

OIL PIPELINE REGULATORY REFORM: STILL IN THE LABYRINTH?

Steven Reed*
Pantelis Michalopoulos**

I. INTRODUCTION

Pursuant to a specific directive in the Energy Policy Act of 1992 (EPAct),¹ the Federal Energy Regulatory Commission (FERC or Commission) has recently completed a wide-ranging series of rulemaking orders that significantly alter its standards and procedures for regulating oil pipeline rates.² A central feature of the new rules is the Commission's adoption of an indexing mechanism for oil pipelines that is designed, at least in part, to replace traditional cost-of-service regulation as the primary means of controlling rate levels.³ The Commission appears to have retreated in this rulemaking from its prior stance of encouraging market-based rates as the principal alternative to cost-based oil pipeline rates. At the same time, while indexing is expressly intended to alleviate the burdens and delays associated with traditional rate review, the new rules preserve a substantial role for the Commission's existing oil pipeline cost-of-service model.

This rulemaking represents at least the fourth major FERC initiative in oil pipeline ratemaking since the Commission inherited regulation of oil pipelines from the Interstate Commerce Commission (ICC) in 1977. In 1982, the Commission sought to rehabilitate the ICC's "fair value" regulatory scheme (known generally as "valuation"), but was unsuccessful in obtaining approval from the U.S. Court of Appeals for the D.C. Circuit.⁴ In 1985, in Opinion No. 154-B, the FERC adopted a more traditional cost-of-service methodology that combined elements of trended original cost

* A.B. Harvard College, 1974; J.D. Harvard Law School, 1979; member of the District of Columbia Bar; Partner, Steptoe & Johnson, Washington, D.C.

** B.S. American College of Greece, 1987; Law Diploma, Law School of Athens, 1988; LL.M. University of Pennsylvania, 1989; member of the New York Bar; Associate, Steptoe & Johnson, Washington, D.C.

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

2. The authors were active participants in these rulemaking proceedings, filing comments on behalf of a number of clients. The views expressed in this Article, however, are entirely those of the authors and do not necessarily represent the views of Steptoe & Johnson or any other entity.

3. Under indexing, which is a form of "price cap" regulation, regulated companies are permitted latitude to vary their rates subject to a defined ceiling that rises and falls in accordance with some measure of inflation.

4. Opinion No. 154, *Williams Pipe Line Co.*, 21 F.E.R.C. ¶ 61,260 (1982) [hereinafter Opinion 154], *reh'g denied*, 22 F.E.R.C. ¶ 61,086 (1983), *vacated sub nom. Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984). See Leonard Coburn, *Farmers Union II: Sisyphus Starts Up The Hill Again*, 5 ENERGY L.J. 309 (1984).

(TOC) and depreciated original cost (DOC) regulation.⁵ In ten years, the Opinion No. 154-B methodology has been applied in a handful of cases, but has yet to be judicially reviewed.

The third major initiative occurred in 1988, when the Commission established a procedure by which an oil pipeline could qualify for "light-handed" regulation by demonstrating that it lacks significant market power in the relevant markets.⁶ To date, however, only two pipelines have completed the market power procedure and obtained rulings that they can employ market-based rates in at least some of their markets.⁷

Against this backdrop of at best only partially successful efforts to "slay the Minotaur,"⁸ Congress in the EPAct ordered the Commission to formulate, by no later than October 24, 1993, a "simplified and generally applicable ratemaking methodology for oil pipelines."⁹ Although the legislative history is not illuminating with respect to the particular kind of methodology FERC was expected to adopt,¹⁰ the Commission seems to have concluded that Congress was signalling an inclination toward an indexing scheme by its enactment of a "grandfathering" provision under which virtually all rates in existence at the time of the EPAct were deemed to be just and reasonable and immune from challenge absent a substantial change in circumstances.¹¹ In the Commission's apparent view, indexing is a logical corollary to grandfathering because of the expectation that rate increases in line with a generalized inflation factor will rarely be challenged or, if challenged, will rarely lead to the kind of protracted and burdensome litigation that has generally characterized oil pipeline regulation in the past.¹²

5. Opinion No. 154-B, *Williams Pipe Line Co.*, 31 F.E.R.C. ¶ 61,377 [hereinafter Opinion No. 154-B], *modified on reh'g*, Opinion No. 154-C, 33 F.E.R.C. ¶ 61,327 (1985), *petition for review dismissed sub nom.* Association of Oil Pipe Lines v. FERC, No. 85-1528 (D.C. Cir. 1986).

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

7. Opinion No. 360, *Buckeye Pipe Line Co.*, 53 F.E.R.C. ¶ 61,473 (1990), *corrected*, 54 F.E.R.C. ¶ 61,117 (1991), *on reh'g*, Opinion No. 360-A, 55 F.E.R.C. ¶ 61,084 (1991); Opinion No. 391, *Williams Pipe Line Co.*, 68 F.E.R.C. ¶ 61,136 (1994).

8. The Commission's ongoing efforts to determine an appropriate regulatory structure for oil pipelines have been compared to Theseus' mythical attempts to slay the Minotaur and escape the labyrinth. Leonard Coburn, *Oil Pipeline Regulation: Has the FERC Finally Slain the Minotaur?*, 6 ENERGY L.J. 209 (1985); *see also* Order No. 561, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, III F.E.R.C. STATS. & REGS. ¶ 30,985, at 30,976 (1993) (Commissioner Hoecker, concurring in part and dissenting in part stating, "[T]he Commission continues to wander the labyrinth, this time with the Congress, rather than the courts, playing Ariadne to our Theseus.").

9. Pub. L. No. 102-486, § 1801(a), 106 Stat. at 3010 (1992).

10. *See, e.g.*, H.R. CONF. REP. NO. 1018, 102d Cong., 2d Sess. 393-94 (1992), *reprinted in* 1992 U.S.C.C.A.N. 1954, 2472, 2584-85; *see also* 138 CONG. REC. S17,647-48 (daily ed. Oct. 8, 1992). The only explicit guidance in the statutory text is that the new methodology must be "in accordance with section 1(5) of part I of the Interstate Commerce Act." EPAct, § 1801(a), 106 Stat. at 3010 (1992). Section 1(5) provides, in pertinent part, that all interstate oil pipeline rates "shall be just and reasonable." 49 U.S.C. app. § 1(5)(a) (1988).

11. EPAct, Pub. L. No. 102-486, § 1803(b), 106 Stat. 2776, 3011 (1992).

12. The burdens of oil pipeline rate litigation have been considerable. Even excluding the extremely lengthy and expensive proceedings involving the Trans Alaska Pipeline System (TAPS), a number of oil pipeline proceedings have lasted more than four years each, including cases involving Williams, Buckeye, ARCO Pipe Line Company, Kuparuk Transportation Company and Endicott

The Commission responded to the EPAct directive in a series of three related rulemaking proceedings, the principal provisions of which took effect on January 1, 1995. The first proceeding culminated in the issuance of Order No. 561, which enshrined indexing as the Commission's primary oil pipeline ratemaking tool.¹³ The other two proceedings began with companion Notices of Inquiry issued on the same date as Order No. 561. One proceeding, which led to a final rule adopted in Order No. 571, addressed certain aspects of cost-of-service rate filings and reporting that remain relevant even in the wake of indexing.¹⁴ The other proceeding, which led to adoption of a final rule in Order No. 572, dealt with procedural requirements applicable to oil pipelines that seek market-based rates.¹⁵

Part II of this Article will briefly describe the pre-existing oil pipeline ratemaking regime that formed the backdrop against which the Commission's new rules were formulated. Part III will provide an overview of the new rules, highlighting those areas where the Commission has imposed new requirements on both pipelines and shippers. This discussion will also identify a number of areas where considerable uncertainty remains regarding the application of the new rules, and will contrast the FERC's version of price cap regulation with the experience of the Federal Communications Commission (FCC) with price cap and market-based regulation of telephone and cable television companies.

II. OIL PIPELINE RATEMAKING PRIOR TO JANUARY 1, 1995

An understanding of the ratemaking standards and procedures applicable to oil pipelines prior to the adoption of the new rules requires at least a brief recitation of the history and background of oil pipeline regulation.¹⁶ Rate regulation of oil pipelines commenced with the Hepburn Act of 1906,¹⁷ which amended the Interstate Commerce Act (ICA) to bring within

Pipeline Company. In at least two cases the companies involved are reported to have incurred rate case expenses exceeding \$5 million.

13. Order No. 561, *Revisions to Oil Pipeline Regulation Pursuant to the Energy Policy Act of 1992*, III F.E.R.C. STATS. & REGS. ¶ 30,985, 58 Fed. Reg. 58,753 (1993) [hereinafter Order No. 561], *modified on reh'g*, Order No. 561-A, III F.E.R.C. STATS. & REGS. ¶ 31,000, 59 Fed. Reg. 40,243 (1994) [hereinafter Order No. 561-A], *petitions for review pending sub nom.* Association of Oil Pipe Lines v. FERC, No. 94-1538 (D.C. Cir. filed Aug. 5, 1994).

14. Order No. 571, *Cost-of-Service Filing and Reporting Requirements for Oil Pipelines*, III F.E.R.C. STATS. & REGS. ¶ 31,006 (1994), 59 Fed. Reg. 59,137 (1994) [hereinafter Order No. 571], *clarified on reh'g*, Order No. 571-A, III F.E.R.C. STATS. & REGS. ¶ 31,012 (1994), 60 Fed. Reg. 356 (1995) [hereinafter Order No. 571-A], *petition for review pending sub nom.* Association of Oil Pipe Lines v. FERC, No. 95-1051 (D.C. Cir. filed Jan. 20, 1995).

15. Order No. 572, *Market-Based Ratemaking for Oil Pipelines*, III F.E.R.C. STATS. & REGS. ¶ 31,007 (1994), 59 Fed. Reg. 59,148 (1994) [hereinafter Order No. 572], *reh'g denied*, Order No. 572-A, 69 F.E.R.C. ¶ 61,412 (1994) [hereinafter Order No. 572-A], *petition for review pending sub nom.* Association of Oil Pipe Lines v. FERC, No. 95-1052 (D.C. Cir. filed Jan. 20, 1995).

16. For a more thorough description of the history of rate regulation of oil pipelines, see Steven H. Brose, *Oil Pipelines*, 3 ENERGY LAW AND TRANSACTIONS § 85.01-129 (David J. Muchow & William A. Mogel eds., 1994). Opinion No. 154, *supra* note 4, at 61,578-88, 61,604-12, also contains a colorful rendition of the same history.

