REPORT OF THE OIL PIPELINE REGULATION COMMITTEE

This report summarizes significant developments with respect to oil pipeline regulation that have occurred during the period of January through December, 2003. The topics are covered in the following order: I. Complaint Cases; II. Market-Based Rates; and III. Jurisdictional Issues.

I. COMPLAINT CASES

A. *Texaco Refining and Marketing Inc. v. SFPP, L.P.*,

Docket Nos. OR96-2: Grandfathered Rates

Presiding Administrative Law Judge Raymond M. Zimmet issued an Initial Decision on June 24, 2003, finding that SFPP, L.P.'s (SFPP) rates are not "grandfathered" under the Energy Policy Act of 1992 (EPAct) and are unjust and unreasonable in violation of the Interstate Commerce Act (ICA).[1] This is the first decision since enactment of EPAct to overturn an oil pipeline's "grandfathered" rates. The decision is now subject to review by the Federal Energy Regulatory Commission (Commission).

1. "Grandfathered Rates" and Regulatory Context of Initial Decision

Oil pipelines are "common carriers" subject to regulation by the FERC under the ICA.[2] In 1992, when Congress enacted Title XVIII of EPAct pertaining to oil pipelines,[3] Congress retained the ICA's requirement that oil pipeline rates be "just and reasonable," but at the same time "grandfathered" certain rates if no challenge had been brought against them within the year prior to EPAct's enactment. The "grandfathered" status of the rates could be revoked upon a showing by a shipper, inter alia, that there had been a substantial change in the economic circumstances of the oil pipeline that were "a basis" for the rate.[4] Then, if that threshold were met, the shipper had to show that the rates were not "just and reasonable," under ICA standards, before any relief could be granted.

In Opinion No. 435, involving earlier complaints filed by shippers against SFPP's rates, the Commission set the evidentiary standards for measuring substantially changed circumstances under EPAct, including setting a threshold of something greater than 10% for proving that a change was substantial.[5] The

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1. *Texaco Ref. & Mktg., Inc.*, 103 F.E.R.C. ¶ 63,055 (2003).
2. 49 U.S.C. § 15301 (2004).
3. Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992).
4. *Id.* § 1803(a).
5. Opinion No. 435, *SFPP, L.P.*, 86 F.E.R.C. ¶ 61,022, 61,066 (1999) (subsequent history omitted). Opinion No. 435 involved an earlier round of complaints by shippers against the rates of SFPP, L.P. in Docket No. OR92-8. The FERC has issued four subsequent rehearing orders in that docket.

Commission further held that a substantial change could be shown by "one or a number of rate elements" and that "the rate elements that significantly affect the economic basis for most rates" are "volumes, asset base, operating, and perhaps, capital costs." To show substantial change under EPAct, "a complainant must establish substantial change to one of these more important elements that are the basis for the rate and explain why this change is likely to have rendered the existing rate unjust and unreasonable."[6] Additionally, the Commission suggested that a complainant could establish substantially changed circumstances under EPAct by showing how the change in the income tax allowance resulting from application of the Commission's *Lakehead* decision "affects the economic basis for the rates that are challenged . . . ."[7]

Docket No. OR96-2 involves a second series of complaints against SFPP's rates filed beginning in 1995. The Commission directed that these complaints be taken up seriatim such that if the first complaint failed the "substantially changed circumstances" test, the judge would move on to the next complaint. After months of discovery and five months of hearing, Judge Zimmet issued his Initial Decision Phase One on June 24, 2003.[8]

2. Initial Decision

In his Initial Decision, Judge Zimmet applied section 1803(b) of EPAct and the standards set by the Commission's Decision in Opinion No. 435 to the series of complaints at issue in Docket No. OR96-2.[9]

For purposes of the analysis, to measure change, the letters "A", "B", and "C" were used as shorthand to denote different points in time. "'A' represent[ed] the 'basis' economic circumstances when the rate in question was allowed to commence"; "B" represented the 12-month period ending October 24, 1992, the enactment date of EPAct; and "C" represented the "realized" economic circumstances after the enactment date, ending no later than the date when a complaint was filed.[10] Where a rate commenced years before the enactment of EPAct and then became grandfathered, the Presiding Judge found that in order to measure a substantial change, A had to be compared with C relative to A. If that comparison showed a substantial change, then a second comparison had to be made, B contrasted with C relative to B, to assure that the substantial change has taken place *after* the enactment date of EPAct.

