1998 WL 35240622 (C.A.D.C.) (Appellate Petition, Motion and Filing)
United States Court of Appeals, District of Columbia Circuit.

AMOCO PRODUCTION COMPANY, et al., Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

No. 97-1607.
June 30, 1998.

On Petition for Review of Orders of the Federal Energy Regulatory Commission

Brief for Respondent Federal Energy Regulatory Commission

Douglas W. Smith, General Counsel, Jay L. Witkin, Solicitor, John H. Conway, Deputy Solicitor, Edward S. Geldermann, Attorney, For Respondent, Federal Energy Regulatory Commission, Washington, D.C. 20426.

1 *CIRCUIT RULE 28(A)(1)

A. *PARTIES AND AMICI*

All parties, intervenors, and amici appearing in the proceedings below and in this court are listed in the petitioners' brief.

B. *RULINGS UNDER REVIEW*

The decisions of the Federal Energy Regulatory Commission under review are:
1.) *NorAm Gas Transmission Company,* FERC Docket Nos. RP97-57-000 and RP97-57-001, "Order After Technical Conference And Denying Rehearing," 79 FERC ¶ 61,126 (May 5, 1997)

2.) *NorAm Gas Transmission Company,* FERC Docket No. RP97-57-003, "Order Denying Rehearing," 80 FERC ¶ 61,100 (July 22, 1997).

C. *RELATED CASES*

This case has not previously been before this Court or any other Court. There are no related cases of which the undersigned is aware.

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***V** *GLOSSARY*

AMOCO	Collectively, Amoco Production Company and Amoco Energy Trading Customers
FERC	Federal Energy Regulatory Commission
OA	Operational Alert
OFO	Operational Flow Order
MMBtu	One Million British Thermal Units
NGA	Natural Gas Act
NorAm	NorAm Gas Transmission Company
POCA	Pennsylvania Office of Consumer Advocates v. FERC, 131 F.3d 182 (D.C. Cir. 1997)

***1** *STATEMENT OF THE ISSUES*

In 1996, the NorAm Gas Transmission Company ("NorAm"), an interstate pipeline, filed proposed tariff sheets with the Federal Energy Regulatory Commission under Section 4 of the Natural Gas Act ("NGA"), 15 U.S.C. § 717c, seeking to revise its penalties for unauthorized overruns and for failure to comply with "operational flow orders" ("OFOs") issued by the pipeline during system emergencies. A group of customers protested, arguing that the increases in penalty levels were unjustified and, in any case, that any monies collected under these penalties should be credited to NorAm's cost of service, with an annual reconciliation and concomitant rate reduction.

In the orders under review, the Commission permitted these revisions to take effect after finding that the increased penalties were reasonable and likely to deter shipper abuses. For the time being, moreover, the Commission allowed NorAm to ***2** continue retaining whatever revenues the revised penalties may generate, after finding that the increase in the penalty levels was more likely than not to lead to a decrease in penalty revenues. Nonetheless, the Commission also stated that if NorAm's increased penalties were shown in the future to generate significant penalty revenues, it would take appropriate action.

The issues presented are: (1) whether the Commission's findings that NorAm had justified its proposed increases in overrun penalties and OFO penalties were reasonable and supported by substantial evidence; and (2) whether the Commission reasonably declined to require NorAm to credit revenues collected from these penalties to its customers.

STATUTES AND REGULATIONS

Pertinent statutes and regulations are set out in the appendix to this brief.

STATEMENT OF THE CASE

I. *NATURE OF THE CASE, COURSE OF PROCEEDINGS, AND DISPOSITION BELOW*

On November 1, 1996, NorAm filed tariff sheets with FERC proposing to revise its penalties to be levied against shippers that cause unauthorized overruns or fail to comply with OFOs issued pursuant to section 20 of its tariff. On November 29,

1996, the Commission accepted and suspended NorAm's filing, subject to refund and conditions and the outcome of a technical conference, which was held on January 23, 1997. *See NorAm Gas Transmission Co.,* 77 FERC ¶ 61,238 (1996).

***3** In the first order under review, *NorAm Gas Transmission Co.,* 79 FERC ¶ 61,126 (May 5, 1997) ("May Order"), the Commission approved NorAm's filing to become effective May 2, 1997. As relevant here, FERC permitted the increase in the unauthorized overrun penalty to become effective after finding that the existing penalties had not been a sufficient deterrent to shipper behavior detrimental to the system. Similarly, it approved the OFO penalty proposal as a reasonable way to ensure improved shipper compliance. In both cases, moreover, after finding no evidence that these penalties would result in significant revenues, the Commission declined to require that NorAm credit whatever penalty revenues it may collect to its customers.

Amoco Production Company and Amoco Energy Trading Customers Corporation (collectively "Amoco"), among others, then sought rehearing, arguing that FERC should have required NorAm to flow all penalty revenues through to its other customers to avoid a windfall for NorAm, and that NorAm had not justified the need for the OFO penalty increase. In the second and final order under review, *NorAm Gas Transmission Co.,* 80 FERC ¶ 61,100 (July 22, 1997)("July Order"), the Commission first found its decision not to require crediting in this instance to be consistent with its stated policy not to review such increases until a subsequent rate filing. Further, it found the increased OFO penalties were warranted based on the evidence in order to bring NorAm's penalties in line with other penalties on NorAm's system, and on ***4** the systems of other nearby pipelines. Accordingly, the Commission denied rehearing.

These petitions for review followed.

