

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Assessment of Information Requirements)
for FERC Financial Forms)

Docket No. RM07-9-000

COMMENTS OF CROWLEY ENERGY CONSULTING

1. Pursuant to the Notice of Inquiry (118 FERC ¶ 61,108) issued by the Federal Energy Regulatory Commission on February 15, 2007 into the Assessment of Information Requirements for FERC Financial Forms, Crowley Energy Consulting submits the following comments regarding the adequacy of the oil pipeline entities' FERC Annual Report of Oil Pipeline Companies, Form 6 financial reporting for the purposes of allowing customer groups to assess the justness and reasonableness of oil pipeline tariff rates. For the reasons set forth within, Crowley Energy Consulting respectfully requests that the Commission revise and augment the reporting requirements for oil pipeline entities as proposed herein.

I COMMUNICATIONS

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II STATEMENT OF INTEREST

2. Crowley Energy Consulting is a recently established consulting firm concentrating on regulatory energy litigation matters before federal and state regulatory commissions. Its principal, Patrick Crowley, retired from the Commission in February 2007 after 28 years

working primarily in oil and natural gas pipeline litigation on behalf of the Commission.

Crowley has extensive experience developing oil pipeline trended original cost studies under the Commission's Order No. 154-B ratemaking methodology. Crowley has developed oil pipeline cost of service studies regarding Olympic Pipe Line Company, Platte Pipe Line Company, Express Pipe Line Company, Anschutz Ranch East Pipeline Company, Conoco Pipeline Company, Frontier Pipeline Company, BP Pipelines (North America) Inc., SFPP, L.P., and Mid-America Pipeline Company. Based on Crowley's personal experience using the Form 6, which is ostensibly the source for the 154-B cost-of-service studies, he concludes the FERC Form 6 is woefully inadequate for either pipeline shippers or the Commission's own staff to build or test the reasonableness of many if not most oil pipeline tariff rates.

III COMMENTS

3. The Commission's February 15, 2007 Notice of Inquiry asks whether the FERC annual and quarterly reports provide sufficient information to the public to permit an evaluation of the form filer's jurisdictional rates and whether the Commission should change the form to improve its usefulness. As Chairman Kelliher noted in his February 15, 2007 press release, complainants have the burden of proof and it is therefore necessary that they have access to public information that provides a sufficient basis for a complaint so that they may meet that burden. The FERC Form 6, as it stands today, does not provide anything close to a sufficient basis for supporting a complaint regarding oil pipeline rates and therefore hampers the Commission's duty under the Interstate Commerce Act to monitor cost-based rates, analyze costs of different services and classes of assets, or compare costs across lines of business. Crowley Energy Consulting recommends that the Commission institute a 'tariff-set rate base' addition to Page 700 of the FERC Form 6 to provide shippers the minimum data sufficient to determine whether a *prima facie* case can be made to challenge an oil pipeline's existing rates.

4. The comments below address the following topics: A) the impact of the Energy Policy Act of 1992, B) the types of oil pipeline rates, C) a note on indexing, D) the data needed to develop rate base, and E) suggested modifications for the FERC Form 6.

A) Energy Policy Act of 1992

5. In 1992, Congress amplified its ‘light-handed’ regulation of the oil pipeline industry with the passage of the Energy Policy Act of 1992 (EPA92), which by and large governs oil pipeline ratemaking at FERC. Among other things, the EPA92 deemed most existing oil pipeline rates just and reasonable (grandfathered), and mandated that FERC develop a streamlined approach to oil pipeline rate filings. Section 1803(b) of the Act states that a complaint against a grandfathered rate must demonstrate that a substantial change has occurred, after 1992, in the economic circumstances on which the oil pipeline rates were established or the nature of the services provided that were the basis for the rates, known as the “changed circumstances” test. Thus, a challenge to grandfathered rates requires supporting information about the underlying factors that gave rise to the rates as well as what changes have taken place in those same factors since 1992. Similarly, to change the rates, a pipeline must show there is a “substantial divergence” between actual costs and the application of the existing rate such that the ceiling rates preclude the pipeline from charging a just and reasonable rate.

