UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Five-Year Review of Oil Pipeline Pricing Index   )   Docket No. RM10-25-000

<u>COMMENTS OF THE ASSOCIATION OF OIL PIPE LINES</u>

The Association of Oil Pipe Lines ("AOPL") hereby submits its comments in response to the June 15, 2010 Notice of Inquiry ("NOI") issued by the Federal Energy Regulatory Commission ("Commission") in the above-captioned proceeding. *Five-Year Review of Oil Pipeline Pricing Index*, 131 FERC ¶ 61,238 (2010). In the NOI, the Commission seeks comments on the appropriate oil pipeline pricing index for the five-year period beginning July 1, 2011. The index for the current five-year period is the Producer Price Index for Finished Goods ("PPI-FG") plus 1.3 percent ("PPI-FG + 1.3"). *Id.* at P 3. The Commission proposes to use the same index for the upcoming five-year period, but invites interested parties to offer "alternative indexing proposals." *Id.* at P 4. As shown below, conservative application of the established, court-approved methodology for calculating the oil pipeline pricing index generates an index of PPI-FG plus 3.64 percent ("PPI-FG + 3.64"). AOPL therefore respectfully requests that the Commission adopt PPI-FG + 3.64 as the oil pipeline pricing index for the five-year period beginning July 1, 2011.

EXECUTIVE SUMMARY

- *The Commission's Oil Pipeline Rate Index.* The Energy Policy Act of 1992 ("EPAct") required the Commission to establish a "simplified and generally applicable ratemaking methodology for oil pipelines." *See* Pub. L. No. 102-486 § 1801(a), 106 Stat. 3010 (Oct. 24, 1992). Pursuant to EPAct, the Commission employs a rate ceiling methodology that caps most oil pipeline rates using an inflation-adjusted index. The Commission's indexing methodology requires oil pipelines to recalculate their indexed rate ceilings effective July 1 of each year. Pipelines may raise their rates up to the level of the index ceiling without filing a cost-of-service justification for the rate change. If changes in inflation cause the ceiling to be lowered, as was the case with the rate ceiling adjustment that took effect July 1, 2010, pipelines with rates at the ceiling must lower their rates accordingly.

- *Established, Court-Approved Methodology.* The methodology for deriving the oil pipeline pricing index is well established. The same methodology used by the Commission to set the initial index has been maintained through two subsequent five-year reviews and has governed oil pipeline rates for more than fifteen years. That methodology has been tested through judicial review on three occasions and approved in all respects. In two of those cases, when the Commission employed the established methodology, its decision was affirmed. The only time the Commission's choice of index was not affirmed by the court of appeals was when the Commission initially deviated from the established methodology during the first five-year review process, but when it subsequently employed the established methodology on remand its decision was

affirmed in all respects. Since that time, the Commission has applied the established methodology, recognizing the importance of maintaining the nexus between pipeline historical cost changes and the rate ceiling on which the industry and market participants have come to rely.

- *Conservative Application of Methodology.*   The testimony of AOPL witness Dr. Ramsey Shehadeh, the leading expert on the oil pipeline rate index, shows that, under the Commission's established indexing methodology, the actual cost increases experienced by oil pipelines during the 2004 through 2009 period result in an index of PPI-FG + 3.64. As Dr. Shehadeh discusses, this is a conservative calculation, as an analysis of a larger data set that includes all pipeline operators with data reported for the endpoint years (as opposed to the smaller set of those pipelines that report data in all years of the sample) demonstrates a more rapid increase in costs (PPI-FG + 3.80). Dr. Shehadeh's analysis therefore makes clear that an index of PPI-FG + 3.64 is the minimum index required by the established methodology. Moreover, since the index in effect during the past five-year period was PPI-FG + 1.3, Dr. Shehadeh's analysis shows that oil pipeline rates have been capped during the review period at a level significantly below actual pipeline cost increases. Use of an index below PPI-FG + 3.64, therefore, would be unreasonable.

- *Robust Data Supporting Calculations*. The data sample used by Dr. Shehadeh includes 110 pipelines, which is a materially larger sample size than was relied upon in the Commission's prior rate index determinations (91 in the 2000 review and 73 in the 2005 review). Indeed, even after excluding outliers, the middle 50 percent and 80

percent subsamples used by Dr. Shehadeh account for approximately 76 percent and 96 percent, respectively, of the total 2004 barrel-miles of those pipelines that are subject to the Commission's indexing methodology. The Commission can therefore be confident that Dr. Shehadeh's calculation of the established methodology is representative of the actual cost increases experienced by oil pipelines during the past five-year period.

