

**ENERGY BAR ASSOCIATION'S
OIL & LIQUIDS PIPELINE REGULATION COMMITTEE**

PRESENTS

“OIL PIPELINES 101”

BROWN BAG MEETING/TELECONFERENCE
(CLE CREDIT IS NOT SECURED FOR THIS MEETING)

February 14, 2012

12:00 noon – 2:00 p.m. (Eastern Time)

**LOCATION: Federal Energy Regulatory Commission
888 First St., N.E., Washington, D.C.**

Dear Colleagues,

The EBA's Oil and Liquids Pipeline Regulation Committee invites you to a “brown bag” lunch on February 14, 2012 with a panel presentation and open discussion on Oil Pipeline practice.

The issues to be covered are:

- What are oil pipelines and how do they differ from other pipelines
- The main law that governs oil pipelines
- Rate making - how is it set and how does it change
- Explanation of Cost of Service and MBR
- Procedural nuances of the practice
- Service Regulation - FERC's broad jurisdiction over transmission
- Latest News and Developments

Panelists:

Andrew Lyon, Office of General Counsel, Federal Energy Regulatory Commission

Elisabeth Myers, Partner, Husch Blackwell, LLP

Daniel Poynor, Partner, Steptoe & Johnson, LLP

**Energy Bar Association: Oil & Liquids Pipeline Regulation Committee
February 14, 2012 “Oil Pipeline 101” Brown Bag Presentation**

OIL PIPELINE REGULATION UNDER THE INTERSTATE COMMERCE ACT

**Andrew L. Lyon
Managing Attorney, FERC Office of the General Counsel**

I. What FERC Regulates - Transportation of oil and oil products

- A. From one state to any other state
- B. From or to any place in the U.S. to or from a foreign country

II Brief History of Oil Pipeline Regulation

- A. Hepburn Act of 1906
 - 1. Common carriage
 - 2. Rate and practices regulation
- B. Department of Energy Organization Act of 1977
 - 1. Jurisdiction transferred from ICC to DOE to FERC
 - 2. Interstate Commerce Act frozen in time as of 10/1/77

III. Interstate Commerce Act

- A. Just and reasonable rates - Section 1(5)(a) of ICA
 - 1. Tariffs filed with the Commission - Section 6(1)
 - 2. Only a rate on file can be charged for transportation – Section 6(7)
 - 3. Changes upon 30-days notice - Section 6(3)
 - 4. Suspension up to 7 months; refunds - Section 15(7)
- B. Transportation must be provided upon reasonable request - Section 1(4)

C. Undue discrimination and preferences prohibited - Sections 2 and 3

IV. What is Not Regulated Under the ICA

A. Entry into service

B. Abandonment of service

C. Mergers and acquisitions

D. Safety - authority rests with the Department of Transportation

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FERC OIL PIPELINE RATEMAKING POST ENERGY POLICY ACT OF 1992

**Elisabeth R. Myers
Partner, Husch Blackwell LLP**

- I. FERC Oil Pipeline Ratemaking After the 1992 EPAct
 - A. EPAct of 1992, effective Oct. 24, 1992.
 1. Mandate for Simplified Ratemaking.
 2. Mandate for Just and Reasonable Rates under ICA § 1(5)
 - Statute provides: “Simplified ratemaking and generally applicable ratemaking methodology in accordance with Section 1(5)” of the ICA. EPAct § 1801(a).
 - Streamlined procedures for oil pipeline rates “to avoid unnecessary regulatory costs and delays.” EPAct § 1802(a).
 - B. New Regulatory Regime -- Order Nos. 561 *et seq.*
 1. “Grandfathered” Rates and “Substantially Changed Circumstances.” EPAct § 1803(b).
 - Grandfathered rate -- a rate that was in effect for the 365-day period ending on the date of enactment of EPAct that was not subject to challenge by protest, complaint or investigation shall be deemed just and reasonable.
 - Subject to complaint only if complainant meets substantially changed circumstances standard.
 - A substantial change has occurred after date of enactment “in the economic circumstances of the oil pipeline which were a basis for the rate.” (or “in the nature of the services provided which were a basis for the rate”)
 - Any rate increase that occurred after the date of enactment of EPAct of 1992 is not “grandfathered.” *ARCO v. Calnev Pipe Line LLC*, 97 FERC ¶ 61,057, at 61,311 (2001). This covers the index increments of all rates.
 2. Indexing
 3. Ways of Establishing Initial Rates
 - a. Settlement
 - b. Cost-of-Service
 - c. Opinion No. 154-B, *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985)
 - Op. 154-B issued on remand of *Farmers Union II -- Farmers Union Central Exch. Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir.), *cert. denied sub nom William Pipe Line Co. v. Farmers Union Central Exch. Inc.*, 469 U.S. 1034 (1984).
 - In *Farmers Union II*, Court provided “important and basic guideposts”:
“Most fundamentally, FERC's statutory mandate under the Interstate Commerce Act requires oil pipeline rates to be set within the "zone of reasonableness"; presumed market forces may not comprise the principal regulatory constraint. Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors. In addition, the rate of return methodology should take

