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ORAL ARGUMENT HAS NOT BEEN SCHEDULED

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IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

Nos. 04-1102, *et al.*
(Consolidated)

EXXONMOBIL OIL CORPORATION, *et al.*,
PETITIONERS,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *et. al.*,
RESPONDENTS.

ON PETITIONS FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION

SUPPLEMENTAL BRIEF OF RESPONDENTS FEDERAL ENERGY REGULATORY COMMISSION AND UNITED STATES OF AMERICA

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October 19, 2006

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CIRCUIT RULE 28(a)(1) CERTIFICATE

A. Parties and Amici

The parties before this Court are identified in the brief of Petitioners.

B. Rulings Under Review

1. *ARCO Products Co. v. SFPP, L.P.*, 92 FERC ¶ 61,244 (2000);

2. *ARCO Products Co. v. SFPP, L.P.*, 106 FERC ¶ 61,300 (2004); and

3. *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005).

C. Related Cases

Chevron Products Co. v. FERC, No. 03-1183, *ExxonMobil Oil Corp. v. FERC*, Nos. 06-1008 *et al*. (consolidated), and *SFPP L.P. v. FERC*, Nos. 02-1112, *et al.* (consolidated) are related to this proceeding as they also concern SFPP's rates.

Lona T. Perry
Senior Attorney

October 19, 2006

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GLOSSARY

AOPL	The Association of Oil Pipe Lines
AOPL	*Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996)
EPAct	Energy Policy Act of 1992
Farmers Union	*Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984)
FERC or Commission	Federal Energy Regulatory Commission
ICA	Interstate Commerce Act
Opinion No. 154-B	*Williams Pipe Line Co.*, Opinion No. 154-B, 31 FERC ¶ 61,377 (1985)
Opinion No. 435 Proceedings	*SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 (1999), *on reh'g*, Opinion No. 435-A, 91 FERC ¶ 61,135 (2000), *on reh'g*, Opinion No. 435-B, 96 FERC ¶ 61,281 (2001), *aff'd in part, rev'd in part, BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1271 (D.C. Cir. 2004)
Order On Initial Decision	*ARCO Products Co. v. SFPP, L.P.*, 106 FERC ¶ 61,300 (2004)
Policy Statement	Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (2005)
Remand Order	*SFPP, L.P.*, 111 FERC ¶ 61,334 (2005)
SFPP Br.	Joint Initial Brief of Petitioners SFPP, L.P. and the Association of Oil Pipelines
Shipper Br.	Joint Initial Brief of Shipper Petitioners

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SUPPLEMENTAL BRIEF OF RESPONDENTS FEDERAL ENERGY REGULATORY COMMISSION AND UNITED STATES OF AMERICA

STATEMENT OF THE ISSUE

Whether the Commission reasonably determined if there were "substantially changed circumstances," within the meaning of § 1803 of the Energy Policy Act of 1992, Pub. L. 102-486, 106 Stat. 2776 ("EPAct"), to the economic basis for SFPP's West, North and Oregon Line rates, justifying reexamination of those rates.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendums to Petitioners' briefs.

INTRODUCTION

The challenged orders, *ARCO Products Co. v. SFPP, L.P.*, 106 FERC ¶ 61,300 (2004) ("Order on Initial Decision"), JA 2585; *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) ("Remand Order"), JA 2637, made determinations regarding whether there had been a "substantial change" in the economic circumstances that were the basis for SFPP's rates on its West, North and Oregon lines, based upon the Commission's calculation of various components in SFPP's rates on those lines. No requests for rehearing of the Commission's substantially changed circumstances determinations were ever filed. The only requests for rehearing of the Order on Initial Decision concerned only East Line issues; there were no requests for rehearing of the Remand Order.

On appeal, shippers and SFPP now raise a number of challenges to the Commission's determinations regarding substantially changed circumstances under the EPAct on the West, North and Oregon Lines, without ever having sought reconsideration of those determinations before the Commission. In particular, none of the arguments discussed in Argument Section III of this brief, challenging the Commission's evidentiary basis for, and calculations underlying, the findings of substantially changed circumstances was raised to the Commission. The Commission sought a partial voluntary remand of the substantially changed

circumstances issue to have the opportunity to consider these arguments, but that motion was denied by the Court without prejudice by Order of August 17, 2006, and the Commission was ordered to file this Supplemental Brief.

Although there is no rehearing requirement in the Interstate Commerce Act, that does not mean that the Court will consider on appeal, for the first time, arguments petitioners utterly failed to raise before the Commission. Rather, as has long been recognized, "orderly procedure and good administration require that objections to the proceedings of an administrative agency be made while it has opportunity for correction in order to raise issues reviewable by the courts." *United States v. L.A. Tucker Truck Lines, Inc*., 344 U.S. 33, 37 (1952). "Simple fairness to those who are engaged in the tasks of administration, and to litigants, requires as a general rule that courts should not topple over administrative decisions unless the administrative body not only has erred but has erred against objection made at the time appropriate under its practice." *Id*.

Following *Tucker Truck*, this Court has refused to consider arguments not raised before the agency "'at the time appropriate under its practice.'" *BNSF Ry. Co. v. Surface Transp. Bd.*, 453 F.3d 473, 2006 U.S. App. LEXIS 14749 at *12 (D.C. Cir. 2006) (quoting *Tucker Truck*, 344 U.S. at 37). *See also, e.g., Western Res., Inc. v. Surface Transp. Bd.*, 109 F.3d 782, 793-94 (D.C. Cir. 1997) (finding

that the Court cannot reach issues petitioner failed to raise before the agency, citing *Tucker Truck*); *Petroleum Communications, Inc. v. FCC*, 22 F.3d 1164, 1169 (D.C. Cir. 1994) (refusing to reach issue not raised before the Commission under § 405(a) of the Communications Act, which codifies the judicially-created doctrine of exhaustion, quoting *Tucker Truck*); *In re Core Communications, Inc*., 455 F.3d 267, 276-77 (D.C. Cir. 2006), *reh'g pending*, No. 04-1368 (under § 405, a party must seek reconsideration before seeking appellate review, even if the issue was raised for the first time by a Commission order). In particular, technical mistakes, such as the computational errors alleged here, must be raised with precision before the agency. *Time Warner Entertainment Co., L.P. v. FCC*, 144 F.3d 75, 81 (D.C. Cir. 1998).

Here, petitioners had ample opportunity to raise before the Commission their objections to the evidentiary basis for, and the calculations underlying, the Commission's substantially changed circumstances determinations, but they entirely failed to do so. As the Commission consequently never had the opportunity to consider those objections, this Court should decline to consider them, in the first instance, on appeal.

STATEMENT OF THE CASE

I. STATUTORY AND REGULATORY BACKGROUND

In 1906, Congress amended the Hepburn Act and extended the definition of common carrier under the Interstate Commerce Act ("ICA") to oil pipelines and required that the rates be just and reasonable. *See* ICA § 1(5), 49 U.S.C. app. § 1(5) (1988). In 1977, in conjunction with the formation of the Department of Energy, regulatory authority over oil pipelines under the ICA was transferred from the ICC to the newly-created FERC. *See* Section 402(b) of the Department of Energy Organization Act, 42 U.S.C. § 7172(b).

In Opinion No. 154, *Williams Pipe Line Co.*, 21 FERC ¶ 61,260 at 61,597 (1982), the Commission concluded that ratemaking for oil pipelines should only "restrain gross overreaching and unconscionable gouging." The D.C. Circuit remanded Opinion No. 154, holding that the ICA required oil pipeline transportation rates to be "just and reasonable." *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1500 (D.C. Cir. 1984). The Court further held that the "most useful and reliable starting point for rate regulation is an inquiry into costs." *Id.* at 1502.