- *Oil Pipeline Costs Continue to Increase*. As Dr. Shehadeh's analysis shows, oil pipeline costs increased during the 2004 through 2009 period at a rate significantly higher than either inflation or the current PPI-FG + 1.3 index. AOPL witness William R. Byrd explains that a key driver of oil pipeline cost increases during the review period is the significant expenditures pipelines made to comply with more stringent safety and integrity management regulations. As Mr. Byrd discusses, those and other regulatory requirements are expected to continue for the foreseeable future and, along with additional new and anticipated regulations, are likely to cause oil pipeline costs to continue to increase. Other significant cost categories for oil pipelines include fuel and power and pipeline construction and expansion projects.

- *Index Consistent With Regulatory Objectives.* Use of the established, court-approved methodology and the resulting PPI-FG + 3.64 index is necessary to give efficient pipeline carriers a reasonable opportunity to recover their costs, continue ongoing efforts to improve pipeline safety and integrity, and expand capacity for shippers. The PPI-FG + 3.64 index will also ensure that pipeline rates do not exceed a just and reasonable level, while giving pipelines an incentive to reduce costs and improve efficiencies. Of additional importance, maintaining the existing methodology for

generating the appropriate index will ensure consistency and predictability with respect to economic regulation of oil pipelines, which is crucial for fostering continued investment in pipeline infrastructure.

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BACKGROUND

The following sets forth the history of the Commission's rate index orders and court review of the indexing methodology.

EPAct and the Commission's Indexing Regulations. EPAct directed the Commission to "establish[] a simplified and generally applicable ratemaking methodology for oil pipelines." *See* Pub. L. No. 102-486 § 1801(a), 106 Stat. 3010 (Oct. 24, 1992). EPAct's purpose was "to streamline regulatory provisions and to 'give pricing flexibility to oil pipelines, while preventing excessive rates and charges against any captive shippers on an oil pipeline.'" *See Assoc. of Oil Pipe Lines v. FERC*, 83 F.3d

1424, 1429 (D.C. Cir. 1996) ("AOPL I") (quoting H.R. Rep. No. 474, pt. 1, 102d Cong., 2d Sess. 132, 153).

In implementing EPAct, the Commission established a general indexing methodology that capped oil pipeline rate increases based on an inflation index. *See Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, FERC Stats. & Regs., Regulations Preambles, 1991-1996 ¶ 30,985 (1993) ("Order No. 561"); FERC Stats. & Regs., Regulations Preambles, 1991-1996 ¶ 31,000 (1994) ("Order No. 561-A"). The Commission explained that "[a]n indexing scheme has a number of benefits." Order No. 561 at 30,948. First, "the hallmark of an indexing system is simplicity. Under indexing, pipelines adjust rates to just and reasonable levels for inflation-driven cost changes without the need of strict regulatory review of the pipeline's individual cost of service, thus saving regulatory manpower, time and expense." *Id.* Further, "an indexing scheme is a form of incentive regulation. As such, it gives greater emphasis to productive efficiency in noncompetitive markets than does traditional cost-of-service regulation." *Id.* Finally, "indexing provides shippers protection from rate increases greater than the rate of inflation." *Id.* at 30,948-49.

Under the Commission's indexing methodology, pipelines are required to recalculate their indexed rate ceilings effective July 1 of each year. 18 CFR § 342.3. Pipelines may change their rates at any time provided they do not exceed the indexed rate ceiling. 18 CFR § 342.3(a). If changes in inflation cause the ceiling to be lowered, as

was the case with the annual index adjustment effective July 1, 2010,[1] then pipelines with rates at the ceiling must lower their rates accordingly. 18 CFR § 242.3(e).

 Initial Rate Index Proceeding and Court Review. The inflation index originally selected by the Commission in Order No. 561 was PPI-FG minus 1 percent ("PPI-FG – 1"). The Commission concluded that PPI-FG – 1 was the index that "most closely approximate[d] the actual cost changes experienced by the oil pipeline industry." Order No. 561-A at 31,092; *see also* Order No. 561 at 30,951. The Commission indicated, however, that it would "undertake an examination of the relationship between the … index and the actual cost changes experienced by the oil pipeline industry every five years." Order No. 561 at 30,941. The Commission explained that "changes in rate ceilings should reflect changes in costs to the pipeline industry," and the Commission would review the index every five years "[t]o ensure this nexus is maintained." Order No. 561-A at 31,092. As explained below, while the Commission has changed the level of the index in each of its five-year reviews, the methodology used to calculate the index has remained the same.

