Client Alert

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FERC Issues Policy Statement Allowing Surcharge Cost Recovery Mechanism for Natural Gas Infrastructure Modernization/Safety Costs

FERC approved a new policy statement allowing natural gas pipelines to seek recovery of certain safety- and reliability-related capital expenditures made to modernize pipeline system infrastructure through a not-often-used surcharge mechanism. *Cost Recovery Mechanism for Modernization of Natural Gas Facilities*, Docket No. PL15-1-000, 151 FERC ¶ 61,047 (2015).

The capital expenditures that would be allowed recovery under the new surcharge would be those infrastructure costs that enhance system reliability, safety and regulatory compliance, such as those required under recent or future regulatory reforms by the US Pipeline and Hazardous Materials Safety Administration (PHMSA), the US Environmental Protection Agency (EPA) and other agencies. The policy statement takes effect on October 1, 2015.

The policy statement sets up a framework for how FERC will evaluate cost recovery proposals for necessary expenditures such as replacing old and inefficient compressors or leak-prone pipelines. Under the framework, FERC will ensure that any cost recovery will be just and reasonable to protect consumers from excessive costs.

The framework establishes five criteria that must be met for a proposed modernization cost surcharge mechanism or "tracker": (1) the pipeline's base rates must have been recently reviewed through an NGA Section 4 rate proceeding, a cost and revenue study, or a collaborative effort between the pipeline and its customers; (2) eligible costs are limited to specifically identified, one-time capital costs incurred to meet safety or environmental regulations or other capital costs shown to be necessary for the safe, reliable and/or efficient operation of the pipeline; (3) captive customers must be protected from cost shifts if the pipeline loses shippers or increases discounts to retain business; (4) the surcharge must allow a periodic FERC review to ensure rates remain just and reasonable; and (5) the pipeline must work collaboratively with shippers to seek their support for any surcharge proposal (but unanimous support is not required).

Generally, FERC requires that interstate natural gas pipeline open access transportation rates be designed to recover costs based on projected units of service, i.e., a stated rate. FERC determined that given the increased concerns with pipeline safety reflected in the Pipeline Safety Act and recent actions by the Department of Energy, PHMSA, EPA and the Department of Transportation, it has a duty to ensure that natural gas pipelines are able to recover the reasonable costs of system upgrades so as not to undercut their incentive to provide service in an efficient and cost-effective manner. As a result, FERC determined that a surcharge mechanism is warranted for a pipeline's recovery of costs that enhance system, safety, reliability and regulatory compliance, assuming certain safeguards covered by the five criteria are in place. The five safeguards were established in a recent rate filing by Columbia Gas Transmission, LLC, 142 FERC ¶ 61,062 (2013), in which FERC allowed the pipeline to recover pipeline modernization costs of up to $1.5 billion over a five-year period.

The surcharge cost recovery mechanism will provide benefits to natural gas pipelines by ensuring efficient cost recovery of potentially significant infrastructure costs without having to make a full rate filing. FERC will require pipelines to seek support for any proposed cost recovery mechanism from its shippers, but FERC does not expect that all pipelines will be able to get unanimous support for any such surcharge. In addition, although FERC declined to mandate an automatic reduction in return on equity (ROE), FERC indicated that it will take into account the existence of a modernization tracker as a factor to be considered for a pipeline's appropriate level of ROE and that an ROE reduction may be considered during shipper and pipeline negotiations on the tracker. Thus, pipelines could see some downward pressure on ROEs if they choose to pursue a modernization tracker.

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