

**BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

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Five-Year Review of Oil Pipeline  
Pricing Index

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**REPLY COMMENTS OF THE  
U.S. DEPARTMENT OF TRANSPORTATION**

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Introduction

The Federal Energy Regulatory Commission (“FERC” or “Commission”) has issued a Notice of Inquiry (“NOI”) on the subject of the appropriate oil pipeline pricing index to be used for ratemaking purposes over the five year period beginning July 1, 2006. 70 Fed. Reg. 40943 (July 15, 2005). In the NOI the Commission proposed to use the Producer Price Index for Finished Goods (“PPI”) and sought comment. The Association of Oil Pipelines (“AOPL”) submitted comments opposing use of the unadjusted PPI, on the grounds that it does not accurately reflect increased costs either incurred in the past by oil pipeline operators or projected for the future.

The United States Department of Transportation (“DOT” or “Department”) expresses no views on the precise index the Commission should choose. DOT submits these reply comments in order to confirm certain points raised by AOPL with respect to regulatory obligations, for we have adopted rules to enhance pipeline safety and integrity that have imposed new compliance costs upon the operators. The Department also wishes FERC to know that in carrying out its mission of monitoring and advancing the safety and efficiency of the nation’s transportation networks, DOT has become concerned about the capacity of the underlying infrastructure -- including oil pipelines -- to meet the growing demands placed upon it. As it deliberates on the appropriate ratemaking index, therefore, we urge the Commission to consider seriously the financial commitment necessary for operators to maintain and expand pipeline system capacity. In this regard we also suggest that FERC consider convening a workshop or technical conference in order to explore regulatory mechanisms that could facilitate this critical investment.

### The Department of Transportation

DOT is broadly responsible for promoting “fast, safe, efficient, and convenient” transportation for the benefit of the general welfare and economic growth. See 49 U.S.C. § 101. Transportation systems include not only the traditional network of highways, airports, and waterways, but also pipelines. All are part of the infrastructure on which we rely for the movement of people and things. All in turn require maintenance to function, improvements to enhance performance, and expansion to meet increased demand when capacity is constrained. The overall costs are substantial, but so are the benefits. Conversely, failure to make these investments would assuredly threaten the safety and continued functioning of that critical infrastructure, with adverse effects on the public interest.

The Department fulfills its charge with respect to transportation infrastructure in many ways: by funding and research support, by working with state and local governments as well as the producers and consumers of transportation products and services, and by regulating safety. AOPL correctly points out that DOT has imposed safety rules on pipeline operators in the recent past, and that these rules have entailed costs that are significant by any measure. We discuss these below, and then turn to the issue of pipeline capacity.

### The Record

DOT understands that a major purpose of the indexed ratemaking methodology at issue is to enable pipelines to recover rising costs by allowing rates to be increased at the same pace as realized or predicted cost increases. Order No. 561, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, 58 Fed. Reg. 58753 (Nov. 14, 1993).<sup>1</sup> The Commission revisits its choice of index every five years in order to ensure that it continues accurately to track changes in pipeline costs. Order No. 561-A, 59 Fed. Reg. 40243 (Aug. 8, 1994).<sup>2</sup>

AOPL maintains that the unadjusted PPI proposed by FERC does not accurately reflect increased pipeline costs resulting from recent regulatory obligations, enhanced pipeline security

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<sup>1/</sup> See also F.E.R.C. Stats. & Regs. (CCH) at ¶ 30,941.

<sup>2/</sup> See also F.E.R.C. Stats. & Regs. (CCH) at ¶ 31,092.

measures since September 11, and “dramatic” escalations in the cost of energy and other operator expenses. AOPL Comments at 1-3. AOPL submits that the index must be adjusted to account for these factors, and that the Commission should adopt PPI+1.3%. *Id.*

DOT has adopted safety rules in the past five years that impose more rigorous obligations on pipeline operators. The regulations require operators to undertake physical modifications of their pipeline systems, more frequent inspections, and repairs. Some of these activities have resulted in routine reductions in pressure, and thus capacity. We do not collect the financial information that would permit a quantitative assessment of the magnitude of all the costs thereby incurred. The Department has, however, acquired information and gained expertise from these activities and others that are germane to this proceeding, and we wish to bring them to the Commission’s attention.

## Discussion

### A.) Regulatory Costs

On December 1, 2000, DOT’s Office of Pipeline Safety (“OPS”) promulgated regulations on “Pipeline Integrity Management in High Consequence Areas for Hazardous Liquid Operators.” 49 C.F.R. Part 195; 65 Fed. Reg. 75377.<sup>3</sup> That proceeding was “the culmination of experience gained from inspections, accident investigations and risk management, and system integrity initiatives.” 65 Fed. Reg. at 75379. The rules required affected operators to, *inter alia*, conduct a “comprehensive analysis [of] the integrity of hazardous liquid pipeline segments that, in the event of a leak or failure, could affect populated areas, areas unusually sensitive to environmental damage and commercially navigable waterways.” *Id.* at 75378. In addition to identifying such pipeline segments, these regulations mandate that operators (1) develop an “integrity management program” that continually assesses their integrity, (2) prioritize all defects, and (3) make prompt repairs according to their priority listing. *Id.*