Using this methodology, the Presiding Judge found that the complainants had shown several "substantial changes." First, as to SFPP's West Line rates, Judge Zimmet found substantial changes in the volumes, the income tax allowance and income tax rate, and the overall allowed return for the 1996

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6. *Id.* at 61,066-67.

7. 86 F.E.R.C. at 61,071 (discussing *Lakehead Pipe Line Co., L.P.*, 71 F.E.R.C. ¶ 61,338 (1995), *reh'g denied*, 75 F.E.R.C. ¶ 61,181 (1996)). Opinion No. 435 and subsequent rehearing orders are pending on appeal before the U.S. Court of Appeals for the D.C. Circuit (Case Nos. 99-1020). Oral arguments were held on November 12, 2003.

8. *Texaco Ref. & Mktg., Inc.*, 103 F.E.R.C. ¶ 63,055 (2003).

9. *Id.*

10. 103 F.E.R.C. ¶ 63,055, at 65,150 (2003); Opinion No. 435, *SFPP, L.P.*, 86 F.E.R.C. ¶ 61,022, 61,069 (1999).

complaint.[11] He held that his findings on the 1996 complaint were sufficient to overcome "grandfathering" on the West Line for purposes of each of the subsequently filed complaints in 1997, 1998, and 2000.[12] Nevertheless, he proceeded to review each of the subsequent complaints in turn. He concluded (with minor exceptions) that complainants had shown substantial changes in every complaint period, in some cases changes as much as 91%. The judge then reviewed SFPP's North Line rates and Oregon Line rates, and found that complainants had shown substantially changed circumstances in certain elements there as well.[13]

Judge Zimmet then addressed the second step of the test. He found that SFPP's rates (with minor exceptions) were not "just and reasonable" under ICA standards. Accordingly, because both parts of the test were met, the "grandfathered" protection for SFPP's rates was revoked as of the date of the complaints as contemplated in EPAct section 1803(b).

Judge Zimmet will issue a subsequent order in Phase Two determining just and reasonable rates for SFPP and reparations for shippers. In the meantime, Judge Zimmet's Phase One decision is pending on briefs on and opposing exceptions before the Commission.

II. MARKET-BASED RATES

A. *Shell Pipeline Company L.P., Docket No. OR02-10*

On May 23, 2003, the Federal Energy Regulatory Commission (FERC or Commission) issued an order on Shell Pipeline Co. L.P.'s (Shell) application for permission to implement market-based rates for transportation of refined petroleum products from two markets (St. Louis, Missouri and Chicago, Illinois) and to six destination markets (Champaign, Illinois; Chicago, Illinois; Evansville, Indiana; St. Louis, Missouri; and Toledo, Ohio).[14] The Commission found that Shell lacks significant market power in its Chicago origin market and its Champaign destination market but established hearing procedures to determine whether Shell has significant market power in the other markets.

Shell defined the relevant product market as refined petroleum products consisting of motor gasoline, distillates, and jet fuel. Shell proposed using the BEA[15] surrounding each delivery location served by Shell as the starting point for determining the geographic destination markets. Shell noted that not only had BEAs been endorsed by the Commission in the past, but they had been used in the *Buckeye* case,[16] which involved many of the same markets served by Shell.

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11. 103 F.E.R.C. ¶ 63,055, at 65,157-58 (2003).

12. *Id.* at 65,157.

13. *See, e.g.*, 103 F.E.R.C. ¶ 65,162, at 65,163, 65,166. (North Line (NL) income tax rate; NL income tax allowance; Oregon Line volumes).

14. *Shell Pipeline Co. L.P.*, 103 F.E.R.C. ¶ 61,236 (2003).

15. A BEA is an "Economic Area" defined by the Bureau of Economic Analysis of the U.S. Department of Commerce.

16. Opinion No. 360, *Buckeye Pipe Line Co.*, 53 F.E.R.C. ¶ 61,473, 62,665-66, n.42 (1988), *order on reh'g*, Opinion No. 360-A, *Buckeye Pipe Line Co.*, 55 F.E.R.C. ¶ 61,084 (1991).

