

GROWING PAINS: FERC’S RESPONSES TO CHALLENGES TO THE DEVELOPMENT OF OIL PIPELINE INFRASTRUCTURE

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I. SUMMARY

There is a well recognized and pressing need for increased energy infrastructure. Often the public attention and the focus of federal regulatory authority focus most sharply on the increased infrastructure in the natural gas and electric industry. There is also a substantial, long-term need for additional oil pipeline capacity. Yet, despite the vital importance of oil pipelines to the United State’s energy supply chain and infrastructure,¹ public attention to oil pipelines seems less visible. Overall national demand for both petroleum

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1. See, e.g., Daniel Yergin, *Ensuring Energy Security*, FOREIGN AFFAIRS MAGAZINE, Mar.-Apr. 2006, at 69, 78.

products and crude petroleum will climb by more than one percent per year for several decades. Strong regional shifts in the sources and destinations of supply and demand require dramatically increased investment in specific areas. Oil pipelines face challenges similar to other energy transmission industries—opposition from landowners and local governments, heightened environmental scrutiny, and other land use issues—in addition to more idiosyncratic problems, such as their uneven access to eminent domain rights. Critical issues also arise in the course of regulation by the Federal Energy Regulatory Commission (FERC or the Commission). The FERC's regulation of oil pipelines is more limited than that of gas or electric companies and does not include any jurisdiction over exit or entry from the business. The FERC does regulate the reasonableness of rates and services and thus has potentially decisive authority regarding the commercial viability of new oil pipeline proposals. The FERC has overcome the absence of certificate authority to provide advance rate and tariff approvals by issuing declaratory orders prior to construction. The FERC continues to address uncertainties for new construction in the form of persistent uncertainty regarding key ratemaking standards. Two major concerns have been: (1) the issue of tax allowances for the partnership and related corporate forms that have become major vehicles for new pipeline investment;² and (2) the standard for removing the special “grandfathered” status of rates deemed just and reasonable under the Energy Policy Act of 1992 (EPAAct 1992). The FERC has ruled on both issues, although both are subject to judicial review and further case law development by the Commission. Until these matters are ultimately resolved they will continue to undercut investment, and the full ramifications of the tax issue are still being resolved at the FERC. Finally, the common carrier status of oil pipelines has increasingly come into tension with the needs of shipper-supported new pipeline facilities. As with other industries, new project sponsors increasingly rely upon long-term volume commitments by shippers. In contrast to its regulation under the natural gas and electric transmission industries, the FERC has traditionally concluded that the Interstate Commerce Act (ICA) does not contemplate firm transportation entitlements. The FERC has recently taken some steps towards reconciling its policies regarding the prorationing capacity among shippers with the need to provide certain classes of shippers—such as those committing to support new capacity construction—with greater assurances of access.

In sum, although oil pipeline infrastructure remains out of the political and media limelight, the FERC and the industry continue to address major regulatory issues affecting needed pipeline system growth.

2. This concern also impacts investments in the construction of new natural gas pipelines and electric transmission facilities.

II. INTRODUCTION AND BACKGROUND

The current U.S. oil pipeline industry³ is sometimes described as a “mature” transportation system.⁴ In contrast to the other major energy transmission industries, oil pipeline infrastructure development does not have as high a profile in regulatory terms or in the general press. For example, the FERC must issue certificates for new natural gas facilities; consequently, FERC rulemaking and caseload dockets are crowded with natural gas matters.⁵ Electric transmission infrastructure, though historically a state commission responsibility, has been the subject of Congressional attention⁶ and high-profile FERC rules⁷ and orders.⁸ Market disequilibria in the natural gas and electric markets result in front page coverage in publications such as the *New York Times*,⁹ the *Washington Post*,¹⁰ and even the *Financial Times*,¹¹ often in concert with calls for the FERC to take some action to alleviate the problem. Retail price volatility creates state-level headlines and political unrest, which ultimately results in calls for the FERC to act. Because of its reduced direct authority over gas as a commodity, one of the FERC’s responses has been to take steps to ensure an adequate infrastructure. Power blackouts and brownouts similarly focus public and legislative attention on regulators’ role in ensuring adequate transmission and generation power.

In contrast, oil pipeline infrastructure has a much lower profile. Periodically, sudden pipeline constraints highlight the importance of adequate

3. Terminology for the industry is quite varied, and pipelines discussed here transport crude oil, bitumen, and synthetic crude processed from tar sands and petroleum products, which encompasses a broad range of substances. Consequently, “liquids pipelines” is a broader term often used in the oil business. However, the terminology most frequently used in federal regulatory settings and by the public at large is “oil pipelines,” and so “oil pipelines” or “petroleum pipelines” is used in this article to refer to the full range of pipelines regulated under the Interstate Commerce Act, 49 U.S.C. §§ 10101-11917 (2000), by the Federal Energy Regulatory Commission (FERC).

4. CHERYL J. TRENCH & THOMAS O. MIESNER, *THE ROLE OF ENERGY PIPELINES AND RESEARCH IN THE UNITED STATES: SUSTAINING THE VIABILITY AND PRODUCTIVITY OF A NATIONAL ASSET* (2006), http://www.aopl.org/posted/888/Energy_Pipeline_RD_FINAL_5_4_06.119126.pdf.

5. The FERC has issued numerous major rules and policy statements affecting gas pipelines in 2006. See, e.g., Order No. 682, *Revision of Regulations to Require Reporting of Damage to Natural Gas Pipeline Facilities*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,227 (2006), 71 Fed. Reg. 51,098 (2006); Order No. 678, *Rate Regulation of Certain Natural Gas Storage Facilities*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,220 (2006), 71 Fed. Reg. 36,612 (2006); Order No. 2005, *Regulations Governing the Conduct of Open Seasons for Alaska Natural Gas Transportation Projects*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,174 (2005), 70 Fed. Reg. 8269 (2005).

6. Energy Policy Act of 2005, Pub. L. 109-58, 119 Stat. 594 (regarding federal transmission siting authority).

7. See, e.g., Order No. 689, *Regulations for Filing Applications for Permits to Site Interstate Electric Transmission Facilities*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,234 (2006), 71 Fed. Reg. 69,440 (2006).

8. *Trans-Elect NTD Path 15, LLC*, 111 F.E.R.C. ¶ 61,140 (2005).

9. David Cay Johnston, *In Deregulation, Power Plants Turn Into Blue Chips*, N.Y. TIMES, Oct. 23, 2006, at A1.

10. Steven Mufson & Sholnn Freeman, *Energy: An Acceleration Toward Alternate Fuels*, WASH. POST, Nov. 9, 2006, at D3.

11. Sheila McNulty, *Hurricanes 'Underlined' Gas Fragility S&P REPORT*, FINANCIAL TIMES (London), Oct. 13, 2005, at p. 16.

pipeline transmission.¹² On both a regulatory plane and in the public consciousness, however, oil pipeline infrastructure issues generally have a much lower profile than those of the gas and electric industries.¹³ Even when retail gasoline prices took center stage in the public's energy awareness in 2006, popular and political attention turned to refiners and integrated oil companies—but not to pipelines.

Consequently, the business of maintaining and growing the oil pipeline infrastructure does not loom large in the public's consciousness. Yet the oil pipeline industry faces significant challenges at the outset of the twenty-first century—regulatory and otherwise. The purpose of this article is to provide an overview of the principal regulatory difficulties and uncertainties facing the industry before the FERC, in light of the need for significant additional oil pipeline infrastructures.

A. *The Current Oil Pipeline System and its Development*

The industry's problems going forward can best be understood in light of both its current state and past development.

1. Current Network

The oil pipeline network today consists of approximately 200,000 miles of pipeline performing a variety of different roles.¹⁴ The crude petroleum systems transport crude oil and synthetic oil from production areas and marine terminals to refineries. Currently, approximately 150 U.S. refineries have a refining capacity of approximately 17.1 million barrels/day—meeting approximately eighty-one percent of U.S. refined products demand (2005 figures).¹⁵ The refiners produce a variety of petroleum products: principally gasoline, heating oil and jet fuel, but also liquefied petroleum gases, kerosene, heavier distillates, naphthas, and asphalt, among others. An entirely separate network of pipelines transports the refined petroleum products from refineries or import terminals to distribution terminals. Gasoline and fuel oil typically move one last leg of transportation via truck, to service stations and secondary terminals or to

12. See, e.g., *Gas Shortage Eases in Phoenix as Pipeline Resumes Pumping*, N.Y. TIMES, Aug. 25, 2003, at A13; Wesley Loy & Richard Richtmyer, *Massive Repairs on the North Slope*, ANCHORAGE DAILY NEWS, Aug. 8, 2006. Oil pipeline "spills" or ruptures also rise to public prominence and Congressional and regulatory attention, but not usually in a FERC context.

13. The modest regulatory footprint of oil pipelines is illustrated vividly by the allocation of FERC Staff resources. Staff's Office of Energy Markets and Reliability (OEMR) is divided into three geographic regions, Eastern, Central, and Western, which divide among them the electric and gas companies according to their locations. However, the nation's approximately 200 jurisdictional oil pipelines, are all handled by the OEMR Central as one of several special assignments. THE FEDERAL ENERGY REGULATORY COMMISSION, ALLOCATION OF UTILITIES TO THE OEMR DIVISIONS (2007), available at <http://ferc.gov/about/offices/oemr/oemr-div.asp?new=sc2>.

14. As a point of comparison, the Interstate Natural Gas Association reports that there are 180,000 miles of interstate natural gas pipeline in the U.S. See, e.g., The Interstate Natural Gas Association of America Website, <http://www.ingaa.org/>.

15. *Petroleum Refineries: Will Record Profits Spur Investment in New Capacity? Before the H. Gov. Reform Comm., Subcomm. on Energy and Res.*, 109th Cong. 1 (2005) (statement of Thomas O'Connor, Project Manager, ICF Consulting) [hereinafter *O'Connor Testimony*], available at 2005 WL 2699346.

homes.¹⁶ Pipelines carry the lion's share of barrel miles of petroleum moved in the U.S.—in 2004, roughly sixty-six percent was carried by pipelines, twenty-seven percent by water carriers, less than four percent by trucks, and less than three percent by railroads.

2. Historical Development

The first crude pipelines succeeded horse-drawn wagons and railroads in the mid-1800s,¹⁷ when pipelines began as conduits for shipping oil to navigable rivers and railheads. By the last two decades of the century, pipelines became the main conduits to regional refineries. Petroleum products pipelines first arrived in the 1920s, and rapidly expanded as the total mileage of petroleum pipelines in the U.S. grew both before, during, and after the Second World War—growing by more than two percent per year throughout the 1940s and 1950s.¹⁸ In the 1960s, annual growth fell below two percent but remained strong.¹⁹

B. *The Need for Future Development*

Although the explosive pipeline growth of the post World War II era is past, the oil pipeline industry continues to serve an expanding and dynamic market.