In response to *Farmers*, the Commission held that "oil pipeline rates as a general rule must be cost-based." Opinion No. 154-B, *Williams Pipe Line Co.*, 31

FERC ¶ 61,377 at 61,833 (1985). Following Opinion No. 154-B, adjudicated proceedings for oil pipelines were long, complicated and costly. *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561, FERC Stats. & Regs. [Regs. Preambles, 1991-1996] ¶ 30,985 (1993), *on reh'g*, Order No. 561-A, FERC Stats. & Regs. [Regs. Preambles, 1991-1996] ¶ 31,000 (1994), *aff'd, Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

To address this problem, in 1992 Congress passed the EPAct. Order No. 561 at 30,944. The EPAct required FERC to simplify its oil pipeline ratemaking methodology and streamline its procedural rules "in order to avoid unnecessary costs and delays." *Id*. Further, the EPAct established a baseline of historically-effective rates that were deemed just and reasonable under the ICA, "thereby forming a base-line for many future oil pipeline rate changes and obviating future debate over the appropriateness of existing rates, many of which are based on valuation or trended original cost methodologies." Order No. 561-A at 31,091.

Congress deemed qualifying existing rates to be just and reasonable to avoid "arbitrary review" of them. 138 Cong. Rec. H3489 (May 20, 1992) (statement of Rep. Brewster). *See also* 138 Cong. Rec. H3809 (May 27, 1992) ("the provision incorporates a transition mechanism for existing base rates, so that we can avoid

thousands of unchallenged rates being unnecessarily subject to question under a new methodology.") Thus, under EPAct § 1803(b)(1)(A), rates that qualify for "grandfathering" are "categorically immune" from challenge in a complaint proceeding under ICA § 13, 49 U.S.C. app. § 13 (1988), except, as pertinent here, where "evidence is presented to the Commission which establishes that a substantial change has occurred after the date of the enactment of this act in the economic circumstances of the oil pipeline which were a basis for the rate." *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263, 1271 (D.C. Cir. 2004).

II. THE PROCEEDINGS UNDER REVIEW

A. The Opinion No. 435, Docket No. OR92-8 Proceedings

SFPP's Opinion No. 435, FERC Docket No. OR92-8, rate proceeding was the first oil pipeline rate case to litigate the grandfathering of rates under the EPAct. *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 (1999), *on reh'g*, Opinion No. 435-A, 91 FERC ¶ 61,135 (2000), *on reh'g*, Opinion No. 435-B, 96 FERC ¶ 61,281 (2001). *See BP West Coast*, 374 F.3d at 1271. The Opinion No. 435 orders addressed complaints filed between November 1992 and August 5, 1995, against SFPP's West Line rates, and concluded that the West Line rates were grandfathered under the EPAct, and that shipper complainants had not established that there were

substantially changed circumstances to the economic basis of those rates. Accordingly, the EPAct protected the challenged West Line rates from review.

B. *BP West Coast*

On July 20, 2004, this Court affirmed much of the Opinion No. 435 orders, but remanded certain points for further review. *BP West Coast*, 374 F.3d at 1312. The most significant remanded issue concerned whether an income tax allowance may be afforded a regulated partnership. The Court concluded that the Opinion No. 435 orders had not adequately justified providing a partnership such as SFPP an income tax allowance. In doing so, the Court rejected the Commission's existing *Lakehead* doctrine,[1] which provided an income tax allowance to partnerships in proportion to the partnership interests owned by corporations, but denied an allowance for partnership interests not owned by corporations. *Id*. at 1285-1292.

On May 4, 2005, in response to the *BP West Coast* remand and following an extensive comment period, the Commission issued the Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (2005) ("Policy Statement"), JA 2795. The Policy Statement overruled the *Lakehead* doctrine and concluded that regulated partnerships would be afforded income tax allowances if they could establish that

[1] *See Lakehead Pipe Line Co., L.P.*, Opinion No. 397, 71 FERC ¶ 61,338 (1995), *on reh'g*, Opinion No. 397-A, 75 FERC ¶ 61,181 (1996).

their partners had an actual or potential income tax liability on the partnership's income. *Id*. at PP 32-33, JA 2800-01.

On June 1, 2005, the Commission issued the Remand Order, addressing both the *BP West Coast* remand and requests for rehearing of the Order on Initial Decision in OR96-2 (which concerned only issues regarding the East Line). 111 FERC ¶ 61,334, JA 2637. In that Order, applying the Policy Statement, the Commission held that SFPP would be permitted to include an income tax allowance in its East and West Line rates if SFPP could establish that its partners would incur an actual or potential income tax obligation from SFPP's regulated income. 111 FERC ¶ 61,334 at PP 21-27, JA 2641-43.

C. The Orders Under Review

In the challenged orders, the Commission addressed the *BP West Coast* remand of the Opinion No. 435 proceeding orders, and also addressed a subsequent series of complaints against the rates for SFPP's East, West, North, and Oregon Lines. These complaints were filed between late 1995 and August 2000 and were consolidated in FERC Docket No. OR96-2.

Following the issuance of Opinion No. 435-A in May 2000, the Commission issued orders consolidating the OR96-2 complaints and setting them for hearing. *ARCO Products Co., et al. v. SFPP, L.P.*, 91 FERC ¶ 61,142 (2000); *ARCO*

Products Co., et al. v. SFPP, L.P., 92 FERC ¶ 61,244 (2000). Following the hearing and post-hearing briefing, the Administrative Law Judge issued an Initial Decision finding substantially changed circumstances on the West, North and Oregon lines. *Texaco Refining and Marketing Inc., et al. v. SFPP, L.P.*, 103 FERC ¶ 63,055 (2003), JA 869. In the Order on Initial Decision, the Commission modified the Administrative Law Judge's method for making the specific calculations used to determine whether there were substantially changed circumstances, and affirmed the findings as to the West Line but reversed the findings as to the North and Oregon lines. *Id.* P 3, JA 871.

Only two parties sought rehearing of the Order on Initial Decision, both challenging findings as to East Line rate issues not relevant to the issue of substantially changed circumstances. While rehearing of the Order on Initial Decision was pending, the Court issued *BP West Coast* and the Commission in response issued the Policy Statement, reversing its *Lakehead* orders. Remand Order P 21, JA 2641-42. In the Remand Order, the Commission revisited the issue of substantially changed circumstances, as the change in the income tax allowance policy affected the analysis. *Id.* P 16, JA 2641.

The adjustment from a partial *Lakehead* income tax allowance to a full income tax allowance increased the relevant costs and therefore decreased any

improvements in the pipeline's return that underpin the substantially changed circumstances analysis. *Id*. There was accordingly no change in the determinations in the Order on Initial Decision regarding the North and Oregon Lines because the Commission found actual cost increases rather than decreases on those Lines. *Id*. As for the West Line, the Commission recalculated the return, and determined that, even with a full income tax allowance, there was still a substantial change in circumstances. Remand Order P 39, JA 2646.

No party sought rehearing of the Remand Order. Petitions for review were filed and this appeal followed.

SUMMARY OF ARGUMENT

In the challenged orders, the Commission determined that SFPP's West Line rates were no longer "grandfathered" under EPAct § 1803(b) because there had been a substantial change in the economic circumstances that were a basis of that rate. The Commission concluded, however, that the North and Oregon lines remained grandfathered as there had been no substantial change under the statute.

No party sought rehearing of these conclusions before the Commission, and, therefore, no challenges to these conclusions were raised before the Commission. For that reason, the Commission sought a partial voluntary remand to reconsider the issue of substantially changed circumstances, but that request was denied by the Court, and the Commission was ordered to file the instant Supplemental Brief. However, because the challenges raised on appeal were never raised to the Commission, under Supreme Court and this Court's precedent, this Court should decline to hear these challenges now.

