ORAL ARGUMENT HAS NOT YET BEEN SCHEDULED

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

No. 05-1426

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
PETITIONER,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.

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

BRIEF FOR RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION

JOHN S. MOOT
GENERAL COUNSEL

ROBERT H. SOLOMON
SOLICITOR

CAROL J. BANTA
ATTORNEY

FOR RESPONDENT
FEDERAL ENERGY REGULATORY
COMMISSION
WASHINGTON, D.C. 20426

AUGUST 23, 2006
FINAL BRIEF: SEPTEMBER 27, 2006

CIRCUIT RULE 28(A)(1) CERTIFICATE

A. Parties and Amici

To counsel's knowledge, all parties are presented in Petitioner's brief.

B. Rulings Under Review

1. Order on Accounting for Pipeline Assessment Costs, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 111 FERC ¶ 61,501 (June 30, 2005), R. 19, JA 30; and

2. Order Denying Rehearing and Providing Clarification, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 112 FERC ¶ 61,309 (Sept. 19, 2005), R. 24, JA 75.

C. Related Cases

This case has not previously been before this Court or any other court. Counsel is not aware of any other related cases pending before this or any other court.

____
Carol J. Banta
Attorney

TABLE OF CONTENTS

PAGE

STATEMENT OF THE ISSUE 1

STATUTORY AND REGULATORY PROVISIONS 1

INTRODUCTION 2

STATEMENT OF FACTS 4

I. Statutory And Regulatory Background 4

II. OPS Regulations Requiring Integrity Management Programs 7

III. FERC Proceeding 9

SUMMARY OF ARGUMENT 14

ARGUMENT 16

I. STANDARD OF REVIEW 16

II. THE COMMISSION REASONABLY INTERPRETED ITS ACCOUNTING RULES TO REQUIRE CERTAIN COSTS OF PIPELINE INTEGRITY MANAGEMENT PROGRAMS TO BE TREATED AS MAINTENANCE EXPENSES 18

A. The Commission Applied Its Accounting Rules To The Various Categories Of Costs And Work Activities Required 19

1. Planning and Recordkeeping 19

2. Inspections and Testing 20

3. Pipeline Modifications and Additions; Remedial and Mitigation Actions 21

TABLE OF CONTENTS

PAGE

B. The Commission Noted That Only A Relatively Small Portion Of Integrity Management Program Costs Would Be Expensed Under The FERC Orders 23

III. THE COMMISSION REASONABLY REJECTED INGAA'S ARGUMENTS THAT ALL COSTS INCURRED IN THE FIRST TEN YEARS OF THE REQUIRED INTEGRITY MANAGEMENT PROGRAMS SHOULD BE CAPITALIZED 25

A. The Commission Reasonably Found That An Integrity Management Program Is Not Akin To A One-Time Major Rehabilitation Project 26

B. The Commission Reasonably Found That The Increased Testing Is A Maintenance Activity And Is Not Sufficiently Tied To Future Economic Benefits To Support Capitalizing The Costs As Assets 31

C. The Commission Reasonably Concluded That Generally Accepted Accounting Principles Do Not Support Capitalizing Pipeline Testing Costs 35

D. The Tax Cases On Which INGAA Relies Were Not Raised Below And Are Inapposite 39

CONCLUSION 41

TABLE OF AUTHORITIES

COURT CASES: **PAGE**

Alabama Power Company v. FERC,
160 F.3d 7 (D.C. Cir. 1998)....................16

American Telephone & Telegraph Co. v. United States,
299 U.S. 232 (1936)....................17

**Amerada Hess Pipeline Corporation v. FERC*,
117 F.3d 596 (D.C. Cir. 1997).................... 17, 18

Anaheim v. FERC,
669 F.2d 799 (D.C. Cir. 1981)....................17

Arkansas Louisiana Gas Co. v Hall,
453 U.S. 571 (1981)....................17

Boston Edison Company v. FERC,
885 F.2d 962 (1st Cir. 1989)....................6

Burlington Truck Lines, Inc. v. United States,
371 U.S. 156 (1962)....................16

Domtar Maine Corporation v. FERC,
347 F.3d 304 (D.C. Cir. 2003)....................39

INDOPCO, Inc. v. Commissioner,
503 U.S. 79 (1992)....................40

Motor Vehicle Manufacturers Association of United States, Inc. v. State Farm Mutual Automobile Insurance Co.,
463 U.S. 29 (1983)....................16

**Northern Border Pipeline Company v. FERC*,
129 F.3d 1315 (D.C. Cir. 1997)....................17

* Cases chiefly relied upon are marked with an asterisk.

