The Changing Industry and FERC Landscape for Oil Pipelines and Shippers

2017 Annual Meeting & *Conference*

April 3-4, 2017

Oil Pipelines: Much Ado About Capacity

Mona Tandon
Partner
Van Ness Feldman

CURRENT STATUS

- New/expansion/reconfigured capacity:
  - Up to 90% can be reserved for committed shippers
    - Firm service at premium rate
  - At least 10% required to be available for uncommitted shippers
- Current situation: existing capacity
  - Capacity in great demand
    - Gaming with prorationing provisions
    - New entities created to get greater capacity
  - Contracted capacity becoming available as contract terms end

Colonial Pipeline Company

- *Colonial Pipeline Company*, 146 FERC ¶ 61,206 (2014)
- Background
  - 5,500 miles of pipe from Houston, TX to Linden, NJ and New York harbor
  - Transports gasoline, heating oil, aviation fuel, refined products
- PDO filed November 8, 2013
  - Due to increased production at Gulf Coast refineries, request for space on its system steadily increased over the years
  - Main lines – allocated for the last two years
  - Shippers' nominated volumes reduced (even with previous tariff changes)
  - Colonial undertook series of capacity expansions and system modifications to address allocations
  - Ability to further increase capacity incrementally diminishing
  - Colonial wanted a means to determine whether to initiate large-scale and expensive expansion

Colonial Pipeline Company (cont.)

- Colonial stated that to determine tenability of a major investment in new capacity – it wanted to secure long-term shipper support via throughput agreements
  - Held widely-publicized open season
  - 76 TSAs were executed by parties representing 75% of volumes shipped and 75% of Colonial's revenues
  - TSAs executed by members of all shipper classes
  - Tiered term and volume commitments with respective rates
  - Preferential prorationing policy for committed shippers (including first access to the allocation of any available excess system capacity)

Colonial Pipeline Company (cont.)

- Certain shippers filed in support of Colonial's PDO
  - TSAs will allow them to slow the erosion of their shipping histories
  - Hopeful that multi-year volume commitments will encourage Colonial to expand its capacity
- Certain shippers protested Colonial's PDO
  - Colonial did not propose any new or expanded capacity, and no concrete plans for such capacity
  - Colonial's proposal unduly prejudicial to shippers that did not execute TSAs
    - Allow Colonial to use its capacity to perform a higher priority service for contract shippers, and would give contract shippers discounted rates
  - Colonial creating new class of shippers out of existing similarly situated shippers
  - Violation of ICA's common carrier provisions

Colonial Pipeline Company: FERC Order

- Threshold issue: can a pipeline create contract or committed service for existing capacity that is fully utilized?
  - Due to increased oil production, changing market dynamics, and the large financial commitments necessary to increase infrastructure, FERC has approved various types of committed or contract rate structures
  - Contract rates have been approved for:
    - New pipelines
    - Expansion projects
    - Reversals/reconfigurations of existing pipelines in order to serve new markets or respond to changing market conditions
  - Contractual commitments necessary:
    - To determine support for the construction of project
    - Obtain financing
    - Ensure initial financial viability of the project, or
    - To determine the support in new or growing markets
    - For reversals/reconfigurations: contract rates ensure that a pipeline's investments to serve new markets are necessary in the long-term

Colonial Pipeline Company: FERC Order (cont.)

- Colonial not immediately constructing new infrastructure or additional capacity
  - No plans articulated for any such capacity expansions either
- Created two classes of shippers (committed and uncommitted) out of one class that was currently receiving the same service on existing capacity – unduly discriminatory
- Generally contract shippers make financial commitments to support the long-term viability of a new project
  - Unnecessary for a long-standing pipeline like Colonial that has been in allocation for many years
- Colonial's proposal would ensure Colonial "a legally unassailable revenue stream whether or not committed shippers make any shipments and without any commitment that new capacity will be added to a constrained system; at the same time it would degrade the service of existing shippers"

Palmetto Products Pipe Line LLC

- *Palmetto Products Pipe Line LLC*, 151 FERC ¶ 61,090 (2015)
- Background
  - New pipeline system
  - Transport refined petroleum products and denatured fuel ethanol
  - From Louisiana, Mississippi and South Carolina to South Carolina, Georgia and Florida
  - 125,000 bpd on segment one (LA and MS receipts to destinations)
  - 42,000 bpd on segment two (SC receipts to destinations)

Palmetto Products Pipe Line LLC (cont.)