These “high consequence areas” are widely spread throughout the United States, and include some 42 percent of the mileage of liquids pipelines regulated by OPS. Thus, many

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<sup>3</sup>/ “Hazardous Liquids” include, but are not limited to, crude oil, petroleum products, natural gas liquids, and liquid petroleum gases such as propane. 49 C.F.R. § 195.2. “High Consequence Areas” are defined as 1) river crossings of navigable rivers; 2) populated areas; and 3) “unusually sensitive areas” from the standpoint of the environment, including watersheds and wetlands. 49 C.F.R. § 195.450.

pipeline companies have chosen to inspect their entire systems. The magnitude of the pipeline network and these tasks led OPS to phase in these regulations over time. For example, operators had to complete inspections of fifty percent of affected pipeline mileage by September 30, 2004.<sup>4</sup> In 2004, these inspections disclosed nineteen thousand “conditions” covered under DOT rules, such as dents, corrosion, gouges, and stress cracks. Depending on the seriousness of the defect, repairs had to proceed immediately, within sixty days, or within 180 days. That year liquids pipeline operators made more than 1,500 repairs of conditions posing “immediate” threats to pipeline integrity. Alternatively, operators could reduce pipeline operating pressures to the point that the defect no longer threatened safety.

OPS estimated some of the industry costs of its rules as follows: Initial “baseline” assessments would cost operators more than \$120 million over seven years (i.e., through 2007); retesting, \$14.5 million annually; preparation of integrity plans, almost \$18 million; and related implementation costs (to ensure data was not only collected but put to use), almost \$10 million the first year and almost \$5 million annually thereafter. See 65 Fed. Reg. at 75400-03. OPS could not estimate repair costs incurred as the result of the required testing, for it was impossible to predict the number and kind of “conditions” that would be disclosed. It is fair to say that overall these expenses were considerable. Most repairs required excavating a pipeline segment and replacing a section of pipe. Some were far more elaborate.<sup>5</sup> Moreover, at any given time a substantial fraction of U.S. petroleum pipelines operate under pressure reductions in order to accommodate repairs. Such restrictions reduce pipeline throughput if the line is operating close to capacity.

The Department is confident that, in the long run, these rules will provide significant benefits for the public and pipeline operators alike. The thousands of repairs and ongoing assessments of pipeline integrity will reduce the incidence and seriousness of pipeline accidents. In the short run, however, the rule has certainly increased costs for operators. Mandatory

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<sup>4</sup>/ The balance of the affected pipeline systems must be assessed by September 30, 2008. Operators will have to reassess their lines completely every five years.

<sup>5</sup>/ Colonial Pipeline, for example, had to construct cofferdams in the middle of the Susquehanna River to remove a dent in a pipe buried beneath the river bottom. That operator has reported that this single repair cost \$8 million.

pressure reductions and temporary service interruptions for inspections have also had the effect of reducing or deferring operator revenues.

The OPS rules were promulgated after FERC adopted the currently effective rate index, and hence the costs they impose on the industry are not reflected in that index. Since the operators have had to bear these costs for some years now and will continue to do so into the future, it is important that the index selected in this proceeding take those costs into account. Failure to do so could lead to various outcomes inconsistent with the public interest:

- Operators may be disinclined to invest in adding capacity to pipelines regulated under such a regime, even though the net public economic benefits from these investments greatly exceed the costs, and even though shippers may be willing to pay higher prices for the incremental capacity.
- Operators may abandon older or marginally economic pipelines as a means as a cost-cutting measure, even though shippers might be willing to be a higher price to keep such lines in operation.
- Operators may be tempted to cut corners on safety, as a way of bringing their costs more in line with their revenues.

#### B.) Pipeline Capacity Constraints

The Department's oversight of the nation's transportation networks has also made it apparent that we are fast approaching the physical limits of the existing infrastructure. Traffic of every sort continues to build yet the basic facilities necessary for the free flow of people and goods have generally not kept pace. The underlying networks thus perform less reliably and efficiently. Congestion and its costs rise, not just for the movement of people and things themselves, but for all those who rely upon transportation in our increasingly interdependent economy. Pipelines, unfortunately, are again no exception. Several recent experiences with hurricanes, accidents, and major repairs have demonstrated that the reliability of the U.S. transportation system as a whole depends on the availability of adequate petroleum product pipeline capacity and throughput.

Such circumstances also evidence a serious underinvestment in petroleum pipeline infrastructure, and underscore that several pipeline systems of national importance lack redundancy. The consequences include: higher prices and less competitive markets for petroleum products in some regions, supply disruptions and price spikes due to relatively minor

service interruptions, and the diversion of petroleum products to other, less efficient and desirable transportation modes.<sup>6</sup> Although DOT appreciates that lack of pipeline capacity may raise transportation costs, we are even more concerned about the potential for widespread disruption of transportation systems in the event of an otherwise minor interruption of pipeline service. Some of the bases for our concern are as follows:

The Federal Trade Commission (“FTC”) earlier this year issued a study called “Gasoline Price Changes: The Dynamics of Supply, Demand, and Competition” Washington, DC: GPO, July 2005 (“FTC Study”).<sup>7</sup> It found that the absence of access to petroleum products pipelines was the most significant explanation for variability in regional gasoline prices, though access to refineries and the use of reformulated gasoline also played important roles. FTS Study at 95-97. The FTC also offered several examples to show that when a regional products pipeline’s capacity was reached, or when a pipeline was taken out of service, gasoline prices could become higher and more variable.