Shell also proposed defining its geographic origin markets using BEAs.

For each destination BEA, Shell calculated a Herfindahl-Hirschman Index (HHI),[17] using the Commission's Capacity Based Method[18] and the Department of Justice (DOJ) Method.[19] Shell included an alternative set of calculations which included all suppliers within 75 to 100 miles of the BEA, which Shell maintained provided competition in the geographic destination markets. For the two origin markets, Shell calculated HHIs using the Commission's Shipment Based Method,[20] the Commission's Capacity Based Method,[21] the Department of Justice Method, and Shell's Market Share Percentage.

Shell's application was uncontested as to the Chicago origin market and the Champaign destination market. However, Tosco Corporation and Toscopetro Corporation protested Shell's application as to all the other markets.

The Commission approved Shell's application as to the uncontested Chicago origin market and Champaign destination market. The Commission noted that Shell calculated an HHI of only 146 under the DOJ Method for the Chicago origin market, and an HHI of just 788 for that market under the Commission's approach. For the Champaign destination market, the Commission observed that Shell calculated an HHI of 2000 using both the DOJ Method and the Commission approach; a capacity-based market share for Shell of 20%; a delivery-based market share well below 50%; and HHIs of well below 1800 if product sources located within 75 to 100 miles of the BEA were included. The Commission held that these market power statistics fell within levels acceptable under Commission precedent.

The Commission set the remainder of Shell's application for hearing. The Commission noted that Tosco's protest raised issues of material fact involving the appropriate definition for the contested destination markets and the resulting HHI statistics for those geographic markets. Allegations to be addressed at hearing include whether Shell's HHI calculations are misleadingly low because Shell (1) treats a pipeline that runs through a BEA as a competitor in that BEA even if the pipeline does not serve a terminal in that BEA; (2) treats subsidiary

17. An HHI is derived by summing the squares of the market shares of all firms competing in a particular geographic market. Thus, a market with four competitors having equal 25% market shares would be calculated as follows: $25^2 + 25^2 + 25^2 + 25^2 = 2500$. The purpose of the HHI calculation is to measure the concentration of the market so that one can assess the likelihood of a pipeline coordinating with competitors to exert market power.

18. For market share, the Capacity Based Method uses the capacity of each competitor that remains after subtracting the capacity committed to serving other markets and, therefore, not available to serve the market at issue. Each competitor is given the lesser of its capacity or an allocated portion of the total market's consumption. The resulting capacity amount for each competitor is then divided by the aggregate of all such amounts, yielding each company's capacity based market share.

19. The DOJ Method divides total consumption in a market by the number of competitors in the market, with each competitor initially allocated an equal share. Each company that has insufficient capacity to supply its allocation is assumed to supply its full capacity, and the remaining supply is allocated evenly among all remaining companies with excess capacity. The process is repeated until all consumption in the market has been allocated. The result is used as each company's market share in the HHI calculation.

20. The Shipment Based Method calculates an HHI using for each competitor's market share an estimate of that competitor's shipments based on actual shipments that competitor made from the origin market.

21. For purposes of origin markets, the Capacity Based Method uses the capacity each competitor has to move products from the origin market after subtracting the capacity committed to supplying the origin market.

pipelines as independent of their parent companies where both the subsidiary and the parent company serve the same BEA; and (3) measures trucking distances between sources and destination markets "as the crow flies," even though trucks have to travel longer, indirect routes.

B. SFPP, L.P., Docket No. OR98-11

On February 28, 2003, the Commission issued an order affirming an Administrative Law Judge's Initial Decision concluding that SFPP, L.P. had failed to establish that it lacked market power for transportation of petroleum products over its 3.8-mile Line 109, running between Sepulveda Junction and Watson Station in Los Angeles County, California.[22] The dispute in this case began when, in December 1995, Texaco Refining and Marketing Inc. (Texaco) and, in January 1996, ARCO Products Company (ARCO) (collectively the Indicated Shippers) filed complaints claiming that SFPP's Line 109 provided jurisdictional service for which a tariff should be required to be on file with the Commission. The Indicated Shippers argued that the then-current five-cent rate was unjust and unreasonable. An additional complaint was filed by Ultramar, Inc. (Ultramar) in August 1996.