- Filed PDO on January 23, 2015
  - 90% / 10% - Committed / Uncommitted shipper split
  - Volume and term commitments
  - Firm service – premium rate
  - Committed shippers' right of first refusal to any expansion capacity (up to 90% of expansion capacity)
  - TSA automatic renewal
  - Segment One: 2 types of long-term leases with Plantation Pipe Line Company
    - Lease capacity that was historically and consistently underutilized on Plantation's system (from Pascagoula, MS to Collins, MS)
      - Had not been used by any shipper for at least 10 years
    - Lease capacity that Plantation will create through expansion and construction
    - Plantation's shippers not impacted by either lease
    - Palmetto to release any portion of leased capacity not used by Palmetto's shippers in any month back to Plantation

Palmetto Products Pipe Line LLC: FERC Order

- Palmetto: lease of unutilized capacity is separate and distinct from Colonial's attempt to offer preferential capacity rights on an existing, but fully utilized, portion of its system
- FERC:
  - Palmetto is creating a new pipeline project
    - Providing new transportation services for refined products to new committed and uncommitted shippers
    - Partly using underutilized existing capacity on an affiliated pipeline
  - Using underutilized capacity, which has not been used for 10 years, will not impact Plantation's existing shippers
    - Analogous to a reversal or reconfiguration to serve new markets or respond to changing market conditions
  - Different than *Colonial* where pipeline was trying to convert existing capacity into contract capacity without any changes to the system

EXISTING CAPACITY: NEW USES?

- Commission's concerns:
  - Degrading anyone's current service?
  - Demand for capacity in question?
  - Creating different categories of shippers out of existing similarly situated shippers?
  - Reconfigured system?
  - Providing new services or reaching new markets?
  - Necessary for long-term viability of a new project?
    - Age of pipeline

Magellan Midstream Partners, L.P. PDO

- PDO filed Nov. 14, 2016
  - Requests FERC's permission to establish a marketing affiliate to buy, sell and ship crude oil
- Background
  - 9,700-mile refined petroleum products pipeline system – TX to ND; and NM to IL
  - 2,100 miles of crude oil pipelines and storage facilities
  - Extensive terminals
  - Currently no production or marketing affiliates
    - Not having a marketing affiliate puts Magellan at a disadvantage in attracting shippers
    - Simply lowering tariff rates won't solve the problem

Magellan PDO (cont.)

- Issues:
  - Many industry participants have marketing affiliates that buy oil upstream, transport on an affiliated FERC-regulated pipeline, then sell oil downstream, sometimes to the same party from which it bought the oil
  - Marketing affiliates either temporarily take title to crude, or transport as an agent for the third party by partially assigning its capacity rights to the third party, or by other similar contractual arrangements
  - Pipeline charges marketing affiliate the tariff rate, but marketing affiliate may charge the third party less than the tariff rate
  - Enable marketing affiliate to facilitate transportation below published tariff rates with different effective transportation costs and terms than other parties who ship directly on the pipeline
  - Benefits integrated pipeline company economics, while other stand-alone shippers may lose money or not be able to ship at all
  - Marketing affiliate creates shipping history for future

Magellan PDO (cont.)

- Proposal / Request:
  - Create a marketing affiliate to buy, sell and ship crude oil
  - Marketing affiliate can buy and sell oil at price differentials between origin and destination that are different from published tariff transportation rates, and ship on the pipeline, resulting in
    - A loss or profit to marketing affiliate, but an overall benefit to the integrated company
    - Value received by the third party buyer/seller is greater than the value it would have received if it were a shipper on the pipeline itself
  - Marketing affiliate can participate in open season and receive up to 90% of capacity (assuming no other shippers participate)
    - Use that capacity for such buy/sell transactions
    - Partially assign its rights to such capacity to third party, and third party can pay a rate to marketing affiliate that is different from the committed shipper rate so long as marketing affiliate pays the tariff rate to pipeline
    - Marketing affiliate can ship third party's oil without taking title, or other similar contractual arrangement, and charge a rate different than the published tariff rate so long as marketing affiliate pays the tariff rate to pipeline
  - Pipeline may transport such oil from marketing affiliate

Magellan PDO (cont.)

- Magellan: proposal is consistent with ICA
- Comments and Protests
- FERC decision?

Questions?

