

OIL PIPELINE REGULATION AFTER *WILLIAMS*: DOES THE END JUSTIFY THE MEANS?

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I. INTRODUCTION

This article analyzes the Federal Energy Regulatory Commission's decision in *Williams Pipe Line Company*,¹ which is a recent, important development in oil pipeline rate regulation. At first blush, the decision in *Williams* may appear to be nothing more than resolution of basic oil pipeline ratemaking principles. Some might add that the decision is important as an example of an evolving FERC methodology for litigating and resolving important rate cases — omission of the initial decision, establishment of a lead-case, substantial reliance on treatises, and dearth of any express reliance upon the record. Finally, others may call attention to the similarity of this decision to other cases insofar as the FERC treats contested matters as raising policy and not factual issues.

It is best to view the *Williams* decision as a statement of regulatory policy, not just as a rate case.² When viewed from this perspective, the broader implications of the decision become apparent. First, *Williams* represents more than just the establishment of the framework for regulating oil pipelines. It is a decision that expresses the basic regulatory theories and concepts that guide this Commission when it considers proposals for not adhering to strict regulatory practices. In addition, *Williams* may well stand as the high-water mark of the Commission's exercise of its power to define and decide issues in terms of "policy, political science, and prudence."³

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¹*Williams Pipe Line Company*, Opinion No. 154, Docket No. OR79-1-000, *et al.*, 21 FERC ¶ 61,260, pp. 61,568-731. (November 30, 1982). Petitions for review were filed with the United States Court of Appeals for the Tenth Circuit. *Association of Oil Pipe Lines v. USA*, Docket Nos. 82-2459, *et al.* By order issued January 21, 1983, these cases were transferred to the pending D.C. Circuit proceedings in *Farmers Union Central Exchange, Inc. v. FERC*, No. 82-2412.

²In many respects, it is difficult to separate the findings in *Williams* from material that may be pure *dicta*. Of course, as attempts are made to apply language of the decision to matters other than the reasonableness of the rates on the *Williams Pipe Line*, the lines of demarcation will be drawn between what the case means and what it simply mentions in passing. In the meantime, the decision leaves parties with this tantalizing thought:

The nice distinctions in which law students are drilled and that they draw when they come to practice at the bar between dictum and holding and between that which is necessary to dispose of the precise question presented for decision and that which could have been left unsaid without necessarily altering the result have an important place in the legal order. But those distinctions can be pushed too far.

Williams at 61,678, n. 155.

³*Williams* at 61,587.

II. THE DECISION

A. Background

Before analyzing *Williams*, the historical background of oil pipeline regulation must be addressed briefly.⁴ Suffice to say that the mechanics, as opposed to policy or theoretical bases, of oil pipeline regulation under the Interstate Commerce Act⁵ have differed from electric utility and natural gas pipeline regulation. This difference centers primarily on the rate base computation employed in the ICC formula for determining or testing oil pipeline rates. Stated simply, the ICC permitted the oil pipeline rate base to be computed using a "valuation formula" which is anchored on the concept of "fair value".⁶ That is, rate base was determined not simply on the basis of depreciated original cost, which has historically been used for natural gas pipelines regulated under the Natural Gas Act.⁷ Instead, the valuation formula includes such factors as reproduction costs, present value of property, going concern value, and other variables which are anathema to modern public utility purists. However, the use of the valuation formula together with the establishment by the ICC of generic rates of return of 8% for crude oil transportation⁸ and 10% for oil products transmission⁹ proved to be a stable, albeit light-handed, form of regulation that existed without serious objection for over 30 years until the *Williams Brothers Pipe Line Company* rate decision in 1975.

The long period of uncontested rate regulation of oil pipelines from the 1940's into the 1970's can also be attributed in large part to a 1941 Consent Decree which, until just recently, acted as a ceiling on the rates charged by most oil pipelines.¹⁰ The Consent Decree resulted from actions brought by the Antitrust Division of the Department of Justice claiming that certain dividends paid by pipelines to their vertically integrated parent owners constituted a violation of the Elkins Act.¹¹ The resulting Consent Decree prohibited pipelines from paying dividends of more than 7% of the ICC determined valuation rate base. This effectively established a limit on the rate of return which pipelines could earn since most oil pipelines were and are owned entirely by oil companies subject to the Consent Decree.

The 7% limit differs from the ICC established 8% and 10% rates of return in that it allows interest charges to be included in the rates over and above the return on the valuation rate base. The ICC return levels include debt cost as part of the total return. In any event, this dual formula form of rate regulation (the ICC valuation formula for oil pipeline ratemaking with the Consent Decree formula operating as a ceiling on return) operated satisfactorily and went uncontested until the *Williams* case.

⁴For a discussion of the history of oil pipeline rate litigation see L. Coburn, *The Case for Petroleum Pipeline Deregulation*, 3 *Energy L.J.* 225, 231-35 (1982).

⁵49 U.S.C. §§ 1 *et seq.* (1976).

⁶L. Coburn *supra* note 4, pp. 295-302.

⁷15 U.S.C. §§ 717 *et seq.* (1976e Supp. V 1981).

⁸See *Reduced Pipeline Rates and Gathering Charges*, 243 I.C.C. 115 (1940) and *Minnelusa Oil Corporation v. Continental Pipe Line Company, et. al.*, 258 I.C.C. 41 (1944).

⁹*Petroleum Rail Shippers' Association v. Alton & Southern Railroad, et. al.*, 243 I.C.C. 589 (1941).

¹⁰*United States v. Atlantic Refining Co.*, C.A. No. 14060 (D.D.C. 1941); The Consent Decree was essentially dissolved on December 13, 1982, by the issuance of an Order Modifying Final Judgment following the submission of Stipulations among the parties, including the Department of Justice.

