

# REPORT OF THE OIL PIPELINE COMMITTEE

This report summarizes decisions and policy developments that have occurred at the Federal Energy Regulatory Commission (FERC or Commission) and the U.S. Courts of Appeals in the area of oil pipeline regulation. The time frame covered by this report is January 1, 2004 to May 31, 2007.

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## I. OIL PIPELINE RATEMAKING AND TARIFF ISSUES

### A. *Treatment of Income Tax Allowance*

Since the FERC issued its Policy Statement on Income Tax Allowances in June 2005,<sup>1</sup> it has issued several decisions addressing the issue of federal income

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1. *Policy Statement On Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139 (2005) [hereinafter Policy Statement].

tax allowance for pass-through entities in the gas, electric, and oil arenas. Moreover, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the FERC's authority to grant income tax allowances to pass through entities.<sup>2</sup> The following provides a summary of these decisions and the FERC's application of the *Policy Statement* in individual cases.

### 1. Policy Statement

In *BP West Coast Products, LLC v FERC*,<sup>3</sup> the D.C. Circuit vacated and remanded the FERC's orders in *SFPP, L.P.*,<sup>4</sup> that SFPP should calculate its income tax allowance in accordance with *Lakehead Pipe Line Co., L.P.*,<sup>5</sup> finding that the FERC had failed to support its policy permitting a partial income tax allowance. In response to *BP West Coast*, the FERC issued a Notice of Inquiry on December 2, 2004, inviting comments as to whether an income tax allowance is appropriate for public utilities structured as partnerships or other types of pass-through entities that pay no income taxes.<sup>6</sup>

Although *BP West Coast* involved an oil pipeline, the FERC's Notice of Inquiry sought comments from all sectors of the industries it regulates. The FERC received one round of comments, with parties' positions largely fitting into four broad categories. Parties advocated that the FERC: (1) provide an income tax allowance only to public utilities that are corporations subject to paying income taxes; (2) provide an income tax allowance to both corporations and partnerships; (3) provide an allowance for partnerships owned by corporations (*Lakehead*); or (4) eliminate the income tax allowance all-together for pass-through entities that pay no income taxes.<sup>7</sup>

The FERC issued the *Policy Statement* on May 4, 2005, permitting a utility organized as partnership or a limited liability corporation to include an income tax allowance in its cost-of-service, provided that the entity seeking such income tax allowance establishes that its partners or members have an actual or potential income tax obligation on the entity's public utility income. The FERC stated that the application of the *Policy Statement* and associated analysis of income tax liability would be addressed in individual rate proceedings. The FERC also expressly abandoned its *Lakehead* policy.<sup>8</sup>

The D.C. Circuit upheld the FERC's application of the *Policy Statement*, and denied shipper petitioners' petitions for review of the FERC's grant of an

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2. *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007).

3. *BP West Coast Products LLC v. FERC*, 374 F.3d 1263, 1291 (D.C. Cir. 2004) (holding that where there is no tax generated by the regulated entity, either standing alone or as part of a consolidated corporate group, the regulator cannot create a phantom tax in order to create an allowance to pass through to the rate payer).

4. Opinion No. 435, *SFPP, L.P.*, 86 F.E.R.C. ¶ 61,022 (1999), *order on reh'g*, 91 F.E.R.C. ¶ 61,135 (2000), *order on clarification and reh'g*, 97 F.E.R.C. ¶ 61,138 (2001).

5. Opinion No. 397, *Lakehead Pipe Line Co.*, 71 F.E.R.C. ¶ 61,338 (1995).

6. Notice of Inquiry, *Inquiry Regarding Income Tax Allowances; Request for Comments*, 69 Fed. Reg. 72,188 (2004).

7. *Id.*

8. *Policy Statement*, *supra* note 1.

income tax allowance to SFPP, L.P.<sup>9</sup> As more fully described below, on remand of *BP West Coast*, the FERC had permitted SFPP an income tax allowance, finding that a pass-through entity, such as SFPP, does not pay any income taxes at the entity level, but SFPP's owners pay income taxes on the income from the utility assets.<sup>10</sup> In *ExxonMobil*, the D.C. Circuit stated that in the *Policy Statement* the FERC had cured the "principal defect" of the FERC's *Lakehead* income tax allowance policy because the FERC had removed the differentiation between individual and corporate partners and extended the allowance to all partners that incur an actual or potential liability for income taxes.<sup>11</sup> According substantial deference to the FERC's expertise with respect to ratemaking and policy, the D.C. Circuit held that the FERC's decisions were not arbitrary or capricious.<sup>12</sup>

The D.C. Circuit relied on the FERC's determination that income taxes paid on the partners' distributive share of the pipeline's income were properly "attributable" to the regulated entity because the taxes must be paid whether or not partners receive cash distributions.<sup>13</sup> Shipper petitioners had argued that the taxes are paid by investors, not the pipeline, and that therefore an income tax allowance for the pipeline would simply result in excess profits. The FERC argued that it was not creating a "phantom" tax allowance and that as a matter of policy "termination of the allowance would clearly act as a disincentive for the use of the partnership format" and impinge on investment in energy infrastructure.<sup>14</sup> The D.C. Circuit stated that it would not "second-guess" the FERC's policy choice and held that the FERC's conclusion was not unreasonable.<sup>15</sup>

Between the time the FERC issued the *Policy Statement* and the D.C. Circuit issued its decision in *ExxonMobil*, the FERC applied its income tax allowance policy in a number of cases.

## 2. Cases Applying the Policy Statement

### a. Orders Involving Trans-Elect

The FERC applied the *Policy Statement* first in a case involving a rate filing by Trans-Elect NTD Path 15, LLC (Trans-Elect). Trans-Elect developed and constructed transmission line upgrades for Path 15, a major electric transmission corridor that runs from southern California to northern California, pursuant to a U.S. Department of Energy authorization.<sup>16</sup> Trans-Elect had filed its proposed transmission revenue requirement and transmission owner tariff on October 4,

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9. *ExxonMobil*, 487 F.3d at 945. The Court issued concurrently an order dismissing a petition for review of the Policy Statement itself as moot, in light of *ExxonMobil*. *Canadian Ass'n of Petroleum Producers v. FERC*, No. 05-1382 (D.C. Cir. May 29, 2007).

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

11. *ExxonMobil*, 487 F.3d at 945.

12. *Id.* at 951.

13. *ExxonMobil*, 487 F.3d at 952.

14. *Id.* at 952-53.

15. *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945, 953 (D.C. Cir. 2007).

16. *Trans-Elect NTD Path 15, LLC*, 109 F.E.R.C. ¶ 61,249, at P 2 (2004).

2004, prior to issuance of the *Policy Statement*.<sup>17</sup> Trans-Elect proposed to include in its “Base Case Revenue Requirement” a full corporate income tax allowance.<sup>18</sup> The owners of Trans-Elect are a Subchapter C corporation (PG&E) and one limited liability company (LLC), Trans-Elect, LLC. Several protesters challenged the inclusion of an income tax allowance in Trans-Elect’s rates.<sup>19</sup>

On December 2, 2004, the FERC issued an order accepting and suspending Trans-Elect’s filing and establishing hearing procedures to determine whether Trans-Elect’s proposed revenue requirement and tariff were just and reasonable.<sup>20</sup> On May 4, 2005, the FERC issued an order denying requests for rehearing of the December 2004 order and conditioning its approval of the income tax allowance on Trans-Elect proving, pursuant to the *Policy Statement*, that the owners had an actual or potential income tax liability on the income from Trans-Elect.<sup>21</sup> Trans-Elect submitted its first compliance filing on June 2, 2005, which included four affidavits of the individual equity owners – which were all corporations. The affidavits set forth that each equity owner had an actual or potential income tax liability equal to their imputed share of Trans-Elect’s income.<sup>22</sup>

In its August 2005 Order conditionally accepting Trans-Elect’s June 2005 compliance filing, the FERC held that the evidence submitted did not meet the requirements of the *Policy Statement* and directed Trans-Elect to provide:

- (1) the projected distributive share of corporate income (positive or negative) from NTD Path 15 that will be attributed to each Equity Owner; (2) that each of the Equity Owners has a projected taxable income level from all income sources that would result in each of them being subject to the 35 percent marginal corporate income tax bracket; and (3) that each Equity Owner is, for federal tax purposes, either automatically classified as a corporation or has elected to be taxed as a corporation and, therefore, will file a corporate income tax return, Form 1120.<sup>23</sup>

Trans-Elect submitted a second compliance filing on September 19, 2005, which the FERC accepted on November 17, 2005, and permitted Trans-Elect to include an income tax allowance in its rates, based on the additional evidence submitted.<sup>24</sup> Rehearing requests followed, which the FERC denied in an order dated April 13, 2006.<sup>25</sup>

#### b. METC

On October 20, 2005, the Michigan Electric Transmission Company, LLC (METC) and the Midwest ISO filed for approval of METC’s (1) adoption of the formula rate in Attachment O of the Midwest ISO Transmission and Energy Markets Tariff to establish rates for the METC pricing zone in the Midwest ISO, effective January 1, 2006, and (2) adoption of the Midwest ISO Schedule 1

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17. *Id.* at P 6.

18. *Trans-Elect NTD Path 15*, 109 F.E.R.C. ¶ 61,249, at P 18.

19. *Id.* at P 20.

20. 109 F.E.R.C. ¶ 61,249 at P 2.

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

22. *Trans-Elect NTD Path 15, LLC*, 112 F.E.R.C. ¶ 61,202, at P 6 (2005).

23. *Id.* at P 10.

24. *Trans-Elect NTD Path 15, LLC*, 113 F.E.R.C. ¶ 61,162 (2005).

25. *Trans-Elect NTD Path 15, LLC*, 115 F.E.R.C. ¶ 61,047 (2006).