 In adopting PPI-FG – 1 in the initial indexing proceeding, the Commission relied on the methodology sponsored by Dr. Alfred E. Kahn on behalf of various shippers. *See* Order No. 561 at 30,952 n.55; Order No. 561-A at 31,096-99. In that study, Dr. Kahn,

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[1] *See Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, "Notice of Annual Change In The Producer Price Index For Finished Goods," 131 FERC ¶ 61,161 (2010) (requiring oil pipelines to lower rate ceilings by 1.2974 percent for the period July 1, 2010 through June 30, 2011).

who was assisted by Dr. Shehadeh, determined the year-to-year changes in costs for each

petroleum pipeline. *See* Testimony of Alfred Kahn, Docket No. RM93-11-000, at 8-9

(Aug. 12, 1993) ("Kahn 1993 Decl."). In order to ensure that the results were not driven

by incomplete or anomalous data, Dr. Kahn excluded data from pipelines that had

extreme changes. *See id.; see also* Appendix to Kahn 1993 Decl. at 3-4. After excluding

statistical outliers, Dr. Kahn calculated the change in costs for the typical pipeline using a

composite of three different statistical measures: the median, the average, and the

weighted average. *See* Kahn 1993 Decl. at 9. Because operating expense data do not

include the capital costs of providing pipeline transportation service (specifically, return

on investment and taxes), Dr. Kahn also performed a "net plant" investment analysis to

estimate how these capital costs changed. *See id.* at 12-17.

Various parties challenged the Commission's approach at the United States Court

of Appeals for the District of Columbia Circuit ("D.C. Circuit"). The D.C. Circuit

concluded that the Commission's methodology was sound and affirmed the

Commission's decision in all respects. *AOPL I*, 83 F.3d at 1428. The court concluded

that "by establishing a general indexing methodology along with limited exceptions to

indexed rates, the Commission has reasonably balanced its dual responsibilities of

ensuring just and reasonable pipeline rates and simplifying and streamlining ratemaking

through generally applicable procedures." *Id.* at 1428. The court also specifically

affirmed the Commission's reliance on Dr. Kahn's methodology, the same methodology

adopted by the Commission in the subsequent five-year rate index reviews and employed

in Dr. Shehadeh's testimony attached hereto. *Id.* at 1433-35.

First Five-Year Review of Rate Index and Court Review. In 2000, the

Commission began its review of the oil pipeline index to determine the appropriate index

level to apply during the five-year period from July 1, 2001 through June 30, 2006.

Initially, the Commission determined that it would continue to apply PPI-FG – 1,

although the methodology it used in reaching that conclusion differed significantly from

the Kahn methodology that the Commission had used to set the original index. *Five-Year*

Review of Oil Pipeline Pricing Index, 93 FERC ¶ 61,266, at 61,846 (2000) ("2000

Order"). Instead of the approach adopted in Order No. 561 and affirmed by the court, the

2000 Order sought to determine the "industry-average" cost change, in which the

operating costs for all pipelines were summed together and divided by total industry

barrel-miles. *Id.* at 61,849-50. The Commission also declined to employ any of the

techniques used by Dr. Kahn to eliminate statistical outliers. *Id.* at 61,851-52. The

Commission further excluded changes in net plant from its estimate of capital cost

changes, instead of including net plant as it had done in Order No. 561. *Id.* at 61,853-54.

On appeal, the D.C. Circuit found that the Commission had not adequately

supported its departure from the existing methodology. *Association of Oil Pipe Lines v.*

FERC, 281 F.3d 239 (D.C. Cir. 2002) ("AOPL II"). The court found that the use of

industry average cost changes can "yield odd results" and "can give an arguably distorted

impression of cost changes." *Id.* at 242. With respect to the Commission's decision not

to eliminate statistical outliers, the court found that the Commission had "deviated from

its previous methodology without adequate explanation." *Id.* at 245. The court explained

that "the object of excluding outliers is to prevent extreme and spurious data from biasing

an analysis, *i.e.*, affecting its result adversely." *Id.* at 246. Therefore, "[t]o the extent that

FERC refused to adjust only because of the direction of the resulting change (upward

rather than downward), refutation is (we hope) superfluous." *Id.* Regarding the

calculation of changes in capital costs, the court noted that Order Nos. 561 and 561-A

"relied heavily on the 1993 Kahn Study, which explicitly used net plant." *Id.* at 246-47.