1. Overall Petroleum Products Demand

Nationally, demand continues to increase for petroleum products generally and for crude oil to be refined domestically. Overall, U.S. demand for petroleum products is expected to increase steadily over the next ten years, by as much as 1.1% per year or more.²⁰ This rising demand will be met by increased petroleum products imports as well as increased refining capacity.²¹ Despite the emergence

16. Although oil pipelines can transport crude or products, currently very few pipelines transport both substances in the same line segments. However, products pipelines often transport a variety of different products in the same pipes, “batching” them in sequences designed to minimize intermixing of the products.

17. The standard unit of measurement in the industry, “barrels,” is evocative of the earliest transportation mode: wooden barrels on wagons. *Penn Refining Co. v. W. New York & P.R.R. Co.*, 208 U.S. 208 (1908). One cost of the early pipeline owners was that of hiring armed guards to protect pipelines from sabotage by vengeful teamsters displaced by the new technology. GEORGE S. WOLBERT, JR., *U.S. OIL PIPELINES: AN EXAMINATION OF HOW OIL PIPE LINES OPERATE AND THE CURRENT PUBLIC POLICY ISSUES CONCERNING THEIR OWNERSHIP* 2 (1979) [hereinafter WOLBERT].

18. Pipeline mileage grew 28% during the 1940s and 24% during the 1950s. JOHN A. HANSEN, *OIL PIPELINE MARKETS: STRUCTURE, PRICING AND PUBLIC POLICY* 32 (1983) (percentages have been calculated from raw data in the chart) [hereinafter HANSEN]. Apart from the anemic decade of the depression, growth during the early part of the 20th Century averaged from more than 3% per year (1910-1919) to more than 12% per year (1900-1909). *Id.*

19. Annual growth averaged 1.7% for 1960-1969. HANSEN, *supra* note 18.

20. *Energy Outlook and Trends Before the S. Comm. on Energy and Natural Res.*, 109th Cong. 1 (2006) (statement of Guy Caruso, Administrator, Energy Information Administration, U.S. Dept. of Energy), available at 2006 WL 370875.

21. Despite the number of refineries shuttered since 1970 and the absence of any greenfield refineries during that time, U.S. refinery capacity has grown substantially through expansion and improvements to existing refineries, and is expected to do so during the next decade. *Refinery Permit Process Before the S. Comm. on Energy and Natural Res.*, 109th Cong. 1 (2006) (statement of Glenn McGinnis, CEO, Arizona Clean Fuels Yuma), available at 2006 WL 1991952.

of alternative fuels, the Energy Information Administration (EIA) projects that traditional petroleum products will continue their dominant energy role in the next several decades—for example, even assuming high pricing incentives, ethanol is only projected to meet a relatively small percentage of national demand by 2030.²²

Despite the rapid growth projected for biofuels and other non-hydroelectric renewable energy sources, and the expectation that orders will be placed for new nuclear power plants for the first time in more than twenty-five years, oil, coal, and natural gas still are projected to provide roughly the same eighty-six percent share of the total U.S. primary energy supply in 2030 that they did in 2005 (assuming no change in existing laws and regulations). Petroleum products, and accompanying pipeline transportation capability, will therefore have to increase significantly over the next twenty-five years.

2. Overall Crude Petroleum Demand

Because refinery capacity will continue to increase, pipeline capacity to supply that demand will increase as well. Imports of refined petroleum products are likely to increase, although trailing well behind the expected rise in petroleum products consumption. The EIA has projected, for example, that between 2005 and 2010, product imports will increase by approximately 300,000 barrels/day, but U.S. refinery capacity would also increase by approximately 1.1 million barrels/day.²³ Expansion in refinery capacity has in recent decades entirely been through additions to existing refineries. Although some refineries can be served from nearby port facilities, this expansion will require additional crude pipeline capacity. The only currently planned new refinery—in Arizona—would require pipeline transportation for crude supplies.²⁴

3. Shifts in Sources of Supply and Demand

National demand will continue to rise, but even if overall demand were static, shifts are changing both the sources of demand and supply differently among regions of the country. For example, over the past twenty years, crude oil production in the Rocky Mountain region has generally declined from peaks in the 1980s, as has production in the Mid-Continent region. In contrast, production of crude oil and synthetic crude oil from tar sands in Western Canada has dramatically increased over the same period, and many Rocky Mountain and Midwestern region refineries are taking steps to refine more crude from those sources. Western Canadian oil sands production is projected to increase from 1.1 million barrels/day in 2005 to 3 million barrels/day in 2015, including substantial exports to the U.S.—causing Canada's National Energy Board to

22. ENERGY INFORMATION ADMINISTRATION, ANNUAL ENERGY OUTLOOK 2007 WITH PROJECTIONS TO 2030 (EARLY RELEASE) – OVERVIEW (2006), available at <http://www.eia.doe.gov/oiaf/aeo/key.html>. Biodiesel and coal-to-liquids are projected to be 7% of distillate consumption—significant, but not revolutionary. The EIA projections do not assume changes in laws or regulations, and may be unduly conservative in that respect. *Id.*

23. *O'Connor Testimony*, *supra* note 15.

24. ENERGY INFORMATION ADMINISTRATION, ANNUAL ENERGY OUTLOOK 2006 WITH PROJECTIONS TO 2030 (2005), available at <http://www.eia.doe.gov/oiaf/archive/aeo06/gas.html>. The EIA provides a detailed projection of petroleum and products trends for the U.S. in its Energy Outlook 2006.

focus on pipeline capacity as a key constraint on the continued development of those Canadian resources.²⁵ Crude oil production in the Gulf of Mexico continues to remain a significant national source, but supplies lie in increasingly deeper and deeper waters further offshore.²⁶ Because demand for petroleum products generally tracks population growth, fast-growing areas of the country have experienced significantly higher rates of increased products consumption. For regions such as the booming urban centers of Arizona and Nevada, and in the Southwest, this accelerated growth has led to the need for greatly increased pipeline transmission capacity.²⁷ Therefore, the increased need for pipeline capacity at the national level has created a far more acute need for more capacity within and between particular regions.

4. Increased Reliance on Pipelines Versus Other Modes of Transportation

Pipelines have become steadily more important as a transportation source, although barges and tankers remain active and competitive at marine and major river ports. Between 1984 and 2004, pipelines' transportation share of total crude oil and petroleum products increased from forty-eight percent to sixty-six percent, while water carriers' share declined from forty-eight percent to twenty-seven percent.²⁸

The result of these trends is constraining: higher overall demand, shifts in geographic sources and consumption locales, and increased reliance on pipelines, all mean that significant additional pipeline capacity will be needed. Indeed, the amount of oil pipeline capacity that is already constructed each year might surprise most energy observers.²⁹ The United States will need substantial increases to the oil pipeline infrastructure over the next decade and beyond.

III. REGULATORY ISSUES AFFECTING INVESTMENT

Pipelines face numerous difficulties in developing new infrastructure that are not within the FERC's regulatory purview. Like all energy projects, oil pipelines face land use restrictions and local governments increasingly at odds with new pipeline construction.

Eminent domain. Unlike gas pipelines, oil pipelines lack the federal eminent domain authority and federal preemptive rights that accompany the FERC natural gas certificate process—eminent domain, for example, is subject

25. NATIONAL ENERGY BOARD, CANADA'S OIL SANDS, OPPORTUNITIES AND CHALLENGES TO 2015: AN UPDATE viii (2006), http://www.neb.gc.ca/energy/EnergyReports/EMAOilSandsOpportunitiesChallenges2015_2006/EMAOilSandsOpportunities2015Canada2006_e.pdf. "The industry has some challenging times ahead with the increase [of] production and the resulting lack of capacity on the major export pipelines." *Id.* at 34.

26. *Lifting Ban on Offshore Fuel Drilling Before the H. Comm. on Res.*, 109th Cong. 1 (2006) (statement of Tom Fry, President, National Ocean Industries Association), available at 2006 WL 1661985.

27. *High Energy Prices Before S. Comm. on Energy and Natural Res.*, 109th Cong. 1 (2005), available at 2005 WL 3008876 (statement of Terry Goddard, Attorney General, Office of Attorney General of Arizona).

28. ASSOCIATION OF OIL PIPE LINES, PIPELINES AND WATER CARRIERS CONTINUE TO LEAD ALL OTHER MODES OF TRANSPORT IN TON-MILES MOVEMENT OF OIL IN 2004 Table 1 (2006), https://www.piersystem.com/posted/888/shift_Report_1984_2004.126714.pdf (table 1 measured in ton-miles).

29. Leena Koottungal, *Semiannual Worldwide Construction Update*, OIL & GAS JOURNAL, Nov. 20, 2006, at 20.

to a patchwork quilt of differing state laws. Some states grant eminent domain authority to all pipelines, some to pipelines that are public utilities, some only to crude pipelines, and some provide no eminent domain authority at all.³⁰

Pipeline safety requirements. The safety regulations, both imposed by the Department of Transportation,³¹ and sometimes as would be imposed by state and local authorities, increasingly factor into pipeline construction.³²

Native American land use. American Indian tribes are increasingly assertive regarding both the use of and compensation for pipeline rights-of-way.³³

State utility commission regulation of intrastate transportation. To the extent that oil pipelines transport petroleum in intrastate commerce,³⁴ state commissions may regulate their rates and services and may indeed go further than the FERC's reach to regulate changes to facilities, leases, and changes in ownership.³⁵

These and similar environmental and permitting issues loom large but are outside FERC's jurisdiction.³⁶ The FERC does, however, exercise substantial authority on key oil pipeline issues.

30. Enbridge Energy was denied eminent domain authority by the Illinois Commerce Commission in a 1997 order that found the interstate pipeline provided inadequate benefits to the state. *Lakehead Pipeline Co. v. Ill. Commerce Comm.*, 696 N.E.2d 345 (Ill. App. Ct. 1998), *appeal denied*, 705 N.E.2d 438 (Ill. 1998). Marathon fought significant land use battles in constructing its products pipelines from the Catlettsburg refinery in Kentucky to Columbus, Ohio, because Ohio only grants eminent domain authority to crude pipelines. 1963 Op. Att'y Gen. 202 (1963). Connecticut provides no eminent domain authority to oil pipelines.