In one such incident, the FTC study reported that from June 7 - 16, 2000, the Wolverine Pipeline in Michigan was shut down, limiting gasoline supplies to the Detroit area. Gasoline prices there rose from \$1.50 per gallon to over \$2.00 per gallon in two weeks, before declining after the pipeline was put back in service. Id. at 72-73.

In another study example, a Kinder Morgan products pipeline ruptured near Tucson, Arizona in June of 2003. Arizona is served by two pipelines, but the failure of the Kinder Morgan pipeline reduced supplies to Arizona by thirty percent. According to the FTC, average retail gasoline prices in Phoenix quickly jumped from \$1.52 per gallon to \$2.11 per gallon. The EPA waived air quality restrictions preventing the use of California gasoline, and Kinder Morgan was able to organize a fleet of fuel trucks to bridge the gap until the pipeline was repaired, reducing prices to about \$1.80 per gallon by the end of September. The FTC also reported that the extra demand for West Coast gasoline in Phoenix drove up gasoline prices as far away as Oregon (though presumably prices also declined in Texas). Id. at 1-5. The cost to Arizona consumers was on the order of \$120 million.

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<sup>6</sup>/ The slack is often taken up by tanker trucks, whose much-increased presence on roadways introduces additional congestion, fuel consumption, exhaust emissions, and threats to highway safety.

<sup>7</sup>/ The FTC Study is available online at: <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>

The overall and ongoing effects of Hurricane Katrina on fuel supply and prices are known all too well. More specifically, the Colonial and Plantation pipelines have a capacity of almost three million barrels of petroleum products per day; together they supply approximately sixty percent of petroleum demand in the area between Alabama and Maryland. They are in fact the sole sources of fuel for many key air transportation facilities, including the Newark International, Washington Reagan National, and Dulles International airports. Before the hurricane, these pipelines had been running at or near capacity all summer, yet national gasoline stocks were already unusually low, and gasoline prices had been rising. In August, Hurricane Katrina caused the shutdown of both pipelines. Multiple pump stations on both pipelines were without power or telecommunications, and fallen trees blocked access to the stations.

DOT and the Department of Energy worked to facilitate the delivery of eighteen two megawatt diesel generators from around the United States, waiving numerous regulations, in order to ensure that the pump stations could resume operation as soon as possible. During the week that the pipelines were out of service, gasoline prices rose by more than \$0.60 per gallon, there were spot physical shortages, and gasoline stocks in several Southeastern cities were completely depleted. Had the pump stations actually flooded or otherwise been unable to return to service promptly, much of the East Coast would have been required to reduce petroleum consumption by thirty percent, and there would have been almost immediate shortages.

These episodes illustrate the immense cost to the public of petroleum pipeline outages. They demonstrate as well that capacity losses on key pipelines can result in cascading disruptions of transportation systems. They also underscore some of the hidden extra costs of inadequate pipeline capacity. The inelastic demand for transportation fuel means that even relatively small restrictions can have disproportionately large price effects. Adequate pipeline capacity is a key to making petroleum products more available and markets more competitive.

Traditional regulation of petroleum pipelines, however, ensures that common carrier pipelines achieve only modest returns from increasing constrained capacity. Consumers, by contrast, would reap large benefits from such new investments. The apparently minor private gains to regulated pipeline operators from expanding capacity and the prospect of sizeable benefits to the public at large counsel the Commission to explore the advisability of some form



of extra capacity or redundancy to be built into transportation systems as a form of insurance against forced outages. DOT does not have a specific view on how these challenges might be solved. However, changes to the current mechanisms by which petroleum pipelines are regulated might play a role in providing for more capacity and redundancy in the national pipeline system.

The Commission has regularly convened technical conferences or workshops, bringing together experts and stakeholders in order to focus on significant problems or issues of fundamental interest. The Department encourages FERC to employ this approach with respect to the interrelationship between pipeline regulation and capacity. The events of the past few weeks provide reason aplenty to consider possible approaches to increasing the reliability of the national petroleum pipeline distribution system.

#### Conclusion

DOT has adopted safety regulations that impose significant obligations and costs on pipeline operators. The Commission should ensure that index chosen in this proceeding reflects those and other legitimate costs. More fundamentally, the extent of capacity restrictions in the nation's pipeline infrastructure is becoming more apparent, as is the realization that current regulatory mechanisms may not lead to appropriate reinvestment in the industry. The Department urges FERC to explore ways to harmonize its regulatory policies with the nation's need for consistent energy supplies.

Respectfully submitted,



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October 13, 2005

Submission Contents

FERCRPLY.pdf..... 1-9