Mona Tandon
Partner
Van Ness Feldman
mxt@vnf.com
(202) 298-1886

Thank you for attending this EBA Program

For more information on EBA and upcoming events please visit:
www.EBA-Net.org

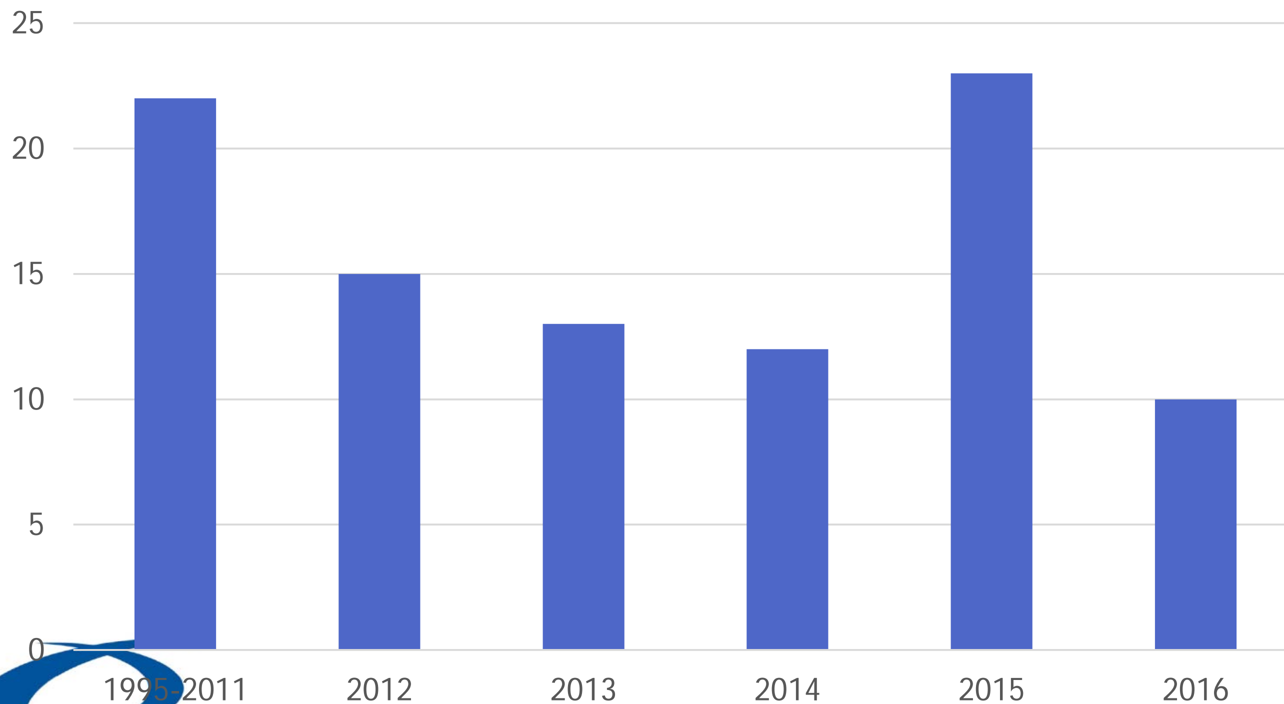
J&R Rates in the Time of PDOs

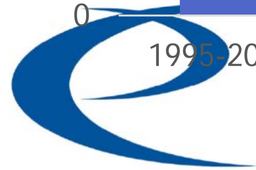
Matthew D. Field
Partner, Venable LLP

Growth in PDOs by Decision Date

- 1995: 1
- 1996: 3
- 1997: 1
- 1999: 1
- 2002: 1
- 2012: 15
- 2013: 13
- 2014: 12
- 2015: 23
- 2016: 10

More PDOs Approved in 2015 than 1995-2011 Combined





ENERGY BAR ASSOCIATION®

Key Features of PDO Process

- Approval of Rate Structure by Commission
- No initial evaluation of specific rates—filing may simply assert a "premium"
- Initial Rates Filed and Approved as Settlement Rates
  - 18 CFR 342.4(c)
  - *Express*: Allows approval for prospective shippers rather than current shippers; re-application not required for subsequent changes pursuant to contract.
    - 76 FERC ¶ 61,245 at 62,258 (1996)

ENERGY BAR ASSOCIATION®

First Principles: Farmers Union II

- “Zone of reasonableness”
- “[P]resumed market forces may not comprise the principal regulatory constraint.”
- “Departures from cost-based rates-must be made . . . when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by these factors.”
    - 734 F.2d 1486, 1530 (D.C. Cir. 1984)

Order No. 561

- "[T]he Commission is still concerned that a pipeline which has market power can establish a higher rate through 'negotiation.' Therefore, the Commission will allow a challenge to the change in rates."
- "[R]easonable grounds for believing that there is a discrepancy between the negotiated rate and the pipeline's cost of service that is so substantial as to render the rate unjust and unreasonable within the meaning of the ICA."
  - FERC Stats. & Regs. ¶ 30,985 at 30,959 (1993)

ENERGY
BAR ASSOCIATION®

Order No. 561-A

"Allowing a protest to a settlement rate permits those shippers who were not party to that agreement to protect themselves and other shippers from an unjust and unreasonable initial rate."