Service formula rate in the tariff.<sup>26</sup> In support of its inclusion of a full corporate income tax allowance in its proposed rates, based on a 35% federal income tax rate, the METC had provided “affidavits and “related information addressing the compliance requirements set forth in the Policy Statement and the recent guidance provided by the Commission” in the Trans-Elect case.<sup>27</sup> The METC stated in its prepared direct testimony that it provided: (1) affidavits of the individual equity owners confirming the tax liability; (2) a schedule of allocation percentages attributable to the taxable income of the equity owners; (3) a schedule depicting taxable income from the equity owners based on data from the formula rate template; and (4) documentation that the equity owners have elected to be taxed as a corporation and have received tax classification assignments and Employer Identification Numbers from the IRS.<sup>28</sup>

The FERC accepted METC’s filing, subject to refund, stating that METC had made a prima facie showing that the owners had an actual or potential income tax liability and permitted METC to include the income tax allowance.<sup>29</sup> On February 27, 2007, the parties settled the remaining disputes.<sup>30</sup>

### c. Kern River

In 2004, pursuant to its 1999 settlement of a prior rate case in Docket No. RP99-274,<sup>31</sup> Kern River filed a general rate case. The FERC accepted and suspended Kern River’s rates subject to refund, conditions, and hearing.<sup>32</sup> Kern River proposed to include a 35% federal income tax allowance in its cost-of-service, based upon its equity return under the FERC’s *Policy Statement*. Kern River, a partnership, claimed it generates taxable income, which is flowed through to its parent, MidAmerican Energy Holdings, a Subchapter C corporation.

On October 19, 2006, in Opinion No. 486, the FERC permitted Kern River to include an income tax allowance in its rates.<sup>33</sup> The FERC found that “[e]ach of the various Kern River entities at issue here has its own tax obligation regardless of its legal nomenclature and must file, at a minimum, a Form 1120 information return with a consolidated Form 1120 return being filed at the parent company level.”<sup>34</sup> The FERC held that even though Kern River is a pass-through entity owned by limited liability corporations, Kern River’s ultimate parent, MidAmerican, is taxed as a Subchapter C corporation. Thus, the parent must file a Form 1120 income tax return. Notwithstanding the fact that MidAmerican does not have any tax liability through 2008, the FERC concluded that a tax allowance on a stand-alone basis should be permitted for the pipeline.<sup>35</sup>

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26. *Michigan Elec. Transmission Co.*, 113 F.E.R.C. ¶ 61,343, at P 3 (2005).

27. *Id.* at P 15.

28. 113 F.E.R.C. ¶ 61,343, at P 22.

29. *Id.*

30. *Michigan Elec. Transmission Co.*, 118 F.E.R.C. ¶ 63,034 (2007).

31. *Kern River Gas Transmission Co.*, 87 F.E.R.C. ¶ 61,128 (1999), *order on reh’g*, 89 F.E.R.C. ¶ 61,144 (1999).

32. *Kern River Gas Transmission Co.*, 107 F.E.R.C. ¶ 61,215 (2004), *order on reh’g*, 109 F.E.R.C. ¶ 61,060 (2004).

33. Opinion No. 486, *Kern River Gas Transmission Co.*, 117 F.E.R.C. ¶ 61,077 (2006).

34. *Id.* at P 220.

35. 117 F.E.R.C. ¶ 61,077, at P 220.

#### d. Orders Involving SFPP

There have been a number of decisions addressing income tax allowance issues for SFPP, L.P., since the D.C. Circuit issued its decision in *BP West Coast*. These decisions are summarized below.

SFPP operates pipelines that transport petroleum products in Texas, New Mexico, Arizona, California, Nevada, and Oregon. SFPP's operation includes a West Line, which consists of pipelines extending from the California origin points of Watson Station and East Hynes into Arizona to Phoenix and Tucson, connecting at the Colton Transmix Facility in California into another pipeline system extending to Las Vegas.<sup>36</sup> SFPP's North Line stretches from Richmond and Concord, CA, to Reno, NV.<sup>37</sup> The East Line stretches from El Paso and Diamond Junction, TX, to Lordsburg, NM, and Arizona destinations of Tucson and Phoenix.<sup>38</sup> SFPP's Oregon Line extends from Portland to Eugene, OR.<sup>39</sup>

Beginning in 1992, the SFPP litigation encompasses three main periods: (1) various complaints in Docket Nos. OR92-8-000, *et al.* against the East and West Line rates and Watson drain dry charges; (2) the proceedings in OR96-2-000 *et al.* against the East, West, North, Oregon, Sepulveda, and Watson Station charges through 2000; and (3) complaints filed against the East, West, North, Oregon, and Sepulveda Line rates and the Watson charges after 2000.<sup>40</sup>

Whether SFPP is entitled to an income tax allowance is only one of the issues, but is a common thread in all of the litigated cases involving SFPP. This summary addresses the income tax allowance issues in SFPP cases decided since the issuance of the *Policy Statement*, starting with the order addressing the remand of *BP West Coast*.

One month after the *Policy Statement* was issued, the FERC issued its order on remand of *BP West Coast*, and addressed an initial decision in a separate docket.<sup>41</sup> Recognizing that both SFPP, a limited partnership, and its parent, Kinder Morgan Energy Partners (KMEP), L.P., a master limited partnership, are both pass-through entities, the FERC, relying on its *Policy Statement*, concluded that SFPP should be afforded an income tax allowance on all of its partnership interests to the extent that the owners of those interests had an actual or potential income tax liability during the periods at issue here.<sup>42</sup> The FERC announced that SFPP would be permitted to include a full income tax allowance in its cost-of-service if 100% of the interests in the relevant test years are owned by

36. SFPP, L.P., LOCAL PIPELINE TARIFF CONTAINING RATES APPLYING ON THE TRANSPORTATION OF PETROLEUM PRODUCTS BY PIPELINE (2007), [http://www.mjrdolph.com/business/products\\_pipelines/FERC158-W.pdf](http://www.mjrdolph.com/business/products_pipelines/FERC158-W.pdf).

37. SFPP, L.P., LOCAL PIPELINE TARIFF CONTAINING RATES APPLYING ON THE TRANSPORTATION OF PETROLEUM PRODUCTS BY PIPELINE (2007), [http://www.mjrdolph.com/business/products\\_pipelines/FERC159-N\\_S1.pdf](http://www.mjrdolph.com/business/products_pipelines/FERC159-N_S1.pdf).

38. SFPP, L.P., LOCAL PIPELINE TARIFF CONTAINING RATES APPLYING ON THE TRANSPORTATION OF PETROLEUM PRODUCTS BY PIPELINE (2007), [http://www.mjrdolph.com/business/products\\_pipelines/FERC157-E\\_S1.pdf](http://www.mjrdolph.com/business/products_pipelines/FERC157-E_S1.pdf).

39. SFPP, L.P., LOCAL PIPELINE TARIFF CONTAINING RATES APPLYING ON THE TRANSPORTATION OF PETROLEUM PRODUCTS BY PIPELINE (2007), [http://www.mjrdolph.com/business/products\\_pipelines/FERC160-O\\_S1.pdf](http://www.mjrdolph.com/business/products_pipelines/FERC160-O_S1.pdf).

40. *SFPP, L.P.*, 111 F.E.R.C. ¶ 61,334, at P 5 (2005).

41. *Id.*

42. 111 F.E.R.C. ¶ 61,334, at P 21.

individuals or entities that had an actual or potential income tax liability in those years.<sup>43</sup> The FERC directed the parties to file briefs on whether the records in the proceedings were adequate to determine whether SFPP had met its burden of proving actual or potential income tax liability pursuant to the *Policy Statement*.<sup>44</sup>

A few months later, the FERC addressed challenges to SFPP's 2005 index rate increases and shippers' request for rehearing of the FERC's June 30, 2005 Order Accepting and Suspending Tariffs, Subject to Refund and Conditions.<sup>45</sup> The FERC held that the income tax allowance was not at issue in this index rate proceeding.<sup>46</sup> The FERC determined that the income tax allowance was part of the foundation of SFPP's base rates and not within the scope of the index rates at issue in the proceeding.<sup>47</sup>

In December 2005, the FERC issued its Order on the Initial Decision involving SFPP's East and West Line rates.<sup>48</sup> This was the first "detailed" application of the *Policy Statement* in the context of master limited partnerships. As noted above in the Remand Order, the FERC had permitted an income tax allowance for SFPP and directed the parties to file briefs on whether the records in the proceedings were adequate to determine if SFPP met the standards contained in the *Policy Statement*.<sup>49</sup> The FERC reversed the Initial Decision's conclusions on the income tax allowance issue, which had been written prior to issuance of the *Policy Statement*.<sup>50</sup>

The FERC's order addressed some of the issues that the *Policy Statement* had set aside for individual rate proceedings, such as: (1) the application of the phrase "subject to an actual or potential income tax liability;" (2) the marginal tax bracket used to determine the allowance for a pass-through entity; (3) which ownership layers should be reviewed; and (4) the possible allocation of an income tax allowance.<sup>51</sup> The FERC stated that "[a]ssuming that there is no allocation of items of income, deductions and credits among the partners other than in proportion to their partnership interests, over time a partnership's net income is reflected proportionately on the returns of the individual partners."<sup>52</sup> Taking official notice of IRS documents, the FERC adopted a rebuttable presumption of a 28% marginal tax percentage for individuals and other entities not filing a Form 1120 return.<sup>53</sup> For C corporations or LLCs filing a Form 1120,

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43. *Id.* at P 27.

44. 111 F.E.R.C. ¶ 61,334, at PP 76-77.

45. *SFPP, L.P.*, 111 F.E.R.C. ¶ 61,510 (2005). In that order, the FERC determined SFPP's filing to be consistent with the Commission's indexing regulations and held that the shippers had not proven that SFPP's proposed indexed rates were so substantially in excess of the pipeline's actual cost increases to amount to unjust and unreasonable rates. Nevertheless, the FERC required SFPP to submit an updated Page 700 for its 2003 FERC Form 6. *Id.* at P 3, 7.

46. *SFPP, L.P.*, 113 F.E.R.C. ¶ 61,253 (2005).

47. 111 F.E.R.C. ¶ 61,510, at P 8.

48. *SFPP, L.P.*, 113 F.E.R.C. ¶ 61,277 (2005).

49. *Id.* at P 7.

50. 113 F.E.R.C. ¶ 61,277, at P 38.

51. *Id.* at P 21.

52. 113 F.E.R.C. ¶ 61,277, at P 25.