The court found that the Commission had "offered no explanation" for abandoning Dr.

Kahn's approach. *Id.* at 247. The court remanded the case to the Commission for further

consideration.

On remand, the Commission acknowledged that the 2000 Order had "strayed from

[the] court-approved methodology contained in Order No. 561 without providing

adequate justification for the modifications." *Five-Year Review of Oil Pipeline Pricing

Index*, 102 FERC ¶ 61,195, at P 18 (2003) ("2003 Remand Order"). "On further

consideration," the Commission "conclude[d] that the most appropriate way to measure

pipeline costs and rate ceilings, and assure that the nexus initially drawn between them

continues, is to apply the same method as applied in initially drawing that connection."

Id. at P 17. In "return[ing] to that method," the Commission determined that "the

cumulative change in [the unadjusted PPI-FG] most nearly reflects the cumulative change

in pipeline operating costs for the period." *Id.* at P 17.

On review, the D.C. Circuit affirmed the Commission's 2003 Remand Order in all

respects. *Flying J v. FERC*, 363 F.3d 495 (D.C. Cir. 2004). First, the court upheld the

Commission's decision to use an average of pipelines' year-to-year cost changes, calling

it a reasonable way to "predict the likely rate of change in the costs to be experienced by

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any given pipeline." *Id.* at 498. Second, it affirmed the Commission's decision to return to its prior method of dropping outliers when calculating average cost changes. *Id.* Third, the D.C. Circuit found that the Commission properly used net plant as a surrogate for capital costs since capital costs reported on the FERC Form No. 6 do not reflect return on investment and income taxes. *Id.* In short, the Court approved in all respects the Commission's return to Dr. Kahn's methodology that had been originally approved in Order No. 561.

Second Five-Year Review of Rate Index. In its subsequent review, the Commission applied the established, court-approved methodology to determine the appropriate index for the period July 1, 2006 through June 30, 2011. *Five-Year Review of Oil Pipeline Pricing Index*, 114 FERC ¶ 61,293, at P 4 (2006) ("2006 Order"). The Commission explained that "[s]ince Order Nos. 561 and 561-A, the Commission has primarily relied upon Dr. Kahn's testimony to develop the methodology to set the index differential, which was subsequently approved by the U.S. Court of Appeals." *Id.* at P 28. The Commission's application of the Kahn methodology in the 2006 Order, based on the analysis put forth in Dr. Shehadeh's testimony filed in the proceeding, generated the current PPI-FG + 1.3 index. *Id.* at P 2. No petitions for judicial review were filed, and the Commission's decision took effect without challenge for the five-year period ending June 30, 2011. As stated, Dr. Shehadeh's testimony, which employs the same, established methodology, generates an index of PPI-FG + 3.64 for the five-year period beginning July 1, 2011.

DISCUSSION

The Commission should continue to apply the established methodology to calculate the oil pipeline pricing index for the five-year period beginning July 1, 2011. Only a proper application of that court-approved methodology can maintain the existing "nexus" between pipeline costs and rate ceilings on which the oil pipeline industry and market participants have come to rely. 2003 Remand Order at P 17.

Pipelines have experienced significant cost increases in recent years, especially due to increased regulatory requirements related to pipeline safety and integrity, and these cost increases are expected to continue for the foreseeable future. Application of the existing methodology will permit efficient pipeline carriers a reasonable opportunity to recover their costs and provide the regulatory predictability needed to attract capital for continued safe pipeline operations and future infrastructure projects.

The Commission's proposal to continue the use of PPI-FG + 1.3 cannot be squared with these considerations. The Order No. 561 methodology, applied consistently with the approach used in past reviews, generates an index of PPI-FG + 3.64. This demonstrates that the actual cost increases experienced by oil pipelines during the 2004 through 2009 period were significantly greater than the current PPI-FG + 1.3 index. Given this showing, use of an index below PPI-FG + 3.64 would plainly be unreasonable. The Commission therefore should adopt PPI-FG + 3.64 as the oil pipeline rate index for the five-year period beginning July 1, 2011.

I.   The Commission's Established Methodology Shows that Pipeline Costs Have Increased at a Rate of PPI + 3.64 Percent During the Applicable Five-Year Period.