A. *Statutory and Regulatory Background*

The NGA confers upon FERC comprehensive regulatory authority over companies that engage in either the sale of natural gas for resale or its interstate transportation. The Commission regulates market entry through NGA § 7, 15 U.S.C. § 717f, by issuing certificates of public convenience and necessity authorizing natural gas companies to transport or sell gas, and market exit through its authority to abandon certificated service. NGA § 7(b), 15 U.S.C. § 717f(b). in addition, under NGA §§ 4 and 5, 15 U.S.C. §§ 717c and 717d, the Commission regulates the price and other terms of jurisdictional sales and transportation, ensuring that the rates and charges for such service, as well as all rules, regulations, practices, and contracts affecting those rates and charges, are just and reasonable, and not the product of undue discrimination.

***5** In Order No. 636, [1] the Commission's major initiative to restructure the natural gas industry, FERC revised its regulations in a manner designed to create a more efficient market for natural gas at the wellhead. As relevant here, the Commission directed pipelines to "unbundle" sales of natural gas from transportation, thereby requiring pipelines to sell gas and transportation services separately, and allowing customers to obtain only the pipeline services they require.

As this Court recently recognized, however, this unbundling did not come without operational challenges to pipelines. *Pennsylvania Office of Consumer Advocate v. FERC,* 131 F.3d 182, 184 (D.C. Cir. 1997)("*POCA*"), *modified on other grounds,* 134 F.3d 422 (D.C. Cir. 1998). Under the new regulatory regime, pipelines have reduced flexibility to adjust when customers unexpectedly deviate from their shipping schedules, and cannot easily compensate for imbalances between gas volumes tendered to the pipeline and taken by a customer. Thus, as *POCA* explains

a pipeline with a limited merchant function facing an overrun might be unable to sustain enough pressure ("line pack") to provide efficient and reliable transportation service ***6** to its other customers. A customer might also arrange to have tendered to the pipeline more gas than the customer ultimately takes within a specified time-frame. In this scenario, if the pipeline lacks the ability to reduce tenders from other sources of supply or to deliver gas to other points, the pressure build-up on the pipeline could threaten system integrity.

131 F.3d at 184. Accordingly, to enable pipelines to preserve system integrity, Order No. 636 directed pipelines in their restructuring proceedings, to propose "operational flow orders" ("OFOs") and to prescribe various penalties to deter shippers from abusing their contractual rights to pipeline capacity. [2]

The history of pipelines' imposing penalties for unauthorized overruns and other shipper activities that threatened system integrity precedes even Order No. 636. In a series of proceedings arising under its Order No. 436 transportation regulations, [3] customers of various pipelines challenged the Commission's approval of these penalties without requiring the affected pipeline to credit revenues collected through penalties to customers. In those cases, the Commission rejected revenue-crediting claims because the penalties at issue were designed to deter shipper abuses, not to compensate the ***7** pipeline, and were not expected to generate significant revenues. *See, e.g., El Paso Natural Gas Co.,* 35 FERC ¶ 61,440 at 62,066-70 (1986); *Natural Gas Pipeline Co. of America,* 39 FERC ¶ 61,153 at 61,598 (1987); *Texas Eastern Transmission Corp.,* 44 FERC ¶ 61,319 at 62,092 (1988); *Northwest Pipeline Corp.,* 48 FERC ¶ 61,135 at 61,521 (1989). Instead, the Commission in each of these cases expressed the willingness to revisit the question of pipeline penalty retention in a subsequent rate case. The Commission's penalty retention policy remains in force to this day. *See, e.g., Northern Natural Gas Co.,* 77 FERC ¶ 61,282 at 62,236 (1996); *Florida Gas Transmission Co.,* 63 FERC ¶ 61,160 at 62,070 (1993); *Northern Natural Gas Co.,* 62 FERC ¶ 61,075 at 61,430-31 (1993); *Panhandle Eastern Pipe Line Co.,* 61 FERC ¶ 61,357 at 62,429 (1992); *Carnegie Natural Gas Co.,* 63 FERC ¶ 61,103 at 61,645-46 (1993), *reh'g denied,* 64 FERC ¶ 61,164 at 62,367-68 (1993), *aff'd in POCA.*

B. *The Facts Of This Case*

1. *Events Leading to the Commission's Orders*

As noted, NorAm filed new tariff sheets in November 1996 proposing to revise its preexisting penalties for unauthorized overrun quantities and for noncompliance with OFOs. Under NorAm's then-existing tariff, customers were subject to penalties for unauthorized overruns in the amount of $10.00 per million British thermal units ("MMBtu") over and above a two-percent tolerance level. NorAm proposed to establish a three-tiered penalty structure for unauthorized overruns. For those exceeding ***8** the two-percent tolerance level, but still less than 5% of authorized quantities, NorAm proposed to retain the $10 per MMBTU penalty. For overruns between 5% and 10% of authorized quantities, NorAm proposed a $25 per MMBTU penalty. Finally, for overruns exceeding 10% of authorized quantities, NorAm proposed a $50 per MMBTU penalty. R. 28, JA 29. [4] NorAm also proposed to change its OFO penalty from $10 to $25 per MMBTU of the gas quantity by which a violator deviated from an OFO. R. 43, JA 44.

In support, NorAm explained that from late December 1995 through February 1996, gas prices had "skyrocketed" due to frigid weather conditions. R. 4, JA 4. During that period, NorAm had encountered 250 instances of unauthorized takes by shippers, despite the fact that it had issued repeated "operational alerts" ("OAs") and OFOs, and had notified interruptible shippers that their service requests would not be scheduled. [5] in over 60% of these cases, unauthorized overruns had exceeded 10% of the quantities authorized, and in many cases, unauthorized takes had exceeded 50% of the amount of gas authorized. NorAm further ***9** stated in some instances, the unauthorized takes "threatened to jeopardize [its] system integrity and its ability to provide service to other firm shippers." R. 4; JA 4.