- FERC Stats. & Regs. ¶ 31,000 at 31,106 (1994)

Has FERC's Position Changed?

- *Seaway:* "To argue that the negotiation process results in unjust and unreasonable rates merely due to a divergence between these and cost-based rates is to attack the Commission's entire ratemaking regime."
  - 146 FERC ¶ 61,151 at P 24 (2014)
- But: "There is no question that the Commission has the authority to review . . . and . . . modify committed rates that it finds to be unjust and unreasonable."
  - *Id.* at P 19.

Implications of PDOs for Shipper Challenges

- Are committed rates presumed reasonable? What does that mean for shipper rights to protest or complain?
  - Who can challenge committed rates?
- Are refunds and reparations available with respect to committed rates?
- If so, against what rates?
  - Can rates be lowered below initial committed rates?

Complicating Factors

- Does *Seaway* rationale apply when capacity reserved for committed shippers? Limits? (e.g., 90% reserved)
- Is a full open season required?
  - Can access to committed rates be time limited?
- What if the only committed shippers are pipeline affiliates?
  - *Enlink Crude Pipeline, LLC*, 157 FERC ¶61,120 (2016)
- Treatment of non-index changes to committed rates

Issues with a "Recourse Rate"

- Does the existence of a cost-based uncommitted rate provide sufficient protection against an exercise of market power?
- What conditions would suggest otherwise?
- How should FERC account for other features of committed service and obligations of committed shippers?

Impact on Shipper Activity

- Increased activity: Shippers participate earlier in PDO process; assert rights prior to filing of initial rate
- Decreased activity: More shippers choose committed rates; duty to support provisions and FERC reluctance to evaluate committed rates limit protests

Questions?

Matt Field

Partner

Venable LLP

mfield@Venable.com

202.344.8281

ENERGY
BAR ASSOCIATION®

Thank you for attending this EBA Program

For more information on EBA and upcoming events please visit:
www.EBA-Net.org

ENERGY BAR ASSOCIATION®

An Institutional Perspective on the Regulation of Pipelines in the United States

Laura T.W. Olive, Ph.D.
National Economic Research Associates, Inc.

A Historical Perspective

- Oil and gas pipeline regulation diverged with the 1906 Hepburn Amendment.
- Oil pipeline regulation evolved around a foundation of "common carriage."
- Gas pipeline regulation evolved in recognition of its foundation in cost-based capacity rights or "contract carriage."
- Piecemeal application of the gas pipeline regulatory model to oil pipeline ratemaking will not achieve the same result.

ENERGY BAR ASSOCIATION®

Public Outrage over Standard Oil

Ida Tarbell

Journalist, Leading Muckraker

Publishes a series of articles on Standard Oil and J.D. Rockefeller's business practices.

