latest best evidence" in its rate calculation. *See Trunkline*, 90 FERC at 61,084. As explained by Mr. Porter, by imputing MDQs on the basis of all FT-2 throughput during the last twelve months of the base and test periods, Mr. Ekzarkhov's proposal allocates costs on the basis of *average* throughput during that period. This ignores the uncontroverted decline in MDQ from 179,800 Dth/day to 119,000 Dth/day (S-10, at 3) that has occurred during the test period. The end-of-test period MDQs represent HIOS's obligation going forward based on the clear trend of declining MDQs, not the throughput levels that were achieved during a past period. HIO-91, at 23.

In addition to ignoring Commission precedent on these elements of rate design, Staff Witness Ekzarkhov's approach also conflicts with his own prior testimony in numerous Commission rate cases. *See* Tr. 716-19. For example, in *CNG Transmission Corp.*, Docket No. RP97-406, Mr. Ekzarkhov followed the Commission's established policy (relied on here by Mr. Porter only), stating: "I believe actual end of test period transportation contract demand ... should be used to establish representative billing determinants" in connection with the firm rates at issue in that particular case. HIO-147,

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reasonable projection of overrun and Rate Schedule IT volumes and associated revenue."); *aff'd in relevant part*, 65 FERC ¶ 61,004, at 61,020 (1993).

at 2. Similarly, Mr. Ekzarkhov acknowledged during cross examination that in *Eastern Shore Natural Gas Co.*, Docket No. RP97-32, he proposed to design firm rates based on *actual* MDQs (as HIOS has proposed here). Similarly, in *Michigan Gas Storage Co.*, Docket No. RP96-290, Mr. Ekzarkhov stated his belief "that firm demand rates and ultimately the firm customer's cost responsibility should be based on each customer's contracted MDQ level which should represent Michigan Gas' service obligation." HIO-149, at 6; *see also* Tr. 719 (acknowledging same); *see also* HIO-148, at 2 ("For rate design purposes, Mr. Ekzarkhov recommends using the company's contract demand . . . levels as of the end of the test period").[67]

Mr. Ekzarkhov also asserts that Mr. Porter ignored overrun volumes shipped by HIOS's FT-2 shippers, resulting in an overcollection by HIOS of its cost of service. *See* S-17, at 4, 8. Mr. Porter did not, however, ignore overrun volumes. Instead, in accordance with the Commission's policy that overrun is an interruptible service and should be treated separately from firm volumes, *see, e.g.*, *Great Lakes*, 64 FERC at 61,163, Mr. Porter based his recommendation on a normal year of throughput for all interruptible services, *including* volumes shipped by HIOS's FT-2 shippers as overrun and volumes shipped under HIOS's IT rate schedule. In fact, Mr. Porter stated that he accepted Mr. Ekzarkhov's use of test period interruptible throughput of 195,327,103 Dth as representative of *all* interruptible throughput. *See* HIO-91, at 21; HIO-140, at 8. As demonstrated in HIO-72, IT service has steadily declined by an average of 8.4 percent per

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[67] HIO-91, at 23. It also should be noted that despite arguing in his prepared surrebuttal testimony that "there is no basis to designate any level of throughput as 'overrun'" because "we don't know what MDQ level was used to establish rates in the last settlement," S-17, at 4, Staff Witness Ekzarkhov acknowledged on cross-examination that this should not have prevented him from determining what amount of throughput is overrun service. Tr. 735.

year.[68] Reducing HIOS's 2002 IT by 8.4 percent yields a normal year IT estimate of 185.4 MMDth. When this IT estimate is added to the 11.1 MMDth of firm service overrun volumes that HIOS actually experienced in 2002, the total estimated throughput for all interruptible services is 196.5 MMDth, *see* HIO-140, at 8, consistent with the amount of interruptible service volumes that Mr. Porter has advocated for rate design purposes. *See* HIOS-91, at 21. Accordingly, contrary to what Mr. Ekzarkhov asserts, Mr. Porter's rate design proposal does not ignore overrun volumes and therefore does not produce an overrecovery of HIOS's cost of service.

B. HIOS's Proposed Rate Design Encourages the Dedication of Firm Long-Term Gas Supplies and Efficient Contracting While Remedying a Significant Pricing Inequity Between Firm and Interruptible Service.

HIOS, through the testimony of Mr. Porter, proposes two rate design changes in this case. First, Mr. Porter supports the use of a 5 percent service differential for Rate Schedule FT-2, pricing the FT-2 reservation charge at 95 percent of the Rate Schedule FT reservation charge. Second, Mr. Porter supports the use of a 3.5 percent service differential for interruptible services, pricing the IT rate at 103.5 percent of the Rate Schedule FT rate.