53. *Id.* at P 32.

the FERC adopted a tax percentage of 35%. For municipals and other exempt entities, the tax percentage adopted was zero.<sup>54</sup>

The FERC directed SFPP to determine its estimated income tax allowance according to specific guidelines, develop new cost-of-service for the East and West Lines, and file interim rates.<sup>55</sup> The FERC stated that it was not requiring the regulated entity to have any actual income that would be taxable to its partners in the relevant test year, but “having such income, or a pattern of such income, would materially simplify a regulated entity’s case.”<sup>56</sup> The FERC announced that it would be satisfied that if a partner filed a Form 1040 or 1120 return, such partner would have an actual or potential income tax liability.<sup>57</sup>

Because the legal standards had changed since the record closed, the Commission required SFPP to file “information explaining the interests that SFPP’s or KMEP’s limited and general partners had in [the] partnership’s net income in each of the years at issue here.”<sup>58</sup> The FERC further stated that SFPP and KMEP could also state the amount of income that was allocated to the limited and general partners for each year.<sup>59</sup> The FERC described how SFPP was to determine the estimated income tax allowance and directed SFPP to use this estimate in the new interim East and West Line rates.<sup>60</sup> Specifically, the FERC instructed SFPP, for the years prior to 1998, and KMEP for 1998 forward to

separate their respective partners (unit holders) into six broad categories and include supporting detail on the units holders within each category: (1) Subchapter C corporations; (2) individuals; (3) mutual funds; (4) other unit holders such as pension funds, IRAs, Keogh Plans, and other entities that are not normally tax paying entities, but would be expected to have taxpaying beneficiaries or owners; (5) those entities listed in (4) that may be taxpaying entities because income from SFPP or KMEP would be deemed unrelated business income; and (6) those institutions and exempt entities, if any, which have no obligation to pay out income or to declare it, such as municipalities. To the extent that the unit holders are pass-through entities such as other partnerships, Subchapter S corporations, and pass-through LLCs, SFPP or KMEP should identify the nature of the entity or individual ultimately subject to an actual or potential income tax liability and place that entity or individual in the appropriate category of unit owner. SFPP should identify the percentage of unit holders that falls into each group.

SFPP and KMEP will then calculate the percentage of taxable partnership income imputed to each group, which the Commission recognizes may not be the same as the percentage of the actual units held by each group depending on how expenses, deductions and income are allocated among the partners. SFPP and KMEP will then develop a weighed tax allowance accordingly . . . SFPP shall prepare supporting affidavits explaining the methodology chosen and include work papers in a separate binder, to be available to parties and the Commission, to support this portion of its compliance filing.<sup>61</sup>

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54. *SFPP, L.P.*, 113 F.E.R.C. ¶ 61,277, at P 32.

55. *Id.* at P 2.

56. 113 F.E.R.C. ¶ 61,277, at n.45.

57. *Id.* at P 28.

58. 113 F.E.R.C. ¶ 61,277, at P 44.

59. *Id.*

60. *SFPP, L.P.*, 113 F.E.R.C. ¶ 61,277, at P 47.

61. *Id.* at PP 45-46.



SFPP submitted its compliance filing in March 2006, lowering its East and West Line rates, calculating reparations in the approximate amount of \$77 million, and tendering affidavits to support its income tax allowance.

On December 8, 2006, the FERC reviewed the Initial Decision issued on August 24, 2005 regarding SFPP's Sepulveda Line.<sup>62</sup> In its discussion of the income tax allowance issues, the FERC did not directly address the conclusions of the Initial Decision but instead relied on its December 2005 Order addressing SFPP's East and West Line rates.<sup>63</sup> In addition, the FERC relied upon its prior statements in the *Policy Statement*.<sup>64</sup> The FERC examined other tax allowance issues such as the use of a marginal tax rate, the stand-alone methodology, the use of presumptions to establish a marginal tax rate, and the use of allocated income percentages.<sup>65</sup>

The FERC stated that the marginal tax rate, rather than the effective tax rate, should be used in determining any income tax allowance.<sup>66</sup> The FERC reasoned that the marginal rate determines an entity's tax liability under a graduated income tax.<sup>67</sup> Further, the FERC stated that its stand-alone methodology determines the tax allowance for a regulated entity by examining the net income of the entity, excluding any non-jurisdictional income or losses of that entity, its corporate parents, or affiliates.<sup>68</sup>

With respect to the use of presumptions, the FERC reiterated its acknowledgement in the December 2005 order that it is difficult to ascertain the marginal rate of the partners because the partnership does not have access to the partners' individual tax returns.<sup>69</sup> The FERC stated that its presumption that Subchapter C corporate partners would have a 35% marginal tax rate may have been "too high in the absence of more proof."<sup>70</sup> The FERC also stated that where it is not possible to determine that a corporate partner fell within the 35% marginal bracket, the 34% marginal tax rate should be used.<sup>71</sup> The FERC concluded that statistics show that taxes actually paid or incurred by non-corporate partners are within the 28% income tax bracket.<sup>72</sup>

Finally, the FERC determined that allocated income percentages, rather than ownership percentage of units, should be used because the income tax allowance should reflect "the rate at which the actual or potential income tax liability is or will be incurred."<sup>73</sup> The FERC directed SFPP to make a compliance filing to justify the inclusion in the rates, in conformity with the

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62. *Texaco Ref. and Mktg., Inc. v. SFPP, L.P.*, 117 F.E.R.C. ¶ 61,285 (2006) (reviewing *Texaco Ref. and Mktg. Inc. v. SFPP, L.P.*, 112 F.E.R.C. ¶ 63,020 (2005)).

63. *Id.* at P 6.

64. 117 F.E.R.C. ¶ 61,285, at P 50.

65. *Id.* at P 51.

66. 117 F.E.R.C. ¶ 61,285, at P 52.

67. *Id.* at P 53.

68. *Texaco Ref. and Mktg., Inc. v. SFPP, L.P.*, 117 F.E.R.C. ¶ 61,285, at P 56 (2006).

69. *Id.* at P 59.

70. 117 F.E.R.C. ¶ 61,285, at P 60.

71. *Id.* at P 64.

72. 117 F.E.R.C. ¶ 61,285, at P 62.

73. *Id.* at P 65.

clarifications discussed above and the December 2005 Order.<sup>74</sup> SFPP made its compliance filing in March 2007.<sup>75</sup>

e. MIG

On April 20, 2007, the FERC issued an order authorizing abandonment and issuing certificates to Missouri Interstate Gas, LLC (MIG), Missouri Gas Company, LLC (MGC), and Missouri Pipeline Company, LLC (MPC).<sup>76</sup> Those entities had filed applications for (1) authority to reorganize into one interstate natural gas facility; (2) authority to acquire and operate facilities; (3) authority to abandon facilities; (4) a blanket construction certificate; (5) a blanket transportation certificate; and (6) approval for initial rates including an income tax allowance.<sup>77</sup> The FERC granted the authorizations with certain conditions and requests for additional submissions.<sup>78</sup>

The Missouri Public Service Commission had challenged the proposed income tax allowance, relying upon *Trans-Elect* and arguing that the Missouri pipelines had failed to establish any entitlement to an income tax allowance because they had not provided the information required under the *Policy Statement* demonstrating an actual or potential income tax liability.<sup>79</sup> Relying on the FERC's December 2005 Order regarding SFPP, the pipelines had argued that the individual owners of the consolidated pipeline should not be treated differently than the individual unit holders.<sup>80</sup>

As reorganized, the organizational structure is as follows: The pipelines are to be owned by EIF Gateway, Inc. (having acquired Dennis M. Langley's 100% interest in DES Energy, Ltd., one of the owners in the intermediate chain of ownership).<sup>81</sup> EIF Gateway is owned by the United States Power Fund II, L.P. and the United States Power Fund II Institutional Fund, L.P.<sup>82</sup> The FERC stated that it would allow an income tax allowance provided that the entity or individual has an actual or potential income tax liability to be paid on that income from the public utility assets, but stated that it could not determine from the information provided whether the reorganized pipeline is entitled to an income tax allowance.<sup>83</sup> Thus, the FERC required the pipelines to "demonstrate when they make their compliance filing to recalculate their rates that they meet the standards for an income tax allowance as set out in the Commission's Tax Policy Statement."<sup>84</sup> The pipelines were required to file the requisite tax allowance information in conjunction with their rate case no later than eighteen months after their interstate service commences.<sup>85</sup>

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74. *Texaco Ref. and Mktg., Inc. v. SFPP, L.P.*, 117 F.E.R.C. ¶ 61,285, at PP 88-89.

75. *Compliance Filing, SFPP, LP*, 117 F.E.R.C. ¶ 61,285 (2006) (No. IS07-137-000).

76. *Missouri Interstate Gas, LLC*, 119 F.E.R.C. ¶ 61,074 (2007).

77. *Id.* at P 1.

78. 119 F.E.R.C. ¶ 61,074, at P 1.

79. *Id.* at P 71.

80. 119 F.E.R.C. ¶ 61,074, at P 71.

81. *Id.* at P 72.

82. *Missouri Interstate Gas, LLC*, 119 F.E.R.C. ¶ 61,074, at P 72 (2007).

83. *Id.* at P 73.

84. 119 F.E.R.C. ¶ 61,074, at P 73.

85. *Id.* at PP 37, 73.

## B. Challenges To Indexed Rates

### 1. Background

In Order No. 561, in satisfaction of the requirements of the Energy Policy Act of 1992 and the Interstate Commerce Act (ICA),<sup>86</sup> the FERC established an inflation indexing methodology to regulate oil pipeline rate changes, as well as providing alternative rate-setting methods for pipelines and shippers that could justify departures from the indexing methodology.<sup>87</sup> The FERC concluded that the indexing methodology would “simplif[y] and expedit[e] the process of establishing oil pipeline rates” while also ensuring that those rates are just and reasonable under the ICA.<sup>88</sup> The FERC considered several possible indices and determined that the yearly change in the Producer Price Index for Finished Goods (PPI-FG) less 1% was appropriate because it most closely tracked the historical changes in actual costs of the oil pipeline industry.<sup>89</sup> The FERC also determined that it would review the index every five years to determine whether it needed adjustment and, if so, how it would be adjusted.<sup>90</sup> After the first five-year period, the FERC reviewed the index and adjusted it to eliminate the subtraction of 1%.<sup>91</sup> In 2006, the FERC undertook its second five-year review and determined that the index should be PPI-FG plus 1.3% for the five-year period beginning July 1, 2006.<sup>92</sup>

The index is based on the change in the final PPI-FG, seasonally adjusted, as published by the U.S. Department of Labor Statistics, for the two calendar years immediately preceding the index year.<sup>93</sup> The index is calculated by dividing the PPI-FG for the calendar year immediately preceding the index year, by the previous calendar year’s PPI-FG.<sup>94</sup> If a pipeline’s rates exceed the maximum allowable rate under the index, a pipeline is required to reduce its rates.<sup>95</sup> In addition, under the FERC’s regulations, a pipeline with indexed rates may request a rate increase that exceeds the index level by using a cost-of-service method, but only after the pipeline shows that there is a “substantial divergence” between a rate based on the pipeline’s actual costs and the rate resulting from application of the indexing methodology, such that the rate at the

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86. 49 U.S.C. §§ 1-2701 (2000).