31. *E.g.*, 49 C.F.R. § 195 (2006).

32. Localities are preempted from imposing inconsistent safety regulations on oil pipelines. *City of Mounds View v. Williams Pipe Line Co.*, 704 F.Supp. 914 (D. Minn. 1989). However, they may persistently raise safety issues throughout the planning and construction process.

33. The Department of the Interior is currently reviewing the issue with the aid of public comments in *Congressionally Mandated Study of Energy Rights-of-Way on Tribal Lands*, 70 Fed. Reg. 77,178 (Dec. 29, 2003).

34. Interstate petroleum products must originate in one state and cross state boundaries before transportation comes to an end—often at a refinery (for crude oil) or at a terminal (for products). The test of whether the transportation has come to an end is the “fixed and original intent of the shipper”—a standard that can be fact-specific. *Sinclair Oil Corp. v. Chevron Texaco Pipeline Co.*, 105 F.E.R.C. ¶ 61,290 (2003).

35. For example, Wyoming and Michigan exercise broad jurisdiction over oil pipelines, including asset transfers, while Connecticut does not regulate them at all, and Ohio regulates only crude petroleum pipelines.

36. One recent development of concern to the industry relates to the apparently expanding environmental requirements for presidential permits issued by the Department of State for facilities crossing U.S. boundaries with other nations. *See* Exec. Order No. 13,337, 69 Fed. Reg. 25,299 (Apr. 30, 2004). Consultation among a number of agencies has traditionally been required, but in contrast the recent application for a presidential permit. The application for a presidential permit for the proposed Keystone Pipeline project to bring Canadian crude petroleum to U.S. markets resulted in an environmental impact study under the National Environmental Policy Act with respect to the entire 1,000+ miles of line to be constructed within the United States. *See* Notice of Intent to Prepare an Environmental Impact Statement and To Conduct Scoping Meetings and Notice of Floodplain and Wetland Involvement; TransCanada Keystone Pipeline, L.P., 71 Fed. Reg. 59,849 (Oct. 11, 2006). Unlike environmental reviews done by the FERC for gas pipelines, under the FERC's policy of expediting full review in coordination with its role of ensuring adequate infrastructure, this newly broadened review for crossing facilities does not focus on the energy implications of the pipeline proposals.

A. *Regulatory Context: The FERC Wields Limited but Critical Authority Over New Pipeline Capacity*

The FERC does not regulate oil pipeline entry, construction, commencement of new services, or abandonment.³⁷ The FERC does require publication of tariffs.³⁸ It also regulates rates,³⁹ determines whether the rules and regulations of service are just, reasonable, and non-discriminatory,⁴⁰ and enforces the obligation to accept requests for transportation on “reasonable request.”⁴¹

Despite its relatively limited scope, the FERC’s authority reaches critical issues for new or expanding pipelines: the price for their service and the terms and conditions for the proposed transportation. Pipeline owners are free to build facilities or not, but once placed in service, the FERC has exclusive jurisdiction over the rates and tariffs. If those rates and terms of service fail to reflect the needs of investors, however, pipelines’ right to abandon service would usually remain quite theoretical, as the capital-intensive, immobile assets cannot readily be redeployed.⁴² Consequently, the manner in which the FERC exercises its jurisdictional authority is of critical importance to the advancement of oil pipeline infrastructure.

B. *Procedural Risks: Advance Approval of Key Rates and Tariff Issues Before Construction*

The absence of a statutory vehicle for approving oil pipeline rates and services posed a *potential* industry problem, but one solved by the FERC within the past decade. Despite the absence of advance rate approval in a certificate process, the FERC has developed a flexible alternative for oil pipelines—the regular use of petitions for declaratory order for approval of long-term rate and tariff certainty.

In the natural gas industry, well in advance of any construction, the FERC authorizes both initial rates and tariff provisions. Project sponsors have therefore known in advance what the key ratemaking components and service conditions that would apply to new projects, and could accept them or reject them before investing in the assets. Although traditionally initial rates have been subject to later revision under the NGA sections 4 and 5, raising some long-term uncertainty, the FERC has also permitted pipelines to establish long-term cost recovery principles such as levelized rates⁴³ and negotiated rates.⁴⁴

37. *Farmers Union Central Exchange v. FERC*, 584 F.2d 408 (D.C. Cir. 1978); *Arco Alaska v. FERC*, 89 F.3d 878 (D.C. Cir. 1996).

38. *Interstate Commerce Act*, 49 U.S.C. app. § 6(1) (1988) (repealed, *see infra* note 80).

39. *Id.* §§ 1(5), 2, 3(1), 15(1), 15(7).

40. *Interstate Commerce Act* § 1(5).

41. *Id.* § 1(4).

42. When market or supply changes diminish the usefulness of pipeline assets for one industry, they are sometimes converted to use in another industry. KN Interstate bought a crude pipeline from Amoco in 1996 and converted it into the Pony Express natural gas project; conversely, an underutilized segment of the Trunkline Gas Co. was converted to use as a petroleum products pipeline in 2001. However, such conversions are not common and investors cannot count upon conversion to save a project that has been left behind by changing markets.

43. *See, e.g., Nw. Pipeline Corp.*, 116 F.E.R.C. ¶ 61,151 (2006).

In contrast, traditionally oil pipelines have simply filed tariffs after construction. In practice, this seemingly risky approach was effective for many decades. Pipelines would execute “T&D” agreements—throughput and deficiency agreements binding prospective shippers to use pipeline capacity or pay for any deficiencies.⁴⁵ Historically, following construction, rate litigation was minimal—at the time the FERC acquired jurisdiction over pipelines in 1978, only a small handful of rate disputes had ever been brought under the ICA.⁴⁶ This lack of litigiousness is not surprising when one considers that the shippers and the owners were typically affiliated. Until the 1980s, very few major oil pipelines were “independent”—that is, not owned by producers, by refiners, or as part of an integrated oil company system.⁴⁷ The pipeline companies, though separately incorporated, were strategically part of a larger system under common ownership for the extraction, refining, and distribution of petroleum. During the past twenty years, significant changes have occurred in pipeline ownership. Although major oil companies and refining/marketing companies continue to have a very major role in the industry,⁴⁸ independent pipelines unaffiliated with major oil companies have acquired or built significant pipeline assets. This process reflects, in part, the decision of some integrated oil companies to spin off pipeline assets as their markets and refinery interests have changed.⁴⁹ Paradoxically, as consolidation has occurred among the major oil companies,⁵⁰ one result has been the divestment of oil pipeline assets at the behest of the Federal Trade Commission.⁵¹ Additionally, large investment funds and investors have been attracted to oil pipeline ownership, particularly through the increasingly popular master limited partnership (MLP), limited partnership (LP), and limited liability corporation (LLC) ownership vehicles.

Consequently, independent pipelines increase in number and importance, and integrated pipelines rely on both affiliated and non-affiliated shippers to support new capacity projects. In this environment, advance approval for significant pricing and service terms of pipeline tariffs has become increasingly important to obtain financial backing. The FERC’s regulations permit pre-pipelines to seek informal staff advice to assist in meeting the Commission’s

44. *E.g.*, *Alliance Pipeline, L.P.*, 80 F.E.R.C. ¶ 61,149 (1997).

45. WOLBERT, *supra* note 17, at pp. 168, 242-44.

46. *See, e.g.*, *Farmers Union Central Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984).

47. WOLBERT, *supra* note 17, at 157-74 (“the empirical evidence appears to support the opening general principle that, with few exceptions, petroleum pipelines have been conceived, financed, and built by the oil companies who need their services,” *id.* at 173); *see also* HANSEN, *supra* note 18, at 19.

48. *Gasoline: Supply, Price and Specifications Before the H. Comm. on Energy and Commerce*, 109th Cong. 1 (2006), available at 2006 WL 1305599 (statement of William H. Shea, President and CEO, Buckeye Partners, LP).

49. In 2004, for example, Shell sold substantial crude and products pipeline assets in different areas of the country, primarily to non-oil company purchasers. Press Release, Shell Oil Products U.S., Shell Completes Sale of Major Refined Products Pipeline Systems (Oct. 4, 2004), available at http://www.shell.com/home/Framework?siteId=usen&FC2=&FC3=/global/news_and_library/press_releases/2004/oil_products_sale_04102004.html.

50. The historical “Seven Sisters” of the oil industry have been replaced with amalgamations of longstanding integrated companies; witness ExxonMobil, BP acquiring ARCO and Amoco, and ChevronTexaco.

51. In the Matter of Exxon Corp., No. C-3907, 2001 WL 147170 (F.T.C. Jan. 26, 2001); In the Matter of Chevron Corp. and Texaco Inc., C-4023, 2001 WL 1022080 (F.T.C. Sept. 7, 2001).

policies,⁵² but such informal, non-binding advice cannot be “taken to the bank” by prospective pipeline sponsors.

The solution has been the increasing use of the declaratory order to provide the necessary assurances. The first project to use this approach was Express Pipeline Partnership (Express), a proposed greenfield pipeline intended to transport substantial volumes of conventional and synthetic petroleum from Western Canada to the Rocky Mountain and Midwest. Express filed a petition for declaratory order stating that prior to commencing construction it required an advance ruling approving tariffs that would reflect a rate structure, consisting of five-, ten- and fifteen-year contracts with discounted, agreed-to rates, escalated independently of the FERC’s generic oil pipeline index. In addition, the petition sought approval in advance of certain viscosity surcharges and certain specified rate components to be used in setting the cost-based rate available to non-contract shippers—depreciable life, return on equity, capital structure, and certain projected capital and operating costs. Express stated that the contract rates and accompanying volume rates, in conjunction with the initial “uncommitted rates” and the commitments by shippers, were essential predicates for the pipeline. Interveners—not customers, but local producers and Canadian interests—protested both the request for declaratory order and the lawfulness of the proposed rates. In response, the FERC decided that the declaratory order mechanism was an appropriate one for oil pipelines seeking advance rate assurances:

[i]n this proceeding, we are presented for the first time with a request for declaratory order approving [the] proposed rates and a rate structure as . . . condition[s] precedent to the construction of a new oil pipeline. The threshold question . . . is whether a declaratory order is the appropriate vehicle for addressing the ratemaking issues raised by the petition of Express.⁵³

Protesting parties urged the Commission to reject the request on procedural grounds, contending that the only permissible route was for the pipeline to file tariffs pursuant to the FERC’s regulations. The FERC concluded that under the Administrative Procedure Act⁵⁴ and its own regulations,⁵⁵ in its discretion, it would be appropriate to address “oil pipeline ratemaking issues” such as those raised by Express in the context of a declaratory order proceeding.⁵⁶ In a subsequent order, the Commission reaffirmed this holding on rehearing and issued the declaratory order, approving the requested rate pre-approvals.⁵⁷ When Express later filed its initial tariffs following construction, and prior to the commencement of service, it was not necessary for the Commission to issue any order in response.

