UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

PIPELINE RATES:

Before Commissioners: Martin L. Allday, Chairman; Charles A. Trabandt, Elizabeth Anne Moler, Jerry J. Langdon and Branko Terzic.

Tarpon Transmission Company) Docket No. RP84-82-004 (Remand)

ORDER AFFIRMING IN PART AND MODIFYING IN PART
INITIAL DECISION

(Issued December 26, 1991)

This order affirms in part and modifies in part an initial decision issued in this proceeding on July 3, 1991. 1/ The instant proceeding was instituted under section 5 of the Natural Gas Act (NGA) pursuant to a Commission order issued April 18, 1990 to determine whether the rates of Tarpon Transmission Company (Tarpon) are just and reasonable. 2/ The principal issues addressed by the initial decision of the Administrative Law Judge (ALJ) are: (1) whether the unique rate redetermination methodology set forth in a contract between Tarpon and Trunkline Gas Company (Trunkline) should continue to be used for Tarpon's rate redeterminations; (2) whether Tarpon has fully collected its investment in plant such that it should no longer earn a rate of return on that investment or collect a depreciation allowance, (3) whether Tarpon should instead be permitted to collect a management fee; and (4) the reasonableness of Tarpon's proposed increases in its cost of service with respect to operating costs such as salaries and fringe benefits, rental costs, supplies, and regulatory costs. The Commission is affirming the initial decision in part and reversing it in part. The Commission generally affirms the ALJ's holding that Tarpon's existing rates are unjust and unreasonable as Tarpon has fully recovered its investment in its gas transmission plant. However, as discussed below, the Commission reverses certain of the ALJ's findings concerning Tarpon's cost-of-service.

<u>Background</u>

Tarpon is a 40-mile offshore pipeline operating in the Gulf of Mexico. Tarpon provides transportation of natural gas

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1/ Tarpon Transmission Company, 56 FERC ¶ 63,001 (1991).

2/ 51 FERC ¶ 61,042, <u>reh'g denied</u>, 51 FERC ¶ 61,310 (1990).

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supplies produced from offshore natural gas reserves owned primarily by Trunkline; Tarpon transports these supplies to an interconnection with Trunkline's pipeline system. Trunkline was Tarpon's principal firm transportation customer from the time Tarpon started service in 1978 until mid-1991. Tarpon also provides interruptible open access transportation services under a Part 284 blanket certificate.

Tarpon and Trunkline entered into a Transportation agreement on February 15, 1977. That contract, as amended from time to time, governed the relationship between Tarpon and Trunkline, until Trunkline terminated the contract effective July 1, 1991. The contract has also served as Tarpon's tariff with the Commission. Section 10.5 of that contract provides for adjustments to Tarpon's rates at certain stated intervals. It provides that "rate determinations shall be based upon a cost of service for the entire life of the reserves transported and to be transported..., taking into consideration actual revenues collected to date." 3/ Section 10.5 thus provides for Tarpon's rates, and its depreciation methodology, to be based on a life-

3/ Section 10.5 provides: 10.5 Rate Adjustment. Trunkline or Tarpon, upon the giving of ninety (90) days written notice to the other prior to the end of the second (2nd), fourth (4th), sixth (6th), eighth (8th), or tenth (10th) years of the primary term hereof, may request that the unit rate currently being utilized to determine the monthly charge and other charges or credits be decreased or increased to reflect changes in costs and/or gas reserves connected to the system. Such rate determinations shall be based upon a cost of service for the entire life of the reserves transported and to be transported pursuant to the Agreement and to other agreements Tarpon may enter into for the utilization of subject facilities, taking into consideration actual revenues collected to date or to be collected prior to the effective date of such unit charge; and such rate shall be calculated in the same manner as used in the calculation of the initial rate hereunder.

of-the-reserves methodology. 4/ The instant case centers on whether the rate redetermination methodology established in Section 10.5 should continue to be used to determine Tarpon's rates.

This proceeding has its genesis in the March 1984 filing by Tarpon, in Docket No. RP84-82-000, to reduce its transportation rate from 18.10 cents to 16.88 cents per Mcf. By order issued July 16, 1984, the Commission accepted the rate decrease filing after suspending it for one day, and allowed the rate to become effective July 10, 1984, subject to refund. 5/ Tarpon prepared a cost of service study supporting its proposed 1984 rate reduction. Hearings were held, and on October 20, 1987, the Commission issued Opinion No. 287, 6/ which reversed an earlier initial decision determining that the filed rate of 16.88 cents was just and reasonable.

The Commission concluded in Opinion No. 287 that the purpose of section 10.5 is to enable Tarpon to collect, and its ratepayers to pay, as closely as possible Tarpon's actual cost of service for the life of the project. However, the Commission concluded that Article 10.5 only adjusts future rates for past over- or underrecoveries of out-of-pocket expenses. The Commission found that the adjustment provision did not apply to the past recovery of investment costs through depreciation expense. Stating that investment is a sunk cost which cannot be over- or underrecovered due to erroneous cost projections, the Commission rejected Tarpon's contention that the aim of Tarpon's tariff is to provide even recovery of depreciation expense over the life of the property through retroactive adjustments of the depreciation rate to reflect changes in the estimated life of the reserves attached to the Tarpon system. 7/ The Commission

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4/ Under this method, the pipeline's costs are recouped based on the estimated reserves of the system rather than the calendar years that those reserves are estimated to be in production. Thus, if 1,000,000 Mcf of production are anticipated over a 10-year period, the pipeline's rates will be calculated so that its capital investment will be fully recovered when 1,000,000 Mcf are transported without regard to whether that occurs in a shorter or longer period than the anticipated 10-year time frame. The life-of-the-reserves method has also been called the unit-of-production method.

5/ 28 FERC ¶ 61,027 (1984).

6/ 41 FERC ¶ 61,044 (1987) reh'g denied, 42 FERC ¶ 61,050 (1988) (Opinion No. 287).

7/ Id. at p. 61,136.

determined that any adjustments to Tarpon's depreciation rates pursuant to section 10.5 should be made prospectively only.

This ruling resulted in Tarpon's transportation rate being substantially lower than if the changes in the depreciation rate had been applied retroactively as well as prospectively. The original projection of both the life, and total amount, of the project's reserves had been significantly lower than actually proved to be the case. A retroactive adjustment to depreciation expenses to reflect the higher actual reserves of the project would have reduced the total amount of accrued depreciation, thus resulting in a significantly higher current rate base. This would have increased Tarpon's allowed return on equity and associated taxes.

The Commission's ruling on section 10.5, together with certain adjustments to Tarpon's operating costs, resulted in a rate of 4.02 cents per Mcf. 8/ Tarpon appealed the Commission's Opinion Nos. 287 and 287-A to the United States Court of Appeals for the District of Columbia Circuit. On October 25, 1988, the court remanded the case to the Commission. 9/ The court concluded that the Commission had not adequately explained its construction of section 10.5 as not permitting a retrospective adjustment to depreciation to reflect the project's increased life. In the Commission's April 18, 1990 remand order, and in the two related 1990 orders on rehearing (the 1990 remand orders), the Commission concluded that section 10.5 should, as Tarpon contended, be construed as applying retrospectively as well as prospectively to all costs, including depreciation, and the Commission thus concluded that the 16.88 cents per Mcf rate should be reinstated. 10/

The Commission explained the consequences of its order as follows:

> Tarpon's theory fulfills section 10.5's goal of retrospectively reshaping the parties' relationship "as so as to approximate that which they would have constructed at the outset had they possessed perfect knowledge." It does this by recalculating the depreciation rate ab initio "to get the appropriate depreciation allowances and return on investment for both past and future

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8/ 51 FERC ¶ 61,310 at p. 62,027 (1990).

9/ Tarpon Transmission Co. v. FERC, 860 F.2d 439 (D.C. Cir. 1988).

10/ 51 FERC ¶ 61,042 (1990), reh'g denied, 51 FERC ¶ 61,130 (1990), and reh'g denied, 52 FERC ¶ 61,330 (1990).

> periods" . . . [T]his method does not result in Tarpon's earning a return on previously collected investment. The retrospective calculation of the depreciation rate results in a lower depreciation expense in the calculation of past costs of service. The revenues formerly attributed to depreciation expense are transformed into return and tax expense dollars ab initio. Hence, Tarpon will not be earning a future return on investment already collected. 11/

The Commission's April 18, 1990 order therefore resulted in a significant increase in Tarpon's rate when the 16.88 cent rate was reinstated in 1990. However, the Commission concluded that this would not mean that Tarpon would overrecover its lifetime cost-of-service if section 10.5 were properly applied:

> Tarpon's interpretation is not contrary to the revenue crediting mechanism. That mechanism requires that revenues already collected be deducted from the lifetime cost of service and refers to aggregate revenues and not individual items. Because of that mechanism, Tarpon will collect no more than its actual investment and a return thereon which reflects the goal of the tariff of enabling Tarpon to earn a lifetime return as if the parties had possessed perfect information from the beginning. 12/

The Commission affirmed these conclusions in its two orders on rehearing. However, the Commission also instituted the current section 5 proceeding, finding such an investigation into Tarpon's rates to be appropriate in light of, among other things, the fact that shippers other than Trunkline are now using, or desire to use, Tarpon's facilities. The Commission directed the parties to address the following issues:

A. Does Article X, section 10.5, of the Tarpon-Trunkline Agreement ("Agreement") still govern Tarpon's rate redeterminations, and, if it does, is it unjust and unreasonable?

B. If necessary, what method should be used in lieu of Article X, section 10.5?

C. Is Tarpon's reinstated rate unjust or unreasonable in light of current facts, such as new reserve estimates?

11/ 51 FERC ¶ 61,042 at p. 61,086.

12/ Id.

D. What is the appropriate treatment of Tarpon's overrecoveries if its rates are to be derived under a new method? 13/

A hearing was conducted in this proceeding and the initial decision issued on July 3, 1991. Briefs on exceptions were filed on August 2, 1991, and briefs opposing exceptions on August 22, 1991. 14/ As in the initial decision, this order addresses the four questions in the Commission's remand order. This order also addresses a large number of cost-of-service issues raised by the parties, concludes that Tarpon's existing rates are too high, and requires Tarpon to file a reduced rate to be effective not later than January 1, 1992.

Summary of the Initial Decision

The initial decision addressed each of the issues raised by the Commission's April 18, 1990 order, and decided certain cost-of-service issues as well. The administrative law judge (ALJ) concluded that, on its face, section 10.5 of the Tarpon-Trunkline Agreement no longer applies to Tarpon's rate determinations, and that Tarpon's current rate is unjust and unreasonable. On this latter point the ALJ found that Tarpon's Form 2A reports indicate that Tarpon has fully recovered, and in fact has substantially overrecovered, its gas transmission rate base and its allowed return. 15/ The ALJ therefore determined that Tarpon was entitled to no further depreciation or return on equity. The ALJ denied Tarpon any transitional rate base 16/ and concluded that Tarpon's rates should be determined on a traditional cost-of-service method. The ALJ also determined that Tarpon's overrecovery of its depreciation costs should be used as an offset for proposed dismantling costs of $832,000, and that such costs had not been included in its cost of service to date.

13/ 51 FERC at p. 61,087.

14/ The following filed both briefs: Anadarko Petroleum Corporation and Chevron U.S.A. Inc. (Anadarko/Chevron), Oryx Energy Co. (Oryx), the Commission Staff, Tarpon, and Trunkline.

15/ The Form 2A report is the annual accounting report filed with FERC by small gas pipelines. Accrued depreciation of gas utility plant is reflected on page 219 of the report.

16/ A transitional rate base would permit Tarpon to continue to have some lower level of depreciation to mitigate the sharp reduction in cash flow that would result if Tarpon's gas transmission rate base is reduced to zero prospectively.