In addition, NorAm asserted that some shippers were gaming the system by paying the $10.00 per MMBtu penalty for unauthorized withdrawals for the few frigid days of the year when spot markets price rose sharply, while at the same time

subscribing to less firm capacity than they needed to meet their peak winter requirements. Consequently, these customers came out ahead by paying less in annual demand charges. Overall, NorAm contended that its purpose in revising its penalties was "not to assess and collect increased dollars, but rather to effectively deter the unauthorized takes which occurred on certain days last winter." R. 4; JA 4.

These same events also formed the justification for NorAm's separate proposal to increase its existing penalty for violations of OFOs from $10.00 per MMBtu to $25.00 per MMBTU of the gas quantity by which a violator had deviated from an OFO. NorAm contended that, just as with its existing overrun penalties, a $10.00 per MMBtu penalty may not be a sufficient incentive to comply with NorAm's OFOs if shippers are faced with an economic choice because of high gas prices and scarce capacity. R. 5, JA 5. NorAm further acknowledged that although there were no documented violations of OFOs during the previous heating season, this should not be attributed to the deterrence value of its existing OFO penalty level. Rather, NorAm attributed the lack of ***10** violations to the aggressive efforts of its staff, who had remained in constant telephone contact with shippers during the OFO periods to ensure their continued compliance with the OFOs. *See* R. 173-74, JA 77-78. As a separate matter, NorAm contended that its proposed increase in OFO penalties would align itself more closely with other pipelines which have OFO penalties in excess of $10 per MMBtu. R. 5, JA 5.

Finally, NorAm acknowledged that, as a result of all the documented abuses over the past 12 months, it had collected approximately $1.78 million in unauthorized overrun penalties. NorAm went on to predict, however, that it would have no need to assess and collect penalties if the proposed penalty changes have the intended effect. Thus, NorAm estimated that its revenue and costs over the twelve-month period following the effective date of its filing would be "zero." R. 6, JA 6.

Amoco protested NorAm's tariff revision, arguing that NorAm had not justified the levels of proposed increase in unauthorized overrun penalties. It further contended that there was no record support for any increase in the OFO penalty, as NorAm had not even utilized its existing OFO penalty provisions to remedy operational integrity problems or imbalances during the prior heating season. R. 237, JA 93. Alternatively, Amoco urged that, if the Commission were to approve the proposed increases in penalties, it should require NorAm to credit all penalty revenues as an offset to rates in order to preclude NorAm from reaping a windfall. R. 238, JA 94. By order issued November 29, 1996, ***11** FERC accepted and suspended NorAm's filing, subject to refund, conditions, and the outcome of a technical conference. At the conference held January 23, 1997, parties and Commission staff addressed the matters in the November 29 order and other issues. Subsequently, four parties filed initial comments and seven parties filed reply comments on the discussions at the technical conference. *See* 79 FERC at 61,542; JA 159.

2. *The Orders Under Review*

The Commission addressed all the comments on NorAm's proposed penalty revisions in the May Order. Turning first to the unauthorized overrun proposal, the Commission began by reciting its principal concern that pipelines be able to ensure system integrity and to deter gaming and other activities that would threaten system integrity. In this regard, FERC found that no party had adequately challenged NorAm's assertions that certain shippers' abusive actions would result in severe operational difficulties on NorAm's system, and, further, that NorAm had presented sufficient evidence that it had incurred unauthorized overruns during the last year. 79 FERC at 61,543, JA 160.

In particular, the Commission took note that, during the past winter peak season, there had been approximately 250 instances where shippers had engaged in unauthorized overruns. Of these, over 60% of the unauthorized quantities had been in excess of 10% of the quantity authorized, and in numerous cases unauthorized quantities exceeded 50% of authorized quantities. ***12** Moreover, the Commission observed that because NorAm was no longer a merchant, it could not purchase the capacity or supply to fill in the gap when a shipper fails to follow the tariff restrictions or purchase sufficient capacity and gas supply to meet its needs. R. 379, JA 160, 79 FERC at 61,543. Thus, while recognizing that NorAm's revised penalty charges would be higher than its existing charges, the Commission nonetheless concluded that they were

permissible because the setting of penalty levels is not a matter for scientific calculation or index of gas costs. Penalty charges are not cost based, and their essential purpose is to deter undesirable shipper behavior.

Id.

The Commission next reviewed NorAm's proposal to raise its penalty level for OFO violations from $10 to $25 per MMBTU. In this regard, the Commission found that NorAm should have some means to ensure that shippers comply with OFOs, and to deter future abuses in the same manner as the penalty for unauthorized overruns. Although recognizing that shippers in the past had complied with OFOs at the lower $10 rate, the Commission nonetheless concluded that the increase to $25 was supported by the fact that shippers had overrun the system in the past at the lower rate. 79 FERC at 61,544, JA 161. Accordingly, FERC determined to approve the OFO proposal as well.

This left the question of whether NorAm should be required to credit back its penalty revenues to its customers. R. 383-84, JA 164-165, 79 FERC at 61,547-48. The Commission here concluded ***13** that no such crediting was warranted, expressing its rationale as follows:

The Commission's policy is to not require pipelines to credit penalty revenues to its customers. Instead, the Commission has stated that it would review such revenues in a subsequent rate case filing. Penalties, if designed correctly, will not generate an excessive amount of revenue. The penalties here are significant and should deter overruns. There is no evidence these penalties will result in significant revenues. It is not known how much revenues the penalties will produce, but it is reasonable to assume, once the higher penalties are in place, the revenues from penalties will decrease as shippers cease incurring penalties as part of their supply strategies.