TABLE OF AUTHORITIES

COURT CASES (continued): **PAGE**

Northwestern Electric Co. v. FPC,
321 U.S. 119 (1944)..........5

Sithe/Independence Power Partners v. FERC,
165 F.3d 944 (D.C. Cir. 1999)..........16

Smith v. Commissioner,
300 F.3d 1023 (9th Cir. 2002) 39, 40

**Transcontinental Gas Pipe Line Corporation v. FPC*,
518 F.2d 459 (D.C. Cir. 1975).......... 17, 18

Union Electric Company v. FERC,
890 F.2d 1193 (D.C. Cir. 1989)..........16

Williston Basin Interstate Pipeline Company v. FERC,
165 F.3d 54 (D.C. Cir. 1999)..........6

ADMINISTRATIVE CASES:

Accounting Release No. 8 (AR-8),
Federal Power Commission (Mar. 6, 1969) 27

Proposed Accounting Release No. 18,
Accounting for Pipeline Assessment Costs,
FERC Docket No. AI05-1 (Nov. 5, 2004).......... 9-10, 21, 27

**Jurisdictional Public Utilities and Licensees*,
111 FERC ¶ 61,501 (2005).......... 3, 4, 7-8, 10-12, 18-25,
28, 29, 36, 38

TABLE OF AUTHORITIES

ADMINISTRATIVE CASES (continued): **PAGE**

**Jurisdictional Public Utilities and Licensees*,
112 FERC ¶ 61,309 (2005)... 3, 13, 29, 30, 31, 32, 33, 34, 36, 37

Northwest Pipeline Corporation,
FERC Docket No. AC94-149-000 (1996)..28

STATUTES:

Internal Revenue Code

26 U.S.C. § 162(a) 39

26 U.S.C. § 263...39

Natural Gas Act

Section 1(b), 15 U.S.C. § 717(b) 4

Section 4, 15 U.S.C. § 717c...5

Section 7, 15 U.S.C. § 717f 4

Section 7(b), 15 U.S.C. § 717f(b)...4

Section 7(c), 15 U.S.C. § 717f(c) 4

Section 8(a), 15 U.S.C. § 717g(a) 5

Section 19(b), 15 U.S.C. § 717r(b)...39

Pipeline Safety Improvement Act of 2002,
Pub. L. No. 107-355, 116 Stat. 2985 7

TABLE OF AUTHORITIES

REGULATIONS: **PAGE**

18 C.F.R. Part 201 (2006) 3, 5

18 C.F.R. Part 201, Gas Plant Instruction No. 10,
Additions and Retirements of Gas Plant (2006) 6, 22

18 C.F.R. Part 201, Operating Expense Instruction No. 1,
Supervision and Engineering, Item 3 (2006) 19

18 C.F.R. Part 201, Operating Expense Instruction No. 2,
Maintenance, Item 2 (2006) 6, 20

18 C.F.R. Part 201, Operating Expense Instruction No. 2,
Maintenance, Item 3 (2006) 6, 19

18 C.F.R. Part 352 (2006) 3, 5

18 C.F.R. Part 352, Carrier Property Accounts Instruction No. 3-6,
Replacements (2006) 6, 22

18 C.F.R. Part 352, Instructions for Operating Revenues
and Operating Expenses No. 4-4,
Expense Classification (2006) 6

18 C.F.R. Part 352, Instructions for Operating Revenues
and Operating Expenses No. 4-4(a),
Operations and maintenance expense (2006) 19, 20-21

49 C.F.R. Part 192, Subpart M 31

49 C.F.R. Part 192, Subpart O 2, 7, 31

49 C.F.R. § 195.452 7

TABLE OF AUTHORITIES

REGULATIONS (continued): **PAGE**

Pipeline Safety: Pipeline Integrity Management in High Consequence Areas (Gas Transmission Pipelines), 68 Fed. Reg. 69,788 (Dec. 15, 2003).. 7, 28, 29, 35

OTHER MATERIALS:

Accounting for the Cost of Asbestos Removal, Financial Accounting Standards Board, Emerging Issues Task Force Issue 89-13.. 36, 37

Capitalization of Costs to Treat Environmental Contamination, Financial Accounting Standards Board, Emerging Issues Task Force Issue 90-8.. 35, 36, 37

Government Accountability Office, GAO-06-1027T, *Gas Pipeline Safety: Views on Proposed Legislation to Reauthorize Pipeline Safety Provisions* (2006)..24

U.S. Department of Transportation, Research and Special Programs Administration, Docket RSPA-00-7666-356, *Final Regulatory Evaluation, Pipeline Integrity Management in High Consequence Areas (Gas Transmission Pipelines)*..............................34

GLOSSARY

Accounting Order	Order on Accounting for Pipeline Assessment Costs, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 111 FERC ¶ 61,501 (June 30, 2005), R. 19, JA 30
Accounting Release	Proposed Accounting Release No. 18, *Accounting for Pipeline Assessment Costs*, Docket No. AI05-1 (Nov. 5, 2004), R. 1, Attachment, JA 3
Br.	Petitioner's Brief
Commission or FERC	Federal Energy Regulatory Commission
FERC Orders	Collectively, Accounting Order and Rehearing Order
GAAP	generally accepted accounting principles
INGAA	Petitioner Interstate Natural Gas Association of America
NGA	Natural Gas Act
OPS	Office of Pipeline Safety, U.S. Department of Transportation
OPS Final Rule	*Pipeline Safety: Pipeline Integrity Management in High Consequence Areas (Gas Transmission Pipelines)*, 68 Fed. Reg. 69,788 (Dec. 15, 2003)
OPS Regulations	Regulations issued by OPS regarding integrity management programs for segments of pipelines in high consequence areas
Rehearing Order	Order Denying Rehearing and Providing Clarification, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 112 FERC ¶ 61,309 (Sept. 19, 2005), R. 24, JA 75

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

No. 05-1426

**INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
PETITIONER,**

v.