Since the ALJ had determined that Tarpon is not entitled to any prospective return on investment, the ALJ adopted a management fee in lieu of return to compensate Tarpon's owners for the ongoing risks involved in operating the pipeline, and to create incentives for efficient operation. Based on the method suggested in Wyoming-California Pipeline Company (WyCal), 17/ the ALJ permitted a management fee of not more than 10 percent of Tarpon's historical annual average pre-tax return, exclusive of salaries. In addition, the ALJ determined that Tarpon's proposed allowance for salaries was excessive, and limited it to the salaries underlying the reinstated rate of 16.88 cents per Mcf. Allowances for pensions and benefits were based on the same limited amounts. The ALJ also concluded that Tarpon's rental payments are too high, and limited those to the average cost of those payments over the life of the project, or some $60,000. The ALJ also concluded that Tarpon's proposed regulatory costs improperly included non-recurring costs related to this litigation, and accordingly he reduced the regulatory cost element in Tarpon's proposed annual cost of service, and determined that the litigation costs related to this proceeding should be amortized over 10 years rather than the three years requested by Tarpon. The ALJ also reduced Tarpon's proposed allowance for materials and supplies to the average level of the costs of those payments over the life of the project.

Discussion

In this order, the Commission affirms in part and reverses in part the ALJ. The Commission first addresses the continued application of section 10.5 of the agreement between Tarpon and Trunkline. The Commission agrees with the ALJ's interpretation of section 10.5 as not applying to any current or future redeterminations of Tarpon's transportation rates. Thus, there is no longer any contractual agreement between Tarpon and Trunkline that the methodology specified in that section should be used to determine Tarpon's rates. The Commission then determines that, for a number of reasons discussed below, the section 10.5 rate redetermination methodology is inconsistent with current Commission policies concerning transportation rates and results in unjust and unreasonable rates. Accordingly, the Commission holds that Tarpon's rates should instead be determined pursuant to the Commission's traditional test period methodology in which Tarpon's cost of service and throughput are projected and Tarpon is at risk for underrecoveries.

The Commission then considers whether, in light of the above holding concerning the section 10.5 rate redetermination methodology, Tarpon's existing 16.88 cent rate is just and reasonable. The Commission finds that that rate is unjust and

17/ 44 FERC ¶ 61,001 at p. 61,008 (1989).

unreasonable based primarily on its affirming of the ALJ's determination that Tarpon has already fully recovered its gas transmission plant, but on grounds different than those used by the ALJ. As explained below, the Commission reaches this result through strict application of the terms of section 10.5. The Commission also concludes that, since section 10.5 does not provide for rate redeterminations after 1988, there is no basis to require Tarpon to return the amounts which a new section 10.5 rate redetermination performed in 1990 would show Tarpon had overrecovered pursuant to the 16.88 cent rate. Since Tarpon's present tariff does not now provide for the return of such overrecoveries, any requirement that Tarpon return them would constitute a retroactive change in Tarpon's rates which the Commission cannot order under NGA section 5.

Finally, the Commission discusses the other cost of service and throughput issues raised by the parties. For the most part the Commission affirms the ALJ's findings on these issues. Thus, the Commission concludes that Tarpon's cost of service is overstated in a number of respects and the volumes on which its rates are based should be increased. The Commission requires Tarpon to make a compliance filing to establish new rates consistent with this order, and to make those rates effective not later than January 1, 1992.

A. Should Tarpon's Rates continue to be Determined Pursuant to the Section 10.5 Methodology?

1. As a matter of contractual interpretation, did the parties intend that section 10.5 control Tarpon's future rate determinations?

Tarpon excepts to the ALJ's interpretation of section 10.5 of the Tarpon/Trunkline agreement as no longer controlling Tarpon's future rate determinations. The other parties support the ALJ's conclusion in this regard. The Commission affirms the initial decision's conclusion that section 10.5 no longer applies.

Tarpon argues that section 10.5 should be interpreted as continuing to apply to its rate determinations because this will effect the intention of the parties that Tarpon's costs be recovered over the entire life of the pipeline. This would permit the recovery of Tarpon's costs on the basis of perfect foresight, i.e., any retrospective adjustment of the rate base would reflect costs over the entire life of the pipeline just as if the parties had known those costs at the time that the Trunkline/Tarpon contract was executed. Therefore, Tarpon argues, continued application of section 10.5 would preserve investor expectations at the time the contract was executed. Tarpon also asserts that its construction is consistent with the mandate of the Court of Appeals, which found that the parties intended to depart from normal ratemaking practices in adopting section 10.5. Tarpon also asserts that its position here is consistent with the analysis adopted by the Commission's remand orders, and that the ALJ's refusal to apply the interpretation of section 10.5 adopted in those orders is not reasoned decision-making. The effective maximum transportation rate under Tarpon's interpretation would be 19.92 cents per Mcf rather than the 16.88 cents per Mcf rate now in effect. 18/

The opposing parties argue that on its face section 10.5 provides for the expiration of that section on July 1, 1988, and that no further extensions were ever executed by the parties. In this regard, Oryx points out that the parties amended the contract on May 21, 1986, to permit an additional redetermination upon 90 days written notice prior to the expiration of the 10th year of the contract. Oryx and Anadarko/Chevron also note that Trunkline has terminated its agreement with Tarpon effective July 1, 1991. 19/ In light of Trunkline's action and the specific language of the agreement, Oryx, Trunkline, and the Staff argue that there are no investor expectations for the continued application of section 10.5. They assert that this is particularly the case given the uncontroverted testimony of Trunkline's witness Kennedy that no continued application of section 10.5 was intended.

The Commission agrees with the initial decision that section 10.5 of the Trunkline/Tarpon agreement expired by its own terms as of July 1, 1988. Section 10.5 provides for rate redeterminations only at stated intervals during "the primary term" of the Tarpon-Trunkline agreement. Article XV of the agreement provided that the primary term of the contract would end 10 years from the date of the first delivery of gas under the contract. Since the first delivery occurred in July 1978, the primary term ended on July 31, 1988. As originally executed by the parties, the agreement permitted Tarpon or Trunkline, by the giving of 90 days notice, to request biannual rate redeterminations only through the first eight years of the primary term, so that the last rate redetermination would have been in 1986. Since the reserves to which Tarpon is attached were originally projected to have a life of 8.25 years, this would have permitted rate redeterminations through the projected life of the reserves. However, by 1986 the reserves were projected to last through 1999. In light of this fact, the parties amended the contract in 1987 to permit one additional redetermination during the last year of the primary term. They did not, however, extend the primary term of the contract itself,

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18/ See Exh. 7A (Drennan) at p. 9.

19/ See Exh. No. 14A, at p. 17, lines 10-15 (corrected); Tr. 2603 (McGee); Tr. 1995 (Carpenter).

and therefore that primary term and the right to rate redeterminations, expired on July 31, 1988.

Furthermore, as permitted by Article XV of the agreement, Trunkline gave the necessary notice to terminate the entire agreement effective July 1, 1991. Thus, not only is section 10.5 plain on its face that Tarpon and Trunkline had the right to such rate redeterminations only through 1988, the agreement as a whole is no longer in effect. Therefore, Tarpon cannot have any contractual right to further rate redeterminations under section 10.5.

Tarpon's arguments for the continued applicability of section 10.5 are based essentially on its assertion that the overall purpose of section 10.5 was to permit Tarpon to recover its costs on the basis of perfect foresight. Tarpon would thereby recover precisely those costs it would have recovered if the parties had known in 1978 the actual life of the reserves and the total volumes to be transported over Tarpon. Tarpon contends, in essence, that the only way this purpose can be achieved is through allowing section 10.5 to govern the determination of Tarpon's rates for the full life of the reserves. It also argues that its investors relied on such continued rate redeterminations when they invested in the project.

The chief difficulty with Tarpon's argument is that it is contrary to the plain meaning of section 10.5. If the parties had intended the rate redetermination provisions of section 10.5 to remain in effect for Tarpon's entire useful life, they could have written the contract so to provide when they originally executed the contract. As discussed above, they did not. Furthermore, by 1986 when the parties amended the contract they were aware that substantial additional reserves had been discovered that would last at least until 1999. Despite this knowledge, the parties only provided a right for a 1988 rate redetermination and did not extend the primary term of the contract beyond that date. 20/ The Commission concludes that these facts demonstrate that the purpose of section 10.5 was not so broad as Tarpon claims. Rather, these facts support the testimony of Trunkline's witness Kennedy that the purpose of the redetermination clause was primarily to protect against the possibility that the reserves would be exhausted more quickly than originally anticipated with the result that Tarpon would fail to recover its costs and the return on equity anticipated

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20/ See Tr. 2616-18 (McGee); Exh. 181, Sch. 1 (McGee).

when the investment was made. 21/ The provision for rate redeterminations during the primary term of the contact, which approximated the original projected life of the reserves, accomplished this purpose by ensuring that if the life of the reserves was shorter than projected Tarpon could redetermine the rates so as to nevertheless recover its costs. However, rate redeterminations after the projected life of the reserves were not needed to protect against the possibility of a failure to recover the amounts anticipated when the investment was made, since those amounts would of necessity be fully recovered once the projected volumes used to calculate the original rates had been transported. Therefore the absence of a provision for such redeterminations once its primary term had expired is consistent with the purpose of the agreement.

Since the parties specifically elected not to extend the primary term of the contract beyond July 31, 1988, or provide a right to request rate redeterminations after that date, the Commission agrees with the opposing parties that the investors could not have reasonably relied on continued rate redetermination after 1988. Accordingly, there are no investor expectations here that merit protection. Tarpon's owners were on notice as to when the right to redetermination would expire, and in any event faced the loss of the entire contract once notice to cancel could be lawfully provided by Trunkline. Both these events have occurred.

Tarpon's argument notwithstanding, the result here is not inconsistent with the Court of Appeal's earlier observation that Tarpon's tariff was a departure from normal ratemaking practices. While this is true, the agreement to use a different type of tariff for a specified period of time does not mean that the parties necessarily intended to use that tariff for the entire life of the project. Such a conclusion would override the specific language contained in the contract that section 10.5 would not control Tarpon's rate redeterminations after July 1, 1988. Tarpon's testimony and argument that section 10.5 should continue to apply as a matter of equity, and to preserve the intentions of the parties, is without merit.

The Commission concludes that there is no longer any contractual requirement that Tarpon's rates be established pursuant to the section 10.5 methodology. The Commission therefore turns to the question of whether the section 10.5 rate

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21/ See Ex. No. 146 at pp. 5, 7-9. Mr Kennedy represented Trunkline during the contract negotiations and participated in the first modification of the anticipated throughput in 1981, the first year in which it became apparent that reserves Tarpon services would be greater than anticipated.

redetermination methodology is just and reasonable and consistent with Commission policy.

(2) Whether rates based on section 10.5 are consistent with Commission policy.

Tarpon argues on exceptions that the ratemaking methodology of section 10.5 is consistent with the Commission's Rate Design Policy Statement 22/ and supports allocative efficiency, and should therefore still be used to design Tarpon's rates, regardless of whether the contract itself requires continued use of that methodology. All the other parties disagree with this assertion. The Commission concludes that the rate redetermination methodology in section 10.5 of the Trunkline/Tarpon contract and the corresponding portion of Tarpon's tariff are unjust and unreasonable in current circumstances, and for that reason may not be used for any of Tarpon's pending or future rate redeterminations.

In the first place, as the court pointed out in Tarpon v. FERC, supra, section 10.5 allows Tarpon to enjoy an interest-free loan as a result of any overrecoveries it receives prior to a rate redetermination. This is because, while section 10.5 requires that the prior revenue overrecoveries be credited against the costs to be recovered through the redetermined rates, the revenue crediting provision contains no adjustment for the value enjoyed by Tarpon by virtue of its overcollections in the previous years. In particular, there is no requirement that Tarpon pay carrying charges on these amounts. Thus far, Tarpon's rates determined pursuant to section 10.5 have consistently been based on an underestimated life, and total amount, of the reserves attached to Tarpon. Thus, Tarpon's rates have consistently resulted in overrecoveries on which Tarpon has not been required to pay carrying charges. In fact, the testimony submitted by Trunkline's witness Kennedy, together with the financial data submitted by those parties opposing the continued use of section 10.5, establishes that Tarpon's construction of section 10.5, and its continued application, will lead to substantial overrecoveries. 23/ Thus, section 10.5 has not, in economic effect, achieved what Tarpon describes as its intended purpose of reaching the same result which would have been reached if the parties had had perfect foresight in 1978.