As Dr. Shehadeh explains in his testimony, PPI-FG + 3.64 is the index that has most closely tracked the actual cost changes in the pipeline industry over the period from 2004 through 2009. *See* Shehadeh Decl. at 2, 5. Dr. Shehadeh is a leading expert in the field of pipeline economics, and particularly with respect to the oil pipeline rate index. He worked directly with Dr. Kahn, on behalf of pipeline shippers, in creating the methodology that the Commission ultimately adopted in establishing the initial index. He also worked with Dr. Kahn in analyzing and supporting the index ultimately adopted by the Commission in the first five-year review, and provided the analysis relied upon by the Commission in adopting the index during the second five-year review that is currently in effect. Dr. Shehadeh calculated the index supported in his testimony using the Commission's established, court-approved methodology. As Dr. Shehadeh explains, the calculations he performed during his review "use[d] the same methods employed in the analyses on which [his] own and Professor Kahn's prior testimonies were based, and that were adopted by the Commission and endorsed by the Court of Appeals." Shehadeh Decl. at 2.

As Dr. Shehadeh discusses, the initial step in applying the Order No. 561 methodology is obtaining the correct data sample. Consistent with the Order No. 561 methodology, Dr. Shehadeh began with cost data reported by oil pipelines to the Commission in the FERC Form No. 6 for the years 2004 through 2009. *See* Shehadeh Decl. at 5-6. Dr. Shehadeh then reviewed the Form 6 data and removed any pipelines

that did not report data for any year in that period. *Id.* at 5. That approach ensured that the results were not biased by pipelines that exited or entered the market during the study period. Dr. Shehadeh also removed the Trans Alaska Pipeline System ("TAPS") carriers (along with TAPS feeder lines), since those pipelines are specifically excluded from the index pursuant to EPAct. *Id.* at Appendix A and Exhibits A10 and A13. Dr. Shehadeh additionally removed any pipelines that had Form 6 reporting errors or incomplete Form 6 data. *Id.* at Appendix A and Exhibit A13.

Because of improvements in pipeline reporting, Dr. Shehadeh was able to obtain an initial sample of 110 pipelines, which is a materially larger sample size than was relied upon in the Commission's prior rate index determinations (91 in the 2000 review and 73 in the 2005 review). Shehadeh Decl. at 10 n.25. The 110 pipelines used in the initial sample account for 91.5 percent of the 2004 barrel-miles of all companies that filed a Form 6 between 2004 and 2009. Indeed, even the middle 50 percent and 80 percent subsamples account for approximately 70.0 percent and 87.8 percent, respectively, of the total 2004 barrel-miles of all pipelines filing a Form 6, and approximately 76 percent and 96 percent, respectively, when only pipelines subject to the Commission's indexing methodology are considered. Shehadeh Decl. at 10 & n.23.[2] This represents an improvement in data over the prior review period, when the middle 50 percent and

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[2] As noted above, TAPS carriers and feeder lines are not subject to the Commission's indexing methodology. 18 CFR § 342.0(b).

middle 80 percent subsamples accounted for 59.2 percent and 78.4 percent, respectively, of total 1999 barrel-miles, and thus demonstrates the reliability of the 2004-2009 Form 6 data for conducting the rate index analysis. *Id*. at 10 & n.24.[3]

As explained in greater detail in his declaration, Dr. Shehadeh reflected relevant changes in corporate ownership rather than omitting data from any company simply because it experienced a change in Form 6 filing status. *See* Shehadeh Decl. at 5, Appendix A and Exhibit A12. For example, where a company changed its name during the applicable period, Dr. Shehadeh ensured that the cost data reported under the different names was analyzed as coming from a single pipeline. Dr. Shehadeh also accounted for mergers and changes in corporate form. *Id.*

Once the initial sample size had been determined, Dr. Shehadeh measured the historical cost changes for each pipeline over the 2004-2009 period. *Id.* at 5-8. Dr. Shehadeh measured both changes in operating expenses and changes in capital costs (using net plant investment as a proxy for the latter). *Id.*

Having determined the changes in operating expenses and capital costs, Dr. Shehadeh then used various statistical techniques to remove outliers and obtain representative amounts. Specifically, for both operating expenses and capital costs, Dr.

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[3] In 2008, the Commission affirmed that Form 6 provides shippers and the Commission with appropriate information, as it terminated the review of the Form 6 report without requiring any modifications. *Review of FERC Form Nos. 6 and 6Q,* "Notice Terminating Proceeding," 125 FERC ¶ 61,308 (2008).

