# NOTE

# THE *OZARK* CASES: PROJECT FINANCING AND THE FERC'S NATURAL GAS PIPELINE MANAGEMENT INCENTIVES

## I. INTRODUCTION

In *Public Service Commission of New York v. FERC*[1] (*Ozark I*) and *Ozark Gas Transmission System v. FERC*[2] (*Ozark II*), the United States Court of Appeals for the District of Columbia reviewed distinct aspects of project financing. The cases, arising from separate Federal Energy Regulatory Commission (FERC or Commission) orders involving Ozark Gas Transmission System (Ozark), concerned the appropriate solution to the declining rate base problem[3] (the "levelized annuity approach") and the maximum interruptible transportation rate and the minimum revenue crediting conditions for open-access transportation.[4] These issues reflect attempts by the Commission to mold project financing to better fit a policy of lower natural gas prices through market competition.

The FERC has imposed requirements on project-financed pipelines that are intended to act as incentives for prudent management[5] and for maximizing throughput.[6] The Commission's actions are in part due to revisions in policy resulting from changes in gas supply conditions—conditions that previously made project financing viable. However, the requirements may now prevent project-financed pipelines from competing effectively or recovering a reasonable return on equity. This note explores the risks faced by project-financed pipelines as a result of these requirements.

## II. PROJECT FINANCING IN THE NATURAL GAS PIPELINE INDUSTRY

### *A. The Concept of Project Financing*

Project financing represents an alternative to a conventional financing arrangement; the two methods differ primarily in the manner in which a loan obligation is secured. With conventional debt financing, the loan may be

1. 866 F.2d 487 (D.C. Cir. 1989).

2. 897 F.2d 548 (D.C. Cir. 1990).

3. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,142 (1987) [hereinafter Opinion No. 273], *order on reh'g*, 41 *F.E.R.C.* ¶ 61,207 (1988) [hereinafter Opinion No. 273-A], *remand granted*, Public Service Commission of New York v. FERC, 866 F.2d 487 (D.C. Cir. 1989), *order on remand*, Ozark Gas Transmission Sys., 50 *F.E.R.C.* ¶ 61,252, *order granting in part and denying in part rehearing*, 53 *F.E.R.C.* ¶ 61,451 (1990).

4. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105 (1987), *remand granted*, Ozark Gas Transmission Sys. v. FERC, 897 F.2d 548 (D.C. Cir. 1990) (no order on remand).

5. *Ozark*, 50 F.E.R.C. ¶ 61,252, at 61,766.

6. *Ozark*, 39 F.E.R.C. ¶ 61,105, at 61,362.

secured by "sufficient unencumbered assets that the lender feels secure in making a loan on the basis of the borrower's general credit"[7]—the general creditworthiness condition. Alternatively, where there are insufficient unencumbered assets, the loan may be secured by "the pledge of specific assets to be funded by the borrowing as collateral"[8]—the sufficient "economic value of the assets to be funded" condition. Where utilities fail to meet either of these preconditions to conventional financing, project financing may be an alternative.

With project financing, "the stream of income to be generated by the project"[9] represents the security for the loan obligation. A portion of the income is allocated through the rate design to recover both debt principal and interest payments even in the event of failure of the project.[10]

Project financing is not unique to the natural gas industry; however, its attributes were particularly conducive for use in pipeline financing in the late 1970s and early 1980s. With natural gas in short supply, the Commission became receptive to the financing of projects even when utilities lacked general creditworthiness and the assets to be financed were not of sufficient economic value to secure loan obligations. The obligation of the Commission to guarantee a long-term supply of natural gas to customers and declining gas supplies were the key factors to the Commission's decisions to permit the use of project financing.[11]

The FERC recognized a presumption that pipelines would lack assets of sufficient economic value to secure loans. The Commission reasoned that "the salvage value of the pipeline to be built should, in all cases, be less than the loan obligation."[12]

The standard to determine whether project financing would be permitted with the inherent risks involved was a cost-benefit analysis. In conventional financing, the sponsors assume the risk of failure as the result of their guarantee of the debt. In project financing, part of the risk of failure shifts to the consumers.[13] Due to the inherent risks to consumers and in spite of the favorable presumption, pipelines requesting project financing had the burden to demonstrate public convenience and necessity and benefit to the public interest before they could obtain authority to operate under section 7(c) of the Natural Gas Act (NGA).[14] The cost-benefit standard articulated by the Commission in order to satisfy this burden was "whether the probable benefits to the consumers of the project sought to be certificated equal or exceed its probably costs to them."[15]

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7. Ozark Gas Transmission Sys., 16 F.E.R.C. ¶ 61,099, at 61,195 (1981) [hereinafter Opinion No. 125].

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.* at 61,196.

12. *Id.* at 61,195.

13. *Id.* at 61,196.

14. 15 U.S.C. § 717f(c) (1988).

15. Opinion No. 125, 16 F.E.R.C. ¶ 16,099, at 61,196 (1981).

### *B. The Minimum-Bill Rate Design of Project Financing*

The difference in the source of debt security between project financing and conventional financing accounts for the difference in the underlying rate designs and the creation of a "minimum bill." The rate design for conventionally financed pipelines serves the purpose of recovering the "costs of doing business including a reasonable rate of return" on undepreciated investment.[16] The rate design for project-financed pipelines serves not only that purpose, but additionally provides the security for the loan obligation.[17] Therefore, the rate design for project-financed pipelines must contain a guaranteed recovery of debt service costs unlike rate designs for conventionally financed pipelines.

The guaranteed recovery of debt service costs to provide the security for project financing requires a two-part rate design and a minimum bill. The two-part rate design consists of separate demand and commodity charges. The demand charge is a fixed monthly charge and relates "to the customer's basic entitlement to receive gas."[18] This charge is assessed regardless of actual throughput to firm customers who "have a contractual right to demand specified quantities of gas on peak days."[19] In Ozark's rate design, the demand charge constituted a minimum bill. The commodity charge relates to the actual volume of gas delivered and is based on a per unit cost.[20] This charge is based on actual throughput to all customers, including both firm customers, and interruptible customers who have no contractual entitlement.