22/ Interstate Natural Gas Pipeline Rate Design, et al., 47 FERC ¶ 61,295 (1989), order on reh'g, 48 FERC ¶ 61,122 (1989).

23/ See Exh. No. 163 (WJW-12), which states that applying only a 16.88 cent rate, rather than the 19.92 cent rate sought here, would result in net cash flows in excess of Tarpon's cost of service of $2,845,902 by the year 2002.

More importantly, Tarpon has been an open access transporter since April 1, 1988. It thus now has multiple and changing customers, rather than the single customer that it had when the Trunkline-Tarpon agreement was executed. Under section 10.5, past over- or underrecoveries are returned, or billed, to Tarpon's current customers. So long as Tarpon had a single customer, Trunkline, this was fair, since past overrecoveries would of necessity be returned to the same customer that had paid them and similarly underrecoveries would be paid by the customer on whose behalf they were incurred. However, this is no longer the case, now that Tarpon has multiple and changing customers who use changing amounts of service over time. Now past overrecoveries could be paid to customers different from those who paid the excess amounts, and underrecoveries could be billed to customers who did not receive any service during the time the underrecoveries were incurred. In short, section 10.5 could operate to discriminate between different generations of customers.

In addition, Section 10.5 is inconsistent with current Commission policies concerning the rates for open access transportation under Part 284 of the Commission's regulations; in particular, section 10.5 guarantees revenues in violation of the Commission's regulations under Part 284. 24/ Tarpon's own witnesses construed section 10.5 to guarantee recovery of all its costs, and to structure its rates, as if the parties had perfect knowledge of Tarpon's costs over the entire life of the reserves to be transported. 25/ Under this construction of the section 10.5 methodology, Tarpon would be guaranteed the recovery of all of its costs each time rates were adjusted without regard to the point at which the costs were incurred in the pipeline's life-cycle. In short, as the Staff, Oryx, and Trunkline argue, Trunkline and Tarpon created a cost-of-service contract that relieved Tarpon of virtually all risk, since any increases in costs or reductions in throughput would be reflected in changes in a tariff that would assure that all costs would be

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24/ See 18 C.F.R. §284.7(d) (1991), which provides:

> Except as provided in § 284.8(d), any 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. (emphasis added)

25/ See Exh. 14A (McGee) at p. 11, lines 14-15.

recovered. 26/

Cost-of-service tariffs have the practical effect of insulating a pipeline against fluctuations in throughput, and thereby protect the pipeline against the loss of volumes due to competition. Moreover, because all operating costs are passed through to the pipeline's customers, incentives for efficient operations are reduced. For this reason cost-of-service tariffs have become increasingly less favored by the Commission. 27/

Finally, contrary to Tarpon's assertions, rates based on the section 10.5 methodology would not encourage allocative efficiency. Since under Tarpon's construction it would be assured of the recovery of its costs regardless of when they were incurred, Tarpon would have no incentive to cut rates to retain competitive load. Rather, Tarpon could use the section 10.5 methodology to retrospectively adjust rates to reflect lower volumes and recover all of its previous and remaining costs from load lacking any competitive alternatives. As the opposing parties note, 28/ Tarpon has not, in fact, reduced rates in selected markets to meet competition even though it is providing open access transportation under Part 284 of the Commission's regulations and is not operating at full capacity. This is the very opposite of the result contemplated by the Commission's Rate Design Policy Statement.

The Commission determines that this commercial anomaly should be laid to rest. This is particularly appropriate since the agreement upon which section 10.5 is based has expired, and the only force it now has is under a tariff regulated by the Commission. Therefore, the Commission concludes that the prospective application of the rate redetermination methodology in section 10.5 of Tarpon's FERC Gas Tariff is unjust and unreasonable under section 5 of the NGA, and accordingly section 10.5 must be eliminated from Tarpon's tariff as of the date the Commission acts on Tarpon's filing to comply with this order. The Commission concludes that, instead, Tarpon's transportation rates should be determined based on the test period methodology prescribed in 18 C.F.R. § 154.63, and those rates should be

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26/ See Exh. 14A at pp. 11-12. Tarpon's witness McGee makes clear that at the time the redetermination is made, all unrecovered costs, as well as any anticipated cost increases, are incorporated into the determination of the rate needed to assure that Tarpon recovers all its cost of the entire life-cycle of the pipeline.

27/ See Pacific Gas Transmission Company, 50 FERC ¶ 61,067 at p. 61,130 (1990).

28/ See Exh. No. 172 (Schlesinger) at pp. 6-7.

designed consistent with the Commission's regulations concerning the design of open access transportation rates, 18 C.F.R. § 284.7(d) (1991).

B. Whether the 16.88 Cent Rate Is Just and Reasonable: What is Current Rate Base?

Tarpon's current 16.88 cent rate is the result of a section 10.5 rate redetermination initiated by Tarpon in 1984. In light of the holding above that the section 10.5 methodology for determining rates is no longer just and reasonable, the Commission now turns to a consideration of whether the existing 16.88 cent rate itself is just and reasonable and, if not, what just and reasonable rate should be established. The most significant issue for this purpose is the level of Tarpon's current net plant balance to be used in determining Tarpon's rate base and depreciation expense. This issue turns primarily on how the fact that Tarpon's rates have, up to now, been determined pursuant to section 10.5 should affect the calculation of Tarpon's current rate base. As discussed below, the Commission concludes that Tarpon has fully recovered its investment in plant and thus the net plant balance to be used in determining Tarpon's current rate base is zero. It follows from this fact that the existing 16.88 cent rate is unjust and unreasonable, since it would allow Tarpon to continue to recover a return on, and of, its initial investment in plant in spite of the fact that investment has already been fully recovered.

In addition, in this section of the order, the Commission considers a second issue arising from the fact that Tarpon's rates have, up to now, been determined pursuant to section 10.5. That is whether, given the fact that rates determined as of 1984 under section 10.5 have been in effect since that time, there should be any further adjustment under that section in order to require Tarpon to return the overrecoveries (determined pursuant to section 10.5) which Tarpon received under those rates. Finally, in the following section of the order, the Commission considers other cost of service issues relevant to determining the justness and reasonableness of Tarpon's rate. Those issues arise from Tarpon's contention at hearing that various aspects of its cost of service have increased since 1984.

1. Level of Net Plant Balance

The ALJ determined that Tarpon has no remaining undepreciated gas transmission plant. The ALJ found that Tarpon's Form 2A reports indicate that, under the rates which have been in effect pursuant to section 10.5, Tarpon has fully recovered, and in fact has substantially overrecovered, its gas transmission rate base and the related allowed return. The parties other than Tarpon support the ALJ's conclusion that Tarpon has fully recovered its investment.

In opposing the conclusion that its transmission plant has been fully depreciated, Tarpon asserts that use of the book values reflected in its Form 2As to determine its current net plant is retroactive ratemaking. It asserts that the balances contained in the Form 2A reports, which show that Tarpon's net plant would be fully recovered in early 1990, 29/ do not reflect Tarpon's book depreciation as it was restated in 1990 in compliance with the Commission's 1990 remand orders. Tarpon asserts that a restated depreciation rate to be filed under section 10.5, as interpreted by the 1990 remand orders, would result in a mid-1990 net plant balance of $5,478,476. This figure is the net plant balance that results from performing a new section 10.5 rate adjustment as of mid-1990, based on the interpretation of section 10.5 in the remand orders and based on the relevant updated information available as of that date. Based on this latter net plant balance, Tarpon asserts that the ALJ's determination directly contradicts the Commission's remand order through retroactive ratemaking, and deprives Tarpon of its net plant in violation of the due process clause.

Oryx, Trunkline, and the Staff argue that the Form 2As reflect the actual cash flows that Tarpon has received under the depreciation component of the rates it has had in effect to date, and that its net plant had in fact been recovered through those cash flows by the end of February 1990. Both Trunkline and Oryx argue that Tarpon's total returns (as calculated on either a net present value or internal rate of return basis) have been extraordinarily high. Oryx, Trunkline, and the Staff argue that the actual cash flows from the depreciation component of Tarpon's filed rates have recovered its cash investment of $21,091,758, and provided it with its allowed return as well. 30/

The Commission believes that Tarpon's current net plant balance should be calculated in a manner different from that apparently used by the ALJ, but also different from that urged by Tarpon. In essence, the Commission concludes that current net plant balance should be determined by starting with Tarpon's 1984 net plant balance as shown in Tarpon's 1984 section 10.5 study used to justify the current 16.88 cent rate. Consistent with the units-of-production accounting method used by Tarpon, that figure should then be carried forward by subtracting depreciation in subsequent years calculated based on the per unit depreciation

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29/ See Exh. No. 148 (White)(corrected).

30/ See Exh. Nos. 115 (CVS-11), 123 (CVS-19), 124 (CVS-20, 157 (WJW-6), 165 (WJW-14). Tarpon also provides internal rate of return figures, but incorrectly credits all revenues to the end of the year. Since revenues are received monthly, Tarpon's methodology significantly understates both the net cash flows and the internal rate of return.

component in the 1984 study, multiplied by actual throughput in subsequent years. As is explained below, Tarpon's net plant balance is fully depreciated by 1990 and Tarpon therefore has a zero net plant balance as of December 31, 1991.

The current 16.88 per Mcf cent rate was established as a result of a section 4 rate case instituted by Tarpon on May 25, 1984 in Docket No. RP84-82-000. While the 16.88 cent figure is not itself derived from a calculation performed pursuant to section 10.5, it was supported, both here and before the Court of Appeals, on the basis of a study showing what rate would result from a section 10.5 rate redetermination performed in 1984, based on Tarpon's interpretation of section 10.5. The Commission required Tarpon to implement a much lower 4.02 cent rate based on an interpretation of section 10.5 different from Tarpon's. The court found that the Commission's interpretation of section 10.5 was not supported by the record. On remand from the Court, the Commission ultimately agreed with Tarpon's interpretation of section 10.5, and, on that basis, the Commission permitted Tarpon to reinstate the 16.88 cent rate in 1990 and make surcharges to its customers in order to recover the 16.88 cent rate from 1984 forward, and that is what Tarpon has done in response to the 1990 remand orders. Therefore, the Commission believes that the 16.88 cent should be treated as, in essence, a rate resulting from a redetermination under section 10.5 performed in 1984. 31/ This is consistent with the purpose of the remand orders which was simply to correct the Commission's 1988 legal error in not adopting section 10.5, as interpreted by Tarpon, as the method for redetermining Tarpon's rates in Tarpon's rate case filed in 1984.

The conclusion that the current 16.88 cent per Mcf rate results in essence from a section 10.5 redetermination performed in 1984 is further buttressed by the fact that, while section 10.5 permitted either Tarpon or Trunkline to request additional rate determinations in 1986 and 1988 by the giving of ninety days written notice, neither party did so. Moreover, as the Commission held in the April 18, 1990 remand order, "Tarpon's and Trunkline's respective rights to request a redetermination lapsed in 1988." 32/ The expiration of the section 10.5 clause, and of the contract, means that there has been no basis for any section 10.5 redetermination since 1988.

Since the current 16.88 cent per Mcf rate arises from a 1984 section 10.5 redetermination, the rate base underlying that

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31/ The Commission thus rejects staff's exception from the ALJ's holding that Tarpon's rates have been established pursuant to section 10.5.

32/ 51 FERC ¶ 61,042 at p. 61,087.

rate must be considered to reflect Tarpon's 1984 net plant balance as shown in Tarpon's study performing a section 10.5 rate redetermination based on 1984 data. Therefore that net plant balance should be used as the starting point for determining Tarpon's current net plant balance. The only remaining question is how that 1984 net plant balance should be carried forward to determine a 1991 net plant balance. Since section 10.5 provides for Tarpon to use the units-of-production accounting method for determining net plant balance, the Commission believes that 1984 net plant balance should be determined consistent with generally accepted accounting practices under the units-of-production methodology. The generally accepted practice is to accrue depreciation determined on the basis of actual throughput in subsequent years. 33/ Thus, the Commission holds that depreciation in subsequent years must be determined by multiplying the per-unit depreciation rate shown in Tarpon's 1984 section 10.5 study by actual throughput in subsequent years as shown on Tarpon's Form 2As.