6. FERC responded to the EPA92 with Order No. 561, which established price caps for oil pipeline rates and instituted an annual indexation for oil pipeline rates tied to the producer price index. The order notes in its introductory paragraphs that the simplification of the rate making methodology must be accomplished in a manner that ensures rates are just and reasonable. FERC’s approach was the indexing system, which established a rate ceiling for each pipeline tariff. As a general rule, the Commission requires oil pipelines to use the indexing system to

change their rates. The Commission anticipated that the indexing system would eliminate the need for much future cost of service litigation.

7. In the interests of balance between pipelines and customers, Order No. 561 provided that customers may challenge existing rates, even if the rates are below the applicable ceiling rates, if they reasonably believe such rates are substantially in excess of actual costs. A cost of service review may be required if the rates significantly under- or over-recover in relation to actual costs. However, the Commission was adamant that it would not entertain complaints that merely alleged that the rate increases did not track the pipeline's actual costs; the complainant must allege that the proposed change in rate is so excessive that the resulting rate is unjust and unreasonable. Although Order No. 561 states that complainants must "simply" state the reasonable grounds for such allegations, shippers bear the burden of showing that the rates are not just and reasonable.

8. The upshot of the EPA92 and Order No. 561 is that complainants have to pass a two pronged threshold to challenge oil pipeline rates: first shippers must show a "changed circumstance" in the underlying economic factors that gave rise to the existing rate, and second, shippers must demonstrate a "substantial divergence" between the tariff rates and the actual cost of service. Consequently, before an oil pipeline shipper can begin exploring whether the rate it pays is just and reasonable, it must ascertain the nature of the rates it is challenging so as to understand the underlying factors that gave rise to the rates. Most current oil pipelines established their rates in six basic ways and, pursuant to the Energy Policy Act of 1992, the basis of any challenge to those rates must be grounded in how the rates were established.

B) Types of Pipeline Rates & Form 6 Support for Those Rates

9. “Initial rates” are established under §342 of the Code of Federal Regulations (CFR) by an oil pipeline by filing a cost, revenue, and throughput study using supporting data as described under §346 of the CFR or by simply filing a sworn affidavit by at least one non-affiliated potential shipper attesting that it intends to use the service proposed at the rate proposed. The attesting shipper need not ever actually use the service it claims it intends to use. Thus, the basis of an initial rate may be merely a number agreed to by some non-affiliated uncommitted entity. While §342(b) provides that if an initial rate is protested, the carrier must file a cost, revenue, and throughput study, the regulation do not specify what the basis of any protest must be other than that the protesting party must have a “substantial economic interest in the tariff.” One would assume that any protest would have to allege that the rates are so substantially in excess of actual costs that the rate is unjust and unreasonable. Yet, if cost was not the real basis or support for the rate, one cannot point to any cost information to support a claim of changed circumstance. Without such support, the Commission may dismiss the protest. A shipper may file a complaint against an initial rate but, as discussed above, the EPA92 requires a showing that some underlying foundation for the rates has substantially changed. The Form 6 provides no information regarding the foundation of initial rates.

10. “Cost of service rates” are established under §§342.2(a), 342.4(a), and 346 of the CFR. A pipeline may seek to establish or change its rates by filing a cost, revenue, and throughput study supporting those rates following the statements, schedules, and workpapers described under §346. To change the rates, a pipeline must show there is a “substantial divergence” between actual costs and the application of the existing rate such that the ceiling rates preclude the pipeline from charging a just and reasonable rate. Clearly, existing cost of service rates must have been built upon some supporting documentation. However, whether such rates are still just

and reasonable requires access to updated documentation, which is only available for examination if one files a challenge to the rates and, through discovery, obtains the supporting documentation. Because the Form 6 merges the cost of service elements from all the filing entity's operating units, line segments, and lines of business into one composite number, the support for any given line or service is lost in the mix leaving shippers unable to discern the foundation for its specific tariff rates. Prior to a challenge, the documentation is not publicly available, making a challenge difficult at best. This bears repeating: the information required to sustain a challenge to oil pipeline rates can only be obtained after the challenge is accepted by the Commission. Therefore, the likelihood of successfully initiating a challenge to oil pipeline rates is slim at best ~ a catch worthy of Joseph Heller.