At the core of HIOS's rate design proposals is an attempt to attract additional firm throughput through the dedication of new reserves under Rate Schedule FT-2 and to encourage interruptible shippers to contract more efficiently by entering into firm contracts. With regard to the proposal to establish a service differential for Rate Schedule FT-2, HIOS has attempted to give recognition to the stable, long-term revenue

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[68] Mr. Ekzarkhov acknowledged at the hearing that interruptible volumes have been declining. Tr. 726.

contribution that FT-2 shippers make to HIOS's fixed costs, and the absence of any such commitment by interruptible shippers. HIO-64, at 27; HIO-91, at 32. FT-2 shippers have dedicated specific gas reserves to the HIOS system. HIO-64, at 26. However, as explained by Mr. Porter:

> Not one single interruptible shipper on the system is making that type of commitment to the system. Not one single interruptible shipper can demonstrate that their service produces the significant rate and revenue stability that FT-2 shippers provide. I believe that these benefits should be recognized in the rate design by creating an incentive for future FT-2 shippers to connect to HIOS.

HIO-91, at 32.

HIOS's interruptible shippers receive substantial benefits from the services provided by HIOS under Rate Schedule FT-2. FT-2 shippers provide a stream of revenues that would not otherwise exist. As a result, there are more units to contribute to fixed cost recovery. This means that, because of the FT-2 service provided by HIOS, all shippers pay *lower* rates and enjoy greater rate stability than they otherwise would. HIO-64, at 28. Specifically, Mr. Porter demonstrated that as a result of the incremental revenues provided by FT-2 service, all shippers pay a rate that is 17 percent, or 3.54 cents, lower than they would otherwise pay. *Id.* at 29. Moreover, because FT-2 service provides a stable stream of revenue, all shippers have much greater rate certainty. *Id.* at 28; HIO-91, at 32.

Unfortunately, HIOS's current rate structure does not reflect the benefits of FT-2 service. In order to remedy this problem and enhance HIOS's ability to attract additional FT-2 throughput to the system, HIOS submits that the maximum rate for service under Rate Schedule FT-2 should be priced at 95 percent of the FT reservation charge.

HIOS also proposes to establish a service differential for service under Rate Schedule IT to encourage efficient contracting and recognize the effective pricing disparity that currently exists between firm and interruptible services. Because HIOS has significant excess capacity (only a 31 percent load factor as of the end of the test period, HIO-64, at 30), shippers have little incentive to pay for firm service. Shippers correctly assume that an interruption of service is unlikely, and thus contract for interruptible service because they can effectively receive uninterrupted "firm" service while paying the interruptible rate. This puts firm shippers at a disadvantage, because although HIOS's IT rate is currently equal to HIOS's 100 percent load factor firm rate, interruptible shippers pay a much lower effective unit rate than firm shippers. *Cf. Texas Eastern Transmission Corp.*, 37 FERC ¶ 61,260, at 61,703 (1986) (recognizing that if a firm customer does not fully use its capacity, its per unit costs will exceed those of an IT customer because the firm customer will pay the reservation charge regardless of whether it uses the capacity). That is because it is virtually impossible for firm shippers to use all of their capacity 100 percent of the time,[69] and yet firm shippers must pay the firm rate even when they cannot use all of their capacity. In contrast, interruptible shippers only pay when they use the system. Firm shippers thus effectively subsidize interruptible shippers' use of HIOS's system, providing interruptible shippers with a "free ride."

HIOS's rate design proposal constitutes a conservative attempt to rectify this pricing inequity. As explained by Mr. Porter, if all of its services were interruptible, HIOS could justify a higher return on equity, recognizing the increased revenue risk of a

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[69] HIO-64, at 32. For example, firm shippers cannot use all of their capacity during periods of lower demand, force majeure, or when maintenance is being performed on their production systems.

fully interruptible system. *See* HIO-64, at 31; *Indicated Shippers v. Sea Robin*, 79 FERC at 61,358 (pipeline's unusual dependence on IT supported a higher ROE due to higher than average business risk). Based on the rate impact of this increase in return on equity, Mr. Porter has recommended a 3.5 percent service differential for interruptible services. See HIO-74. This modest adjustment would price the interruptible rate at 103.5 percent of the FT rate. The 3.5 percent increase above the 100 percent load factor FT rate would ameliorate the pricing inequity between firm and interruptible services, and is based on the additional risk experienced by HIOS in transporting unstable IT throughput in comparison with more stable firm throughput.[70]