**FEDERAL ENERGY REGULATORY COMMISSION,
RESPONDENT.**

**ON PETITION FOR REVIEW OF ORDERS OF THE
FEDERAL ENERGY REGULATORY COMMISSION**

**BRIEF OF RESPONDENT
FEDERAL ENERGY REGULATORY COMMISSION**

STATEMENT OF THE ISSUE

Whether the Commission reasonably interpreted its accounting rules in requiring jurisdictional natural gas and oil pipeline companies to account for certain costs of pipeline testing and maintenance, necessary to assure pipeline safety, as expense, rather than capital, items.

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendum to this brief.

INTRODUCTION

This case concerns the Commission's interpretation of its own accounting rules in determining whether certain costs incurred by FERC-jurisdictional pipeline companies should be capitalized or charged to maintenance expenses.

In response to the Pipeline Safety Improvement Act of 2002, the U.S. Department of Transportation's Office of Pipeline Safety ("OPS") promulgated regulations requiring natural gas and oil pipeline operators to develop "integrity management programs" to enhance pipeline safety. *See* 49 C.F.R. Part 192, Subpart O ("OPS Regulations"). OPS determined that a higher level of assurance was needed to protect "high consequence areas," and accordingly required pipeline operators to undertake substantial additional safety measures beyond those it had previously required.

Those OPS Regulations are not at issue in this case. Nothing in FERC's accounting guidance undermines the enhanced safety measures mandated by OPS or pipelines' obligation to comply with the OPS Regulations. It is the province of Congress and OPS to impose such heightened safety requirements. But the wholly separate matter of determining how FERC-regulated pipeline companies should account for the costs of complying with such requirements — with the resulting impact on FERC ratemaking — is properly left to the Commission.

FERC's long-established Uniform System of Accounts governs how

regulated pipelines are required to maintain their books and records. *See* 18 C.F.R. Part 201 (2006) (Uniform System of Accounts for natural gas companies); 18 C.F.R. Part 352 (2006) (Uniform System of Accounts for oil pipeline companies). In the challenged orders, the Commission interpreted how FERC's uniform accounting rules would apply to pipelines' costs incurred under the OPS Regulations, and permitted a substantial portion of the costs to be capitalized under the rules regarding addition and replacement of plant. *See* Order on Accounting for Pipeline Assessment Costs, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 111 FERC ¶ 61,501 (2005) ("Accounting Order"), R. 19, JA 30; Order Denying Rehearing and Providing Clarification, *Jurisdictional Public Utilities and Licensees*, Docket No. AI05-1, 112 FERC ¶ 61,309 (2005) ("Rehearing Order," and together with the Accounting Order, the "FERC Orders"), R. 24, JA 75.[1] The Commission found, however, that certain pipeline testing and recordkeeping costs must be expensed because the Uniform System of Accounts classifies costs of inspecting, testing, and reporting on the condition of plant to determine the need for repairs and replacements, as maintenance expenses.

Moreover, the Commission effectively grandfathered all compliance costs for the first two years of the OPS Regulations, permitting costs incurred before

---

[1] "R." refers to a record item. "JA" refers to the Joint Appendix page number. "P" refers to the internal paragraph number within a FERC order.

January 1, 2006 — including testing and recordkeeping costs that would otherwise be expensed — to be capitalized. Therefore, "a significant portion of the cost of integrity management programs can be expected to be capitalized as a result of" the Commission's orders in this case. Accounting Order at P 30, JA 39.

Petitioner Interstate Natural Gas Association of America ("INGAA") and its members seek to capitalize *all* costs in the first ten years of the integrity management program. *See, e.g.,* Br. 31-32 n.8. Accordingly, this appeal concerns only the narrow portion of compliance costs that is related to certain testing and recordkeeping activities incurred after the first two years of the program and accounted for as expense items.

STATEMENT OF FACTS

I. Statutory And Regulatory Background

The Natural Gas Act ("NGA") confers upon FERC jurisdiction to regulate (1) the transportation and sale for resale "of natural gas in interstate commerce," and (2) "natural-gas companies engaged in such transportation or sale." NGA § 1(b), 15 U.S.C. § 717(b). NGA § 7, 15 U.S.C. § 717f, requires a natural gas company to obtain permission and approval from FERC before abandoning any portion of its FERC-jurisdictional facilities, and to obtain from FERC a certificate of public convenience and necessity before acquiring or operating any such facilities. NGA § 7(b) and (c), 15 U.S.C. § 717f(b) and (c). The NGA also gives

FERC rate authority over natural gas companies; NGA § 4 governs rates proposed by pipelines. 15 U.S.C. § 717c.

The Commission also is empowered to require public utilities under its jurisdiction to keep "accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this chapter . . . ." NGA § 8(a), 15 U.S.C. § 717g(a). The Commission "may prescribe a system of accounts to be kept by . . . natural-gas companies, and . . . may determine by order the accounts in which particular outlays or receipts shall be entered, charged, or credited." *Id.* In accordance with those provisions, the Commission has adopted the Uniform System of Accounts. 18 C.F.R. Part 201 (2006) (Uniform System of Accounts for natural gas companies); *see also* 18 C.F.R. Part 352 (2006) (Uniform System of Accounts for oil pipeline companies). The Commission's authority to prescribe a uniform system of accounts and to require jurisdictional utilities to keep accounts in the manner prescribed is long settled. *Northwestern Elec. Co. v. FPC*, 321 U.S. 119, 122-23 (1944).