This method of calculating current net plant balance is fully consistent with the 1990 remand orders, and does not constitute retroactive ratemaking. As discussed above, this method relies on Tarpon's own 1984 section 10.5 study to determine the starting net plant balance as of 1984. It uses 1984 as the starting point, since the 1990 remand orders represented the final determination by the Commission of the just and reasonable rates that Tarpon was allowed to establish in its 1984 rate case, and Tarpon has not instituted any rate case since then. The units-of-production accounting method provided for in section 10.5 requires that, while the rates established in a rate case are in effect, net plant balances will be reduced in subsequent years based on actual throughput in those years. Thus, the Commission's use of actual throughput as shown in Tarpon's Form 2As to determine depreciation in subsequent years is neither inconsistent with section 10.5 nor retroactive ratemaking. To the contrary, use of actual throughput simply implements the tariff that was in effect during those years, and any other method would be inconsistent with the filed rate doctrine.

Applying the section 10.5 methodology to Tarpon's rate base as of April 1984, when this proceeding was filed, Tarpon's net plant balance is fully depreciated by 1990 and Tarpon therefore has a net plant of zero as of January 1, 1991. This figure is derived from Tarpon's Exhibit No. 7 (McGee 2-A) dated May 1985, introduced in the previous phase of this proceeding, and reintroduced as part of present remand phase as Ex. No 181. This exhibit restates Tarpon's actual Form 2A net plant to reflect

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33/ See Burton, et al., Handbook of Accounting and Auditing, Warthen, Gorham, and Lamont, 1981, at 20-18.

what net plant would have been in 1984, and in subsequent years, if section 10.5 had been applied in the 1984-1985 proceeding. 34/ The exhibit shows that Tarpon would have had an average net plant balance for gas transmission of $8,568,544 between July 10 and December 31, 1984. Mr. McGee's exhibit also states that the depreciation rate would be .082928323 per unit of throughput for that latter part of 1984 and .082967665 per unit of throughput for each of the years thereafter. Applying actual volumes for the balance of the year 1984 through 1990, and estimated volumes for the year 1991, produces a total recognized depreciation expense of $11,717,059.64 for that period. This results in negative net plant balance of approximately $3,148,515.64 as of December 31, 1991, assuming that the Commission had applied section 10.5 to Tarpon's rate base in the 1984-85 phase of this proceeding in the manner required by the court of appeals' remand. Since a negative net plant would occur before December 31, 1991, under the methodology of this order, Tarpon has a net gas transmisssion plant of zero as of December 31, 1991, and must design its rates on that basis.

Tarpon's contention that its mid-1990 net plant balance should be the $5.4 million net plant balance that would result from a 1990 section 10.5 rate redetermination ignores the fact, discussed above, that the redetermination provision of section 10.5 expired on July 31, 1988, and thus neither the contract between Tarpon and Trunkline nor Tarpon's tariff permits section 10.5 rate redeterminations after that date. Tarpon supports its proposal for a rate base based on a 1990 section 10.5 rate redetermination on equitable grounds. It argues that determining net plant balance in that manner is a necessary transition to the traditional ratemaking methodology required by this order that protects legitimate investor expectations of continued use of the 10.5 methodology. Tarpon concedes that a 1990 section 10.5 rate redetermination would show that the 16.88 cent rate has resulted in overrecoveries which must be credited against future rates under the section 10.5 crediting mechanism and, if granted a net plant balance based on a 1990 rate redetermination, it agrees to such revenue crediting.

The Commission rejects Tarpon's proposed "transitional" rate base. As already discussed, Tarpon's investors had no legitimate expectations of further section 10.5 rate redeterminations after 1988. That section does not provide for any rate redeterminations after 1988, but terminated in that year. Furthermore, the investors knew that Trunkline had the option of terminating its contract with Tarpon altogether after 1988, and Trunkline has now exercised that option.

34/ As the Staff argues, Tarpon has other assets besides its gas transmission plant, such as office furniture. Tarpon is entitled to a return on such items.

In light of these facts and the fact that the method of determining the current net plant balance required here is entirely consistent with the terms of section 10.5, as interpreted by Tarpon and the Commission's remand orders, it is difficult to see how investors could have reasonably relied on Tarpon's rate base continuing to be determined in the manner sought by Tarpon. Furthermore, in terms of the investors' expectations as to the return on their investment in 1978 when the investment was made, or even as late as 1984 when the last rate redetermination took place, the investors have already more than met their expectations. The 1984 rate redetermination was based on a projection that the total volumes to be transported over Tarpon for the life of the project would be approximately 250 million Mcf, and that these reserves would be exhausted by 1999. Thus, the 1984 rates were calculated to allow full recovery of Tarpon's return on, and of, equity through the transportation o. the projected approximately 250 million Mcf through 1999. However, in fact Tarpon has already transported the full 250 million Mcf and more. Thus, Tarpon has already recovered the entire return on and of equity which the 1984 rates were designed to recover only by 1999. 35/

In addition, the Commission's conclusion that there are no equitable reasons requiring allowing Tarpon a transitional rate base is buttressed by the fact that, as explained in the next section, Tarpon is being allowed to retain the approximately $2.4 million in overrecoveries that it would be required to return if a new section 10.5 redetermination were performed as of mid 1990. Finally, the Commission is allowing Tarpon a management fee to provide an incentive for efficient management and to mitigate the impact of the lower cash flow that will result from the determination that Tarpon has a zero net plant balance. In light of all these facts, the Commission finds no equitable ground or hardship to Tarpon's investors justifying granting any adjustment to the net plant balance and rate base calculation required here.

In light of the determination that Tarpon has no net plant the Commission need not determine here the depreciation rate to be used to amortize Tarpon's net plant from the effective date of this order. The Commission will, however, determine Tarpon's projected throughput for the remainder of its useful life since the projections used to develop the current 16.88 cent rate are outdated. That projected total throughput will be used to calculate the negative salvage value permitted by this order. To assure use of the most recent information to develop Tarpon's rates, the Commission will accept Staff's most recent estimate of Tarpon's total projected throughput of 357,783,000 Mcf. The

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35/ As is evidenced by the testimony of Witnesses White and Swanson, discussed supra, Tarpon has consistently earned total returns in excess of its cost of service.

latter of the two sets of figures are based on forecasts of production Staff obtained from Tarpon's customers and is the better of the two estimates contained in the record.

2. Disposition of overrecoveries.

In establishing a section 5 hearing on Tarpon's rates, the Commission's 1990 remand orders directed that the parties consider whether Tarpon has had any overrecoveries through the use of the section 10.5 methodology up to now, and what should be the disposition of those overrecoveries, if any. 36/ The ALJ determined that overrecoveries had occurred but did not make any specific determination of the amount. He did conclude that any overrecoveries caused by Tarpon's overrecovery of its Form 2A depreciation expense should be used to offset its claim for negative salvage value. 37/ The parties other than Tarpon support the ALJ, and Trunkline urges that any overrecoveries be deducted from Tarpon's restated rate base.

On exceptions, Tarpon argues that there are no overrecoveries because no party alleges that Tarpon actually charged more for its services than its lawfully published rates. However, while Tarpon did not charge more than its published rate, there have been overrecoveries pursuant to Tarpon's 16.88 cent rate in the following sense. The record clearly shows that if a new section 10.5 rate redetermination were performed in 1990 based on relevant data and projections as of that date, it would show that the 16.88 cent rate had resulted in overrecoveries in prior years which, under the section 10.5 revenue crediting mechanism, must be credited against the cost-of-service used to calculate the redetermined rate. Tarpon itself concedes that if its rate were now redetermined under its interpretation of section 10.5, the revenue crediting mechanism would require the return of prior overrecoveries. The issue raised by the remand orders was whether, in light of the expiration of section 10.5 and any NGA section 5 action that the Commission might take, these overrecoveries should be returned, for example through a final section 10.5 adjustment conducted as of the date new rates established under section 5 take effect.

36/ The opposing parties do not assert that Tarpon's overrecoveries, if any, were caused by the overrecovery of expenses other than depreciation and the related changes that would have to be made to Tarpon's accumulated deferred income tax account. However, they challenge several of the operating costs that Tarpon incurs.

37/ While the depreciation allowance is used to recoup the original cost of an investment in facilities, negative salvage value is the cost of physically retiring that facility.

The Commission concludes that it lacks authority to require Tarpon to return these overrecoveries, whether as a deduction from rate base as proposed by Trunkline, an offset against negative salvage value as required by the ALJ, or as a credit against the overall cost-of-service used for calculating the new rates. The new just and reasonable rates established in this proceeding will be set not under section 10.5 of Tarpon's tariff, but under section 5 of the NGA. Action under NGA section 5 must be prospective only. The Commission has no authority under NGA section 5 to require that overrecoveries which occurred under the old rates found unjust and unreasonable be returned. The Commission could require return of overrecoveries only to the extent that Tarpon's current tariff required such return. However, as previously discussed the rate redetermination provision of section 10.5 have expired. While Trunkline or Tarpon could have requested a section 10.5 rate redetermination, including the return of past overrecoveries in 1986 or 1988, neither did so. After 1988, the right of any party to request a redetermination expired and was not renewed. As was discussed above, all parties were aware that the renegotiation provisions of section 10.5 would expired in 1988, and that a failure to extend them would mean all rights, either beneficial or adverse, would expire at the same time. Thus, there is no basis in section 10.5 for any further rate redeterminations.

Thus, the only remedy available here is to require Tarpon to file new rates prospectively. The Commission will do so here by requiring Tarpon to file rates not later than 30 days after the effective date of this order, to be effective not later than January 1, 1992, and to be consistent with the above discussion and the holdings below concerning Tarpon's other operating costs. In this regard, consistent with the above discussion, the Commission also reverses the initial decision's conclusion that, since Tarpon has substantially overrecovered its depreciation cost, it should be prevented from recovering any negative salvage value due to its prospective demolition or removal costs. However, as is discussed below, the Commission will not allow Tarpon to fully recover the negative salvage value, based on reasons other tha those relied on by the ALJ.

C. Determination of Tarpon's cost of service.

The ALJ also addressed several of the operating expenses that are contained in an updated cost of service that Tarpon presented at the hearing in order to show that a number of its costs have increased since 1984 when it filed the existing 16.88 cent rate. The parties filed exceptions with regard to: (1) Tarpon's capital structure; (2) its rate of return; (3) whether a management fee should be allowed, and if so, how large; (4) the throughput to be used; (5) the failure to include a depreciation allowance for assets other than the transmission components addressed in the previous sections of this order; (6) the number and salaries of its employees; (7) the size of its employee benefits and pensions, office supplies, and rent expense; (10) the time frame for the amortization of Tarpon's litigation costs; (11) the allowance for outside services; (12) the treatment of Tarpon's anticipated expenses for assuming greater control of its own facilities; (13) the treatment of funds to be collected to cover negative salvage costs; (14) the appropriate income tax allowance; (15) the amount and method for calculating deferred income taxes; and (16) the ALJ's failure to determine that Tarpon's current rate was unjust and unreasonable by comparing Tarpon's current rates to the sum of Tarpon's costs other than those costs based on the section 10.5 methodology discussed in last portion of this order.

In addition, Tarpon challenges the use by the ALJ of historical costs for the 1983-1989 period rather than more current expenses in determining the reasonableness of Tarpon's operating expenses. 38/ This is a generic issue that runs through many of the cost determinations contained in the initial decision and is based in part on changes in the ownership of Tarpon that occurred in 1987 and 1989. On July 1, 1987, Tarpon's current owners created LaSalle Energy Corporation, which at the same time acquired United Gas Pipeline Company (United), a large interstate pipeline, and included Tarpon in the transaction as an affiliated company. Thereafter, certain of Tarpon's management and administrative functions were performed by LaSalle and United employees. Tarpon became independent of LaSalle in November, 1989, when control of LaSalle and United was sold to independent third parties. Tarpon thereafter increased the staff on its own payroll, leased the office space previously occupied by LaSalle, and began to incur other costs that are related to the independent ownership. 39/ Tarpon therefore objects to the use by the ALJ of cost levels now embedded in Tarpon's rates (which reflect its 1983-84 cost levels) to determine current operating expenses, claiming that those costs are unrepresentative of its current operations.

