

**TESTIMONY OF
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CHAIRMAN
FEDERAL ENERGY REGULATORY COMMISSION**

**BEFORE THE SUBCOMMITTEE ON ENERGY AND WATER
DEVELOPMENT
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE**

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Mr. Chairman and Members of the Subcommittee:

Thank you for this opportunity to appear before your Subcommittee to discuss Energy Supply and Constraints in Western North Dakota. My testimony today will include a description of the nation's oil pipeline network, a brief history of oil pipeline regulation, a description of the Federal Energy Regulatory Commission's (FERC) authority under the Interstate Commerce Act to regulate the transportation of oil and oil products by pipelines and the jurisdictional limitations of the Act on that authority, a description of current oil pipeline rate regulation, and comments on North Dakota crude oil transportation.

OIL PIPELINES IN THE UNITED STATES

The nation's oil pipeline network consists of approximately 200,000 miles of pipelines performing a variety of roles. Crude petroleum systems transport crude oil and synthetic oil from production areas and marine terminals to refineries. The refiners produce a variety of petroleum products, principally gasoline, heating oil, and jet fuel, but also liquefied petroleum gases (*e.g.*, butane

and propane), kerosene, heavier distillates, naphthas, and asphalt. A system of pipelines separate from crude oil lines transport refined petroleum products from refineries or import terminals to distribution points. Both crude oil and petroleum product transportation is measured in barrels (bbls.). A barrel equals 42 U.S. gallons.

A BRIEF HISTORY OF OIL PIPELINE REGULATION

The Interstate Commerce Act (ICA) gives the Commission the authority to regulate the transportation rates and practices of oil pipelines. The Hepburn Act of 1906 began the regulation of interstate oil pipelines, making pipelines common carriers subject to regulation. The Act was an amendment to the existing Interstate Commerce Act that from its enactment in 1887 had focused primarily on railroad and telegraph company regulation. The responsibility for regulating oil pipeline rates was vested in the Interstate Commerce Commission (ICC) and remained with the ICC until 1977, when the Department of Energy Organization Act was enacted. That Act transferred jurisdiction over oil pipeline regulation from the ICC to the new Department of Energy and the Federal Power Commission, predecessor to FERC.

Regulation of oil pipelines is governed by the version of the ICA as it stood on October 1, 1977, the day of enactment of the Department of Energy Organization Act. That version can be found only as an appendix to the 1988 edition of Title 49 of the United States Code (cited as 49 App. U.S.C. § 1, et seq.

(1988)). The 1977 version of the ICA also has been reproduced and made available on the FERC website.

REQUIREMENTS, AND LIMITATIONS, OF THE ICA

The ICA applies to the transportation of oil and oil products, *i.e.*, crude oil and petroleum products, from one state to any other state, from any place in the United States to a foreign country, and from a foreign country to any place in the United States (but only insofar as such transportation takes place within the United States). Because oil pipelines are common carriers, the ICA requires that they provide transportation upon reasonable request. This means, for example, that an oil pipeline operating at full capacity must prorate that capacity among current shippers to make capacity available for a new shipper requesting transportation service from the pipeline. In prorationing, the Commission cannot legally give preferential treatment to domestic oil producers over foreign sources.

The ICA requires that all charges for oil pipeline transportation must be just and reasonable. Oil pipelines must file tariffs showing all their rates and charges and can make changes to those rates and charges only after 30 days' notice to the Commission and the public. On its own motion or in response to a protest, the Commission can suspend tariff filings for up to seven months and institute investigations into their lawfulness; at the end of the suspension period, the proposed tariffs can go into effect subject to refund. The Commission can also investigate the lawfulness of oil pipeline rates and practices and prescribe changes upon complaint or its own initiative.

Some matters the ICA does **not** confer jurisdiction over are the siting and construction of oil pipelines (authority rests with states and local jurisdictions), mergers and acquisitions, abandonment of service, and safety (authority rests with the Department of Transportation's Pipeline and Hazardous Materials Safety Administration).