FERC's accounting rules provide that costs incurred in "[i]nspecting, testing, and reporting on condition of plant . . . to determine the need for repairs, replacements, rearrangements and changes[,] and inspecting and testing the

adequacy of repairs [that] have been made" are to be charged to maintenance expense in the period the costs are incurred. 18 C.F.R. Part 201, Operating Expense Instruction No. 2, *Maintenance*, Item 2 (2006). Similarly, "[w]ork performed specifically for the purpose of preventing failure, restoring serviceability[,] or maintaining life of plant" is also a maintenance expense item. 18 C.F.R. Part 201, Operating Expense Instruction No. 2, *Maintenance*, Item 3 (2006). *See also* 18 C.F.R. Part 352, Instructions for Operating Revenues and Operating Expenses No. 4-4, *Expense classification* (2006) (rule for oil pipelines). The rules also provide for the capitalization of costs related to the addition and replacement of plant. *See, e.g.,* 18 C.F.R. Part 201, Gas Plant Instruction No. 10, *Additions and Retirements of Gas Plant* (2006); 18 C.F.R. Part 352, Carrier Property Accounts Instruction No. 3-6, *Replacements* (2006).

The accounting treatment of costs as an expense item or as a capital item affects a pipeline's FERC-approved rates. Capital expenditures are recovered in both the depreciation and return on equity elements of such rates. Operating expenses, such as maintenance, are recovered as expenses and are not included in the rate base for calculating the return on invested capital. *See generally Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 56-57 (D.C. Cir. 1999); *Boston Edison Co. v. FERC*, 885 F.2d 962, 964-65 (1st Cir. 1989).

II. OPS Regulations Requiring Integrity Management Programs

Following pipeline accidents in 1999 and 2000 and enactment of the Pipeline Safety Improvement Act of 2002, Pub. L. No. 107-355, 116 Stat. 2985 (codified at 49 U.S.C. § 60109), the OPS developed regulations that require natural gas pipeline and hazardous liquid pipeline operators to develop, implement, and follow an integrity management program for segments of pipeline in "high consequence areas." *See Pipeline Safety: Pipeline Integrity Management in High Consequence Areas (Gas Transmission Pipelines)*, 68 Fed. Reg. 69,788 (Dec. 15, 2003) ("OPS Final Rule") (codified at 49 C.F.R. Part 192, Subpart O (integrity management program requirements for gas pipeline operators)); *see also* 49 C.F.R. § 195.452 (similar requirements for hazardous liquid pipelines). The OPS Regulations require pipeline operators to assess, evaluate, repair, and validate, through a comprehensive analysis, the integrity of certain pipeline segments.

To comply with the required process, pipeline operators must develop integrity management plans, prepare pipelines for inspection, conduct pipeline assessments, make subsequent repairs, and perform other ongoing activities. *See generally* Accounting Order at PP 2-7 (describing requirements of OPS Regulations), JA 31-32. For example, to develop the required plans, pipeline operators must identify the affected pipeline segments and create documentation and recordkeeping systems for both the initial assessment and subsequent

inspections. *Id.* at P 3, JA 31. Pipeline operators also must make necessary additions, modifications, and replacements to segments of pipeline that require inline inspection tools, such as smart pigs, but are not currently designed for such inline inspections. These activities may include, for example, installing pig launchers and receivers and replacing portions of pipe. *Id.* at P 4, JA 31. Then the operators must assess the identified pipeline segments using hydrostatic tests, smart pigs, or other methods. *Id.* at P 5, JA 31-32.

The OPS Regulations require gas pipeline operators to complete an initial assessment of 50 percent of all pipe located in a high consequence area by December 2007, complete the remaining 50 percent by December 2012, and conduct reassessments every 7 to 10 years. *Id.* Oil pipeline operators were required to complete a baseline assessment of 50 percent of all pipe located in a high consequence area by February 2005, and must complete the remaining 50 percent by August 2009 and conduct reassessments every 5 years. *Id.*

Pipeline operators must investigate and remedy any major defect identified through these assessments, and must also evaluate the need for additional preventative and mitigative measures. *Id.* at P 6, JA 32. They also must develop programs to conduct training and drills, enhance damage prevention programs, and meet periodic compliance reporting requirements. *Id.* at P 7, JA 32.

III. The Commission Proceedings and Orders

A. Proposed Accounting Release

On November 5, 2004, the Commission published a Notice of Proposed Accounting Release, *Accounting for Pipeline Assessment Costs*, Docket No. AI05-1 (Nov. 5, 2004), R. 1, JA 1, stating that FERC's Chief Accountant proposed to issue guidance on accounting for pipeline assessment activities. The proposed guidance clarified that certain costs of a pipeline integrity management program, related to the inspection aspects of such programs, "are properly accounted for as maintenance and charged to expense in the period incurred." Proposed Accounting Release No. 18, *Accounting for Pipeline Assessment Costs* at P 1 ("Accounting Release"), R. 1, Attachment, JA 3.