Staff Witness Ekzarkhov opposes HIOS's rate design proposals. Initially, he points out that the Commission's preference has been to design IT rates based on the 100 percent load factor equivalent of a pipeline's firm rate. S-9, at 20. As a general matter, HIOS does not dispute that assertion, although HIOS's proposed service differential is much smaller than was considered in the cases cited by Mr. Ekzarkhov.[71] More importantly, it should be recognized that since the issuance of Order No. 637, the Commission has not considered in a pipeline rate case a proposal such as HIOS's to

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[70] HIO-64, at 31. It also should be noted that HIOS's proposed rate design would price overrun service for firm shippers at the same load factor as interruptible service. This reflects the fact that overrun service is interruptible in nature. As stated by Mr. Porter in unrebutted testimony, HIOS's proposal "would ensure that [FT] shippers did not under-contract for firm services in order to transport quantities of overrun at a rate lower than the IT rate." HIO-64, at 32. *Cf. National Fuel Gas Supply Corp.*, 63 FERC ¶ 61,291, at 63,024 (1993) (approving tariff modifications which would ensure certain firm shippers do not rely on overrun service for firm capacity needs).

[71] *See, e.g., Southern Natural Gas Co.*, 99 FERC ¶ 61,345 (2002) (proposed 75 percent load factor rate); *Williams Natural Gas Co.*, 77 FERC ¶ 61,277 (1996) (proposed 125 percent load factor rate).

create a rate differential between firm and interruptible service.[72] And Order No. 637 suggests that the Commission may reconsider its preference for 100 percent load factor IT rates.

In Order No. 637, the Commission endorsed the concept of term-differentiated rates. Order No. 637, FERC Stats. & Regs. [Regulations Preambles 1996-2000] ¶ 31,091, at 31,293 (2000). The Commission explained the concept as follows:

> Term-differentiated rates would match price more closely with risk-adjusted value, and could result in *a rate structure that prices capacity held for a longer term at a lower rate than capacity held for a shorter term.*

Order No. 637, at 61,293 (emphasis added). Thus, in language echoed by Mr. Porter's testimony, the Commission stated that encouraging lower rates for long-term service, such as FT-2 service, would help to reduce the bias in favor of short-term contracts, such as IT service, and would encourage shippers to enter into long-term firm contracts. *Id.*

The Commission's acceptance of term-differentiated rates in Order No. 637 provides additional support for HIOS's proposed rate differentials. In keeping with Order No. 637, HIOS has proposed to reduce the extreme bias on its system in favor of short-term (e.g., interruptible) contracts, thereby encouraging shippers to enter into firm contracts. *Cf.* Order No. 637, at 31,292-93. Tellingly, Mr. Ekzarkhov does not address the Commission's new policy regarding term-differentiated rates.

Mr. Ekzarkhov's specific criticisms of HIOS's rate design proposals also lack merit. For example, in an attempt to counter Mr. Porter's contention that FT-2 volumes

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[72] In the post-Order No. 637 certificate proceeding at *Southern Natural Gas Co.*, 99 FERC ¶ 61,345, at 62,479 (2002), the Commission rejected a new pipeline's proposed 75 percent load factor IT rate. But in that case the Commission did not have the benefit of a fully developed record, including prepared testimony and an evidentiary hearing, in contrast with the instant case.

benefit interruptible shippers by allowing them to pay lower rates than they would but for the FT-2 service, Mr. Ekzarkhov claimed HIOS provided no proof that the two current FT-2 shippers (Exxon and BP) would not have used the HIOS system as IT customers but for the FT-2 tariff. S-9, at 18. Mr. Porter's rebuttal testimony laid this criticism to rest. Mr. Porter was personally involved in the negotiations with Exxon and BP, who adamantly insisted that their reserves be contracted under a firm service like what is now reflected in the FT-2 rate schedule. HIO-91, at 33. Exxon and BP required absolute assurance of firm, not interruptible, transportation of their gas. *Id.* Thus, contrary to what Mr. Ekzarkhov alleges, the record indicates that Exxon and BP would not have relied on IT had HIOS not offered FT-2 service. Their FT-2 volumes thus constitute incremental throughput that enable HIOS to spread its fixed costs over a greater number of billing determinants, thereby lowering the rates paid by IT shippers.