¹¹49 U.S.C. § 1 (1976).

B. Procedural History

The *Williams* decision is the latest chapter in the history of litigation before the Interstate Commerce Commission, and now the FERC¹² regarding the principles that should govern the review of the justness and reasonableness of oil pipeline rates. The instant case began in 1971, when the predecessor of Williams Pipe Line Company, Williams Brothers Pipe Line Company, filed tariff sheets seeking authority to increase certain local rates and initiate joint rates. Protests were filed by certain oil producers and refiners located primarily in the Great Plains area which historically have used the Williams system to transport petroleum products. Following hearings, an Administrative Law Judge of the ICC concluded that the rates were just and reasonable. The initial decision was affirmed by the ICC, which upheld the use of the “valuation” rate base and a 10 percent overall rate of return as supported by “consistency and fairness.”¹³

The protesting shippers filed a petition for review in the United States Court of Appeals for the District of Columbia Circuit. Following the transfer of jurisdiction over the rates in question from the ICC, the FERC requested that the Court defer adjudication on the merits and remand the case so that it could establish appropriate regulatory principles. The Court in *Farmers Union*¹⁴ granted that request and, in addition, commented on a number of objections that had been raised to the ICC’s regulatory approach and ratemaking practices. *Farmers Union* characterized the justification for the ICC valuation rate base as “weak and outmoded,” and cited with approval Mr. Justice Brandeis’ characterization of fair value rate bases as “viciously circular.”¹⁵ However, *Farmers Union* did not go so far as to hold that the FERC must apply to oil pipelines the full panoply of regulatory precedent developed under the Federal Power Act and the Natural Gas Act. In fact, the Court stated:

we may infer a congressional intent to allow a freer play of competitive forces among oil pipeline companies . . . and . . . we should be especially loath uncritically to import public utilities notions into this area without taking note of the degree of regulation and of the nature of the regulated business.¹⁶

The Court instructed the FERC to “build a viable modern precedent for use in future rate cases that not only reaches the right result, but does so by way of ratemaking criteria free of the problems that appear to exist in the ICC’s approach.”¹⁷

Following issuance of *Farmers*, the FERC issued an order consolidating the pending *Williams* rate cases and setting them for evidentiary hearing.¹⁸ The Presiding Administrative Law Judge issued an order that bifurcated the proceedings. Phase I was to deal with “ratemaking principles which must be

¹²Jurisdiction over oil pipeline rates and practices was transferred to the FERC in 1977. Department of Energy Organization Act §§ 402(b), 306; 42 U.S.C. §§ 7172(b); 7155 (Supp. V. 1981).

¹³Petroleum Products, Williams Brothers Pipe Line Co., 35 ICC 479, 484 (1976).

¹⁴*Farmers Union Central Exchange v. FERC*, 584 R.2d 408, 410 (D.C. Cir. 1978), *cert. den. sub nom. Williams Pipe Line Company v. FERC*, 439 U.S. 995 (1978).

¹⁵*Id.* at 418 and n. 27, *citing* *Southwestern Bell Tel. Co. v. Missouri Public Service Comm’n*, 262 U.S. 276, 289-312 (1923) (Brandeis, J. concurring). The court also criticized the ICC’s application of its rate of return standards, stating that the ICC had failed to pay even the most “exiguous attention to *Hope* or the actual cost of equity capital to Williams.” *Id.* at 418 n. 27, *citing* *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

¹⁶*Id.* at 413, *citing* J. Bonbright, *Principles of Public Utility Rates* 4-5 (1961).

¹⁷*Id.* at 421.

¹⁸*Williams Pipe Line Company*, Docket Nos. OR79-1, *et al.*, slip op. at 3, issued February 23, 1979.

developed in light of the *Farmers Union* decision." Phase II would encompass the application of those principles to the Williams' rates at issue.¹⁹ The parties were invited to file initial and reply comments, and cross-examine the authors thereof, on the following basic issues: general regulatory approach; rate base; acquisition adjustment; working capital; treatment of debt guarantees; system-wide or point-to-point regulation; capital structure; taxes; depreciation; transactions with affiliates; test period; throughput variations; and transitional approaches.²⁰

After conclusion of extensive evidentiary proceedings (56 witnesses, 76 hearing days) on December 27, 1979, the FERC issued an order omitting the initial decision and instructing the parties to submit initial and reply briefs directly to the Commission.²¹ Following submission of reply briefs, the FERC ordered oral argument to be held on June 30, 1980 to discuss "the general principles that should guide the Commission in its oil pipeline ratemaking work and on the inferences that ought to be drawn from the record" in *Williams*.²² As a result of changes in Commission membership following oral argument, the FERC requested that reargument be held on November 19, 1981.²³

Following the second round of argument, the shippers filed a complaint and petition for *writ of mandamus* with the United States District Court for the District of Columbia, claiming that the delay in resolving the *Williams* proceeding was unreasonable and violative of the Interstate Commerce Act and the Administrative Procedure Act (APA).²⁴ The District Court granted the writ in part, and ordered the FERC to issue its decision within 60 days.²⁵ As a result of a stay issued by the D.C. Circuit, the FERC was required to issue its decision on the merits by the end of November, 1982.

¹⁹Invitation to Submit Comments on Ratemaking Principles for Oil Pipeline Rate Cases, slip op. at 1, issued April 11, 1980.

²⁰*Id.* at 2-3.

²¹Association of Oil Pipelines, Docket No. OR79-5, *et al.*, Order Staying Procedures and Terminating a Rulemaking Inquiry, 10 FERC ¶ 61,023, p. 61,034 (January 9, 1980).