In the event the Court entertains the challenges newly raised on appeal, in the main those challenges should be rejected. In the first instance, the Commission properly found that the EPAct requires that complainants satisfy a high threshold in order to show substantially changed circumstances. The EPAct purpose was to

limit litigation over pre-EPAct rates, with a built-in safety valve for circumstances where a pipeline is charging unacceptably high rates.

The Commission properly rejected Shippers' contention that grandfathering could be defeated based upon a substantial change in any rate *element*, viewed in isolation, including the income tax allowance. Considering individual rate elements in isolation precludes consideration of off-setting rate elements, and potentially defeats grandfathering where carriers are not charging unacceptably high rates, and indeed may be losing money. The concern is not any particular element of the cost-of-service, but rather that the resulting threshold be high enough to fulfill the statutory purpose of sheltering grandfathered rates from undue challenge.

For its part, the Association of Oil Pipe Lines ("AOPL") argues that the Commission should be precluded from using a cost-of-service approach in assessing substantially changed circumstances, because many oil pipeline rates were set by settlement and were not based on standard cost-of-service ratemaking. However, the Commission found that shippers will not agree to settlement rates without some reason upon which to believe the rates are reasonable. Here, in particular, SFPP filed cost-of-service information with the Commission expressly to demonstrate the reasonableness of the settlement rates. Where, as here, such information is available, comparing the current rates with the economic basis for the

settlement rates on a cost-of-service basis is a reasonable way to assess whether there was a substantial change in the circumstances of the rate.

SFPP and Shippers also challenge the specific application of the substantially changed circumstances standard to SFPP. SFPP contends that the Commission erred in finding substantially changed circumstances on the West Line because the Commission allegedly used an overstated figure for SFPP's 1992 West Line cost-of-service. Even assuming, *arguendo*, that SFPP is correct, it would not change the result of the analysis. Under the Commission's methodology, SFPP's number is so low relative to the other years' cost-of-service that it would produce anomalous results and it would therefore be disregarded. Accordingly, this argument provides no basis for overturning the Commission's determinations.

Shippers contend that the Commission erred in using volume as a proxy for SFPP revenues. Using volume as a proxy for revenues was rational here where SFPP did not modify the subject rates except for adjustments permitted under the Commission's indexing method. With constant rates, revenues are a linear function of volume, and therefore increases or decreases in revenue are a direct function of changes in volume. While Shippers contend that this method fails to fully account for SFPP's excess revenues, the North Line figures relied upon by Shippers fail to limit excess revenues to those accruing *after* EPAct enactment.

SFPP challenges the Commission's addition of percentage values that do not have the same base element, *e.g.*, adding a percentage increase in volume to a percentage decrease in expenses to get a total percentage increase in pipeline return. Assuming, *arguendo*, that this criticism (articulated for the first time on appeal) has merit, it would have no effect on the finding of substantially changed circumstances on the West Line as the record reflects excess profits over the base year allowed return that well exceed the threshold for substantially changed circumstances.

As to the North and Oregon Lines, Shippers have raised issues regarding the findings of no substantially changed circumstances on these lines that would appear to require further Commission analysis for resolution. Indeed, these issues formed a significant basis of the Commission's request for a partial voluntary remand of the substantially changed circumstances issue. However, as these issues were never raised to the Commission, the Court should decline to hear these issues on appeal. If the Court chooses to consider these issues on the merits, the Commission respectfully requests that the issues of substantially changed circumstances on the North and Oregon Lines be remanded to the Commission for initial consideration of the issues raised.

ARGUMENT

I. THE STANDARD OF REVIEW

Review of Commission ratemaking decisions occurs under the arbitrary and capricious standard of 5 U.S.C. § 706(2)(A). *Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424, 1431 (D.C. Cir. 1996) ("*AOPL*"). The relevant inquiry for a reviewing court under this standard is whether the agency has "examine[d] the relevant data and articulate[d] a rational connection between the facts found and the choice made." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). Where the subject under review involves ratemaking, "and thus an agency decision involving complex industry analyses and difficult policy choices–the court will be particularly deferential to the Commission's expertise." *AOPL*, 83 F.3d at 1431; *see also Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968)("[T]he breadth and complexity of the Commission's responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties.").

As to this Court's review of the Commission's interpretation of a statute it administers, the Court applies the framework set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). Under *Chevron*, unless Congress has directly spoken to the contrary, or FERC has

impermissibly interpreted the statute, the Court must defer to the Commission's construction of ambiguous provisions. *AOPL*, 83 F.3d at 1439. *See AT&T Corp. v. FCC*, 220 F.3d 607, 621 (D.C. Cir. 2000) ("As long as the agency's interpretation is reasonable, we uphold it 'regardless whether there may be other reasonable, or even more reasonable, views'") (quoting *Serono Lab., Inc. v. Shalala*, 158 F.3d 1313, 1321 (D.C. Cir. 1998)).

Here, where EPAct § 1803 expressly empowers the Commission to administer and enforce that section**,** the Commission's permissible construction of that statute is entitled to deference. "[A] very good indicator of delegation meriting *Chevron* treatment is express congressional authorization to engage in the process of rulemaking or adjudication that produces regulations or rulings for which deference is claimed." *United States v. Mead Corp*., 533 U.S. 218, 229 (2001). Thus, because the Commission is authorized to adjudicate complaints arising under the EPAct, its interpretation of the EPAct provisions employed in such adjudications should receive *Chevron* deference. *BP West Coast*, 374 F.3d at 1272.

SFPP asserts that the Commission's application of the EPAct "substantially changed circumstances" standard is not entitled to deference because the Commission's interpretation of the statute is unreasonable or otherwise contrary to

the Congressional purpose. SPFF Br. 11-12. As demonstrated below, that contention is without merit.

II. THE COMMISSION PROPERLY INTERPRETED AND APPLIED THE EPACT "SUBSTANTIALLY CHANGED CIRCUMSTANCES" STANDARD.

Shippers and AOPL challenge the Commission's interpretation of the EPAct requirement of a "substantial change" in the "economic circumstances of the oil pipeline which were a basis for the rate." Shippers seek to lower the statutory threshold by narrowing the Commission's focus to a substantial change in any individual rate element, whether or not that change is offset by changes to other rate elements. For its part, AOPL seeks to raise the threshold by broadening the Commission's focus to encompass amorphous non-cost considerations in its substantially changed circumstances analysis. As demonstrated below, neither approach has merit. Rather, the Commission's decision to make changes in a pipeline's ultimate return the focus of the substantially changed circumstances inquiry was reasonable.

A. The EPAct "Substantially Changed Circumstances" Standard Imposes A High Burden.

Under EPAct § 1803(a)(1), an oil pipeline rate in effect for the year preceding enactment of the EPAct (October 24, 1992) is deemed just and reasonable if the rate has not been subject to protest, investigation or complaint

during that year. *BP West Coast*, 374 F.3d at 1271. These grandfathered rates are immune from challenge in a complaint proceeding under ICA § 13, except where, as relevant here, "evidence is presented to the Commission which establishes that a substantial change has occurred after the date of the enactment of this Act in the economic circumstances of the oil pipeline which were a basis for the rate. . . ." EPAct § 1803(b)(1)(A). *See BP West Coast*, 374 F.3d at 1271; Order on Initial Decision P 14, JA 2587.

In interpreting this statutory standard, the Commission concluded that a "substantial" change is a more rigorous test than a "material" change. Opinion No. 435 at 61,065-66. The term "material" is qualitative and goes to the relative importance or weight of a matter, or indicates its relevance, not necessarily its quantity or size. *Id*. In the context of ratemaking "substantial" more appropriately reflects a considerable difference in amount or degree since ratemaking is a quantitative discipline based on numerical formulas and relationships. *Id*.