In addition, Mr. Ekzarkhov briefly disputes the notion that interruptible shippers enjoy a "free ride," on the theory that FT-2 shippers, like interruptible shippers, pay a volumetric rate. S-9, at 19. However, he does not dispute the fact that if a firm shipper transports volumes at a level less than its fixed cost obligation, its unit cost of transportation increases because it must pay a reservation charge even though it is not fully utilizing its capacity. HIO-91, at 33-34. In contrast, interruptible shippers enjoy a "free ride" because they have no obligation to pay if they do not actually transport volumes. HIO-91, at 34. HIOS's proposal would seek to end this cross-subsidization, which conflicts with the Commission's goal of promoting economically efficient

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Moreover, HIOS's proposed service differential is much smaller than that proposed in *Southern Natural.*

transportation rates.[73]

Finally, in a related argument Mr. Ekzarkhov contends that, as a result of the fact that HIOS has excess capacity, "there is effectively no difference between the reliability of" FT-2 and interruptible services. S-9, at 19. But Mr. Ekzarkhov's point actually supports HIOS's rate design proposals. Because HIOS is less than half full, shippers will not contract for FT service -- and in fact did not contract for any Rate Schedule FT service during the test period (S-9, at 6) -- because they will end up paying a higher effective unit rate for transportation than if they took interruptible service instead. HIO-91, at 34. Indeed, the only shippers who contract for firm service on HIOS's system are shippers with the unique requirements of HIOS's FT-2 shippers. Thus, the fact that no difference currently exists between the reliability of firm and interruptible service actually supports HIOS's proposal to rectify the pricing inequity that currently discourages shippers from signing firm contracts.

III. Fuel and Lost and Unaccounted for Gas

As discussed below, in response to concerns raised by its shippers in their direct testimony, including shipper proposals to change the way HIOS recovers for the cost of fuel and LAUF gas, HIOS has agreed in its rebuttal testimony to change the manner in which it recovers the cost of fuel/LAUF under its Commission-approved tariff. Because HIOS's proposal addresses all of the concerns raised by its shippers, and is superior to

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[73] *See, e.g., Interstate Natural Gas Pipeline Rate Design*, 47 FERC ¶ 61,295, at 62,052 (1989) (stating that the Commission's regulations "provide guidance in the development of rates that promote economic efficiency; that is, the efficient functioning of natural gas markets. Transportation rates (and policies) which inhibit efficient operation of markets are themselves inefficient and cannot result in an equitable assignment of the pipeline's costs or revenue responsibility.").

any of their proposed alternatives, the Presiding Judge should recommend that the Commission approve HIOS's proposal as a just and reasonable resolution of this issue. HIOS also explains herein why the foregoing issue arises under Section 5 of the NGA, which provides for a prospective change only. Finally, HIOS will explain why the question of refunds in connection with fuel/LAUF is not properly part of this case.

A. Background

In the filing that HIOS made to initiate this rate case, HIOS did not propose to increase or otherwise change the manner in which it charges for the cost of fuel and LAUF. HIOS's existing tariff requires HIOS to compute its fuel/LAUF charge each month based on actual fuel used and LAUF volume during the prior three months. HIO-91, at 37 (discussing Section 1.6 of the General Terms and Conditions of HIOS's tariff). The existing fuel/LAUF mechanism has been part of HIOS's tariff since the time HIOS restructured its services pursuant to the open access requirements of Order No. 636 in the early 1990s. HIO-91, at 39.

The issue of fuel/LAUF initially arose in this case when Exxon and Indicated Shippers proposed to change HIOS's existing fuel/LAUF mechanism in their direct testimony. Exxon proposed a fixed rate of 1 percent for fuel/LAUF; in the alternative, Exxon proposed an annual fuel/LAUF "tracker" mechanism. EM-1, at 10-11. Indicated Shippers proposed an annual or semi-annual fuel/LAUF tracker, and also asserted that HIOS should bear a higher burden of proof for any future LAUF charge above 0.5 percent. IND-1, at 17. Both Exxon and Indicated Shippers complained that HIOS recently increased its fuel/LAUF charge above the 1 percent level that HIOS had historically charged. EM-18, at 4; IND-1, at 17. In addition, Exxon asked the Commission to require refunds for any charges not authorized by HIOS's tariff. EM-18,

at 5. Exxon, however, acknowledged that the "parties challenging the current fuel provision bear the burden of showing that the provision is unjust and unreasonable, and that an alternative is just and reasonable." EM-18, at 3.

In response to its shippers' concerns about recent increases in its fuel/LAUF charge, and as discussed more fully below, HIOS provided data to its shippers demonstrating that it has *undercollected* its fuel/LAUF, despite the recent increases. *See* IND-35. In addition, while not conceding that its current fuel/LAUF mechanism is unjust and unreasonable, HIOS agreed on rebuttal to revise its existing fuel/LAUF mechanism. Specifically, and in accordance with the Commission's standard ratemaking methodology, HIOS proposes to change its existing tariff to require an annual redetermination of its fuel/LAUF rate, based on the average of actual fuel and LAUF for the prior three-year "test period."[74] HIOS would file the redetermined rate with the Commission, allowing all shippers to review and comment on the filing. HIO-91, at 40.

