Energy Alert

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Five Ratemaking Takeaways from FERC's *Panhandle Eastern Pipe Line Company, LP* Order

December 22, 2022

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On December 16, 2022, the Federal Energy Regulatory Commission (FERC) issued *Panhandle Eastern Pipe Line Company, LP*, its first opinion and order on an initial decision in a Natural Gas Act (NGA) section 4 general rate case proceeding in nearly ten years. The last NGA section 4 general rate case to be fully litigated was *El Paso Natural Gas Co.*, a 2013 decision that derived rates based on a test period that straddled 2010 and 2011.[1] The changes experienced by the natural gas industry since that time are immense. For example, *El Paso* predated market changes spurred by hydraulic fracturing that accelerated the replacement of coal with natural gas for base generation, the export of liquefied natural gas (LNG), and the general debate over the future dependence upon and use of natural gas, from proposed municipal gas bans to the blending of hydrogen into a gas stream to reduce its carbon footprint.

Yet, despite these monumental shifts in the natural gas marketplace, *Panhandle* often reads like an old school rate case decision, with principles expounded upon that would be familiar to any rate case lawyer practicing before FERC over the past two decades. While much of the decision is straight and narrow, a number of key themes and takeaways can be found in the text. Here are five of them:

1) The new "last litigated ROE" is 11.25 percent.

It is an axiom of regulatory law that a regulated monopoly, such as an interstate natural gas pipeline company, is permitted the opportunity to earn a reasonable return on its investments. The just and reasonable return on equity (ROE) is one of the most litigated components of any rate case because ROE can be one of the largest drivers of a rate increase or decrease. In *Panhandle*, FERC set the pipeline's ROE at 11.25 percent. This is the median return generated when FERC averaged the results it obtained from a Discounted Cash Flow (DCF) analysis and a Capital Asset Pricing Model (CAPM) analysis using a five-member proxy group.

FERC policy often uses the "last litigated ROE" as a proxy for just and reasonable rates when it is developing initial rates for existing facilities being acquired by a new pipeline. It has also relied upon the "last litigated ROE" in rulemaking proceedings that concerned pipeline rates. Prior to *Panhandle*, the last litigated ROE was the *El Paso* decision's 10.55 percent. Hence, *Panhandle* marks an increase of 70 basis points and may change the calculation made by pipelines and shippers when they consider whether to litigate a rate case proceeding or agree to a black box settlement without a stated ROE.

2) There continues to be ratemaking uncertainty spurred by *United Airlines v. FERC*.

In 2018, FERC revised its ratemaking policy to prohibit pipelines organized as pass-through entities for income tax purposes, such as master limited partnerships (MLPs), from collecting an income tax allowance (ITA) in their rates.[2] The 2018 policy also considered the treatment of accumulated deferred income tax (ADIT). Prior to the 2018 policy change, MLP pipelines had recorded ADIT to compensate them for the tax timing difference between the accelerated depreciation permitted by the Internal Revenue Service (IRS) and the straight line depreciation required by FERC ratemaking. ADIT served as a debit to rate base, so a higher ADIT lowered rate base, resulting in lower rates, while a lower ADIT resulted in a higher rate base, with ADIT resetting to zero whenever there was a taxable event, such as a sale or restructuring, consistent with tax normalization rules. The 2018 policy held that MLP pipelines could retain their ADIT balances when their ability to collect an ITA was abolished, as opposed to refunding amounts to pipeline shippers, because doing so would result in unlawful retroactive ratemaking. This policy on MLP rates followed *United Airlines v. FERC*, a 2016 D.C. Circuit decision which held that FERC acted arbitrarily and capriciously for permitting such a recovery because it had not explained why this would not result in a double-recovery of income tax costs in rates, both from the ITA and from the return on investment.[3] In 2020, the D.C. Circuit issued *SFPP, L.P. v. FERC*, which affirmed the 2018 policy change as consistent with *United Airlines*.[4]

The *Panhandle* pipeline reorganized as an MLP in 2018, prior to the policy change, making *Panhandle* the first fully litigated NGA section 4 general rate case to grapple with the precedent initiated with the *United Airlines* decision. It considered the treatment of ADIT and excess ADIT (EDIT), both in rate base and the equity component of capital structure. FERC followed its precedent that permitted the removal of ADIT from rate base, but held that the maintenance of a rate base account for EDIT as a regulatory liability, and the amortization of EDIT back to ratepayers, did not violate the rule against retroactive ratemaking. It then held that this rate base treatment for ADIT and EDIT then necessitated the removal of ADIT from the equity component of capital structure, as well as the removal of EDIT from retained earnings used to determine the equity component of capital structure. The practical result of this finding was to thin the equity component in capital structure used to calculate the pipeline's rates. In a partial dissent, Commissioner Danly encouraged rehearing on whether *SFPP* required this result.