Moreover, the legislative history of the EPAct, while limited, indicates that the word "substantial" was substituted for the word "material" during the drafting phase, and as such implies the two words reflect a different standard. *Id*. The Commission further concluded that Congress would not have used the word "substantial" rather than the word "material" if the conventional accounting

threshold of ten percent, or another relatively low quantity, was meant to be the test for establishing substantially changed circumstances. *Id*.

Based upon this analysis, in the challenged orders the Commission found that a "substantial" change was one that is considerable in quantity or significantly large, and that a change of less than fifteen percent does not meet this standard. Remand Order P 40 & n.65, JA 2646.

B. The Commission Properly Declined to Find Substantially Changed Circumstances Based on One Rate Factor Taken in Isolation.

Shippers contend that the Commission is required to find a substantial change in circumstances any time one element of the cost-of-service has a substantial change, regardless of whether that change is offset by changes in other elements of the cost-of-service. Shipper Br. 33-34. The EPAct requires a complainant to prove a substantial change in "a" basis of the rate, which Shippers interpret to refer to any one element of the pipeline's rate. *See id*. 5, 40-41.

As this Court found in *BP West Coast,* the statutory requirement of a substantial change in "the pipeline's economic circumstances" which were "a basis for the rate" can only mean "the basis upon which the rate was last considered to be just and reasonable, either as a filed rate, a settlement rate, or one for which the Commission has made a legal determination.'" *BP West Coast*, 374 F.3d at 1279

(quoting Opinion No. 435, 86 FERC at 61,068). Thus, the focus throughout the Opinion No. 435 proceedings and here has been on changes in a pipeline's return, and hence its profit expectations, that ultimately determine whether there has been a substantial change in the economic basis of the pipeline's rate for purposes of EPAct. Remand Order P 38 & n.59, JA 2646 (citing Order on Initial Decision PP 16, 29, 45-46, 50, 74, JA 2587, 2589, 2592, 2593, 2597). *See also* Remand Order P 30, JA 2643-44; Opinion No. 435 at 61,067.

Shippers contend that considering the entire economic basis of the rate converts the substantially changed circumstances standard from "a" (singular) basis of the rate, to "the" (plural) bases of the rate. Shipper Br. 6. However, EPAct § 1803(b)(1) itself identifies the two bases for the rate: (1) "a" basis of the rate is the pipeline's economic circumstances (§ 1803(b)(1)(A)), and (2) "a" basis of the rate is the nature of the services provided (§ 1803(b)(1)(B)).[2] The pipeline's economic

[2] EPAct § 1803(b) provides as follows:

> (b) Changed circumstances. No person may file a complaint under section 13 of the Interstate Commerce Act against a rate deemed to be just and reasonable under section (a) unless –
>
> (1) evidence is presented to the Commission which establishes that a substantial change has occurred after the date of the enactment of this Act –
>
> (A) in the economic circumstances of the oil pipeline which were a basis for the rate; or
>
> (B) in the nature of the services provided which were a basis for the rate. . .

circumstances are one basis, and the nature of the services provided is another basis. The Commission's interpretation therefore gives full effect to the statutory language. On the other hand, the statutory language provides no grounds on which to assume that the "economic circumstances of the oil pipeline which were a basis for the rate" was intended to refer to changes in an *individual element* of the pipeline's economic circumstances, such as the pipeline's income tax allowance.

Further, to fulfill the EPAct purpose, the central issue as to substantially changed circumstances should not be the cost-of-service factors themselves, but the level of the threshold that results. Order on Initial Decision P 73, JA 2597. The Commission concluded that its analysis here employed a reasonable threshold. *Id*. Because rate stability is a goal of the EPAct, it mandates structuring a threshold that restricts challenges to grandfathered rates, making rate levels more predictable by limiting the disruptive influence of too frequent challenges. *Id*. P 74, JA 2597.

> [Section 1803(b)'s] purpose is to serve as a safety valve. It permits the Commission to respond to cases where a rigid application of the grandfathering rule would allow a pipeline to charge unacceptably high rates.
>
> While that purpose is not sufficient to resolve detailed issues of interpretation and application, it does provide the framework within which those issues should be resolved. It implies that the goal in resolving such issues should be making successful challenges to grandfathered rates uncommon, but equally important not make them

practically impossible.

Remand Order P 74 n.61, JA 2597 (quoting the statement of Robert C. Means on behalf of ARCO in Exhibit UIT 40 at 2-3, JA 2369-70).

This Court has recognized that "Section 1803's overarching purpose" is to "limit[] litigation over pre-EPAct rates." *BP West Coast*, 374 F.3d at 1281. *See* Remand Order P 40 n.65, JA 2646. *See also AOPL*, 83 F.3d at 1444 (affirming limiting review of indexed rates to incremental change in costs and rates since EPAct enactment, the date then-existing rates were declared just and reasonable, because permitting a challenge to the entire rate would forfeit the benefit of grandfathering); *Frontier Pipeline Co. v. FERC*, 452 F.3d 774, 778 (D.C. Cir. 2006) (the EPAct grandfather clause "confers special protections" on rates that had been in effect one year prior to the statute's enactment and had not been the subject of complaint during the intervening year). Thus, the Commission reasonably considered whether the threshold is sufficiently high to fulfill the purpose of the statute. *See* Shipper Br. 5, 43.

Examining the potential interaction of individual rate factors shows why the substantially changed circumstances test cannot turn solely on consideration of one factor in isolation. Assume volumes (revenues) increased significantly but costs were constant. This would imply an increase in return and possible excess profits.

However, if volumes (revenues) increased significantly and costs increased proportionately, then return would not increase. In fact, if costs increased more rapidly than volumes (revenues), then the carrier could be making *less* return than was anticipated at the time the rate was designed. Thus, focus only on large increases in volumes (or revenues) may result in a finding of substantially changed circumstances, and thus the loss of grandfathering protection, when the carrier is actually losing money. This result is contrary to the statutory purpose of insulating established rates except for providing a "safety valve" for unacceptably *high* rates.

This likewise disposes of Shippers' contention that the Commission erred in not finding substantially changed circumstances for the Phoenix delivery point in 1995 and 1996. Shipper Br. 37-40. This complaint is based on the fact that the Commission relied on the percentage change in cost-of-service, rather than percentage changes in stand-alone cost elements. *Id*. 37-38. As demonstrated above, reliance on individual stand-alone cost elements as the basis for a finding of a substantial change in circumstances is contrary to the EPAct language and intent.

Accordingly, the ultimate issue here is profits and at what point the Commission's jurisdiction should attach to prevent these from becoming excess in relationship to the economic circumstances that are the basis for the rate. The Commission's use of the pipeline's ultimate return to determine substantially

changed circumstances recognized the basic fact that the factors listed in Opinion No. 435 can have offsetting or reinforcing impacts. This was a reasonable exercise of the Commission's discretion and should be sustained.

C. The Income Tax Allowance and Substantially Changed Circumstances.

Shippers complain that the challenged orders deviated from the statement in Opinion No. 435 that a change in the income tax allowance policy could be a stand-alone basis for a finding of changed circumstances. Shipper Br. 44-45. This argument lacks merit.

First, Shippers' argument that the income tax allowance in isolation would support a finding of substantially changed circumstances depends upon Shippers' contention that *BP West Coast* precludes any income tax allowance for SFPP. *See* Shipper Br. 41, 45. As discussed in the Commission's earlier brief in this proceeding (*see* FERC Initial Brief at 23-31), this contention is without merit.