The Accounting Release noted that "[t]hese costs generally include hydrostatic testing, smart pigging, and direct pipeline assessment techniques." *Id.* at P 1, JA 3. Addressing the particular requirements of the OPS Regulations, the Chief Accountant observed that "[t]he assessment activities required under a pipeline integrity management program constitute steps performed as part of an on-going inspection and testing program" (*id.* at P 7, JA 5), and explained that FERC's Uniform System of Accounts treats costs incurred to inspect, test, and report on the condition of plant to determine the need for repairs or replacements as maintenance expenses (*id.* at P 8, JA 5). Therefore, "[w]e view the various

testing techniques that will take place because of the new safety regulations to constitute a work activity falling within our rules for maintenance expense." *Id.*

B. Accounting Order

On June 30, 2005, after reviewing the comments of INGAA and other parties, the Commission issued its Accounting Order, the first of the FERC Orders now on review. Recognizing the increased testing costs resulting from the OPS Regulations and the "diverse accounting practices in the [pipeline] industry," the Commission expressed concern about the "comparability of financial statements among jurisdictional entities" and the increased difficulty of reviewing existing pipeline rates. Accounting Order at P 8, JA 32; *see also id.* at P 19 (noting that comments indicated "that there is different accounting taking place regarding the costs related to the various other activities pipelines are performing to implement their integrity management programs"), JA 35-36. Therefore, the Commission expanded upon the proposed guidance, providing "specific guidance on how jurisdictional entities shall account for all activities related to developing and implementing an integrity management program." *Id.*

The Commission identified six categories of costs that pipeline operators will incur to:

> (1) prepare a plan to implement the program; (2) identify high consequence areas; (3) develop and maintain a recordkeeping system to document program implementation and actions; (4) prepare affected pipeline segments for inspection; (5) inspect affected pipeline

> segments; and (6) develop and perform remediation actions to correct an identified condition which could threaten a pipeline's integrity.

Accounting Order at P 18, JA 35. Before addressing those categories, however, the Commission addressed the contention of some commenters, including INGAA, that all costs related to integrity management programs should be capitalized because they are in effect costs of a major rehabilitation project. The Commission disagreed, concluding that the programs' "primary aim is not to increase the capacity or efficiency of the pipeline," but rather to "provide information about the condition of existing facilities to ensure that operation of the pipeline remains within established safety parameters." *Id.* at P 21, JA 36. The Commission also concluded that such programs are not analogous to the kind of one-time projects for which the Commission has allowed capitalization of assessment costs. *Id.* at P 22, JA 36.

The Commission then determined that costs incurred in preparing a plan, identifying high consequence areas, and developing and maintaining a recordkeeping system are required to be expensed and should be charged to the appropriate operation and maintenance account in the period they are incurred. *Id.* at PP 24-25, JA 37. Likewise, the costs of inspecting pipeline segments must be charged to maintenance expense (as the Accounting Release had determined). *Id.* at P 27, JA 38. Pipeline additions or modifications undertaken in preparation for a pipeline assessment, such as installation of pig launchers or receivers, should be

accounted for "in accordance with applicable [Uniform System of Accounts] requirements related to the addition or replacement of plant" — meaning that costs may be capitalized "if they are considered retirement units or result in a substantial addition." *Id.* at P 26, JA 38. Costs of remedial and mitigation actions should be similarly treated, with replacement of a retirement unit to be capitalized and replacement of minor items to be expensed as maintenance. *Id.* at P 28, JA 38.

The Commission further determined that, in light of the costs of compliance and in order to allow companies time to implement any necessary changes to their accounting systems, its guidance would be effective January 1, 2006 and would be "prospective in application. Amounts capitalized in periods prior to January 1, 2006 will be permitted to remain as recorded." *Id.* at P 29, JA 38.

C. Rehearing Order

INGAA filed a timely request for rehearing, challenging the Commission's application of its accounting rules and contending that pipeline companies should be permitted to capitalize all costs incurred after 2005 in connection with preparing for and performing baseline assessments and updating and integrating the plans required by the OPS Regulations. R. 20, JA 45; *see also* Br. 17 & n.6. (Two other parties to the FERC proceeding filed requests for clarification, R. 21 and R. 22, which are not at issue in this case; neither entity is a party to this appeal.)

On September 19, 2005, the Commission issued its Rehearing Order,

denying INGAA's plea to broaden the scope of safety costs eligible for capital accounting. The Commission reaffirmed its determination that the costs of conducting baseline assessments and related bookkeeping and data integration should be treated as maintenance costs, rather than capitalized, for accounting purposes. Rehearing Order at P 8, JA 77-78. The Commission also clarified that pipelines could adopt the required accounting at any time on or before January 1, 2006, and that its guidance was not intended to allow pipelines that had already expensed compliance costs to change their accounting and capitalize those costs before January 1, 2006. *Id.* at PP 16-17, JA 80-81.

This petition followed.

SUMMARY OF ARGUMENT

The Commission properly interpreted and applied its accounting rules in determining how jurisdictional natural gas and oil pipeline companies should account for the costs of implementing pipeline integrity management programs. The Commission's conclusion that the costs of certain activities required by pipeline safety regulations should be charged to operating expenses, rather than capitalized, was reasonable and supported by the record.