17. Pub. L. No. 59-337, 34 Stat. 584 (codified as amended in scattered sections of 49 U.S.C.).

its purview "common carriers engaged in . . . [t]he transportation of oil . . . by pipe line."¹⁸ Like railroads and other common carriers subject to regulation under the ICA, oil pipelines were required to post tariffs with the ICC,¹⁹ to charge only just and reasonable rates,²⁰ and to avoid unjust discrimination and undue preferences, including any deviation from the published tariff rates.²¹ Under section 13(1) of the Act, shippers are allowed to challenge an already existing rate by bringing a complaint.²² Alternatively, shippers can challenge a rate change initiated by the carrier through a protest, which typically requests the Commission to exercise its authority under section 15(7) to suspend the rate change for up to seven months, to require the change to go into effect subject to refund, and to investigate the reasonableness of the change.²³

From 1906 until the late 1930s, the ICC paid little attention to oil pipelines. In 1940, the ICC for the first time enunciated a standard for assessing the reasonableness of oil pipeline rates.²⁴ That standard was essentially a "fair value" methodology, which gave significant weight both to the depreciated original cost value of the pipeline's assets and to a calculation of the cost of reproduction new (CRN). These factors were weighted together by the ICC to produce a "valuation" that served as the basis for calculation of the revenue requirement.²⁵ The pipeline's allowable reve-

18. 49 U.S.C. app. § 1(1)(b) (1988). The ICA as it applies to oil pipelines is the Act as it stood as of the date of enactment of the Department of Energy Organization Act, Pub. L. No. 95-91, 91 Stat. 565 (1977), which provided among other things for the transfer of jurisdiction over oil pipelines to the newly created FERC. Revised Interstate Commerce Act, Pub. L. No. 95-473 § 4(c), 92 Stat. 1337, 1470 (1978). For this reason, the 1978 recodification of the ICA beginning at 49 U.S.C. § 10101 and all subsequent amendments to that Act are inapplicable to oil pipelines. The version of the ICA that does apply to oil pipelines is found in the appendix to the 1988 edition of Title 49 of the United States Code.

19. 49 U.S.C. app. § 6 (1988).

20. 49 U.S.C. app. § 1(5) (1988).

21. 49 U.S.C. app. §§ 2, 3(1) (1988).

22. 49 U.S.C. app. § 13(1) (1988). Under section 13, the Commission can also institute an investigation of any rate, rule or practice of a regulated carrier on its own motion.

23. 49 U.S.C. app. § 15(7) (1988). The complaint and protest schemes differ in several significant respects. For example, in a section 13 complaint proceeding, the burden of proof falls on the complainant. *ASG Indus. v. United States*, 548 F.2d 147, 152 (6th Cir. 1977); *Moline Consumers Co. v. Chicago, Burlington & Quincy R.R.*, 213 I.C.C. 135 (1956). In a suspension proceeding under section 15(7), by comparison, the burden of proof is on the carrier to justify its rate change. *Rail-Water, Grain in Bulk, Missouri, Illinois & Indiana to Buffalo*, 321 I.C.C. 564, 567 (1963). On the other hand, in a section 15(7) proceeding, only the carrier's change in rates is at issue; a party seeking to challenge the pre-existing rate is required to file a complaint and bear the burden of challenging the prior rate. *See, e.g., Order No. 561-A, supra* note 13, at 31,104 (1994) ("[T]o allow a protestant in a section 15(7) proceeding . . . to challenge that part of the rate that was pre-existing would . . . be contrary to the statutory scheme.").

24. *See Reduced Rates and Gathering Charges*, 243 I.C.C. 115 (1940). This decision was followed by *Petroleum Rate Shippers' Ass'n v. Alton & S.R.R.*, 243 I.C.C. 589 (1941); *Minnelusa Oil Corp. v. Continental Pipe Line Co.*, 258 I.C.C. 41 (1944); and *Reduced Pipeline Rates & Gathering Charges*, 272 I.C.C. 375 (1948). Together, these decisions defined oil pipeline ratemaking for the succeeding three decades.

25. The ICC derived its valuation by weighting the original cost of the pipeline's non-real estate assets, the CRN value of the assets, and the CRN less depreciation, and adding to that weighted average the present value of land and rights of way together with working capital. *See Atlantic Pipe Line Co.*, 47 I.C.C. Valuation Rep. 541, 584-98 (1937); *Ajax Pipe Line Co.*, 50 I.C.C. Valuation Rep. 1,

nues were determined by applying a fixed rate of return (ultimately set by the ICC at 8% for crude oil pipelines and 10% for petroleum products pipelines) to the ICC valuation base.²⁶

The ICC valuation methodology did not undergo significant change from the late 1940s until the early 1980s.²⁷ The initial spur to change was a case in which the ICC applied the valuation approach to uphold the reasonableness of a rate increase filed by the Williams Brothers Pipe Line Company.²⁸ The challenging shippers sought review of the ICC's order in the D.C. Circuit, and while that review proceeding was pending, Congress transferred jurisdiction of oil pipelines from the ICC to the FERC.²⁹ The FERC was granted a remand of the proceeding in order to reconsider the regulatory system it would apply to oil pipelines thereafter.³⁰ After a considerable delay, the Commission adopted with minor changes the ICC's valuation methodology and announced that it would apply to that base a generous rate of return that included a " 'real,' entrepreneurial" return on equity.³¹ In *Farmers Union Central Exchange v. FERC (Farmers Union II)*, the D.C. Circuit rejected the FERC's methodology, holding that it had not been shown to be cost-based and that any departures from a cost-based approach must be supported by a reasoned explanation, which in the court's view the agency had failed to provide.³²

In the wake of the *Farmers Union II* debacle, the FERC finally abandoned the effort to prolong the ICC valuation methodology as such, and instead issued a further order in the *Williams* proceeding—Opinion No. 154-B.³³ That brief opinion promulgated a relatively concise set of principles that were intended to govern oil pipeline ratemaking in the future. In

24-36 (1949). The weights given to the various valuation elements were determined by a formula that came to be known as the "Oak Formula" because it was first publicly disclosed in testimony given by an ICC engineer named Jesse C. Oak in Ex Parte No. 308. See S. Brose, *supra* note 16 at § 85.03[1][c].

26. See cases cited *supra* note 24.

27. One reason the valuation methodology did not evolve further appears to have been the existence of the Consent Decree in *United States v. Atlantic Refining Co.*, 360 U.S. 19 (1959), an antitrust case brought against the major U.S. integrated oil companies. That decree, to which most of the vertically integrated companies in the country were parties, limited the dividends that oil pipeline subsidiaries could pay to their corporate parents. Because the Consent Decree limits were more stringent and carried more serious penalties than the valuation standards, many in the industry considered the Consent Decree the real constraint on oil pipeline ratemaking for most of the post-World War II period. See S. Brose, *supra* note 16 at § 85.03[2].

28. *Petroleum Prods., Williams Bros. Pipe Line Co.*, 351 I.C.C. 102, *aff'd on recons.*, 355 I.C.C. 479 (1976). While *Williams* was pending, the ICC instituted a rulemaking to reexamine the continued viability of the valuation approach. Notice of Proposed Rulemaking, *Valuation of Common Carrier Pipelines*, Ex Parte No. 308 (Sept. 3, 1974).

29. Department of Energy Organization Act, Pub. L. 95-91, 91 Stat. 565 (codified at 42 U.S.C. § 7155 (1988)).

30. *Farmers Union Cent. Exch. v. FERC*, 584 F.2d 408 (D.C. Cir.), *cert. denied*, 439 U.S. 995 (1978) (*Farmers Union I*).

31. Opinion No. 154, *Williams Pipe Line Co.*, 21 F.E.R.C. ¶ 61,260, at 61,644 (1982). Opinion No. 154 is one of the longest, and quite possibly the strangest, decisions ever rendered by the FERC. See Coburn, *supra* note 8 at 209 & n.5.

32. 734 F.2d 1486, 1502-03 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984). For a more comprehensive discussion of *Farmers Union II*, see Coburn, *supra* note 4.

33. See *supra* note 5.

particular, Opinion No. 154-B established a new approach to the determination of the rate base and the rate of return on rate base that was, and remains, unique to oil pipeline regulation.

The Opinion No. 154-B rate base approach is an amalgam of several distinct rate base elements. In recognition of the industry's long reliance on the ICC valuation methodology, which generally provided for a rate base in excess of the depreciated net book value of the pipeline's assets, Opinion No. 154-B provided for a transition mechanism (the so-called "starting rate base"). The starting rate base is made up in part of the pipeline's last ICC-style valuation (typically as of December 31, 1983) and in part of the pipeline's depreciated original cost.³⁴ On a forward-looking basis, the pipeline's rate base is determined in part on a trended original cost basis, meaning that the equity portion of the rate base is trended to reflect inflation. The debt portion of the rate base, by contrast, is maintained on a depreciated original cost basis.³⁵

With respect to rate of return, Opinion No. 154-B provides that the trended equity portion of the rate base will receive only a "real" equity rate of return, meaning one from which the inflation component has been deducted.³⁶ The debt portion of the rate base, on the other hand, is subject to a nominal debt return, reflecting the fact that the debt rate base is not subject to trending.³⁷ In most other respects, the Opinion No. 154-B methodology reflects the standard cost-of-service regulatory principles applied by the FERC to other regulated industries.³⁸

In the wake of Opinion No. 154-B, there have been only a handful of initial decisions, and only two full Commission opinions, applying the new methodology to evaluate the rates of particular oil pipelines.³⁹ Nonetheless, many of the methodological controversies regarding Opinion No. 154-B have been largely resolved and the areas of uncertainty regarding its application have been significantly narrowed. In fact, the Commission commented in Order No. 571 that it "believes that the Opinion No. 154-B methodology is well-defined and for the most part generally understood in the industry."⁴⁰ However, Opinion No. 154-B does have a number of significant limitations. Perhaps the most important of these is that by its

34. Opinion No. 154-B, *supra* note 5, at 61,833-36.

35. Opinion No. 154-B, *supra* note 5, at 61,833.

36. Opinion No. 154-B, *supra* note 5, at 61,834. The Commission did not prescribe a particular inflation index in Opinion 154-B. Opinion No. 154-B, *supra* note 5, at 61,835.

37. Order No. 154-B, *supra* note 5, at 61,835.

38. One exception to this general characterization is the issue of rate design. The FERC typically requires natural gas companies and electric utilities that it regulates to set their rates applying fully allocated cost principles. Opinion No. 154-B, however, did not purport to prescribe cost allocation or rate design principles for oil pipelines. Opinion 154-B, *supra* note 5 at 61,838 n.2. The Commission acknowledged this in Order No. 561-A. Order No. 561-A *supra* note 13 at 31,107.

39. See Opinion No. 351, *ARCO Pipe Line Co.*, 52 F.E.R.C. ¶ 61,055, *modified on reh'g*, Opinion No. 351-A, 53 F.E.R.C. ¶ 61,398 (1990); *Kuparuk Transp. Co.*, 55 F.E.R.C. ¶ 61,122 (1991); see also *Lakehead Pipe Line Co.*, 69 F.E.R.C. ¶ 63,006 (1994) (initial decision); *Lakehead Pipe Line Co.*, 65 F.E.R.C. ¶ 63,021 (1993) (initial decision); *Endicott Pipeline Co.*, 55 F.E.R.C. ¶ 63,028 (1991) (initial decision); *Southern Pac. Pipe Lines, Inc.*, 39 F.E.R.C. ¶ 63,018 (1987) (initial decision).

40. Order No. 571, *supra* note 14, at 31,168.

terms it applies only to derive an overall system-wide cost-of-service for the pipeline. It does not specify any method for deriving individual, point-to-point rates, and in the ten years of its existence, it has not been applied by the Commission to establish or evaluate individual rates.⁴¹ Thus, the issue of standards for individual rates remains a major area of uncertainty under the Opinion No. 154-B regime.