RATEMAKING UNDER THE ICA

The Commission until 1992 historically used two ratemaking methodologies for the adjudication of oil pipeline rates – cost-based and market-based. The Commission's cost-based ratemaking methodology for oil pipelines employs a "trended original cost" rate base and was instituted in Opinion No. 154-B, *Williams Pipe Line Co.*, 31 FERC & 61,377 (1985). In brief, a pipeline's annual revenue requirement is calculated using a rate base that is trended to account for inflation.

As an alternative to the cost-based ratemaking approach, the Commission adopted a market-based approach for Buckeye Pipe Line Company in Opinion No. 360, *Buckeye Pipe Line Company, L.P.*, 53 FERC & 61,473 (1990). *Buckeye* implemented a lighter-handed regulatory approach that permitted rates charged by the pipeline in competitive markets to be determined by market forces.

In Title XVIII of the Energy Policy Act of 1992 (EPAct 1992), Congress directed the Commission to establish a "simplified and generally applicable ratemaking methodology for oil pipelines." Congress in EPAct 1992 also

protected oil pipelines' existing rates by deeming them "to be just and reasonable" as of the date of enactment.

There was no legislative history to discern how Congress intended the Commission to simplify its ratemaking methods, and the text of EAct 1992 itself provided little guidance. In response, the Commission instituted rulemakings that culminated in Order No. 561, which adopted rate methodologies for oil pipeline rate changes, Order No. 571, which established filing requirements for cost information that pipelines must include with cost-of-service rate filings, and Order No. 572, which established filing requirements for pipelines proposing to charge market-based rates. These ratemaking methodologies became effective on January 1, 1995, and were affirmed by the U.S. Court of Appeals for the D.C. Circuit in 1996, *Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir 1996).

The regulations adopted in response to EAct 1992 provide an indexing, or a price cap, methodology as the simplified and generally applicable ratemaking methodology for oil pipelines. The existing rates deemed to be just and reasonable by Congress in EAct 1992 form a baseline for future oil pipeline rate changes within an indexed ceiling. The index used under the Commission's regulations is the annual change in the Producer Price Index for Finished Goods (PPI-FG), including an annual adjustment factor, currently plus 1.3 percent. Under indexing, oil pipeline rates may be adjusted up to the ceiling level established by the index. Rates changed under the index methodology may not exceed the ceiling level. If the ceiling level goes down, pipelines must lower existing rates that exceed the

new ceiling level. The regulations also provide for challenges to individual rates on the basis that they are substantially in excess of the pipeline's costs, even though the rate may be at or below the ceiling level.

A pipeline can seek to charge rates above its index ceiling level by showing that its cost of service substantially exceeds the revenue resulting from application of the index, or by negotiating an agreement with all its current shippers to charge higher rates. A pipeline that desires to charge market-based rates may do so after it has asked for and received from the Commission a finding that it lacks significant market power in the markets it serves.

Other provisions of the Commission's regulations also provide procedures to resolve contentious issues short of full-blown litigation. All protested tariff filings are referred to a settlement judge, and disputed rates are set for hearing only after settlement proves infeasible.

NORTH DAKOTA CRUDE OIL TRANSPORTATION

There has been dramatic growth in crude oil production in the Williston Basin area of North Dakota that has increased the North Dakota oil producers' need for available oil pipeline capacity to move their crude oil to market. In 2007, North Dakota crude oil production was approximately 125,000 barrels per day. In March 2008, daily production levels had risen by 22,000 barrels to approximately 147,000 bpd, or an increase of approximately 17.5 percent on an annual basis. Existing pipelines serving the area are operating at full capacity, requiring that they apportion their capacity among shippers.