The manner in which fixed and variable costs are allocated to the separate charges, and in particular to the minimum bill, guarantees the project-financed pipeline's recovery of debt service costs. Variable costs are those that depend upon the volume of gas transported; these costs are recovered through the commodity charge.[21] Fixed costs "include the costs the pipeline incurs as a result of owning the facilities, such as debt, depreciation, return on equity and related income taxes, and other taxes such as property taxes, and certain costs of maintaining and operating the facilities."[22] Depending on the rate formula, fixed costs may be recovered through the demand charge alone or through both the demand charge and the commodity charge.[23]

Ozark's demand charge recovered not only operating and maintenance expenses and "taxes other than income,"[24] but most importantly for project financing, debt service costs—"an allowance to amortize the debt principal and the interest cost of debt."[25] Ozark's commodity charge recovered "return on equity, depreciation expense related to equity, and income taxes."[26] The minimum bill's guaranteed recovery of debt service costs provided the security

16. W. FOX, JR., FEDERAL REGULATION OF ENERGY § 16.09, at 463 (1983).
17. *See* Opinion No. 125, 16 F.E.R.C. ¶ 61,099 (1981).
18. Consolidated Gas Supply Corp. v. FPC, 520 F.2d 1176, 1180 (D.C. Cir. 1975).
19. *Id.*
20. *Id.*
21. *Id.*
22. Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,698 (1987).
23. *Consolidated Gas*, 520 F.2d at 1180.
24. Opinion No. 125, 16 F.E.R.C. ¶ 61,099, at 61,194 (1981).
25. *Id.*
26. *Id.*

for project financing: "In the event the project were to fail, the minimum bill would be levied on the customers of the shippers in the form of a surcharge for gas they do not receive."[27]

### C. *The Declining Rate Base*

A utility's rate base and authorized rate of return determine the return on investment and individual rates. The conventional rate base consists of the original cost of the plant[28] funded by a mixture of debt and equity devoted to public service,[29] less annual depreciation and deferred taxes.[30] An overall rate of return, representing the weighted rate of return on debt and rate of return on equity, is established by the Commission on a case-by-case basis.[31] The allowed return is then calculated by multiplying the utility's rate base by the authorized rate of return. The return is then included in the cost of service[32] and is apportioned through rates to the service classifications.

An alternative method to calculate rate base, the "*Ozark* methodology,"[33] has been adopted by the Commission for project financing to account for the minimum bill's financing of debt. The *Ozark* methodology differs from the conventional method primarily in the treatment of debt capital and deferred income taxes. Under the conventional method of reducing the rate base for deferred income taxes (DITs), the DITs are attributed to both equity and debt in proportion to their relative contribution to overall capital.[34] On the other hand, the *Ozark* methodology establishes an equity-only rate base, which is calculated by "subtracting deferred income taxes . . . and debt from the net rate base [i.e., gross plant less accumulated depreciation plus working capital]."[35] The Commission contended that an equity-only rate base is appropriate for project financing because the debt is financed through the payment of the demand charge.[36]

A declining rate base is a problem that if not remedied may produce an increase in the allowable rate of return on equity and may result in rates that might be deemed excessive. A "day one" rate base, consisting of the total investment at the beginning of the rate period, will decline during the remainder of period that the rates are in effect if no adjustment is made for annual depreciation and deferred income taxes.[37] Reductions in the initial rate base caused by annual depreciation and deferred income taxes are typically offset

27. *Id.* at 61,195.

28. AMERICAN GAS ASSOCIATION, 2 REGULATION OF THE GAS INDUSTRY § 30.33[9] (1990).

29. *Id.* at § 25.03[2][a].

30. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,764 (1990).

31. W. FOX, JR., FEDERAL REGULATION OF ENERGY § 16.09, at 463 (1983). The overall rate of return may include a component related to preferred stock. This component is treated for all practical ratemaking purposes as debt.

32. Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,698 (1987).

33. Ozark Gas Transmission Sys., 32 F.E.R.C. ¶ 63,019 (1985).

34. AMERICAN GAS ASSOCIATION, 2 REGULATION OF THE GAS INDUSTRY § 30.33[9] (1990).

35. Trailblazer Pipeline Co., 50 F.E.R.C. ¶ 61,188, at 61,588 (1990).

36. *Id.* at 61,594. For a critique of the *Ozark* methodology *see id.* at 61,594-97.

37. Opinion No. 125, 16 F.E.R.C. ¶ 61,099, at 61,194 (1981).

by the investment required for expansions to facilities.[38] The Commission contends that, if the decline in the rate base is not offset due to lack of major additions to facilities and the rates remain constant, a real rate of return on equity in excess of that authorized may result.[39] The Commission further claims, that the rates, though unchanged, might then be excessive and violate NGA section 4(a) as being unjust and unreasonable.

## III. THE *OZARK* CASES

### *A. Background*

Ozark lacked general creditworthiness and the assets to be funded were not of sufficient economic value to secure loan obligations when it applied for a NGA section 7(c) certificate of public convenience and necessity to transport natural gas in the Arkoma Basin. Although it "made only a marginal case for project financing,"[40] Ozark demonstrated that "the probable benefits to the consumers of the project sought to be certificated equal[ed] or exceed[ed] its probable costs to them."[41] In Opinion No. 125, the Commission found that project financing of Ozark's pipeline was in the public interest.