Without adopting Tarpon's assertions of what current cost levels are prudent or reasonable, the Commission agrees, that given the age of this case, Tarpon's present and prospective operating costs should be determined on the most reliable

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38/ The Staff and Tarpon used the calendar year 1989 for the twelve-month test period.

39/ Tarpon's actual physical operations were performed by Trunkline until termination of the Trunkline\Tarpon contract on July 1, 1991.

information in the record. 40/ This is generally the 1989 cost-of-service study that Tarpon submitted in this proceeding, plus additional information that has been submitted to the record where its use is appropriate. Even though this is a section 5 proceeding, Tarpon submitted the 1989 cost-of-service study because the only other extant cost information as of the remand was the cost-of-service study that Tarpon used to support its 1984 section 4 filing. Relying solely on a six-year old record when more recent information was available in a remand phase would be unfair to all the parties. In fact, no party objected to the use of an updated cost-of-service study as a matter of principle, although there was substantial disagreement whether all the costs contained in that study were prudent or representative of Tarpon's future costs. The parties therefore addressed the 1989 study as if it were submitted to justify newly filed rates, although technically the study was part of Tarpon's justification of its existing 16.88 cent rate. To the extent that Tarpon has advanced the study in order to show increased costs over those included in its current rates, it has the burden of proving that the study is credible. The burden ultimately remains on parties challenging the existing rate to prove that that rate is unjust and unreasonable and that the lower rate that they seek is just and reasonable. The details of the specific cost contentions are addressed below.

1. Capital Structure

As noted, the ALJ did not adopt a capital structure or rate of return for Tarpon. However, while Tarpon's net investment in the gas transmission portion of Tarpon's rate base is now zero, Tarpon still has a small rate base resulting from recent purchases of furniture. Accordingly, the issues of capital structure and rate of return must still be decided. Pursuant to Opinion No. 287, Tarpon presently has an imputed capital structure for regulatory purposes of 55 percent debt and 45 percent equity. 41/ However, Tarpon's current actual capital structure is 100 percent equity, since all of the debt incurred for its construction has been retired, and Tarpon seeks to use its actual capital structure to calculate its allowed return. The Staff, however, argues that to lower the cost to the ratepayers, Tarpon should have an imputed capital structure of 50 percent debt and 50 percent equity. The somewhat higher equity component and lower debt component than under Tarpon's existing rates would reflect the increased risk Tarpon is facing due to the elimination of its minimum bill and the commencement of open

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40/ This is consistent with the approach used to determine Tarpon's actual net plant as of the effective date of this order.

41/ 41 FERC ¶ 61,044 at p. 61,138 (1987).

access transportation. Staff would apply the imputed debt component to a current rate base of approximately $300,000, or total imputed debt of $150,000, relying on Alabama-Tennessee Natural Gas Co. 42/

Tarpon argues in reply that Staff's position is based on an assumption that lenders would provide debt financing to Tarpon at a rate of 10.25 percent. Tarpon asserts that its risks are high due to its volumetric structure, its lack of a minimum bill, and the fact that since its assets are approaching the end of their useful life, operating and maintenance expenses are very high in relationship to its return allowance. It asserts that any material variation in the operating and return expenses is likely to endanger Tarpon's return allowance, increasing the risk of a default on the level of debt the Staff would impute to Tarpon. These risks make it unlikely that Tarpon could issue debt other than at junk bond rates. According to Tarpon, Staff has not justified its conclusion that Tarpon has the same risk as a Baa rated utility and could obtain a rate of 10.25 percent on its financing.

The Commission will allow Tarpon to use its actual capital structure. In Alabama-Tennessee, supra, the Commission adopted a hypothetical capital structure as an exception to its general policy of not using such capital structures. The Commission did so to avoid the prescription of an unusually low return on equity to mitigate the effects on ratepayers of abnormally high equity ratios. However, the concerns addressed in Alabama-Tennessee do not exist in this case, since the principal source of return, the transmission rate base, has been fully amortized, and the remaining rate base is too small to result in any significant difference in return if an imputed capital structure is applied. 43/ The difference between Staff's estimated cost of debt and equity is 150 basis points, for a total annual pre-tax savings under Staff's proposal of $2250. On the throughput advanced by Tarpon, the minimum amount suggested in this proceeding, the 150

42/ 40 FERC ¶ 61,244 at p. 61,814 (1987). This case holds that the Commission will impose an imputed capital structure if a capital structure is so weighted to equity as to be outrageous or an imputed structure is necessary to protect consumer interests.

43/ The Commission's use of a hypothetical structure at the time that a significant rate base exists reflects the fact that such long lived assets would normally be financed in least in part by debt, which is in turn retired through cash flows from depreciation. In the instant case, Tarpon's debt has been retired as part of its ongoing operations, at least in part by cash generated though its depreciation charges, and in the same time frame. See Exh. 29A (Lieb) at p. 5.

basis point differential results in a savings of one hundredth of a cent per Mcf. Since none of Tarpon's customers have objected to the use of an all equity capital structure, the Commission will permit Tarpon to use a one hundred percent equity capital structure here. This result is consistent with the preference for actual capital structures and has no significant impact on consumers, given the fact that Tarpon's gas transmission plant is fully depreciated and will not yield the return that would be derived from a new investment.

2. The cost of equity.

The ALJ did not make a determination of Tarpon's cost of equity, although he rejected Tarpon's proposal to increase its rate of return to 15.5 percent from the 15 percent approved in Order No. 287 and included in Tarpon's rates. On exceptions Tarpon asserts that its financial risk is somewhat lower than the average pipeline because it has an all equity structure. It also asserts that its business risk is above average because: (1) it operates under a purely volumetric rate with no demand charge; (2) it faces significant variations in the level of its throughput; (3) it is dependent on a single outlet, Trunkline, and therefore cannot diversify its markets, and (4) transportation competition in its markets has recently increased. Tarpon concludes that, on balance, its overall risk is about that of the average interstate gas pipeline, that the Staff analysis understates the business risks facing such pipelines, and that its appropriate cost of equity capital is 15.5 percent.

In contrast, the Staff asserts that Tarpon's risk is somewhat less than the average pipeline. Staff based its conclusion primarily on the fact that Tarpon had a monopoly for over 80 percent of the volumes it transported during the period reviewed by staff, and that the volatility of its throughput was associated primarily with take-or-pay problems encountered by Trunkline in the mid-1980's. Staff also asserts that, unlike other pipelines, Tarpon has no exposure to take-or-pay liabilities and has no significant risk from involvement in developing additional gas fields.

To develop its cost of equity estimates, the Staff used a discounted cash flow analysis (DCF), and a capital asset pricing model (CAPM) as a check. The DCF was based on a sample of 15 integrated natural gas pipelines, together with a control group of eight natural gas pipelines involved primarily in transmission. This analysis produced a cost of capital of 12.42 percent for the 15 pipeline sample 44/ and 12.41 percent for

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44/ See Exh. 30A (Lieb) at p. 1.

the eight pipeline control group. 45/ The CAPM was based on an analysis of the dividends, expected growth rates, and betas of two widely based stock market indices, the Value Line and the Institutional Brokerage Estimate System (IBES). 46/ Using these two sources, witness Lieb developed an estimated growth rate for the 15 company sample of 8.2 percent per year and a dividend yield of 3.20 percent, for a total cost of equity capital of 12.42 percent. The similar figure for the IBES growth was 16.07 percent, which Staff considered to be overstated, given the pipeline industry's depressed earnings in recent years. Staff concluded that because Tarpon has less risk than the average pipeline, its cost of equity capital should be 12 percent.

The Commission concludes that Tarpon's cost-of-equity capital should remain at the 15 percent adopted in Order No. 287. supra. Neither Staff nor Tarpon has justified a change in Tarpon's current cost-of-equity on the record before the Commission. Tarpon has somewhat overstated its risk in three regards. First, Tarpon fails to take into account the fact that it retains a transportation monopoly over 80 percent of the reserves it presently serves. It can discount its rates to meet competition in the smaller area in which it faces competition, although to date it has declined to do so. Second, the volatility of Tarpon's throughput has diminished since it began providing open access transportation in 1988. 47/ Tarpon's historical volatility was caused primarily by Trunkline's problems with take-or-pay liabilities and Trunkline's need to restrict its purchases. Finally, while Tarpon's throughput has been disrupted due to engineering problems with Trunkline's system, the risk of this recurring is small and is covered by insurance.

At the same time, Staff's analysis overlooks that Tarpon is at risk for a greater portion of its throughput than when it first began operations and that it facing greater uncertainly than in 1987 when the Commission issued Order No. 287. Tarpon has lost business to the Green Canyon Pipeline, 48/ and the

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45/ Id. at p. 2.

46/ A stock's beta measures its relative risk in comparison to all other stocks in a portfolio or market sample. The greater the beta the greater the stock's price change will be compared to the average portfolio or market change.

47/ See Exh. 31A (Lieb).

48/ Green Canyon's current transportation rate is 8.2 cents per Mcf, or almost twice the 4.2 cents per Mcf rate Tarpon had

(continued...)

construction of off-shore pipelines authorized by the Commission in recent years has increased, thereby increasing the possibility of additional competition in the future. The increase in competition within the natural gas industry as a whole means that there is less assurance that gas will move from Tarpon's wells, including those in fields over which it may have a transportation monopoly. Trunkline has also terminated its contract with Tarpon, which also results in greater uncertainty. Tarpon's risk is therefore greater than Staff has attributed to it.

Moreover, Staff chose to reject that portion of its cost of equity study that resulted in a higher cost of equity, based on the IBES which resulted in an equity cost of 16.07 percent. While the difference in the two equity costs is explained in part on expectations of future growth in pipeline earnings, Staff did not present any clearly articulated grounds for doing so. No other party has asserted that Tarpon's equity cost of capital should be significantly less than 15 percent even though most other cost-of-service issues have been extensively litigated in this proceeding. The Commission therefore concludes that neither the Staff nor Tarpon has justified a change in the cost of equity capital originally contained in Order No. 287.

3. Throughput

The ALJ failed to make a determination of Tarpon's projected annual throughput. All parties agree that this omission was an error, and the Commission should make such a determination. Tarpon proposes a throughput of 18,245,323 Mcf, Anadarko\Chevron 23,660,667 Mcf, Staff 23,000,000 Mcf, Oryx 20,900,340 Mcf, and Trunkline, 23,095,534 Mcf. The record indicates Tarpon's four-year average throughput for the years 1986 through 1989 was 22,287,123 Mcf, its actual throughput for the twelve months ended June 30, 1990 was 21,527,036 Mcf, and its actual throughput for the entire calendar year 1990 was 17,435,502 Mcf, or if adjusted for the six-week break in Trunkline's pipe beginning on December 5, 1990, some 18,695,683 Mcf.

Tarpon transports reserves produced from Eugene Island Block Nos. 380 and 381 and from SMI Block No. 174. The parties generally arrive at their throughput projections by projecting throughput from each of the blocks and then adding these projections together. The parties' disagreements on the matter of throughput turn on three issues: (1) whether production from Eugene Island Block No. 380 is likely to decline; (2) whether throughput from SMI Block No. 174 should be adjusted to reflect the competitive impact of the Green Canyon Pipeline; and (3) what minimum throughput, if any, Tarpon must achieve to comply with

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48/(...continued)
in effect before it filed its 16.88 cent rate in April 199

the conditions of its certificate. The Commission will adopt a projected throughput for Tarpon of 21,814,373 Mcf based on Staff's reply testimony. This reflects a projection of 16,954,027 Mcf from Eugene Island Block No. 380 and Block No. 361 based on actual throughput for the 12 months ended October 31, 1990, and 4,860,346 from SMI Block No. 174 based on actual throughput from that block for the 12 months ended April 30, 1991.

The first major point of disagreement among the parties concerning throughput is future production from Eugene Island Block No. 380. Staff's projected 16,954,027 Mcf in throughput from Eugene Island Block No. 380 (as well as from Eugene Island Block No. 361) is based on actual throughput from those blocks during the 12 months ended October 1990. Tarpon asserts, however, that Trunkline's own witness indicated that the volumes from this block were likely to decline even below the 8,300,000 Mcf upon which Tarpon's projections were based. Oryx and Trunkline reply that an updated survey by the same witness indicated that output from that block would increase to 10,000,000 Mcf rather than the lower level forecasted by Tarpon. Under the circumstances, the Commission will reject Tarpon's assertion that any throughput projections should reflect a risk of declining throughput from Eugene Island Block No. 380, and adopt the projection for that Block in Staff's reply testimony.