Ironically, it was this very uncertainty over the appropriate treatment of individual rates that led to the initial creation of the market-based rate alternative for oil pipelines. In 1987, Buckeye Pipe Line Company filed a general rate increase for all products movements on its system, leading to a Commission rate investigation under Opinion No. 154-B. As part of its presentation in that case, Buckeye filed certain confidential cost allocation data relating to individual rates on its system pursuant to a protective order. Just before its case was scheduled to go to hearing, the administrative law judge ordered Buckeye to disclose its cost allocation data to avoid closing the hearing to the public. Buckeye appealed to the Commission, arguing in part that it was operating in competitive markets and that disclosure of its cost information on individual movements would expose it to severe competitive harm.

The Commission, in a seminal order, determined that Buckeye would be given an opportunity to demonstrate, in a separate phase of the proceeding, that it in fact lacked significant market power.⁴² To the extent the pipeline could show that competition adequately constrained its rates, it would be subject to "lightheaded" regulation.⁴³ As a result, Buckeye's cost-of-service hearing was canceled and it was remitted to a bifurcated proceeding in which the first phase would address market power issues and the second phase would define the regulatory rules applicable to Buckeye's various movements. Subsequently, the *Buckeye* procedure was extended to all other oil pipelines and became a standard feature of oil pipeline rate regulation.⁴⁴

In the *Buckeye* case, Phase I evolved into an elaborate antitrust-type inquiry regarding the competitiveness of more than twenty individual destination markets served by the Buckeye system. In addition to numerous factual issues, the case raised a host of methodological questions, including the appropriate definition of the product and geographic markets as well as the appropriate threshold levels for various measures of market concentration and the definition of significant market power itself. In the initial decision, the presiding administrative law judge largely adopted the pipeline's

41. In the two Opinion No. 154-B cases that have come before the Commission, only system-wide revenue levels were in issue. See Opinion No. 351, *ARCO Pipe Line Co.*, 52 F.E.R.C. ¶ 61,055, at 61,232, *modified on reh'g*, Opinion No. 351-A, 53 F.E.R.C. ¶ 61,398 (1990); *Kuparuk Transp. Co.*, 55 F.E.R.C. ¶ 61,122, at 61,362 (1991).

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

43. 44 F.E.R.C. ¶ 61,066, at 61,186. The nature of this lightheaded regulation was not defined, but it would apparently mean that Buckeye did not have to disclose the cost data on individual movements that sparked the original controversy. *Id.*

44. The absolute right of an oil pipeline to elect a bifurcated rate hearing under the *Buckeye* procedure was established in *Texas Eastern Products Pipeline Co.*, 45 F.E.R.C. ¶ 61,306 (1988).

market definitions and methodology and held that Buckeye lacked significant market power in all 22 of its relevant markets.⁴⁵ In Opinion No. 360, the Commission affirmed the initial decision's approach, as well as the result reached in all but five of Buckeye's markets.⁴⁶ The Commission also endorsed Buckeye's proposal for a case-specific form of lighthanded regulation designed especially to fit Buckeye's circumstances. Under that proposal, Buckeye essentially accepted some constraints on its ability to raise rates in its competitive markets in exchange for greater latitude to change rates in the markets in which it had not been found to lack significant market power.⁴⁷

The market power analysis pioneered in *Buckeye* was followed by the Commission, with some variations, in the second market power case decided on the merits. In Opinion No. 391, the Commission reviewed an initial decision holding all but 10 of Williams Pipe Line Company's 32 relevant markets to be adequately competitive.⁴⁸ Applying much the same type of analysis as in *Buckeye*, the FERC determined that Williams had demonstrated lack of significant market power in 13 markets, but had fallen short in the remaining 19. In addition to reversing the administrative law judge's findings in nine of Williams' markets, the Commission declined to follow the judge's lead in establishing more explicit "screens" for market power based on HHI and other market concentration data.⁴⁹ Instead, the Commission indicated an intention to follow "more closely the approach utilized in *Buckeye*," suggesting that it did not view numerical thresholds as

45. *Buckeye Pipe Line Co.*, 50 F.E.R.C. ¶ 63,011, *aff'd in part and rev'd in part*, 53 F.E.R.C. ¶ 61,473 (1990), *corrected*, 54 F.E.R.C. ¶ 61,117, *reh'g*, 55 F.E.R.C. ¶ 61,084 (1991). The geographic market was defined in the initial decision as essentially the Business Economic Areas (BEAs) developed by the Bureau of Economic Analysis of the U.S. Department of Commerce. 50 F.E.R.C. at 65,048. The product market was defined as "the transportation of all refined pipelineable petroleum products." *Id.* at 65,047. Significant market power was defined as the ability to sustain a 15% real increase in price over two years without an offsetting loss of revenue. *Id.* at 65,049. The *Buckeye* initial decision made extensive use of a measure of market concentration called the Herfindahl-Hirschman Index (HHI), which combines the market shares of the various participants in a market into a single number that allows the degree of concentration of different markets to be readily compared. *Id.* at 65,048-49.

46. Opinion No. 360, *Buckeye Pipe Line Co.*, 53 F.E.R.C. ¶ 61,473 (1990), *corrected*, 54 F.E.R.C. ¶ 61,117, *on reh'g*, Opinion No. 360-A, 55 F.E.R.C. ¶ 61,084 (1991). In two markets, the Commission held it did not need to address the market power issue.

47. Specifically, in its competitive markets, Buckeye could not raise its rates by more than 15% real (i.e., after inflation) over a two-year period. In addition, if Buckeye raised its market-based rates by more than the amount of the Gross National Product deflator plus two percent, it had to justify the increase either on the basis of competition or other factors. The rates in Buckeye's remaining markets were tied to the level of rate increases in Buckeye's competitive markets. 53 F.E.R.C. ¶ 61,473 at 62,675-77. Notably, Buckeye has now obtained a waiver of the Commission's new indexing rules to permit a continuation of the ratemaking system adopted in Opinion No. 360. *Buckeye Pipe Line Co.*, 69 F.E.R.C. ¶ 61,302 (1994). In effect, under this order Buckeye is permitted in certain circumstances to raise any or all of its rates by amounts that may exceed the index level otherwise applicable under Order No. 561.

48. Opinion No. 391, *Williams Pipe Line Co.*, 68 F.E.R.C. ¶ 61,136 (1994), *reviewing* 58 F.E.R.C. ¶ 63,004 (1992) (initial decision).

49. 68 F.E.R.C. ¶ 61,136, at 61,662.

an appropriate measure of market power.⁵⁰ With respect to lighthanded regulation, the Commission left the rates in Williams' 13 competitive markets free from any ongoing rate constraint. However, the issue of the appropriate rate standards for the remaining 19 markets was remanded to the administrative law judge for Phase II of the proceeding.⁵¹

In summary, under the old regime, the FERC had developed two distinct avenues by which an oil pipeline could seek to defend its rates against a shipper's challenge, both of which, up to a point, followed a common procedural path. Pipelines were not required to file detailed supporting material justifying a rate change along with the tariff filing itself but could wait to see whether any shipper or other party protested the changed rates.⁵² If a protest occurred and the Commission's Oil Pipeline Board ordered an investigation, the pipeline's new rates would ordinarily go into effect subject to refund after a one day suspension.⁵³ At the first prehearing conference before an administrative law judge, the pipeline could elect, at its sole option, whether to defend its rates on market power or cost-of-service grounds.

If it elected the bifurcated market-power option, the pipeline would have an opportunity for discovery, after which it could file its case-in-chief on market power and proceed forward solely on that issue. If it succeeded in showing lack of market power, the pipeline would receive lighthanded regulation in those markets, although the precise parameters of lighthanded regulation were not well-understood. If the pipeline opted for the Opinion No. 154-B approach, it would file its case-in-chief on cost-of-service issues and proceed forward to a decision on the validity of its rates directly. In neither event was there any constraint on the pipeline filing any rate it chose, and only rarely was the pipeline prevented from collecting its chosen rate, subject to refund, throughout the course of the litigation.

50. *Id.* at 61,663.

51. *Id.* at 61,696.

52. Although the statute does not impose any requirements on oil pipeline rate filings other than the requirement that 30 days' notice be given absent special permission, *see* 49 U.S.C. app. § 6(3) (1988), the Commission Staff had developed a practice even before the enactment of the new rules of requesting pipelines to submit detailed cost-of-service schedules along with significant rate filings. In that connection, the Staff periodically made available versions of a computer spreadsheet known as the "ABC Pipeline" model that reflected the Staff's interpretation of the Opinion No. 154-B methodology. The Staff strongly encouraged companies to use the ABC Pipeline model, or some approximation of it, for cost-of-service filings.

53. While the Commission has the statutory power to suspend rates for up to seven months, it has followed for many a policy years of suspending oil pipeline rates for only one day absent a showing by the protestant of unusual circumstances, such as a threat of irreparable injury from the proposed rates. *E.g., Buckeye Pipe Line Co.*, 13 F.E.R.C. ¶ 61,267 (1980); *Amoco Pipeline Co.*, 51 F.E.R.C. ¶ 62,198 (1990). More recently, the Commission has begun suspending rates for a nominal period only, permitting the suspended rates to go into effect on the same day that they were originally intended to be effective. *See, e.g., Lakehead Pipe Line Co.*, 69 F.E.R.C. ¶ 62,174 (1994).

Although the volume of litigation under this system was relatively light,⁵⁴ and although most of the cases that were initiated ended in settlements, many participants—both pipelines and shippers—expressed acute dissatisfaction with the existing regime. In particular, it was widely perceived that the effort required to litigate an oil pipeline case, either under Opinion No. 154-B or the market power alternative, could be disproportional to the benefits either party could hope to derive from the litigation. Moreover, despite years of litigation, many uncertainties still remained regarding the long-term development of Commission regulation, particularly with respect to the assessment of individual pipeline rates.

III. THE NEW RULES

A. *The Energy Policy Act*

It was against this backdrop that Congress considered and ultimately passed Title XVIII of the Energy Policy Act of 1992. The legislative history of this Title shows that Congress was aware of, and intended to remedy, the burdens and complexity that characterized both the methodology and the procedure of oil pipeline ratemaking.⁵⁵ To that end, Title XVIII contemplated both procedural and substantive simplification of oil pipeline regulation. Prospectively, the Act required the FERC to issue a final rule establishing a "simplified and generally applicable" ratemaking methodology for oil pipelines within one year.⁵⁶ The Act separately required the Commission to streamline its procedures relating to oil pipeline rates, taking into account, among other things, certain specifically enumerated issues.⁵⁷

As a basis for this forward-looking rulemaking, the Act created a presumption that certain existing or past rates are just and reasonable, thus immunizing those rates from future challenges except in limited circumstances. The rates deemed just and reasonable included rates in effect for the 365-day period ending on October 24, 1992 that had not been chal-

54. For example, in the ten years since Opinion 154-B, there have only been four Commission opinions on the merits in oil pipeline rate cases.

55. See 138 CONG. REC. H3489 (daily ed. May 20, 1992) ("We are all aware of the financial drain on our economy caused by unnecessary and costly regulatory mandates placed on industry. Of course, not all regulation is bad, but [oil pipeline] procedures at FERC are beyond understanding and have little or no benefit to the shippers and consumers.") (Statement of Rep. Brewster).