87. Order No. 561, *Revisions to Oil Pipelining Regulations Pursuant to the Energy Policy Act*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 30,985 (1993), 58 Fed. Reg. 58,753 (1993) [hereinafter Order No. 561], *order on reh’g*, Order No. 561-A, *Revisions to Oil Pipelining Regulations Pursuant 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) [hereinafter Order No. 561-A], *aff’d*, *Ass’n of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

88. Order No. 561, *supra* note 87, at 30,941.

89. *Id.* at 30,951; *Order Establishing Index for Oil Price Change Ceiling Levels*, 114 F.E.R.C. ¶ 61,293 at P 3 (2006). The Commission’s selection of PPI-FG less 1% was upheld by the D.C. Circuit in *Ass’n of Oil Pipe Lines v. FERC*, 83 F.3d 1424.

90. Order No. 561, *supra* note 87, at 30,947.

91. *Id.* at 30,977-4.

92. 114 F.E.R.C. ¶ 61,293, at P 2.

93. 18 C.F.R. § 342.3(d)(2) (2007).

94. *Id.*

95. 18 C.F.R. § 342.3.

ceiling level would preclude the pipeline from being able to charge a just and reasonable rate within the meaning of the ICA.<sup>96</sup>

On May 16, 2007, the FERC issued a Notice of Annual Change in the Producer Price Index for Finished Goods, permitting eligible interstate oil pipelines to increase their 2007-2008 ceiling rates by .043186%.<sup>97</sup> The index is currently based on the annual change in the Producer Price Index for Finished Goods, plus 1.3%.<sup>98</sup>

## 2. Reviewability of the FERC's Decision not to Investigate Rate Protest

In Docket No. IS05-327, BP West Coast Products LLC and ExxonMobil Oil Corporation (Indicated Shippers) protested the 2005 indexed increase in SFPP's rates.<sup>99</sup> The FERC found that the Indicated Shippers had not met their initial burden under the regulations<sup>100</sup> of "alleg[ing] . . . reasonable grounds for asserting . . . that the rate increase is so substantially in excess of the actual cost increases incurred by the carrier that the rate is unjust and unreasonable . . . ."<sup>101</sup> Indicated Shippers petitioned for review of this order and the FERC's subsequent order denying rehearing. Following briefing and oral argument, the D.C. Circuit issued a judgment dismissing the petitions, stating that the matter did not warrant a published opinion.<sup>102</sup> In the unpublished decision that accompanied its judgment, the D.C. Circuit observed that it denied the petitions on jurisdictional grounds, noting the FERC's determination not to initiate an investigation into a protested rate under ICA § 15(7) was not reviewable.<sup>103</sup> The D.C. Circuit cited the U.S. Supreme Court's decision in *Southern Railway Co. v. Seaboard Allied Milling Corp.*<sup>104</sup>

## 3. Applying the Index to Cost-Based Rates

Two FERC cases in 2006 addressed the circumstances under which indexing can be applied to a rate that was established on a cost of service basis. In Docket No. IS06-356-000, SFPP, LP, had previously filed to revise its ceiling rates for its East Line pipelines (serving New Mexico and Arizona) during the indexing year (July 1, 2005, through June 30, 2006) on a cost basis – to reflect expansion costs – and then filed to increase those cost-based rates for the next indexing adjustment (July 1, 2006 through June 20, 2007).<sup>105</sup> After the FERC accepted the indexing adjustment in its initial order,<sup>106</sup> certain shippers sought rehearing, arguing that a pipeline should not be permitted to index a rate when that rate already is based on the pipeline's actual cost of service for the same

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96. *Id.* § 342.4(a); Order No. 561-A, *supra* note 87, at 31,091-31,092.

97. *Notice of Annual Change in the Producer Price Index for Finished Goods*, 119 F.E.R.C. ¶ 61,155 (2007).

98. *Five-Year Review of Oil Pricing Index*, 114 F.E.R.C. ¶ 61,293, at P 2 (2006).

99. *Order Accepting and Suspending Tariffs, Subject to Refund and Conditions*, 111 F.E.R.C. ¶ 61,510, at P 2 (2005).

100. 18 C.F.R. § 343.3(c)(1) (2007).

101. *SFPP, L.P.*, 111 F.E.R.C. ¶ 61,510 (2005), *reh'g denied*, 113 F.E.R.C. ¶ 61,253 (2005).

102. *Exxon Mobil Oil Corp. v. FERC*, No. 05-1471 (D.C. Cir. Feb. 27, 2007).

103. *Id.*

104. *Southern Railway Co. v. Seaboard Allied Milling Corp.*, 442 U.S. 444, 454 (1979).

105. *SFPP, L.P.*, 115 F.E.R.C. ¶ 61,388 (2006).

106. *Id.*

calendar year that would be referenced by the use of the index because that would in effect allow the pipeline to reflect its cost increases twice.<sup>107</sup> The FERC agreed, granting rehearing and directing the pipeline to rescind the indexing increase in dispute.<sup>108</sup> The carrier has sought rehearing contending that, under § 342.3(d)(5), the “ceiling rate” to which the index is to be applied can be a cost-of-service rate established during the twelve months preceding the index filing.<sup>109</sup>

Subsequently, in Docket Nos. OR07-3-000 and OR07-6-000, shippers raised similar arguments against SPFF’s indexed rates for its North Line pipeline (serving northern California and Reno, NV) where the carrier had revised its ceiling rates on a cost basis to reflect an expansion.<sup>110</sup> Relying on the FERC’s order in Docket No. IS06-356 discussed above, shippers complained that these increases should similarly be rejected because the increased rates were based on applying the index factor for the year 2004 to ceiling rates that were based on the carrier’s 2004 actual costs.<sup>111</sup> Looking to the carrier’s 2005 filing to revise the ceiling rates for the North Line, the FERC examined whether use of the index would result in a rate increase “substantially in excess of actual cost increases” and determined it would not on the basis that the 2005 filing reflected an under-recovery of costs by the revised rates.<sup>112</sup> The FERC stated: “Since the July 1, 2005, indexed increase did not result in rates that exceeded the actual costs upon which SFPP’s . . . rates were based, the July 2005 index increase did not result in rates so substantially in excess of SFPP’s actual costs that the resulting . . . rates were unjust and unreasonable.”<sup>113</sup>

Comparing the orders in these proceedings, the FERC apparently has not established any presumption that applying an index factor for a particular calendar year to rates based on actual cost increases incurred in that calendar year necessarily results in rates that are unjust and unreasonable. Rather, the FERC in each instance looked at the revenue impact of using both the general index and pipeline-specific costs pertaining to the same index year.

### C. Prorating Policies

#### 1. Background

In recent years, the FERC has issued a number of orders refining and clarifying its policies regarding the apportionment of oil pipeline capacity when nominations exceed available capacity (usually termed “prorating”). Common carrier oil pipelines subject to ICA § 1(4) have an obligation “to provide and furnish transportation upon reasonable request therefore.” In contrast to gas

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107. *SFPP, LP*, 117 F.E.R.C. ¶ 61,271, at P 2 (2006).

108. *Id.* at P 5.

109. 117 F.E.R.C. ¶ 61,271, at P 2.

110. *BP West Coast Products, LLC, v. SFPP, LP*, 118 F.E.R.C. ¶ 61,261 (2007), *petitions for review filed sub nom.*, *ExxonMobil Oil Corp. v. FERC*, Nos. 07-1163 (D.C. Cir. filed May 25, 2007).

111. *BP West Coast Products, LLC*, 118 F.E.R.C. ¶ 61,261, at P 4.

112. *BP West Coast Products, LLC, v. SFPP*, 118 F.E.R.C. ¶ 61,261 (2007), *petitions for review filed sub nom.*, *ExxonMobil Oil Corp. v. FERC*, Nos. 07-1163, et al. (D.C. Cir. filed May 25, 2007).

113. *BP West Coast Products, LLC*, 118 F.E.R.C. ¶ 61,261, at P 8.

pipelines subject to the Natural Gas Act (NGA),<sup>114</sup> which have historically provided “firm” capacity rights to transportation based on contracts, oil pipelines have operated as common carriers under principles first articulated for coaches and railroads under the common law. However, the statutory obligation to accept “any shipments” is limited by the requirement that it be upon “reasonable request.”<sup>115</sup> As the FERC has found, the “reasonableness of the request is a factual question and the carrier is entitled to adopt reasonable rules to allocate insufficient capacity.”<sup>116</sup> The FERC has also been guided in assessing the reasonableness of allocation methods by the requirement that they not be unduly discriminatory under the ICA.<sup>117</sup> In addition, the FERC has applied very different rules to transportation on off-shore pipelines that operate beyond ICA jurisdiction. The FERC’s recent orders have addressed tariff proposals, protests, and complaints in light of these general principles.

## 2. Traditional Allocation Methodologies

The FERC reviewed efforts by two pipelines over the past two years to change prorationing methodologies from “pro rata”—allocating all shippers equally based on monthly nominations—to a system in which shippers’ allocations would be determined by their relative volume levels during past periods, or “historical volume” allocation.