account of the risks associated with the regulated enterprise. It should not be forgotten, too, that the choice of a proper rate of return is only part of what should be an integrated ratemaking method, and accordingly FERC must carefully scrutinize the rate base and rate of return methodologies to see that they will operate together to produce a just and reasonable rate.”

Farmers Union II, 734 F.2d at 1530.

The ICA “requires *meaningful* rate regulation;” and “not even ‘a little unlawfulness is permitted.’”

Farmers Union II, 734 F.2d at 1507, 1508.

➤ On remand, Op. 154-B adopted a cost-based method to be applied in all oil pipeline rate regulation based on trended original cost.

➤ Trended Original Cost

-- different than Depreciated Original Cost used for electric and gas ratemaking in its treatment of inflation in the rate of return on equity and use of a starting rate base writeup.

-- TOC distinguishes between the nominal rate of return on equity which includes inflation and the real rate of return on equity from which inflation is subtracted. The real rate of return on equity times the equity share of the rate base yields the yearly allowed equity return in dollars. The nominal rate of return times the equity rate base is used to write up the rate base. *I.e.*, it is capitalized into the equity rate base and results in an additional return on equity to the pipeline.

-- TOC explained in Op 154-B at 61,834.

4. Ways of Changing Rates

a. Annual Indexing -- the norm

b. Cost-of-Service Rates and “Substantial Divergence”

➤ To qualify for a cost-based rate increase, the pipeline must show three things:

-- The revenues received under the current rates are not sufficient to cover the pipeline’s “cost of service.”

-- There is a “substantial divergence” between the revenue shortfall and the cost of service claimed.

-- The costs are reasonable and prudent and the revenue estimates correct so that the resulting rate will be just and reasonable, the projected revenues being equal to or less than the cost of service.

c. Market Based Rates (Order No. 572)

➤ A pipeline may apply for market-based rates upon a showing that its rates will be constrained by market forces. But the market-based rate must be in the same “zone of reasonableness” as a cost-based rate. *Farmers Union II*, 734 F.2d at 1502.

d. Settlement Rates

5. FERC Form 6 Annual Report, Page 700

a. Order No. 571 initiated a new Page 700

b. NOPR re Page 700, Docket No. RM11-21 (issued July 2011)

➤ Would amend Page 700 of FERC Form No. 6 annual report to ensure that the oil pipelines report only interstate barrel and barrel-mile data and not a combination of interstate and intrastate throughput.

- Commission proposed to direct oil pipelines that reported combined interstate and intrastate data on lines (1) through (12) of Page 700 of their 2010 Form 6 to file a revised Page 700 containing only interstate data for the years 2009 and 2010.
- Requiring only interstate data to be reported is a change that shippers have long sought because the Form 6 Page 700 is supposed to be the primary screening tool by which shippers and the Commission can evaluate oil pipeline index rate increases and other rate filings. Having the Form 6 as an effective tool is essential in an era when the Commission relies on shippers to bring problems to its attention. Yet, the combined reporting of the interstate and intrastate data has made analysis problematic. FERC only has jurisdiction over interstate rates.
- The Commission rejected the requests of shippers just a couple of years ago in another proceeding to do just this, plus more. NOPR is a very limited proposal that falls far short of the comprehensive Form 6 reforms shippers have sought in the past.
- Several rounds of Comments filed by AOPL, shippers, and “Citizen Gooch” -- comments and petition for redress of grievances by former FERC General Counsel Gordon Gooch.
- Gooch comments submitted data showing that 26% of all oil pipelines that filed the Form 6 in 2010 reported excess revenues on their Page 700s.