56. EPLA, Pub. L. No. 102-486, § 1801(a), 106 Stat. 2776, 3010 (1992).

57. These issues included: (1) identification of information to be filed with pipeline tariffs, and availability to the public of any Commission analysis of a tariff filing; (2) standing requirements for filing of protests and complaints; (3) the level of specificity required for a protest or complaint; (4) an opportunity for the oil pipeline to file a response to an initial protest or complaint; and (5) identification of specific circumstances under which the Commission Staff could initiate a protest proceeding. See EPLA, § 1802(b), 106 Stat. at 3010. In § 1802, the Act also required the Commission to terminate any rate proceeding upon withdrawal of the challenged tariff (assuming the prior tariff is reinstated and appropriate refunds are made for the interim period). Likewise, any section 13 complaint proceeding must be terminated if the complaint is withdrawn. See EPLA, § 1802(d), 106 Stat. at 3011. The Act also required the Commission to establish alternative dispute resolution procedures for oil pipelines. See *id.* § 1802(e), 106 Stat. at 3011.

lenged or investigated during that period as well as rates in effect on the 365th day preceding October 24, 1992 (even though they may have been changed since that day) if, again, they had not been challenged by protest or complaint, or investigated, in the intervening period.⁵⁸ No one may complain against the rates entitled to this statutory presumption except in one of two cases: either (1) the complainant shows that a substantial change has occurred since October 24, 1992 in the economic circumstances of the oil pipeline or in the nature of the service provided, and the substantially changed circumstances, or nature of the service, were the basis for the rate; or (2) the complainant had been contractually prohibited from complaining for a period starting before January 1, 1992 and ending at least on October 24, 1992, and brought the complaint within 30 days after its release from this prohibition.⁵⁹ Congress also cautioned that the statutory presumption should not be read to prohibit the filing of Section 13 or 15(1) complaints alleging that a rate is discriminatory.⁶⁰

B. The FERC's Response: From Staff Proposal to Final Rules

The FERC's first step in complying with this statutory mandate was to publish and invite comments on a Staff Proposal, which was issued without Commission endorsement on March 18, 1993.⁶¹ The Proposal announced the Staff's intention to review the comments received and present to the Commission a draft Notice of Proposed Rulemaking.⁶²

The Staff Proposal began with a brief review of the history and background of oil pipeline regulation and the congressional directives set forth in the EAct. The Staff concluded that Congress, in the EAct, did not authorize the FERC simply to deregulate oil pipeline rates.⁶³ However, even under the traditional "just and reasonable" rate standard, the Staff concluded that "rates need not be established only with reference to costs" and that "[m]arket factors may be taken into account."⁶⁴ In general, the Staff laid down three benchmarks for the new simplified ratemaking methodology: (1) it must "reduce[] the necessity and likelihood of prolonged litigation"; (2) it must be capable of being "applied by pipelines and reviewed by shippers and by the Commission expeditiously"; and (3) it

58. See EAct, Pub. L. No. 102-486, § 1803, 106 Stat. 2776, 3011 (1992).

59. See EAct, § 1803(b), 106 Stat. at 3011. These grandfathering provisions of the EAct have been strictly construed by the Commission in order to preserve the immunity conferred by Congress. See *SFP, L.P.*, 65 F.E.R.C. ¶ 61,028 (1993); see also *Lakehead Pipe Line Co.*, 65 F.E.R.C. ¶ 63,021, at 65,129-31 (1993).

60. EAct, § 1803(c), 106 Stat. at 3011.

61. Subsequently, the Commission has followed a similar procedural path in initiating its pending rulemaking on *Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines*. See Request for Comments on Alternative Pricing Methods, 70 F.E.R.C. ¶ 61,139 (Issued Feb. 8, 1995).

62. See Commission Staff Proposal For Revisions to Oil Pipeline Regulation Pursuant to the Energy Policy Act of 1992, at 80 (FERC issued Mar. 1993) (Staff Proposal).

63. See *id.* at 13.

64. *Id.* at 13-14.

must be "usable without significant variation or modifications by most, if not all, pipelines."⁶⁵

To meet this test, the Staff Proposal put forward an indexing methodology under which a pipeline would be able to increase each of its point-to-point rates up to a ceiling established by the annual increase in an inflation index, and would be required to decrease its rates in the event of an annual decrease to the index.⁶⁶ As the appropriate index, the Staff Proposal recommended the Producer Price Index for Finished Goods (PPI-FG or PPI), measured by the Bureau of Labor Statistics of the Department of Labor, which the Staff suggested should be reduced by a "productivity offset" of 1%.⁶⁷ For the purpose of determining the applicable PPI-1% change, the Staff Proposal divided pipelines into four groups, each corresponding to the beginning of a calendar quarter.⁶⁸ The annual ceiling for each group, which was to be established at the beginning of the relevant quarter, would cap rate changes for the ensuing four quarters. Shippers would not be allowed to challenge rate increases within the index ceiling except upon a showing of extraordinary circumstances that would cause those rates to be unreasonable and result in windfall returns for the pipeline.⁶⁹ Conversely, a pipeline could not change its rates in any given year by an amount exceeding the change in the applicable annual index unless it could justify the change in rates on the basis of one of two alternative methodologies: first, a pipeline would have to show that, due to extraordinary circumstances, rates within the ceiling would not permit the pipeline to recover its costs. In this case, the pipeline could justify rates in excess of the index ceiling on the basis of the cost-of-service methodology established in Opinion No. 154-B.⁷⁰ Alternatively, a pipeline could show that it lacked significant market power in the relevant markets. In that case, the pipeline's rates could be market-based and would not be subject to regulatory constraints.⁷¹

65. *Id.* at 15.

66. See Commission Staff Proposal For Revisions to Oil Pipeline Regulation Pursuant to the Energy Policy Act of 1992, at 1, 25-26 (FERC issued Mar. 1993).

67. See *id.* at 24. In an indexing scheme, a productivity offset is generally considered appropriate where the productivity of the regulated industry is deemed to be higher than the national average. In such a case, a productivity offset from the inflation increase would give the regulated firm an incentive to improve its own level of productivity and efficiency, while giving the public the benefit of a part of the higher industry-wide productivity attained. Conversely, in the absence of an offset, a firm in an industry of higher-than-average productivity would essentially be allowed to increase its net revenue by the amount of the productivity increment. While the Staff Proposal contemplated a "productivity" offset of 1%, this offset apparently was not predicated on a conclusion that the oil pipeline industry has experienced higher-than-average productivity. In fact, virtually no commenter in the rulemaking proceedings expressly suggested that oil pipelines were likely to see future increases in productivity greater than the average for American industry as a whole.

68. See *id.* at 26.

69. See *id.* at 28. As in the EPAct, shippers would retain the right to file discrimination claims. *Id.*

70. See *id.* at 57-59. Under the Staff Proposal, Opinion No. 154-B would also have formed the sole basis for initial rates for new service. *Id.* The Staff also made recommendations on what information should accompany the filing of a rate change or an initial rate based on the cost-of-service methodology.

71. See Commission Staff Proposal For Revisions to Oil Pipeline Regulation Pursuant to the Energy Policy Act of 1992, at 28-29 (FERC issued Mar. 1993).

In connection with the market power alternative, the Staff recommended a number of simplifying rules. In particular, the Staff proposed to model its market definitions on the analysis used in Opinion No. 360 (*Buckeye*), especially with regard to the presumptive use of BEA's as the applicable geographic markets.⁷² In addition, the Staff proposed the creation of a rebuttable presumption that the pipeline lacks significant market power upon a showing that any one of three numerical threshold tests was satisfied in the market. These thresholds were an HHI of 2500 or less, a pipeline market share of 10% or less, or a waterborne transportation market share of 10% or more of deliveries/receipts.⁷³

The Commission received 24 sets of comments on the Staff Proposal. On July 2, 1994, it issued a Notice of Proposed Rulemaking that differed significantly from the Staff Proposal.⁷⁴ Among the chief differences were the following:

(1) The NOPR proposed use of the Gross Domestic Product Implicit Price Deflator (GDP Deflator), instead of PPI-1%, as the applicable inflation index. It praised the GDP deflator as "the best indicator of inflation in the overall economy" and as "totally independent of the behavior of any pipelines," and opined that "no other general inflation index is better than the GDP deflator in predicting future costs in the oil pipeline industry."⁷⁵ It also abandoned the concept of a productivity offset because the Commission saw "little justification" for it.⁷⁶

(2) The NOPR modified the threshold showing shippers would have to make to challenge rates lying within the index ceiling on the basis of cost of service, aligning this showing to the statutory standard for challenging rates deemed just and reasonable — a substantial change in circumstances.⁷⁷

(3) The NOPR retained the pipeline's ability to use the cost-of-service alternative upon a showing of "extraordinary circumstances," but

72. *Id.* at 39-40. The Staff noted that the Commission had rejected a "corridor" approach to defining the geographic market for oil pipelines, under which the relevant market would be pipeline transportation between two defined points. *Id.* at 31-32. Rather, the Staff focused on the potential for competition in the distinct origin and destination markets. *Id.* at 32-35.

73. *See id.* at 29-52. The Staff also proposed that only parties with a direct economic interest should have standing to protest a new or changed rate, and that a shipper's downstream customers should not have standing unless they could show that their economic stake was substantial and that no other party could adequately represent it. *Id.* at 62. The Staff recommended elimination of staff-initiated investigations, including abolition of the Oil Pipeline Board, and made streamlining recommendations in response to some of the issues that the EPCA had directed the Commission to consider. *Id.* at 67.

74. Notice of Proposed Rulemaking, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, IV F.E.R.C. STATS. & REGS. ¶ 32,497 (1993), 58 Fed. Reg. 37,671 (July 13, 1993) [hereinafter NOPR].

75. NOPR, *supra* note 74, at 32,729.

76. NOPR, *supra* note 74, at 32,729 n.42. In addition, the NOPR made clear that the index would be cumulative, i.e., that increases not taken in one year would not be foregone by the pipeline.

77. NOPR, *supra* note 74, at 32,730.

explained that "extraordinary circumstances" means "substantial, unforeseen, and uncontrollable increases in cost."⁷⁸

(4) The NOPR retained the alternative of market-based rates upon a showing of lack of market power, but explicitly abandoned all of the recommendations in the Staff Proposal for simplifying that showing.⁷⁹

(5) The NOPR introduced the concept of negotiated rates, providing that an initial rate for new service "must be charged at the rate agreed upon between the pipeline and the shipper."⁸⁰

(6) The NOPR set forth detailed procedures for use of Alternate Dispute Resolution (ADR) mechanisms, including a provision for parties to elect binding arbitration in place of Commission adjudication. The most significant new ADR provision is the requirement that all tariffs suspended after January 1, 1995 must automatically be referred to a settlement judge for "required negotiations."⁸¹

(7) The NOPR went beyond the Staff Proposal in recommending changes to the FERC's tariff regulations.⁸² Among other things, the Commission proposed allowing incorporation of "special permission" requests in the tariff filing, allowing the withdrawal of pending tariffs prior to their effective date, revising tariff formats, abolishing the obligation to file concurrences and powers of attorney with the Commission, and abolishing all rules on pipeline valuation.⁸³

Forty-two parties commented on the NOPR, and on October 22, 1993 (the last business day before the statutory deadline), the Commission issued the final rule, Order No. 561. The Commission also opened two related dockets by Notices of Inquiry. In Docket No. RM94-1-000, the Commission sought comments on its market-based methodology and the possibility of streamlining it.⁸⁴ In Docket No. RM94-2-000, the Commis-

78. NOPR, *supra* note 74, at 32,731. The Commission specifically indicated that "extraordinary circumstances" could not include "increases in fuel and power costs, increases in insurance costs, and industry-wide expenses mandated by environmental and safety regulations." NOPR, *supra* note 74, at 32,731.