This mechanism—using a declaratory order to secure advance certainty for prospective oil pipeline projects, both for new projects and large scale

52. 18 C.F.R. § 388.104 (2006).

53. *Express Pipeline P’ship*, 75 F.E.R.C. ¶ 61,303, at p. 61,966 (1996) [hereinafter *Express I*].

54. 5 U.S.C. § 554 (c) (2000).

55. 18 C.F.R. § 385.207 (2006).

56. *Express I*, *supra* note 53, at p. 61,967.

57. *Express Pipeline P’ship*, 76 F.E.R.C. ¶ 61,245 (1996). The FERC did not approve the specific costs of the pipeline plant, and hence the level of uncommitted rates, which were contingent upon the actual cost of constructing the pipeline. *Id.*

expansions of existing facilities⁵⁸—has since been adopted for numerous projects, seeking a wide range of rate findings and advance tariff approvals. The issues addressed have included: requests for approval of specific cost of service approvals, such as use of an acquisition premium;⁵⁹ the use of joint rate structures; advance assurance that a new project would not disturb the “grandfathered rate” status of certain rates protected under Section 1803 of the EPCRA 1992;⁶⁰ findings that line and service abandonment in connection with new replacement services;⁶¹ approval of proposed rate discounts;⁶² whether expansion rates should be rolled-in or incremental;⁶³ use of supplemental revenues from surcharges on Canadian affiliated pipeline to defray the costs of a U.S. project;⁶⁴ and the use of a system-wide surcharge to base rates to fund an expansion.⁶⁵

The Commission has also issued declaratory orders to provide rate and service assurances for pipelines operating in the Outer Continental Shelf.⁶⁶ These pipelines operate under the Outer Continental Shelf Lands Act (OCSLA),⁶⁷ rather than the ICA, and the OCSLA applies different statutory standards, but the pipeline project sponsors have required the same need for certainty prior to the commitment of major investments.

A related avenue toward advance approval has also been pioneered by Enbridge Energy (Enbridge)—the preemptive “offer of settlement” to resolve proposed rates in advance.⁶⁸ Among other assets, Enbridge operates the largest oil pipeline in North America, its crude petroleum system stretching from western Alberta across the U.S. border to Chicago and on to Sarnia, Ontario.⁶⁹ As Canadian exports to the U.S. of oil and bitumen production has risen during the past twenty years, Enbridge has enlarged and extended its mainline system on both sides of the international border on a number of occasions, typically obtaining advance agreement from the association of Canadian producers (CAPP)⁷⁰ for both the rate submitted to Canada’s National Energy Board (NEB)

58. *SFPP, L.P.*, 102 F.E.R.C. ¶ 61,089 at PP 18-29 (2003).

59. *Loughorn Partners Pipeline*, 73 F.E.R.C. ¶ 61,355 (1995); *Rio Grande Pipeline Co.*, 100 F.E.R.C. ¶ 61,022 (2002); *Enbridge Energy Co., Inc.*, 110 F.E.R.C. ¶ 61,211 at PP 27-39 (2005).

60. *Colonial PipeLine Co.*, 89 F.E.R.C. ¶ 61,095 (1999), *order on reh’g*, 95 F.E.R.C. ¶ 61,355 (2001); *Plantation Pipe Line Co.*, 98 F.E.R.C. ¶ 61,219 (2002); *Colonial Pipe Line Co.*, 116 F.E.R.C. ¶ 61,078 (2006).

61. 95 F.E.R.C. ¶ 61,355.

62. *Plantation Pipe Line Co.*, 98 F.E.R.C. ¶ 61,219, at pp. 61,865-866.

63. *SFPP, L.P.*, 102 F.E.R.C. ¶ 61,089 at PP 11-23 (2003).

64. *Enbridge Energy Co., Inc.*, 110 F.E.R.C. ¶ 61,211 at PP 48-54 (2005).

65. *Colonial PipeLine Co.*, 116 F.E.R.C. ¶ 61,078 (2006).

66. *Proteus Oil Pipeline Co.*, 102 F.E.R.C. ¶ 61,333 (2002); *Caesar Oil Pipeline Co., LLC*, 102 F.E.R.C. ¶ 61,339 (2002); *Enbridge Offshore Facilities, LLC*, 116 F.E.R.C. ¶ 61,001 (2006).

67. 43 U.S.C. § 1334(e)-(f) (2000).

68. “Preemptive” offers of settlement have been filed in natural gas rate settings to obviate the need for rate litigation. *Texas E. Transmission Corp.*, 67 F.E.R.C. ¶ 61,170 (1994); *Dominion Transmission, Inc.*, 96 F.E.R.C. ¶ 61,288 (2001). Of course, given the role of certificate orders, there has not been a need for this procedural mechanism for facilities pricing in natural gas cases.

69. The portion of the system in the United States was historically named “Lakehead Pipe Line Partners, L.P.” (and earlier Lakehead variants), but in 2001 became Enbridge Energy Partners, L.P.

70. Canadian Association of Petroleum Producers, <http://www.capp.ca>.

and to the FERC.⁷¹ Enbridge subsequently found a very different approach for the offer of settlement. On December 21, 1998, the FERC approved an offer of settlement reached between Enbridge and CAPP that had been “filed in advance of a . . . rate filing and not in response to any litigated proceeding, in an attempt to avert a potential future rate dispute by reaching a negotiated agreement on the manner in which the costs of the expansion project[] will be handled.”⁷² The filing was unopposed and the FERC approved it on standard settlement grounds. Subsequently, Enbridge filed a broader and more ambitious “facilities surcharge framework” to permit the pipeline to recover the costs of specific additional facilities through incremental surcharges. In addition, Enbridge submitted four settlements for discrete proposed projects and accompanying surcharges, and a proposal to submit additional future agreements resulting from negotiations with CAPP to use the facilities surcharge mechanism to recover additional costs. Once again, this filing was made “in advance of [the proposed] tariff rate filing[s] and not in response to any litigated proceeding,” to avert future disputes, and the FERC approved it as being unopposed.⁷³ The FERC has not approved all such filings, however. Enbridge filed a further request, *inter alia*, to charge all mainline shippers a surcharge to support the costs of an extension of the system that would not be used by all shippers. After some shippers filed opposing comments, the FERC considered the settlement on the merits as a contested settlement, and rejected the proposed settlement.⁷⁴ This mode of advance approval will therefore be subject to merits review when the proposal is contested.

The FERC’s use of declaratory orders, and to a lesser extent preemptive settlement offers, as alternatives to the certificate orders long used for gas pipelines represents a practical solution to meeting the needs of the oil pipeline infrastructure in a changed industry context, by using the tools available under the ICA and elsewhere. Interestingly, a similar approach is being taken with regard to electric transmission projects. As with oil pipelines under the ICA, transmission projects under the Federal Power Act (FPA) lack certificate procedures, and with the recent growth of stand-alone transmission companies, new transmission sponsors have also sought advance rate assurances prior to construction, through the declaratory order route⁷⁵—a route formalized in Order No. 679, following the Energy Policy Act of 2005 (EPAct 2005).⁷⁶

C. Overhanging Risks from Ratemaking Policies

Ratemaking standards powerfully affect projected revenues, which in turn influence investment plans for infrastructure. In the late 1980s and early 1990s,

71. *Enbridge Energy Co, Inc.*, 110 F.E.R.C. ¶ 61,211 (2005).

72. *Lakehead PipeLine Co.*, 85 F.E.R.C. ¶ 61,397 (1998).

73. *Enbridge Energy, Ltd. P’ship*, 107 F.E.R.C. ¶ 61,336 (2004).

74. *Enbridge Energy, Ltd. P’ship*, 117 F.E.R.C. ¶ 61,279 (2006).

75. *American Elec. Power Serv. Corp.*, 116 F.E.R.C. ¶ 61,059 (2006); *Western Area Power*, 99 F.E.R.C. ¶ 61,306 (2002), *reh’g denied*, 100 F.E.R.C. ¶ 61,331 (2002), *aff’d sub nom.* Public Utils. Comm. of the State of Cal. v. FERC, 367 F.3d 925 (D.C. Cir. 2004); *Michigan Elec. Transmission Co., LLC*, 105 F.E.R.C. ¶ 61,214 (2003); *American Transmission Co., LLC*, 105 F.E.R.C. ¶ 61,388 (2003); *ITC Holdings Corp.*, 102 F.E.R.C. ¶ 61,182 (2003), *reh’g denied*, 104 F.E.R.C. ¶ 61,033 (2003).

76. *Promoting Transmission Investment through Pricing Reform*, 116 F.E.R.C. ¶ 61,057 (2006).

industry concern regarding both the direction of the FERC regulation and the uncertainty faced by pipelines prompted legislative reform efforts that ultimately resulted in Title 18 of the EAct 1992,⁷⁷ which deemed most existing rates “just and reasonable” and required the FERC to implement a simplified and streamlined form of oil pipeline regulation. Though the FERC did implement reforms, the EAct 1992 raised its own unique, long-term rate uncertainties, particularly with respect to when grounds exist for depriving “grandfathered” rates of their legislated protection. As discussed below, oil pipelines have also been affected by the FERC’s ratemaking policies for cost-based rates.⁷⁸ Although the FERC has addressed these ratemaking questions, ongoing uncertainties continue to shadow new projects and how best to structure them.

1. Overview of Oil Pipeline Ratemaking

Oil pipeline rates are subject to the same “just and reasonable” statutory standard as gas pipelines and electric companies. That was not always the case. After becoming subject to the ICA in 1906, oil pipelines had been regulated by the Interstate Commerce Commission (ICC) under a distinctive “fair value” or “valuation” methodology quite different than traditional cost of service ratemaking that the Federal Power Commission (FPC) and the FERC came to exercise under the NGA or the FPA.⁷⁹ After jurisdiction over oil pipelines transferred to it in 1977,⁸⁰ the FERC initially attempted to fashion a more “light-handed” approach, re-adopting a version of the ICC’s methodology. The D.C. Circuit rejected that attempt, emphasizing that the “just and reasonable” standard required a nexus to cost of service, or, if “light-handed” regulation were chosen, demonstrable evidence that competitive forces were present.⁸¹ In response, the FERC issued Opinion No. 154-B and adopted a “trended original cost” standard of ratemaking substantially similar to the depreciated original cost approach used for other industries.⁸² For cost-of-service ratemaking purposes, Opinion No.

77. Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776.

78. Another ratemaking issue, disputes over cost allocation formulas, has not been as significant an issue for oil pipelines as for gas pipelines. For almost two decades, between the early 1980s and 2000, FERC regulation of natural gas pipelines enlivened by numerous, long-running and sharply-litigated rate allocation disputes regarding whether pipeline expansions should be priced on an “incremental” or a “rolled-in” basis. Oil pipeline expansions have not generated the same sort of allocation disputes—largely because as discussed below in Section II.C., pipelines have not granted capacity entitlements.

79. HANSEN, *supra* note 18, at 30-31; WOLBERT, *supra* note 17, at 139-40. Wolbert noted that thousands of oil pipeline tariffs became effective without challenge by shippers or regulators. *Id.*

80. The Department of Energy Organization Act, Pub. L. No. 95-91, § 402(b), 91 Stat. 565, 584 (1977), *codified at* 42 U.S.C. § 7172(b) (1988) (repealed 1994), *recodified as amended*, 49 U.S.C. § 60502 (West 1996) transferred regulatory authority over oil pipelines from the ICC to the FERC. In the Revised Interstate Commerce Act, Pub. L. No. 95-473, 92 Stat. 1337 (1978), Congress recodified the ICA, *see* 49 U.S.C. §§ 10101-11917 (1988), but provided that oil pipeline regulation remained governed by the ICA as it existed on October 1, 1977. *See* Interstate Commerce Act § 4(c). Citations to the ICA in this article are to the version before repeal, found in 49 U.S.C. §§ 1-15 (1976), reprinted in 49 U.S.C. app. §§ 1-15 (1988).

81. *Farmers Union Central Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984), *cert. denied*, 439 U.S. 995 (1984).

82. *Williams Pipe Line Co.*, 31 F.E.R.C. ¶ 61,377 (1985), *opinion on reh'g*, 33 F.E.R.C. ¶ 61,327 (1985) (collectively referred to as Order No. 154-B). As the Court of Appeals has observed, the trended and depreciated original cost approaches differ only in the timing of capital recovery. *See also* *Farmers Union Central Exch. v. FERC*, 734 F.2d at 1429, n. 7.

154-B continues to be the ratemaking standard. Shortly thereafter, the FERC also adopted a policy of permitting pipelines to justify or defend rates as being market-based if they could demonstrate that they lacked significant market power in the relevant markets.⁸³ Ultimately, numerous pipelines have sought and obtained market-based rate authority for rates serving all or some of their markets.⁸⁴ In the immediate aftermath of Opinion No. 154-B and *Buckeye*, however, the industry was troubled by the substantial remaining uncertainties. Many pipeline rates had not been set under cost-of-service filings and rate design standards remained unclear. Moreover, litigation regarding both Opinion No. 154-B cost-based rates and market-based rates was expensive and protracted. The result of the industry's concerns and input from shipper interests was EPAct 1992, Title 18; the House Report noted the need to “[reduce] costs, delays, and uncertainties.”⁸⁵

EPAct 1992 addressed several aspects of oil pipeline regulation: (1) it directed the FERC to “issue a final rule which establishes a simplified and generally applicable ratemaking methodology for oil pipelines in accordance with Section 1(5) of part I of the Interstate Commerce Act” (section 1(5) contains the “just and reasonable” standard);⁸⁶ (2) directed the FERC to issue a final rule to “streamline procedures of the Commission relating to oil pipeline rates in order to avoid unnecessary regulatory costs and delays;”⁸⁷ and (3) all rates that had not been protested or subject to a complaint during the year prior to October 24, 1992, were “deemed to be just and reasonable (within the meaning of section 1(5) of the Interstate Commerce Act . . .),”⁸⁸ subject to what the D.C. Circuit has referred to as “narrow exceptions.”⁸⁹ In response, the FERC issued several rules implementing the new requirements, chiefly contained in Order No. 561.⁹⁰ Order No. 561 provided that new pipeline rates (that is, rates for new services) could be set either by filing a cost of service submission or with the support of one non-affiliated shipper (subject to being supported by cost of service should protests be filed).⁹¹ Rate changes were to be chiefly governed by a generic oil pipeline index, up or down, initially set at the Producer Price Index—Finished Goods (PPI-FG), minus one percent.⁹² The index was applied

83. *Buckeye Pipe Line Co.*, 44 F.E.R.C. ¶ 61,066 (1988), *reh'g denied*, 45 F.E.R.C. ¶ 61,046 (1989).

84. *See, e.g.*, Opinion No. 391 and 391-A, *Williams Pipe Line Co.*, 68 F.E.R.C. ¶ 61,136 (1994) and 71 F.E.R.C. ¶ 61,291 (1995); *Kaneb Pipe Line Operating P'ship*, 83 F.E.R.C. ¶ 61,183 (1998); *Explorer Pipeline Co.*, 87 F.E.R.C. ¶ 61,374 (1999); *Longhorn Partners Pipeline, L.P.*, 83 F.E.R.C. ¶ 61,345 (1998); *TEPPCO*, 92 F.E.R.C. ¶ 61,121 (2000); *Colonial Pipe Line L.P.*, 92 F.E.R.C. ¶ 61,144 (2000).

85. H.R. REP. NO. 474 (1992), *reprinted in* 1992 U.S.C.C.A.N. 1953, 2048.

86. Energy Policy Act of 1992, Pub. L. No. 102-486, § 1801(a), 106 Stat. 2776.

87. *Id.* § 1802(a).

88. Energy Policy Act of 1992 § 1803(a).

89. *Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

90. Order No. 561, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 30,985 (1993), 58 Fed. Reg. 58,753 (1993); *order on reh'g*, Order No. 561-A, *Revisions to Oil Pipeline Regulations to the Energy Policy Act of 1992*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. 31,000 (1994), 59 Fed. Reg. 40,243 (1994), *aff'd*, *Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

91. 18 C.F.R. § 342.2 (2006).

92. Subsequently, the index has been changed by rulemaking to be the PPI-FG, without adjustment. *See Flying J Inc. v. FERC*, 363 F.3d 495 (D.C. Cir. 2004).

to EPCRA 1992's baseline rates (and to any new rates thereafter established). Rates changed to any level below the index ceiling would be presumptively just and reasonable, although shippers could protest the application of the index, and pipelines could justify increasing rates above the index, if they could show a substantial divergence between the change in the carrier's costs and the change in revenues that would be produced under the index.⁹³ Carriers could also justify rates on the basis of lack of significant market power (prospectively from a FERC finding)⁹⁴ and via "settlement rates" agreed to in writing by all current shippers.⁹⁵ Despite the options, the FERC intended that the index would meet the Congressional mandate to establish a "simplified and generally applicable" form of regulation, primarily relating to the rates "grandfathered" under section 1803(a), which were to form a "baseline for many future oil pipeline rates and obviating debate over the appropriateness of [the] existing rates."⁹⁶

As the FERC intended, most pipeline rate changes have been made pursuant to the ceiling index during the subsequent decade. Although the regulations did to some extent "obviate debate" over rates for many individual pipelines, they have not obviated concern by pipeline sponsors over the ultimate direction of the FERC's rate regulations and the potential impact on pipelines—particularly new pipelines. Two areas of uncertainty, in particular, have arisen: the standard to be applied to determine when a complainant has successfully challenged the "deemed" just and reasonable status of grandfathered rates; and the extent to which MLPs, LPs, and LLCs will be permitted to recover a tax allowance as part of their cost of service. The FERC has issued orders on both of these topics, which are also currently subject to appeal; independent of the Court's and the FERC's further resolution of these issues, they have created substantial uncertainty in projecting the revenue impact of infrastructure investments by oil pipelines.

2. Standards for Challenging "Grandfathered Rates" and the Impact of Expansions

Congress deemed "grandfathered rates" to be just and reasonable, but the statute did not render them immune to later challenge. Section 1803(b) of EPCRA 1992 established a threshold requirement for challenges to a grandfathered rate:

[n]o person may file a complaint . . . against a rate deemed to be just and reasonable under subsection (a) unless . . . evidence is presented to the Commission which establishes that a substantial change has occurred after the date of the enactment of this Act . . . -- (A) in the economic circumstances of the oil pipeline which were a basis for the rate; or (B) in the nature of the services provided which were a basis for the rate⁹⁷

93. 18 C.F.R. § 343.3 (2006) (establishing indexing); 18 C.F.R. § 342.4(a) (2006) (establishing carrier rights to exceed the ceiling); 18 C.F.R. § 343.2 (2006) (establishing shipper rights to protest application of the cap).

94. 18 C.F.R. § 342.4(b) (2006).

95. 18 C.F.R. § 342.4(c) (2006).

96. Order No. 561, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 30,985, at p. 30,940 (1993), 58 Fed. Reg. 58,753 (1993).

97. Energy Policy Act of 1992, Pub. L. No. 102-486, § 1803(b), 106 Stat. 2776.

In Order No. 561, the FERC did not set a standard for meeting the “changed circumstances” language of the statute. However, it did indicate that the grandfathered rates should play an important role in the index program.⁹⁸

The FERC first addressed the meaning of “changed circumstances” on a threshold basis in its Order No. 435 series, addressing complaints against “grandfathered” rates of SFPP, L.P.⁹⁹ There the Commission found that the complainants had not demonstrated “changed circumstances,” but provided guidance on the kinds of elements to be used, chiefly cost of service elements. If “substantially changed circumstances” were shown to have occurred within the meaning of the statute, then the rates would lose their grandfathered status and would be subject to challenge on ordinary cost of service grounds like other pipeline rates.