Shehadeh calculated the median of the individual pipeline cost changes, the mean (weighted by barrel-miles), an unweighted mean and a composite simple average of the prior three calculations. Dr. Shehadeh then conducted two analyses to eliminate outliers. First, he eliminated both the top 25 percent and bottom 25 percent of pipelines when calculating the weighted and unweighted mean (*i.e.*, the "middle 50 percent"). Second, he eliminated the top 10 percent and bottom 10 percent of pipelines in calculating the means (*i.e.*, the "middle 80 percent"). Shehadeh Decl. at 7-9.

The composite average of the middle 50 percent subsample showed average annual rates of growth in pipeline costs of 5.69 percent during the 2004-2009 period. The composite average of the middle 80 percent subsample showed average annual rates of growth in pipeline costs of 7.66 percent during that period. The midpoint between these two composite averages is 6.68 percent. By contrast, the average annual rate of growth of the PPI-FG during the years 2004 through 2009 was 3.04 percent. Dr. Shehadeh's analysis therefore shows that actual oil pipeline cost increases during the period 2004 through 2009 exceeded the PPI-FG at an average rate of 3.64 percentage points per year. The appropriate index resulting from the established indexing methodology is therefore PPI-FG + 3.64. Shehadeh Decl. at 8-11.

Dr. Shehadeh's analysis shows that PPI-FG + 3.64 is a conservative demonstration of pipeline cost changes. Dr. Shehadeh examined an alternative sample that included any pipeline that reported data in both end-point years (*i.e.*, 2004 and 2009), but not necessarily in all intervening years. That approach (which added four pipelines to the data sample) resulted in an index of PPI-FG + 3.80. *See* Shehadeh Decl. at 10-11. This

alternative calculation confirms that Dr. Shehadeh's application of the Commission's established methodology is conservative and the resulting index of PPI-FG + 3.64 is the minimum appropriate index.

II.   The PPI-FG + 3.64 Index Generated by the Established Methodology is Consistent With Oil Pipeline Industry Experience.

As the Commission and the D.C. Circuit have explained, the relationship between historical inflation and historical pipeline costs is the soundest method for approximating future cost changes.[4] Applying the established rate index methodology here demonstrates that PPI-FG + 3.64 is the appropriate index for the five-year period beginning July 1, 2011.

Mr. Byrd states in his declaration that "the increase in oil pipeline costs calculated by Dr. Shehadeh for the 2004 through 2009 period is consistent with the regulatory obligations and cost pressures faced by oil pipeline operators during that period." Byrd Decl. at 13. In Mr. Byrd's opinion, "these regulatory trends and the corresponding cost increases will likely continue for the foreseeable future and are likely to grow." *Id.* at 13-14. Mr. Byrd's declaration thus explains that the significant expenditures made by oil pipelines for regulatory compliance, especially for pipeline safety and integrity, help to further support the results generated by the Commission's established indexing methodology.

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[4] *See, e.g.,* Order No. 561 at 30,951; Order No. 561-A at 31,092; *AOPL II*, 281 F.3d at 247.

A. Increased Costs Due to Integrity Management Regulations

Oil pipelines have experienced significant cost increases in recent years, particularly due to more stringent regulation imposed by the U.S. Department of Transportation ("DOT") concerning integrity management and pipeline safety. Byrd Decl. at 2-9, 13. The DOT integrity management regulations require, among other things, all liquids pipelines to identify each line segment that could affect a "high consequence area" (*i.e.,* areas of particular environmental sensitivity or high population density). Pipelines are then required to develop a written integrity management program that addresses the threats to each such line segment and carry out baseline assessments of the identified segments. Pipelines must then engage in a continual process of assessment and re-assessment to maintain the pipeline's structural integrity and to remediate any defects found. *See* Byrd Decl. at 3.

As Mr. Byrd details in his declaration, the integrity management regulations have required pipelines to incur substantial additional costs. Assessment of pipelines requires expensive technology, including rental of in-line inspection tools (or "smart pigs"), which are intended to detect various types of pipeline anomalies. Assessment is a labor-intensive process, often requiring excavation of identified anomalies and manual inspection by trained personnel. Remediation of any defects can also be extremely costly. Finally, pipelines must document and measure the effectiveness of all of these efforts, which also increases expenses. Byrd Decl. at 3-7.