²²*Williams, supra*, Order Scheduling a Consolidated Oral Argument and Prescribing Procedures Therefor, slip op. at 1, issued May 9, 1980. The issues specified for argument were (*id.* at 2-3):

- (i) What useful social function can oil pipeline regulation serve in today's world?
- (ii) What goals should the Commission set for itself in this field?
- (iii) What regulatory methodology is best suited to the attainment of those goals?
- (iv) Whom does oil pipeline rate regulation protect? From what?
- (v) Suppose that oil pipeline rates were much lower than they now are. Would the ultimate consumer of gasoline and fuel oil benefit? If he did benefit, would the benefit be substantial?
- (vi) Conversely, suppose the oil pipeline rates were much higher now are. Would the increase necessarily be passed along to the consumer? If it were passed through, would the impact on end product prices be substantial?
- (vii) Assume that vigorous regulatory action were taken to lower oil pipeline rate levels. What impact would that have on the Nation's energy security?
- (viii) Conversely, assume that oil pipeline rates were almost wholly unconstrained and that they were determined in the main by the carriers' assessment of their own self-interest. What effect would this have on the Nation's energy security?

²³*Williams, supra*, Order Directing Reargument Before the Commission and Prescribing Procedures Therefor, 17 FERC ¶ 61,021, (October 2, 1981).

²⁴5 U.S.C. § 551 *et seq.* (1976 & Supp. V. 1981).

²⁵*Farmers Union Central Exchange v. FERC*, Civ. No. 82-2065, Order issued August 23, 1982; supplemented with Findings of Fact and Conclusions of Law on September 14, 1982. The Court concluded that the failure to issue any decision in the four years that the proceeding had been pending before the FERC "is an abrogation of its statutory responsibility" under the Interstate Commerce Act and a violation of the APA. *Id.*, slip. op. at 3-4.

B. *The Decision*

Summarized below are the major holdings of the *Williams* decision.²⁶ A more extensive discussion of the Commission's rationale will be presented in the several sections *infra*.²⁷

A significant portion of the FERC's decision in *Williams* pertains to the question of whether the oil pipeline industry should be regulated based on ratemaking practices developed in natural gas pipeline and electric rate cases.²⁸ The FERC looked to two key factors to resolve this issue. First, it compared the legislative purpose of the Federal Power Act²⁹ and Natural Gas Act ("consumer protection") with that of the Hepburn Act ("producer protection").³⁰ Second, the FERC discussed a number of market-oriented distinctions between oil pipelines and electric utilities, natural gas pipelines, and natural gas producers. These matters include the assumption of a greater level of competition deemed to exist in the oil pipeline industry, the perceived absence of any mechanism for flowing through to ultimate consumers the benefit of lower oil pipeline rates, and the relative size of the transportation charge to the total price paid for oil and refined products.³¹ Based on an analysis of these points, the FERC found no justification to exist for applying "utility-type regulation" to oil pipelines.

Having drawn distinctions between oil pipelines and other FERC-regulated entities, the Commission decided not to apply to oil pipelines an original cost-less depreciation rate base methodology (which is the rate base method historically applied to natural gas pipelines and electric utilities under the Natural Gas Act and Federal Power Act, respectively). It also rejected suggestions that it adopt rate base methodologies that are more "inflation-sensitive" than the ICC valuation rate base method. Instead, the Commission found no reason to depart from the *status quo*, the so-called "Oak method," with its weighting of original cost, reproduction cost, and other variables.³²

The Commission in *Williams* addressed other rate matters. It required oil pipelines to justify the validity of payments to affiliates, and conditioned the granting of acquisition adjustments on a showing of "substantial benefits" to ratepayers. The FERC rejected the ICC's rate of return standards, and proposed a three-part methodology for determining rate of return in contested cases.³³ It also affirmed use of tax normalization with rate base deduction of deferred taxes,

²⁶The decision is distinctive by its sheer length, consisting of 391 pages, 581 footnotes, plus an appendix. In addition, there were no less than 39 pages of concurring and dissenting statements by three of the five members of the Commission.

²⁷In addition, a succinct summary of the *Williams* decision is included with the report of the Committee on Oil Pipeline Regulation, Federal Energy Bar Association, which has been reprinted in this Volume of the *Energy Law Journal*.

²⁸For a description of the key differences in FERC and ICC ratemaking practices regarding pipeline rate cases, see P. Navarro and T. Stauffer, *The Legal History and Economic Implications of Oil Pipeline Regulation*, 2 *Energy L.J.* 291, 295-303 (1981).

²⁹16 U.S.C. §§ 824 *et seq.* (1976 & Supp. V. 1981).

³⁰*Williams* at 61, 584. The Hepburn Act of 1906 granted the ICC authority to determine the justness and reasonableness of oil pipeline rates, to prevent discrimination and rebates, and to review access questions. See 34 Stat. 584 (codified at 49 U.S.C. § 1, 6, 11, 14, 15, 16, 16a, 18, 20, 41) (1976).

³¹*Id.* at 61,649, 61,593, 61,585.

³²*Id.* at 61,630. It did, however, make minor changes to the ICC valuation formula, but left for further consideration matters pertaining to working capital and depreciation. *Williams* at 61,704-05, n.386. The "Oak method" derives its name from the witness who described the ICC valuation method in an evidentiary record for the first time. See testimony of Jesse C. Oak in FERC Docket No. OR78-2 (March 25, 1977).