### a. ConocoPhillips Transportation Alaska

In *ConocoPhillips I*,<sup>118</sup> the FERC considered a complaint against the pipeline’s newly-established change in prorationing methodology.<sup>119</sup> The pipeline operated one of the undivided interests of the Trans-Alaska Pipeline System (TAPS) and argued that the circumstances of the TAPS line supported a move from pro rata to historical volume prorationing.<sup>120</sup> Although TAPS as a whole would be operating at levels below its capacity, shippers could nominate on different TAPS carriers’ tariffs, and thus could oversubscribe a single carrier.<sup>121</sup> In particular, the carrier asserted that fluctuating shipper nominations between months could create problems with respect to the line fill obligations of shippers.<sup>122</sup> Therefore, the carrier proposed to allocate capacity during prorationing on the basis of a twelve-month “Rolling Base” period reflecting “Regular Shippers” past shipments of volumes, reserving 5% of capacity for new shippers.<sup>123</sup> To address “transition issues” in moving from a pro rata to historical policy, the pipeline proposed to implement the historical methodology on a

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114. 15 U.S.C. § 717 (2000).

115. *Belle Fourche Pipeline Co.*, 28 F.E.R.C. ¶ 61,150, at p. 61,281 (1984) [hereinafter *Belle Fourche*].

116. *Id.*

117. *See Belle Fourche*, *supra* note 115, at p. 61,282.

118. *ConocoPhillips Transp. Alaska, Inc.*, 112 F.E.R.C. ¶ 61,213 (2005) [hereinafter *ConocoPhillips I*].

119. A shipper filed a protest shortly before the tariff became effective with an alternative request that it be considered a complaint. The Commission treated the filing as a complaint. *ConocoPhillips I*, *supra* note 119, at PP 3, 29.

120. *Id.* at P 15.

121. *ConocoPhillips I*, *supra* note 118, at PP 11-12.

122. *Id.* at P 12.

123. *ConocoPhillips I*, *supra* note 118, at P 5.

gradual basis, allowing all shippers to be considered “Regular Shippers” for an initial six month period, thus allowing all potential shippers an equal opportunity to nominate volumes during the period of pro rata allocation.<sup>124</sup> The pipeline would then switch to the new historical methodology, relying first on the initial six-month historical volumes to allocate capacity among Regular Shippers, and then the twelve month rolling base period once twelve months of volume experience had occurred.<sup>125</sup>

The complainant opposed granting the Regular Shippers a preference relative to the “New Shippers,” as well as the pipeline’s granting a preference among Regular Shippers based on historical volumes, among other technical criticisms.<sup>126</sup> In response, the pipeline defended the change in methodologies as being supported by the factual circumstances noted above, and emphasized that the FERC has accepted historical prorating methodologies as not being unduly preferential in past orders.<sup>127</sup>

The FERC denied the complaint on the ground that the shipper had failed to show actual harm because the policy would only become effective a number of months in the future, during which time the shipper “has the same opportunity as any other shipper to establish its entitlement to future capacity during periods of prorating.”<sup>128</sup> The FERC further agreed with the pipeline that “prorating policies based on historical volumes are an acceptable means of allocating capacity on other pipelines,” and that there was no evidence that the policy would not be effective on this pipeline or would harm the shipper.<sup>129</sup>

One month later, the FERC dismissed further challenges to the new prorating policy, and to certain modifications to it, further reaffirming that the historical shipment prorating policy was not unlawful, because, “[a]lthough the prorating policy rewards shipper loyalty, the Commission reiterates that it is not unduly discriminatory, as all have an equal opportunity to become loyal shippers.”<sup>130</sup>

#### b. Platte Pipe Line Company

On April 19, 2006, Platte Pipe Line Company filed a tariff supplement proposing a new proration policy for its system from Guernsey, Wyoming to Wood River, Illinois, changing from a pro rata to a historical system based on a six-month rolling average of past shipments, reserving 10% of segment capacity for “New Shippers.”<sup>131</sup> Platte stated that the change responded to a worsening allocation problem accompanied by increasing manipulation of nominations, chiefly through the submission of inflated nominations, that the existing tariff provisions would not alleviate.<sup>132</sup> Platte also stated that shippers of the

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124. *Id.* at P 18.

125. *ConocoPhillips I*, *supra* note 118, at P 18.

126. *Id.* at PP 5-8.

127. *ConocoPhillips I*, *supra* note 118, at PP 20-25.

128. *Id.* at PP 26-27.

129. *ConocoPhillips I*, *supra* note 118, at P 28.

130. *ConocoPhillips Transp. Alaska, Inc.*, 112 F.E.R.C. ¶ 61,326, at P 19 (2005) (hereinafter *ConocoPhillips II*).

131. *Id.* at P 4.

132. *ConocoPhillips II*, *supra* note 130, at P 21.

overwhelming majority of volumes on the system had requested the change to historical based prorationing.<sup>133</sup> Certain shippers protested, challenging the factual need for changing the methodology and arguing that reliance upon historical volumes would be discriminatory, would favor a limited set of shippers, and would improperly set allocations based on a retroactively-imposed historical period, among other concerns.<sup>134</sup>

In *Platte I*, the FERC suspended the tariff for seven months and set the lawfulness of the proposed tariff and the issues raised by protesters for a technical conference.<sup>135</sup> The FERC explained its use of the maximum suspension period, concluding that “the retroactive nature of the proposal renders it unjust and unreasonable,” because Platte’s establishment of a Historical Shipper allocation entitlement based on past shipments based on a retroactive period had the effect of “denying all shippers, both existing and prospective, an equal, nondiscriminatory opportunity to establish a pattern of historical shipments before the historical shipment based proration policy takes effect.”<sup>136</sup> The FERC found that this step created an undue preference, “whether intended or not,” because it had a “retroactive application notice of which has not been provided, thus rendering the retroactive aspects unjust and unreasonable.”<sup>137</sup> The suspension period would, the FERC reasoned, allow the rolling six-month period to be used for establishing allocations to be based on a period in which shippers would be on notice of the impact of their shipment levels and allow them to “develop a record of historical shipments if they so choose.”<sup>138</sup> The suspension would also allow the exploration of all issues at the technical conference. The FERC Staff convened a technical conference in July 2006 and accepted subsequent written comments.<sup>139</sup>

On December 19, 2006, the FERC issued *Platte II*, accepting the suspended tariffs subject only to the filing of certain revisions to the prorationing plan suggested by the pipeline during the technical conference process.<sup>140</sup> The FERC found that no single prorationing methodology would satisfy all the competing interests in the proceeding, “[al]though there could be a number of different methods that might be appropriate for the Platte system.”<sup>141</sup> Although the FERC noted that additional capacity would be the most effective response to alleviate prorationing, it stated that it lacked the authority to order such construction.<sup>142</sup> The FERC then reviewed its precedents regarding historical-based prorationing systems, finding that it has permitted such systems in past orders, based on the facts in those proceedings.<sup>143</sup> The FERC concluded that the historical method proposed by Platte was reasonable, citing the ability of shippers to become New Shippers under the 10% set-aside, and then to become Historical Shippers over

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133. *Id.* at P 8.

134. *ConocoPhillips II*, *supra* note 130, at P 11-18.

135. *Platte Pipe Line Co.*, 115 F.E.R.C. ¶ 61,215 (2006) [hereinafter *Platte I*].

136. *Id.* at P 30.

137. *Platte I*, *supra* note 135, at P 30

138. *Id.* at P 31.

139. Notice of Technical Conference, *Platte Pipe Line Co.*, No. IS06-259-000 (F.E.R.C. June 15, 2006).

140. *Platte Pipe Line Co.*, 117 F.E.R.C. ¶ 61,296 (2006) [hereinafter *Platte II*].

141. *Id.* at P 42.

142. *Platte II*, *supra* note 140, at P 42.

143. *Id.* at P 43.



time even during periods of prorating.<sup>144</sup> The FERC accepted certain steps proposed by Platte to limit the ability of shippers to game the system through the use of affiliates, but declined to require even more stringent steps.<sup>145</sup> The FERC also declined to adopt proposals by some shippers to adopt policies recognizing expenditures undertaken in the expectation of or desire for capacity, or that would allocate capacity according to types of production.<sup>146</sup> The FERC reviewed challenges to the set-aside of 10% for New Shippers (and a limit of 3% for individual New Shippers), and found the 10% level supported in light of the facts, particularly in that it balanced the interests of the New Shippers and Historic Shippers in the capacity.<sup>147</sup> Similarly, the FERC approved the 3% level under the facts presented, noting that Platte could propose a change after gaining experience under the new methodology.<sup>148</sup> One party proposed to allocate capacity on the basis of state conservation rules designed to protect production of petroleum, supported by analogy to curtailment precedents under the NGA.<sup>149</sup> The FERC declined, on both procedural and substantive grounds.<sup>150</sup> In particular, the FERC stated that in interpreting the ICA it is not bound by precedents under the different, and less limited, NGA and the Federal Power Act.<sup>151</sup> Thus, the FERC found that the limited obligation of carriers under the ICA to avoid discrimination in allowing access to their facilities did not require the pipeline to make the requested distinctions among prospective shippers on the basis of the relative merits of their methods of oil production.<sup>152</sup>

### 3. Priority Allocation Rights

The FERC addressed a different type of allocation question—whether and under what circumstances an oil pipeline common carrier subject to the ICA may provide a higher priority in allocation to one class of shippers—in in *MidAmerica*.<sup>153</sup> The issue arose when MidAmerica filed tariffs to establish a new volume incentive program and to change its allocation procedures to accommodate the new incentive volumes.<sup>154</sup> The proposal was protested by a shipper, but after considering the pleadings, the FERC dismissed the protests regarding allocation and found the incentive program and its allocation priority to be reasonable and non-discriminatory.<sup>155</sup>

The background for this order commenced in 1999, when MidAmerica expanded its Rocky Mountain segment and offered seven-year incentive contract

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144. *Platte II*, *supra* note 140, at P 56.

145. *Id.* at P 46. The Commission also required clarification of certain defined terms in the prorating policy. *Platte II*, *supra* note 140, at P 49.

146. *Id.* at P 48.

147. *Platte II*, *supra* note 140, at P 56.

148. *Id.* at PP 56-57.

149. *Platte II*, *supra* note 140, at PP 58-59.

150. *Id.* at PP 62-66.

151. *Platte II*, *supra* note 140, at PP 58-65.

152. *Platte II*, *supra* note 140.