B. HIOS's Fuel/LAUF Proposal Is Just and Reasonable and Superior to the Alternatives.

HIOS's redetermination proposal has several advantages over the alternatives proposed by Exxon and Indicated Shippers. First, as a general rule the Commission disfavors tracker mechanisms, such as the proposals made by Exxon and Indicated Shippers. *See, e.g., Koch Gateway Pipeline Co.*, 85 FERC ¶ 61,426, at 62,611 (1998). For example, in *Koch, supra*, the Commission rejected Indicated Shippers' proposed fuel tracker as follows:

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[74] HIO-91, at 39-40. The new fuel/LAUF rate would be determined by dividing the three-year average fuel and LAUF by the three-year average billed volumes on the HIOS system. *Id.* at 40.

> Indicated Shippers supports the establishment of a fuel tracker which, it claims, would match actual fuel costs with the fuel rates charged to shippers. But there is no requirement that Koch have a fuel tracker. In 1995, the Commission adopted a regulation permitting pipelines to adjust fuel use percentages in limited rate filings. [citing 18 C.F.R. § 154.403] But these filings are not trackers because they do not include a true-up mechanism. [citation omitted] Generally, the Commission does not favor trackers. [citing *Indicated Shippers v. Sea Robin Pipeline Co.*, 79 FERC ¶ 61,072 (1997).] The fact that the settlement does not have a fuel tracker is thus consistent with Commission policy and regulations.

In contrast to a tracker, which provides for a true-up of over- or under-collections that occurred in the preceding year, the Commission's typical ratemaking method calculates rates based on costs from a prior test period, with no true-up mechanism. HIOS employed this standard ratemaking method in designing its proposed fuel/LAUF mechanism, in accordance with the Commission's general policy against trackers.

Second, HIOS's proposal to base the fuel/LAUF charge on a three-year average will significantly reduce the volatility of the charge. Thus, if HIOS experiences an anomalous event in one year, using a three-year average to redetermine HIOS's fuel/LAUF charge will tend to minimize the impact of such anomalies.[75] In contrast, using a shorter period -- such as the one-year period proposed by Exxon -- would increase the exposure of HIOS and its shippers to short-term spikes and decreases in fuel/LAUF.

Third, HIOS's proposal has the benefit of transparency. HIO-91, at 40. The proposal is simple for all interested parties to understand. To provide additional transparency in the process, HIOS also proposes to state its redetermined fuel/LAUF charge in its tariff, something not currently required. *Id.* at 40.

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[75] HIO-91, at 40. *See ANR Pipeline Co.*, 78 FERC ¶ 61,290, at ¶ 62,267 (1997) (approving three-year fuel redetermination mechanism due to, *inter alia*, the "smoothing effect" of using a three-year period instead of a shorter period).

Fourth, HIOS's proposed fuel/LAUF mechanism will be simple to administer. Neither HIOS nor its shippers (or the Commission) would benefit from the expense, delay and uncertainty caused by a mechanism which results in protracted proceedings before the Commission. HIOS's redetermination mechanism will be a straightforward matter of updating HIOS's fuel/LAUF charge on an annual basis by using the average fuel/LAUF for the prior three-year period. In contrast, the trackers proposed by Exxon and Indicated Shippers would require HIOS to track any over- or under-recoveries each month of the year and then recover them the following year (or on a semi-annual basis, as suggested by Indicated Shippers) by adjusting the next year's rate accordingly. *Id.* at 42. By its very nature, a redetermination mechanism is simpler and therefore less prone to generate litigation than a tracker mechanism.

Indicated Shippers' witness Crowe argues that pipelines without fuel trackers often overrecover their fuel costs. IND-14, at 2. But Ms. Crowe's criticism does not withstand analysis. HIOS's proposal is no more likely to cause HIOS to overrecover than underrecover its fuel costs in any given year; whether any overrecovery or underrecovery occurs in a particular year will depend on whether the actual fuel for the year at issue is higher or lower than the average of the prior three years. In any event, because by definition a redetermination mechanism provides for a fuel/LAUF charge based on the pipeline's *average* fuel and LAUF, over time HIOS's proposal will not result in either a net underrecovery or overrecovery.