³³*Id.* at 61,636-52.

rejected rate base deduction of investment tax credits, and deemed "out of place" issues regarding test periods and throughput variations.³⁴ Finally, the Commission adopted a policy of favoring system-wide regulation over use of cost allocation techniques to derive rates for point-to-point transportation.³⁵ Concurring and dissenting statements were filed by Commissioners Sheldon, Richard, and Hughes. Commissioner Sheldon questioned the proposed rate of return methodology, and proposed establishment of generic rates of return.³⁶ Commissioner Hughes also objected to the rate of return approach, and suggested that an inflation-adjusted original cost method should be adopted in lieu of the ICC rate base method.³⁷

C. *The Aftermath*

Following issuance of the decision, petitions for review were lodged with the D.C. Circuit and Tenth Circuit.³⁸ The shippers filed a petition for rehearing with the Commission. The petition claimed the following errors: (1) erroneous interpretation of intent of and standards under the Interstate Commerce Act; (2) no adequate rationale for retaining the ICC valuation rate base method; (3) establishment of improper rate of return methodology; and (4) failure to adopt cost allocation rules.³⁹ The FERC denied rehearing on the grounds that parties "would benefit from an expeditious judicial resolution" of *Williams* rather than from administrative rehearing.⁴⁰

Following issuance of the *Williams* decision, the FERC also made clear that other oil pipeline proceedings would be affected by that decision. First, the FERC remanded the first phase of the *Trans-Alaska Pipeline System* (TAPS) case, Docket No. OR78-1, for further hearings. Specifically, it asked the parties to consider whether certain essential facts underlying the *Williams* decision — competition, materiality of oil pipeline rates to ultimate consumers, effect on independent producers — apply to TAPS. It also requested development of a record to determine whether the *Williams* methodology is appropriate to TAPS.⁴¹

In addition, FERC issued an order applying the *Williams* decision to pending oil pipeline rate cases. Specifically, it terminated over 500 dockets involving pipeline rate filings that had not been the subject of protests.⁴² Commissioner Hughes dissented, arguing that it was premature to apply the substantive and

³⁴*Id.* at 61,653-59. Note, however, that it gave pipelines the option of choosing between normalization or flow-through.

³⁵*Id.* at 61,650-51. By comparison, transportation arrangements under the Natural Gas Act are usually approved on the basis of setting rates for service based on the fully-allocated costs of the transaction.

³⁶*Id.*, Sheldon, C., concurring at 61,718-19.

³⁷*Id.*, Hughes, C., dissenting and concurring at 61,724-30.

³⁸*See* n.1.; all review petitions are now before the D.C. Circuit.

³⁹Petition for Rehearing, mimeo at 1-7, filed December 30, 1982.

⁴⁰*Williams* Pipe Line Company, Opinion No. 154-A, Docket No. OR79-1-016, slip op. at 2, issued January 31, 1983.

⁴¹TAPS, Docket Nos. OR78-1-014, *et al.*, Remand Order, 21 FERC ¶ 61,092 (November 30, 1982).

⁴²*American Petrofina Pipe Line Company, et al.*, Docket Nos. IS80-14-000, *et al.*, Order Terminating Investigations and Denying Petitions for Rehearing, slip op. at 2, issued December 21, 1982. The Department of Justice sought and was granted rehearing of the dismissal of one case involving Phillips Pipe Line Company. Phillips Pipe Line Company, Docket Nos. IS78-1, *et al.*, Order Granting Rehearing and Granting Rehearing for the Purpose of Further Consideration, slip op. at 2, issued February 16, 1983.

procedural mandates of the *Williams* decision to pending oil pipeline rate cases, especially since “it is less than a certainty that the *Williams* order will survive judicial review.”⁴³

III. IMPLICATION FOR OIL PIPELINES: CLEAR AND MURKY WATERS

A. Basic Regulatory Approach

The fundamental regulatory policy issue before the FERC was whether the “just and reasonable” standard embodied in the Hepburn Act reflected the same policy goals (and hence required the same regulatory approach) as the Federal Power Act and Natural Gas Act. The Commission found the policy goals underlying oil pipeline regulation to be vastly different from those supporting regulation of electric utility or natural gas pipeline counterparts. The FERC found from its reading of the legislative history of the Hepburn Act that there was “no intent to limit these carriers’ rates to barebones cost. What we perceive is an effort to restrain gross overreaching and unconscionable gouging.”⁴⁴ From this reading, an essential theme emerges: the “primary end of the regulatory scheme is not consumer protection [as is the case for electric and natural gas regulation]. It is equity among entrepreneurs.”⁴⁵

To achieve equity, the Commission in *Williams* adopted a “light-handed” method of regulation designed to reflect two key considerations. Regulatory intervention “should be resorted to only in cases of egregious exploitation and gross abuse.” Otherwise, the FERC would “meddle unduly” with the “market process.”⁴⁶ Second, the FERC must not set unduly low rates of return, because “the social need in this field is for returns high enough to induce the construction of new pipelines and to avert the premature abandonment of old ones.”⁴⁷ In short, the regulatory rule of thumb adopted is “to err on the side of liberality” because “the dangers of giving too little vastly outweigh those of giving too much.”⁴⁸

How will the FERC ensure that these two regulatory concepts will be honored? The answer is to limit the grounds for suspending filings and to restrict the role of the FERC Staff.⁴⁹ The key question is whether this regulatory and procedural approach will pass judicial muster. The answer is far from certain. In defense of its “light-handed” approach to regulation of the oil pipeline industry, *Williams* presents strong arguments for a flexible approach that must be countered if opponents are to prevail in obtaining utility-type regulation. However, this uncertainty must be recognized as attention shifts from the primary issues of *Williams* to the specific resolution of individual rate cases.