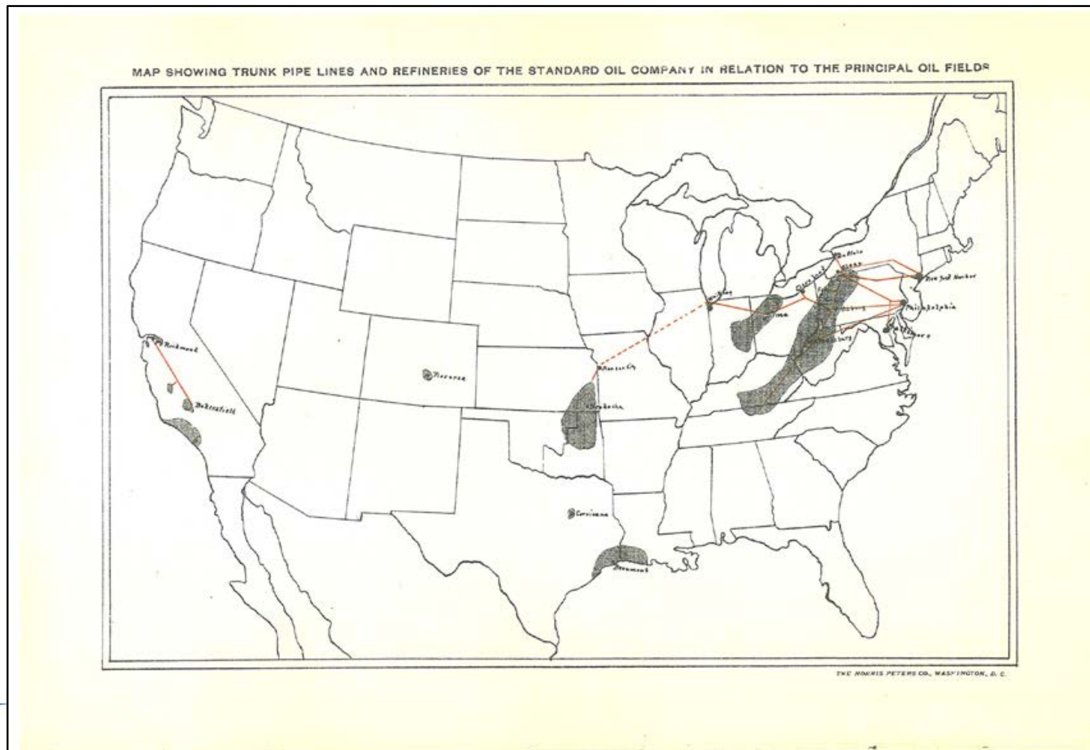
President Theodore Roosevelt

Politician, Progressive

Pushes Congress to investigate and curb Standard Oil's monopolization of the industry.

Standard Oil Pipelines in 1906

What Congress looked at:



ENERGY BAR ASSOCIATION®

Congressional Response

- Congress' only regulatory oversight experience was with railroads.
- The Interstate Commerce Act (ICA) of 1887 created the Interstate Commerce Commission to regulate railroads.
- The ICA was extended to cover oil pipelines (all pipelines transporting oil or oil commodities *except* water and natural/artificial gas) with the **Hepburn Amendment** in 1906.
  - Pipelines are deemed "common carriers" but can own the product they transport (no "commodities clause").

ENERGY BAR ASSOCIATION®

Public Outrage over Gas Pipelines

Samuel Insull

Business Magnate, Protégé of Thomas Edison

Insull's public utility holding company collapses in 1931-32, during the Great Depression.