### *B.* Ozark I: *The Declining Rate Base Solution*

#### 1. Opinion Nos. 273 and 273-A: The Rate of Refiling Requirement

The nature of Ozark's system created the potential of a declining rate base and rates that could generate revenues in excess of the authorized rate of return. Ozark's sole function was transportation;[42] pipelines such as Ozark that only transport natural gas "require no major additions to plant,"[43] i.e., offsets to the declining rate base. Because there would be no offsets to Ozark's declining rate base, the Commission believed that Ozark's real rate of return on equity would exceed that originally authorized for the pipeline and the rates for the period would become unjust and unreasonable.[44]

In Opinion Nos. 273[45] & 273-A,[46] the Commission chose to remedy Ozark's declining rate base by requiring Ozark to file for periodic rate reviews. Rates can be reviewed if the Commission requires a change in rates under NGA section 5,[47] or if a pipeline files for a rate change under NGA section 4.[48] Under section 5, the Commission initiates the rate review; however, the relief is prospective only.[49] The Commission claimed that prospective relief

38. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,764 (1990).
39. *Id.* at 61,763 n. 2, 61,764.
40. Opinion No. 125, 16 F.E.R.C. ¶ 61,099, at 61,198 (1981).
41. *Id.* at 61,196.
42. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,764 (1990).
43. *Id.*
44. *Id.* at 61,763 n.2, 61,764-65.
45. Opinion No. 273, 39 F.E.R.C. ¶ 61,142 (1987).
46. Opinion No. 273-A, 41 F.E.R.C. ¶ 61,207 (1988).
47. 15 U.S.C. § 717d (1988).
48. 15 U.S.C. § 717c (1988).
49. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,765 (1990). That is, any change is effective when the Commission issues an order determining the just and reasonable rates.

would not provide adequate protection from excessive rates charged before the rate revision.[50] Under section 4, the pipeline initiates the rate review for periodic rate increases. The Commission reasoned that Ozark would have little incentive to file under section 4.[51] Therefore, in its attempt to protect consumers, the Commission required Ozark to make a rate filing pursuant to section 4 every three years.[52]

Having imposed the three-year filing requirement, the Commission rejected the use of an "average rate base" proposed by intervenor Public Service Commission of New York (PSCNY) to remedy Ozark's declining rate base.[53] Unlike the day-one rate base, the average rate base approach "averages the rate base for the periods the rates are expected to be in effect," and "reflects the expected decline of the rate base due to depreciation and deferred income taxes over the effective rate period."[54]

### 2. *Ozark I*

In *Ozark I*, the D.C. Circuit Court of Appeals reviewed petitions by both Ozark and PSCNY concerning the appropriate remedy to the declining rate base problem. Ozark claimed that the Commission lacked the authority to require periodic rate filings under section 4.[55] PSCNY claimed that the Commission's rejection of the average rate base methodology was arbitrary and capricious.[56]

The court of appeals rejected the use of periodic rate filings as the appropriate and lawful remedy to the declining rate base problem. The court found no statutory or judicial basis that would give the Commission the authority to impose a periodic rate refiling requirement in Ozark's situation.[57]

The court of appeals did not address the Commission's rejection of the PSCNY's proposed average rate base. The court noted that the FERC's decision in Opinion Nos. 273 and 273-A was based on the adoption of the rate refiling as the appropriate solution.[58] An analysis of the average rate base methodology was left to the order on remand.

A remand was necessary to remedy Ozark's declining rate base. The court accepted PSCNY's "substantial evidence" of Ozark's declining rate base over Ozark's "vague objections."[59] The case was remanded in order that the FERC "consider appropriate and lawful solutions."[60] Upon remand, the Commission adopted the levelized annuity methodology as the solution to the

50. Opinion No. 273, 39 F.E.R.C. ¶ 61,142, at 61,512 (1987).
51. *Id.*
52. *Id.*
53. Opinion No. 273, 39 F.E.R.C. ¶ 61,142, at 61,512; Opinion No. 273-A, 41 F.E.R.C. ¶ 61,207, at 61,567.
54. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,765 (1990).
55. *Ozark I*, 866 F.2d 487, 490 (D.C. Cir. 1989).
56. *Id.*
57. *Id.* at 490-92.
58. *Id.* at 490.
59. *Id.* at 493.
60. *Id.* at 490.

declining rate base.[61] The levelized annuity methodology will be discussed in Part IV, section D below.

### C. Ozark II: *The Open-Access Transportation Conditions*

#### 1. Order No. 436 and Blanket Certificate Transportation

The key factors in the Commission's decisions permitting project financing, i.e., declining gas supplies and the corresponding obligation to ensure consumers of a secure, long-term supply of natural gas,[62] changed dramatically during the early to mid-1980s. This was a period of excess gas deliverability.[63] Consequently, the Commission attempted to foster competition in order to achieve lower gas prices for consumers.

Competition was encouraged through Order No. 436's[64] "open-access" transportation policy which was intended to reduce the regulation of transportation through the issuance of blanket transportation certificates. Prior to Order No. 436, pipelines were required to obtain a NGA section 7(c) certificate of public convenience and necessity for each transaction. Order No. 436 created the "blanket" certificate of public convenience and necessity, which eliminated the need for prior approval of each transaction by introducing self-implementing interstate transportation service.[65] Acquiring the advantages offered by a blanket certificate was conditioned largely on the pipeline's agreeing to provide transportation on a non-discriminatory basis—allowing open access to the pipeline.

The issuance of blanket transportation certificates was controlled by Order No. 436, which implemented regulations that directly conflicted with the two-part rate design guaranteeing project financing. Section 284.7(d)[66] expressly precluded a two-part rate design by requiring full allocation of costs. It stated:

> [A]ny rate filed for service subject to this section must be a one-part rate that recovers the costs allocated to the service to the extent that the projected units of that service are actually purchased and *may not include a demand charge, a minimum bill* or minimum take provision or any other provision *that has the effect of guaranteeing revenue.*[67]

Section 284.7(d) was intended as an incentive to maximize throughput. Pipelines were required to fully allocate costs—including those that might be recovered through demand charges—to both firm and interruptible transpor-

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61. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,766-68 (1990).

62. Opinion No. 125, 16 F.E.R.C. ¶ 61,099, at 61,196 (1981).

63. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105, at 61,360 (1987).

64. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regulations Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,665 (1985), *modified*, Order 436-A, [Regulations Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,675 (1985), *modified further*, Order 436-B, III F.E.R.C. Stats. & Regs. ¶ 30,688, *reh'g denied*, Order 436-C, 34 *F.E.R.C.* ¶ 61,404, reh'g denied, Order No. 436D, 34 F.E.R.C. ¶ 61,405, *reconsideration denied*, Order No. 436-E, 34 *F.E.R.C.* ¶ 61,403 (1986), *vacated and remanded sub nom.*, Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied sub nom.*, 485 U.S. 1006 (1988).

65. Trailblazer Pipelines Co., 39 F.E.R.C. ¶ 61,103, at 61,326 (1987).

66. 18 C.F.R. § 284.7 (1990).

67. *Id.* (emphasis added). A reservation fee is permissible.

tation. The FERC reasoned: "If the pipeline fails to actually transport the projected level used in designing its system rates, it will fail to earn its full allowed return on equity; if it is able to transport more than its projected level, it will exceed its allowed return."[68] Section 284.7(d) would, therefore, promote competition by encouraging maximum use of the transportation system.[69]

Although the FERC was willing to waive the requirements of section 284.7(d), it imposed conditions on the waiver that would also serve as incentives to maximize throughput. Recognizing the advantages of a blanket transportation certificate, Ozark requested a waiver of section 284.7(d).[70] Ozark claimed that any allocation of demand charges to interruptible transportation would fail to provide the debt security required for project financing and would result in an automatic default under the terms of the pipeline's loan.[71] The Commission argued that it was in the public interest to waive the requirements of section 284.7(d) and grant a blanket certificate.[72]

However, conditions designed to maximize throughput and encourage competition were attached to the waiver. These conditions were intended to ensure that conventionally financed pipelines were not unfairly disadvantaged and that Ozark's firm shippers did not subsidize interruptible shippers.[73] Firm shippers would be charged the minimum bill. Interruptible shippers would be charged their fully allocated costs including transmission-related fixed costs formerly recovered in the demand charge. The maximum interruptible transportation rate would be based on a 100% load-factor usage.[74] Any demand-related revenues collected from interruptible shippers would be credited to firm shippers.[75]

### 2. The Maximum Interruptible Transmission Rate Condition

The non-discriminatory policy of Order No. 436 requires that costs, including fixed costs, be allocated to all service classifications including interruptible transportation. Prior to Order No. 436, the Commission did not always require that pipeline costs be allocated to interruptible transportation due to its minor importance.[76] With the emergence of interruptible transportation as a significant service in the pipeline industry, the Commission decided that interruptible shippers should be treated equally.[77] Equality included rates based on "costs properly allocated to the service" pursuant to 284.7(d). Interpreting the phrase "costs properly allocated," the Commission held that "pur-

68. Trailblazer Pipeline Co., 39 F.E.R.C. ¶ 61,103, at 61,326 (1987).

69. *Id.*

70. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105 (1987). *See also Trailblazer*, 39 F.E.R.C. ¶ 61,103; Northern Border Pipeline Co., 39 F.E.R.C. ¶ 61,104 (1987).

71. *Ozark*, 39 F.E.R.C. ¶ 61,105, at 61,359.

72. *Id.*

73. *Id.* at 61,361-62.

74. *Id.* at 61,361. The 100 % load factor rate is equivalent to the per unit cost that a firm shipper would pay if it transported its full, i.e., 100%, entitlement.

75. *Id.*

76. Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,702 (1987).

77. *Id.*

suant to section 284.7(d)(4), it is reasonable for a pipeline to fully allocate all its transmission-related fixed costs, whether classified as demand or commodity, to interruptible transportation."[78]

To maintain equality between firm and interruptible services, the allocation of transmission-related fixed costs to interruptible shippers requires a rate comparable to that paid by firm shippers; to this end, the Commission formulated the 100% load factor rate. Prior to Order No. 436, the interruptible rate was equal to the firm commodity rate; revenue collected from interruptible transportation was credited to firm shippers.[79] The full allocation requirement meant that the new interruptible rate had to incorporate a per unit cost for the fixed costs that were previously paid by the firm shippers. However, the per unit cost that a firm shipper incurs varies with the amount of throughput.[80] A firm shipper is obligated to pay all demand-related fixed costs associated with the capacity to which it is entitled under contract.[81] If the firm shipper takes its full entitlement, i.e., at 100% load factor, the costs are spread over the greatest volume and the per unit cost is the least. Because the firm shipper is obligated to pay all demand-related fixed costs associated with its entitlement, the less gas transported the less volume there is over which to spread the costs.[82] The per unit cost increases as the actual volume transported decreases. On the other hand, the interruptible shipper is responsible only for the fixed costs associated with the capacity it actually uses.[83] In this sense, the interruptible shipper is comparable to the firm shipper which uses 100% of its entitlement. The Commission held:

> [T]he interruptible rate is equivalent to the per unit cost a firm customer would incur if it transported gas at its full capacity entitlement every day of the year, i.e., if it transported gas at a 100 percent load factor. Thus, the per unit cost of transporting gas an interruptible customer bears will be the same as the per unit cost the firm customer bears if it uses its entitlement fully.[84]

In spite of the arguments against the use of the 100% load factor rate,[85] the Commission held it "to be appropriate for interruptible transportation by pipelines providing service under Order No. 436."[86] The Commission believed that this method would recover fully all costs allocated to interruptible service. Yet, the "100 percent load factor rate ensures that [the interruptible customer] will pay no more than it would as a firm customer."[87] It provides the interruptible shipper with the least expensive cost-based rate that a firm shipper would pay.

The Commission gave Ozark permission to selectively discount its maximum interruptible transportation rate if Ozark believed that doing so would

78. *Id.* at 61,703.
79. *Id.* at 61,702.
80. Northern Natural Gas Co., 37 F.E.R.C. ¶ 61,272, at 61,814 (1987).
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *See* Texas E. Pipeline Co., 37 F.E.R.C. ¶ 61,260, at 61,703-05 (1987).
86. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105, at 61,361 (1987).
87. Wyoming Interstate Co., 34 F.E.R.C. ¶ 61,340, at 61,634 (1986).

make the pipeline more competitive. Following past precedent, the Commission adopted the 100% load factor to set Ozark's maximum interruptible transportation rate at 55¢ per Mcf[88]—the rate that Ozark's firm shippers would pay if they took full entitlement. Ozark proposed a maximum rate of 22.5¢ per Mcf; it alleged that a higher rate would make it non-competitive.[89] The Commission found no basis for Ozark's proposal, but suggested that Ozark could choose to discount the interruptible rate.[90] However, selective discounting had adverse implications for Ozark when coupled with the Commission's minimum revenue crediting condition.