3) Arguments about the future of natural gas use may be unavailing for ratemaking purposes.

In *Panhandle*, FERC set depreciation rates based upon a 35-year economic life. FERC held that it did not have a uniform 35-year economic life policy, but the adopted a 35-year economic life consistent with it prior precedents, and consistent with what the pipeline had proposed. In doing so, FERC rejected calls for a longer economic life based upon abundant natural gas supply, as argued for by its own trial staff. However, the *Panhandle* decision also sets up a marker for rate case litigants that may argue for shorter economic lives based upon public policies and market preferences that could reduce future natural gas demand. A shorter economic life would result in higher depreciation rates.

Certainly, future reduction to natural gas demand is a prevailing argument made by opponents to new pipeline infrastructure in the context of FERC's "public need" determination under NGA section 7, and has previously been entertained by some of the FERC commissioners. And, while the future use of natural gas was discussed in NGA section 7 orders issued concurrently with *Panhandle*, as well as in depreciation testimony and briefs filed in the underlying rate case proceeding, the debate was neither acknowledged now discussed in the *Panhandle* text. This suggests that, for ratemaking purposes, FERC may not be ready to deviate too far from its prior precedent.

4) Affiliate contracts remain subject to intense scrutiny.

A prominent issue in several orders voted on at FERC's December 2022 open meeting, including *Panhandle*, concerned affiliate contracts and whether they result in just and reasonable rates. The *Panhandle* NGA section 4 rate case was borne, in part, out of an investigation under NGA section 5 into the affiliate relationship between a pipeline and a storage company. A holdover from that investigation considered whether the *Mobile-Sierra* doctrine protected a negotiated rate agreement between the affiliates and whether the rate therein could be passed on the pipeline's customers. FERC demurred on the larger issue of whether *Mobile-Sierra* could apply to affiliate contracts and did not issue an order as to the justness and reasonableness of the contract rate, but instead as to the justness and reasonableness of the rate based onto the pipeline's ratepayers, effectively requiring the pipeline to absorb the difference. Otherwise, FERC reiterated its precedent that a pipeline typically has a heavier burden of proof to support the need for affiliate contracts, or the rates contained therein, when it is in a rate case posture. FERC found that in some instances the pipeline met its burden while in other instances it did not.

5) FERC generally defers to the pipeline on rate design.

Pipeline rate design constituted another important topic in the *Panhandle* proceeding, including how the pipeline classified and allocated costs to different cost centers and classes of ratepayers. In almost all instances, FERC deferred to the pipeline on matters of rate design, including whether to continue an existing rate design or to adopt proposed changes. This is not surprising. Third-parties seeking changes to a pipeline's rate design have an elevated burden of proof under NGA section 5. They must demonstrate that the existing rate design is unjust and unreasonable and that their proposed changes are just and reasonable. A pipeline has the same burden, but often has access to additional data that makes it easier to overcome. One of the few areas where FERC rejected the pipeline's proposed rate design concerned changes in the allocation of costs to small customers, a class of customers that FERC has traditionally protected.

Conclusion

There were a number of additional issues litigated in the *Panhandle* proceeding that are not the subject of this posting, such as the impact of COVID-19 on rates, the recovery of negative salvage in rates and system storage costs. For questions concerning the case and to understand the implications of the decision on diverse sets of interests, please reach out to your rate counsel.

[1] *El Paso Nat. Gas Co*., Opinion No. 528, 145 FERC ¶ 61,040, at P 73 (2013) (El Paso), *order on reh'g*, Opinion No. 528-A, 154 FERC ¶ 61,120 (2016), *order on compliance & reh'g*, Opinion No. 528-B, 163 FERC ¶ 61,079 (2018).

[2] *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, 162 FERC ¶ 61,227 (Revised Policy Statement), *order on reh'g*, Revised Policy Statement Rehearing Order, 164 FERC ¶ 61,030 (2018).

[3] *United Airlines, Inc. v. FERC*, 827 F.3d 122 (D.C. Cir. 2016).

[4] *SFPP, L.P. v. FERC*, 967 F.3d 788 (D.C. Cir. 2020).

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