B. Ratemaking Practices

Williams does not resolve all ratemaking issues for oil pipelines. As discussed *infra*, the FERC has left the field open for reexamination of the rate base issue on

⁴³*Id.*, Hughes, C. dissenting at 1.

⁴⁴*Williams* at 61,597.

⁴⁵*Id.* at 61,650.

⁴⁶*Id.* at 61,649. The “market process” refers to the interplay of competition. This issue is discussed in Section IV, *infra*.

⁴⁷*Id.* at 61,645.

⁴⁸*Id.* at 61,613.

⁴⁹*Id.* at 61,612.

occurrence of certain conditions. Rate of return is resolved on a broad level, but the specific features of that rate remain to be examined in future proceedings. Likewise, depreciation and working capital issues are left open for further comment and review. The nature of these open issues and the possible range of alternative results are as follows.⁵⁰

1. *Rate Base.* The decision to retain the fundamentals of an ICC valuation rate base was made with some reluctance: “[w]ere we writing on an absolutely clean slate . . . we would fashion an inflation-sensitive, anti-bunching rate base policy simpler and more logical than the ICC’s.”⁵¹ The FERC did not invite reexamination of its rate base choice, but did use language that could lead to requests for reconsideration in the future. Any of three general statements might be relied on: (1) if a case involves “matters of vital import to the consumer; (2) “[s]hould inflation be conquered at last;” or (3) if “Congress addresses itself to the oil pipeline scene as a whole and supplies us with a better guide to its regulatory treatment”⁵²

What different rate base method might be adopted in a future case? Significantly, the FERC is far from enamored with the notion of applying original cost regulation to oil pipelines.⁵³ The reluctance has “more to do with rate of return than with original cost as such.” First, the FERC expressed uncertainty as to how an equity ratio could be established, given that oil pipelines appear to be financed on a “virtually all-debt basis.” Strong skepticism was also expressed to using hypothetical capital structures, especially when the purpose is to impute equity, rather than less costly debt.⁵⁴ Second, the FERC was dubious that risk could be fairly evaluated, given that investors look to parent debt guarantees. Finally, the FERC believed that original cost based rates could result in an inadequate incentive to build new pipelines or continue operating old ones, especially if those rates are higher than under the ICC method.⁵⁵

What is the likely alternative? The FERC discussed its preferred choice:

In this very special industry an inflation-sensitive rate base would probably be far better. That is so because original cost regulation rests on an implicit assumption that the regulated entity has a realistic chance under prudent and competent management of actually earning the returns that the regulators are willing to allow. When multiple factors preclude the company from earning that kind of money, the whole approach runs into sand.⁵⁶

⁵⁰Other issues were examined in some detail. The FERC rejected (1) rate recovery of past losses, *Id.* at 61,629 and 61,702, n. 364; (2) use of consolidated taxes, *Id.* at 61,652-53; and (3) rate base deduction of investment tax credits, 61,657-58. It allowed pipelines to choose between normalization or flow-through, *Id.*, but required rate base deduction, *Id.* at 61,653-57. The FERC provided for acquisition adjustments, *Id.* at 61,633-36, and passthrough of payments to affiliates, *Id.* at 61,651-52, assuming certain tests were met.

⁵¹*Id.* at 61,630, n. omitted.

⁵²*Id.* at 61,616, 61,703 n. 371, 61,632.

⁵³As a general proposition, the FERC is not enthusiastic about applying original-cost based regulation in today's economic environment: “[i]n an age of inflation [the original cost method] looks unreal.” *Id.* at 61,618. However, the FERC did not go so far as to find the original cost method to be so defective as to warrant across-the-board change to an inflation-sensitive rate base:

Were we to agree with the industry's contentions about the inherent deficiencies of the original cost method, we should have to concede that our treatment of investors under the Power and Gas Acts is fundamentally and inherently unfair. We are not inclined to make that concession.

Id. at 61,697, n. 317. Does this mean that the FERC has closed the door on examination of electric and natural gas rate base methods? As the market for natural gas customers becomes more uncertain, “innovative regulatory responses to changes in the economics of gas transmission may be in order.” *Id.* at 61,703, n. 370.

⁵⁴*Id.* at 61,620-21 and 61,698 n. 329.

⁵⁵*Id.* at 61,622 and 61,625.

⁵⁶*Id.* at 61,630.

What would that inflation sensitive rate base be like? Its basic feature would be that the rate base is adjusted by the CPI or GNP deflator, and that a real, inflation-free rate of return would be applied to the equity portion of rate base.

During the course of the *Williams* proceeding, oil pipelines argued that any change from the ICC rate base method would raise complex transition questions for an industry which has historically operated under predictable, if light-handed, regulation. *Williams* provides some indication that if a change in methodology does occur, the FERC might carry forward for some pipelines the rate base amount last produced under the ICC valuation method. That result would not be premised on any theory of a regulatory guarantee. The FERC stated that “[p]ipeline owners have no vested right to the perpetuation of a particular methodology.”⁵⁷ This does not mean that the ICC rate base would have no significance in the transition process for some pipelines. The FERC stated “we think it clear that the regulatory methodology was a substantial factor in many oil pipeline investment decisions.”⁵⁸ How might this transition dilemma ultimately be resolved? The FERC may take the path of least calculation — carryforward of the last valuation. Such course would avoid the “formidable,” “difficult,” and “costly” endeavors that might otherwise occur in the development of transitional rate bases.⁵⁹

2. *Rate of Return.* The real area of innovation in *Williams*, as well as the likely subject of continued controversy, pertains to the establishment of the proper rate of return that is to be applied to the total rate base. How does *Williams* require the rate of return to be calculated? It is to consist of: (1) an amount sufficient to cover debt service; (2) “a fully compensatory suretyship premium” to be applied to recognize the perceived cost of any parent company guarantee that was “material to the lenders,” and (3) a “‘real’ entrepreneurial rate of return” to be applied to the equity portion of rate base.⁶⁰