The complainants filed new complaints in 1996, which were subsequently litigated before an Administrative Law Judge, who issued an initial decision which became the subject of Commission rulings in March 2004¹⁰⁰ and June 2005.¹⁰¹

The Commission concluded that on the facts of the SFPP record, the complainants had shown “changed circumstances” as to the principal rates challenged, for SFPP’s West Line, but not for its North and Oregon Lines. The standard applied in the *SFPP March 2004 Order*, as refined in the *SFPP June 2005 Order*, focused on major cost of service indicators changed between the levels at the establishment of the rate, in 1992, and at the time the complaints were filed. The two orders focused in particular on three elements of cost of service—volume, rate base, and allowed return—and did not adopt a “precise definition” of “substantially changed circumstances,” but did conclude that the degree of change had to exceed “10 percent or other similarly low number.”¹⁰² Using volume as a proxy for revenue and changes in rate base and allowed return as indicia of changes to total expenses, the FERC summed the increase in volume with the decrease in expenses, and compared the results in the complaint years (1995-1999) to the “base year.”¹⁰³ Therefore, an increase of revenues of thirteen percent summed with a decrease in rate base or allowed return of twelve percent would result in a “change in circumstances” of twenty-five percent. In fact, the FERC found an “aggregate” improvement of twenty percent to twenty-five percent depending on the use of overall costs and revenues or delivery point specific costs and revenues, which the FERC found to constitute “substantially changed circumstances.” In contrast, the FERC found the aggregate changes in

98. Order No. 561-A, *Revisions to Oil Pipeline Regulations to the Energy Policy Act of 1992*, [Regs Preambles 1991-1996] F.E.R.C. STATS. & REGS. 31,000, at p. 31,104 (1994), 59 Fed. Reg. 40,243 (1994).

99. Opinion No. 435, *SFPP, L.P.*, 86 F.E.R.C. ¶ 61,022 (1999); *SFPP, L.P.*, 87 F.E.R.C. ¶ 61,056 (1999); Opinion No. 435-A, *SFPP, L.P.*, 91 F.E.R.C. ¶ 61,135 (2000); Opinion No. 435-B, *SFPP, L.P.*, 96 F.E.R.C. ¶ 61,281 (2001), *vacated in part and aff’d in part*, *BP W. Coast Products, L.L.C. v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004).

100. *ARCO Products Co. v. SFPP, L.P.*, 106 F.E.R.C. ¶ 61,300 (2004) (SFPP March 2004 Order).

101. *SFPP, L.P.*, 111 F.E.R.C. ¶ 61,334 (2005). (SFPP June 2005 Order).

102. 111 F.E.R.C. ¶ 61,334 at PP 37-38.

103. 111 F.E.R.C. ¶ 61,334 at P 38.

revenues and costs for the other two lines to fall below ten percent, and hence no “substantially changed circumstances.”¹⁰⁴

Shippers and pipeline interests both petitioned for review of these determinations—the shippers arguing that “changed circumstances” should have been found for the North and Oregon Lines, and SFPP, L.P. and the Association of Oil Pipe Lines (AOPL) arguing that “changed circumstances” should not have been found for the West Line. Specifically, SFPP, L.P. challenged the mechanics of the calculations, particularly the Commission’s decision to compare changes to the economic results between the time of EPAct 1992 enactment to those prior to the complaint filing dates in relation to the basis economic circumstances. AOPL argued that the FERC should not have imposed a single, narrow cost of service standard for the basis of grandfathered rates, using an Opinion No. 154-B methodology, when most pipeline rates were not set on cost of service grounds and when the result would be to undercut the goals of EPAct 1992 and Order No. 561.¹⁰⁵

Regardless of whether the FERC’s standard is sustained on judicial review, the industry may well be entering a period in which the “grandfathered rates” “deemed” just and reasonable by Congress in 1992, may become more vulnerable to complaint and “de-grandfathering” as time passes. This process has serious implications for the dynamics of oil pipeline expansions. The industry has expressed the concern that loss of grandfathered rate status merely by the passage of time and modest increases in earned return, are threats that would seem to undercut pipeline incentives for efficiency. More pointedly for purposes of infrastructure expansion, the industry has argued that if a pipeline believes that an expansion will result in the loss of grandfathered rate status for much of its system, that threat alone would weaken the projected economics of investing in expansions.

This potential is not merely hypothetical. The FERC has already received several petitions for declaratory order in which a pipeline sought assurances that construction of pipeline extensions or expansions and accompanying throughput would not compromise the grandfathered status of the pipeline’s non-expansion rates.¹⁰⁶ Although the FERC granted the pipeline requests in its 2002 orders regarding the impact of changes related to new pipeline laterals and attendant additional mainline volumes for Colonial and Plantation, the FERC provided a more circumspect response to Colonial’s request.

Colonial sought the FERC’s assurance that a substantial expansion of its mainline funded by a surcharge would not affect the grandfathered status of its preexisting rates. The FERC stated that Colonial could use the grandfathered rates for the new expansion volumes, which were not a “new service” under the EPAct, 1992 and that the mere act of charging grandfathered rates to incremental

104. *Id.*

105. Those arguments are all before the D.C. Circuit at the time this article is being written in *ExxonMobil Oil Corp. v. FERC*, No. 06-1271 (D.C. Cir. filed July 12, 2005).

106. *Colonial Pipeline Co.*, 89 F.E.R.C. ¶ 61,095 (1999), *order on reh’g*, 95 F.E.R.C. ¶ 61,355 (2001) (seeking the assurance for a proposed project to replace and rebuild a lateral line); *Plantation Pipe Line Co.*, 98 F.E.R.C. ¶ 61,219 (2002); *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078 (2006) (seeking the assurance that a significant mainline expansion funded by a surcharge would not undo the grandfathered rate status of its preexisting rates).

volumes does not constitute a “substantial change in circumstances” under the statute, and the proposal does not “by itself” create a need for Colonial to defend the existing grandfathered rates. However, the Commission further stated that shippers’ rights to challenge the rates in the future would be preserved:

[a]s Colonial indicates in its Petition, the grandfathered rates will remain subject to complaint under the “substantial change in circumstances” standard. Thus, shippers will have no less right or ability to challenge those rates once the expansion is completed than they do today. Likewise, we hold that the URC designed to recover the net unrecovered expansion costs, whether collected for shipments on the existing or the expansion facilities, will not be grandfathered. Further, a complainant can continue to challenge any changes due to indexing of the rates charged for shipments on the existing pipeline and the expansion pipeline without having to satisfy the requirements of section 1803 of 1992 EPA Act. Finally, this order does not prejudice any complaint that may be filed in the future, as economic and service-related circumstances may develop.¹⁰⁷

The FERC therefore declared that the “mere fact” of charging grandfathered rates to incremental volumes would not *ipso facto* eliminate the grandfathered rate status of the preexisting base rates, but at the same time did not preclude later shipper challenges, whose right would be “no less . . . than . . . today,” and would not prejudice future complaints.¹⁰⁸ Colonial did not seek clarification, but the order suggests limits to the extent that the FERC may declare grandfathered rates to be unaffected by system expansions. In turn, this possible limitation raises further questions for pipeline owners and investors weighing the risks and benefits of pipeline expansions that may, depending upon future interpretations, threaten to undercut grandfathered rates over the long term.

Both the standard for grandfathered rates, and the FERC’s willingness to protect grandfathered rates for expanding pipelines, or limits to the FERC’s willingness to do so, may have significant impacts on decisions to expand capacity.

3. Tax Allowances for MLPs, LLCs, and Other Pass-Through Entities

The Commission’s policy regarding income tax allowances for entities that do not have a direct income tax liability affects all FERC-regulated industries, but even more than gas pipelines and electric companies, the policy has the potential to affect oil pipelines’ cost of service evaluations. More so than other industries, oil pipelines have been converted and built increasingly on the basis of corporate forms such as master limited partnerships (MLPs), limited partnerships (LPs), and limited liability companies (LLCs) that act at the first stage as a “pass through” entity for purposes of the federal income tax. The first major oil pipeline became an LP in 1986,¹⁰⁹ and a review of the “regulated entities” list on the FERC’s website indicates a long list of additional entities.¹¹⁰ A recent estimate places approximately forty-three percent of interstate oil pipeline barrel miles in pipelines with LP or LLC corporate forms.¹¹¹ Therefore,

107. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078 at PP 52-53.

108. *Id.*

109. *Buckeye Pipe Line Company, L.P.*, 44 F.E.R.C. ¶ 61,066 (1988).

110. The list includes 48 LLCs and 12 LPs.

111. Interview with the Association of Oil Pipe Lines, Dan Mihalik, December 2006, (personal communication).

it is perhaps appropriate that the question of the tax status of pass through entities has largely been defined, before the FERC and the reviewing courts, in oil pipeline cases.

The income tax allowance is a cost of service component linked to the return on equity. If the FERC only permitted pipelines to recover their return on equity, they would be under compensated because a significant percentage of that return would be attributed to the federal government because of the income tax. Consequently, the FERC's regulations call for providing an income tax allowance for regulated companies.¹¹² The FERC traditionally treated pipelines operating as partnerships in the same manner as regular corporations for purposes of determining whether their cost of service would include an income tax allowance.¹¹³ The FERC first reconsidered this policy in a case involving the Lakehead system, which was an LP. The FERC determined that an LP would be permitted to include an income tax allowance in its rates equal to the proportion of its LP interests owned by corporate partners, but could not include a tax allowance for its partnership interests that were not owned by corporations.¹¹⁴ The FERC allowed the tax allowance for corporate partner interests for several reasons: the double taxation of corporate earnings; equalization of returns between different types of publicly held interests; and encouraging capital formation and investment.

This policy was challenged on the petition for review of the Opinion No. 435 cases, and was addressed by the D.C. Circuit in *BP West Coast*.¹¹⁵ The court vacated and remanded the FERC's *Lakehead* policy, rejecting all of the FERC's grounds for it. The court concluded that only the costs of the regulated entity may be recovered and that taxes are but one cost paid by a corporate partner as part of its cost of doing business.¹¹⁶ Furthermore, the court declined to accept that the investor should be able to obtain the same returns without regard to which instrument the investor purchases, because if any income tax allowance were provided they would benefit all investors proportionately because the additional income is shared on a pro rata basis and hence non-corporate partners would receive an excess rate of return.¹¹⁷ The court concluded that the double taxation function is a consequence of corporate structure and its tax consequences, not the regulated utility's risk. According to the court, an investor's return and risk should be no more appropriately attributed to the regulated entity than the investor's other costs for purposes of defining the costs the regulated entity should be permitted to recover. The court also rejected the asserted need to permit the allowance in order to incent capital investment.¹¹⁸ Again, the court concluded that if a partnership paid no income taxes, or had no potential income tax liability, it failed to incur an income tax

112. See, e.g., 18 C.F.R. § 346.2(c)(4) (2006) (oil pipelines); 18 C.F.R. § 154.312(m) (2006) (gas pipelines).

113. *Sea Robin Pipeline Co.*, 21 F.E.R.C. ¶ 61,155 (1982).

114. *Lakehead Pipe Line Co., L.P.*, 71 F.E.R.C. ¶ 61,388 (1995), *reh'g denied*, 75 F.E.R.C. ¶ 61,181 (1996).

115. *BP W. Coast Products, L.L.C. v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004).

116. *Id.* at 1288.