Second, as discussed in the preceding section, the Commission reasonably concluded that the substantially changed circumstances analysis should not turn on any rate factor, including the income tax allowance, viewed in isolation, as this could lead to anomalous results, and result in a threshold that does not adequately discourage challenges to grandfathered rates. *See* Order on Initial Decision P 73, JA 2597.

Third, the Commission in the Order on Initial Decision reasonably concluded that the *Lakehead* income tax allowance policy should not be employed as a stand-alone basis for changed circumstances. Resolution of the issue was very complex, and it would vary from year to year as the ownership structure of the pipeline changed, a factor that is entirely *unrelated* to changes in the pipeline's return, which is the touchstone of the substantially changed circumstances analysis. Remand Order P 28, JA 2643.

Fourth, the *Lakehead* policy has since been rejected by this Court and the Commission. *BP West Coast*, 374 F.3d at 1280; Remand Order P 29, JA 2643. The Remand Order assumed that, under the Policy Statement, SFPP would be entitled to a full income tax allowance. Remand Order P 29, JA 2643. That means that, currently, a full income tax allowance is applied to the rates, just as a full income tax allowance was applied when the rates first went into effect. *See* Initial Decision P 145, JA 890. Accordingly, absent a significant change in the marginal tax rate, the income tax allowance issue is no longer likely to create enough of a difference in the base and current rates to constitute a stand alone-basis for finding substantially changed circumstances.

A full income tax allowance, moreover, is nothing more than a "gross-up" figure applied to the allowed return to assure that the company has a reasonable

opportunity to earn its allowed after-tax return. Thus, unlike underlying revenues and operating costs, an income tax allowance does not determine the carrier's net income or its allowed return. *See* Policy Statement P 21, JA 2798-99.

It was reasonable for the Commission to assume a full income tax allowance at this threshold level. Under the Policy Statement, the amount of the income tax allowance is a technical issue based on the weighted marginal tax rates of the partners. This determination is to be made at hearing if the jurisdictional threshold has been met, and it would be very difficult to make this determination at the threshold level while also complying with the EPAct's mandate of a simplified approach to oil pipeline regulation. Moreover, to presume that the pipeline is not entitled to an income tax allowance would undercut the Policy Statement and likely assure a routine determination of substantially changed circumstances in contravention of the EPAct. The Commission should be affirmed.

D. Shippers' Complaints That SFPP's Rates Are Unjust and Unreasonable Due to "Excess Profits" Are Unavailing in the Context of the Substantially Changed Circumstances Standard.

Shippers complain that the effect of the Commission's methodology is to require a showing of "substantial change" in the cost-of-service, when, under the ICA, there is "zero tolerance" for unjust and unreasonable rates. Shipper Br. 6.

Shippers assert that SFPP is presently exacting "excess profits," which according to Shippers renders SFPP's rates unjust and unreasonable. *Id*. 29.

Shippers challenge the very structure of the EPAct. Under the EPAct, certain rates are by definition "just and reasonable" unless the specific exceptions in § 1803(b) are met. *AOPL*, 83 F.3d at 1445. Commission policy which adheres to this standard by precluding later re-examination of grandfathered rates fully complies with the ICA § 1(5) requirement that pipeline rates be just and reasonable. *Id*. Accordingly, there is no violation here of the Commission's obligation to ensure just and reasonable rates.

Under the EPAct, the justness and reasonableness of a rate under a standard cost-of-service analysis is not relevant to determining whether the complainant has established that there are substantially changed circumstances. Opinion No. 435 at 61,066. A challenged rate might not be just and reasonable if the Commission were to examine it without the presence of the jurisdictional threshold, but the statute bars such an examination. *Id*. Even if the level of the challenged rate might be reduced if the statutory threshold were met, reasonableness may not be determined until the complainant first establishes that there has been a substantial change in the economic circumstances that were the basis for the rate. *Id*.

Shippers' arguments regarding SFPP's alleged excess profits, *see* Shipper Br. 29, 34, fail to take into account the fact that, under the EPAct, the substantial change in economic circumstances must have occurred *after* EPAct passage. As this Court found, "[t]he statute provides that 'no person may file a complaint . . . unless . . . evidence is presented . . . which establishes that a substantial change has occurred after the date of . . . enactment.' EPAct § 1803(b). From the 'after the date of enactment' language, we are given the earliest point at which a shipper may show a substantial change." *BP West Coast*, 374 F.3d at 1279. Thus, the substantial change analysis cannot be premised upon excess profits that date from prior to EPAct enactment.

Shippers question the Commission's conclusion that certain cost over-recoveries on the North line were in part attributable to pre-1992 gains, and therefore to that extent not within consideration for substantially changed circumstances. *See* Shipper Br. 34-35; Order on Initial Decision P 62, JA 2595. Although Shippers assert that this conclusion "cannot possibly be true," Shipper Br. 34-35, the Commission reviewed the cost and revenue factors for the North Line after 1992 in relation to the 1989 base year, and found that as much as 50 percent of the returns may be attributable to the years before 1992, because, after

that time, the cost-of-service factors increased in an amount sufficient to mitigate the effect of any gains in volume. Order on Initial Decision P 62, JA 2595.

As the Commission's methodology properly sets the threshold for changed circumstances and limits measurement of changed circumstances to changes occurring after EPAct enactment, the Commission's methodology correctly interprets the statute and should be affirmed.

E. AOPL Provides No Basis for Requiring Analysis of Non-Cost Factors in Assessing Substantial Change.

AOPL argues that the Commission should not be permitted to base its changed circumstances analysis on cost-of-service factors. SFPP Br. 36-43. AOPL contends that, as many oil pipeline rates were set by agreement, a cost-of-service analysis was not used as their basis and therefore the Commission errs in applying a cost-of-service analysis to determine whether there are changed circumstances. *Id*. 36.

The fact that the grandfathered rates were initially set by settlement does not preclude the use of a cost-of-service analysis in evaluating changed circumstances. As this Court found in *BP West Coast*, the EPAct "changed circumstances" standard requires consideration of "the basis upon which the rate was last considered to be just and reasonable, either as a filed rate, a settlement rate, or one for which the Commission has made a legal determination.'" *BP West Coast*, 374

F.3d at 1279 (quoting Opinion No. 435, 86 FERC at 61,068). It is reasonable to assume that shippers would not agree to a settlement rate that was not based on a reasonable projection of volumes and costs. Opinion No. 435 at 61,068 n. 73. To make this determination, the shippers would have had basic rate design information available to them to determine whether the settlement suited their interests. *Id*. Further, it is not impossible to estimate the economic value of a settlement even if there are no documents providing the details. *Id*. at 61,072.

It is important to note that the Commission has not held that Opinion No. 154-B cost-of-service methodology *must* be used in deciding an issue of substantially changed circumstances. *See* Remand Order P 38 n. 56, JA 2645 (noting that the Commission did *not* adopt the full Opinion No. 154-B cost of service analysis "as the standard protocol to be used in determining substantially changed circumstances"). As AOPL notes, the Commission only concluded in the instant case that use of the Opinion No. 154 methodology was "appropriate." SFPP Br. 43.

