

Report of the Committee on Oil Pipeline Regulation

The past year has seen several significant developments in the field of oil pipeline regulation. Foremost among those developments was the passage of the Energy Policy Act of 1992¹ which, among other things, requires substantial reforms in the way that the Federal Energy Regulatory Commission (FERC) regulates oil pipelines. Other 1992 legislative developments include the amendment and reauthorization of the Hazardous Liquid Pipeline Safety Act of 1979 (HLPSA).² The amendments, implemented pursuant to the Pipeline Safety Act of 1992,³ impose additional pipeline inspection and reporting duties upon the Department of Transportation (DOT). On the administrative front, the FERC issued its Policy Statement on Incentive Regulation,⁴ which establishes an alternative to the traditional cost of service approach to setting rates for oil pipelines, as well as for natural gas pipelines and electric utilities that have market power. Finally, in two cases, *Bonito Pipe Line Co.*⁵ and *Oxy Pipeline, Inc.*,⁶ the FERC clarified the extent of its jurisdiction under the Interstate Commerce Act (ICA)⁷ over oil pipelines operating on the Outer Continental Shelf (OCS).

I. ENERGY POLICY ACT OF 1992

On October 24, 1992, President George Bush signed into law the Energy Policy Act of 1992 (Act), including Title XVIII, "Oil Pipeline Regulatory Reform," which requires substantial reforms in the FERC's oil pipeline program.⁸ Among other things, the Act directs the FERC to issue a final rule within one year, developing a simplified, generally applicable ratemaking methodology for oil pipelines.⁹ The Act also directs the FERC, within 18 months after the date of the enactment, to issue a final rule to streamline procedures relating to oil pipeline rate proceedings in order to avoid unnecessary regulatory costs and delays.¹⁰

Issues to be considered by the FERC in streamlining its procedures

1. Pub. L. No. 102-486, 106 Stat. 2776 (1992).

2. 49 U.S.C.A. app. §§ 2001-2015 (West Supp. 1993) (amending the original Act found at 96 Pub. L. No. 129, 93 Stat. 1003 (1979)).

3. Pub. L. No. 102-508, 106 Stat. 3289 (1992).

4. *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities*, 61 F.E.R.C. ¶ 61,168 (1992).

5. 61 F.E.R.C. ¶ 61,050 (1992).

6. 61 F.E.R.C. ¶ 61,051 (1992).

7. 49 U.S.C. §§ 10501-10562 (1988).

8. Oil pipeline is defined by the Act to include any common carrier, within the meaning of the ICA, which transports oil by pipeline subject to the functions and authority vested in the FERC pursuant to section 402(b) of the Department of Energy Organization Act (42 U.S.C. § 7172(b) (1988)). Pub. L. No. 102-486, § 1804(2)(A). However, the Trans-Alaska Pipeline system, and any pipeline delivering oil directly to that system, is expressly excluded from such definition, and thus the reforms mandated by the Act. *Id.* § 1804(2)(B).

9. Pub. L. No. 102-486, § 1801.

10. *Id.* § 1802(a).

include (1) the identification of information which must be contained in an oil pipeline's tariff filing; (2) who has standing to protest a tariff filing or file complaints thereto; (3) the level of specificity required for a protest or complaint; (4) an opportunity for an oil pipeline to file a response to an initial protest or complaint; and (5) the circumstances under which commission staff may initiate a protest.¹¹ The Act also mandates that if an oil pipeline withdraws a tariff then under investigation, the underlying proceeding shall be terminated, and the previous tariff rate shall be reinstated. Any amounts collected under the withdrawn tariff that are in excess of the previous tariff shall be refunded to the shippers.¹² In addition, if a complaint with respect to an oil pipeline tariff is withdrawn, any proceeding with respect to such tariff shall be terminated.¹³ The Act also requires the FERC to establish alternative dispute resolution procedures, which shall be the preferred method of adjudicating rate disputes.¹⁴ Any proposed rates resulting from such procedures must be given expedited consideration by the FERC.

For purposes of promoting a smooth transition to the new ratemaking methodology, the Act states that rates for oil pipelines on file with the FERC and in effect for one year prior to the date of enactment without suspension, protest, or complaint will be deemed just and reasonable. These rates will no longer be subject to challenge except on the grounds of undue discrimination or preference, or if changed circumstances, as set forth in the Act, are alleged.