R. 383, JA 164, 79 FERC at 61,547.

Amoco then requested rehearing of the May Order. As pertinent here, they first challenged the Commission's determination that NorAm's proposed penalty increases should be accepted without a concomitant revenue crediting requirement, essentially contending that this would result in a windfall to NorAm. R. 443-48, JA 174-179. Further, Amoco argued that, given the absence of any documented OFO violations during the previous year, the Commission had also erred in allowing NorAm to increase the level of OFO penalties. R. 450, JA 181.

In the July Order resolving this request, the Commission began its analysis by once again rejecting assertions that an increase in penalties would likely increase the revenues that NorAm would collect for shipper abuses. In so holding, it explained as follows:

[T]he decision not to require crediting in this instance is consistent with the ***14** Commission's policy, as stated in *[Northern Natural Gas Company,* 77 FERC ¶ 61,282 (1996) ("*Northern*")]. While the instant increase in penalties may have been characterized as significant, that does not mean that the revenues they produce will be significant. Generally, an increase in penalties is in response to abuses on the system, and is designed to eliminate those abuses. Therefore, the increase in the penalty level is more likely than not to lead to a decrease in penalty revenues. The Commission's statement that the penalty is significant is not a finding that revenues also will be significant and thus require crediting to prevent NorAm from being unjustly enriched. There is nothing raised in opposition to establish that NorAm's penalties are so designed as to ensure excess revenues.

80 FERC at 61,342, JA 194. Nonetheless, the Commission stated that if in the future it were to appear that NorAm's revenues have increased to a significant degree as the result of its instant penalties, the Commission would be able to take appropriate action. *Id.*

Next, the Commission turned to the argument that NorAm's increased OFO penalties were unsupported because the pipeline had encountered no OFO violations during the past year at the preexisting $10 per MMBTU penalty level. Here, it explained that its intent had been to bring the OFO penalties in line with other penalties on NorAm's system and the systems of other

nearby pipelines. Thus, once having found that an increase in the overrun penalty was appropriate due to abuses in the past, FERC found it reasonable that the OFO penalty be adjusted accordingly. Were it otherwise, the Commission further explained, NorAm would have had a penalty structure that penalized shippers $25 for ***15** ordinary overruns, but, if those overruns occurred during emergency situations, the penalty would drop to only $10. 80 FERC at 61,343, JA 195. At the same time, the Commission also took into account the fact that NorAm had been able to secure full compliance only by using its personnel resources during emergency periods to call shippers to ensure that they remained in compliance with the tariff. *Id.* Accordingly, in all these circumstances, FERC concluded that the increased OFO penalty should act as a more effective and efficient means to ensure such compliance. *Id.*

***16** *SUMMARY OF ARGUMENT*

The Commission's determination that NorAm had justified its proposal to increase the level of its unauthorized overrun and OFO penalties was reasonable and well-grounded in the record.

It is undisputed that during the 1995-1996 peak winter heating season NorAm had encountered approximately 250 incidents of unauthorized overruns at the $10 per MMBtu penalty level. In this circumstance, the Commission could reasonably infer that the $10 per MMBtu penalty level then in effect was too low to deter abuse, and thus warranted an increase.

The Commission was also correct to conclude based on this record that OFO penalties should also be increased even though there were no documented OFO violations. As NorAm had shown that widespread overruns had been occurring at the $10 per MMBtu penalty level, it was logical for the Commission to conclude that the existing $10 per MMBtu penalty level for OFO violations was likewise inadequate to deter future OFO abuses. Moreover, as FERC also deduced, had NorAm not been permitted to increase its OFO penalty level to $25 per MMBtu (the same as the increased level for unauthorized overruns), NorAm would have been left with an anomalous penalty structure that would have penalized shippers $25 per MMBtu for ordinary overruns, but only $10 per MMBtu for overruns that occurred during emergency situations. Moreover, the Commission properly relied on evidence showing that OFO compliance during the past year had been accomplished only through extraordinary efforts by NorAm staff, and that increasing ***17** OFO penalties would bring NorAm into line with other nearby pipelines' OFO penalty structure. Thus, these conclusions must also stand.

In addition, the Commission reasonably adhered to its longstanding policy, upheld by this Court, in the course of permitting NorAm to retain penalty revenues, rather than requiring NorAm to credit such revenues to NorAm's firm shippers. In this regard, the Commission reasonably assumed that there would not be significant revenues collected as the result of the increased penalties. As this application of the policy falls well within the range of “predictive judgments” about ratemaking that the Commission may make, it should be sustained as well.

At the same time, the record makes clear that the Commission stands ready to take appropriate action if its predictions regarding insignificant penalty revenues prove to be erroneous. The Commission's regulations require NorAm to account for and report annually its penalty revenues, thereby assuring that FERC can monitor the situation. Alternatively, customers remain free to bring a complaint proceeding under NGA § 5 if abuse occurs.

Petitioners' various objections to these rulings are without merit. Petitioners' claim that the orders under review are inconsistent with Commission precedent is a makeweight, as all the cited cases are distinguishable. Petitioners' separate claim that the Commission's orders are inconsistent with *Northern* is similarly unfounded, as the Commission here followed the same “wait-and-see” approach as it applied in *Northern.*

***18 ARGUMENT**

I. THE COMMISSION REASONABLY DETERMINED THAT NORAM HAD JUSTIFIED ITS PROPOSED INCREASES IN PENALTIES FOR UNAUTHORIZED OVERRUNS AND OFO VIOLATIONS.

"Judicial scrutiny under the [NGA] is limited to assuring that the Commission's decisionmaking is reasonable, principled, and based on the record." *POCA,* 131 F.3d at 185. Moreover, under Section 19(b) of the NGA, 15 U.S.C. § 717r(b), the findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. As now demonstrated, the orders here satisfied these requirements in all aspects.