79. NOPR, *supra* note 74, at 32,726.

80. NOPR, *supra* note 74, at 32,750.

81. NOPR, *supra* note 74, at 32,737. All parties are required to participate in the settlement judge process; the judge may be required to submit periodic status reports to the Commission. NOPR, *supra* note 74, at 32,737. Notably, the Commission has now proposed more general ADR rules for all the industries it regulates and has raised the question whether oil pipelines should be included under those general rules. See Notice of Proposed Rulemaking, *Administrative Dispute Resolution*, IV F.E.R.C. STATS. & REGS. ¶ 32,510, 59 Fed. Reg. 59,715 (1994).

82. 18 C.F.R. §§ 341-345, 347, 352, 360-61 (1993). See also NOPR, *supra* note 74, at 32,741-49.

83. See NOPR, *supra* note 74, at 32,735. Some suggested changes went beyond the procedural streamlining exercise that the EPA had mandated. For example, in a number of respects, the new tariff rules *increased* the requirements on pipelines. See NOPR, *supra* note 74, at 32,746 (imposing new rule expanding mandatory contents of tariffs).

84. The questions put by the Commission in the Notice of Inquiry included: (1) whether the Commission should continue to permit pipelines to seek market-based rates upon a showing of lack of market power; (2) whether market-based rates should be subject to any constraint; (3) whether a showing of lack of market power should establish the pipeline's ability to charge market rates indefinitely or for a specified period; (4) whether it is advisable, feasible and/or legal to utilize threshold tests of market power; (5) what the probative value of any such threshold tests should be; (6)

sion stated its belief that "it is time to require oil pipelines to submit appropriate information with their cost-of-service rate filings,"⁸⁵ and asked what that information should be. The Notice also asked whether the Commission should revise Form No. 6, the oil pipelines' main annual financial submission, and whether the revised Form No. 6 should include the information needed to support a cost-of-service filing.⁸⁶

Petitions for rehearing of Order No. 561 were filed by 25 parties, and the Commission issued its Order on Rehearing, Order No. 561-A, on July 28, 1994. The Order modified some aspects of the final rule, including the showing that the pipeline must make before using the cost-of-service methodology. On the same day, the Notices of Inquiry in the two ancillary dockets matured into Notices of Proposed Rulemaking, which eventually culminated in two final rules issued on October 28, 1994—Order No. 571 in the cost-of-service filing and reporting rulemaking and Order No. 572 in the "market-based" rulemaking.⁸⁷ Several parties have filed petitions to review these Orders in the U.S. Court of Appeals for the D.C. Circuit.⁸⁸ Subject to appellate review, those three Orders, as revised or clarified on rehearing, comprise the new system governing oil pipeline rates, which will be described below.

C. *The New Regime*

Like the Staff Proposal and the NOPR, Order No. 561 anchors the new ratemaking methodology in indexing.⁸⁹ Rate changes may not exceed

methodological questions on defining markets, measuring concentration and market shares, taking into account other factors; (7) what documentation should accompany a pipeline's initial market-based rate filing; and (8) what protestants against an initial market-based filing must allege. See Notice of Inquiry, *Market-Based Ratemaking for Oil Pipelines*, IV F.E.R.C. STATS. & REGS. ¶ 35,527, 58 Fed. Reg. 58,814 (1993).

85. Notice of Inquiry, *Cost-of-Service Filing and Reporting Requirements for Oil Pipelines*, IV F.E.R.C. STATS. & REGS. ¶ 35,528, at 35,711, 58 Fed. Reg. 58,817 (1993) [hereinafter Cost-of-Service Notice of Inquiry].

86. See Cost-of-Service Notice of Inquiry, *supra* note 85, at 35,712.

87. On December 28, 1994, the Commission also issued Order Nos. 571-A and 572-A, clarifying Order No. 571 and denying rehearing of Order No. 572.

88. Challenges to Order No. 561 have been consolidated under the caption *Association of Oil Pipe Lines v. FERC*, No. 94-1538. Included in that docket are issues raised by the Association of Oil Pipe Lines (AOPL), the primary industry trade association, such as the Commission's choice of index and its imposition of various restrictions on pipeline tariff filings, including the requirement that rates be decreased automatically if the index declines. See Non-Binding Statement of Issues, *Association of Oil Pipe Lines v. FERC*, No. 94-1538 (D.C. Cir. filed Sept. 7, 1994). Also included are issues raised by various shippers and their representatives, including whether the FERC erred by applying the index to the entire rate (including the capital cost component), whether the Commission should have provided for periodic reviews of indexed rates, and whether shipper challenges to indexed rates could properly be limited to the increment of the increase. See Statement of Issues To Be Raised, *Total Petroleum, Inc. v. FERC*, No. 94-1644 (D.C. Cir. filed Oct. 28, 1994). Challenges to Order Nos. 571 and 572 are pending under the captions *Association of Oil Pipe Lines v. FERC*, No. 95-1051, and *Association of Oil Pipe Lines v. FERC*, No. 95-1052, respectively. The merits of these various appeals are outside the scope of this Article.

89. The Commission's adoption of indexing was not without controversy. Commissioner Massey dissented outright, stating that he was "not convinced that the Congressional mandate for the Commission to adopt a simplified and generally applicable ratemaking methodology requires the use of

the change in an annual index. Shippers may not challenge rate changes within the index except under specified, narrow circumstances. Pipelines may justify rates in excess of the index ceiling by using the cost-of-service or market-based alternatives or based upon an agreement with the relevant shippers, but only upon meeting the threshold standards established in the new rules.⁹⁰

1. Indexing

In adopting the new rules, the Commission cited three assumed benefits of indexing—simplicity, increased incentives for efficiency, and protection of shippers against rate increases in excess of inflation⁹¹—and concluded that indexing would “accommodate[] the need to change rates rapidly to respond to competitive forces,” while reducing the “time and expense traditionally associated with filing rate cases.”⁹²

Despite the strong endorsement of the GDP deflator as the inflation index in the NOPR, the Commission in the final rule reverted to the Staff Proposal and chose the PPI-1% as the applicable index.⁹³ However, the Commission also instituted a five-year review process: every five years beginning on July 1, 2000, the Commission will review the selection of the index and re-assess how well it has tracked industry costs, as evidenced from Form 6 data.⁹⁴

The Final Rule uses the chosen index to cap *individual* pipeline rates for particular movements.⁹⁵ The initial ceiling applicable to each pipeline

an indexing system.” Order No. 561, *supra* note 13, at 30,977-4 (Massey, dissenting). Moreover, although Commission Hoecker joined in supporting the overall indexing scheme, he dissented from two aspects of the order: (1) the limitation of protests against indexed rates to the incremental change in the rates and (2) the provision permitting initial rates for new service to be set by negotiation. Order No. 561, *supra* note 13, at 30,977-2 - 30,977-3 (Hoecker, concurring in part and dissenting in part). In addition, Commissioner Hoecker expressed sympathy with Commissioner Massey’s view that the Commission should have explored the alternative of a simplified cost-of-service methodology, rather than adopting indexing as the centerpiece of the new rules. Order No. 561, *supra* note 13, at 30,977-2 & n.13.

90. As with the EPAct, the new rules do not apply to the Trans Alaska Pipeline System (TAPS) or any pipeline that delivers oil into TAPS. Order No. 561, *supra* note 13, at 30,961.

91. Order No. 561, *supra* note 13, at 30,948-49.

92. Order No. 561, *supra* note 13, at 30,950-51.

93. The Commission justified its choice of PPI-1% by asserting that historically the changes to PPI-1% had tracked pipeline costs more closely than other alternatives. Order No. 561, *supra* note 13, at 30,952. On rehearing, the Commission reaffirmed this choice. *See* Order No. 561-A, *supra* note 13, at 31,099. Neither order refers to the one percent deduction as a “productivity offset.” The choice of index is one of the primary issues in the judicial review proceeding involving Order No. 561. *See supra* note 88.

94. Order No. 561, *supra* note 13 at 30,952.

95. The application of the index to individual rates was not widely questioned during the rulemaking proceeding. It is noteworthy, however, that the FCC does not apply its price cap methodology to individual rates, but rather to “baskets” of services. *See, e.g.*, Notice of Proposed Rule Making, *Policy and Rules Concerning Rates for Dominant Carriers*, 2 F.C.C.R. 5208 (1987); Further Notice of Proposed Rulemaking, 3 F.C.C.R. 3195 (1988); Report and Order and Second Further Notice of Proposed Rulemaking, 4 F.C.C.R. 2873 (1989) (AT&T Price Cap Order), *modified on recons.*, 6 F.C.C.R. 665 (1990); *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990) (LEC Price Cap Order), *erratum*, 5 F.C.C.R. 7664 (1990), *modified on recons.*, 6 F.C.C.R. 2637 (1991),

rate is set at the level of the rate on December 31, 1994 (except that, if this rate is subsequently lowered by the Commission, the initial rate too would be readjusted).⁹⁶ This ceiling rate then rises and falls annually in accordance with changes in the PPI-FG as published by the Bureau of Labor Statistics in May of each year for the year before. The Commission will publish the applicable figure for the change in PPI-FG minus 1% shortly after the BLS report is issued. Except for the first year, the new index ceiling will take effect July 1 of each year.

For each of its rates in effect on December 31, 1994 or thereafter, each oil pipeline must track the change in the rate ceilings applicable to such rates each time the new index is published. The calculation of the new ceiling is reflected in the formula:

$$\text{New Ceiling Level} = \text{Old Ceiling Level} ((\text{PPI}_n / \text{PPI}_{n-1}) - 0.01)$$

where PPI_n is the final index for the prior full calendar year, and PPI_{n-1} is the final index for the year before. The ceiling will cap changes to each rate during the "Index Year" (which is defined as the next period from July 1 to June 30).⁹⁷ For example, if the pipeline's rate from point A to point B was \$1.00/bbl. on December 31, 1994, the initial ceiling would have been set at \$1.00. On September 1, 1994, the Commission published the PPI-1% index value for January 1, 1995 - June 30, 1995, which was 0.2175%.⁹⁸ Thus, for the period through June 30, 1995, the pipeline's rate could not go above \$1.002175/bbl. unless the conditions were met for using an alternative ratemaking method.