First, the Commission reasonably determined that the requisite planning, recordkeeping, and pipeline testing are maintenance activities that FERC's Uniform System of Accounts require to be charged to operating expenses. In contrast, the costs of alterations to physical plant, including modifications to prepare for assessment and repairs made to correct identified problems, may be capitalized as provided in FERC's accounting rules. The Commission recognized that pipelines would incur significant costs in complying with the OPS Regulations, but explained that the FERC Orders would permit a substantial portion of those costs (to the extent they would be governed by FERC's accounting guidance at all) to be capitalized.

Second, the Commission reasonably rejected INGAA's arguments that *all* costs of compliance should be capitalized in the first ten years of the integrity management programs. The Commission found that the period for completing

baseline assessments is not comparable to a one-time major rehabilitation project because the OPS Regulations mandate an ongoing process of continual evaluation and assessment of pipeline integrity. The Commission further explained that, though the OPS Regulations increased the required level of testing and remediation, the nature and purpose of the work — operational safety and maintenance of pipeline assets — remain the same. Moreover, the connection between inspection costs and future economic benefits is too speculative to support capitalizing such costs. Finally, the Commission concluded that generally accepted accounting principles also do not support capitalizing those costs.

ARGUMENT

I. STANDARD OF REVIEW

The Court reviews FERC orders under the Administrative Procedure Act's arbitrary and capricious standard. *See, e.g., Sithe/Independence Power Partners v. FERC*, 165 F.3d 944, 948 (D.C. Cir. 1999). A court must satisfy itself that the agency "articulate[d] a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Motor Vehicle Mfrs. Ass'n of United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

The Commission's promulgation of its accounting rules is related to its ratemaking authority. *See Union Elec. Co. v. FERC*, 890 F.2d 1193, 1197 (D.C. Cir. 1989) ("FERC accounting rules exist primarily if not exclusively as a component of its ratemaking"). Moreover, this Court has recognized that, "[a]part from its duties regarding the rates utilities may charge for their service, the Commission has been delegated authority over accounting procedures *per se*." *Alabama Power Co. v. FERC*, 160 F.3d 7, 8 (D.C. Cir. 1998).[2] As a result, "this

---

[2] *Alabama Power* involved the Federal Power Act, but courts have applied interpretations of Federal Power Act provisions to their counterparts in the Natural Gas Act because "the relevant provisions of the two statutes are in all material

court has repeatedly declined to draw accounting rules for the Commission." *Anaheim v. FERC*, 669 F.2d 799, 806 (D.C. Cir. 1981) (internal quotation marks and citation omitted).

Thus, "the petitioner bears a heavy burden when it challenges [FERC] accounting regulations . . . . The effect of the accounting rules should not be viewed and analyzed piecemeal . . . . Rather, the Commission should be free to fashion individual accounting rules unless a rule is arbitrary or capricious . . . ." *Id.* (internal quotation marks and citation omitted; alterations in original). Indeed, "an accounting rule, at least when it does not represent a change of policy, should be reversed only where it is ' "so entirely at odds with fundamental principles of correct accounting" as to be the expression of a whim rather than an exercise of judgment.' " *Transcontinental Gas Pipe Line Corp. v. FPC*, 518 F.2d 459, 465 (D.C. Cir. 1975) (quoting *American Tel. & Tel. Co. v. United States*, 299 U.S. 232, 236-37 (1936)), *vacated on other grounds*, 423 U.S. 326 (1976).

As with other interpretations of its own regulations, the Commission's interpretation of the accounting rules it adopts is entitled to "considerable deference." *Amerada Hess Pipeline Corp. v. FERC*, 117 F.3d 596, 600 (D.C. Cir. 1997); *see also Northern Border Pipeline Co. v. FERC*, 129 F.3d 1315, 1318 (D.C.

---

respects substantially identical." *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 n.7 (1981) (internal quotation marks and citation omitted).

Cir. 1997) ("[w]e afford substantial deference to the Commission's interpretations of its own regulations, deferring to the agency unless its interpretation is plainly erroneous or inconsistent with the regulation[s]") (internal quotation marks and citation omitted; alterations in original) (affirming FERC's interpretation of accounting rule). Moreover, courts defer to the Commission's particular expertise in regulating pipelines. *See Transcontinental Gas*, 518 F.2d at 465 ("[I]n an attack on individual accounting rules, the reviewing court must defer to agency expertise."); *Amerada Hess*, 117 F.3d at 601 ("FERC is entrusted with administering the regulations relating to oil pipelines and has an expertise in the field based on that jurisdiction.").

II. THE COMMISSION REASONABLY INTERPRETED ITS ACCOUNTING RULES TO REQUIRE CERTAIN COSTS OF PIPELINE INTEGRITY MANAGEMENT PROGRAMS TO BE TREATED AS MAINTENANCE EXPENSES

In the Accounting Release, FERC's Chief Accountant explained that costs of pipeline testing under an integrity management program should be accounted for as maintenance costs and expensed in the period they are incurred; in the Accounting Order, the Commission agreed with that analysis and expanded the scope of its guidance to address all types of activities and costs required by the OPS Regulations. The Commission considered the nature of each of those activities and explained how they corresponded to various categories of costs in FERC's accounting rules. *See* Accounting Order at PP 23-28, JA 37-38. The Commission

also explained that its accounting guidance would result in only a relatively small portion of the costs of integrity management programs being treated as expense, rather than capital, items. *See id.* at P 30, JA 39.