II. HAZARDOUS LIQUID PIPELINE SAFETY ACT

On October 24, 1992, President Bush signed into law the Pipeline Safety Act of 1992.¹⁵ Among other things, the Pipeline Safety Act amends and extends the authorization of the HLPESA for fiscal years 1992, 1993, and 1994.¹⁶ The amendments to the HLPESA are most notable however, for what they did not include. Although earlier versions of the legislation had included provisions calling for the mandatory implementation of expensive pipeline inspection methods, the enacted version delayed such measures while still addressing the environmental and safety concerns raised by pipeline corrosion. Section 203 of the HLPESA was amended to require the DOT to identify, within two years from the date of enactment, all pipeline facilities which pass through "environmentally sensitive" or "high-density population areas" and within three years to require increased inspection of pipelines in those areas. The increased inspection requirements include a provision permitting the DOT to issue regulations defining under what circumstances pipeline operators must utilize "instrumented internal inspection" devices¹⁷ to conduct pipe-

11. *Id.* § 1802(b)(1)-(5).

12. *Id.* § 1802(d)(1).

13. *Id.* § 1802(d)(2).

14. *Id.* § 1802(e).

15. Pub. L. No. 102-508.

16. Oil pipelines are subject to § 2001 of the Hazardous Liquid Pipeline Safety Act. 49 U.S.C.A. app. § 2001 (West Supp. 1993).

17. More commonly known as "smart pigs." A smart pig is a device which gathers information on the conditions of pipeline walls while cleaning corrosion products, liquids, or obstructions from the inside of the pipeline.

line safety inspections. The Pipeline Safety Act consequently requires only that the DOT "survey and assess the effectiveness of emergency flow restriction devices" within two years and within two additional years prescribe regulations dictating when the flow restriction devices must be utilized.

The enforcement provisions of the HLPESA were also augmented by increasing the maximum civil penalty available under the Act from \$10,000 to \$25,000. In addition, federal district courts were granted jurisdiction to enforce the Act with their contempt powers. The Act further provides for additional requirements regarding abandoned pipelines, including underwater facilities. Specifically, section 216 of the Pipeline Safety Act requires that the DOT identify which of such pipelines may pose a hazard to navigation and to issue regulations designed to lessen the potential for mishaps. Section 307 requires the DOT to survey federal and state policies with respect to abandonment and to study the need for additional federal action on previously abandoned facilities.

Certain generally applicable provisions were also added which apply to both hazardous liquid and natural gas pipelines. Most notable among these is a provision allowing for a fine and/or prison term not to exceed five years for persons engaged in excavation who fail to use an available one-call notification system to determine the location of underground facilities or fail to heed pipeline location markings, and subsequently damage a hazardous liquid or natural gas pipeline in a manner which results in death, serious bodily harm, property damage in excess of \$50,000, or, in the case of a hazardous liquid pipeline, the release of more than fifty barrels of product.¹⁸

III. INCENTIVE RATEMAKING

In October, 1992, the FERC issued its Policy Statement on Incentive Regulation.¹⁹ The Policy Statement was adopted in an attempt to lower costs to customers while encouraging utilities²⁰ to operate more efficiently and, thereby, increase their rate of return.²¹ The FERC concluded that traditional cost-based regulation does not offer a company serving noncompetitive markets²² sufficient incentives to reduce spending and increase efficiency. The stated goal of the Policy Statement is to offer incentives fostering long-term, rather than short-term, efficiency achievements. These incentives are to be created through rate structures individually tailored and advanced by each company, but developed in accordance with the requirements laid out in the Policy Statement.

18. Pipeline Safety Act of 1992, Pub. L. No. 102-508, § 304.

19. 61 F.E.R.C. ¶ 61,168 (1992).

20. The Policy Statement was intended to apply to natural gas pipelines, oil pipelines and electric utilities. *Id.* at 61,588. However, it is unclear what affect section 1 of the Energy Policy Act will have upon the Policy Statement with respect to oil pipelines.

21. The FERC stated that to operate efficiently "[u]tilities should operate at optimum levels, allocate services first to the highest valued uses, invest in new capital when economically warranted, and capture expanding markets." 61 F.E.R.C. ¶ 61,168 at 61,587.