In concluding that NorAm had justified a need for higher overrun penalties, the Commission found, based on record evidence, that NorAm had experienced around 250 incidents -- during a single winter peak season -- of shippers taking unauthorized quantities of gas at NorAm's preexisting $10 per MMBtu penalty level. Moreover, the evidence showed that in more than 60 percent of those cases, the quantities taken by shippers exceeded the amounts authorized by 10% and, in numerous cases, unauthorized overruns by individual shippers exceeded 50% of authorized quantities. R. 5, JA 5. No party disputes these facts, which formed the basis for the Commission's conclusion that NorAm's existing unauthorized overrun penalties were not an effective deterrent to shipper abuses.

This evidence, together with other facts, then underlay the Commission's determination to approve the increases in OFO penalties. As the Commission observed, because NorAm is no ***19** longer a merchant, it cannot purchase the capacity or supply to fill in the gap when a shipper fails to follow tariff restrictions or purchase sufficient capacity and gas supply to meet its own needs. 79 FERC at 61,543, JA 160. In these circumstances, therefore, it was also logical for the Commission to infer that NorAm needed more adequate penalties to ensure the operational integrity of its system. *Id.* Moreover, although FERC recognized that NorAm's revised penalties would be significantly higher than NorAm's existing penalties, it was nonetheless reasonable to conclude these higher penalties were also likely to deter future shipper misconduct, particularly as they would also be more in line with Commission-approved penalties on other nearby pipelines. 79 FERC at 61,544, JA 161. Accordingly, these findings should be sustained.

Petitioners contend nonetheless that the record does not support NorAm's proposal to increase its OFO penalties. Br. 24-27. The assertion here is that because NorAm did not encounter a single incident in which a shipper violated an OFO during the previous 12 months before filing its proposal, the Commission could only have rationally concluded that NorAm's existing OFO penalty level was effective to deter shipper violation of OFOs. Pet. Br. 26.

The argument, however, conveniently ignores too many other salient facts. At a minimum, given NorAm's evidence showing that there had been 250 incidents of unauthorized gas takes at a time when overrun penalties were at $10 per MMBtu, it was surely ***20** logical for the Commission to infer that, if shippers were insufficiently deterred from committing unauthorized overruns at the $10 per MMBtu penalty level during periods when demand for capacity and gas was unusually high, they likewise would lack a sufficient incentive to comply with OFOs with penalties priced at that same $10 per MMBtu level. 80 FERC at 61,342, JA 194. Indeed, as the Commission observed, if NorAm were not permitted to increase its OFO penalty, its tariff would have been left with an anomalous penalty structure that penalized shippers $25 per MMBtu for ordinary overruns, but only $10 per MMBtu for overruns that occurred during emergency situations. 80 FERC at 61,343, JA 195. Additionally, the Commission was entitled to weigh the fact that the lack of an OFO crisis during the past season had been achieved in large part because of extraordinary efforts by NorAm's staff, who, during emergency periods, had called shippers continuously to ensure that they remained in compliance with the tariff. Finally, as a matter of expertise, the Commission was right to take into account that NorAm's new OFO penalty ($25 per MMBtu) would bring it more closely into line with penalties on the systems of other nearby pipelines. *Id.* As this overall predictive judgment was thus reasonably based on the evidence, petitioners' attack on that judgment should be rejected.

Tacitly acknowledging as much, petitioners further attempt to overcome this rationale by asking the Court to assume that OFOs are not in fact "related" to overruns, and that the Commission therefore should have provided an explanation as to ***21** why the two types of penalties must be identical. Br. 25-26. The record quickly subverts this claim as well. NorAm's showing in fact

established that very connection, specifically averring that "failure to comply with OFOs can result in the same type of peril to system operations and integrity as unauthorized overrun quantities ...." R. 269, JA 109. Moreover, as the Commission explained, if shippers are faced with an economic choice because of high gas prices and scarce capacity, a $10.00 per MMBtu penalty might not be a sufficient incentive to comply with NorAm's OFO directives. *See* 80 FERC at 61,342, JA 194; *accord* R. 5, JA 5. [6]

II. THE COMMISSION REASONABLY DETERMINED THAT THE RECORD IN THIS PROCEEDING DID NOT JUSTIFY REQUIRING NORAM TO CREDIT REVENUES COLLECTED FROM ITS REVISED OVERRUN AND OFO PENALTIES TO ITS CUSTOMERS.

The task of rate-setting necessarily requires the Commission to make predictive judgments about the operations and costs of regulated entities. *POCA,* 131 F.3d at 187. Although FERC must base its judgments on the evidence before it, "the Commission cannot guarantee that the results will be error-free." *Id.* That ***22** over- or under-collections of costs will occur is an accepted feature of the regime. Id., *citing Associated Gas Distribs* v. *FERC,* 898 F.2d 809, 810 (D.C. Cir. 1990).

In the orders under review, the Commission declined to require NorAm to credit penalty revenues, finding no reason to depart from its longstanding policy of allowing pipelines to retain such revenues. As the Commission explained:

> Penalties, if designed correctly, will not generate an excessive amount of revenue. The penalties here are significant and should deter overruns. There is no evidence these penalties will result in significant revenues. It is not known how much revenue the penalties will produce, but it is reasonable to assume, once the higher penalties are in place, the revenues from penalties will decrease as shippers cease incurring penalties as part of their supply strategies.

79 FERC at 61,547. As these findings fall well within the range of "predictive judgments" about ratemaking that the Commission may permissibly make, *POCA,* 131 F.3d at 187, they, too, should be affirmed.