Evidently recognizing the Commission's general policy against trackers, both Exxon and Indicated Shippers also advocate alternative "fixed rate" proposals. These proposals, however, also have major defects. Exxon proposes to require HIOS to amend

its tariff to provide for a flat 1 percent rate for fuel and LAUF. EM-18, at 6. But Exxon provides no support for why the rate should be set at a 1 percent level, as opposed to a higher level of, for example, 2 or even 3 percent. HIO-91, at 41. Thus, Exxon has failed to carry its burden of proving that its proposal is just and reasonable. In fact, Exxon has recognized that recently HIOS's fuel/LAUF rate has substantially exceeded 1 percent, and has acknowledged that data provided by HIOS in discovery suggests that HIOS has been undercollecting its fuel/LAUF quantities, even with the higher fuel/LAUF rate in effect. EM-1, at 18. Indeed, the record evidence shows that HIOS undercollected its fuel at least through the end of the test period. IND-35; Tr. 858-59.

HIOS also believes that it is neither necessary or fair for either HIOS or its shippers to bear the risk that HIOS's actual fuel/LAUF will be significantly more or less than a fixed rate, whether it be 1 percent as proposed by Exxon or a different level. HIO-91, at 41-42. Under HIOS's redetermination mechanism, neither HIOS nor its shippers would have to bear this risk.[76]

In a variation on Exxon's unsupported fixed rate proposal, Ms. Crowe proposes that any LAUF factor of greater than 0.5 percent be subject to a higher burden of proof. IND-1, at 17. In support of her proposal, she claims that a LAUF factor of 0.5 percent is a representative level of LAUF on several other pipeline systems. IND-1, at 17. She makes no attempt, however, to show that those other pipelines are similar to HIOS. In addition, just as the Commission's regulations require HIOS to base its transportation rates on its own operating expenses (not on the operating expenses of other pipelines),

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[76] Exxon also asserts that a fixed rate would give HIOS an incentive to keep its actual fuel/LAUF as low as possible. But HIOS already has that incentive, as an unreasonably high charge would discourage shippers from using HIOS's system, resulting in lower transportation revenues for HIOS. *See* Tr. 862.

see supra Section I.A.3.a., the Commission's regulations also require HIOS to base its fuel/LAUF charge on the fuel/LAUF actually experienced on HIOS's system (not on the fuel/LAUF experienced on other pipelines). *See* 18 C.F.R. § 154.403 (2003); *El Paso Natural Gas Co.*, 84 FERC ¶ 63,004, at 65,021 (1998) (Levant, J.) ("Edison has not made a case for rejecting El Paso's fuel charge simply by comparing it with a general industry average."); *see also Mojave Pipeline Co.*, 79 FERC at 62,485 ("To determine one pipeline's rates based on other pipelines' costs would be contrary to the Commission's traditional method of determining cost-based rates for pipelines, where each pipeline's rates are determined based on its own costs."). As for her proposal to change HIOS's burden of proof, Ms. Crowe retreated from this position in a data response provided to HIOS in discovery. HIOS-91, at 41.

In sum, HIOS's proposed three-year redetermination mechanism for fuel/LAUF is just and reasonable because it follows the Commission's standard "test period" ratemaking concept and will produce less volatility than the current charge or the proposals suggested by Exxon or Indicated Shippers. It also will improve transparency and will be simple to administer. The proposed trackers by Exxon and Indicated Shippers are not just and reasonable because Exxon and Indicated Shippers have failed to carry their burden of demonstrating why the Commission should depart from its general policy against trackers. Moreover, the fixed rate proposals by Exxon and Indicated Shippers would cause HIOS to continue to undercollect its fuel/LAUF, and thus have not been demonstrated to be just and reasonable. For these reasons, the Presiding Judge should adopt HIOS's proposed fuel/LAUF mechanism.

C. Section 5 Applies to the Only Fuel/LAUF Issue in This Case.

It is black letter law that if a shipper proposes to change a pipeline's Commission-approved tariff, it must do so under Section 5 of the NGA. *See, e.g., Colorado Interstate Gas Co.*, 77 FERC ¶ 61,347, at 62,518 (1996) (citing *Western Res., Inc. v. FERC*, 9 F.3d 1568, 1580 (D.C. Cir. 1993)). In addition, it is equally well established that "[t]he Commission may only make changes to a pipeline's tariff under Section 5 prospectively." *Texas Eastern Transmission, L.P.*, 103 FERC ¶ 61,135, at ¶ 10 (2003). The Commission has no authority in this case to award retroactive relief, such as refunds, under Section 5. *Western Res., Inc. v. FERC*, 9 F.3d 1568, 1581 (D.C. Cir. 1993) ("In a § 5 proceeding, of course, the Commission is without authority to order refunds.") (citing *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 578 (1981))).