22. The FERC affirmed that market-based approaches to regulation may apply to companies which lack significant market power. *Id.*

The new policy states that the FERC may (1) divorce rates from the underlying cost of service, with the regulated company retaining a portion of any efficiency savings generated;²³ (2) lengthen the period between rate cases to a period set in the initial incentive rate proposed and approved by the FERC;²⁴ and (3) allow cost savings achieved by implementation of the new policy to be shared between customers and stockholders.²⁵ Although the FERC did not propose any specific methodologies by which a company may structure its incentive rate proposals, it did set forth five very general standards that must be observed in formulating such a proposal. These standards require (1) incentive mechanisms to be prospective in nature; (2) participation in the program to be voluntary; (3) incentive rates to be formulated in such a way that they may be understood by all parties; (4) all proposals to contain a quantifiable estimate of the consumer benefits of the program versus the consumer costs under traditional cost-based regulation, with the cost-based rates acting as a cap on incentive rate increases; and (5) all proposals to provide that the quality of service will be maintained and include standards by which quality of service will be measured.

Under the FERC's new policy, a company must first establish a just and reasonable starting rate derived through a traditional cost of service analysis, which then becomes a base rate subject to certain incentive rate mechanism adjustments including, but not limited to, an automatic adjustment index, flexible pricing arrangements, performance targets, benefit sharing, and "consumer welfare bonuses."²⁶ All such mechanisms are to be left to the individual company to develop for FERC approval in accordance with the general standards set out in the Policy Statement. The FERC acknowledged that it had not previously applied the same cost of service ratemaking principles to oil pipelines as it had to natural gas pipelines.²⁷ However, the FERC stated that the new incentive policy did not require that initial rates under an incentive rate proposal be derived solely from net depreciated original cost, so long as the starting rates were just and reasonable. The FERC expressed that "there is no reason to believe that a fair distribution of benefits and risks between shareholders and ratepayers cannot be achieved in setting base rates for oil pipeline incentive rate proposals."²⁸ Moreover, since the incentive regulation is appropriate only in noncompetitive markets, the FERC will not entertain incentive rate proposals from oil pipelines that choose to pursue market-based rates.²⁹ Further, since the FERC has found trended original

23. The FERC explicitly provided that such efficiency savings are to be retained permanently. *Id.* at 61,588.

24. It is unclear whether this provision is applicable to oil pipelines which have no set period for rate review, particularly in light of the Energy Policy Act.

25. 61 F.E.R.C. ¶ 61,588 at 61,588.

26. The FERC's description of the incentive mechanisms is intentionally vague and not meant to be exhaustive. The FERC expressly stated that the discussion is meant to guide parties who might want to use those mechanisms. However, all are free to propose other mechanisms that meet the standards set forth here. *Id.* at 61,601.

27. *Id.* at 61,588.

28. *Id.* at 61,589.

29. *Id.*

cost to be an acceptable alternative to original cost for setting oil pipeline rates, it will accept proposals from oil pipelines so long as the starting rates are consistent with the cost-based ratemaking principles applicable to oil pipelines.³⁰

In an attempt to increase the time period between rate cases, the FERC has permitted automatic rate adjustment mechanisms to be employed to allow rate flexibility between rate cases.³¹ Each utility may choose its own index and file it for approval along with the starting rates. The FERC has suggested indices that track general rates such as the Consumer Price Index (CPI), the Producer Price Index (PPI), or a combination of appropriate indices.³² The FERC warned, however, that the index chosen should not be so narrowly drawn that a single company's actions could affect the index value. In order to propose an index the company must be able to demonstrate a correlation between the company's historical costs and the performance of the index selected. Each proposal must also provide for a specific period of time after which the index will be reevaluated to determine whether it has been an accurate indicator against which to measure the company's performance.