11. "Grandfathered rates" are the rates, whatever their origination, in existence in 1992 when EPA92 was enacted. The FERC Form 6 provides information about the costs, revenues, and throughput for any given current and previous year but not the foundation for the existing rates nor the changes that have taken place in regard to those foundation since 1992, making the Form 6 woefully insufficient for gathering the information necessary to form the basis of a complaint by either shippers or the Commission staff as to the justness and reasonableness of the existing rates.

12. "Settlement rates" are simply rates established pursuant to settlement negotiations between parties, and may or may not have any supporting documentation or rationale that is publicly available. Certainly nothing in the Form 6 provides substantiation for existing settlement rates, or whether there has been a substantial change, since 1992, in one or more underlying factors that established those rates.

13. “Indexed rates” are the result of the application of the Commission’s annual index allowance to oil pipeline existing rates. Initial rates build upon rates established by one of the methods noted above. Like the other types of rates, indexed rates may be challenged if the proposed rate substantially diverges from actual costs so as to make the proposed rates unjust and unreasonable. Whether the actual costs for any particular service or line have substantially diverged from the company wide composite costs is not discernable.

14. “Market based rates” are rates established above the indexed ceiling rate where the pipeline has made a showing that it lacks market power in the relevant market or there are market power mitigation measures in place to prevent the exercise of market power by the pipeline. Like initial rates or settlement rates, market based rates may be developed without using cost allocation data. Thus, the data in the Form 6 may not be the basis for market based rates making the showing of a changed circumstance of a factor underlying the establishment of a market based rate problematic.

C) A Note on Indexing

15. The indexing scheme promulgated by the Commission applies the producer price index to the whole of the tariff rate. It does not select inflation prone cost elements or test whether inflation has been factored into the rates already. Because the indexing process applies to the whole tariff rate, all components of the underlying cost of service must be assumed to have responded to inflation. However, it is far from clear that all components of the cost of service do respond to inflation. Depreciation, for example, is calculated from base figures and amortized over the life of the pipeline. The original cost of the existing plant in service does not grow over time. Under oil pipeline ratemaking methodology, the growth in the value of plant in service is picked up in the trending of original cost via an inflation component. To allow inflation of the

depreciation component of the cost of service double counts the recovery of that growth in value; once in the depreciation expense, once in the return on equity. If sufficient plant additions have occurred such that the cost of service substantially diverges from the existing rates, the pipeline may file a proposed rate increase to confront the changed circumstance.

16. The return on capital on the other hand already captures anticipated inflation, so to allow inflation of the return component double counts that recovery as well. Debt instruments incorporate inflationary pressures anticipated by the lender into the interest rates applied to the principle. To allow inflation of the debt costs permits recovery of a cost not incurred by the pipeline. The return on equity incorporates a real return and an inflationary return to reward investors for the risk and future value of capital invested. With the inflation already embedded within the return on equity, to allow inflation again is to reward the investors twice for the same cost.

17. Inflation of the income tax component is an interesting issue. First off, many if not most pipelines are now structured as partnerships, which do not pay income taxes. Hence, the inclusion of an income tax in the cost of service compensates the pipelines for a cost they do not incur. To then add an inflation index on top adds insult to injury. Be that as it may, the income tax allowance is calculated by applying a tax rate to the return on equity, which already incorporated an inflationary component. Now, the cost of service is based on a number of assumptions, including forecasted throughput. So, if throughput falls within a close range of the forecast, the pipeline will recover the specified return on equity (including inflationary expectations) and the associated income tax. In that case, the impact of inflation on taxation is already embedded in the tariff via the application of the tax rate times the return component –

$$\text{rate base} * (\text{real return} + \text{inflation return}) * \text{income tax}$$

Indexing of the tax component is the same thing as –

rate base * (real return + inflation) * income tax * inflation, or:

(rate base * real return * income tax * inflation) + (rate base * income tax * inflation²)

So, to add an inflation index to income tax permits the double recovery of the inflation portion of return on equity in the cost of service.