3. The Minimum Revenue Crediting Condition

The concurrent recovery of a portion of the demand-related costs from interruptible services under Order No. 436 and of all demand-related costs from firm shippers through the minimum bill necessitated a revenue-crediting provision in order to prevent overrecovery of costs.[91] The minimum bill paid by Ozark's firm shippers recovered demand-related costs attributable to interruptible shippers. The Commission required Ozark to "credit at a minimum an amount equal to per unit demand costs for every Mcf of blanket certificate transportation to the firm shippers demand charge billings and reservation fees."[92] Although Ozark agreed that revenue crediting was necessary, the credit proposed by Ozark differed substantially from that adopted by the Commission.

The maximum interruptible transportation rate adopted by the Commission resulted in a substantially higher credit to be paid to the firm-service customers. The interruptible transportation rate prior to full allocation was equal to the firm commodity rate.[93] The difference between the previous interruptible rate and the new maximum interruptible rate, therefore, should represent the fully allocated per unit demand-related costs that should be credited to the firm shippers. The firm commodity rate for Ozark's firm shippers was 16.28¢ per Mcf.[94] Based on Ozark's proposed maximum interruptible rate of 22.5¢ per Mcf, Ozark would credit 6¢ per Mcf to the firm service. The Commission rejected Ozark's proposed maximum interruptible rate as being subjective and "lacking factual support."[95] The Commission rejected Ozark's proposal to credit approximately 6¢ per Mcf of throughput to the firm shippers' demand charge.[96] The Commission's maximum interruptible rate based on 100% load factor usage of approximately 55¢ per Mcf[97] required that Ozark credit approximately 37¢ per Mcf to the firm service.[98]

88. *Ozark*, 39 F.E.R.C. ¶ 61,260, at 61,360.
89. *Id.*
90. *Id.* at 61,362.
91. *Id.*
92. *Id.* at 61,361 (citation omitted).
93. Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,702 (1987).
94. *Ozark*, 39 F.E.R.C. ¶ 61,105, at 61,359 (1987).
95. *Id.*
96. *Id.* at 61,359.
97. *Id.* at 61,360.
98. *Ozark II*, 897 F.2d 548, 551 (D.C. Cir. 1990).

The 55¢ per Mcf maximum interruptible transportation rate, coupled with the requirement that deficiencies in revenue credits due to discounting be made up from equity, placed Ozark in a commercially unreasonable position. Based on Ozark's subjective belief that the competitive interruptible rate was 22.5¢ per Mcf, the Commission gave Ozark permission to discount the interruptible rate.[99] However, Ozark was still required to credit 37¢ per Mcf for every Mcf of blanket transportation.[100] This meant that, if Ozark chose to discount the interruptible rate below 37¢ per Mcf, the deficiency would be made up from Ozark's equity capital.[101]

The Commission's crediting provision was intended to act as an incentive to maximize throughput and to prevent subsidization of interruptible shippers by firm shippers.[102] The risk of equity funds would be avoided by the generation of revenues in excess of the minimum credit that would result from near maximum throughput.

### 4. *Ozark II*

Ozark's objection to the revenue-crediting condition resulted in the FERC vacating Ozark's blanket transportation certificate and the appeal in *Ozark II.* Ozark feared that revenue crediting would result in a default under the terms of its loan because it would cause a reduction in demand-charge revenues.[103] Additionally, Ozark argued that in order to be competitive it would have to either (1) charge a maximum interruptible transportation rate in excess of comparable rates in order to recover the minimum credit; or (2) discount the rate to be more competitive and be liable for any deficiency in the credit.[104] The FERC rejected Ozark's arguments, holding that without the minimum revenue-crediting condition, Ozark would overrecover costs.[105] The Commission held, therefore, that Ozark's blanket transportation certificate would not serve the public convenience and necessity.[106] Ozark appealed the vacation on the grounds that the conditions attached were unreasonable.[107]

The D.C. Circuit Court of Appeals held that the maximum interruptible transportation rate and minimum revenue-crediting conditions were not justified nor reasonably tailored to the objective or promoting fair competition.[108] The only discernable basis that the court could find for these conditions was uniformity in treatment by the Commission.[109] The court held that these conditions were unreasonable because they would actually hinder competition in the Arkoma Basin and create a monopoly in the remaining pipelines.[110] The

99. *Ozark*, 39 F.E.R.C. ¶ 61,105, at 61,361-62.
100. *Id.*
101. *Id.* at 61,361.
102. *Id.*
103. Ozark Gas Transmission Sys., 43 F.E.R.C. ¶ 61,012, at 61,038 (1988).
104. *Id.*
105. *Id.*
106. *Id.* at 61,039.
107. *Ozark II*, 897 F.2d 548, 551-553 (D.C. Cir. 1990).
108. *Id.* at 553.
109. *Id.*
110. *Id.*

court recognized an absurdity in relaxing statutory requirements for project-financed pipelines in order to promote competition while at the same time imposing additional requirements that would restrict competition.[111]

The court of appeals also rejected the Commission's suggestions that Ozark should first attempt to renegotiate its loan terms that conflicted with section 284.7(d) before requesting a waiver.[112] The Commission opposed Ozark's proposals because Ozark had not attempted to seek a waiver of default provisions in its loan agreements.[113] The court, and even the Commission, recognized that the maximum interruptible rate and the minimum revenue crediting conditions could coerce a project-financed pipeline into renegotiating the terms of its loan.[114] However, the court held that "[i]t makes no sense for FERC to urge Ozark to seek restructuring of its financing, since FERC approved the financing arrangement in the first place."[115] Renegotiation of loans was held to be an unreasonable condition.