Having determined the ceiling for an Index Year, the pipeline may, but is not compelled to, raise its rates up to the ceiling applicable to that Index Year. The pipeline may file such increases at any point during the Index Year. If the pipeline chooses not to increase its rates to the applicable ceiling, it will not forego the increase, but instead will be able to take it in subsequent Index Years, as the new index ceiling will be determined on the basis of the prior ceiling, not on the basis of a lower rate that the pipeline may have been charging.⁹⁹ If, on the other hand, the PPI-1% index

aff'd sub nom. National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). See also *In re Revisions to Price Cap Rules for AT&T Corp.*, CC Docket No. 93-197 (released Jan. 12, 1995). This basket approach preserves a certain amount of rate design flexibility for the carriers subject to price cap regulation. By comparison, the effect of the FERC indexing order is effectively to freeze in place the pattern of rates that existed on December 31, 1994, subject only to a general inflation adjustment or selective rate reductions (in response, for example, to competition).

96. Order No. 561, *supra* note 13, at 30,953-54. Notably, the rate in effect on December 31, 1994 need not be the same as, or even bear any particular relationship to, the grandfathered rate for the same service that may have been in effect on October 24, 1992.

97. As an exception, the first Index Year was essentially the six-month period from January 1, 1995 to June 30, 1995, because the rule was not effective before that date. See Order No. 561, *supra* note 13, at 30,954.

98. See Notice of Annual Change in the Producer Price Index for Finished Goods, Minus One Percent, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, IV F.E.R.C. STATS. & REGS. ¶ 35,528, 59 Fed. Reg. 46,423 (1994).

99. This is the so-called "cumulative" feature of the index. The index ceiling rises in each year (assuming positive inflation greater than 1 percent), regardless of whether the pipeline's actual rate

decreases, and the rate exceeds the new ceiling as a result, the pipeline must, by July 1 of that year, decrease its rate to the new ceiling.¹⁰⁰

Under the Final Rule, shippers may not challenge rate changes within the ceiling except by alleging "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, or that the rate decrease is so substantially less than the actual cost decrease incurred by the carrier that the rate is unjust and unreasonable."¹⁰¹ This limitation follows from the Commission's conclusion that "declining to consider most cost-of-service challenges to proposed rates that comply with the index is an essential feature of an index-based ratemaking methodology."¹⁰² The Commission's apparent view was that indexed rates will be presumptively just and reasonable and that, although the presumption can be rebutted in some instances, those instances must be narrowly defined if indexing is to have any meaning.¹⁰³

The limitations on shippers' ability to challenge indexed rates, while clear in theory, are somewhat vague in practical terms. For example, the rules as adopted do not define what it means for a rate increase to be "so substantially in excess of the actual cost increases . . . that the rate is unjust and unreasonable."¹⁰⁴ Moreover, the time period over which the relevant costs are to be measured is not well-defined. For example, if a pipeline's costs increase 3% per year for three years (for a cumulative increase of approximately 10%), would that justify a 10% increase at the end of year 3 if no prior rate increases had been taken to reflect past cost increases? Would it matter if costs had increased 10% in year 1 and the rate increase

increases. The FERC has made clear, however, that a pipeline may *not* file a rate above the index solely to make up for losses incurred in prior periods when rates were below the index ceiling. Order No. 561-A, *supra* note 13, at 31,106 n.36.

100. Order No. 561-A, *supra* note 13, at 31,099. Far from being a remote eventuality, the obligation to decrease rates under indexing may already be a live issue by the time this article is published. As of January 6, 1995, the non-final average PPI-FG for 1994 as set by the Bureau of Labor Statistics was 125.5. This is a change of 0.64% over 1993's 124.7 figure. See UNITED STATES DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, LABSTAT SERIES REPORT (Jan. 18, 1995). Assuming no substantial increase in the final number, the "minus 1%" adjustment will mean that the index change applicable beginning July 1, 1995 is negative 0.36%. Whether the *de minimis* nature of this change will lead pipelines to request, or the FERC to grant, a waiver of the obligation to decrease existing rates to reflect this change in the index is not yet clear. The requirement that all pipelines decrease their rates to reflect a decline in the index is an issue in the judicial review proceeding regarding Order No. 561. See *supra* note 88.

101. 18 C.F.R. § 343.2(c)(1) (1994). In addition, the new rule significantly tightens the requirements for standing to protest a rate change. The protestant must submit a verified statement describing in detail the conditions that give it a "substantial economic interest" in the rates in question. See Order No. 561-A, *supra* note 13 at 31,107-08.

102. Order No. 561, *supra* note 13, at 30,955.

103. For example, if cost-based challenges to indexed rates were permitted without limit, a pipeline might have little incentive to improve its productivity, since cost-cutting gains would generally flow to shippers rather than to the pipeline's owners.

104. 18 C.F.R. § 343.2(c)(1). On rehearing, the Commission defended this vagueness, noting that the "so substantially in excess" standard is "not susceptible to mathematically precise definition." Order No. 561-A, *supra* note 13 at 31,103.

did not come until year 3? These and many other issues will undoubtedly have to be litigated before the contours of this important aspect of the indexing scheme become clear.

In addition, the interplay between indexing and market-based rates has yet to be well-defined. First, unlike the FCC's price caps—which apply only to so-called “dominant” carriers¹⁰⁵—the FERC indexing scheme presumptively applies to all oil pipeline rates except those for which the pipeline succeeds in showing that it lacks significant market power. Thus, indexing is likely to cause reduced pricing flexibility for pipelines in competitive markets where rates can sharply fluctuate up or down in response to changing supply and demand conditions. Whether the market-based rate alternative as it has been retained in the new rules will be adequate to prevent indexing from causing serious market distortions will depend heavily upon how the Commission chooses to apply the new market rate procedures.

Second, assuming that pipelines may succeed in obtaining market-based rates in some, but not all, of their markets, the Commission must face the issue of how it will reconcile relatively unconstrained pricing on part of a system with the application of indexing on the rest. This problem becomes most acute if a shipper challenges certain of the carrier's rates on cost-of-service grounds, thus raising the question whether the Commission should examine the pipeline's revenues on an overall system-wide cost-of-service basis or on a segmented basis only. Again, this is an issue that is likely to require clarification beyond that available on the face of the rules.

105. See Notice of Proposed Rule Making, *Policy and Rules Concerning Rates for Dominant Carriers*, 2 F.C.C.R. 5208 (1987); Further Notice of Proposed Rulemaking, 3 F.C.C.R. 3195 (1988); Report and Order and Second Further Notice of Proposed Rulemaking, 4 F.C.C.R. 2873 (1989) (AT&T Price Cap Order), *modified on recons.*, 6 F.C.C.R. 665 (1990); *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990) (LEC Price Cap Order), *erratum*, 5 F.C.C.R. 7664 (1990), *modified on recons.*, 6 F.C.C.R. 2637 (1991), *aff'd sub nom.* National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). The FCC has made the determination of which carriers (or categories of carriers) are dominant and which are non-dominant by generic rulemakings. The rates of carriers found to be non-dominant in those rulemakings are entitled to streamlined review, and are not subject to price caps. Notice of Inquiry and Proposed Rule Making, *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Therefor*, 77 F.C.C.2d 308 (1979); First Report and Order, 85 F.C.C.2d 1 (1980); Further Notice of Proposed Rulemaking, 84 F.C.C.2d 445 (1981); Second Report and Order, 91 F.C.C.2d 59 (1982), *recons. denied*, 93 F.C.C.2d 54 (1983); Further Notice of Proposed Rulemaking, 47 Fed. Reg. 17,308 (1982); Third Report and Order, 48 Fed. Reg. 46,791 (1983); Third Further Notice of Proposed Rulemaking, 48 Fed. Reg. 28,292 (1983); Fourth Report and Order, 95 F.C.C.2d 554 (1983); Fourth Further Notice of Proposed Rulemaking 49 Fed. Reg. 11,856 (1984); Fifth Report and Order, 98 F.C.C.2d 1191 (1984); Sixth Report and Order, 99 F.C.C.2d 1020, *vacated and remanded sub nom.* MCI Telecomm. Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985). The Fourth Report and Order was vacated by the D.C. Circuit in *AT&T v. FCC*, 978 F.2d 727 (1992), *aff'd*, *MCI Telecomm. Corp. v. ATT*, 114 S. Ct. 2223 (1994). See also Notice of Proposed Rulemaking, *Tariff Filing Requirements for Non-dominant Common Carriers*, 8 F.C.C.R. 1395 (1993), Memorandum Opinion and Order, 8 F.C.C.R. 6752 (1993), *vacated sub nom.* Southwestern Bell Corp. v. FCC, Nos. 93-1562, 93-1568, 93-1590 and 93-1624 (D.C. Cir. Jan. 20, 1995).

2. Cost of Service Alternative

As the rules were ultimately adopted, a pipeline may justify a rate in excess of the index ceiling based on the cost-of-service methodology if it can show that there is a substantial divergence between the actual costs experienced by the carrier and the rate resulting from application of the index, such that rates at the ceiling level would preclude the carrier from charging a just and reasonable rate within the meaning of the ICA.¹⁰⁶ While the pipeline must also "substantiate the prudence of the costs incurred,"¹⁰⁷ the Commission clarified in Order No. 571 that this is not part of the threshold showing; prudence must be substantiated only if and after a protestant raises a reasonable challenge to the prudence of the pipeline's costs.¹⁰⁸ The Commission also explained that, at least initially, the pipeline need only show a substantial divergence between total costs and total revenues resulting from the indexed rates, not between costs allocated to a particular movement and the rate for that movement.¹⁰⁹

Formulation of this threshold standard in its present form was the most significant change effected by the Commission on rehearing from Order No. 561. Order No. 561 had contemplated a higher threshold showing for pipelines wishing to use cost of service, under which the pipeline would have had to show that "it is affected by uncontrollable circumstances that preclude[] it from recovering all of its prudently incurred costs under the indexing system."¹¹⁰ Order No. 561-A lowered the standard in order to track "more closely" the showing shippers must make to challenge a rate on the basis of cost-of-service—the "substantial divergence" test.¹¹¹

Once the pipeline makes the showing entitling it to cost-of-service review, the new rules contemplate no substantive change in the Opinion No. 154-B methodology. It is important in this respect to note that notwithstanding the choice of PPI-1% for purposes of indexing, the new rates do not affect the opportunity for case-by-case determination of an inflation index for purposes of trending. Further, the Commission explicitly reaffirmed the rate design flexibility left open by Opinion No. 154-B. In Order No. 561-A, the Commission emphasized that issues of cost allocation and rate design have not been determined in a fully litigated case, that Order No. 561 is not intended to decide this issue, and that "proponents of 'stand-alone' cost methodology or other costing methodologies will not be precluded from advocating such methodologies in individual cases."¹¹²

106. 58 Fed. Reg. 58,753, at 58,779-80 (to be codified at 18 C.F.R. § 342.4(e)).

107. *See id.*

108. Order No. 571, *supra* note 14, at 31,167.

109. Order No. 571, *supra* note 14, at 31,166-67.

110. Order No. 561, *supra* note 13, at 30,957. The examples of "uncontrollable circumstances" given in Order No. 561 included such items as "increased safety or environmental regulations" and a "natural disaster that disables facilities." Order No. 561, *supra* note 13, at 30,957.

111. *See* Order No. 561-A, *supra* note 14, at 31,106-07.