117. *BP W. Coast Products*, 374 F.3d at 1292-93.

118. *Id.*

cost and any such allowance would be a “phantom cost” that would not justify the goal of encouraging infrastructure investment. The court distinguished allowances for the income taxes of pass through entity unit holders from the “stand alone” principle that a company need not show an actual tax liability when it filed as part of a larger corporate family.¹¹⁹ Accordingly, the court also rejected the argument that the tax allowance reflects all unit-holders rather than just the corporate unit-holders.¹²⁰

On remand, the FERC issued a Notice of Inquiry, seeking public comment on how it should treat tax allowances.¹²¹ After receiving numerous written submissions, the FERC issued a *Policy Statement on Income Tax Allowances* on May 4, 2005.¹²² In the *Policy Statement*, the FERC rejected the *Lakehead* policy¹²³ and adopted a new general policy: an income tax allowance should be permitted on all partnership interests, or similar legal interests, if the owner of that interest has “an actual or potential income tax liability on the public utility income earned through the interest.”¹²⁴ The FERC therefore focused not on whether the pass-through entity itself pays income taxes, but rather on whether the owners pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity, which the FERC reasoned “are just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation.”¹²⁵ Noting that a detailed discussion of the partnership tax practice had not been considered by the court in *BP West Coast*, the FERC found that its conclusion did not violate the court’s concern that the tax allowance would compensate for “an income tax cost that is not actually paid by the regulated utility”—a conclusion resting heavily on comments submitted.¹²⁶ The FERC emphasized that “just as a corporation has an actual or potential income tax liability on income from the first tier . . . assets it controls, so do the owners of a partnership or LLC on the first tier assets and income that they control by means of the pass-through entity.”¹²⁷ Therefore, the FERC reasoned that without a tax allowance on the public utility’s income, the return to investors would be less than if they had invested directly in the asset.¹²⁸ Disallowing an income tax allowance would act as a disincentive for the use of the partnership format, and the new policy would not increase costs to ratepayers and might reduce them in some circumstances. The FERC concluded that its policy would not result in “phantom income taxes” and “will facilitate important public utility investments”¹²⁹ The FERC noted that the problem of different

119. See, e.g., *City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985); *BP W. Coast Products*, 374 F.3d at 1286.

120. *BP W. Coast Products*, 374 F.3d at 1286.

121. *Inquiry Regarding Income Tax Allowances*, 69 Fed. Reg. 72,187 (Dec. 13, 2004).

122. *Inquiry Regarding Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139 (2005), *reh’g dismissed*, 112 F.E.R.C. ¶ 61,203 (2005) [hereinafter *Policy Statement*].

123. *Policy Statement*, *supra* note 122, at P 33.

124. *Id.* at PP 1, 38-40.

125. *Policy Statement*, *supra* note 122, at P 33.

126. *Id.* at P 34.

127. *Policy Statement*, *supra* note 122, at P 34.

128. *Id.* at P 33.

129. *Policy Statement*, *supra* note 122, at P 37.

interest holders benefiting differentially, depending upon whether their taxable status contributes to the presence of a tax allowance, would need to be resolved within the context of the partnership agreements, and that the particulars of which interest owners would have actual or potential tax liabilities would require determinations on a case-by-case basis.¹³⁰

This *Policy Statement* was the subject of a petition for review by a producer association,¹³¹ as well as in individual cases,¹³² and the D.C. Circuit will likely determine in the first half of 2007 whether the *Policy Statement* addresses the concerns of its *BP West Coast* remand and the statutory requirements.

The importance of the tax allowance issue is enormous for the oil pipeline industry. Structures such as MLPs, LPs, and LLCs have become the norm in establishing new pipelines and the industry's success in attracting outside capital has rested in large part on the widespread use of these entities for pipeline ownership. The recent trend in which independent pipelines have become increasingly prominent has occurred in step with broader use of these structures—exemplified by the pass-through entities owning the Buckeye, TEPPCo, Kinder Morgan, and Enbridge assets. Major new oil pipeline assets constructed in the past decade have occurred through these structures: the Enbridge expansions (new crude petroleum capacity from Western Canada to the Midwest); Express Pipeline (new crude petroleum pipeline from Western Canada to the Rocky Mountains); Keystone Pipeline, L.P. (projected new pipeline from Canada); Centennial Pipeline LLC (new products pipeline from the Gulf Coast to the Midwest); Longhorn Partners Pipeline L.P. (new products line from East Texas to West Texas and the El Paso gateway); and SFPP, L.P. (expansion of system capacity to California markets). The industry has contended that loss of the tax allowance would have a chilling effect on investment generally,¹³³ as well as create substantially greater concerns as to the rate certainty of grandfathered rates.¹³⁴ In contrast, some shipper interests, unsurprisingly, take the view that *BP West Coast* precludes any tax allowance and that new facilities will be constructed regardless of the exclusion of “phantom taxes.” The Commission's *Policy Statement* provided substantial support for additional infrastructure development, but until fully resolved on judicial review and implemented in specific proceedings, the tax allowance will remain an industry concern.

130. *Id.* at PP 41-42.

131. *Canadian Ass'n of Petroleum Producers v. FERC*, No. 05-1382 (D.C. Cir. filed Sept. 29, 2005).

132. *Transmission Agency of N. Cal. v. FERC*, No. 05-1402 (D.C. Cir. filed Oct. 21, 2005); *ExxonMobil Oil Corp. v. FERC*, No. 06-1271 (D.C. Cir. filed July 12, 2005).

133. *See, e.g.*, SAM BROTHWELL, GLOBAL SECURITIES RESEARCH AND ECONOMICS GROUP, MERRILL LYNCH, ENERGY PARTNERSHIPS: LAKE REARS ITS HEAD (Dec. 8, 2004).

134. The FERC ruled that although disallowance of the income tax allowance would not alone be grounds for “substantially changed circumstances,” a determination that the tax allowance has been lost or reduced would be a factor in the calculation of the changed circumstances. *SFPP, L.P.*, 111 F.E.R.C. ¶ 61,334 (2004).

D. Oil Pipeline Capacity Allocation – Competing Demands and Changing Policies

Interstate oil pipelines are declared “common carriers” by the ICA.¹³⁵ The term “common carrier” has a long history as a matter of the English common law and in the English Railway Act of 1845.¹³⁶ The statutory language establishing this obligation can be found in ICA section 1(4), which states in pertinent part: “[i]t shall be the duty of every common carrier subject to this chapter to provide and furnish transportation upon reasonable request therefore . . .”

In addition, the obligations of the pipeline as a common carrier at common law are incorporated into the ICA.¹³⁷ Traditionally, this obligation has been that pipelines must allocate their capacity reasonably and in a non-discriminatory fashion. The FERC noted some of the principal precedents for this principle in *Belle Fourche*,¹³⁸ which rejected a pipeline tariff giving unrestrained discretion to the carrier to refuse tenders when it had reached capacity. The FERC there quoted earlier Supreme Court cases, which themselves noted relevant precedents reaching back to the older common law establishing a carrier’s rights and obligations “if his coach be full.”¹³⁹ The standard enunciated by the Supreme Court was not precise: “[t]he law exacts only what is reasonable from such carriers—but, at the same time, requires that they should be equally reasonable in the treatment of their patrons.”¹⁴⁰

Historically, pipelines have responded to capacity constraints by engaging in “prorating:” prorating their capacity in various ways among shippers. Although there is very little case law under the ICC, prorating appears to have occurred among regulated pipelines throughout the late 20th century. With some exceptions, pipelines would typically respond to sustained prorating by adding modest capacity¹⁴¹—not a surprising result when it was common for a substantial identity of ownership to exist between the pipeline and its shippers. More recently, oil pipeline tariffs have varied in allocating capacity during periods of prorating. Some tariffs allocate simply on the basis of relative nominations submitted—a method that during times of heavy demand can lead to “gaming” of nominations and the submission of “air barrels” to increase allocations. The FERC has also, in a number of instances, sanctioned pipeline tariffs allocating capacity on the basis of past historical volumes (historical volume-based prorating), as well as other methods.¹⁴²

135. Interstate Commerce Act, 49 U.S.C. app. § 1(b) (1988) (repealed, *see supra* note 80).

136. *See, e.g.*, STEPHEN BREYER, REGULATION AND ITS REFORM (1982).

137. *See, e.g.*, 49 U.S.C. app. § 1(22) (1988) (“nothing in this chapter contained shall in any way abridge or alter the remedies now existing at common law or by statute, but the provisions of this chapter are in addition to such remedies;”).

138. *Belle Fourche Pipeline Co.*, 28 F.E.R.C. ¶ 61,150, at p. 61,282 (1984).

139. *Id.* at 61,281 (*quoting* Pennsylvania R.R. Co. v. Puritan Coal Co., 237 U.S. 121 (1915)).

140. *Belle Fourche Pipeline Co.*, 28 F.E.R.C. ¶ 61,150 at 61,281.

141. WOLBERT, *supra* note 17, at pp. 366-70, 408-10.

142. *See, e.g.*, *Explorer Pipeline Co.*, 87 F.E.R.C. ¶ 61,394, at p. 62,387, n.14 (1999); *SFPP, L.P.*, 86 F.E.R.C. ¶ 61,022, at p. 61,115 (1999); *Total Petroleum, Inc. v. Citgo Products Pipeline*, 76 F.E.R.C. ¶ 61,164, at p. 61,947 (1996). The FERC has stated that, “prorating policies based on historical volumes are an acceptable means of allocating capacity on other pipelines . . .” *ConocoPhillips Transp. Alaska, Inc.*, 112

Oil pipelines therefore form a striking contrast to the gas pipelines and electric utilities regulated by the FERC. Under the Natural Gas Act (NGA) and FPA, contracts between the regulated company and its customers have formed a fundamental element of the FERC (and FPC) regulation.¹⁴³ Pipelines enter into contracts with customers before and after construction and operation, and a highly specific series of rules have emerged over time to determine when the FERC should and can override such agreements under its statutory authority.¹⁴⁴ New natural gas pipelines seek certificate authorizations on the basis of all, or nearly all, of the projected capacity being committed to the exclusive contractual entitlement of a defined set of firm shippers—indeed, at one time, the FERC found the absence of such contracts a serious problem in finding that the requested certificate was in the public convenience and necessity.¹⁴⁵ The FERC has at various times expressed concern when a high percentage of new gas transportation contracts are not for extended periods of time.¹⁴⁶ Similarly, the FERC has recognized that electric transmission customers need long-term assured access to transmission lines via long-term firm contracts.¹⁴⁷

Recent trends in the oil pipeline industry have caused some pipelines and shippers to reassess the extent to which the common carrier obligation accommodate greater capacity assurances for shippers willing to make long term commitments to pay for new pipeline capacity. When many pipelines chiefly transported affiliated volumes, the pipeline's assessment of financing new capacity rested largely on projections of market need and supply—affiliated shippers could commit to long-term T&D agreements with the dual assurance that the likely shippers were known, and that the pipeline would have a common incentive to increase capacity should prorationing cause problems in the future. In a market environment in which independent pipelines are projecting costly new projects that require financial commitments from unaffiliated shippers,¹⁴⁸

F.E.R.C. ¶ 61,213 at P 28 (2005). Oil pipelines have not traditionally provided “firm service” in which customers receive guarantees of delivery absent force majeure circumstances.