Congressman Sam Rayburn

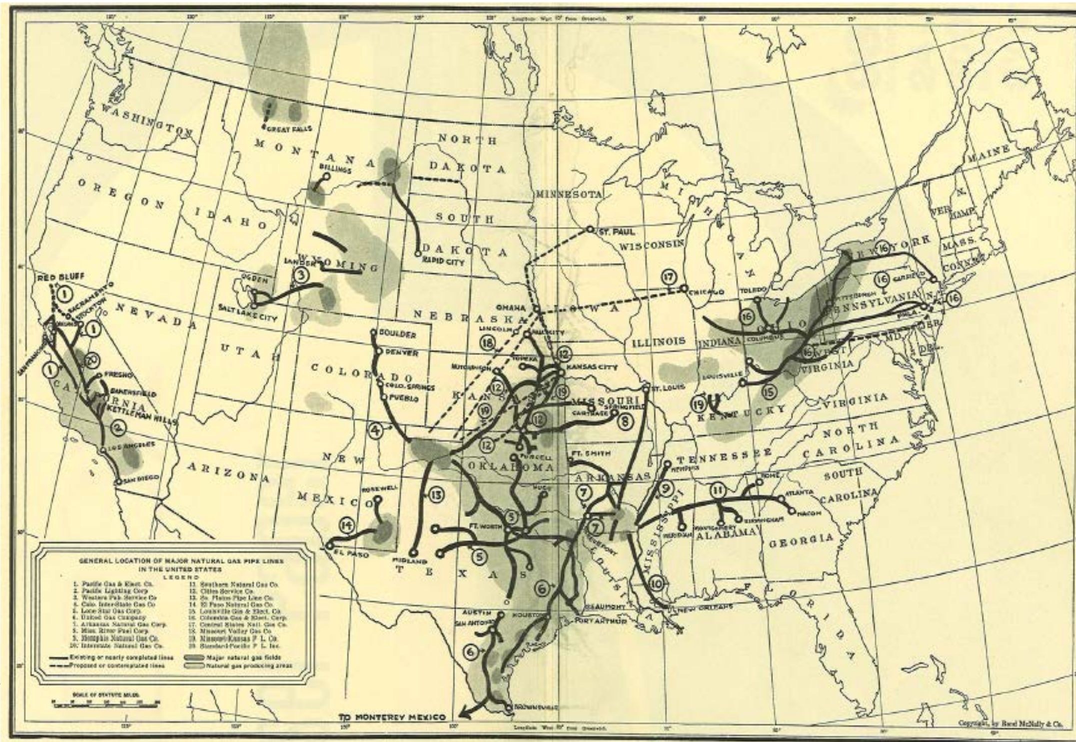
Democrat, Texas

Pushes Congress to investigate holding companies.

ENERGY BAR ASSOCIATION®

Gas Pipelines in 1930

What Congress looked at:



ENERGY BAR ASSOCIATION®

Congressional Response

- The **Public Utility Holding Company Act of 1935** (PUHCA) gave the SEC jurisdiction over public utility securities and the power to break up companies. By the 1950s, few holding companies remained.
- The **Natural Gas Act of 1938** enacted to regulate interstate pipelines
  - Federal Power Commission (or FPC, predecessor to the FERC) given jurisdiction
  - Includes accounting regulation and cost determination
  - FPC has certification authority (limited to instances where a new pipeline would serve a market already served by an existing pipeline).

ENERGY BAR ASSOCIATION®

Growing up with Common Carriage: The Transition to Light-handed Rate Regulation—"Muddling Through"

- Deregulating Oil Pipelines: 1986 DOJ Oil Pipeline Report
  - Sets the standard analyzing concentration "origin" and "destination" markets.
- DC Court of Appeals guides the FERC towards cost-based ratemaking.
  - FERC has statutory obligation to ensure rates are "just and reasonable."
- Energy Policy Act of 1992: Simplifying Regulation
  - Congress directs FERC to minimize regulatory costs and delays.
  - FERC establishes an indexing methodology for rate increases which is updated every 5 years.

ENERGY BAR ASSOCIATION®

Growing up with Contract Carriage—Sharpening the Focus on Regulatory Contractual Rights

- FERC provides financial incentives to encourage pipelines to adopt open access in Order No. 436 (1985)
- FERC creates independent contract carriage in Order No. 636 (1992)
- FERC works on creating a viable secondary market in contract rights
  - "Straight fixed-variable" tariffs
  - "Incremental Pricing" for new and expanded capacity
  - Fully informed and costless trading system
- Effective deregulation

ENERGY BAR ASSOCIATION®

Recent Attempts to use Contract Carriage concepts for Common Carriers (1)

- Petitions for Declaratory Orders
  - Pipelines have applied for—and FERC has granted—approval to offer contract carriage options and priority service.
  - The FERC received 74 petitions for Declaratory Orders of this type between 2011 and 2015.
  - FERC allowed Shell to set up a tariff structure with transferrable histories (a "sublet" market of sorts).
- But, as common carriers, pipelines still have to set aside capacity for "walk-up" service.

ENERGY
BAR ASSOCIATION®

Recent Attempts to use Contract Carriage concepts for Common Carriers (2)

- October 2016 ANOPR on Indexing Methodology and Reporting Requirements
  - Proposed that pipelines with revenue 15 percent greater than their costs (over two years) unable to apply the index to raise rates.
  - Proposed to deny an increase if the result would produce a difference of 5% between the rate and reported barrel-mile cost change that year.
  - Additional filing requirements on Page 700 of FERC Form 6.
- Indexing methodology developed as a shift to light-handed regulation.
- More oversight would shift back to a more stringent, gas-pipeline-like cost-of-service based regulation.

ENERGY BAR ASSOCIATION®

Conclusions

- Evolution around common carriage and contract carriage separates gas pipelines and oil pipelines today.
- History shows that oil pipeline regulations have muddled through to develop a more light-handed approach.
- Similarly, the institutions that underpin gas pipeline regulation result in a market that "regulates itself" and a fully competitive secondary market.
- The gas pipeline model cannot be easily applied piecemeal to oil pipeline regulation to achieve the same result.

ENERGY
BAR ASSOCIATION®

An Institutional Perspective on the Regulation of Pipelines in the United States

Laura T.W. Olive, Ph.D.
Senior Consultant
NERA—Boston
+1 617 927 4588
laura.olive@nera.com

2017 EBA Annual Meeting & Conference