For all these reasons, the Commission has recognized that "implementing pipeline integrity management programs will involve significant costs." *See Jurisdictional Public*

Utilities and Licensees, 111 FERC ¶ 61,501 at P 30 (2005) ("Order on Accounting for

Pipeline Assessment Costs").[5] Indeed, "[c]ompliance with the integrity management

regulations is likely to be the largest single variable cost item for most pipelines and these

costs show no signs of decreasing." Byrd Decl. at 7. As Mr. Byrd explains, in an

informal industry survey, pipelines that account for approximately three-quarters of

DOT-jurisdictional oil pipeline miles estimated that integrity management costs

(including both capital and expense) were approximately $2.7 billion for the years 2004

through 2009. In addition, integrity management costs related to pipeline-owned tankage

for the same group of pipelines were estimated to have been approximately $600 million

in both capital and expense for the 2004 through 2009 period. Thus, the total amount of

capital costs and operating expenses incurred with respect to pipeline and tankage

integrity during the 2004 through 2009 period for the referenced group of pipelines alone

was estimated at approximately $3.3 billion. Byrd Decl. at 7.

One measure of the dramatic surge in oil pipeline costs related to integrity

management is the increase in outside services expenses. Most pipeline assessment costs

relate to rental of smart pigs and the hiring of vendors to conduct the assessment and to

perform the required data analysis. As Dr. Shehadeh notes in his declaration, the median

change in the outside service costs recorded in FERC Account 320 increased by a

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[5] The Commission has further recognized that "[p]ipeline operators have also
implemented other integrity managements programs in non-high consequence areas."
Order on Accounting for Pipeline Assessment Costs at P 31.

cumulative 69.3 percent between 2004 and 2009. Shehadeh Decl. at 12. Thus, while outside services expenses are not the only costs related to IMP compliance, and while not all outside services expenses are related to pipeline integrity, the significant increase in this single cost category illustrates the increasing cost pressures oil pipelines face with respect to integrity management compliance.

Mr. Byrd identifies several reasons why, in his opinion, costs related to pipeline integrity are likely to increase in the future. First, in-line inspection tools are becoming more sophisticated. The increased sophistication of inspection tools not only makes the tools more expensive to rent, but it also enables them to detect more anomalies. The additional anomalies detected must be investigated and, if necessary, remediated, thus increasing costs. Second, the U.S. DOT's Pipelines and Hazardous Materials Safety Administration ("PHMSA"), which is responsible for enforcing the integrity management regulations, has imposed increasingly stringent regulatory obligations on pipeline operators with respect to pipeline integrity. Third, new or expanded regulatory requirements may be imposed as Congress considers reauthorization of the Pipeline Safety Act, which is expected to occur later in 2010 or in 2011. Fourth, the recent events involving the Deepwater Horizon oil spill in the Gulf of Mexico could well lead to significant additional regulatory requirements with respect to pipeline integrity. In sum, every indication is that the regulatory burdens faced by oil pipelines with respect to integrity management and the corresponding costs of compliance will only increase in future years. *See* Byrd Decl. at 8-9.

B.   Other Pipeline Cost Drivers

While pipeline integrity regulations have been the primary cost-driver for oil pipelines in recent years, Mr. Byrd explains that other regulatory obligations, such as public awareness program regulations and "operator qualification" regulations, have also imposed significant costs. These regulatory obligations, which were in place for all or most of the 2004-2009 period, will continue in future years and continue to require pipelines to incur significant costs. Byrd Decl. at 9-11.

In addition to the regulations in existence during the past five-year period, various new and anticipated regulations are likely to add to the costs of operations for oil pipelines in the coming years. As Mr. Byrd explains, in December 2009, PHMSA promulgated new control room management regulations, which will impose significant costs on pipeline operators. Byrd Decl. at 11-12. PHMSA is also expected to release new guidelines regarding land-use on or near pipeline rights-of-way. These guidelines "could have significant cost implications for pipeline operations and maintenance, including relocations and new construction." *Id.* at 13. New Chemical Facility Anti-Terrorism Standards promulgated by the Department of Homeland Security may also require pipelines to incur additional costs related to security of their facilities. *Id.* at 13. Proposed rules recently issued by the Environmental Protection Agency regarding emissions of greenhouse gases may impose additional costs and obligations on oil pipelines. *Id.* at 12.