Equally significant, the Commission took pains to assure that NorAm's customers would have adequate recourse in the event that the revised penalties approved here were to ultimately generate significant revenues for NorAm. The Commission reiterated in the May Order that it would review such revenues in a subsequent rate case filing. 79 FERC at 61,547, *citing Northern Natural Gas Co.,* 77 FERC ¶ 61,282 at 62,235 (1996) ("*Northern*"). Moreover, the Commission underscored its commitment in this regard by stating that if, in the future, it ***23** appears that NorAm's revenues have increased to a significant degree as the result of the instant penalties, the Commission would take appropriate action. 80 FERC at 61,342. Such a pledge to monitor the level of penalties obtained by pipelines, and to revisit them if the revenues should prove to be significant in the future, supports the Commission's exercise of this policy. *See POCA,* 131 F.3d at 186.

Petitioners criticize these regulatory protections because they do not require pipelines to file Form No. 2 until May 1 of the year following the calendar year for which penalty revenues are reported. Pet. Br. 20. [7] This "too little, too late" claim was not raised on rehearing before FERC, and thus cannot be raised now. UDC, 88 F.3d at 1170. In any event, given this Court's finding that the FERC's accounting regulations are adequate to allow the Commission to monitor pipeline revenues despite the fact that there might be temporary over-collections, this quibble cannot compel a different result.

Petitioners next contend that the fact that NorAm collected and retained $1.78 million in penalty revenues during the previous year should in and of itself negate the usual deference ***24** accorded the Commission's predictive judgments in penalty cases. Pet. Br. 10, 22. Assertedly, the Court should require NorAm to credit revenues generated under its revised penalties in order to avoid any risk of unjust enrichment. Pet. Br. 23.

Self-evidently, however, this argument goes too far. As the Commission recognized, the $1.8 million in penalty revenues generated over the past year at most establishes that NorAm's *former* penalty levels were set too low to deter shipper abuses.

More to the point, the Commission has also taken steps to allow NorAm to correct this very infirmity in its former penalty structure by approving the setting of penalties at much higher levels -- 2.5 times higher for OFO penalties and for overrun penalties exceeding 105% but less than 110% of authorized quantities, and five times higher for overruns exceeding 110% of authorized amounts. Should that predictive judgment of a resulting deterrence prove correct, the revenues, too, will likely disappear. [8] See *Northern Natural Gas Co.,* 78 FERC ¶ 61,355 at 62,493 (1997) ("It is incongruous to believe that shippers that were gaming the system would continue to do so in ***25** the face of" higher penalties.) Thus, this contention, too, must be rejected. [9]

Petitioners next assert that the determinations in this case are inconsistent with FERC rulings in other cases. *See* Pet Br. 15 n.38, citing, *inter alia, South Georgia Natural Gas Co.,* 63 FERC ¶ 61,190 (1993), for the proposition that "cash-out" revenues are not to be a profit center, and should therefore be credited to customers. As now explained, however, these cases involve materially different situations from the overrun and OFO penalties involved here.

"Cash-outs" are monies paid to the pipeline, in lieu of make-up gas, to liquidate imbalances that have accrued during an extended period of time (usually one month). *See Arkla Energy Resources Co.,* 64 FERC ¶ 61,166 at 62,474-80 (1993), *order on reh'g,* 65 FERC ¶ 61,343 at 62,704-06 (1993). Apart from a makeup component, cash-outs may also include a penalty component set at a level much lower than other transportation penalties, and much closer to the market price of gas. *See* ***26** *Transcontinental Gas Pipe Line Corp.,* 55 FERC ¶ 61,446 at 62,372 (1991). Because cash-outs involve compensation for makeup gas and relatively low penalties, the Commission expects them to generate significant revenues for the pipeline, and therefore, requires that they be credited to customers. *K N Interstate Gas Transmission Co.,* 76 FERC ¶ 61,112 at 61,586 (1996); *Arkla Energy Resources Co.,* 65 FERC ¶q 61,343 at 62,707 (1993); *Columbia Gas Transmission Corp.,* 64 FERC ¶ 61,365 at 63,552 (1993); *National Fuel Supply Corp.,* 61 FERC ¶ 61,357 at 62,428-29 (1992); *Transcontinental Gas Pipe Line Corp.,* 55 FERC ¶ 61,446 at 62,372 (1991). In light of its different treatment of cash-outs, the Commission has repeatedly acknowledged that "cash-outs" constitute an exception to its general policy that revenues from transportation penalties need not be credited by the pipeline. See *Northern,* 78 FERC at 62,492-93 and n. 11; *Panhandle Eastern Pipe Line Co.,* 61 FERC ¶ 61,357 at 62,429 (1992). [10]

***27** Nor does the record here suggest that NorAm's overrun penalties and OFO penalties may be likened to cash-outs. As NorAm explained, the primary purpose of the overrun and OFO penalties revised in this case is to deter shipper practices that threaten system integrity. R. 4-5, JA 4-5. They are not designed to operate like a cash-out mechanism to reconcile accumulated imbalances that have accrued over an extended period of time. Indeed, NorAm has completely separate tariff provisions authorizing NorAm to cash out monthly imbalances, and requiring NorAm to credit the revenues from cash-outs. *See* Sections 5.7 and 23.8 of the General Terms and Conditions of NorAm Gas Transmission Company's currently effective tariff. *See also Arkla Energy Resources Co.,* 64 FERC ¶ 61,166 at 62,474-80 (1993), *order on reh'g,* 65 FERC ¶ 61,343 at 62,704-06 (1993). [11] Equally noteworthy, these cash-out provisions in NorAm's existing tariff were not altered in any respect by the Commission's orders in this case. [12]

***28** Petitioners further assert that the Commission impermissibly deviated from *Northern* in approving the revised penalties without concomitantly requiring NorAm to offset rates to account for penalty revenues. Purportedly, *Northern* suggests that pipelines which have collected significant penalty revenues in the past must, in their next rate case, "establish representative levels for penalty revenues in the derivation of its rates" to ensure that the pipeline "is not unreasonably enriched by the penalties." Br. 18, *citing Northern,* 78 FERC at 62,492-93.