The complaints were consolidated and a hearing established to determine, inter alia, whether service over the line is jurisdictional and whether the rate being charged therefore was just and reasonable. On August 5, 1997, the Commission issued an order finding the service to be jurisdictional, requiring SFPP to file a tariff therefore, and indicating that SFPP could file an application for market-based rate authority for the service.[23] On December 31, 1997, SFPP filed the application for market-based rate authority. The application was protested by Texaco, ARCO, Ultramar, Tosco Corporation (Tosco), and Chevron Products Company (Chevron).

On September 30, 1998, the Commission issued an order holding that SFPP lacked market power in the Line 109 Watson Station destination market, but that the record was inadequate to determine whether SFPP lacked market power in the Sepulveda Junction origin market.[24] Hearings on this latter issue were held February 7-17, 2000.

The Commission's February 28, 2003 Order rejecting SFPP's market-based rate application focused on transportation options available to Ultramar, Texaco and GATX.[25] The Commission concluded that at the time the evidentiary record closed in 1999, there were sufficient pipeline alternatives for all Line 109 shipments of Ultramar and Texaco. However, the Commission found that this alternative pipeline capacity was not available for GATX to use as an alternative to Line 109.

The Commission found that there was sufficient trucking capacity to move the 8 million barrels GATX shipped over Line 109 in 1999. The Commission also found that this amount could be trucked at a competitive price to local

22. *SFPP, L.P.*, 102 F.E.R.C. ¶ 61,240 (2003).
23. *SFPP, L.P.*, 80 F.E.R.C. ¶ 61,200 (1997).
24. *SFPP, L.P.*, 84 F.E.R.C. ¶ 61,338 (1998).
25. 102 F.E.R.C. ¶ 61,240 (2003).

markets. Nevertheless, the Commission found that SFPP had failed to show that trucking was a good alternative for GATX because SFPP had not demonstrated how much of the 8 million barrels were CARB compliant.[26] As the Commission stated,

> [s]ince petroleum product must be CARB compliant to be sold in the local market, the lack of this essential data precludes the Commission from determining whether trucking is in fact an effective source of competition for that even thought [sic] the trucking capacity is available and the delivered price competitive throughout the greater Los Angeles local market.[27]

The Commission found further evidence of market power over GATX in the fact that SFPP failed to reduce its five cent rate when Ultramar and Texaco substantially reduced the amount of volumes they shipped over Line 109. The Commission noted that although SFPP may have had no incentive to reduce its price to recapture business it lost, it also had incentives to keep the price at the same level for all other customers based on its perception that GATX had no effective alternatives.

> While SFPP may have misjudged the market position of Ultramar and Texaco, its failure to reduce prices for GATX suggests SFPP continued to have some degree of market power as to that customer and would therefore seek to maximize its revenues by not reducing its rate on the remaining volumes.[28]

Finally, the Commission rejected SFPP's claim that GATX, a terminal, lacked standing as a shipper. The Commission held that "any party whose economic position may be injured by the carrier's rate has standing to file a complaint."[29] Commissioner Brownell dissented.

On July 28, 2003, the Commission issued an order denying rehearing of its order rejecting SFPP's market-based rate application.[30] The Commission rejected SFPP's claim that there was no potential for exercise of market power over GATX because GATX's terminal was now owned by an affiliate of SFPP. The Commission reasoned that the requirement that all rates be just and reasonable is designed "not only to protect customers or shippers using the transportation services, but also to assure that rates and charges for transportation services do not have an unjust and unreasonable impact on the consumers of the goods that will be transported over the common carrier's system."[31] The Commission held that its "obligation under the ICA to assure that rates and charges are just and reasonable extends beyond the immediate parties to the transaction."[32]

26. CARB compliant barrels are barrels of petroleum products that meet the minimum standards of the California Air Resources Board for emissions produced when the product is consumed by an internal combustion engine.

27. 102 F.E.R.C. ¶ 61,240, at 61,717.

28. *Id.* at 61,722.

29. 102 F.E.R.C. ¶ 61,240, at 61,719.

30. *SFPP, L.P.*, 104 F.E.R.C. ¶ 61,136 (2003).