Here, SFPP used the Opinion No. 154-B methodology to design and justify the West Line rates at issue. Order on Initial Decision P 51, JA 2593. The economic expectations underlying the West Line settlement rates were in evidence through the "TOP Sheets" SFPP submitted to the Commission in January to justify

its rate filing.[3] *Id*. PP 39, 44, 51, JA 2591-93. SFPP in fact prepared a three-volume study to justify the rates and submitted the entire study to the Commission Staff. *Id*. P 44, JA 2592. Similarly, with regard to the North Line, the analysis of substantially changed circumstances was based upon a 1989 cost-of-service study submitted to the Commission Staff to justify the rate increase. *Id*. P 59 & n.54, JA 2595.[4]

AOPL's argument that most pipeline rates have not been set on a cost-of-service basis misses the point that the Commission analysis assumes that rates are profit-driven rather than cost-based. The cost-of-service approach used here was the means available to measure the change in return to determine at what point excess profits may result and intervention may be warranted. To the extent AOPL argues that the Commission should address such issues as the firm's internal evaluation of broad economic and commercial factors without regard to return, or the unknown substance of a pipeline's negotiations with its shippers, it is the

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[3] While TOP Sheets are normally cost-of-service data submitted by Staff to support its testimony in a cost-of-service proceeding, in the instant case the cost data was prepared by SFPP and submitted to the Commission to justify a rate filing. However, since the parties used the nomenclature "TOP Sheets" the Commission orders used the same term.

[4] There was no cost-of-service information available with regard to the Oregon Line for calendar year 1985, the last time the rates were increased and filed with the Commission. Order on Initial Decision P 63, JA 2595.

equivalent of saying that there should be no meaningful test at all. Indeed, AOPL's vague suggestion of factors to consider hardly amounts to a useful alternative test, and certainly not one based on "economic circumstances." Rational economic regulation requires some sort of quantification and a rational basis for that quantification.

AOPL complains that the cost-of-service analysis is contrary to the rationale for the indexing method the Commission developed in Order No. 561, as pipelines may eventually lose their grandfathered status due to reduction of costs through efficiency. SFPP Br. 37-38. This argument in the first instance ignores the Commission's high threshold for substantially changed circumstances, which should mitigate those concerns. Remand Order PP 39-40, JA 2591.

Further, the Commission's indexing methodology has never been intended to insulate grandfathered rates in perpetuity. Rather, as this Court has recognized, indexing permits an efficient recovery of short term, systemic cost increases without the complications of a general rate increase filing. *See AOPL*, 83 F.3d at 1430. While the indexing method is designed in part to allow carriers to keep efficiency gains and to minimize regulatory intervention, the AOPL argument assumes that carriers are entitled to keep all efficiency gains and the resulting increase in profits forever. To the contrary, the regulations promulgated by Order

No. 561 expressly provide for complaints against indexed-based increases if these so substantially exceed the carrier's actual cost increases that the resulting rate is unjust and unreasonable. *See* 18 C.F.R. § 342.2(c)(2).

Thus, AOPL overstates the preservation of grandfathered rates under the Commission's indexing policy while ignoring the provisions of the EPAct designed to protect shippers against unjust and unreasonable rates. The fact that, over time, efficient pipelines may fall within the scope of the Commission's rate regulation is a reflection of the EPAct policy choices balancing rate stability and consumer protection.[5]

AOPL also argues that making grandfathered rates more vulnerable to challenge reduces incentives to increase efficiencies. SFPP Br. 41. This argument assumes that all grandfathered rates exceed their cost-of-service or the return that was embedded in whatever method was used to establish the rate. The argument also assumes that carriers will forgo efficiencies notwithstanding the high threshold set for finding substantially changed circumstances, and that the difference in incentives warrants allowing the carrier to keep all efficiency gains that may arise in

[5] Similarly, AOPL suggests that, over time, depreciation could ultimately result in the loss of grandfathered status on a pipeline with steady costs. SFPP Br. 38. AOPL fails to explain, however, why a pipeline should continue to collect the same allowed return over time on a rate base that is depreciating.

the post-1992 period. However, the purported risks have not prevented pipelines from investing where long term gains will accrue, and the Commission has in fact accepted rate designs that will expressly protect existing grandfathered rates against the additional returns that may come from increased investment. *See Colonial Pipeline Co.*, 116 FERC ¶ 61,078 PP 49-53 (2006). If the carrier does invest in existing assets, the rate base will rise and the probability of a finding of substantially changed circumstances will be reduced.

The EPAct locks-in, beyond a period of short duration, profit levels that may have accrued before the passage of the Act, and some allowance must be made for efficiency gains. However, the purpose of the grandfathering provisions is to limit challenges to rates and charges, not to shield those rates and gains forever. Ultimately, even as to grandfathered rates, the returns become too high for tolerance under the statute. Thus, the Commission's return-oriented approach fully complies with the EPAct of 1992 and the indexing procedures in its regulations.

F. The Substantially Changed Circumstances Standard Is Not Discriminatory.

The Remand Order reiterated the conclusion in the Opinion No. 435 orders that a percentage of less than 10 percent could not establish substantially changed circumstances under the EPAct. Remand Order P 40 n. 65, JA 2646. The Commission then concluded that any gain in return over the base period of less

than 15 percent would not constitute a "substantial" change. *Id*. The Commission therefore found that the changes here, which exceeded 20 percent, satisfied the substantially changed circumstances test. *Id.* P 39, JA 2646.

Shippers contend that this percentage definition of "substantial" discriminates against shippers and consumers, because *Plantation Pipe Line*, Unpublished Letter Order, Docket No. IS98-141 (June 24, 1998), employed an eight percent standard to determine whether a cost increase to a pipeline is substantial. Shipper Br. 30 (citing *Plantation*; Initial Decision P 117 n. 29 (referencing the *Plantation* Letter Order)). *Plantation*, however, is inapposite.

Pursuant to Commission regulations (18 C.F.R. §§ 342.0-342.4), the indexing system for oil pipeline rates produces an annual ceiling on individual pipeline rates. *See* Initial Decision P 12, JA 872. While, generally, pipeline rates are not to exceed the ceiling, a pipeline may charge a rate in excess of the ceiling if it can show that the ceiling precludes it from charging a just and reasonable rate due to a "substantial divergence" between its actual costs and its indexed rate. *Id*.

In *Plantation*, the pipeline sought waiver of the indexing regulations, which in that year would have resulted in a rate decrease, on the ground that Plantation was already under-recovering its cost-of-service by approximately $12 million at its current rates, and it had been under-recovering its cost-of-service since the

inception of indexing. *See* Plantation Petition for Waiver, Ex. ARCO-9 at 1, JA 2533. The request for waiver was granted. *See Plantation*, Ex. ARCO-8 at 1, JA 2531. The ALJ determined that Plantation's cost-of-service exceeded the index ceiling by less than eight percent, and therefore concluded eight percent sufficed as a showing of "substantial divergence." Initial Decision P 117 n.29, JA 886.

In the context of indexing, the Commission is not applying the EPAct "substantially changed circumstances" standard, which commands a high threshold for the reasons already discussed. It implements instead the basic statutory requirement for reasonable rates, which does not favor a methodology that would consistently foreclose a carrier from recovering its cost-of-service. *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The legal standards, therefore, are not symmetrical. Moreover, while Plantation's immediate cost-of-service may have exceeded the index ceiling by eight percent, the cumulative under-recovery of Plantation's cost-of-service was much higher. *See* Plantation Petition at 2, JA 2534. Therefore, *Plantation* is not sufficiently comparable to the application of the EPAct here that the application of a different standard is unduly discriminatory.

III. THE COMMISSION'S APPLICATION OF THE SUBSTANTIALLY CHANGED CIRCUMSTANCES STANDARD TO SFPP.

On appeal, Shippers and SFPP raise a number of challenges to the evidentiary basis for, and calculations underlying, the Commission's findings on

the issue of substantially changed circumstances. As no rehearing was ever sought of the Commission's determinations on this issue, the Commission never had the opportunity to consider these issues, and the Court should decline to hear them now. The alleged errors are the type of technical mistakes that this Court has found must be raised with precision before the agency. *Time Warner*, 144 F.3d at 81. These arguments in large measure formed the basis for the Commission's motion for a partial voluntary remand of the substantially changed circumstances issue, which was denied without prejudice by the Court.

