

FERC POLICY STATEMENT REGARDING PIPELINE RECOVERY OF SYSTEM MODERNIZATION COSTS

Date: 29 April 2015

Oil & Gas Alert

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On April 16, 2015, the Federal Energy Regulatory Commission ("FERC" or the "Commission") issued a Policy Statement on [Cost Recovery Mechanisms for Modernization of Natural Gas Facilities](#) (the "Policy Statement")^[1], opening the door for interstate natural gas pipeline companies to recover system modernization costs from shippers through surcharges and tracker mechanisms. The Policy Statement, which will impact interstate natural gas pipelines and their shippers alike, will go into effect on October 1, 2015.

The Policy Statement, which was approved unanimously by the five commissioners, closely tracks the Commission's [November 20, 2014 Proposed Policy Statement](#), and is specifically intended to address costs incurred by pipelines related to pipeline safety and greenhouse gas emission ("GHGs"). FERC explicitly recognizes that allowing the surcharge mechanisms that fall within the purview of the Policy Statement represents a departure from its past practice.^[2] Historically, with narrow exceptions, the Commission has been reticent to allow regulated pipeline companies to establish surcharge mechanisms. However, as the Commissioners pointed out in their discussion at the April 16, 2015 meeting, including [FERC's newly installed Chairman, Norman Bay](#), the Policy Statement is aimed at incentivizing the modernization of U.S. interstate natural gas pipeline infrastructure in the face of emerging issues, like pipeline integrity and methane leakage.

One of the most critical aspects of the Policy Statement is that the Commission expressly *declines* to limit potential recovery to costs incurred in complying with *existing* laws and regulations. Instead, the Commission determined that "all prudent one-time capital costs that satisfy the eligibility requirements may be included in a cost modernization tracker, *regardless of whether PHMSA, FERC, EPA, or some other government agency has adopted a regulation requiring incurrence of the cost.*"^[3] In light of the substantial uncertainty surrounding federal and state GHG-related laws and regulations and multiple pending U.S. Pipeline and Hazardous Materials Safety Administration rulemakings, the absence of a tie to a specifically enacted law or implemented agency regulation may present an opportunity for pipelines to seek a more liberal recovery from shippers for voluntary system modernization initiatives.

Anticipating shippers' concerns, however, the Commission confirmed that it will not approve a pipeline's proposed surcharge mechanism if it finds that the costs were not prudent. Specifically, the Commission has included provisions that seek to ensure that any related surcharge mechanisms are narrowly tailored and do not become "runaway trackers." To that end, the Commission will require interstate natural gas pipelines to satisfy [five standards](#), described in greater detail below, to establish a system modernization surcharge mechanism.

Importantly, as noted above, the Commission explains that the Policy Statement is intended to benefit pipeline companies that take proactive measures to address certain issues even before government regulations imposing modernization requirements are finalized.^[4] Outgoing FERC Chairman Cheryl LaFleur noted in her comments at

the April 16, 2015 meeting that such issues include increased reliance on natural gas, changing pipeline safety regulations, and an increasing emphasis on GHG emissions. Although the Commission declines to limit the regulatory initiatives for which pipelines may be able to recover related costs through a surcharge mechanism, the Policy Statement does specifically mention PHMSA's pending pipeline safety regulations and the Environmental Protection Agency's ("EPA") anticipated GHG regulations. FERC references the high percentage of existing natural gas pipelines that were built prior to 1970, when PHMSA's regulations went into effect, and the fatal September 2010 San Bruno, California pipeline incident.^[5] In response to the Pipeline Safety, Regulatory Certainty, and Job Creation Action of 2011, pending rulemakings will expand PHMSA's jurisdictional reach by, for example, eliminating certain provisions that grandfathered pre-1970s pipelines and increasing other regulatory requirements for interstate natural gas pipelines. By all indications, the \$2.5-3.5 billion in federal funding proposed by the Obama Administration in the [Quadrennial Energy Review](#), released on April 21, 2015, to support states' pipe replacement programs will focus on gas distribution systems, not interstate pipelines.^[6] Consequently, FERC's surcharge and cost tracker mechanism appears to be the sole method for interstate pipeline operators to recover the costs of system modernization projects to comply with new pipeline safety requirements. In addition, the Policy Statement references [EPA's 2014 White Paper](#) and the Department of Energy's statements, both discussing methane leaks associated with natural gas compressors and related infrastructure.^[7]