The parties' dispute concerning the appropriate throughput projection from SMI Block No. 174 turns on the base period to be used for projecting Tarpon's throughput and the impact on the projection of the competition facing Tarpon in SMI Block No. 174. The 4,860,346 Mcf projected volume from SMI Block No. 174 in Staff's reply testimony was based on actual volumes from that block during the months ending April 1990. Staff contended post-April 1988 throughput figures for SMI Block No. 174 are distorted, since Tarpon increased its rate from 4.02 cent per Mcf to 16.88 cents per Mcf in May 1990 as a result of the Commission's remand order and that increase resulted in the loss of throughput from the block. The volume was instead transported on the Green Canyon Pipeline (Green Canyon) which started operation in April 1990 and had an 8.1 cent per Mcf rate, as opposed to Tarpon's 16.88 cent per Mcf rate. Tarpon argues that since Green Canyon is affiliated with Transco, that Transco will therefore ship gas over Green Canyon regardless of Tarpon's rates (in part to meet Green Canyon's minimum throughput condition), and this that Tarpon can expect to transport none of this gas.

All the other parties assert that Tarpon was transporting substantial amounts of gas from Block No. 174 until April of 1990, when Tarpon filed its reinstated rate, thereby raising its rate to 16.88 cents per Mcf. Based on this latter fact, they argue for inclusion of a substantial part, if not all, of the gas Tarpon previously handled from Block No. 174 in Tarpon's projections. The opposing parties assert that Tarpon could recapture the volumes by selectively discounting its rates to meet competition, and that to exclude the Block No. 174 volumes from Tarpon's projected throughput simply rewards it for failing to meet competition.

The Commission agrees that some volumes from Block No. 174 should be included in Tarpon's forecast. Numerous marketers and shippers other than Transco shipped gas from Block No. 174 prior to the time that Tarpon filed its reinstated rates. The record indicates that independent marketers transported some 1,141,179 Mcf on Tarpon for the period January through May 1990, and that 70 percent of the total 1989 volume was for marketers. While Tarpon argues that an estimated 81 percent of Block No. 174's future production is committed to Transco, this is not the same as saying that 81 percent of the production that Tarpon transported before it increased its rates in April 1990 is also dedicated to Transco. By failing to draw this distinction Tarpon overstates its competitive risk in this block. In fact, Tarpon makes no such representation, since much of Tarpon's previous transportation from Block No. 174 was for independent marketers. Since Tarpon has refused to offer transportation discounts to attempt to hold the gas previously moved from Block 174, 49/ its assertion that it could not transport any of this gas even if it were to lower its rates lacks credibility. In any event, given the rate that would result from this order, Tarpon should be fully competitive with Green Canyon's rate of 8.1 cents per Mcf. Futhermore, even if Staff's projection of throughput from SMI Block No. 174 is overstated, this should be offset by that fact that volumes from Blocks 380 and 361 may have also suffered some erosion in volume due to Tarpon's large rate increase in May of 1990 and Staff's projection has not been adjusted to reflect that revision. 50/

The Commission accordingly will adopt a projected throughput for Tarpon of 21,814,373 Mcf based on Staff's reply testimony. The 21,812,373 Mcf contained in MacMahon's well-reasoned reply testimony approximates Tarpon's four year average volume for the years 1986 through 1989 of 22,287,123 Mcf, and is only slightly

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49/ See, among others, Exh. No. 51 Staff- MDM-11), which contains a letter by an independent marketer requesting a discount to preserve the same netback it would receive by shipping over Green Canyon.

50/ See Exh. No. 50A (MacMahon) at pp. 4, 11-13. The Commission also agrees that Tarpon's witness Drennan understated the historical throughput from Blocks Nos. 360 and 361 by using only the first 9 months of 1990 rather than the previous twelve months. This effectively excluded some of the colder months of the twelve-month period.

more than the 21,527,036 Mcf actually transported in the twelve months ended June 30, 1990. This latter figure is naturally somewhat depressed due to the large price increase Tarpon instituted in May 1990. While the figure adopted here is somewhat less than the 23,000,000 Mcf suggested by Trunkline, Staff's initial testimony, and Anadarko\Chevron, it allows for some permanent loss of volumes due to increased competition, while creating incentives for Tarpon to price aggressively to recover volumes lost due its large rate increase in May, 1990.

Finally, both Oryx and Anadarko\Chevron argue that section 2.65 of the Commission's regulations 51/ require Tarpon to design its rates to reflect throughput of at least 60 percent of its annual available capacity. Oryx and Anadarko\Chevron construe this requirement as 60 percent of the actual maximum annual capacity that Tarpon has transported. For example, Anadarko\Chevron assert that Tarpon actually attained an average throughput of 93,471 Mcf per day, an amount in excess of its stated design capacity. It asserts that the annual capacity available on Tarpon's system is 34,117,015 Mcf, and that 60 percent equals a minimum rate design determinant of 20,470,209 Mcf per year. The comparable Oryx calculation is 31,755,000 Mcf and a design capacity of 19,053,000 Mcf.

According to Tarpon, Oryx and Anadarko\Chevron have misconstrued section 2.65. Tarpon construes section 2.65 to apply only to the recovery of capital investments in facilities. Tarpon argues that the regulation imposes a certificate condition that the average unit cost of the pipeline's rates must be predicated upon load factors of not less than 60 percent of the design annual capacity available. 52/ It asserts that the Commission intended the regulation to be forward looking at the time of certification, and that if the regulation was intended to address actual maximum throughput that is later achieved, it would have stated this. The design throughput used in Tarpon's certificate was 27,375,000 Mcf per annum, or a minimum volume of 16,425,000 Mcf. Tarpon argues that, in any event, since its throughput is declining, the Commission should waive the

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51/ See 18 C.F.R. 2.65(a)(4) (1991), which governs the construction of offshore pipelines, which states in part:

> [A]n applicant should...[d]emonstrate that its proposed facilities will be utilized, either by it individually or jointly with other pipeline companies, at a minimum annual load factor of 60 percent of the annual capacity available by the end of a 12-month period following the installation thereof, unless a waiver is issued.

52/ Citing 18 C.F.R. § 2.65(b) (1991).

application of section 2.65 to Tarpon. Since the Commission has adopted a throughput level that is higher than any that would result under the various interpretations of section 2.65 advanced here, the issue is moot and the Commission will not construe that section here.

4. Other Depreciation

The ALJ denied Tarpon any further depreciation on the grounds that its rate base had been fully recovered not later than the first quarter of 1990. However, as Tarpon, Staff, and Oryx point out, Tarpon has other assets, principally furniture, that it is depreciating over a seven-year time frame. The Commission will permit Tarpon to depreciate those assets other than its original gas and transmission plant at their current book rate.

5. The payment of a management fee

Applying the standard in Wyoming-California Pipeline Company (WyCal), the ALJ granted Tarpon a management fee of not more than 10 percent of average annual pre-tax return earned over the years before Tarpon's gas transmission plant was fully depreciated. 53/ The ALJ reasoned that a management fee acts as an incentive to investors in the absence of a return on equity. The ALJ also concluded that such an allowance provides a source of dividends so as to provide some value to Tarpon's stock. Tarpon supports the concept of a management fee if the Commission denies it further return on its gas transmission plant, but claims that the fee selected is too low. Tarpon proposes a management fee of approximately $1.6 million, as compared to the $200,000 management fee adopted by the ALJ. Tarpon asserts that its proposed management fee is necessary to compensate Tarpon for its relatively high business risk, and that its proposal is consistent with the method suggested by Staff in Tarpon's last section 4 proceeding. It claims that there is no reason at this point to change that methodology. It also asserts that WyCal is not proper precedent because WyCal was a certificate proceeding, and the formula suggested in WyCal was not based on a record or reasoned decision-making.

Staff opposes the management fee on the grounds that Tarpon's owners are compensated through their salaries, that such a fee would provide an excessive return, and that the fee may not

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53/ 44 FERC ¶ 61,001 at p. 61,008 (1989). The calculation of the formula is discussed at Exh. 39A (Lieb) at p. 24. The pre-tax returns from Tarpon's Form 2 for the years 1978 through 1989 totaled $23,179,544. The average pre-tax return was $2,001,117 per year. The maximum 10 percent fee under the WyCal formula therefore equals $200,112.

be awarded since, unlike the case in WyCal, there was no mention of such a fee in Tarpon's certificate proceeding. Oryx argues that a management fee is appropriate to compensate the owners for the risks of continuing to operate the pipeline and to encourage efficient operations. Oryx asserts that the 10 percent management fee proposed by the ALJ amounts to approximately $200,000, and is substantially equivalent to that suggested by its own witness, $164,000. Oryx also argues that Tarpon's proposed fee of approximately $1,139,195 is grossly excessive. Anadarko\Chevron support the concept of a management fee but oppose Tarpon's proposed management fee. They assert that Tarpon's proposed fee is more than eight times the $168,000 recommended by their witness McIlvoy.

The Commission will affirm the ALJ's determination that Tarpon is entitled to a management fee, but the Commission reduces the amount of that management fee to no more than $167,000. While a management fee is a matter of first impression, since no such determination has been made on a fully litigated record, the Commission agrees with Oryx, Trunkline, and Anadarko/Chevron (all of whom are customers), as well as Tarpon, that a management fee is appropriate in light of the fact that Tarpon's investment in its transmission plant is now fully depreciated. As Oryx points out, the fee is an operator's fee to compensate Tarpon's owners for the risks of continuing to operate the pipeline and to provide incentive for efficient operations. While Tarpon's owners receive salaries for the daily management of the pipeline, they continue to have an entrepreneurial interest in the pipeline. Absent an owner's fee, they would have only limited incentives to manage the operations of the pipeline on an efficient basis, because the actual return on equity is so small once Tarpon's the gas transmission plant has been depreciated. Under these circumstances a modest management fee is a more effective means of encouraging efficiency than an occasional regulatory proceeding, particularly if the pipeline exceeds its throughput projection. 54/ The conclusion here is therefore consistent with the Commission's orders in Green Canyon Pipe Line Co., supra, 55/ and Kern River Gas Transmission Company. 56/

54/ The return on equity would increase proportionately if the throughput projection were exceeded. However, the total equity return projected here is less than $25,000 because of the low residual rate base remaining. Even if Tarpon doubled its throughput, the increase in the equity return would be minimal.

55/ 47 FERC at p. 62,113, n. 11.

56/ 50 FERC ¶ 61,310 at p. 61,150 (1990).

However, the Commission will modify the initial decision's holding on the amount of the fee to reflect the more refined versions of the management fee issue that are included in the record. First, the Commission will reject the management fee suggested by Tarpon, since, as the protesting parties argue, the formula upon which that proposal is based is inappropriate. Tarpon's proposed fee is derived from a percentage of operating and maintenance expenses. That method of calculating a management fee creates incentives for inefficiency rather than efficiency, since the higher Tarpon's cost-of-service, the greater its management fee would be. This is contrary to the goals of the Commission's Rate Design Policy Statement, which seeks to encourage efficiency. Moreover, the actual percentage Tarpon used is based on the ratio of operating profit to gross revenues of several major pipelines. As those parties objecting to Tarpon's proposed fee correctly state, such pipelines have far greater assets than Tarpon, more complex operations, and significant assets at risk. The profit ratio of a major pipeline is an inappropriate model for a small 40-mile pipeline like Tarpon.

The fee Tarpon proposes here is clearly excessive and is disproportionate to Tarpon's size. Tarpon's proposal would result in a management fee of $1,139,195, without any additional allowance for income taxes, and would consist of almost one half of the cost-of-service Tarpon has proposed in this proceeding. As Trunkline points out on brief, the management fee adopted by the ALJ is equivalent to a 14.7 percent weighted return, Tarpon's original rate-of-return in Opinion No. 287, on a rate base of $1,272,738. Oryx points out that the fee accepted by the ALJ is equivalent to 15 percent (approximately the equity cost Tarpon claims here) on a rate base of $1,333,333. They assert both figures point to the reasonableness of the WyCal standard. In contrast, the fee that Tarpon proposes is equivalent to a 15 percent return on $6,290,000, a greater rate base than it claims it is entitled to under its own construction of section 10.5.