112. *See* Order No. 561-A, *supra* note 13, at 31,107. *See also* Order No. 571, *supra* note 14, at 31,166-67.

On the other hand, Order No. 571 did augment the filing requirements associated with a cost-of-service filing. Whereas under the old rules a pipeline did not have to accompany its rate filings with supporting cost-of-service information, the new rules require the oil pipeline to submit a calculation of its overall cost of service with any filing of a rate that exceeds the index ceiling. As grounds for the new requirement, the Commission reasoned that this information is necessary to determine whether the pipeline has made the threshold showing of substantial divergence that is now required before the pipeline may use cost-of-service.¹¹³ Cost-of-service rate filings must be accompanied by seven related statements, some of which are derived from others, each setting forth the calculation of the various elements of the pipeline's Opinion No. 154-B costs.¹¹⁴ Consistent with its holding that the pipeline need not show "substantial divergence" of costs and index changes with respect to a particular point-to-point rate, the Commission made clear that the pipeline does not have to provide cost allocation and rate design schedules with its rate filing.¹¹⁵ This is so regardless of whether the pipeline wishes to use cost-of-service for a general rate increase or for particular rates.

In addition, a cost-of-service presentation can, and in many cases must, be made to establish initial rates for new service.¹¹⁶ For example, if the pipeline cannot reach agreement with at least one non-affiliated shipper on the new rate (or if it has no non-affiliated shippers), it must justify its initial rate on cost-of-service grounds.¹¹⁷ Alternatively, even if the rate is set based on a shipper's agreement, the pipeline's initial rate may be protested, in which case it must still be justified on a cost-of-service basis. However, in some cases it may be to the pipeline's advantage to set an initial rate on a cost-of-service basis. For example, an initial rate to a new delivery point on an existing system can apparently be set based on cost-of-service without any threshold showing, even if the new rate is higher than comparable rates on the same system that are constrained by indexing.¹¹⁸

113. Order No. 571, *supra* note 14, at 31,165.

114. The statements are: Statement A—Total Cost of Service (which is derived from the information in Statements B through G); Statement B—Operation and Maintenance; Statement C—Overall Return on Rate Base; Statement D—Income Taxes; Statement E—Rate Base; Statement F—Allowance for Funds Used During Construction (computation of AFUDC for each year since 1984); and Statement G—Revenues (a 12 month revenue computation using presently effective rates, proposed rates, and maximum ceiling rates if different from presently effective rates). See Order No. 571, *supra* note 14, at 31,167.

115. See Order No. 571, *supra* note 14, at 31,166.

116. Order No. 561, *supra* note 13, at 30,959-61.

117. Order No. 561, *supra* note 13, at 30,960. The rule is not clear on whether that justification can be—or must be—on a total system or an individual rate basis.

118. To the extent such a rate might otherwise conflict with Section 4 of the ICA, the so-called "long haul-short haul" provision, the new rules provide that permission to "charge a greater amount for a shorter distance over the same line in the same direction" is automatically granted if the Commission does not disapprove the carrier's application within 30 days. 18 C.F.R. § 341.14(a)(1994). It is notable in this regard that the Commission has defined "new service" broadly to include addition of new receipt and delivery points on an existing system. Order No. 561, *supra* note 13, at 30,961; Order No. 561-A, *supra* note 13, at 31,105.

The other component of the augmented information-filing requirements imposed by Order No. 571 is the cost-of-service information that pipelines will now have to include in Form No. 6, the Annual Report for Oil Pipelines. This requirement applies to all oil pipelines whether or not they plan to resort to a cost-of-service justification for their rate changes (and indeed whether or not they plan to make any rate changes). Order No. 571 added to Form No. 6 a new schedule, "Annual Cost of Service Based Analysis Schedule," which will appear at page 700. That schedule requires pipelines to report their total annual cost of service in accordance with Opinion No. 154-B, as well as operating revenues and throughput in barrels and barrel-miles.¹¹⁹ The Commission explained that this information "would permit a shipper to compare proposed changes in rates against the change in the level of a pipeline's cost of service," and "compare the change in a shipper's individual rate with the change in the pipeline's average company-wide barrel-mile rate."¹²⁰ On this basis, the shipper "can determine whether a pipeline's cost of service or per-barrel/mile cost is so substantially divergent from the revenues produced by its rates to warrant a challenge that requires the pipeline to justify its rates."¹²¹ Pipelines are required only to report the result of the Opinion No. 154-B calculation and not the underlying calculations or supporting data for the result. However, in the event a pipeline makes a major change in the application of the methodology, it must report that it has done so, and it must also recalculate the prior year's cost of service in accordance with such change.¹²² The first revised Form No. 6 will be for calendar year 1995 and is due by March 31, 1996. However, Order No. 571 also requires each pipeline to submit separately the new schedule for years 1993 and 1994 at the same time as its first index rate change or by March 31, 1995, whichever is earlier.¹²³

3. Market Based Rulemaking

In Order Nos. 561 and 572, the Commission confirmed that pipelines may continue to seek market-based rates on the basis of a showing that they do not possess significant market power in the relevant markets.¹²⁴ However, the Commission refrained from endorsing any of the substantive guidelines that had been put forward in the Staff Proposal and by various commenters.¹²⁵ Instead, the Commission "will continue to develop oil pipeline precedents on a case-by-case basis."¹²⁶ In a number of respects,

119. Order No. 571, *supra* note 14, at 31,168.

120. Order No. 571, *supra* note 14, at 31,168.

121. Order No. 571, *supra* note 14, at 31,168.

122. Order No. 571, *supra* note 14, at 31,168.

123. Order No. 571, *supra* note 14, at 31,170. Order No. 571 also made other changes to Form No. 6, simplifying or deleting a number of other schedules. Also, consistent with the Commission's decision to place the obligation to perform depreciation studies on individual pipelines, Order No. 571 imposed detailed new requirements for the contents of such studies. See Order No. 571, *supra* note 14, at 31,173-75.

124. Order No. 561, *supra* note 13, at 30,957-59; Order No. 572, *supra* note 15, at 31,179.

125. See Order No. 572, *supra* note 15, at 31,184.

126. Order No. 572, *supra* note 15, at 31,184.

however, the Commission has retreated from the procedural and substantive standards established in *Buckeye* to such an extent that further case-by-case development of the market-based rate alternative may be problematic.

Under the *Buckeye* precedent, a pipeline could file new or changed rates and, upon challenge, elect to justify them on the ground that it did not have significant market power. During the pendency of the proceeding, the pipeline would bear a refund obligation in the event the Commission ultimately ruled against the carrier's rates. If, however, the pipeline demonstrated that it lacked significant market power, it did not need to await a Commission determination to that effect in order to collect the rates that would be permitted as a result of its competitive status. Thus, while the market power inquiry was long and complex, it generally did not delay the competitive pipeline's ability to collect market-based rates. Moreover, the *Buckeye* and *Williams* decisions appeared to offer a road map for future cases that could conceivably avoid some of the expense and complexity that marked those proceedings.

Under the new rules, by contrast, a pipeline may no longer choose to defend the reasonableness of its new or changed rates on the ground that it lacks significant market power. Rather, the pipeline must await a determination by the Commission before it is allowed to charge market-based rates. During the pendency of the market power proceeding, the new rules specify that the pipeline's rates are still subject to indexing.¹²⁷

A Commission determination that the pipeline lacks significant market power now may be obtained only through a separate application for such a determination.¹²⁸ This application, which is filed before any opportunity for discovery, must contain a wide array of information, including categories that go beyond the information the Commission has required in previous *Buckeye*-type proceedings. Moreover, the specific requirements indicate that the Commission has essentially invited parties to relitigate many of the issues that made the *Buckeye* and *Williams* proceedings so protracted and burdensome in the first place. These specific requirements are set forth in nine required statements that the pipeline must submit along with its application for market-based rates.

Statement A must describe the geographic markets in which the carrier seeks to establish lack of significant market power, including both origin and destination markets. The pipeline must explain why its method for defining the appropriate markets is proper, even where it uses BEAs (which the Commission specifically approved in both *Buckeye* and *Williams*). The pipeline does not need to analyze point-to-point corridors in its initial filing, but Order No. 572 specifically leaves protestants free to argue

127. Order No. 572, *supra* note 15, at 31,181. An interesting question is whether a pipeline can file cost-of-service-based rates in excess of the index and, simultaneously, an application for market-based rates in the same markets. If the Commission were to rule on the market power application prior to the end of the cost-of-service proceeding, a favorable ruling might obviate the need for further cost-based review.

128. Order No. 572, *supra* note 15, at 31,180.

that a point-to-point corridor is an appropriate geographic market in the circumstances of the particular case, inviting relitigation of another issue that had been exhaustively addressed in *Buckeye* and *Williams*.¹²⁹

Statement B must identify the relevant product markets and must explain why the particular definition is appropriate. Order No. 572 speculates that transportation of crude oil could be in a different market from transportation of natural gas liquids as well as a different market from transportation of separate petroleum products like motor gasoline, distillates and jet fuel. This, too, would be a departure from the *Buckeye* and *Williams* precedents, both of which defined the relevant product market as including all pipelineable petroleum products. In any case, Order No. 572 refrained from deciding the issue and left it to the pipeline to select its product market in the first instance and bear the burden of proving its appropriateness.¹³⁰

Statement C must describe the carrier's own facilities and services in the relevant markets identified in Statements A and B. Among other things, the requested information must include shipper deliveries and receipts.¹³¹ To the extent that this information is prohibited from disclosure under section 15(13) of the ICA, the pipeline will have to file a request for privileged treatment under the Commission's rules.¹³²

Statement D calls for a description of competitive alternatives, including common carrier and private pipelines, barges, trucks and refineries within the geographic market "to the extent available."¹³³ The Commission added this qualification to the proposed rules in recognition of the fact that detailed information on the pipeline's competitors will often be outside the pipeline's reach.

Statement E requires the pipeline to describe potential competition in the relevant markets. As with Statement D, the pipeline need only submit responsive data to the extent available and may provide its best estimate of potential competition drawn from publicly available information.

Statement F requires the submission of maps, and Statement G calls for the pipeline to set forth the calculation of the HHI and the pipeline's market share in the relevant markets, as well as any other market measures on which the pipeline may be relying. Notably, the calculation of HHI must take account of the competitive alternatives listed in Statement D as well as the potential competition set forth in Statement E. Also, the pipeline may use capacity data to calculate the HHIs. The calculation of the pipeline's market share, however, must be based on receipts in its origin

129. Order No. 572, *supra* note 15, at 31,188-89. However, Order No. 572 did specify that the burden of showing the appropriateness of a corridor approach is with the protestant. Order No. 572, *supra* note 15, at 31,189.

130. See Order No. 572, *supra* note 15, at 31,189-91.

131. Order No. 572, *supra* note 15, at 31,191.

132. Order No. 572, *supra* note 15 at 31,183-84; see also 18 C.F.R. § 388.112 (1994). Section 15(13) of the ICA prohibits disclosure of competitively sensitive shipper information except in certain narrowly defined circumstances. See 49 U.S.C. app. § 15(13) (1988).