While the Policy Statement leaves room for the Commission to render decisions on proposed system modernization surcharges on a case-by-case basis, the language suggests an attempt to balance the need for flexibility to ensure that pipelines are able to recover their cost of service with the requirement to protect rate payers from pipeline over-collection. The contours of the surcharge mechanisms that will be permitted under the principles outlined in the Policy Statement will be defined over time, through rate cases under Section 4 of the Natural Gas Act ("Section 4 rate case"), both full and limited, and pipeline settlements with their shippers. Interstate pipeline companies seeking to implement surcharge mechanisms will need to work closely with shippers in order to try to gain support for such proposals. Shippers for their part will have to review closely the pipelines' proposals to ensure the surcharge mechanisms meet the five standards FERC establishes in the Policy Statement.

FIVE STANDARDS AND ADDITIONAL CONSIDERATIONS IN THE POLICY STATEMENT

The five standards set forth in the Policy Statement that pipelines will have to satisfy to establish a system modernization surcharge mechanism establish a foundation for the implementation of an objective surcharge mechanism. These standards, described in greater detail below, are:

Standard 1: Review of Existing Rates;

Standard 2: Eligible Costs Must be Limited;

Standard 3: Avoidance of Cost Shifting;

Standard 4: Periodic Review of the Surcharge; and

Standard 5: Shipper Support.

The Commission also addressed questions related to accelerated amortization of capital costs included in a modernization surcharge mechanism, whether full or partial reservation charge credits will be required for service disruptions related to system modernization projects, and pipelines' return on equity. These issues are discussed in greater detail following the review of the five standards.

Standard 1: Review of Existing Rates.

In order to receive authorization for a modernization surcharge mechanism, a pipeline must have had its base rates publicly available in its FERC tariff recently reviewed to demonstrate that the existing base rates are just and reasonable. FERC notes that this could be accomplished either (1) through a general Section 4 rate case, during which all of the underlying costs and resulting rates are subject to review, or (2) through a "collaborative effort between the pipeline and its customers."

The Policy Statement maintains the requirement that a pipeline seeking to establish a modernization cost surcharge demonstrate that its existing rates are just and reasonable. While a full Section 4 rate case is an option available to pipelines to satisfy this burden of proof, the Commission explains that it is also "open to considering alternative approaches," and will make determinations on a case-by-case basis. As it has done in rate proceedings in the past, the Commission encourages pipelines seeking modernization cost recovery mechanisms to provide their shippers with robust supporting data and information. In light of the significant time and cost associated with full Section 4 rate cases, it is likely that many pipeline companies will seek to avail themselves of "alternative approaches," whether through settlements with customers or through other methods.

Standard 2: Eligible Costs — One-Time Capital and Certain Non-Capital Costs Targeted at Regulatory Compliance, Safety, or Efficiency Goals.

Notably, as a threshold matter, the Commission declines to limit eligible costs to those incurred in compliance with already enacted laws and currently effective regulations. Instead FERC finds that it is in the public interest to encourage voluntary pipeline initiatives to improve safety and efficiency, regardless of whether such initiatives are in response to a government law or regulation.

On a more granular level, the costs that would be eligible for recovery through the mechanism generally must be one-time capital costs that are incurred to modify existing system infrastructure to (1) comply with new, more stringent regulations and/or (2) employ new technologies that reasonably increase safety and/or efficiency. The Commission maintains its existing position that ordinary capital maintenance costs should not be included in a cost recovery mechanism and, to this end, pipeline companies will be required to demonstrate that the costs included in the recovery mechanism do not fall within this category. Pipelines may seek to use a recent history of their ordinary capital system maintenance costs as a means for establishing a representative level of capital maintenance costs to exclude from a proposed modernization surcharge mechanism.