While Tarpon claims that its risks warrant a high fee, the Commission has already concluded in its evaluation of Tarpon's cost of equity capital that Tarpon has overstated these risks. Even with Tarpon's risks, no mature business operating in a competitive market could capture such returns unless it held a monopoly position. In the absence of barriers to entry, the size of the return would have long since encouraged entry that would reduce the company's return. Thus, the purpose of the management fee is to encourage Tarpon to take actions to prevent an injurious loss of throughput by more aggressively marketing its gas supplies, pricing its services to increase volume, and to minimize costs. The Commission believes that the size of the management fee should be high enough to encourage such activities, but not so high that it would be equivalent to a monopoly return unavailable to a firm operating under competitive conditions. The record establishes that Tarpon has taken few steps to achieve any of the above goals, apparently on the expectation that the large return available to Tarpon under its current rates removes any need for such actions. In fact, the huge management fee proposed by Tarpon would have the practical effect of insulating Tarpon's management from the consequences of its lack of activity in this regard. Tarpon's objections to a fee based a some measure on historical return on rate base are without merit.

The parties in this proceeding have suggested some modest modifications in this proceeding to the WyCal standard in light of the information in the record and the difficulty in applying WyCal literally in this case. Staff asserts that the formula looks to past returns rather than current conditions and may not reflect a pipeline's current risks. 57/ Thus, if returns were low in some years due to short term problems, the pipeline would have its management fee reduced prospectively even if it has been performing efficiently in recent years. Similarly, if the pipeline had greatly exceeded its allowed return, the management fee would probably be overstated, the result that would obtain in this case given Tarpon's high historical returns. Both Staff and Trunkline's witness McIlvoy point out that a fee calculated on the average rate base over the life of the project is more predictable, is easier to calculate, and is less subject to the influence of past performance.

Mr. McIlvoy would apply Tarpon's current pre-tax rate-of-return to 10 percent of the average annual rate base, which is approximately 50 percent of gross investment, plus prepayments now included in Tarpon's rate base. Using a pre-tax rate-of-return of 14.64 percent, Mr. McIlvoy's recommended fee would be $167,947, which is comparable to witness Swanson's fee of $164,495. Both of these sums represent reasonable levels of a management fee for a small pipeline like Tarpon. The Commission agrees that the approach suggested here, which is based on record evidence, is more appropriate in this litigated case than the use of the WyCal formula, which to date has been applied in certificate cases where the overall return has been estimated as part of the certificate proceeding. The Commission will therefore adopt formula supported by the record here. This is an owner's fee that applies the current pre-tax cost-of-capital to 10 percent of the historical average rate base, plus Tarpon's current Form 2A prepayment balance. This should provide an incentive for increased throughput and efficiency without providing a fee that would be so high that competitors would enter the market in the absence of significant barriers to entry.

57/ See Lieb, supra, at p. 25.

6. The number of employees and their compensation.

Until December 31, 1989, Tarpon had only three employees, and the cost-of-service underlying Tarpon's current rates only reflects the 1984 cost of $165,721 for those employees, plus reimbursements to LaSalle and United for the part time services of some of their employees. At hearing, Tarpon asserted that due to its commencement of open access transportation service and the Commission's electronic filing requirement, Tarpon developed a need for additional employees. However, because Tarpon had been affiliated with LaSalle and United in 1987, the additional work was initially performed by United employees. Tarpon asserts that after the affiliation with LaSalle ended in 1989, Tarpon had to hire an additional two employees. Accordingly, it proposed a salary cost to $264,000 to reflect the increased cost of these additional employees and the extra duties to be performed by its senior officers. The ALJ concluded that the expense of the two additional employees hired by Tarpon after its separation from LaSalle were excessive and imposed an undue burden on the Tarpon's ratepayers. The ALJ therefore limited Tarpon's salaries to those underlying the rates reinstated in response to the Commission's 1990 remand orders.

Tarpon excepts, arguing that this limits Tarpon to the part-time salaries that existed when the salary component of the reinstated rate was first filed with the Commission, namely 1984. It argues that the ALJ therefore limited Tarpon's salaries to 1984 levels, and that they have lost at least one third of their value in the interim. Tarpon asserts, moreover, that the two additional employees were necessary to handle open access tariff filings and related commercial matters that were previously handled by United before LaSalle was sold by Tarpon's current owners, and it should therefore obtain the full $264,000 it proposed to include in its cost-of-service. Staff, Anadarko Chevron, and Oryx agree with the ALJ that the salary expenses for Tarpon's employees are overstated. Oryx concludes that total employees should not exceed half the time of a president, and a full time administrator and secretary.

The Commission will permit Tarpon to include in its cost-of-service an allowance for salaries of $205,301, its 1989 Form 2A allowance as adjusted to deduct the salary increases that occurred in that year. 58/ The Commission agrees that the sharp increase in historical salaries of the two senior officers when LaSalle was sold is not supported by the limited evidence of the actual duties performed by these individuals, and therefore should not be included in the allowance. On the record here the recent increase in salaries has not been justified by the fact Tarpon became independent, particularly since the record

58/ See Staff Ex. 54 (AP-3), schedule 3.

indicates that most of Tarpon's open access administrative functions are performed by the second vice president and his secretary.

Both the second vice president and his secretary were hired to perform the administrative functions previously handled by United Pipeline and LaSalle. Since most of Tarpon's day to day administrative functions are handled by the second vice president and his secretary, Tarpon has not clearly indicated on this record why the ratepayers should pay such large increases in salaries to the president and senior vice president. This is particularly true since these individuals are involved in other business activities, such as Tarpon Resources, Inc, no rigorous allocation has been produced, and protesting parties such as Oryx have asserted that Tarpon is overstaffed. Tarpon will therefore be limited to the $205,301 in salary costs it incurred in 1989.

7. Insurance policies and pensions.

The ALJ rejected Tarpon's proposal to increase the allowances for insurance and pension benefits paid its officers to those contained in its reinstated rates. Tarpon asserts this was error because, as in the case of Tarpon's salaries, it does not use Tarpon's current costs and ignores undisputed evidence that Tarpon's health insurance costs actually increased from 1989 to 1990, and that some of the beneficiaries are relatively high risk individuals. Despite the protests to the premium levels, the Commission is not prepared to jeopardize benefits that may be legitimately needed to meet the health needs of individuals who have unusual health risks. The Commission will therefore accept Tarpon's proposed premium level as appropriate to meet the needs of the individuals insured.

8. Office expenses and supplies.

The ALJ limited Tarpon's office supplies and miscellaneous deductions to the average cost of supplies for the life of the project through 1990, omitting from the average of $171,000 in unusually high travel expenses incurred in 1987. Tarpon excepts, arguing that its proposed office expenses are based on 1990 costs, the first year of its new independent operations, and that office supplies and expenses were understated in the years 1987 through 1989 because it was sharing expenses with United and LaSalle. It argues that the stand alone expenses it advances are consistent with its similar expenses in the earlier years when Tarpon was an independent company.

Oryx supports the ALJ's conclusion, noting that Tarpon's 1990 office expenses included unusually large travel expenses, and that Tarpon made no allocation of those travel expenses between those related to the extensive litigation that occurred in 1990, and those for other activities, such as marketing. Oryx also argues that Tarpon fails in its efforts to justify a high level of office expenses by comparing those expenses to earlier years. Oryx notes that in such years as 1987, when Tarpon was primarily a stand alone-company, such expenses were much lower.

The Commission will affirm the ALJ's conclusion and permit office expense allowance of $58,545. This is somewhat higher than the Staff's recommended allowance of $42,776 based on office expenses during 1989, and thus will allow a modest increase to support Tarpon's independent operations. In reaching this conclusion, the Commission notes that the following expense items Tarpon projected for 1990 are unusually high for a small company with a minimal sales effort: travel, $34,943.54; telephone, $15,851.68; communication services, $5,794.48, and office supplies of $6,928.20. However, all of these costs are consistent with the extensive litigation in this proceeding and Tarpon's ongoing litigation on the rates it reinstated in 1990. To the extent a significant portion of these costs are related to such litigation, they are non-recurring and overstate Tarpon's anticipated cost-of-service, and should not be included in the office expense component of the rates approved by this order.

9. Office rent.

The ALJ concluded that Tarpon's proposed rental cost for space and furniture was excessive, and limited that cost to the average of such costs incurred over the life of the project through 1990, or about $42,000 per year. The ALJ noted that when Tarpon had only three employees and was conducting independent operations, its total rental costs were frequently under $60,000. Oryx supports the ALJ's conclusion and would limit total rents, including parking and furniture to $27,303. The figure recommended by Staff was the 1989 level. The Commission agrees that Staff's figure is a reasonable rental.

Tarpon argues that it increased its employees when it became independent and had increased functions that had to be performed. This would not justify a 250 percent increase in total rent for the administration of 40-mile long pipeline. This increase occurred because Tarpon assumed LaSalle's lease when the latter was sold. This may have been desirable from the viewpoint of the parties to the sales transaction, but it burdened Tarpon with an inordinately high rental expense. Therefore the Commission will adopt Staff's recommendations that the actual 1989 rental costs be used, plus a somewhat higher allowance for furniture. This will be calculated as the ratio of the rental cost permitted in this order to Tarpon's suggested rental for all of its existing space, or 38.5 percent. The furniture allowance permitted here is $5,085.85 instead of the $13,200 claimed by Tarpon in its cost of service.

10. The amortization of Tarpon's regulatory expenses.

The ALJ determined that Tarpon's regulatory expenses should be divided between those that are recurring and non-recurring. While the ALJ allowed Tarpon to include in its rates both types of costs, the ALJ determined that those regulatory expenses that are non-recurring (estimated at 70 percent of the claimed amounts) should be amortized over 10 years rather than the three years used by Tarpon in its filing. The ALJ determined that Tarpon's recurring regulatory cost should be amortized over three years.

Tarpon excepts, arguing that regulatory costs are normally amortized over the time frame that the rates will be in effect, which is normally three years. Tarpon also argues that to the extent its regulatory expenses are divided between recurring and non-recurring expenses, the recurring expenses should be included in its annual cost of service. Oryx agrees with the ALJ that the expenses of this section 5 proceeding should be included in a cost component that is recovered over 10 years, while ordinary regulatory expenses, such as tariff filings, would be included in a cost component that is recovered over three years. Oryx argues, however, that some regulatory expenses, such as those related to the collection of the reinstated rates Tarpon filed in 1990 (the recoupment proceedings) should not be included, since these are past costs and may not be recovered in future rates. Anadarko/Chevron support the ALJ's conclusion on the time frame over which the expenses should be amortized. In addition, the Staff asserts that Tarpon's projections for its 1990 to 1994 litigation expenses are not known and measurable, and therefore may not be included in its future rates.

The Commission will adopt the ALJ's approach, with some minor modifications. The Commission will also separate Tarpon's regulatory expenses into recurring and non-recurring expenses. The former will be set at $44,484, the average cost for the period 1986-88, and will be recovered as part of Tarpon's normal annual cost of service for as long as its new rate remains in effect. 59/ The total regulatory expenses listed by Tarpon for 1989 were $304,657, with $1,094,139 projected for 1990, 60/ and another $720,000 projected for the years 1991-1994. Even if the annual $44,484 in recurring costs is deducted for non-recurring regulatory costs, this would leave a total in non-recurring regulatory expenses of $1,896,376 for a five-year

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59/ See Exh. 121 (Swanson) at p. 40.

60/ See Exh. No. 135, p 3. Tarpon claims its 1990 regulatory expenses were $100,000 higher than the projected $1,094,139, and Exh. No. 135 indicates that the 10 months actual for 1990 were $826,884.

period, an extraordinary amount for this small 40-mile pipeline. As Oryx points out, the three-year period covered by Tarpon's proposal would add $577,213 a year for three years, or some 3 cents per Mcf.