143. In contrast to oil pipelines, most railroad transportation now travels under contracts; however, the revised Interstate Commerce Act under which railroads operate, codified at 49 U.S.C. §§ 10101-11917 (2000), modified by major legislative changes in 1978, 1980, and 1995, differs significantly from the statutory provisions applicable to oil pipelines, which remain fixed in their 1977 terms.

144. See, e.g., *United Gas Pipeline Co. v. Memphis Light, Gas and Water Div.*, 358 U.S. 103 (1958). The FERC has an ongoing rulemaking proceeding intended to refine the scope of deference to be granted to private jurisdictional contracts. *Standard of Review for Modifications to Jurisdictional Agreements*, 113 F.E.R.C. ¶ 61,317 (2005).

145. *El Paso Natural Gas Co.*, 65 F.E.R.C. ¶ 61,273 (1993); *Questar Pipeline Co.*, 67 F.E.R.C. ¶ 61,145 (1994).

146. *Crossroads Pipeline Co.*, 71 F.E.R.C. ¶ 61,076, at p. 61,261 (1995).

147. See, e.g., Order No. 681, *Long-Term Firm Transmission Rights in Organized Elec. Mkts.*, 71 116 F.E.R.C. ¶ 61,077 (2006). Long-term firm transmission rights have a more complex history for jurisdictional power companies than for gas pipelines, but such rights have existed previously, and have become even more prominent as the Commission has noted, where “our focus is providing load serving entities with long-term power supply arrangements to meet their service obligations with the opportunity to obtain long-term firm transmission rights that will support the financing and construction of new infrastructure.” Order No. 681, *Long-Term Firm Transmission Rights in Organized Elec. Mkts.*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,226 at P 260 (2006), 71 Fed. Reg. 43,564 (2006).

148. See NATIONAL ENERGY BOARD, CANADA'S OIL SANDS, OPPORTUNITIES AND CHALLENGES TO 2015: AN UPDATE 34 (2006), http://www.neb.gc.ca/energy/EnergyReports/EMAOilSandsOpportunitiesChallenges2015_2006/EMAOilSandsOpportunities2015Canada2006_e.pdf. The NEB also noted that one of the critical

the absence of firm capacity rights becomes an increasingly more serious problem. Shippers are not likely to sign contracts for long-term T&D commitments with unaffiliated pipelines, in the absence of any assurances that they are likely to be able to reliably use capacity that they have been required to fund. For projects in which the shippers' commitments form the financial basis for funding of the new capacity, sole reliance on pro rata allocations, or even historical volume allocation, are not likely to provide adequate protection for shippers. Under these circumstances, the Commission will be asked to revisit the traditional approaches to situations in which a carriers' "coach be full."

Although the Commission has not yet received a request for "firm" oil pipeline service, it has approved or accepted some tariff proposals for pipeline expansions that have provided some degree of capacity assurances for shippers while preserving the common carrier nature of the pipeline service. For some years, Explorer Pipeline has offered a tiered proration provision under which expansion capacity (Bid Capacity) is sold in a monthly auction¹⁴⁹ and is subject to first allocation, prior to allocation for regular (non-auction) transportation or discounted transportation.¹⁵⁰

The FERC also recently issued an order approving a tariff under which a defined set of expansion capacity, which is subject to contract shipper commitments, is separately allocated during prorationing. The *Mid-America*¹⁵¹ proceeding involved, *inter alia*, a tariff provision providing that certain "expansion capacity" from a 1999 expansion would be allocated for prorationing purposes based on the contracts and prior to, and separate from, the allocation of other capacity, which was to be prorated based on historical volumes. The 1999 expansion capacity filing was not the subject of a FERC order, but accompanied an expansion and corresponding set of seven-year contracts at incentive rates that would apply only to the expansion capacity—more specifically, eighty percent of the expansion capacity was allocated to the contract shippers, and twenty percent to other shippers on the standard prorationing basis. In the 2006 order, the pipeline filed a tariff extending the prorationing provision to cover newly executed renewed incentive rate agreements, under which shippers committing to the new long-term agreements for expansion capacity would be subject to the separate prorationing procedures initially established for the original contract shippers. A shipper protested the filing, challenging both the alleged preferential allocation and the fact that the original purpose of the contracts—supporting the expansion—did not apply to the new incentive contract shippers.

The FERC upheld the tariff provision, because: (1) all shippers, both current and new, would be permitted to participate in the new incentive rate contract program; (2) the same incentive rates would apply to the new contracting parties as applied to the first contracting parties; and (3) the pipeline

issues facing the industry would be the "type of carriage," including the suggestion that new demands may be made with respect to the traditional common carriage role of pipelines. *Id.*

149. Explorer has market-based rates to the relevant markets served under the auction.

150. See *Explorer Pipeline Co.*, 87 F.E.R.C. ¶ 61,374 (1999).

151. *Mid-America Pipeline Co., LLC*, 116 F.E.R.C. ¶ 61,040 (2006), *reh'g denied, appeal pending, sub nom. Williams Energy Servs., LLC v. FERC*, No. 06-1327 (D.C. Cir. filed Sept. 18, 2006).

had not changed the prorationing procedures applicable to the incentive rates.¹⁵² Further, the FERC found that because the pipeline was expanding the expansion capacity while retaining the eighty percent/twenty percent split in allocation methods, and because the vast bulk of the pipeline's capacity was being offered on the traditional prorationing basis, non-contract shippers would be able to move their volumes on seventy-five percent of the capacity, and "neither historical shippers nor new shippers will be denied access even if they do not sign long-term volume dedications."¹⁵³ More such filings are likely to follow.¹⁵⁴

The approach taken in *Mid-America* illustrates the FERC's ability to adapt its common carrier policy to the changing circumstances in which pipelines operate, and may provide a basis for a broader acceptance of capacity preferences that do not foreclose access to all and meet the FERC's requirements for non-discrimination.

In *Belle Fourche*, the FERC emphasized the need for "reasonable rules," as emphasized by the Supreme Court, and also recognized that ICA section 3(1) prohibits "undue discrimination" when allocating insufficient capacity.¹⁵⁵ The Commission has found that the requirements of the "undue discrimination" prohibition do not preclude a pipeline from offering exclusive, contractual, discounted rate provisions on a long-term basis, so long as all shippers have an opportunity to take advantage of those contracts in an open season.¹⁵⁶ As recognized in *Mid-America*, the same principle may apply when the rate contracts also provide for separate allocation in prorationing. Furthermore, if a pipeline limits its special allocation status to expansion capacity, while still making the rest of the pipeline available on standard prorationing procedures, the FERC's goal of preserving the common carrier status of the pipeline should be protected as well. The NEB, which also enforces a "common carrier" standard for oil pipelines under the Canadian National Energy Board Act,¹⁵⁷ permits preferences in capacity allocation for contract volumes so long as some varying percentage of the pipeline remains available for purely common carrier volumes.¹⁵⁸

152. *Mid-America Pipeline Co., LLC*, 116 F.E.R.C. ¶ 61,040 at P 23.

153. *Id.* at P 24.

154. *E.g., Mobil Pipe Line Co.*, F.E.R.C. Tariff No. A-1153 (Nov. 14, 2006) (proposing prorationing procedures strongly resembling the general contours of those approved in *Mid-America Pipeline Co., LLC*).

155. *Belle Fourche Pipeline Co.*, 28 F.E.R.C. ¶ 61,150, at p. 61,282 (1984).

156. *See, e.g., Express Pipeline P'ship*, 76 F.E.R.C. ¶ 61,245 (1996). The Commission recently reaffirmed this concept in a related setting, under the NGA. In Order No. 686, *Revisions to the Blanket Certificate Regulations and Clarification Regarding Rates*, [2006 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 31,231 (2006), 71 Fed. Reg. 63,680 (2006), the FERC generally held that gas pipelines may without engaging in "undue discrimination," grant lower rates to "foundation shippers" who advance support for proposed new projects. There as well, the Commission conditioned this finding on giving a fair opportunity to all prospective shippers to become foundation shippers and thus benefit. This clarification was granted in light of the pipelines' and producers' contention that encouraging foundation shippers would be helpful in incenting additional infrastructure. *Id.* at P 68.

157. National Energy Board Act, R.S.C., ch. N-7 (1985), available at http://laws.justice.gc.ca/en/show/doc/cs/N-7/bo-ga:l_III/en.

158. Press Release, National Energy Board, NEB Approves IPL Line 9 Reversal Application (Dec. 18 1997), available at http://www.neb-one.gc.ca/newsroom/releases/nr1997/nr9768_e.htm.

The FERC has the means to resolve the apparent tension between the common carrier obligation of oil pipelines and the expected demand for shipper capacity assurances for shipper-supported new infrastructure. As the *Mid-America* decision demonstrates, an open and free opportunity to become a contract shipper with rate and separate prorationing rights, through an open season or other transparent process, should fully satisfy the “undue discrimination” standard of the statute. Ensuring that some capacity is available for regular capacity allocation, fully satisfies the common carrier obligation of ICA section 1(4). Providing shippers and pipelines with the tools to support new infrastructure projects meets the broader goals of the statutory and Supreme Court precedent obligations to adopt “reasonable” rules in the circumstances. Given the precedent available, the Commission may establish a mechanism to address the need for capacity certainty for future construction, in the same manner that it addressed the need for rate certainty by its innovative use of the declaratory order provision.

IV. CONCLUSION

Oil pipelines largely remain out of the brightest media spotlights yet face significant needs to expand and extend their facilities well into this century. Despite the FERC’s limited reach as to oil pipelines, it has taken a number of steps to ensure that the industry’s rate and tariff regulation do not impede needed adequate investment, within the standards of the ICA. Such steps will remain necessary, as the infrastructure of the oil pipelines is an integral part in the nation’s energy supply and energy security.