The Commission has not issued any order upon remand of *Ozark II*.

## IV. DISCUSSION

### *A. Similarly Situated Utilities*

The *Ozark* cases and the order upon remand have affected other project-financed pipelines that comprise critical portions of pipeline systems. Examples of companies whose hearings and arguments before the Commission parallel those of Ozark include Northern Border Pipeline Company (Northern Border), Overthrust Pipeline Company (Overthrust), Wyoming Interstate Company, Ltd. (WIC) and Trailblazer Pipeline Company (Trailblazer).

Northern Border is a project-financed pipeline which comprises the eastern leg of the Alaskan Natural Gas Transmission System extending from Monchy, Saskatchewan, Canada to Ventura, Iowa.[116] Like Ozark, Northern Border requested a waiver of the requirements of section 284.7(d) in its application for a blanket transportation certificate.[117] The Commission responded with the maximum interruptible transportation rate and minimum revenue crediting conditions. Unlike Ozark, Northern Border was able to accept the blanket certificate.

Overthrust, WIC and Trailblazer are project-financed pipelines which respectively comprise the western, central and eastern portions of the Trailblazer Pipeline System extending from Uinta County, Wyoming to Beatrice, Nebraska.[118] The Commission, as it did with Ozark and Northern Border, imposed the maximum interruptible transportation rate and minimum revenue crediting conditions on Trailblazer's and Overthrust's blanket transporta-

111. *Id.* at 552.
112. *Id.*
113. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105, at 61,360 (1987).
114. *Ozark II*, 897 F.2d at 552.
115. *Id.*
116. Northern Border Pipeline Co., 39 F.E.R.C. ¶ 61,104, at 61,343 (1987).
117. *Id.* at 61,345.
118. Trailblazer Pipeline Co., 39 F.E.R.C. ¶ 61,103, at 61,321 (1987).

tion certificates.[119] These certificates were later vacated by the Commission.[120] In addition, the levelized annuity rate base approach was imposed upon and objected to by both Trailblazer and Overthrust.[121]

### *B. 100% Load Factor Maximum Interruptible Rate and Minimum Revenue-Crediting*

The revenue-crediting condition places Ozark in a commercially unreasonable position due to the combined effects of the maximum interruptible transportation rate and the risk to equity as the result of selective discounting. The use of the fully allocated maximum interruptible rate based on 100% load factor usage would give Ozark no alternative other than to discount to a more competitive rate. In doing so, Ozark would put itself at risk due to any revenue deficiencies.

The full allocation of demand-related costs to interruptible service has been met with opposition.[122] The court in *Ozark II* rejected full allocation as being necessary in this situation.[123] The court recognized merit in Ozark's proposed credit based on a lower maximum interruptible rate.[124] However, Ozark's proposed lower rate is not based on full allocation of costs, but rather on competition. To make exceptions to full allocation without justification could thwart the nondiscriminatory policy underlying blanket transportation and market competition. On the other hand, competition and project financing might be defeated for the sake of iron-clad adherence to full allocation without regard to the particular situation.

The use of the 100% load factor to set the maximum interruptible rate has also been opposed.[125] Ozark's proposed interruptible rate was subjective and based on what Ozark felt was necessary to be competitive. On the other hand, the 100% load factor provides an objective basis to setting rates. However, opponents contend that, among other things, it is "unreasonably high, considering the inferior nature of interruptible service as compared to firm."[126] The Commission's response to these objections has been selective discounting.[127] The issue is unsettled.

The disparate application of revenue crediting to conventionally financed and project-financed pipelines arises from the incentives that revenue crediting was intended to create in open-access transportation. Order No. 436 rejected the use of revenue crediting because it created no incentives for conventionally

119. *See Trailblazer*, 39 F.E.R.C. ¶ 61,103 (1988); Overthrust Pipeline Co., 44 F.E.R.C. ¶ 61,077 (1988).

120. *See* Trailblazer Pipeline Co., 43 F.E.R.C. ¶ 61,013 (1988); Overthrust Pipeline Co., 45 F.E.R.C. ¶ 61,196 (1988).

121. *See* Trailblazer Pipeline Co., 50 F.E.R.C. ¶ 61,188 (1990); Overthrust Pipeline Co., 53 F.E.R.C. ¶ 61,118 (1990). *See infra* Part IV, section D.

122. *See* Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,698-703 (1987).

123. 897 F.2d 548, 553 (D.C. Cir. 1990).

124. *Id.* at 552.

125. *See* Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260 at 61.703-05 (1987).

126. AMERICAN GAS ASSOCIATION, 2 REGULATION OF THE GAS INDUSTRY § 35.04[2] (1990).

127. Trailblazer Pipeline Co., 39 F.E.R.C. ¶ 61,103, at 61,324 (1987).

financed pipelines to "provide access to the commodity market."[128] However, in a situation like Ozark's where the pipeline is at risk for equity, the revenue crediting provides an incentive to maximize throughput.[129]

The minimum crediting condition serves to aggravate the problem already created by the maximum interruptible rate. The requirement that any deficiency in revenue crediting created by discounting be made from equity capital stems from the Commission's intention of protecting customers of firm shippers.[130] If the minimum bill was not credited to the full extent of interruptible service, any deficiency in crediting would be passed along. The customers of the firm shippers would then subsidize interruptible shippers. In this manner, the revenue crediting serves a valid purpose. Yet, the Commission in it orders vacating the blanket certificates recognized the D.C. Circuit's previous opposition to the use of revenue crediting conditions to adjust "previously approved rates for services not before it in the certificate proceeding."[131]

### *C. Loan Renegotiation*

*Ozark II* leaves in question the possibility that in some instances loan renegotiation might be a reasonable condition to the waiver of section 284.7(d). The court of appeals held that "requiring Ozark to seek renegotiation of its loan agreements with a third-party lender is not a reasonable condition to obtaining a waiver, especially where, as here, the agreement of many lenders would be required."[132] Past experience with willing lenders might make loan renegotiation a more feasible and, therefore, reasonable condition.