Although the Policy Statement is targeted at recovery of one-time *capital* costs, the Commission explains, albeit reluctantly, that pipelines may be able to recover certain *non-capital* costs, such as those "directly related to the modernization projects" on which the proposed surcharge mechanism is based, a statement that can be expected to lead to significant disputes between pipelines and their customers.

Finally, pipeline companies must identify specifically each capital investment to be recovered and an upper limit on the capital costs related to each project to be included in the recovery mechanism, although pipelines may be

permitted to modify this list and the associated cost limits at a later time. Again, this flexibility in modifying the upper limit could result in challenges from shippers that certain costs were incurred imprudently.

Standard 3: Avoidance of Cost Shifting.

In keeping with Commission policy, interstate natural gas pipelines will be required to design the proposed recovery mechanism so that it protects its captive customers from cost shifts if the pipeline loses shippers or has to offer increased discounts to retain customers. The Policy Statement notes that one way to achieve this goal is for the pipeline to agree to a floor for the billing determinants that can be used to design the recovery mechanism.

Standard 4: Periodic Review of the Surcharge.

Pipeline companies will be required to include a method to allow for periodic review of the recovery mechanism and the pipeline's base rates to ensure that they remain just and reasonable. The Commission notes that it will establish appropriate procedures to address any complaints that raise an issue of material fact regarding the continued justness and reasonableness of a pipeline's base rate or surcharge. We expect pipelines may look to existing FERC-approved surcharge or tracker mechanisms for examples of how to structure any proposal.

Standard 5: Shipper Support.

Pipeline companies will be required to demonstrate that they worked collaboratively with shippers to seek support for the recovery mechanism. The Commission will not require 100% shipper support, which is consistent with the way that the Commission generally handles settlements in Section 4 rate cases.

ADDITIONAL CONSIDERATIONS

In addition to the standards noted above, the Commission addressed the following:

Accelerated Amortization. The Commission will allow pipelines and shippers to determine whether accelerated or non-accelerated amortization of the capital costs included in the recovery mechanism is warranted.

Reservation Charge Crediting. Initially, the Commission will address on a case-by-case basis the issue of whether full or partial reservation charge credits should be provided when the pipeline must interrupt primary firm service to install or repair facilities related to the modernization surcharge mechanism. FERC policy requires that pipelines provide full reservation charge credits to primary firm customers when service is interrupted for a non-force majeure event and requires partial reservation charge credits during force majeure events. Over time, it is possible that a general Commission policy will emerge from the individual case determinations.

Return on Equity. While it declines to require an automatic reduction in a pipeline's return on equity if the pipeline has a modernization surcharge mechanism, the Commission explains that it may take the surcharge mechanism into consideration when determining whether a pipeline's level of recovery is just and reasonable.

CONCLUSION

The potential for significant added costs to a shipper's overall transportation charges on interstate pipelines as a

result of these potential new interstate natural gas pipeline surcharges, coupled with FERC's decision not to tie the acceptance of modernization costs to enacted laws or implemented regulatory regimes, likely will result in significant challenges to individual pipeline's proposals as they are filed with FERC. Moreover, the Commission likely will continue to draw boundaries around its Policy Statement as more and more pipelines seek FERC approval for proposed surcharge mechanisms to recover the modernization costs. As a result, interstate pipelines and shippers alike will have to follow multiple proceedings to discern the evolving parameters of FERC's newly announced Policy Statement.

NOTES:

[1] *Cost Recovery Mechanisms for Modernization of Natural Gas Facilities*, 151 FERC ¶ 61,047 (2015) [hereinafter Policy Statement]. The Policy Statement was published in the Federal Register on April 22, 2015. 80 Fed. Reg. 22,366.

[2] Policy Statement at P 33.

[3] Policy Statement at P 68 (emphasis added).

[4] Policy Statement at PP 68-71.

[5] Policy Statement at P 26.

[6] Dep't of Energy, Quadrennial Energy Review: Energy Transmission, Storage, and Distribution Infrastructure at 2-38 (2015), available at <http://energy.gov/epsa/quadrennial-energy-review-qer> (last visited Apr. 22, 2015).

[7] Policy Statement at PP 28-29.

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