Although challenges are certain to be raised to any attempt to quantify a “suretyship premium,” the major focus of attention is likely to be on the “real entrepreneurial rate of return.” Two features of the entrepreneurial rate warrant comment. Oil pipelines have broad discretion to choose among a number of “yardsticks” to establish the nominal rate of return “most favorable” to the pipeline.⁶¹ Once this nominal rate is established, the pipeline is to subtract therefrom “the inflation allowance that the valuation rate base formula gave the specific pipeline . . . during the particular period in question.”⁶²

A concern raised by Commissioner Sheldon is whether this approach allows for unreasonably high rates.⁶³ The answer to that issue will not be known until the record is developed in a specific oil pipeline case. Likewise, it is still too early to tell

⁵⁷*Id.* at 61,625.

⁵⁸*Id.* at 61,702, n. 353.

⁵⁹*Id.* at 61,704, n. 376.

⁶⁰*Id.* at 61,644.

⁶¹*Id.* at 61,645. The “yardsticks” include (1) realized nominal returns on book equity in the oil industry over (a) the past 5 years or (b) the past year; (2) realized nominal returns on book equity in American industry over (a) past 5 years or (b) most recent year; (3) parent’s realized nominal return on book, non-pipeline equity over (a) past 5 years or (b) most recent fiscal year; or (4) total dividend and capital gain returns on “a diversified common stock portfolio” over (a) past 5 years or (b) the “long run,” which can range upwards from 25 years.

⁶²*Id.* at 61,646.

⁶³*Id.*, Sheldon, C., concurring at 61,718. Commissioner Sheldon did not, however, disagree with the Commission’s findings that oil pipelines should be afforded higher rates of return than electric utilities because “integrated oil companies and profit-maximizing conglomerates . . . need some assurance that they have a fair chance of earning as much on a pipeline as they would be likely to earn on something else in the unregulated sector.” *Id.* at 61,623, n. 1 omitted.

whether the subtraction required to produce the nominal rate may result in an "over-or-under compensa[ti]on [of] equity investors," as argued by Commissioner Hughes.⁶⁴ The first chance to test these criticisms, and to develop a record on alternatives, may well be the ongoing *Williams* or *TAPS* remand proceedings.

3. *Depreciation, working capital.* Phase II of the *Williams* proceeding will be the likely forum for resolution of two other rate issues. The FERC expressed concern over the apparent mismatch between straight line depreciation (which is used to calculate the depreciation expense component of the cost of service), and the "condition percent" (which is used in the calculation of the valuation rate base). Likewise, parties will have the opportunity in *Williams*, or in some other proceeding, to address the question of what level of rate base should be maintained once a pipeline is fully depreciated on the books. Also, the remand proceedings will allow for further discussion of the proper method to compute cash working capital.

C. Implications for TAPS

In a companion order to *Williams*, the Commission remanded the record in Phase I of the *TAPS* proceeding for a limited hearing on the question of whether the conclusions drawn in the former proceeding are applicable to the latter case.⁶⁵ Application of *Williams* to *TAPS* depends on (1) the extent of competitive forces on *TAPS*, (2) the degree to which ultimate consumers see any benefit from rate reductions, and (3) the effect of the rates on independent producers. Based solely on a reading of *Williams*, it appears that the FERC may be skeptical on these issues. For example, it states that if "[f]or all practical purposes, the shippers are the owners and the owners are the shippers," it may be necessary to apply "controls as stringent as those that the governing statute permits us to impose."⁶⁶

This apparent skepticism may warrant a cautionary conclusion. Assuming that *TAPS* rates are constrained by competitive forces, a *de minimis* impact of transportation rates on ultimate consumers, and minimal effect on independent producers, there still is no guarantee that the FERC will then adopt the full range of ratemaking practices adopted in *Williams*. By the same token, it might well happen that the record in the *TAPS* case will give rise to adoption of certain concepts that produced the "light-handed" regulatory approach reflected in *Williams*.

D. Preliminary Considerations

At best, the *Williams* decision gives affected interests a regulatory framework in which to consider the resolution of just and reasonable rate levels. The decision, however, leaves certain basic questions open regarding the proper rate levels to be charged.

As a result, attention may shift to a legislative resolution of the oil pipeline rate quandry. Indeed, the FERC invites Congress to "take a fresh and a hard look at oil pipeline rate regulation," adding that until such examination is made, "oil pipeline rate law will remain a quagmire for this agency and for reviewing courts."⁶⁷ The

⁶⁴*Williams*, Hughes, C., dissenting and concurring at 61,725.

⁶⁵See n. 41, *supra*.

⁶⁶*Id.* at 61,600.

⁶⁷*Id.* at 61,586. For a general discussion of legislative efforts, see L. Coburn, *supra*.

decision may well stand as the cornerstone of any effort to deregulate pipelines on the theory that the competitive market is a real substitute for regulation.⁶⁸ *Williams* also could become a focal point of concern over allegations of excessive rates, leading to calls for stricter regulation. The only conclusion at this point is that until the FERC's new approach is given a chance to work, Congress may be reluctant to do anything in the field of oil pipeline rate regulation.

IV. SIGNIFICANCE OF *WILLIAMS* TO FERC PRACTICE

A. *Regulatory Procedures*

What does *Williams* mean in terms of procedural approaches that might carry over to other areas of FERC regulation? Certain procedural aspects of the *Williams* decision — use of lead case approach, omission of initial decision, treatment of record — have been seen before in electric and natural gas cases, while other matters — limited role of Staff, suspension guidelines — are somewhat unusual. *Williams* may well turn out to be the “test-case” that determines whether these approaches should be followed in other FERC proceedings.