18. Where does all this discussion on indexing leave us? If we know that depreciation, debt cost, return on equity, and income tax either do not respond to inflation or inflation is already taken into account in setting the original cost of service component, then the indexing paradigm only serves to provide additional return on equity to the pipeline owners. If costs have not gone up or there is no cost, additional revenue becomes return on equity. Therefore, the indexed rates are by definition in excess of the pipeline cost of service. The Form 6, however, somehow manages to evade this fact for most pipeline entities filing Form 6.

D) Data Required to Develop Rate Base

19. As noted above and reiterated in Order No. 571, indexing is the primary rate changing mechanism with a cost of service filing accepted only as an alternative if a substantial divergence can be shown between the ceiling indexed rate and actual costs. A pipeline requesting a rate higher than the ceiling rate would be required to make a cost allocation and rate design study showing how the substantial divergence. On the other hand, Order No. 571 noted that upon challenge “the pipeline must provide data supporting its proposed individual rates, including allocation and rate design. It will not be allowed to charge rates higher than its properly allocated costs would justify *for any one service.*” (Emphasis added) [Order No. 571 at 31,167]

20. Pipeline costs build upon five basic cost-of-service elements: 1) operating expense, 2) depreciation expense, 3) debt costs, 4) return on equity, and 5) income taxes. While each of these elements may appear to be straight-forward cost items readily available from an annual report, they are in fact advanced rate concepts developed using complex allocation models, forecast estimates, market shares, weighted averages, and historical data bases. In a formal rate case, each element is often the subject of a weighty tome all its own. Page 700 of the Form 6 makes a valiant, although unsuccessful, effort to encapsulate these cost elements.

21. The FERC Form 6 Page 700 provides a company-wide snapshot of the entity's costs, revenues, and throughput and requires that the values shown on Page 700 conform to the trended original cost ratemaking methodology proscribed in Order No. 154-B. Note 7) on Page 700 states that the Commission or its staff may request the pipeline provide workpapers supporting the data on page 700. Page 700 does not provide that other parties may request such supporting data. Hence, the supporting documentation behind existing cost of service derived rates is not publicly available, and thereby not sufficient, to support the burden of proof required of shippers to demonstrate that existing rates are unjust and unreasonable.

22. Whether those costs reported in the Form 6 accurately derive or report actual costs is not discernable. Similarly, given that some entities file one Form 6 covering numerous operating companies, separate operating segments, geographic service lines, and differing types of services, whether the one set of costs and throughput figures can act as a 'stand-in' for each service, each geographic line of business, or each affiliated pipeline entity's set of services is highly questionable. How is a shipper to discern the costs and throughputs that give rise to its particular rate via the Page 700 figures?

23. Furthermore, the crux of oil pipeline ratemaking is found not in the operating expense, which, it could be argued, are somewhat discernable through Page 700, but rather in the rate base upon which the rates are founded. The Commission's oil pipeline rate methodology, established in Order No. 154-B, requires the development of a 'trended original cost' rate base unlike anything seen under natural gas pipeline or electric transmission ratemaking. The trended original cost rate base incorporates regulatory concepts and regulatory assets not found in any books of account or any entries in the oil pipeline Form 6. Thus, from its very outset, an oil pipeline shipper cannot test the reasonableness of any rate because the data upon which the rate is based, only comes into existence during a rate investigation.

24. The trended original cost methodology grows out of a complex mathematical model that begins with the creation of a regulatory asset called the "starting rate base" and then adds to it another regulatory asset every year called the "deferred return." These elements, plus the actual net plant in service, create the rate base upon which a return is calculated.