As to arguments concerning the calculations underlying the finding of no substantially changed circumstances on the North and Oregon Lines, Shippers have raised issues regarding these findings that would appear to require further Commission analysis for resolution. If the Court chooses to consider these issues on the merits, the Commission respectfully requests that the issues of substantially changed circumstances on the North and Oregon Lines be remanded to the Commission for consideration of the issues raised.

A. SFPP's Arguments Regarding Erroneous 1992 Costs Provide No Basis to Overturn the Commission's Determination of Substantially Changed Circumstances on the West Line.

SFPP contends that the Commission erred in finding substantially changed circumstances on the West Line because the Commission's analysis used a figure

for 1992 costs that "is both ficticious and overstated." SFPP Br. 16. Table 7 of the Remand Order identifies the West Line's cost-of-service for 1992 as $53.86 million, which SFPP contends should be $38.49 million. *Id*. at 24.

Even assuming, *arguendo*, that SFPP were correct regarding this figure, it would not change the result of the substantially changed circumstances analysis on the West Line. In measuring substantially changed circumstances, there are three periods of time potentially relevant: (1) period A which is the year that the grandfathered rate was filed and took effect (the economic basis of the rate); (2) period B which is the 12 month period ending October 24, 1992 (the date of EPAct enactment); and (3) period C which is the year in which the complaint was filed. Order on Initial Decision P 19, JA 2588. Any substantially changed circumstances must occur after the effective date of the EPAct, and constitute a change in the economic circumstances that were the basis for the rate. *Id*. P 22, JA 2588. Thus, generally, the change from B to C is evaluated relative to A ((C-B)/A). *Id*.

There are situations, however, where use of this formula creates anomalous results. For example, where a factor is expected to increase over time, such as volume, but B is less than A, the formula must be changed to (C-A/A) to assure

that the measured change is measured against A, not B.[6] *Id*. P 24, JA 2589. Similarly, for a factor expected to decrease, such as costs and rate base, the formula would also be (C-A)/A when the value for B is greater than A.[7] *Id*. P 25, JA 2589.

Because of such anomalous results, the Commission rejected using 1992 figures for volume and rate base in the substantially changed circumstances calculations for SFPP's West Line. *See id*. PP 26, 54 & n.51, JA 2589, 2594. On SFPP's West Line, volumes declined from 60,480,000 in 1989 (the A value), to 52,160,000 at the enactment of the EPAct (the B value). *Id*. P 26, JA 2589. Thus, the comparison for purposes of the substantially changed circumstances formula was between 1989 (A) and 1995 (C), because the 1992 (B) value would create an

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[6] For example, assume A is 100, B is 80 and C is 100. The change from B to C is 20, or a change relative to A of 20 percent, while the change from A to C is 0. Order on Initial Decision P 24, JA 2589. As the EPAct requires evidence of a substantial change in the circumstances that were the basis for a grandfathered rate, that change must reflect an increase above the basis, *i.e*., above A, in this example a value of 100. *Id*. In this instance, using a comparison of C-B relative to A would reflect a change from some point that is less than the basis value of A, *i.e*. from 80 to the basis value 100, in the example. *Id*. This comparison would reflect a change not in the basis for a grandfathered rate but rather in a value that is *less* than the basis for the rate.

[7] If A is 100, for example, B is 120, and C is 100, this formula would reflect no change above A, the basis for the rate, at C. Order on Initial Decision P 25, JA 2589. Again, using a comparison of C-B relative to A instead, would reflect a change from a point *greater* than the value of A, and thus would not reflect a change in the basis for the rate. *Id*.

anomalous result. *Id*. P 54 & n. 51, JA 2594. Likewise, the West Line rate base for 1992 was greater than that for the base period 1989. *Id*. (citing Appendix B, Table 3). The comparison there also is between 1989 (A) and 1995 (C), because the (B) value would again produce an anomalous result. *Id*. P 54 & n. 51, JA 2594.

Accordingly, in both instances, the proper formula to be employed is (C-A)/A. *Id*. Assuming, *arguendo*, that SFPP's claimed figure for the 1992 cost-of-service (B) value is correct, it would similarly produce an anomalous result. While costs are expected to decline, they are expected to continuously decline over time, as SFPP's costs did using the Commission's 1992 cost-of-service figure of $53.86. *See* Remand Order Table 7, JA 2659. In such circumstances, the (C-B)/A formula is properly employed.

Under SFPP's scenario, however, SFPP's costs declined dramatically in 1992 and then rebounded significantly in subsequent years. SFPP Br. 24 Table 4. Using the standard formula (C-B)/A under these circumstances results in a significantly *positive* change in the cost-of-service, when the cost-of-service significantly *declined* from the 1989 (A) value ($56,918) to the 1995 (C) value ($47,647). *Id*. Given this anomalous result, the standard formula could not be employed. Rather, to avoid the anomalous result, the formula (C-A)/A should be employed, rendering SFPP's recalculated B value of the 1992 cost-of-service irrelevant to the analysis.

This is the revised table, using SFPP's own cost-of-service figures:

Period	Year	SFPP Calculated COS	COS % Change (C-B)/A	COS % Change (C-A)/A
(A)	1989	$56,918		
(B)	1992	$38,495		
(C)	1995	$47,647	+16.08%	-16.29%
	1996	$45,743	+12.73%	-19.63%
	1997	$45,853	+12.93%	-19.44%
	1998	$47,710	+16.19%	-16.18%
	1999	$47,031	+15.00%	-17.37

See Remand Order Table 7, JA 2659. Accordingly, because the (C-A)/A formula must be applied if SFPP's 1992 cost-of-service figure is correct, the resulting negative change in the cost-of-service is even larger than the negative change in the cost-of-service found by the Commission using the (C-B)/A formula and the allegedly inflated cost-of-service figure for 1992. *See id.* Thus, if SFPP's 1992 cost-of-service figure is correct, it provides an even stronger basis for finding substantially changed circumstances.

This also responds to SFPP's argument, SFPP Br. 24-26, that SFPP's cost-of-service has increased since 1992, offsetting improvement in the pipeline's

circumstances through the increases in volume. Putting aside the anomalous figure for 1992, the appropriate comparison is between the 1989 figures and the 1995-1999 period during which complaints were filed. As evidenced by SFPP's Table 5, SFPP Br. 25, SFPP's West Line cost-of-service for 1995 to 1999 has remained almost constant, and is approximately $10 million *less* than the 1989 cost-of-service. Similarly, putting aside the anomalous 1992 figure for volumes, SFPP's volumes on the West Line have *increased* from 60 million barrels in 1989 to 70 to 77 million barrels in 1995-1999. Order on Initial Decision Appendix A at 34, JA 2599. Accordingly, SFPP's circumstances clearly have not declined in comparison to the 1989 base year, which is the relevant comparison for purposes of determining substantially changed circumstances under the EPAct.

B. The Commission Reasonably Used Volumes as a Proxy for Revenues.

In the orders under review, the Commission used volume as a proxy for revenue, as volume measures the growth or decline of the pipeline's business. Order on Initial Decision P 29, JA 2589. Shippers argue that using volumes as a proxy does not measure all excess revenue, and it is not "rational" to use a proxy when the actual data is in the record. Shipper Br. 33, 36.