6. Protests (18 C.F.R. § 343.3)

a. Standing -- “substantial economic interest” in the rate/tariff filing. 18 C.F.R. § 343.2(b) & 18 C.F.R. § 343.3(a).

b. Being a “shipper” is not the test for standing to protest. “Whether an entity is a current or future shipper is relevant for purposes of determining substantial economic interest but it is not the only consideration. There is not a bright line test. As the Commission has stated, the “‘substantial economic interest’ standard is intended to assure that parties protesting a filing have sufficient interest in the matter to warrant the commitment of agency and pipeline resources to a review of the merits.” [fn citing *Shell Pipeline Company, LP*, 104 FERC ¶ 61,021, at 61,052 (2003).] Such standing is therefore based on all the facts and circumstances of the particular proceeding.”

Enbridge Pipelines (Southern Lights) Inc., 134 FERC ¶ 61,067, P 11 (2011).

- Where costs of a shipper are directly passed through to another party, the Commission has found standing. *Mid-America Pipe Line Co.*, 123 FERC ¶ 61,085, at P 5 (2008).

c. Burden of proof on pipeline

d. Commission action limited to issues raised in the protest. 18 C.F.R. § 343.3(c).

e. Suspension

- 7 months statutory maximum. In practice unusual, because threshold is high. *Buckeye*. More typical term of suspension is one day.

f. Withdrawal of protest that caused initiation of investigation automatically terminates investigation. 18 C.F.R. § 343.3(d).

g. Index protest

- Protest “must allege reasonable grounds for asserting that the rate violates the applicable ceiling level, or that the rate increase is so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable.” 18 C.F.R. § 343.2(c).
- This is a burden of production, not proof. *AOPL v. FERC*, 83 F.3d 1424, 1444 (D.C. Cir. 1996).
- In practice, Commission has shifted burden of proof to shippers. Order on Rehearing, *SFPP, L.P.*, 113 FERC ¶ 61,253, at P 22 (Dec. 12, 2005) (“Indicated Shippers retain the burden of proof in any challenge to these indexed rates.”).
- Only two index rate increases ever set for hearing. The first (Calnev) settled; the second (SFPP) is now wending its way through the settlement and hearing process.
- Dismissal of protest to index not subject to judicial review. *ExxonMobil Oil Corporation v. FERC*, Case Nos. 05-1471 and 05-1472, Unpublished Slip Op., 2007 WL 754800 (D.C. Cir. Feb. 27, 2007).

h. FERC jurisdiction under ICA § 15 -- *Ayrshire Collieries Corp. v. U.S.*, 335 U.S. 573 (1949).

- Different than the NGA which distinguishes between Sections 4 and Section 5 authority.
- Under ICA Section 15(7), Commission has authority to determine the lawfulness not only of the rates proposed by a pipeline in a particular proceeding, but also of the underlying existing rates.

“This proceeding is an investigation and suspension proceeding under s 15(7) of the Interstate Commerce Act, 44 Stat. 1447, 49 U.S.C. s 15(7), 49 U.S.C.A. s 15(7). That section, which gives the Commission broad authority upon complaint or its own initiative to investigate and determine the lawfulness of any new rate, ^{FN7} provides that ‘after full hearing, whether completed before or after the rate * * * goes into effect, the commission may make such order with reference***582** thereto as would be proper in a proceeding initiated after it had become effective.’

...

“The power of the Commission to deal with the situation as if the proposed new rates had become effective is necessarily a comprehensive one. It seems too plain for argument that such broad authority is ample for the modification of either proposed or existing rates or both. The power granted the Commission under s 15(1) to deal with rate schedules already effective supports that view. ^{FN8} For once the Commission****284** finds the rate to be unjust or ***583** unreasonable or unjustly discriminatory or unduly preferential or prejudicial or otherwise unlawful, the Commission is granted the power under s 15(1) to determine and prescribe the just and reasonable rate. The Commission is not bound either to approve or disapprove in toto the new rates that are proposed. It can modify the proposal in any respect and require that the proposed rates as modified or wholly different rates be substituted for the present ones. That has been the view of the Commission since the beginning; ^{FN9} and we think it is the correct one.”