It is not unusual for an individual rate case such as *Williams* to be turned into the “lead-case” for establishment of basic regulatory policies.⁶⁹ Yet, there are problems that arise when that approach is taken. As Commissioner Hughes explains in *Williams*, care must be taken to ensure that the lead case involves a representative pipeline:

The ‘lead case’ designation made this a more difficult decision by forcing consideration of a number of questions not present with respect to the *Williams* pipeline, but important to the industry as a whole. *Williams* is indeed an atypical oil pipeline because of its origin, in its lack of oil company affiliation, its capital structure and its markets. It is truly an unrepresentative lead case, which promises to be the lodestar for results that will be inequitable either to *Williams* or to the more typical members of this industry.⁷⁰

Another feature of *Williams* is of note to other proceedings. Commissioner Hughes questioned the value of omitting the initial decision, especially since such decision “would have given us a summation of the record and an analytical springboard.”⁷¹ The FERC may find that in this case, it would have been preferable to have had an initial decision, especially if the decision is successfully challenged on the grounds of failure to explain and identify the record support for the policy conclusions that were derived from its perception of competition and rate impact.⁷²

Indeed, a major feature of the *Williams* decision is the FERC's treatment of the evidentiary record. In *Williams*, the FERC made no citations to the record in its lengthy decision.⁷³ Instead, it relied on treatises to justify its conclusions regarding

⁶⁸See text accompanying n. 81 and 82, *infra*. Such result is uncertain given that the decision cites to no specific record evidence on that issue.

⁶⁹Oftentimes, the FERC and its predecessor have established general ratemaking policies in an individual rate case, and then have applied that precedent to other regulated entities.

⁷⁰*Williams*, Hughes, C., dissenting and concurring at 61,720.

⁷¹*Id.*

⁷²See, e.g., *Columbia Gas Transmission Corp. v. FERC*, 628 F.2d 578, 593 and n. 77 (D.C. Cir. 1979).

⁷³The decision is the longest ever issued by the agency.

the existence of competition, *de minimis* impact of rate regulation, and need for higher returns. Its justification for this approach was stated as follows:

That is our essential difficulty with this massive record. Most of it is devoted to financial analysis. Experts discoursed at length on risk, on competition, on the rates of return that investors in this, that, and the other thing have required, were then requiring, were likely to require in the future, and ought to require were they as rational as the witnesses and also as well-informed as they were about the ups and downs in the stock market since 1926, about the history of interest rates, about how bondholders have fared over the long run, and kindred subjects.

Much of this is interesting. Some of it is instructive. And a little of it can honestly be called thought-provoking. However we have not found it especially helpful. In spite of the witnesses' eminence and academic attainments, their testimony seems beside the point. It digs deeply into the financial surface of things. This does not take us very far.⁷⁴

Others will debate whether this approach and explanation satisfies the Interstate Commerce Act and Administrative Procedure Act. In the meantime, this decision focuses attention on the extent to which the FERC should resolve rate issues with minimal discussion of — or even reliance upon — the record. To a significant extent, the answer to this question depends on how far the courts ultimately allow the FERC — in this or other cases — to treat factual disputes as primarily involving policy questions which can be, and perhaps should be, resolved without the need for evidentiary support.

Other procedural facets of *Williams* are innovative and merit study. For example, the FERC in *Williams* held that “no oil pipeline rate filing is to be suspended or investigated unless someone outside the Commission requests such action” and ordered its trial staff to “refrain from participation” in contested electric or natural gas cases.⁷⁵ The policy predicates for this approach — conflicts essentially “among business men” who are “well able to fend for themselves” — might be found to exist in some electric or natural gas proceedings, although it is doubtful that similar restrictions would be placed on the FERC staff in such cases.

B. Distinctions Between Regulated Entities

In *Williams*, the FERC saw strong differences among the classes of jurisdictional entities. A central theme of *Williams* is that differing regulatory treatment of jurisdictional entities can be justified on the basis of differing economic and market conditions:

Our administrative discretion . . . [is] broad enough for us to define a regulatory procedure which makes some sense in the contemporary economic environment. As the Supreme Court told us in the context of the Natural Gas Act, it is the end result of our regulation, and not the particular ratemaking methodology we employ, that counts. Thus, we feel free to adopt a light-handed method of regulation for this industry. And much of the ICC's methodology serves that end.⁷⁶

⁷⁴*Williams* at 61,623.

⁷⁵*Id.* at 61,611-12.

⁷⁶*Id.* at 61,585-86, citing *Permian Basin Area Rate Cases*, 390 U.S. 747, 776-77 (1968); *Hope*, 320 U.S. at 602-03; *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

Indeed, the FERC interprets such Natural Gas Act precedent as *Permian*⁷⁷ as justification for the decision to use a less stringent regulatory approach than that applied to natural gas pipeline counterparts:

(1) When we till the oil pipeline field, one with which our predecessor, the Federal Power Commission, had no connection, we are not free to slumber on concepts, traditions, and approaches developed by that agency for other fields with a different legal and historical evil.

(2) We must look hard at the particulars of this industry and at the special features of its legal and economic history.