31. *Id.* ¶ 61,493.

32. 104 F.E.R.C. ¶ 61,136, at 61,493.

The Commission also denied SFPP's claim that there is adequate pipeline and trucking competition to protect shippers upstream of GATX. The Commission found that, in the absence of more specific information regarding those upstream shippers' needs, it is unclear whether excess capacity on the ARCO Transmission Services Corporation system would be available at the points needed to provide effective alternatives. The Commission stated that if, as SFPP argued, "GATX and SFPP are a single integrated entity at this point, then the burden to establish that sufficient alternatives exist upstream of GATX devolves to them both."[33] Commissioner Brownell again dissented.

The Commission remanded and consolidated the case with the complaint proceedings pending before Judge Zimmet in Docket No. OR96-2 to determine the just and reasonable rate for the Sepulveda line.

III. JURISDICTIONAL ISSUES

A. *Plantation Pipe Line Co. v. Colonial Pipeline Co., Docket No. OR03-4*

On September 11, 2003, the Commission issued an order dismissing Plantation Pipe Line Company's (Plantation) complaint against Colonial Pipeline Company (Colonial), which was filed pursuant to sections 3(4), 13(1), 15(1) and 15(3) of the Interstate Commerce Act (ICA).[34] Plantation asserted that Colonial had violated section 3(4) of the ICA by refusing to allow an interconnection between the Plantation and Colonial pipeline systems in Greensboro, North Carolina.[35]

Plantation claimed that an interconnection between the systems in Greensboro would allow Colonial's shippers to utilize excess Plantation capacity when Colonial's system between Collins, Mississippi and Greensboro is constrained. According to Plantation, Colonial insisted that any use of the proposed interconnection and Plantation's capacity be limited to deliveries at destinations where Colonial is authorized to charge market-based rates. Plantation stated that it offered to: (1) pay all reasonable costs associated with designing and constructing the interconnection facilities; (2) construct the interconnect in a way that accommodated the configuration and operations of Colonial's system; and (3) ensure that the interconnect would allow shippers to meet the Colonial's tariff rules and regulations.

The Commission dismissed Plantation's complaint, finding that it has no jurisdiction under the ICA to compel an interconnection between oil pipelines.

33. *Id.* ¶ 61,494.

34. *Plantation Pipe Line Co.*, 104 F.E.R.C. ¶ 61,271 (2003).

35. Section 3(4) of the ICA provides in pertinent part:

> All carriers subject to [ICA jurisdiction] shall, according to their respective powers, afford all reasonable, proper, and equal facilities for the interchange of traffic between their respective lines and connecting lines, and for the receiving, forwarding, and delivering of passengers or property to and from connecting lines; and shall not discriminate in their rates, fares, and charges between connecting lines, or unduly prejudice any connecting line in the distribution of traffic that is not specifically routed by the shipper.

Interstate Commerce Act, 49 U.S.C. § 3(4) (1887).

The Commission held that the plain language of section 3(4) of the ICA does not allow the Commission to order interconnections between oil pipelines. According to the Commission, the section neither grants a carrier the unilateral right to interconnect with another pipeline, nor gives the Commission authority to order, or even to approve, an interconnection. The Commission cited the Supreme Court's interpretation of section 3(4) in *Alabama v. Vicksburg*.[36] The Commission further noted that it is well established that the Commission has no jurisdiction over the abandonment of service by oil pipelines.[37] The Commission then stated, "Given the Commission's lack of authority over the abandonment of service by oil pipelines, it would be illogical and inconsistent for the Commission to conclude here that it has the power to compel an interconnection that Colonial does not want and could abandon."[38]

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36. Alabama & V. Ry. Co. v. Jackson & E. Ry. Co. 271 U.S. 244, 248-49 (1926).

37. *See, e.g.*, Opinion No. 154, *Williams Pipe Line Co.*, 21 F.E.R.C. ¶ 61,260, 61,690 (1982), *reh'g denied*, Opinion No. 154-A, *Inter-City Minnesota Pipelines, Ltd.*, 22 F.E.R.C. ¶ 61,087 (1983).

38. *Plantation Pipe Line Co.*, 104 F.E.R.C. ¶ 61,271, 61,906 (2003).