Ayrshire Collieries, 335 U.S. at 581-582.

7. Complaints under ICA § 13

a. Statute says: “Any Person”

- In practice, Commission appears to require showing of substantial economic interest.
- Under the complaint regulation, 18 C.F.R. § 206 -- complainant must show a good faith quantification of the financial or other impact on complainant.

- However, for complaints against index rates, the Commission has established a “substantial exacerbation” threshold standard with respect to bringing a complaint against an index increase when the pipeline’s Page 700 shows excess revenues. Shipper must show that application of the index means that the “resulting rate increase would substantially exacerbate that over-recovery.” *BP West Coast Products LLC v. SFPP, L.P.*, 121 FERC ¶ 61,141, at P 10 (2007).
 - b. Reparations available going back 2 years from the filing of the complaint, with some limitations:
 - i. Grandfathered rate level is floor
 - ii. *Arizona Grocery Co. v. Atchison, T. & S.F. Ry. Co.*, 284 U.S. 370 (1932).
- Lawful vs. legal rates: the Supreme Court in *Arizona Grocery* distinguished between “legal” rates, rates being on file, and “lawful rates,” rates found by the Commission to be just and reasonable on the merits after hearing.
- Preexisting lawful rate as the lower limit on reparations
 - c. Burden of proof on complainant
 - d. Rate must be in effect before it can be challenged by complaint
 - e. Withdrawal of complaint terminates any proceedings with respect to that complaint. EPCAct § 1802(d)(2).
- 8. FERC Five-Year Review of the Index, Docket No. RM10-25
- Original index formula established at PPI-FG minus 1.
- Currently, as a result of latest five-year review, it is PPI-FG plus 2.65, effective for the next index cycle for index rates to be filed effective July 1, 2012.

Resources:

FERC Staff Oil Pipeline Handbook (in 4 volumes), put together by Bill Froehlich (2nd Edition 1992) (available from the FERC website)

Matthew Bender Treatise, *Energy and Transactions*, Chapter 3 overview (which I just updated) and Chapter 85 on Oil Pipeline Regulation (which Daniel Poynor updates)

Elisabeth R. Myers, *Ten Years On, Oil Pipeline Deregulation Leads to Excesses—Gas, Electric Next?* Natural Gas and Electricity (August 2010 Wiley) (containing citations for many of the propositions herein and more).

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**RECENT OIL PIPELINE DEVELOPMENTS:
INNOVATIVE RATE AND TARIFF MECHANISMS SUPPORTING OIL PIPELINE
INFRASTRUCTURE EXPANSION**

**Daniel J. Poynor
Partner, Steptoe & Johnson LLP**

- I. Growth in Oil Pipeline Infrastructure Projects Spurred by New Production
 - A. Increased Crude Oil Production (*e.g.*, Western Canadian oil sands, Bakken)
 - B. Increased NGL Production (*e.g.*, Marcellus)
- II. Cross-Border Permitting Issues
 - A. Unlike domestic pipeline projects, cross-border pipelines need federal approval
 - B. Presidential permits issued for Alberta Clipper and base Keystone projects
 - C. Keystone XL project – brief discussion of project and FERC’s potential role
- III. Innovative Rate and Tariff Mechanisms Supporting New and Expanded Pipeline Projects
 - A. Contrast recent proposals with traditional T&D agreements and volume discounts
 - B. Brief overview of TSA, open season, and petition for declaratory order process
 - C. Priority service for pipeline expansions and new pipeline projects
 - 1. Is “firm service” consistent with oil pipeline common carrier obligations?
 - 2. How much capacity can be reserved for firm service?
 - 3. Must the pipeline charge a premium rate for priority service?
 - D. Ratemaking issues
 - 1. Surcharges (*e.g.*, Colonial, Calnev, various Enbridge cases)
 - 2. Other non-traditional ratemaking methodologies (*e.g.*, TransCanada Keystone, Enbridge Southern Lights)
 - 3. Market- based rates (*e.g.*, Seaway)