25. The starting rate base alone is a complex rate base element not discernable via the Form 6. The starting rate base incorporates the original cost of the plant in service, accrued depreciation, and capital structure, all as of 1983; as well as the cost of reproduction new for the whole pipeline system as of 1983. The model creates a transition rate base element, which amortizes over the then-estimated life of the pipeline. The amortized amount is added to the cost of service; the unamortized amount is added to the rate base upon which a return is awarded.

26. The deferred return is also a complex rate base element not discernable through the Form 6. The trended original cost model does a number of things that require the use of historical data not available in any given year's Form 6. The model first divides the rate base into debt portions and equity portions. It then 'trends' the equity portion by the annual inflation rate for each year

since 1983. The model divides the nominal return-on-equity component of the cost of service into real return and inflationary return; deferring the inflation component for collection in later years. The deferred return then becomes a regulatory asset, which amortizes over the remaining life of the pipeline. The annual amortized amount from each year's deferred return is added to annual the cost of service while the unamortized amount is added to the rate base upon which a return is calculated. The deferred return compounds over time as it folds back into rate base upon which further return is awarded.

27. If a shipper faced a pipeline made up of a single line, Page 700 might suffice for making a *prima facie* case to challenge existing rates. However, many if not most entities filing Form 6 have multiple operating units cobbled together over the years through merges, divestitures, expansions, and conversions. Because the cost of services provided to any given shipper is heavily dependent on the composition of the rate base that underpins that service, the build-up of a given line segment rate base associated with that service is likely to be quite different from the company-wide rate base reported in the Form 6. The differences are diffuse throughout the components of rate base: the ratios of gross plant to net plant deriving the rate base and starting rate base, the equity ratios establishing the equity portion of the starting rate base, the estimated life of that line segment in 1983, and the build up of the accumulated deferred income tax balance, which is an offset to rate base. The result is that the beginning point for creating the starting rate base and deferred return rate base components for the several lines are not compatible and the composite figures do not and cannot reflect the sum of the parts.

28. Depreciation is another complex element for which the Form 6 composite figures obscure the determination of just and reasonable rates for any given line or operating unit. Customers on any given operating segment will, over time, have contributed amounts in the tariff rates toward the recuperation of return of capital. The result is not merely an academic exercise in developing

rate base and a resulting cost of service but can lead to significant differences in the rates developed for different customer groups. The age and resource lives of different lines will give rise to differing levels of accrued depreciation and net plant, leading to possibly large variations in rate base between the Form 6 composite figure and the individual lines. The data in the Form 6, as it exists today, does not provide the information necessary for shippers to develop even the vaguest notion of whether the rates for their particular service are still just and reasonable, thus contravening the principle stated in Order No. 571 that pipelines will not be allowed to charge rates higher than their properly allocated costs would justify *for any one service*.

E) Modifications to Form 6.

29. Showing that the existing rates on any given line have substantially diverged from the actual costs for that service is a tall order. Doing so requires a 154-B cost of service tailored as closely as possible to the cost for providing that service. While one might wish for a separate 154-B derived rate base for each tariff offered by a pipeline, the burden would be impossible. However, there could be better approximations than the current Form 6 reportage of rate base for oil pipelines. One possibility is to require the addition of “tariff-set rate bases” to Page 700, *i.e.*, a 154-B rate base development for each set of tariffs that build upon a common rate base.

30. For instance, assume a Rainbow Pipeline made up of line segments or operating units acquired over time: Blue Line, Red Line, and Green Line. The Blue Line may have ten destination points with tariffs built up over time through initial rates, settlement rates, and indexed rates, but all predicated on the rate base underlying the Blue Line. Rainbow Pipeline would then include in its Form 6 a 154-B derived Page 700 rate base for the Blue Line to support Blue Line tariffs. Similarly, Rainbow Pipeline would also include in its Form 6 a separate 154-B derived Page 700 rate base for the Red Line to support all Red Line tariffs and for Green Line to

support all Green Line tariffs. If however, the Red and Green Line tariffs were developed using a single rate base even though they served separate geographic markets, these two sets of tariffs would be represented by only one 154-B Page 700 rate base derivation. If Rainbow Pipeline had, at some point, acquired Yellow Line, a multi-line (non-linear) network pipeline operation, for which the tariffs were all based on the multi-line rate base, Rainbow Pipeline would submit a separate 154-B Page 700 rate base covering all the Yellow Line tariffs.