In the instant case the use of volumes as a proxy for revenue was rational. During the period at issue SFPP did not modify the subject rates except for

adjustments permitted under the Commission's indexing method. These adjustments, taken on an industry-wide basis, have the effect of maintaining rates in roughly constant dollars after 1994, the first year that the annual index factor was applied. If rates are constant, as the West Line rates were, revenue therefore is a linear function of volume. Thus, if the base volumes upon which the rates were designed by the carrier are known, as here, increases or decreases in revenue are a direct function of changes in volume. The use of volume to determine the revenue gains or losses is therefore rational, particularly if there are issues as to the accuracy of the revenue figures.

The Commission's use of volumes as proxy for revenues in this case, moreover, is supported by the record. In Appendix A of the Order on Initial Decision, pp. 37-38, JA 2602-03, there is a chart setting forth SFPP's estimated over-recovery for the West Line rates for each year: 1995, $15.845 million; 1996, $18.844 million; 1997, $20.936 million; 1998, $20.803 million, and 1999, $21.851 million. Comparison of these numbers to the volume figures for the West Line, *see* Appendix B of the Order on Initial Decision p. 39, JA 2604, shows that volumes are a reasonable proxy for revenues. The volumes on that page are: 1995, 70.398 barrels, 1996; 73.688 million barrels; 1997, 76.391 million barrels; 1998, 76.600 million barrels; and 1999, 77.710 million barrels. The pattern of increase in

volumes thus sufficiently parallels the increase in excess revenues reflected in Attachment A that volume acts as a reasonable proxy for revenues for purposes of making the threshold substantially changed circumstances determination.

C. The Commission's Addition of Percentages in Assessing Substantially Changed Circumstances on the West Line Does not Warrant Reversal of Its Determinations Regarding the West Line Rates.

In making its substantially changed circumstances analysis, the Commission added together percentages of change in rate elements to get an overall percentage change in pipeline revenues. *See* Remand Order P 38, JA 2645. SFPP asserts that this was error as the Commission was adding percentage rates of change where the rates of change referred to different base elements. SFPP Br. 27-30.

Assuming, *arguendo*, that this criticism has merit, it would not in any event alter the Commission's ultimate conclusion with regard to substantially changed circumstances on the West Line. Other evidence of record establishes that returns from SFPP's West Line rates beginning in 1995 were more than adequate to support the result in the challenged orders.

As discussed in Section III(A) *supra*, volumes and costs on the West Line in 1992 were well below those SFPP used to justify its West Line rates in 1989, and therefore it is improper to use the 1992 or (B) values to evaluate changed circumstances. The proper method is to compare 1989 (the (A) value) to the

complaint year (the (C) value). As the West Line in 1992 was under-performing in comparison to base year 1989, it can be assumed that excess profits on the West Line accrued after EPAct enactment in 1992.

Accordingly, West Line excess profits accruing after 1992 EPAct enactment can be determined from Appendix A of the Order on Initial Decision, pp. 37-38, JA 2602-03. The allowed return in the 1989 TOP sheets was $14.5 million. *See* Ex. UIT-4, R. 1617, JA 2303. As discussed in the preceding section, Appendix A pp. 37-38 demonstrates that the recovery above that allowed return was: 1995, $15.845 million; 1996, $18.844 million; 1997, $20.936 million; 1998, $20.803 million; and 1999, $ 21.851 million. In each case the over-recovery was more than 100 percent of the 1989 base allowed dollar return of $14.5 million.

Appendix A, JA 2602-03 does use a partial rather than a full income tax allowance, which would lower the cost-of-service. However, given the magnitude of the over-recoveries reflected on Appendix A, JA 2602-03, the use of the full tax allowance should not affect the outcome. The Commission was correct in finding substantially changed circumstances for the West Line rates as a whole.

D. The Court Need Not Reach the Issue of Allocating Costs to Particular West Line Points.

Shippers assert that the Commission apportioned volume (revenue) increases among the specific delivery points on the West Line, but failed to apportion costs

among the same points, thus over-allocating costs to certain of those points. Shipper Br. 38-40. For the reasons stated by Shippers themselves, it is as a matter of law not necessary to reach this point.

As Shippers state, SFPP justified its West Line rates utilizing a projected 1989 cost-of-service that did not allocate costs among different delivery points. Shipper Br. 38-39. *See* Order on Initial Decision P 53, JA 2594. It was only *following* the hearing before the Administrative Law Judge that SFPP contended that it was necessary to determine a cost-of-service for each destination point, something SFPP's own witnesses did not even do. Shipper Br. 38-39; Initial Decision P 159, JA 892. Accordingly, the Commission reasonably agreed with the Administrative Law Judge that it was appropriate to examine cost-of-service factors for all points on the West Line in the aggregate. Shipper Br. 38-39. *See* Order on Initial Decision P 53, JA 2594.

Thus, the Commission's finding of substantially changed circumstances for the West Line rates as a whole is sufficient to satisfy the EPAct standard and permit Shippers to pursue challenges to SFPP's West Line rates. In any event, given the huge increase in returns for the West Line rates as a whole after 1995, there is no practical need to reach the issue with regard to the individual points.

E. Substantially Changed Circumstances on SFPP's North and Oregon Lines

With regard to SFPP's North and Oregon Lines, the Commission found no substantial change in economic circumstances as, for both lines, the cost-of-service increased in most years compared to the base year even as volume also increased. Remand Order P 40, JA 2646. As reflected in Tables 1 and 2 to the Remand Order, with the use of a full tax allowance, the resulting change on the North Line was still below ten percent. *Id*. Similarly, the rate base factor and the allowed return factor (with the exception of one year) were both less than 15 percent. *Id*. The Oregon Line, with or without a full income tax allowance, reflected a negative return. *Id*. For other cost factors, the combination of the percentage change in volumes and those cost factors is negative or less than 10 percent. *Id*. The Commission therefore concluded that there were no substantially changed circumstances on the North and Oregon Lines. *Id*.

Shippers challenge the determination as to the North and Oregon Lines on the ground that the Commission erred in using cost-of-service figures calculated according to the so-called "435-A (no *Lakehead*)" methodology as opposed to the

so-called "ARCO" based cost of service.[8] Shipper Br. 46-48. According to Shippers, the ARCO methodology was in use during the 1992 pre-EPAct period, whereas the 435-A (no *Lakehead*) methodology has never been used. *Id*. Shippers also complain that the Commission combined percentages rather than actual dollars in a manner that yielded a false result. *Id*. 35.

Resolution of both of these issues raised by Shippers with regard to the North and Oregon Lines would appear to require further Commission analysis. Indeed, these issues formed a significant basis of the Commission's request for a partial voluntary remand of the substantially changed circumstances issues. As these issues were never raised to the Commission, the Court should not hear these issues on appeal. If the Court chooses to consider these issues on the merits, the Commission respectfully requests that the issues of substantially changed circumstances on the North and Oregon Lines be remanded to the Commission for consideration of the issues raised.

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[8] The ARCO cost-of-service methodology refers to the cost-of service Order No. 154-B methodology issued in 1985, as modified in 1990 by *ARCO Pipeline Co*., 52 FERC ¶ 61,055 (1990). Initial Decision P 141 n. 33, P 145 n. 34, JA 889-90. The ARCO methodology, therefore, was developed prior to the *Lakehead* decision and employs a full corporate income tax allowance. Initial Decision P 145 n.34, JA 890.

CONCLUSION

For the reasons stated, the petition for review should be dismissed or denied in all respects.

Respectfully submitted,

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ExxonMobil Oil Corp. v. FERC, Docket No. OR96-2
D.C. Cir. Nos. 04-1102, *et al.* (consolidated)

CERTIFICATE OF COMPLIANCE

In accordance with this Court's Order of August 17, 2006, ordering that this Supplemental Brief for Respondents not exceed 12,500 words, I hereby certify that this brief contains 10,828 words, not including the tables of contents and authorities, the certificate of counsel, the glossary, this certificate and the addendum.

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