153. *Mid-America Pipeline Co.*, 116 F.E.R.C. ¶ 61,040 (2006), *review pending sub nom.* Williams Energy Servs., LLC, v. FERC, Nos. 06-1375, et al. (D.C. Cir. filed Nov. 14, 2006).

154. 116 F.E.R.C. ¶ 61,040, at P 1.

155. *Id.* at P 23.

rates to expansion shippers.<sup>156</sup> In addition, the “Expansion Capacity” was subject to a separate prorationing method. Mid-America provided that 80% of the Expansion Capacity would be allocated among shippers having executed an incentive contract, and 20% of the expansion capacity would be subject to the same prorationing basis as the pre-expansion capacity (Base Capacity), under which 90% of capacity was prorated according to historical volumes and 10% was reserved for new shippers.<sup>157</sup>

The initial filing was not the subject of a protest or the FERC order. However, on May 19, 2006, MidAmerica filed a supplement establishing a new volume incentive program for demethanized mix, and to change the existing prorationing policy to include the new incentive program.<sup>158</sup> The initial seven-year incentive contracts for the 1999 Expansion Capacity were to expire on February 1, 2007, and MidAmerica’s tariff supplement sought to make the prorationing provisions applicable to Expansion Capacity apply as well to the new seven-year incentive contract rates.<sup>159</sup>

A shipper protested, *inter alia*, the continued application of the prorationing rights for Expansion Capacity contract shippers, asserting that the continued priority provided to these shippers was no longer justified because the contract capacity would not be new capacity; that the Expansion Capacity should be made subject to the general historical prorationing methodology for the rest of the system; and that the proposed prorationing proposal would be unduly preferential.<sup>160</sup> MidAmerica responded to the protest, noting, among other points, that significant new capacity would be added to the Expansion Capacity by new construction in 2007.<sup>161</sup>

The FERC ruled that the new tariff provision applying the existing prorationing rules to the new incentive program was not discriminatory.<sup>162</sup> The FERC emphasized the following points in support of this conclusion: (1) all shippers, both current and new, would have an equal opportunity to participate in the new volume incentive program; (2) the new incentive program offered the same lower rates as the expiring program; (3) the pipeline was applying the same methodology to the new program as to the existing program; (4) the pipeline would be expanding capacity subject to the Expansion Capacity allocation methodology; and (5) because of the relative size of the Base Capacity and the Expansion Capacity, 75% of the pipeline capacity would continue to be subject to the historical volumes methodology, and thus “neither historical shippers nor new shippers will be denied access even if they do not sign long-term volume dedications.”<sup>163</sup> Consequently, the FERC upheld a provision granting contract rate shippers priority during prorationing as to a percentage of the pipeline’s capacity.<sup>164</sup>

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156. 116 F.E.R.C. ¶ 61,040, at P 10.

157. *Id.* at P 10.

158. 116 F.E.R.C. ¶ 61,040, at P 1.

159. *Id.* at P 8.

160. 116 F.E.R.C. ¶ 61,040, at P 10.

161. *Id.* at P 16.

162. 116 F.E.R.C. ¶ 61,040, at P 23.

163. *Id.* at 23-24.

164. 116 F.E.R.C. ¶ 61,040, at P 24.

#### 4. Capacity Allocation under the Outer Continental Shelf Lands Act

The FERC continued a series of orders approving priority prorationing rights for certain shippers on contract carrier pipelines under the Outer Continental Shelf in *Enbridge Offshore*.<sup>165</sup> The carrier filed a petition for declaratory order seeking approval of the terms of service for a projected offshore pipeline designed to connect petroleum supplies from the Green Canyon Block 650 with another contract oil pipeline, Caesar Oil Pipeline Company. The carrier proposed to function as a contract carrier, hold an open season, and execute long-term contracts that would give initial “anchor” shippers “precedence in allocating capacity,” then sign up other shippers on a first-come, first-served basis after the open season.<sup>166</sup> The FERC stated that, “[t]he issue presented is whether an oil pipeline subject to the anti-discrimination provisions of Section 5 of the Outer Continental Shelf Lands Act (OCSLA) may operate as a contract carrier when it connects to another oil pipeline that the Commission granted authority to operate as a contract carrier in a prior declaratory order.”<sup>167</sup> The referenced prior order was *Caesar Oil*, in which the FERC had found that the language of the OCSLA prohibiting undue discrimination and referring to reasonable and “proportionate” transportation did not prevent oil pipelines from operating as contract carriers and did not require that they must apportion on the basis of pro rata allocations.<sup>168</sup> This result accorded with the FERC’s conclusion that the same language in OCSLA permitting gas pipelines to operate as contract carriers offering firm transportation rights would permit oil pipelines to engage in other than pro rata transportation.<sup>169</sup> The FERC had also found that the ICA and its statutory requirements did not apply to pipelines transporting oil solely on the (Outer Continental Shelf) OCS.<sup>170</sup>

The FERC agreed with the applicant that *Caesar Oil* and related precedents<sup>171</sup> permit OCS pipelines to operate as contract carriers consistent with the anti-discrimination provisions of § 5 of the OCSLA.<sup>172</sup> As it had in the earlier OCS cases, the FERC also found that the contract carriage proposal would “send the appropriate economic signals to encourage development in the deepwater Gulf of Mexico.”<sup>173</sup>

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165. *Enbridge Offshore Facilities, LLC*, 116 F.E.R.C. ¶ 61,001 (2006) [hereinafter *Enbridge Offshore*].

166. *Id.* at P 1.

167. *Enbridge Offshore*, *supra* note 165, at P 1.

168. *Caesar Oil Pipeline Co.*, 102 F.E.R.C. ¶ 61,339, at PP 33-36 (2003).

169. Order No. 509, *Interpretation of, and Regulations Under, Section 5 of the Outer Continental Shelf Lands Act (OCSLA) Governing Transportation of Natural Gas by Interstate Natural Gas Pipelines on the Outer Continental Shelf*, [Regs. Preambles 1986-1990] F.E.R.C. STATS. & REGS. ¶ 30,842 (1988), 53 Fed. Reg. 50,925 (1988) (to be codified at 18 C.F.R. pt. 284).

170. *Id.* at P 15.

171. See generally *Proteus Oil Pipeline Co.*, 102 F.E.R.C. ¶ 61,333 (2003).

172. *Enbridge Offshore*, *supra* note 165.

173. *Id.* at P 19.

## II. INDUSTRY TRENDS

A. *Ultra-Low Sulfur Diesel Implementation and Surcharges*

The U.S. Environmental Protection Agency (EPA) issued regulations effective June 1, 2006, that significantly reduced the sulfur content of diesel fuel produced by U.S. refineries to meet “ultra-low sulfur diesel” (ULSD) standards.<sup>174</sup> By June 1, 2006, 80% of the diesel fuel produced by U.S. refineries for on-road use must have met a limit of 15 parts-per-million (ppm) sulfur.<sup>175</sup> The remaining 20% of on-road diesel and all non-road diesel must meet the same requirement by June 1, 2010.<sup>176</sup> Locomotive and marine diesel must meet the 15 ppm requirement by June 1, 2012.<sup>177</sup>

Before June 1, 2006, there had been no such federal restriction on certain types of fuels and on-road diesel fuel could contain sulfur content upwards of 450 ppm. Consequently, petroleum product pipelines that had never before had to transport diesel with such significantly reduced sulfur content must modify their facilities to ensure compliance with the federal mandate, including modifications to ensure that transportation of ULSD is not incidentally contaminated by the transportation of the multitude of other high-sulfur content products permissible on the market.

In response to this mandate, the FERC found that the costs necessary to comply with the pertinent EPA standards are extraordinary costs that do not necessarily apply to all oil pipelines or to all products transported on such pipelines, nor are those costs attributable to shipments by all shippers on a given pipeline. As such, ULSD costs are not the type of general, industry wide, or carrier-wide, costs that the FERC intends to permit recovery through the annual oil pipeline index methodology.<sup>178</sup>

The FERC has allowed carriers subject to these regulations to recover ULSD-related costs through a surcharge.<sup>179</sup> In order to avoid skewing the industry wide oil pipeline price index, the FERC requires pipelines implementing a surcharge to recover ULSD-related costs to separately account for all costs and revenues that relate to the ULSD surcharge.<sup>180</sup> The FERC also requires the pipeline to footnote the amount of dollars attributed to the surcharge invested in Carrier Plant on page 212 in the Form No. 6 and any revenues and expenses attributable to the surcharge on page 700 of the Form No. 6 in its annual filing to the FERC, as well as footnote any current and accrued amounts in its quarterly reports to the FERC.<sup>181</sup>

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174. 40 C.F.R. §§ 80.500–80.620 (2006).

175. *Id.* § 80.500.

176. 40 C.F.R. § 80.510(b).

177. *Id.* § 80.510(c).

178. *SFPP, L.P.*, 118 F.E.R.C. ¶ 61,267, at P 6 (2007) (citing *Magellan Pipeline Company, L.P.*, 115 F.E.R.C. ¶ 61,276 (2006)); Letter Order, *Inland Products Pipeline*, Docket Nos. IS06-542-000, IS06-542-001 (Sept. 26, 2006); Letter Order, *Valero Logistics Operations, L.P.*, Docket No. IS06-548 (Sept. 26, 2006).

179. *Magellan Pipeline Co., L.P.*, 115 F.E.R.C. ¶ 61,276, at P 9 (2006).

180. *Id.*

181. *Magellan Pipeline Co., L.P.*, 115 F.E.R.C. ¶ 61,276, at P 13; *See also SFPP, L.P.*, 118 F.E.R.C. ¶ 61,267, at P 8 (2007).