31. The methodology described above would permit ratepayers a meaningful examination of the rate base, operating costs, and throughput relevant to their share of the pipeline's cost-of-service. The tariff-set rate base presentation is the minimum required to provide shippers sufficient data to determine whether a *prima facie* case can be made for a challenge to existing oil pipeline rates.

32. What happens if Rainbow Pipeline has some market based rates for some destinations on an otherwise cost-based Red Line? Since market based rates do not rely on a rate base foundation, a 154-B Page 700 would be irrelevant. Market based rates would be measured against the market power tests established by the Commission. However, some share of Red Line costs, including rate base, must be allocated to the market based Red Line tariffs so that the cost-based Red Line tariffs are not encumbered with costs already borne by other customers. The reduction methodology for Red Line rate base for 154-B Page 700 rate base derivation purposes should be noted in a footnote.

IV RESPONSE TO THE COMMISSION'S GENERAL QUESTIONS

33. (1) Do the annual and quarterly Financial Forms provide sufficient data for the public to permit an evaluation of the filer's jurisdictional rates? As noted above, the oil pipeline Form 6

does not provide sufficient information to enable either shippers or the Commission Staff to make an evaluation of the filer's jurisdictional rates.

34. (2) If not, what additional data is needed to conduct such an evaluation? Please specify the form (or forms) to which your suggestions pertain. As noted above, Crowley Energy Consulting recommends that the Commission institute a 'tariff-set rate base' addition to Page 700 of the FERC Form 6 to provide shippers the minimum data sufficient to determine whether a *prima facie* case can be made to challenge an oil pipeline's existing rates.

35. Questions (3) through (6) are not applicable to these comments.

36. (7) How burdensome would any requirement for additional information be to filers of Financial Forms? The information, upon which the current Page 700 is built, is already in the hands of the pipeline entities. Because plant additions and retirements have location codes, the buildup of plant under 154-B ratemaking methodology is readily accomplished. The derivation of the starting rate base is a formulaic process in electronic spreadsheets that incorporates just four plant balance figures from 1983, which the pipeline should have available by location code for each tariff-set rate base: plant in service, accrued depreciation, reproduction cost new, equity ratio. Similarly, the deferred return component of rate base is also a formulaic process in electronic spreadsheets that calculates an iterative process to fold the deferred inflation return back into rate base year after year. Once the initial Page 700 is built, per tariff-set rate base, each subsequent year need only add in the annual plant addition and retirement by location code to the 154-B spreadsheet. So, while there may be a modest burden in the first year, subsequent annual reporting by tariff-set rate base should not be unduly burdensome given that the result is the ability to monitor for just and reasonable rates and carry out the Commission's duty under the

Interstate Commerce Act to monitor cost-based rates, analyze costs of different services and classes of assets, or compare costs across lines of business.

37. Questions (8) through (12) are not applicable to these comments.

V CONCLUSIONS

38. The Commission has stated in a number of places its intent to maintain a balance between pipelines and shippers in regard to establishing just and reasonable rates for the movement of oil. However, the existing ratemaking paradigm weighs heavily in favor of pipelines through the use of nearly impossible-to-meet threshold tests for reasonableness. The existing Form 6 Page 700 data so thoroughly folds together all the costs from all the services on all the filing entity's lines that no meaningful comparison can be made of the composite costs, revenues, and throughputs reflected on the Page 700 with the actual costs, revenues, and throughput relevant to any particular tariff. Few if any challengers can meet the tests. Therefore, in order to re-establish a balance between pipelines and shippers, Crowley Energy Consulting recommends the Commission change the Form 6 Page 700 to include "tariff-set rate bases" to support a 154-B rate base development for each set of tariffs that build upon a common rate base.

Respectfully submitted,

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