A. The Commission Applied Its Accounting Rules To The Various Categories Of Costs And Work Activities Required

1. Planning and Recordkeeping

The Commission identified three categories of planning activities necessary for the required integrity management program: (1) costs of preparing an implementation plan; (2) costs of identifying high consequence areas; and (3) costs of developing and maintaining a recordkeeping system. Accounting Order at P 23, JA 37. The Commission then considered how each kind of activity fit into FERC's accounting rules.

The Commission found the first two categories comparable to other operations and maintenance activities that the Uniform System of Accounts requires to be expensed. Under those accounting rules, "costs incurred in preparing instructions for operations and maintenance activities are required to be expensed." Accounting Order at P 24 & n.7 (citing 18 C.F.R. Part 201, Operating Expense Instruction No. 1, *Supervision and Engineering*, Item 3, and 18 C.F.R. Part 352, Instruction for Operating Revenues and Operating Expenses No. 4-4(a), *Operations and maintenance expense*), JA 37. Therefore, the Commission found, the costs of preparing a plan to implement an integrity management program

should likewise be charged to the appropriate operation and maintenance account when they are incurred. Accounting Order at P 24, JA 37. Similarly, costs incurred in identifying high consequence areas "are part of the process for determining what segments to inspect or test, which . . . is a maintenance activity." *Id.*

As to the third category, the Commission determined that "the costs incurred to develop and maintain a recordkeeping system to document integrity management program implementation and actions must also be charged to the appropriate operation and maintenance expense account in the period incurred, since these costs relate to maintaining the integrity of the pipeline, a maintenance activity." *Id.* at P 25, JA 37. The Commission excepted, however, costs incurred for development of and upgrades or enhancements to internal-use computer software, which could be capitalized. *Id.* at P 25 n.8, JA 37.

2. Inspections and Testing

The Commission observed that its accounting rules provide that costs of inspecting, testing, and reporting on the condition of plant to determine the need for repairs and replacements should be charged to maintenance expense in the period when the costs are incurred. Accounting Order at P 21 & n.6 (citing 18 C.F.R. Part 201, Operating Expense Instruction No. 2, *Maintenance*, Item 2, and 18 C.F.R. Part 352, Instructions for Operating Revenues and Operating Expenses

No. 4-4(a), *Operations and maintenance expense*), JA 36. The Commission found that pipeline assessments required by the OPS Regulations fall under this category. Accounting Order at PP 21, 27, JA 36, 38; *see also* Accounting Release at P 8 ("We view the various testing techniques that will take place because of the new safety regulations to constitute a work activity falling within our rules for maintenance expense."), JA 5.

Specifically, the Commission explained that the program required under the OPS Regulations "incorporates a process for continual evaluation and assessment or inspection, along with remediation, so as to maintain the integrity of the pipeline." Accounting Order at P 21, JA 36. As such, the program's "primary aim is not to increase the capacity or efficiency of the pipeline," but rather to provide information about the condition of pipeline facilities for safety purposes. *Id.* Accordingly, the Commission reasonably concluded that costs of inspecting affected pipeline segments under the program must be charged to maintenance expense in the period the costs are incurred. *Id.* at P 27, JA 38.

3. Pipeline Modifications and Additions; Remedial and Mitigation Actions

The Commission also reasonably determined that alterations to pipelines' physical plant, both to prepare for testing and to deal with problems identified through such testing, should be treated in accordance with FERC's accounting rules regarding the addition and replacement of plant. Specifically, the

Commission directed that the costs of pipeline additions or modifications undertaken to prepare for assessment — such as installation of pig launchers and receivers and modification of pipes to allow pigging — should be so treated. Accounting Order at P 26 & n.9 (citing 18 C.F.R. Part 201, Gas Plant Instruction No. 10, *Additions and Retirements of Gas Plant*, and 18 C.F.R. Part 352, Carrier Property Accounts Instruction No. 3-6, *Replacements*), JA 38. Such modifications "can be capitalized if they are considered retirement units or result in a substantial addition." Accounting Order at P 26, JA 38.

When the required inspections identify a need for repair or replacement, the Commission determined, remedial and mitigative actions — such as replacing identified segments of pipe or installing automatic shut-off valves and computerized monitoring and leak detection systems — taken to correct an identified condition that could threaten pipeline integrity should likewise be treated in accordance with FERC's rules regarding addition or replacement of plant. *Id.* at P 28, JA 38. Thus, if a retirement unit is replaced as part of a remedial action, the costs should be capitalized to the appropriate plant account. On the other hand, replacement of minor items of property should be expensed to the appropriate maintenance account. *Id.*

B. The Commission Noted That Only A Relatively Small Portion Of Integrity Management Program Costs Would Be Expensed Under The FERC Orders

The Commission did not, as INGAA contends, "ignore the financial impact of its decisions." Br. 35. To the contrary, in reaching its accounting determinations, the Commission recognized "that implementing pipeline integrity management programs will involve significant costs." Accounting Order at P 30, JA 39. The Commission explained, however, that only a narrow portion of those costs would be affected by the Commission's accounting guidance.