The Commission agrees that Tarpon's litigation costs in 1989 and 1990 were very high. However, rather than deny Tarpon the costs it actually incurred though 1990 and 1991, the Commission will affirm the equitable remedy adopted by the ALJ and permit these costs to be amortized over ten years. The section 10.5 issue Tarpon has litigated here was intended to resolve the basic rate design for Tarpon for the rest of its useful life, estimated at ten years, and the non-recurring expenses are appropriately amortized over that period. The Commission agrees that the projected non-recurring litigation costs for the years 1992-94 are speculative, particularly in light of the high costs that Tarpon seems to incur. Tarpon may file to recover those costs, if prudently occurred, as non-recurring costs once they are known, and are properly reflected in Account No. 186. 61/ Any recovery must be consistent with the ten-year amortization period adopted by this order.

In reaching these conclusions the Commission notes that Tarpon's reference to the average three-year period for rate filings is based on the restatement portion of the Commission's PGA regulations, and is inapplicable to Tarpon, which provides only transportation and does not have a PGA tariff. The Commission has concluded also, contrary to Oryx's assertion, that the costs of the litigation related to the Commission's 1990 remand orders is properly recovered through the amortization period adopted in this proceeding. All those costs relate to the fundamental issue involved here, and were part of the costs incurred in Tarpon's test period. 62/ The Commission concludes that the solution adopted here is an equitable resolution of the parties' concerns.

11. Allowances for outside services.

Tarpon's existing rates include $85,159.10 as the cost of hiring outside help to perform various legal, accounting, rate and other services for Tarpon. At hearing, Tarpon asserted that its expenses for outside services have increased to $252,974. This was the amount paid for such services in 1990. Tarpon

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61/ See Williston Basin Interstate Pipeline Company, 56 FERC ¶ 61,104 at p. 61,373 (1991).

62/ As Tarpon points out, many of these costs were incurred because the shippers protesting their inclusion resisted compliance with the Commission's 1990 remand orders.

states that when is was affiliated with LaSalle, LaSalle personnel performed the services in question on a reimbursable basis. However the amount Tarpon now seeks to include in its cost-of-service for outside services is approximately twice what LaSalle charges for these services.

The ALJ concluded that Tarpon's allowance for outside services should not exceed an amount that would simulate that provided by LaSalle when the two companies were affiliated, although he did not specifically determine this amount. Tarpon excepts, arguing that the increased cost of outside services was due to its new status as a stand alone company, that the ALJ's conclusion does not make any allowance for inflation, and that Tarpon's projected allowance of $252,974 is appropriate. Oryx argues that Tarpon's 1990 expenses were unusual and related to its creation as an independent company, and that therefore many of these expenses would be non-recurring. These include a full FERC audit, filing of several Form 2As, and related legal fees.

Commission will adopt Staff's 1989 figure of $138,152, which is the upper range of Tarpon's expenses for outside services during the years 1986, 1987, and 1989. 63/ Tarpon's witness Drennan conceded that much of the 1990 expense was for a non-recurring FERC audit and the installation of a computer system. Moreover, many of the other projected 1990 expenses appear to have been caused by establishing Tarpon as an independent company. Contrary to Tarpon's assertion, inflation between the years 1989 and 1990 (about 4 percent) does not justify almost doubling Tarpon's allowance for outside services.

12. Tarpon's anticipated expenses for assuming control of its own operations.

On November 21, 1990, Tarpon requested that the ALJ amend the procedural schedule in this proceeding to permit Tarpon to submit supplemental evidence concerning the potential cost of operating its own facilities following Trunkline's termination of the agreement under which its employees operate the Tarpon pipeline. Tarpon had been notified on November 13, 1990, that Trunkline was terminating the existing operating agreement, and therefore Tarpon would be required to begin operating its own facilities as of November 15, 1991. The ALJ denied Tarpon's request on the grounds that additional evidence would disrupt the proceedings, and that because the assumption of operations would not begin until November 15, 1991, the costs were not related to

63/ 1988 was abnormally high due to accounting expenses of $384,703.05, which are clearly unrepresentative.

the determination of whether Tarpon's current rate was just and reasonable. 64/

Tarpon excepts, noting that the additional costs were required by an event that fell within the nine month test period, and that its anticipated costs are established by its offer of proof. It claims it will be required to file yet another rate case, that the costs are already beginning to be incurred as it plans the transition to independent operations, and that it will fail to recover some $300,000 annually in operating costs and the depreciation associated with a $200,000 metering device if the costs are not allowed at this time.

Oryx, Trunkline, and Anadarko/Chevron support that ALJ's procedural ruling that Tarpon's prospective costs are not current costs, are speculative, and are not known and measurable. The Commission agrees that the costs of Tarpon's proposed independent operations are speculative, and are appropriately handled through a section 4 filing once those costs are established.

13. The treatment of negative salvage value.

As was discussed above, the ALJ determined that Tarpon should have no allowance for negative salvage value 65/ because Tarpon has overrecovered its depreciation costs. Tarpon excepts, arguing that it has not overrecovered its depreciation costs, and that denial of negative salvage value constitutes retroactive ratemaking. It argues that, even if the salvage costs have been already recovered, the Commission may not reduce Tarpon's rates prospectively to the extent those costs have not been recovered through a component of Tarpon's rates that specifically address those costs. Moreover, Tarpon asserts that, to the extent the ALJ required that any calculation of negative salvage value include an allowance for income made on previous collections, this was error.

The Commission will reverse the ALJ's conclusion and permit Tarpon to recover its negative salvage costs of $832,000 over the remaining life of the pipeline. The Commission believes that negative salvage costs are an appropriate cost to be recovered from Tarpon's current customers. Negative salvage value should be collected over the useful economic life of the pipeline to

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64/ See ALJ's Order Denying Motion to Modify Procedural Schedule issued December 4, 1990.

65/ Negative salvage value is the difference between the salvage value, if any, of facilities removed when the pipeline is demolished and removed from service, and the cost of those two activities. Negative salvage value therefore becomes part of the pipeline's life-time cost-of-service.

assure that the cost is equitably distributed over all generations of shippers. 66/ Tarpon's rates have not previously included an allowance for negative salvage costs. Consequently, the Commission believes it is equitable to permit Tarpon to include in its rates an allowance to recover these costs during its remaining economic life.

At the hearing Tarpon sponsored evidence that its negative salvage costs would be $832,000. This estimate was not challenged by any of the participants at the hearing. Consequently, the Commission will accept Tarpon's estimate. The Commission recognizes that this is a projection of future costs and that it may be reexamined in future Tarpon rate proceedings.

Finally, Tarpon shall place any funds attributed to the negative salvage value component of its rate in a separately designated, interest bearing account and shall not use the funds for general corporate purposes or for distribution to its shareholders. Any surplus from the account upon liquidation of the pipeline shall be refunded to the ratepayers.

14. The treatment of allowance for federal income taxes.

Staff asserts that the ALJ erred in not establishing a federal income tax allowance as an element of Tarpon's operating expenses. Staff claims that the income tax allowance should be $3,346, using a the traditional test-period methodology. Tarpon agrees that a federal income tax allowance is appropriate but bases its proposed allowance on assumptions different from those of Staff, namely in the calculation of the return allowance. The Commission concludes that the tax allowance should be based on the return on equity and the management fee allowed in this order.

15. Calculation of Accumulated Deferred Income Taxes.

The Staff argues that Tarpon's present accumulated deferred income tax (ADIT) balance should be zero. Tarpon excepts, arguing that Staff's position is based on its assumption that Tarpon has completely depreciated its plant. Oryx also addressed this issue, arguing that if Tarpon's interpretation of section 10.5 is adopted, all accumulated deferred income taxes should be adjusted retroactively to parallel the adjustment of Tarpon's rate base.

66/ See Tennessee Gas Pipeline Company, 32 FERC ¶ 61086 at p. 61,220 (1985); Middle South Energy Company, 31 FERC ¶ 61,30[illegible] at p. 61,658 (1985).

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The Commission agrees that Tarpon's accumulated deferre income taxe balance should be calculated on the basis that its gas transmission plant has been fully depreciation. As depreciation expense for tax purposes diminishes, actual paymen to the Treasury begin to exceed those from book depreciation because the income taxes deferred from earlier years begin to be paid. As these payments are made, the accumulated deferred income tax balance is reduced to zero. Since Tarpon's book gas transmission plant has been fully depreciated under the ruling here, its ADIT balance should reflect this. To the extent that Tarpon has taken ADIT for other assets that are not yet fully depreciated, such as furniture, it may retain the ADIT that is attributed to those assets until they are also fully depreciated.

16. <u>Use of an alternative method for determining that Tarpon's rates are just and reasonable.</u>

Anadarko/Chevron excepts from the ALJ's failure to make an alternative determination that Tarpon's current rate is unreasonable. Anadarko/Chevron and Trunkline argued that Tarpon's currently effective rate is based on a projected throughput of 9,508,876 Mcf, which is only 39.22 percent of Tarpon's actual 1988 throughput of 23,095,534 Mcf and only 49.6 percent of Tarpon's projected throughput 1990 throughput of 18,245,323. They assert that, if one accepts Tarpon's current throughput and cost estimates, other than the its proposed return on equity or management fee and income tax allowance, and substitutes Anadarko/Chevron's proposed management fee and income tax allowances, Tarpon's effective rate would be 8.7 cents per Mcf. This is approximately one half the 16.6 cents per Mcf rate ultimately advanced by Tarpon's witness Drennan.

The Commission has rejected both the management fee that Tarpon proposed and its allowance for income taxes. Therefore, the Commission agrees that the alternative calculation demonstrates that Tarpon's existing transportation rate is too high, and is unjust and unreasonable under section 5 of the NGA. However, in light of the conclusions here, which should result in a rate less than 8.7 cents per Mcf, the ALJ did not err by failing to accept the alternative calculation.

C. <u>Application of the Commission's Rate Design Policy Statement.</u>

Staff asserts on brief that Tarpon's current rate structure, if reduced to a level that is just and reasonable, conforms to the Commission's Rate Design Policy Statement. <u>67/</u> Tarpon's

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67/ Interstate Rate Natural Gas Pipeline Rate Design, <u>et al.</u>, 47 FERC ¶ 61,295 (1989), <u>order on reh'g</u>, 48 FERC ¶ 61,122 (1989).

firm transportation rate is a one part volumetric rate that permits discounting, although Tarpon has not used that authority to date. The Commission also concludes that Tarpon's short mileage and the absence of backhauls or exchanges moots the issue of mileage-based rates. Staff asserts that there is no need for a capacity adjustment mechanism under the Rate Design Policy Statement because there is no shortage of capacity. Finally, since Tarpon owns no gathering or storage facilities, unbundling is not an issue. No other party disputes these conclusions and there appears to be no record evidence to the contrary. The Commission therefore concludes that the rates to be developed under this order will conform to the Rate Design Policy Statement. However, like all other interstate pipelines, Tarpon will be subject to any final order in In Re Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, issued July 31, 1991. 68/ Nothing in this order is intended to prevent Tarpon from filing new rates that have a demand charge for firm transportation customers or to exempt it from the provisions of the cited rulemaking.

The Commission notes that while Tarpon has a purely volumetric rate, no party to this proceeding has proposed to change that rate to one containing a demand charge for firm customers. In fact, Trunkline has canceled the only firm transportation contract that is listed in Tarpon's FERC'c gas tariff, and therefore issues relating to allocation of firm capacity appear moot at this time.

Moreover, Tarpon also has an interruptible rate that is the same as the maximum rate. No party has objected to this parity in the maximum rate, and the Commission concludes that the maximum interruptible transportation rate should remain at the same level because interruptible transportation has a high quality of service, as reflected in the fact that there have been no curtailments in the last five years. Moreover, there is no evidence of capacity shortages on Tarpon's system.

68/ 56 FERC ¶ 61,178 (1991).

The Commission orders:

(A) The initial decision is affirmed and modified as more specifically stated in this body of this order.

(B) Within 30 days of the issue date of this order Tarpon shall file tariff sheets that conform to this order, which sheets shall have an effective date of not later than January 1, 1992.

By the Commission.

(S E A L)

Lois D. Cashell

Lois D. Cashell,
Secretary.

Document Content(s)