At the same time, crude oil imports from Canada are rising. Annual crude oil production levels for 2007 published by the Alberta Resources Conservation Board reveal the Alberta Basin yielded about 482,000,000 barrels that year or 1,860,000 bpd, a 3 percent increase from 2006. Significantly, Canadian imports are projected to reach 3,400,000 bpd by 2017. Canadian oil imports currently comprise 20 percent of U.S. crude oil supply and represent our largest source of oil imports. We expect this trend to continue. These imports are reliable supplies from a secure country and improve our energy security.

However, Canadian imports require space in the pipeline and can create bottlenecks in pipeline capacity that limit the amount of crude oil that can be moved out of the North Dakota production region. Pipelines serving North Dakota are increasing their capacity, which should help to alleviate capacity shortages; nevertheless, it is likely that with additional growth in North Dakota crude oil production and Canadian imports the pipelines' proposed capacity increases still will not be adequate to transport North Dakota production without capacity prorationing among shippers seeking that capacity.

While the Natural Gas Act authorizes the Commission to issue certificates of public convenience and necessity to natural gas companies to construct and operate pipelines for the transportation of natural gas in interstate commerce, there is no similar authority with regard to oil pipelines. For natural gas pipelines, the Commission serves as the lead agency in charge of processing applications to construct interstate natural gas pipeline facilities, conduct the necessary

environmental review pursuant to the National Environmental Policy Act, and coordinate the timing of other necessary federal permits. The Natural Gas Act allows the Commission to attach reasonable conditions to its decisions or “certificates.” Further, Commission authorizations convey the right of eminent domain to the recipients of the certificate which may be exercised in the U.S. District Court for the district where the facility will be located or in state courts. In the instances where there is an application for a new pipeline or where a new service on an existing system is being proposed (most likely due to facility additions), the Commission has the authority to approve initial rates for the new service. It should also be noted that interstate natural gas pipelines are contract carriers, *i.e.*, their services are provided on a contractual basis. Thus, if a pipeline is already fully used, a new shipper is not entitled to a prorated share of the capacity.

The siting of oil pipelines by contrast is handled primarily by state agencies. The Interstate Commerce Act, thus, does **not** authorize the Commission to regulate the siting or construction of oil pipelines.

The Commission recognizes the need for investment in energy transportation infrastructure to meet the nation’s growing demand for energy and encourages new and expansion crude oil pipeline projects. The Commission, in fact, has approved several settlement proposals involving rates for expansion of Enbridge Pipeline’s North Dakota mainline to provide additional crude oil takeaway capacity for the North Dakota production area, and rates for other

Enbridge Energy Company proposals to expand the major pipelines importing Canadian crude oil to help relieve pipeline capacity bottlenecks. However, there is no ICA or other statutory provision that allows the Commission to regulate how much foreign oil can displace domestic oil in oil pipelines, since oil pipelines under the ICA are common carriers that must provide nondiscriminatory service to all who request it.

The Commission's regulatory authority also begins only at the border and extends only to transportation that takes place within the United States, regardless of the source of the oil being transported. The Commission thus does not have a role in regulating foreign sources of crude oil entering the United States, but only its movement once it crosses the border. The Commission also does not regulate how much crude oil is coming into the United States from Canada.

CONCLUSION

The nature of the problem is that North Dakota oil production and Canadian crude oil imports exceed current pipeline takeaway capacity in the region. Both domestic and Canadian crude oil production are increasing, exacerbating the competition for limited pipeline capacity. There have been additions to pipeline takeaway capacity in the region, but not enough to eliminate constraints or accommodate future increases in North Dakota production or Canadian imports.

The best solution is to increase the pipeline capacity available to both sources of crude oil. FERC supports energy infrastructure development and the Commission has participated as a member of the Interstate Oil and Gas Compact

Commission Crude Oil Market Infrastructure Task Force that was first convened in 2006 to investigate the crude oil market dynamics in the Rocky Mountain region. However, the parties themselves must resolve who will commit to support the development of new infrastructure and who is willing to pay for it. FERC for its part will continue to work with all parties to achieve these ends.