Here, it is undisputed that HIOS's shippers, not HIOS, initially proposed to change the manner in which HIOS's existing Commission-approved tariff addresses fuel/LAUF. Therefore, as Staff counsel agreed at the hearing (Tr. 825), the Commission may only change HIOS's tariff regarding the treatment of fuel/LAUF on a prospective basis. As Exxon has acknowledged, it bears the burden of proof under Section 5 of the NGA on the fuel/LAUF issue. EM-18, at 3; *Koch Gateway Pipeline Co.*, 85 FERC ¶ 61,426, at 62,610 (1998) (holding that parties seeking to change a pipeline's fuel rate bear the burden under NGA Section 5 of proving that the existing fuel rate is unjust and unreasonable). In accordance with the precedent discussed *supra*, the important corollary to Exxon's concession that it has the burden of proof is that any relief can only be prospective.

In addition to raising the issue of whether HIOS's tariff should be changed, Exxon and Indicated Shippers have also raised the separate issue of whether the Commission

should initiate procedures to determine whether HIOS overcollected fuel and LAUF since October 2002, and have suggested that if HIOS is found to have collected more than what its tariff allows, then it should be required to provide appropriate refunds to its shippers. EM-18, at 5. HIOS respectfully submits that the Presiding Judge should reject this argument, for two reasons.

First, the issue of whether HIOS overcollected its fuel/LAUF by charging more than its tariff authorized is not properly raised in this proceeding. It was not an issue raised by the rate filing HIOS made to initiate this case. Nor was it an issue that the Commission set for hearing in its hearing order. *See* 102 FERC at ¶ 14. Exxon appears to recognize this as well, as it asks the Commission to "initiate appropriate procedures" to address this issue. EM-18, at 5. However, this rate case is about whether HIOS's proposed rates, and the parties' proposed changes to HIOS's existing fuel/LAUF charge, are just and reasonable. If Exxon truly believes that HIOS charged more for fuel/LAUF than the rate set forth in its tariff, then Exxon may file a complaint with the Commission. However, the Commission should reject Exxon's effort to short-circuit the Commission's complaint process through a vague request that the Commission "initiate appropriate procedures" in the middle of a rate case.

Second, even assuming *arguendo* that Exxon and Indicated Shippers could properly raise their overcollection issue in this case, the record evidence fails to support it. Neither Indicated Shippers nor Exxon submitted any prepared testimony to support a claim for refunds. On the hearing's final day, Indicated Shippers made a belated attempt through cross examination of HIOS witness Porter to prove that an overcollection occurred, but that attempt yielded no evidence to support their theory. *See* Tr. 826

(where Staff counsel stated that Indicated Shippers could not succeed in making their case only through cross-examination); Tr. 833:22-23 (where the Presiding Judge stated that Indicated Shippers had not yet proved their case). The record contains no evidence that HIOS overcollected. In fact, the record evidence affirmatively indicates that HIOS significantly *undercollected* its fuel/LAUF at least through the end of the test period. *See* IND-35 (showing HIOS experienced an underrecovery of its fuel/LAUF of 3.8 billion cubic feet); Tr. 858-59 (same); *see also* Tr. 830 (HIOS has not changed its way of doing business relating to fuel/LAUF for years). Thus, the facts indicate that HIOS's fuel/LAUF charge was too *low*, causing HIOS to *underrecover* its fuel/LAUF. *See* Tr. 818 (where the Presiding Judge stated that the one percent charge may have been too low). For all the foregoing reasons, no basis exists on which to order HIOS to provide refunds relating to fuel/LAUF in this proceeding.

CONCLUSION

For the foregoing reasons, HIOS respectfully requests that the Presiding Judge issue an Initial Decision approving HIOS's proposed rates and adopting HIOS's proposed change to its mechanism for recovering the cost of fuel/LAUF.

Respectfully submitted,

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PROPOSED FINDINGS OF FACT

Pursuant to Rule 706(b)(ii) of the Commission's Rules of Practice and Procedure, HIOS submits the following proposed findings and conclusions:

Cost of Service

1. HIOS's overall cost of service is $36,516,647. HIO-104, at 3; HIO-105; Tr. 243. This amount is just and reasonable. Proposals for a lower cost of service are unsupported, and will not produce just and reasonable rates. The specific elements of HIOS's cost of service are set forth below.

2. HIOS's operating expenses are $19,698,676. HIO-104, at 5-7; HIO-105. This amount is just and reasonable. Indicated Shippers' proposal to reduce HIOS's operating expense allowance based on the purported operating costs of other pipelines, and based on allegations that HIOS's operating expenses are inflated, is rejected because it conflicts with the record evidence and Commission precedent.

3. HIOS's proposed depreciation and amortization expense allowance is $1,611,641. This amount, which is just and reasonable, is supported by evidence demonstrating that the remaining economic life of the HIOS system is ten years from the end of the test period. Depreciation and amortization expenses based on a longer economic life of the system are unsupported and will not produce just and reasonable rates. HIO-104, at 19-21; HIO-76 through HIO-82; HIO-117; HIO-119 through HIO-132.