### B. Pipeline Transportation of Ethanol

On March 13, 2007, Senators Tom Harkin (D-IA) and Richard Lugar (R-IN) introduced legislation (S.B. 859) that would require the Secretary of Energy to spend up to \$1 million in fiscal year 2008 to conduct, in coordination with the Secretary of Agriculture and the Secretary of Transportation, studies of the feasibility of constructing dedicated ethanol pipelines.<sup>182</sup> The legislation would require that feasibility studies consider (1) existing and potential barriers to the construction of dedicated ethanol pipelines, including technical issues (e.g., corrosion),<sup>183</sup> siting of the lines, financing, and regulatory issues; (2) the potential for phased development of dedicated ethanol pipeline infrastructure, beginning with localized gathering networks before moving to development of major interstate pipelines; (3) the risks faced by sponsors of a dedicated ethanol pipeline project and ways of mitigating those risks; (4) options that would mitigate project sponsors' exposure to regulatory, financing and siting risks; (5) the financial incentives (e.g., return on equity) that may be needed to get project sponsors to invest in the first dedicated ethanol pipelines; and (6) scenarios in which ethanol production by year 2020 has reached 20 billion, 30 billion, and 40 billion gallons.<sup>184</sup>

On March 16, 2007, the Congressional Research Service (CRS) issued a report for Congress regarding agricultural, infrastructure, and market issues believed to constrain expanded ethanol production.<sup>185</sup> The report identifies four problems with pipeline transportation of ethanol that hinder increased reliance on it as a fuel source nationwide: (1) the tendency of ethanol to separate out of ethanol-blended gasoline during pipeline transportation; (2) the technical problem of addressing the corrosiveness of ethanol, which may damage existing pipelines; (3) the practical difficulty arising from the fact that shipments of ethanol would typically need to move in the opposite direction of existing oil pipeline movements (i.e., from rural areas in the Midwest to more densely populated areas largely along the nation's coasts); and (4) the fact that, to date, the major U.S. pipelines have not invested the capital that would be needed to allow for significant pipeline transportation of ethanol or ethanol-blended gasoline.<sup>186</sup>

The CRS report concludes that while some pipelines are pursuing solutions that would allow them to transport ethanol or ethanol-blended gasoline—such as coating pipeline interiors with epoxy or another corrosion-resistant substance, or replacing all vulnerable pipeline components with new components designed to withstand the corrosiveness of ethanol—such modifications will be costly, if not technically infeasible.<sup>187</sup>

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182. S. 859, 110th Cong. (2007).

183. See generally *Gasoline: Supply, Price and Specifications: Hearing Before the H. Comm. on Energy and Commerce*, 110th Cong. (2006) (testimony of Bill Shea, President and CEO, Buckeye Partners, LP).

184. S. 859, 110th Cong. (2007).

185. BRENT D. YACOBUCCI & RANDY SCHNEPF, CRS ORDER OF CODE RL 33928, REP. ETHANOL AND BIOFUELS: AGRICULTURE, INFRASTRUCTURE, AND MARKET CONSTRAINTS RELATED TO EXPANDED PRODUCTION (2007) [hereinafter REP. ETHANOL AND BIOFUELS].

186. *Id.* at CRS-8. The report notes that there are “[s]ome small, proprietary ethanol pipelines . . .” in existence. REP. ETHANOL AND BIOFUELS, *supra* note 187, at CRS-8 n.18.

187. *Id.* at CRS-9.

### C. *New Domestic Liquids Projects*

#### 1. Colonial Pipeline Company

On July 20, 2006, the FERC issued a declaratory order with respect to a major proposed expansion of Colonial Pipeline Company's (Colonial) mainline system.<sup>188</sup> Colonial's expansion project involves the construction of 500 miles of 36-inch diameter pipeline parallel to its existing line from Baton Rouge, Louisiana to Atlanta, Georgia, giving Colonial the capacity to deliver an additional 800,000 barrels per day at a projected cost of approximately \$1 billion.<sup>189</sup> Protests in opposition to Colonial's petition for declaratory order were filed by the Air Transport Association of America, Inc. (ATA) and Hunt Refining Company (Hunt).<sup>190</sup>

Colonial's petition for a declaratory order sought predeterminations that (i) its proposed expansion would not affect the grandfathered status of any of Colonial's existing rates; (ii) it could add a Uniform Rate Component (URC) to its base rates to recover the expansion costs; and (iii) the proposed cost-of-service methodology for calculating the URC would be accepted.<sup>191</sup> Regarding the grandfathered rate issue, Colonial indicated in its petition that it would not undertake the expansion, absent assurance that doing so will not expose its existing rates to challenges otherwise barred by the Energy Policy Act of 1992.<sup>192</sup> Colonial noted that the FERC had granted a declaratory order under similar circumstances in a case involving Plantation Pipe Line Company.<sup>193</sup>

Colonial further stated that its URC would be applied equally to all shipments that originate at Gulf Coast origins and are delivered to destinations beyond Baton Rouge, Louisiana; would be calculated based only on the incremental costs of constructing and operating the new line; would be based on the Opinion No. 154-B methodology; and would be subject to indexing.<sup>194</sup> By layering the URC on top of the existing rates for service on its mainline and stub lines, Colonial would avoid having to provide cost-of-service justification for the overall rates it charges for transportation between Gulf Coast origins and destinations downstream of Baton Rouge. Only the incremental costs would come before the FERC.<sup>195</sup> Colonial stated that the FERC "plainly "has the discretion to interpret its tariff rules to permit the proposed methodology" and claimed that the methodology response to the FERC's call for "balanced innovative proposals that provide incentives for appropriate infrastructure investment."<sup>196</sup>

Colonial's petition also sought a predetermination that it would be able to develop an overall return allowance for the URC based on the weighted average

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188. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078 (2006), *reh'g denied*, 119 F.E.R.C. ¶ 61,183 (2007).

189. 116 F.E.R.C. ¶ 61,078, at PP 8-9.

190. *Id.* at P 22.

191. 116 F.E.R.C. ¶ 61,078, at PP 11-17.

192. *Id.* at P 13.

193. *Plantation Pipe Line Co.*, 98 F.E.R.C. ¶ 61,219, at p. 61,867 (2002).

194. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, at 17 (2006).

195. *Id.*

196. JOSEPH T. KELLIHER, FERC, DEP'T OF ENERGY, FY 2007 CONGRESSIONAL PERFORMANCE BUDGET REQUEST (2006), <http://www.ferc.gov/about/strat-docs/FY07-budg.pdf>, at 4.

of the parents of Colonial's shareholder companies, which currently equates to 71% equity and 29% debt.<sup>197</sup> Further, Colonial requested a predetermination that its return on equity for the URC be set at the upper end of the range of reasonable returns developed by applying the traditional discounted cash flow methodology to a proxy group of publicly traded oil pipeline companies.<sup>198</sup> Colonial claimed that allowing its URC to be set at the upper end of the range of reasonable returns is necessary to give it the incentive to build the expansion and therefore addresses the public's need for "robust pipeline infrastructure" and relief of capacity bottlenecks.<sup>199</sup>

ATA countered, arguing that based on information from Colonial's annual FERC Form No. 6 reports, Colonial is already benefiting from "massive over-recoveries."<sup>200</sup> Thus, ATA contended that rather than allow Colonial to charge an incremental adder, the FERC should issue a show cause order directing Colonial to defend its existing rates, including both its grandfathered cost-based rates and its market-based rates.<sup>201</sup>

ATA further argued that Colonial's request for a predetermination that the expansion would not alter the grandfathered status of Colonial's rates under the Energy Policy Act of 1992 sought relief that is contrary to the FERC's statutory authority under that Act and the ICA; that the *Plantation Pipe Line* case on which Colonial relies is inapposite; that the FERC has not allowed oil pipelines to charge incremental rates and should not do so here; that a uniform "one size fits all" rate for recovery of the expansion costs is inappropriate because Colonial's rates vary depending on distance and/or location; that it was premature for the FERC to address Colonial's rate design proposals before Colonial actually files its cost of service data; and that Colonial failed to provide any support for its requests for a twenty-year depreciation period, for a return based on its parents' capital structure, and for a return at the top end of the range of reasonableness.<sup>202</sup>

Hunt also challenged the "one size fits all" aspect of Colonial's URC proposal. Hunt noted that under Colonial's existing rate structure, a shipper with a shorter haul pays a lower rate than a shipper with a longer haul.<sup>203</sup> Under Colonial's URC proposal, however, each shipper would be assessed the same URC.<sup>204</sup> As a result, short-haul shippers would be subjected to higher percentage rate increases than long-haul shippers.<sup>205</sup> Hunt contended that the proposed URC conflicts with the FERC precedent requiring distance-based rates.<sup>206</sup>

Hunt further contended that revenues from the expansion volumes alone would be sufficient to compensate Colonial for the expansion without charging a

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197. 116 F.E.R.C. ¶ 61,078, at P 62.

198. *Id.* at P 17.

199. 116 F.E.R.C. ¶ 61,078, at P 19.

200. *Id.* at PP 23-24.

201. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, at 24 (2006).

202. *Id.* at PP 25-27.

203. 116 F.E.R.C. ¶ 61,078, at P 28.

204. *Id.* at P 17.

205. 116 F.E.R.C. ¶ 61,078, at P 28.

206. *Id.* at P 28 (citing *Northern Natural Gas Co.*, 14 F.P.C. 11, 24 (1955), *aff'd*, 236 F.2d 372 (8th Cir. 1956), *cert. denied*, 352 U.S. 967 (1957)).

URC on any movements.<sup>207</sup> Hunt also challenged Colonial's proposal to use its parent companies' 77% equity ratio, noting that Colonial is a separate corporate entity with approximately \$1 billion of its own debt.<sup>208</sup> Hunt suggested that Colonial might finance the acquisition primarily with debt and thereby reap excess returns.<sup>209</sup> Hunt also challenged Colonial's request that its return be set at the top of the range of reasonableness, noting that Colonial's risks would be no higher than average in light of the thick equity ratio on which it seeks to base its rates, the fact that it would be recovering the expansion costs by increasing its rates on all customers, and the fact that Colonial claims capacity will be "tight for years to come."<sup>210</sup> Hunt urged the FERC to institute alternative dispute resolution (ADR) procedures to facilitate negotiation of a satisfactory rate structure.<sup>211</sup>

The FERC's order found that Colonial's proposed expansion is the kind of project the FERC wishes to encourage in order to ensure competitively priced deliveries to consumers.<sup>212</sup> The FERC rejected the arguments of ATA and Hunt that it was premature to provide Colonial with the rate assurances it seeks.<sup>213</sup> The FERC held that "in certain instances, it is useful to remove uncertainty regarding rate methodology issues prior to construction of a project and prior to the filing of proposed rates because the assurances facilitate financing and other investment decisions."<sup>214</sup> The FERC did, however, emphasize that it was not approving any specific rate at this time, and that, when Colonial files its actual rates, it will need to submit cost data in support of the rates that is consistent with the FERC's other ratemaking principles.<sup>215</sup>

The FERC rejected Hunt's calls for an order to show cause or institution of ADR procedures, finding that they were not warranted at this time.<sup>216</sup> The FERC noted that "[i]f a party can provide evidence that there has been a substantial change in circumstances to challenge the current grandfathered rates or that Colonial has market-power in markets where it is authorized to charge market-based rates, the party may file a complaint."<sup>217</sup>

The FERC held that it would allow Colonial to charge its existing grandfathered rates for transportation over the expansion facilities since there will have been no change in either service or the type of product carried.<sup>218</sup> The FERC also held that the expansion, in and of itself, would not constitute a "substantial change in circumstances," as those terms are used under § 1803(b) of the Energy Policy Act of 1992.<sup>219</sup> However, the FERC stated that it will condition Colonial's establishment of a URC on its being calculated in a manner

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

208. *Id.* at P 29 (2006).