The Policy Statement expanded upon the "performance target" concept currently embodied, for example, in throughput projections.³³ A company could set "targets" for virtually any cost. The FERC suggested salaries, interest, operation and maintenance, and taxes. If the company achieved the target level of costs, it would share the difference with consumers. If it failed to meet the target it would absorb a portion of the losses. The FERC also suggested having rate of return adjustable on a performance target basis. For setting a specific target level, the FERC suggested indexing a company's costs against the average costs for similar companies.³⁴

The FERC also expanded upon a current practice in the area of benefit sharing.³⁵ Using the marketing fee, which natural gas pipelines can now collect through their Order No. 636³⁶ capacity release programs, as an example, the FERC found benefit sharing programs to be a possible element of an incentive rate proposal, yet failed to suggest a specific type of program. The Policy Statement is equally vague with respect to the possibility of implementing a "Consumer Welfare Bonus" by which a company would earn a bonus for good customer service. However, the FERC did note, without elaboration, that this may not be possible for pipelines or wholesale power suppliers.

In conclusion, it is important to remember that the Policy Statement sets forth an experimental program to be implemented by companies voluntarily

30. *Id.* Again, the FERC must reconcile the Policy Statement with the requirements established by the Energy Policy Act.

31. *Id.* at 61,590-91.

32. Specific indices such as CPIenergy, CPIgas and electric services, or PPIenergy were also suggested. *Id.* at 61,591.

33. *Id.* at 61,592-93.

34. *Id.* at 61,592.

35. *Id.* at 61,592-93.

36. *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. Stats. & Regs. ¶ 30,939 [57 Fed. Reg. 13,267] (1992).

on a case-by-case basis. The experimental period will be used to evaluate the performance of the program, after which it will be either refined or abandoned. In addition, it should be remembered that the new policy is applicable only to companies serving non-competitive markets.

IV. FERC DISCLAIMS JURISDICTION OVER OIL PIPELINES OPERATING ON THE OUTER CONTINENTAL SHELF

On October 8, 1992, the FERC issued a decision³⁷ which held, *inter alia*, that the ICA is not applicable to oil pipelines transporting solely on or across the OCS. After quoting the jurisdictional authority of section 1(1) of the ICA,³⁸ the FERC stated that "[w]hile the OCS appertains to the United States, the OCS is not a State or territory of the United States."³⁹ Thus, under the circumstances presented in the *Bonito* and *Oxy* proceedings, transportation performed by each pipeline did not fall within the jurisdictional language of the ICA.

The FERC acknowledged that the Outer Continental Shelf Lands Act⁴⁰ provides that the OCS is to be treated as "an area of exclusive federal jurisdiction located within a State" for the purpose of applying federal laws.⁴¹ The FERC determined, however, that the ICA would not apply to transportation within such a federal enclave unless the facilities exited the enclave and the oil moved in interstate commerce.⁴² The FERC did caution however, that any "pipeline that starts on the OCS and transports oil through the seaward boundaries of the State to shore for further movement in interstate commerce is jurisdictional under the ICA."⁴³

37. *Bonito Pipe Line Co.*, 61 F.E.R.C. ¶ 61,050 (1992). On the same day of the *Bonito* decision, the FERC issued an order in *Oxy Pipeline, Inc.*, 61 F.E.R.C. ¶ 61,051 (1992), which reached the same conclusion, based upon a more narrow set of facts and in a proceeding that was not contested.

38. Section 1(1) of the ICA states in pertinent part:

[the ICA] shall apply only to common carriers engaged in . . . [t]he transportation of oil . . . by pipeline . . . from one State or Territory of the United States . . . to any other State or Territory of the United States . . . or from one place in a Territory to another place in the same Territory, or from any place in the United States through a foreign country to any other place in the United States, or from or to any place in the United States to or from a foreign country, but only insofar as such transportation takes place within the United States

49 U.S.C. § 10501.

39. 61 F.E.R.C. ¶ 61,050 at 61,221.

40. 43 U.S.C. §§ 1331-1356 (1988).

41. *Id.* § 1333(a)(1).

42. The FERC stated that the question of whether commerce is interstate or intrastate is to be determined from the essential character of the commerce. The Commission also stated that the transportation intent of the shipper at the time the shipment commences its journey is one of the most significant factors in making that determination. 61 F.E.R.C. ¶ 61,050 at 61,221 n.21.

43. *Id.* at 61,221 n.22.

John W. Ebert, Chair
Cheryl C. Burke, Vice Chair

John M. Cleary
David D'Alessandro
Philip R. Ehrenkranz
Michele F. Joy
John E. Kennedy
Martin Lobel

Robert H. Loeffler
Ray Paabo
David M. Schwartz
Albert S. Tabor, Jr.
Win Whittaker