In *Northern,* the Commission was confronted with claims by shippers that a pipeline's proposal to increase transportation penalties required that revenues be credited to avoid unjust enrichment to the pipeline. Ultimately, the Commission rejected the demands for revenue crediting, finding that the pipeline's increased penalties were likely to deter future shipper abuses, and that penalty revenues would thus likely be insignificant because of such deterrence. 78 FERC at 62,493. As here, the Commission adopted a wait-and-see approach to whether the increased penalties would generate significant revenues before requiring revenue crediting. *Id.* Hence, if anything, *Northern* supports the outcome here.

***29** To be sure, the Commission stated in *Northern* that its "established policy is to review penalty revenues in the pipeline's *next* rate case," at which time the pipeline "can establish representative levels for penalty revenues in the derivation of its rates." 78 FERC at 62,492 (emphasis added). According to petitioners, this means that, in *this* case, the Commission should have required NorAm now to project representative levels of penalty revenues in its rates. Pet. Br. 14. Again, however, petitioners argue too much. Self-evidently, the Commission stated that it would look at the penalties in the future if it appears that NorAm's penalties were excessive. 80 FERC at 61,342, JA 194. As this is precisely what *Northern* anticipates, no more was required. [13]

Petitioners further claim that NGA § 4 is insufficient to protect customers against the possibility that NorAm will reap windfall profits from its increased penalties because NorAm has no obligation to file a new § 4 rate case. A corollary contention is that NorAm would have no incentive to file a § 4 rate case. Pet. Br. 19-20.

***30** Both contentions are specious. Self-evidently, a pipeline may be underrecovering its overall costs regardless of whether it is collecting penalty revenues, and thus may see fit at any time to file a new § 4 rate case to satisfy its higher revenue requirement. More to the point, the argument overlooks the fact that the Commission is empowered to take "appropriate action" under NGA § 5 if it appears that NorAm is generating excessive revenues as a result of being permitted to retain the revenues from penalties. *See* 80 FERC at 61,342, JA 194; *POCA,* 131 F.3d at 186-87. [14]

In any event, the fact that NorAm is under no obligation to file a § 4 rate case at any given interval does not distinguish this case from any other penalty case. Carnegie, the pipeline whose penalty retention was upheld by this Court in *POCA,* was under no obligation to file a new § 4 rate case at intervals dictated by the Commission or Carnegie's customers. The same was true in *Northern.* In any event, as explained *supra* at p. 23, n.7, NorAm, as a major pipeline, must file annual reports ***31** disclosing its yearly revenues from penalties. Thus, the Commission will have current information at its ready disposal to act promptly under NGA § 5 if and when NorAm generates excessive penalty revenues.

Finally, petitioners would analogize the potential penalty revenues in this case to pipeline "overcharges" under the NGA, for which equitable relief in the form of revenue crediting is supposedly always required. Pet. Br. 22-23. This analogy quickly fails. Penalty levels, by design, are not intended to recover the pipeline's cost of service, but to deter customer conduct inimical to the system. As this Court recognized in rejecting a similar NGA § 4 claim for penalty revenue crediting, the NGA's "just and reasonable" mandate does not require flow-through of penalty revenues in every case. *POCA,* 131 F.3d at 188. Rather, claims for penalty revenues, like refunds of overcharges, "are discretionary, not mandatory, so any claim for such relief would still be subject to question." *Id.* Thus, even if some penalty revenues are generated by NorAm's increased penalties, NorAm's customers have no automatic entitlement to these monies. Accordingly, this argument, too, should be rejected.

32** ***CONCLUSION

For the foregoing reasons, the petition for review should be denied.

Appendix not available.

Footnotes

* Authorities chiefly relied upon are marked with an asterisk.

1 "Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Wellhead Decontrol," [Regs. Preambles Jan. 1991-June 1996] FERC Stats. & Regs. ¶ 30,939 (1992), *order on reh'g,* Order No. 636-A, [Regs. Preambles Jan. 1991-June 1996] FERC Stats. & Regs. ¶ 30,950 (1992), *order on reh'g,* Order No. 636-B, 61 FERC ¶ 61,272 (1992), *reh'g denied,* 62 FERC ¶ 61,007 (1993), *aff'd in part and remanded in part,* *United Distrib. Cos.* v. *FERC,* 88 F.3d 1105 (1996), *cert. denied,* 117 S.Ct. 1724 (1997).

2 OFOs are orders "directing customers to take actions that would help keep the pipeline system in balance." *POCA* 131 F.3d at 185. In this proceeding, NorAm has described the OFO provisions of its tariff as granting NorAm "the right to require certain actions that would tend to alleviate threatened operational conditions." R. 5, JA 5.

3 Order No. 436, FERC Stats. & Regs. ¶ 30,665 (1985), *aff'd in part, remanded in part on other grounds, Associated Gas Distribs, v. FERC,* 824 F.2d 981 (D.C. Cir. 1987).

4 Alternatively, NorAm's penalty for unauthorized overruns exceeding 5% of authorized quantities would be the current market price for gas, if higher. R. 3, 28, JA 3, 29. Moreover, shippers taking unauthorized quantities less than 50 MMBTU would not be subject to any overrun penalties unless the amount taken exceeded 110% of the quantities authorized. R. 3, JA 3.