A project-financed pipeline's lenders might be willing to renegotiate the terms of the loans. In imposing a similar requirement upon Northern Border, the Commission stated that the pipeline had "been successful in the past in renegotiating terms under its loan agreements with its lenders."[133] No showing was made that Ozark's lenders would have been unwilling to renegotiate.

Strictly adhering to financing arrangements developed under prior conditions and precluding renegotiation ignores the impact that changes in those conditions have made on Commission policy. The court of appeals held that the Commission could not require restructuring of financing the Commission had approved.[134] Changing conditions necessarily alter the Commission's policies. One example is the emergence of interruptible transportation as a significant service which induced the corresponding change in the interruptible rate.[135] The Commission stated that "[t]he conditions that existed when the Commission established this policy no longer exist."[136] A key factor to the

128. Northern Border Pipeline Co., 39 F.E.R.C. ¶ 61,104, at 61,345 (1987).

129. Ozark Gas Transmission Sys., 39 F.E.R.C. ¶ 61,105, at 61,362 (1987).

130. *Id.* at 61,362.

131. Trailblazer Pipeline Co., 43 F.E.R.C. ¶ 61,013, at 61,040 (1988), quoting Northern Natural Gas Co. v. FERC, 827 F.2d 779, 795 (D.C. Cir. 1987)

132. 897 F.2d 548, 553 (D.C. Cir. 1990).

133. Northern Border Pipeline Co., 36 F.E.R.C. ¶ 61,283, at 61,707 (1986).

134. *Ozark II*, 897 F.2d at 552.

135. *See infra* Part III, section C, subsection 2.

136. Texas E. Transmission Corp., 37 F.E.R.C. ¶ 61,260, at 61,702 (1987).

Commission permitting project financing—declining gas supplies[137]—no longer exists. The Commission should not be constrained to follow policies that were appropriate when natural gas supplies were low.

### *D. The Levelized Annuity Approach to the Declining Rate Base*

Upon remand from *Ozark I*, the Commission considered alternative solutions to excessive returns on equity that might result from a declining rate base, including PSCNY's proposed average rate base treatment; the Commission adopted the "levelized annuity methodology."[138] The levelized annuity approach "reflects the decline in rate base over time"[139] by "levelizing the rates over the life of the project."[140] The methodology begins by determining the *Ozark* rate base as follows:

> The rate base is calculated for each year of the life of the project by taking the original cost of the plant and subtracting the amount of accumulated depreciation expense and accumulated deferred taxes in each year. Additionally in a project-financed pipeline the equity rate base for each year is determined by subtracting all outstanding debt from the total rate base.[141]

A monthly commodity charge that produces the return on equity is then calculated:

> The annual return on equity is the equity rate base multiplied by the cost of equity capital. The present value of the return on equity and tax allowance (two of the components of the commodity charge for project-financed pipelines) is computed by taking the sum of all positive and negative annual returns on equity and their associated tax allowances (discounted to present value at the rate equal to Ozark's cost of equity capital) for the life of the project. An annual annuity is then computed which, when discounted over the life of the project using the same rate, would generate the same present value.[142]

The Commission preferred the levelized annuity approach over the PSCNY's average rate base treatment and its potential problems. The levelized annuity approach is similar to the average rate base treatment in that both reflect "the decline in rate base over time."[143] However, the levelized annuity approach was designed to avoid potentially extreme fluctuations in the return that could result from the use of the average rate base.[144] The most extreme fluctuations could result from negative and positive returns on the equity-only rate base established by the *Ozark* methodology.[145] A negative equity-only rate base, and a negative return, may result from the "combined effects of greater accumulated depreciation, deferred taxes and outstanding debt."[146] The levelized annuity approach levelizes the rates by incorporating

137. Opinion No. 125, 16 F.E.R.C. ¶ 61,099, at 61,196 (1981).
138. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252 (1990).
139. *Id.* at 61,766.
140. *Id.*
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.* at 61,766-67.
145. *Id.*
146. *Id.* at 61,766.

both negative and positive returns in the annuity determination.[147] In addition, the Commission contended that the levelized annuity, unlike the average rate base treatment, is not inconsistent with Commission regulations that require certain data be filed for major rate changes.[148]

The levelized annuity approach was also designed to act as an incentive for prudent pipeline management.[149] Because the approach prevents equity owners from recovering their investment in the early stages of the project, they must "manage the pipeline prudently for the remainder of the pipeline's life."[150]

The Commission's adoption of the levelized annuity approach has been met with opposition from project-financed pipelines, including Ozark,[151] Trailblazer[152] and Overthrust,[153] and from the Interstate Natural Gas Association of America (INGAA).[154] The arguments purport that the levelized annuity approach is contrary to basic ratemaking principles, the FERC's own regulations, the Natural Gas Act and case law.

First, opponents contend that the levelized annuity approach is contrary to ratemaking principles embodied in the Commission's regulation section 154.69.[155] They claim that this regulation requires rates be established by analyzing test period data.[156] Rather than basing rates on known or reasonably expected conditions, Trailblazer contended that "the [levelized annuity] approach is dependent upon too many projections of future events regarding matters such as discount rates, taxes, project life, Commission policy, gas markets, and gas flows."[157] Opponents suggest that such a discriminatory departure from the prescribed requirements of Commission regulations requires a reasoned explanation.

On the other hand, the Commission's position is that the levelized annuity approach is not contrary to section 154.69. Its interpretation is that "section 154.69 dos not establish rate design;" it "merely sets forth data filing requirements."[158] Furthermore, these filing requirements do not prohibit the use of a "forward-looking methodology such as . . . the levelized annuity approach."[159] The Commission's response to the claimed departure from section 154.69 has been, in the first instance, to place the burden of showing that

147. *Id.*

148. *Id.* at 61,767-68.

149. *Id.* at 61,767; Trailblazer Pipeline Co., 50 F.E.R.C. ¶ 61,188, at 61,591 (1990).