4. HIOS's proposed negative salvage allowance of $1,431,508 is just and reasonable. This conclusion is based on HIOS's negative salvage study, which is not contested, and the finding that the remaining economic life of HIOS's system is ten years from the end of the test period. HIO-83; HIO-84; HIO-104, at 20-21; HIO-110.

5. HIOS's income tax allowance of $4,803,071 is determined by multiplying the federal income tax rate by the management fee allowance approved below. HIO-104, at 22; HIO-105; S-1, at 10-11. In addition, it is undisputed that HIOS incurred state ad valorem (property) taxes of $104,809. HIO-75, at 18; HIO-105 (line 6).

6. HIOS's proposed rate of return of 12.08 percent is just and reasonable. This return is based upon the following elements, which are also found to be just and reasonable: (1) a capital structure of 56 percent equity and 44 percent debt; (2) an 8.04 percent cost of debt; and (3) a return on equity of 15.25 percent. The return on equity is based on Professor Williamson's proxy group of five gas pipelines. Staff's and Indicated Shippers' proposed proxy groups consisting predominately of gas distribution companies are rejected because, *inter alia,* gas distributors

have significant lower risks and a significantly lower cost of equity than gas pipelines. HIO-85; HIO-88; HIO-133, at 4-6, 11-12; HIO-134; HIO-135.

7. HIOS's proposed management fee of $9,323,608 is just and reasonable. HIOS's management fee is needed to: (1) provide an incentive for the owners to continue to operate and maintain the pipeline, including an incentive for the owners to invest in existing or new facilities in accordance with the Commission's important policy of encouraging the development and maintenance of pipeline infrastructure; (2) provide sufficient cash flow to cover fluctuations in revenues and expenses, thereby preventing insolvency; and (3) substitute for the return allowance that would be provided to a pipeline with a positive rate base. HIO-64, at 7-8; HIO-85, at 23-26; HIO-140, at 1-2. Staff relies on the *Tarpon* method; however, as applied to HIOS, that method creates a significant risk of insolvency, penalizes HIOS for making necessary investments in its pipeline system, ignores important factors which were not present in *Tarpon* such as HIOS's supplemental depreciation, and therefore fails to produce just and reasonable rates. Similarly, Indicated Shippers' proposal to manufacture a positive rate base through arbitrary manipulation of the negative salvage allowance is inappropriate, and does not produce just and reasonable rates. HIO-64, at 5-25; HIO-65 through HIO-70; HIO-91, at 2-15; HIO-92 through HIO-94.

8. HIOS's proposed revenue credits of $456,666, based upon actual revenue data at the end of the test period, are just and reasonable. HIO-104, at 23.

Billing Determinants and Rate Design

9. HIOS's proposed billing determinants of 95,200 Dth for calculating the FT-2 reservation charge, based on the contractual MDQs in effect as of the last day of the test period, and adjusted to reflect the 80 percent fixed cost obligation of FT-2 shippers, are just and reasonable. HIOS's proposed billing determinants of 34,748,000 Dth for firm usage rates, and 195,327,103 dth for interruptible services (including overrun), also are just and reasonable. The proposals by Staff and Indicated Shippers are unjust and unreasonable because they conflict with Commission precedent by (1) using *imputed* MDQs, instead of *actual* MDQs reflecting HIOS's FT-2 firm service obligations, (2) failing to adjust the MDQs to reflect the 80 percent minimum bills set forth in the firm contracts of HIOS's FT-2 shippers, and (3) including *interruptible* overrun volumes in the design of *firm* reservation rates. HIO-91, at 20, 27; HIO-102, at 2.

10. In order to recognize the benefits provided by HIOS's FT-2 shippers to the rest of HIOS's shippers, HIOS proposes to use a 5 percent service differential for Rate Schedule FT-2, pricing the FT-2 reservation charge at 95 percent of the Rate Schedule FT reservation charge. In addition, to rectify a pricing inequity between firm and interruptible service, and to encourage efficient contracting, HIOS proposes to use a 3.5 percent service differential for interruptible services, pricing

the IT rate at 103.5 percent of the Rate Schedule FT rate. These rate design changes are just and reasonable. HIO-64, at 27-31; HIO-91, at 31-36.

Fuel/LAUF

11. HIOS proposes to change its tariff to provide for an annual re-determination of its fuel and LAUF rates based on its actual fuel and LAUF for the previous three-year period. This proposal is just and reasonable. HIO-91, at 37-43.

CERTIFICATE OF SERVICE

I hereby certify that I have this 30th day of January, 2004, served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

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