133. Order No. 572, *supra* note 15 at 31,192.

markets or deliveries in its destination markets. In the same statement, the pipeline may also provide alternative indicators of its lack of market power, including a calculation of barge market share.¹³⁴

Statement H invites the pipeline to discuss other pertinent factors, such as exchanges, excess capacity, competition with vertically integrated companies and profitability, while Statement I requires the submission of the pipeline's proposed testimony, which will serve as the pipeline's case-in-chief in the event the Commission sets the application for a hearing.¹³⁵

Procedurally, upon filing the application for a market power determination with the Commission, the pipeline must also serve the letter of transmittal on its shippers and subscribers, who may make a written request to the pipeline for a copy of the complete application within 20 days after filing. In the event the pipeline requests privileged treatment, it must include a proposed form of protective agreement with its letter of transmittal, and shippers or subscribers must execute the agreement upon making a request for the full application. Protests may be filed within 60 days after the filing of the application, and are presumably subject to the same standing requirement that applies to protests against new or changed rates.¹³⁶ The Commission will then issue an order in which it will either rule summarily on the application or institute an investigation and establish additional procedures, which may or may not include a formal hearing before an administrative law judge.¹³⁷

Under the new rules on market power determination, the market-based "alternative" is not really an equal alternative to indexing and cost of service. Rather than being a methodology for justifying new or changed rates (like the other two), it is at most a method for obtaining a Commission ruling on the basis of which rates may ultimately be implemented. In addition, the new market power determination procedure requires the pipeline to carry the burden of proving lack of significant market power without the benefit of any discovery, even though proof may turn in part on competitive information to which the pipeline may not have access. On the other hand, the Commission applied much the same restriction to protestants, who also are not entitled to discovery before they file their responsive case. This may herald a salutary intent on the Commission's part to decide market power issues on the basis of the application, the protests and the testimony attached thereto without routinely setting cases for investigation and hearing.¹³⁸ This would be consistent with the practice of the FCC, which routinely rules on competition and market power questions on the

134. Order No. 572, *supra* note 15, at 31,192-93.

135. Order No. 572, *supra* note 15, at 31,193-94.

136. See *supra* note 101.

137. Order No. 572, *supra* note 15, at 31,194.

138. It should be noted, however, that both the pipeline and the protestants are allowed to request discovery immediately after the protestant's case is filed. See Order No. 572, *supra* note 15, at 31,196.

basis of pleadings and attached testimony, without a hearing or a full-blown discovery stage.¹³⁹

In any event, absent a clearer indication of the Commission's intentions in this regard, the new rules require the pipeline to incur the substantial expense of mounting its case-in-chief at the outset, with no assurance that the Commission will rule on the application without setting it for investigation and no basis for believing that the determination will require less than a multi-year proceeding. During the pendency of the market power proceeding, the pipeline is unable to collect rates exceeding the index ceiling unless it resorts to a cost-of-service justification. Moreover, the pipeline's existing rates remain subject to cost-of-service challenges in the interim, in which the pipeline may well be barred from raising lack of significant market power as a defense.¹⁴⁰

4. Negotiated Rates

One of the most innovative aspects of the new rules is the provision permitting oil pipelines to set their rates based on negotiations directly with shippers. This feature of the rules began rather modestly in the NOPR that led to Order No. 561, where it was proposed that initial rates for new service should be set on the basis of negotiations between the pipeline and the proposed shipper.¹⁴¹ In Order No. 561, this provision was expanded to include existing rates as well as new rates, at the same time that pipelines were given the option to set initial rates on a cost-of-service basis as well as a negotiated basis.¹⁴²

The terms of this so-called "Settlement Rate Methodology" are as follows. For existing rates, the pipeline must obtain "unanimous agreement" from all shippers currently utilizing the rate in order to file a new rate that exceeds the index ceiling.¹⁴³ Even then, to prevent what the Commission feared might be an exercise of market power to coerce agreement from

139. For example, under the 1992 Cable Act, which provides an exemption from rate regulation for systems found to face "effective competition," see 47 U.S.C. § 543(a)(2) (Supp. IV 1992), the FCC routinely rules without full-blown discovery or a hearing on the presence or lack of "effective competition" in a cable franchise area. See 47 C.F.R. § 76.900 (1994) (setting forth the Commission's procedures for determining whether the "effective competition" standard is met). However, the Commission's determinations in this respect are aided by the statute, which sets forth numerical benchmarks, largely ascertainable on the basis of public information. Satisfaction of these benchmarks in effect erects an irrebuttable presumption of effective competition. See 47 U.S.C. § 543(f) (Supp. IV 1992). Furthermore, to the extent that the statutory tests require the use of information not readily available to a cable operator (e.g., a competing distributor's reach and number of subscribers), the cable operator may request this information from its competitor, which must respond within 15 days of the request. See 47 C.F.R. § 76.911(b)(2) (1994).

140. To avoid such results, one commenter in the rulemaking sought clarification from the Commission that pipelines could continue to assert lack of significant market power as a defense to a cost-based challenge to an indexed rate. In Order No. 572, however, the Commission rejected this position, holding that cost-of-service proceedings would henceforth be limited to cost issues only. Order No. 572, *supra* note 15, at 31,186.

141. NOPR, *supra* note 74, at 32,750.

142. Order No. 561, *supra* note 13, at 30,960.

143. Order No. 561, *supra* note 13, at 30,959.

shippers, the new rate is subject to challenge by a shipper that can show "reasonable grounds" to believe that the substantial divergence test has been met.¹⁴⁴ For initial rates for new service, the pipeline need not reach agreement with *all* potential shippers (since many may be unknown), but rather must obtain the concurrence of at least one non-affiliated shipper.¹⁴⁵ As with existing rates, the new rate, even though agreed to by a non-affiliated party, is still subject to challenge; moreover, such initial rates bear no presumption of validity.¹⁴⁶

The principal limitation of the negotiated rate provision is the fact that negotiated rates have been given only a very limited presumption of lawfulness (or in the case of initial rates no such presumption). Without some assurance that negotiated rates will be protected against cost-based challenges, pipelines may lack the incentive to pursue such arrangements, even though they could be highly beneficial to shippers. For example, a shipper could attain a greater measure of future rate certainty than exists under the existing regulatory structure by agreeing to an immediate rate increase in exchange for a moratorium or limitation on future increases over a defined period. This may be an area the Commission will want to revisit after an initial period of experience with the new rules.

5. Overall Assessment of the New Rules

While the newly promulgated oil pipeline ratemaking rules promise to bring substantial changes to the procedures and standards under which oil pipelines have been regulated for at least the last ten years, in many respects the new rules represent more of a reversion to the past than a bold new step into the future.

First, indexing itself is not a particularly radical step, despite the strenuous opposition it evoked both from some commenters and within the Commission itself.¹⁴⁷ As the Commission majority noted, the principal effect of indexing, if it works properly, is simply to preserve the value of existing rates in real (i.e. inflation-adjusted) terms.¹⁴⁸ Moreover, the concept of adjusting rates for general inflation rather than specific cost increases of particular companies goes back at least to the *Permian Basin Area Rate Cases*,¹⁴⁹ and has been upheld repeatedly since then.¹⁵⁰ Not sur-

144. Order No. 561, *supra* note 13, at 30,959.

145. Order No. 561, *supra* note 13, at 30,960.

146. Order No. 561, *supra* note 13, at 30,960-61. Significantly, the Commission has indicated that shippers can agree to rate escalator clauses that exceed or otherwise differ from the PPI-1% index, so long as the agreement is unanimous. Order No. 561, *supra* note 13, at 30,961.

147. See, e.g., Order No. 561, *supra* note 13, at 30,977-4 (Commissioner Massey, dissenting).

148. Order No. 561, *supra* note 13, at 30,950.

149. 390 U.S. 747 (1968).

150. See *Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos.*, 498 U.S. 211 (1991) (approving application of inflation index to "old" gas prices under "just and reasonable" standard); *National Rural Telecomm. Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993) (upholding FCC "price cap" regulation involving general inflation index).

prisingly, therefore, no party in the judicial review proceedings regarding the new rules has directly argued that indexing itself is unlawful.¹⁵¹

Similarly, with respect to the market-based rate alternative, the Commission seems to have stopped well short of exercising the full extent of its authority to simplify and streamline the market power determination. The general permissibility of market-based rates is by now well established.¹⁵² Moreover, there is ample evidence available that the oil pipeline industry is substantially, if not pervasively, competitive.¹⁵³ The Commission balked, however, at exercising its authority to establish substantive guidelines through rulemaking rather than case-by-case adjudication. In this regard, the FERC is lagging well behind other agencies such as the FCC in seeking to achieve the goal of reducing unnecessary regulatory constraints in clearly competitive markets.¹⁵⁴

In any event, because of the form of indexing methodology the Commission has adopted, and in particular the choice of an index that is currently failing to keep pace with general inflation in the economy, the Commission's hope that indexing may alleviate the burdens of past cost-of-service litigation—that it may finally “slay the Minotaur”—seems unlikely to be realized. The index contributes to this problem simply because, at current rates of inflation, the PPI-1% index has been virtually flat for several years and currently shows no signs of increasing sharply in the near future. Thus, pipelines that encounter any substantial increases in overall costs, or declines in anticipated throughput, are likely to be driven to pursue the cost-of-service alternative to prevent incurring significant losses due to indexing. At the same time, the Commission's apparent receptiveness to cost-based challenges to existing rates suggests that, while such challenges may face more substantial threshold hurdles than in the past, they are nonetheless likely to continue even under the new regime. Indeed, such challenges may even be encouraged by the Commission's new requirements for disclosure of cost-of-service information in the Form No. 6 Annual Report.

In short, given that indexing at present imposes a virtually flat ceiling on rates, and given the apparent downgrading of the *Buckeye* market-based rate alternative, litigation under Opinion No. 154-B may be on the verge of a substantial comeback. Such a result would, of course, be deeply ironic, since it was largely the perceived shortcomings of cost-of-service rate litigation that sparked passage of the oil pipeline provisions of the EPIA and thus led directly to the promulgation of these new rules. How-

151. See sources cited *supra* note 88.

152. See, e.g., *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir. 1993) (upholding market-based rates where Commission found competition adequate to constrain pipeline charges within “just and reasonable” levels).

153. For example, the Department of Justice concluded in 1986 that all but eleven pipeline systems in the United States (and all of the purely crude oil carriers) could safely be deregulated altogether. See DEPARTMENT OF JUSTICE, OIL PIPELINE DEREGULATION (May 1986).

154. Order No. 572 does recognize, however, that there are many efficiencies to be gained from reducing regulation in competitive markets, entirely apart from the effects on the regulated company. Order No. 572, *supra* note 15, at 31,180.

ever, the likelihood at present is that Opinion No. 154-B will once again become the dominant oil pipeline methodology unless the Commission applies its new rules in a way that averts that outcome.

IV. CONCLUSION

The FERC's recent oil pipeline rules open a new chapter in the history of oil pipeline rate regulation. It remains to be seen, however, whether these rules constitute a pathway to the future or merely another wrong turn in the labyrinth. Assuming the new rules survive judicial review, much may depend on how the FERC chooses to apply them, particularly in those areas where the agency has retained considerable discretion. In exercising that discretion, the FERC will need to monitor the new rules closely to ensure that the problems that created the need for a new regulatory regime do not simply recur in other guises.