209. 116 F.E.R.C. ¶ 61,078.

210. *Id.* at P 30.

211. 116 F.E.R.C. ¶ 61,078, at P 31.

212. *Id.* at P 44.

213. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, at P 45 (2006).

214. *Id.*

215. 116 F.E.R.C. ¶ 61,078, at 45.

216. *Id.* at P 46.

217. 116 F.E.R.C. ¶ 61,078, at 46.

218. *Id.* at P 50.

219. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, at P 51 (2006).



that nets out the revenues earned by charging the existing rate on expansion volumes.<sup>220</sup>

The FERC held that it would be appropriate for Colonial to assess the URC in a “one-size fits all” manner because all shippers would benefit from the bottleneck relief the expansion will provide.<sup>221</sup> Further, the FERC found that applying the URC to all shipments equally, regardless of length of haul, would preserve existing rate differentials, and that to do otherwise “could have significant market repercussions.”<sup>222</sup>

The FERC found that a number of factors support Colonial’s request to have the return on equity be set at the high end of the range of reasonable returns, but stated that it would defer ruling on any particular return on equity until Colonial submits a cost of service to implement the URC.<sup>223</sup> The FERC held that it would allow Colonial to use its parents’ capital structure if it is shown to be reasonable at the time Colonial files its cost of service “in light of the unique circumstances of Colonial’s capital structure and Commission precedent.”<sup>224</sup> The FERC denied Colonial’s request for a predetermination that it could use a twenty-year depreciation life for expansion facilities, as Colonial provided no support for that proposal.<sup>225</sup>

## 2. Calnev Pipe Line, LLC

On May 14, 2007, Calnev Pipe Line LLC (Calnev) filed a petition for declaratory order with the FERC in Docket No. OR07-10-000, seeking predeterminations on its proposed expansion project that are, in some respects, similar to those requested by the pipeline in the *Colonial* case, discussed above.<sup>226</sup> Calnev’s expansion project would involve constructing a sixteen-inch diameter loop of its existing fourteen-inch diameter pipeline from Colton, California to Las Vegas, Nevada.<sup>227</sup> An existing eight-inch pipeline would be taken out of service and reserved for future use.<sup>228</sup>

To allow Calnev’s parent, Kinder Morgan Energy Partners, L.P., to commit capital to the project, the petition requested that the FERC provide Calnev certain assurances through a declaratory order.<sup>229</sup> Like Colonial, Calnev requested predeterminations that: (1) the expansion could not be used as a basis to challenge the grandfathered status of existing Calnev rates; and (2) Calnev may recover the costs of constructing and operating the expansion facilities through a URC which would be additive to its base rates.<sup>230</sup>

However, Calnev also made two additional requests that raise novel and important legal issues. First, Calnev sought a predetermination that no portion of

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220. *Id.* at P 52.

221. 116 F.E.R.C. ¶ 61,078, at P 55.

222. *Id.* at P 57.

223. 116 F.E.R.C. ¶ 61,078, at PP 59-60.

224. *Id.* at P 62.

225. *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, at P 63 (2006).

226. *Calnev Pipeline, LLC*, 120 F.E.R.C. ¶ 61,073, at P 1 (2007).

227. *Id.*

228. 120 F.E.R.C. ¶ 61,073, at P 5.

229. *Id.* at P 1.

230. 120 F.E.R.C. ¶ 61,073, at PP 11, 13.

its proposed expansion facilities would be found not “used and useful.”<sup>231</sup> Calnev contended that it has sized its expansion facilities to accommodate future growth in population and fuel demand.<sup>232</sup> Calnev stated that it did not expect the expansion capacity to be fully utilized at the time it is placed into service and requested assurance that would not be placed at risk for any excess capacity.<sup>233</sup>

Second, Calnev requested a predetermination that it would be allowed to calculate its URC based on the FERC’s current cost-of-service methodology, including an income tax allowance based on the *Policy Statement*,<sup>234</sup> or that, in the event of a material change to that methodology before the URC is filed or at any time during its effectiveness, it would be allowed to calculate the URC in a manner that produces a cash flow equivalent to what the preexisting methodology would have yielded.<sup>235</sup>

Protests were filed by a number of shippers, and as of the date of this writing, no FERC action had been taken on Calnev’s petition for declaratory order.

### 3. Enbridge Offshore Facilities, LLC

On July 3, 2006, the FERC issued a declaratory order finding that Enbridge Offshore Facilities, LLC (Enbridge Offshore), an oil pipeline subject to the anti-discrimination prohibitions of § 5 of the OCSLA may operate as a contract carrier, as opposed to a common carrier.<sup>236</sup> The case involves Enbridge Offshore’s proposed construction and operation of a twenty-six mile, twenty-inch diameter crude oil pipeline extending from offshore production facilities in the Atwater Valley area, approximately 170 miles south of New Orleans, Louisiana, to a sub-sea connection with Caesar Oil Pipeline Company (Caesar).<sup>237</sup>

The FERC found that Enbridge Offshore’s petition is properly considered under the OCSLA, rather than the ICA, because Enbridge Offshore’s facilities lie entirely on the outer continental shelf.<sup>238</sup> The FERC held that Enbridge Offshore may operate as a contract carrier under the precedent established by *Caesar Oil*.<sup>239</sup>

The FERC also found good public policy reasons to allow Enbridge Offshore to operate as a contract carrier.<sup>240</sup> Specifically, the FERC found that the rights afforded by contract carriage would provide the pipeline and producers the assurance they need to undertake the large capital expenditures for development activities in the deepwater Gulf of Mexico.<sup>241</sup> By operating as a

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231. *Id.* at P 12.

232. *Calnev Pipeline* 120 F.E.R.C. ¶ 61,073, at P 12 (2007).

233. *Id.*

234. *Inquiry Regarding Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139, at P 32 (2005).

235. 120 F.E.R.C. ¶ 61,073, at P 13.

236. *Enbridge Offshore Facilities, LLC*, 116 F.E.R.C. ¶ 61,001, at PP 9, 10, 13, 19 (2006). A “common carrier” is a carrier that allocates capacity on a pro rata basis, rather than based on contractual rights. *Id.* at P 9.

237. 116 F.E.R.C. ¶ 61,001, at P 1.

238. *Id.* at P 16.

239. *Caesar Oil Pipeline Co.*, 102 F.E.R.C. ¶ 61,339, at PP 33, 34, 37 (2003).

240. *Id.* at PP 1, 20-28, 33.

241. 102 F.E.R.C. ¶ 61,339, at PP 32, 33.

contract carrier, Enbridge Offshore could offer producers firm transportation service, i.e., guaranteed transportation of contracted quantities except in the event of pipeline downtime due to force majeure or routine maintenance.<sup>242</sup> Thus, producers would be assured of having an outlet for their production.

#### 4. TransCanada Keystone Pipeline, LP

Progress is being made on TransCanada Keystone Pipeline, LP's (Keystone) proposed crude oil pipeline project that would have an initial capacity of 435,000 barrels per day and would extend from a supply hub in Hardisty, Alberta, Canada, to existing terminals in Wood River and Patoka, Illinois.<sup>243</sup> The length of the proposed pipeline in the United States is 1,078 miles from the Canada-United States border to Patoka, and the pipeline would traverse the states of North Dakota, South Dakota, Nebraska, Kansas, Missouri, and Illinois.<sup>244</sup>

Keystone filed an application for a Presidential Permit with the U.S. Department of State in April 2006.<sup>245</sup> The Department of State is expected to issue a Draft Environmental Impact Statement in the summer of 2007.

In April 2007, the Illinois Commerce Commission granted Keystone a Certificate in Good Standing to operate as a common carrier by pipeline in the state, which includes authorization to exercise eminent domain.<sup>246</sup> In April 2007, Keystone filed applications for a Corridor Certificate, Route Permit, and Certificate of Public Convenience with the North Dakota Public Service Commission.<sup>247</sup> Keystone also filed an application with the South Dakota Public Utilities Commission for a permit under the South Dakota Energy Conversion and Transmission facility Act in April 2007.<sup>248</sup>

In Canada, the project will involve the sale to Keystone of an existing 537-mile, 34-inch-diameter pipeline currently owned by TransCanada PipeLines Limited, and conversion of that line to crude oil service; the construction of a new 230-mile pipeline extension from Hardisty to the existing pipeline; and the construction of a pipeline extension from the existing pipeline to the international border. In December 2006, Keystone filed an application with the Canadian National Energy Board for approval to construct and operate the Canadian facilities and approval of the tolls and tariff for the pipeline.<sup>249</sup> That application is currently pending before the Canadian National Energy Board. In February 2007, the Canadian National Energy Board approved the transfer at net book value of a portion of TransCanada PipeLines Limited's Canadian Mainline natural gas transmission facilities to Keystone.<sup>250</sup>

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242. *Id.* at P 37.

243. TRANSCANADA, PROPOSED KEYSTONE PIPELINE PROJECT, <http://www.transcanada.com/keystone/> (last visited Sept. 5, 2007).

244. *Id.*

245. TRANSCANADA, *supra* note 243.

246. *Id.*

247. TRANSCANADA, *supra* note 243.

248. *Id.*

249. TRANSCANADA, *supra* note 243.

250. *Id.*

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