In addition to the regulatory obligations discussed above, it should be recognized that there are other significant cost drivers for oil pipelines. For example, the cost of fuel

and power is a significant expense for oil pipelines. Oil pipelines are some of the largest

consumers of electric power on many utility systems. Substantial amounts of electricity

are consumed to power electric motors that drive large pumping stations used to transport

petroleum products. The rate index methodology offers strong incentives for oil

pipelines to operate their systems in the most energy-efficient manner possible, and the

industry has a strong record of doing so. *See, e.g.,* Shehadeh Decl. at 3 n.6.

Nevertheless, energy prices continue to rise, and oil pipelines are not immune to these

cost pressures.[6] Moreover, given the oil pipeline industry's significant reliance on

electric power, if statutory or regulatory initiatives to place a price on carbon emissions

are implemented, this could have a material impact on the costs incurred by oil pipelines.

While the nature and impact of these regulations is not fully known at this time, these

requirements will almost certainly increase the cost of electricity.[7]

Finally, capital costs can be expected to continue to grow. The past few years

have seen significant increases in investment due to pipeline expansion projects and new

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[6] According to the U.S. Energy Information Administration ("EIA"), inflation-adjusted retail electricity prices reached a twenty-year high in 2008. Although electric power prices fell after that point due to the economic downturn, prices are projected to continue to rise on an inflation-adjusted basis even under the most pessimistic of EIA's economic growth scenarios. *See* http://www.eia.gov/oiaf/aeo/pdf/trend_3.pdf.

[7] For example, the EIA's Annual Energy Outlook 2010 assumes that any new regulations will impose an effective cost of $15/ton of CO2 emissions, which would increase baseline coal electrical generation costs by about three percent. *See* http://www.eia.doe.gov/oiaf/aeo/pdf/2016levelized_costs_aeo2010.pdf

pipeline construction.[8]   The Commission has "acknowledge[d] the potential need for

increased capacity of the nation's oil transportation system." 2006 Order at P 64. As the

Commission has explained, "[t]he ability of pipelines to [undertake past] system

expansion and environmental, safety and security measures is due in no small part to the

appropriateness of the current index level. There is no guarantee that in the future

pipelines will retain that ability unless the Commission once again adopts an index that

allows the pipelines to recover their expected cost increases." 2006 Order at P 63.

In sum, an index of PPI-FG + 3.64 accurately tracks the relationship between

inflation and pipeline cost experience over the 2004 through 2009 period. Artificially

forcing the index below the PPI-FG + 3.64 level would frustrate expectations on which

past pipeline investments have been made, hinder pipeline carriers' efforts to expand

capacity and improve pipeline safety and integrity, and impede the ability of efficient

pipeline carriers to recover their costs.

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[8] For examples of the many new construction and expansion projects to
come before the Commission in recent years, see *TransCanada Keystone Pipeline,
LP*, 131 FERC ¶ 61,139 (2010); *Enbridge Pipelines (Toledo) Inc.,* 130 FERC ¶
61,270 (2010); *White Cliffs Pipeline, L.L.C.*, 126 FERC ¶ 61,070 (2009); *Enbridge
Pipelines (Southern Lights) LLC*, 121 FERC ¶ 61,310 (2007), *order on reh'g*, 122
FERC ¶ 61,170 (2008); *Enbridge Pipelines (North Dakota) LLC,* 125 FERC ¶
61,052 (2008); *CCPS Transportation, LLC,* 121 FERC ¶ 61,253 (2007), *order on
reh'g,* 122 FERC ¶ 61,123 (2008); *Calnev Pipe Line LLC*, 120 FERC ¶ 61,073
(2007); *Nexen Marketing U.S.A., Inc. v. Belle Fourche Pipeline Co.,* 121 FERC ¶
61,235 (2007); *Mid-America Pipeline Co., LLC*, 116 FERC ¶ 61,040 (2006);
Colonial Pipeline Co., 116 FERC ¶ 61,078 (2006), *order on reh'g*, 119 FERC ¶
61,183 (2007); *Enbridge Energy Co., Inc.*, 110 FERC ¶ 61,211 (2005).

CONCLUSION

For the reasons set forth above, the Commission should continue to apply the established Order No. 561 methodology and adopt an oil pipeline pricing index of PPI-FG + 3.64 for the five-year period from July 1, 2011 through June 30, 2016.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document on each person designated on the official service list compiled by the Secretary for this proceeding.

Dated at Washington, D.C. this 20th day of August, 2010.

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