5 As the Commission explained in the May Order, "OAs are generally an informational notice to all shippers while OFOs are typically more specific." R. 377 n.2, JA 190 n.2, 79 FERC at 61,541 n.2.

6 Additionally, petitioners claim that higher OFO penalties are unwarranted because they may entice NorAm to invoke OFOs as a means to try to increase its penalty revenues. Br. 26. This argument, however, was not raised on rehearing to the Commission, and is therefore jurisdictionally barred from this Court's consideration. *See* NGA 19(b) of the NGA; *United Distribution Cos. v. FERC,* 88 F.3d at 1163, 1170. In any event, even if in the future NorAm were to issue OFOs (or impose OFO penalties) without justification, an affected customer may still file a complaint under NGA § 5 alleging that NorAm is abusing its authority to police the integrity of its system, and the Commission may, if warranted, take action against NorAm.

7 As a "major" pipeline within the meaning of the Commission's accounting regulations, NorAm is required to file an annual report (Form No. 2) that includes a statement of its revenues under Account No. XXX of the Commission's Uniform System of Accounts. That account requires pipelines to keep "in a separate account revenues from penalties earned pursuant to tariff provisions." *See POCA, citing* 18 C.F.R. Part 201 at 603 (1997). These regulations assure that the Commission will have accounting mechanisms in place to track the levels of penalties garnered by NorAm or any other pipeline. *Id.*

8 The Commission's predictive judgments about the deterrence value of NorAm's revised penalties have been borne out partially by the fact that NorAm, in its Form No. 2 filed with the Commission on May 1, 1998, reported that its penalty revenues were $236,893 for the calendar year 1997. Because NorAm's penalty increases did not go into effect until May 1, 1997, *i.e.,* after the winter heating months of early 1997, it is conceivable that its penalty revenues for calendar year 1998 will be significantly lower than the $236,893 reported for 1997.

9 *POCA* does not compel a different result either. Petitioners seek to find support for a revenue crediting requirement in the Court's statement there "that if Carnegie were to collect substantial penalties, these revenues would not be justified by the pipeline's cost of service." *See* 131 F.3d at 187 (emphasis in original). But this statement merely suggests that pipeline collection of "substantial" penalty revenues might, *if the penalties remain unchanged,* call for a cost-of-service adjustment in the pipeline's next rate case. Similarly, petitioners go too far in requesting the Court to require NorAm to "disgorge the windfall in penalty revenues it has collected." Pet. Br. 11. This claim for relief was never made to FERC.

10 At Br. 15, petitioners also seek to find inconsistency in the Commission's decision not to require NorAm to credit revenues from its revised OFO penalties, asserting that the Commission imposed such a requirement on a pipeline in *Williams Natural Gas Co.,* 78 FERC ¶ 61,342 at 62,466 (1996). This claim is not properly before the Court because petitioners did not raise it on rehearing, and thus this Court does not have jurisdiction to consider it. *See* UDC, 88 F.3d at 1170, NGA § 19(b). In any event, the Commission in *Williams* did not impose any revenue crediting of OFO penalties on that pipeline. Rather, without opposition from any party or any analysis of the likelihood of significant OFO penalty revenues, the pipeline in *Williams voluntarily proposed* to credit OFO penalty revenues, and the Commission then accepted William's revenue crediting proposal in the face of unanimous support by its customers. Here, in contrast, NorAm did not initially propose to credit OFO penalty revenues, but rather has sought to continue the *status quo ante* under which NorAm was permitted to retain any OFO penalties it might collect. In these circumstances, *Williams* is simply inapposite.

11 At the time that its cash-out mechanism became part of its tariff, NorAm did business under the name "Arkla Energy Resources Company."

12 At Pet. Br. 15 n.38, petitioners rely on two additional cases, *Colorado Interstate Gas Co.,* 69 FERC ¶ 61,081 (1994) ("*CIG*"), and *United Gas Pipe Line Co.,* 64 FERC ¶ 61,015 (1993) ("United"), in support their claim of a purported Commission policy that favors revenue crediting of imbalance penalties. Both of those cases, however, involved the crediting of revenues from "cash-out" imbalances only. *See CIG* 69 FERC at 61,332 (citing an earlier order issued on April 22, 1993 in *Colorado Interstate Gas Co.,* 63 FERC ¶ 61,101 at 61,558-59 (1993), requiring crediting of cash-out revenues); *see also United,* 64 FERC at 61,135. Accordingly, these cases are likewise inapposite.

13 Petitioners also quibble with language differences between the orders under review and the orders in *Northern,* suggesting that, unlike the situation in *Northern,* a customer on NorAm has no assurance that the excess revenues from penalties will be addressed in the next rate case. Br. 20. Inasmuch as the Commission expressly relied on the *Northern* orders in ruling that the question of excess

penalty revenues could be examined in NorAm's next rate case, 79 FERC at 61,547 and n.17, JA 383 n.17, this claim should be rejected as frivolous.

14 Petitioners themselves acknowledge that individual customer may always file a complaint under NGA § 5. Br. 20. That provision applies to any individual customer claim that NorAm has wrongly assessed a penalty, or to a more general claim that penalty revenues have become a significant source of revenue to NorAm. Petitioners nonetheless consider a § 5 complaint to be unfair because it is "time-consuming." Br. 20. Complaints, however, are the Congressionally chosen avenue for redress under the NGA. See *Mobil Oil Exploration & Producing Southeast v. United Distrib, Cos.,* 498 U.S. 211, 229 (1991). In any event, in the absence of any evidence that the Commission has failed to act promptly on a complaint about excessive penalty revenues, petitioners' concerns amount to rank speculation.

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