(3) If that look convinces us that the gas and electric model is inappropriate to 'the needs to be served' (*General Stores Corp. v. Shlensky*, 350 U.S. 462, 466 [1956]) in this industry under the particular statute here involved, we have both the power and the duty to regulate oil pipelines in a way quite different from the way in which we deal with the jurisdiction inherited from the Federal Power Commission.⁷⁸

1. *Regulation of final product sold.* The first distinction drawn relies heavily on the deregulated status of oil. The Commission deemed important that prices for this end product are determined by market forces and not by regulation:

Moving oil through a pipeline is transportation. And though regulated (at times highly regulated), transportation enterprises have never been regulated in 'public utility' fashion. Of course, it can be said that the transmission of electricity or gas is also 'transportation.' That type of transportation, however, is an integral part of a tightly regulated business. When the product arrives at its eventual destination, the maximum price at which it can be sold to the ultimate consumer is regulated. This is not true of oil. See generally, *Bonbright* at 4-5.⁷⁹

This distinction may prove too much. If, at some future point, natural gas producer rates or electric generation is deregulated, an argument might well be made that transportation rates should, as in the case of oil pipelines, be lightly regulated. Thus *Williams* may stand as a precedent in the event of total deregulation of the transported commodity.

2. *De Minimis Impact.* A second distinction drawn by *Williams* was that ultimate consumers of oil, unlike those of electricity or natural gas, will not see the effects of any change in transportation rates. This is deemed attributable primarily to differing "transportation economics":

The transportation economics of oil differs from that of gas and electricity. In the latter industries the transportation charge bulks large in the price that the consumer pays. In oil, on the other hand, the charge is an almost infinitesimal component of the price to the ultimate consumer. Only in the context of the Trans Alaska Pipeline System do we find an apparent exception.⁸⁰

The FERC also noted that even if the "negligible impact" on product cost that might result from rigorous cost-of-service regulation was deemed significant, there was no assurance that ultimate consumers would see the benefits of a rate reduction.⁸¹

This is not the first time that issues of *de minimis* impact on ultimate consumers was deemed central to a decision to apply a light-handed regulatory approach. Yet,

⁷⁷*Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

⁷⁸*Id.* at 61,685, n. 187.

⁷⁹*Id.* at 61,678, n. 154.

⁸⁰*Id.* at 61,585.

⁸¹*Id.* at 61,601. The FERC quantified this negligible impact sum as "a fraction of 2%" of the cost of oil. *Id.* at 61,585.

the FPC's decision to exempt small producer rates from direct regulation under the Natural Gas Act by a blanket order on claims of insignificant impact were rejected by the Supreme Court:

Even if the effect of increased small-producer prices would make a small dent in the consumer's pocket, when compared with the rates charged by the large producers, the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted.⁸²

Notwithstanding the foregoing, it is not too far-fetched to expect claims that the FERC should adopt generic, light-handed approaches in dealing with electric and natural gas cost of service issues that involve insignificant sums when compared with the cost of purchased power or natural gas.

3. *Competition.* Based on a "study of the record and of the literature," *Williams* found that "[c]ompetition both actual and potential is a far more potent price-constraining force in oil pipelining than it is in the other areas in which we work."⁸³ The fact that the FERC relied on unspecified portions of the record makes it less than clear what specific type of testimony might persuade the FERC in its review of competition issues as they affect electric utilities (*e.g.*, price squeeze, access to transmission) and natural gas pipelines (*e.g.*, gas supply, gas sales).

C. *Theoretical Approach*

Williams may provide a significant impetus to questioning of the continued validity of standard, conventional cost of service techniques. At present, the broader implication of *Williams* is what it means in terms of general regulatory approach. The Commission sets forth a heady test that must be met before it will be convinced to make major changes in regulatory practices or principles:

Absent a clear and a contemporary legislative mandate directing us to do so, it is not for us to reshape the oil pipeline industry or any other industry.

Were there a showing that the status quo makes for gross injustice or that its effects on the general welfare are palpably deleterious, a different situation would be presented.⁸⁴

Whether these statements are the guiding principles of this Commission, or simply passing philosophical thoughts, will be apparent as the FERC evaluates proposals to establish *via* regulation such basic changes as alteration of natural gas contractual relationships or establishment of bulk power markets. *Williams* may also stand as a signal of the basic theoretical criteria that will guide any decision to change existing methodologies:

No showing has been made that any other oil pipeline rate base methodology would be so much better, so much fairer, and, so much more equitable as to enable us to say confidently that such other method would be clearly worth both the social cost of drastic regulatory change and the institutional cost of this Commission and to the legal order of a headlong drive into the deep and muddy waters of administrative legislation.⁸⁵

This focus on weighing benefits against social and institutional costs may well be seen in other cases where the FERC relies on "pragmatic considerations" to resolve issues on grounds of "policy, political science, and prudence."⁸⁶

⁸²FPC v. *Texaco, Inc.*, 417 U.S. 380, 399 (1974).

⁸³*Id.* at 61,649, n. omitted, 61,627.

⁸⁴*Id.* at 61,587-88, n. omitted.

⁸⁵*Id.* at 61,682, n. 172 (emphases in original).

⁸⁶*Id.* at 61,672, n. 104, 61,587.

V. CONCLUSION

Critics of the ICC regulatory approach, as well as opponents of any application of FERC regulatory concepts to oil pipeline regulation, have focused on abstract principles of ratemaking. *Williams* attempts to resolve that dispute. Its answers are fully satisfactory to neither side, but they focus attention on a matter of serious weight: whether the approach taken will result in practical difficulties of implementation. If the Commission is ready to exercise and clarify its new rules effectively and speedily, the whole debate may prove to be academic. Attention may then shift to Congress to resolve the question of to what extent, and by what criteria, should oil pipelines be regulated. If such result occurs, it is not unlikely that parties involved in other areas of FERC regulation may well consider the merits, if not the propriety, of seeking legislative solutions to that agency's efforts to set regulatory policy.