150. *Ozark*, 50 F.E.R.C. ¶ 61,252, at 61,767.

151. Ozark Gas Transmission Sys., 53 F.E.R.C. ¶ 61,451 (1990).

152. Trailblazer Pipeline Co., 50 F.E.R.C. ¶ 61,188 (1990).

153. Request for Rehearing and Clarification of Overthrust Pipeline Co., Overthrust Pipeline Co., 53 F.E.R.C. ¶ 61,118 (1990) (No. RP85-60-000).

154. Request of Interstate Natural Gas Association of America for Rehearing, Ozark Gas Transmission Sys., 53 F.E.R.C. ¶ 61,451 (1990) (No. RP84-53-011).

155. 18 C.F.R. § 154.63 (1990).

156. *See Trailblazer*, 50 F.E.R.C. ¶ 61,188, at 61,591; Request at 6, *Ozark* (No. RP84-53-011); Request at 37-40, *Overthrust* (No. RP85-60-000).

157. *Trailblazer*, 50 F.E.R.C. ¶ 61,188, at 61,591.

158. *Id.*, at 61,598.

159. Ozark Gas Transmission Co., 50 F.E.R.C. ¶ 61,252, at 61,768 (1990).

the projections are not accurate on the pipeline.[160] Then, if the projections in fact do not prove to be accurate, to point out one avenue of relief—"file a section 4 rate case with the Commission."[161]

The use of projected conditions raises opponents' second contention—that the levelized annuity approach's assumption that the rate base will perpetually decline circumvents requirements of section 5 of the NGA.[162] Opponents allege that by setting the rates on projected, rather than known, conditions, the Commission avoided its section 5 duty. Under section 5, the Commission is obligated to monitor changes in known conditions under which initial rates were set in a section 4 proceeding.[163] If the Commission believes that rates have become excessive, the Commission must initiate a rate hearing. Opponents claim that imposing rates in a section 4 proceeding based on projected conditions is an attempt by the Commission to avoid its duty to revise rates through a section 5 proceeding.

The requirements of section 5 raise opponents' third contention—that the levelized annuity approach, if at all, may only be applied prospectively. Generally, section 5 permits only prospective, not retroactive, application of any rate change.[164] Ozark, therefore, argued that requiring refunds to customers would be an abuse of discretion.[165] In response, the Commission cited an exception to prospective-only application of section 5.

The retroactive application of rate changes depends upon the propriety of the application of the "legal error" exception. Rates may be applied retroactively "when the Commission commits a legal error that unlawfully delays the time as of which it establishes a corrected rate under section 5."[166] The Commission held this to be the situation with Ozark. The INGAA contended that the exception constitutes a remedy which is not applicable to a mere adoption of the levelized annuity approach. Case law has established that a finding of unjust and unreasonable rates must be made before any remedy is required.[167] The INGAA pointed out that the Commission has made no showing of a need for this remedy having previously established a just and reasonable rate for Ozark.[168]

Fourth, opponents contend that the levelized annuity approach, coupled with the *Ozark* equity-only rate base methodology, prevents a utility from earning a sufficient return on investment.[169] The INGAA has claimed that depriving a pipeline of the opportunity to earn a fair rate of return violates

160. *Trailblazer*, 50 F.E.R.C. ¶ 61,188, at 61,598.

161. *Id.*

162. *See* Request at 7-8, *Ozark* (No. RP84-53-011); Request at 36-37, *Overthrust* (No. RP85-60-000).

163. Request at 7-8, *Ozark* (No. RP84-53-011); Request at 36-37, *Overthrust* (No. RP85-60-000).

164. *Ozark*, 53 F.E.R.C. ¶ 61,451, at 62.589 (1990).

165. *Id.* at 62,585.

166. *Id.* at 62,589, quoting Transwestern v. FERC, 897 F.2d 570, 578 n. 5 (D.C. Cir. 1990).

167. Request at 8-14, *Ozark* (No. RP84-53-011), discussing Office of Consumers' Counsel v. FERC, 826 F.2d 1136 (D.C. Cir. 1987), and Tennessee Valley Municipal Gas Association v. FPC, 470 F.2d 446 (D.C. Cir. 1972).

168. Request at 11-12, *Ozark* (No. RP84-53-011).

169. Trailblazer Pipeline Co., 50 F.E.R.C. ¶ 61,188, at 61,591 (1990). *See also* Request at 4-6, *Ozark* (No. RP84-53-011).

priniciples established by the Supreme Court in *FPC v. Hope Natural Gas*,[170] and *Bluefield Water Works & Improvements Co. v. Public Service Commission*.[171] The Commission rejected such arguments and contended that approach merely levelizes the return over the life of the project. In doing so, the Commission claimed, the approach precludes the recovery of return on equity in the first years to such an extent that equity investors would have no incentive for subsequent prudent management.[172] The INGAA has raised the concern, however, that there is no guarantee that a sufficient return on equity will be realized in later life of the project to compensate for the diminished return in the early years.[173] The potential exists that unforeseeable conditions might prevent recovery. For instance, as the INGAA suggested, the Commission might change the rate base approach in the future and not allow the full recovery of the return. This approach also assumes that the project will be in existence for its projected life and makes no provision in the event it should not.

## V. CONCLUSION

The vacation of blanket transportation certificates and the imposition of the levelized annuity approach threaten the viability of project financing as it is now structured. The conditions imposed by the FERC were intended as incentives to attain the immediate goals of maximum throughput and prudent management. However, these conditions potentially preclude the attainment of the FERC's ultimate goal—lower natural gas prices through increased competition. By making investment in project-financed pipelines less attractive, the pipelines and the critical pipeline system legs that they serve are at risk, thereby, threatening competition.

*Douglas B. Anderson*

170. 320 U.S. 591 (1944).
171. 262 U.S. 679 (1923).
172. *Trailblazer*, 50 F.E.R.C. ¶ 61,188, at 61,597-98.
173. Request at 4-5, *Ozark* (No. RP84-53-011).