A substantial portion of the projected total costs of implementation would not be subject to the challenged FERC orders in any event. Noting that OPS had estimated the total cost of complying with the OPS Regulations over a twenty-year period would be approximately $4.7 billion, the Commission cited INGAA's own estimates "that 58 percent, or approximately [$2.7 billion] of the overall . . . cost of the rule" will be incurred by entities that are subject to FERC's jurisdiction — thus, conversely, approximately $2 billion in costs will be incurred by nonjurisdictional entities and thus will not be governed by FERC's accounting rules at all. *See* Accounting Order at P 30, JA 39.

Of the costs subject to FERC's accounting rules, the Commission concluded that "a significant portion" would be capitalized under the Commission's orders. *Id.* First, by delaying the effective date of implementation to January 1, 2006, and

applying the accounting guidance prospectively from that date — as INGAA itself had advocated (R. 14 at 5, JA 14) — the Commission effectively grandfathered all costs in the first two years of the integrity management programs, regardless of the nature of the work activities undertaken in that period. The first-year cost of compliance was estimated at approximately $794 million for all entities (which includes the 42 percent attributable to nonjurisdictional entities), of which approximately $262 million was estimated for baseline testing. Accounting Order at P 30, JA 39. The Commission pointed out that, at the time it issued its Accounting Order in June 2005, "the integrity management programs are in their second year, [so] these costs have already been incurred." *Id.*[3] Therefore, all of those costs, as well as additional costs incurred through the remainder of 2005, could be capitalized. *See id.* at P 29, JA 38.

Second, the Commission anticipated that approximately 80 percent of the annual cost of baseline testing will be capitalized under the rules regarding addition and replacement of plant. Because the estimates for baseline testing included "both the estimated cost of testing the pipelines and the cost of required

---

[3] Indeed, the Government Accountability Office recently reported that "33 percent of the identified pipelines in highly populated or frequently used areas had been assessed and over 2,300 repairs had been completed as of December 31, 2005 (latest data available)." Government Accountability Office, GAO-06-1027T, *Gas Pipeline Safety: Views on Proposed Legislation to Reauthorize Pipeline Safety Provisions* at 2 (2006); *see also id.* at 6.

piping modifications to accommodate testing," and assuming the inspection costs incurred in years one through ten were comparable to those estimated for years eleven through twenty, the Commission expected that approximately $208 million (80 percent) of the projected $262 million annual cost going forward will consist of costs such as the addition of equipment and replacement of portions of pipe. Accounting Order at P 30, JA 39.

Therefore, the Commission understood that the bulk of the costs of complying with the OPS Regulations would not be charged to expenses. Indeed, Commissioner Brownell, who dissented in part from the Commission's determination, acknowledged the limited impact of the accounting guidance: "Since the net effect of these findings is that most of the costs necessary to set up the new safety program are capitalized and the on-going costs incurred to maintain the program are expensed, I do not disagree with the outcome." 111 FERC at 63,127, JA 41.

III. THE COMMISSION REASONABLY REJECTED INGAA'S ARGUMENTS THAT ALL COSTS INCURRED IN THE FIRST TEN YEARS OF THE REQUIRED INTEGRITY MANAGEMENT PROGRAMS SHOULD BE CAPITALIZED

INGAA's various objections to the Commission's accounting guidance essentially build on a single premise: that the Commission should have treated all aspects of the integrity management programs required by the OPS Regulations as a single, indivisible project, without regard to the specific activities that pipeline

operators will be required to perform (*see, e.g.,* Br. 30, 32-33). Indeed, INGAA goes so far as to suggest that it was "not appropriate" for the Commission even to consider for itself the nature of those activities (Br. 30). The Commission considered INGAA's arguments and rejected those premises.

The question for this Court, of course, is not whether the Commission *could* reasonably have chosen another course, permitting capitalization of testing and recordkeeping costs; so long as the Commission's interpretation of its accounting rules was reasonable, the FERC Orders must be upheld. *See supra* Section I. Nevertheless, the Commission adequately explained why INGAA's arguments in favor of capitalizing all costs failed. And, in any event, the Commission did permit pipeline operators to capitalize a substantial portion of the setup costs, as it effectively grandfathered the first two years of the integrity management programs. *See supra* Section II.B.

A. The Commission Reasonably Found That An Integrity Management Program Is Not Akin To A One-Time Major Rehabilitation Project

INGAA's principal argument is that the initial ten-year period of the integrity management program must be viewed as analogous to a one-time major rehabilitation project, such that all costs incurred during that period, including costs of baseline testing and recordkeeping, can be capitalized. *See* Br. 25-33. The comparison, however, is inapt.

In the Accounting Release, FERC's Chief Accountant noted that, in limited circumstances, the Commission had previously allowed some pipeline testing costs to be capitalized. *See* Accounting Release at PP 4-5 & n.3, JA 4. Those instances involved tests that were ancillary to a discrete pipeline construction or rehabilitation project. In one case, the Chief Accountant permitted entities to capitalize the costs of certain hydrostatic retesting where the initial tests of a newly constructed pipeline had not met the requirements of subsequent legislation; the full capacities of the pipeline could not be utilized absent that retesting. *See* Accounting Release at P 4, JA 4.[4] In the other case, FERC's Deputy Chief Accountant permitted a pipeline to capitalize the costs of pipeline coating and

---

4 *See also* Accounting Release No. 8 (AR-8), Federal Power Commission (Mar. 6, 1969) (copy attached in Addendum):

> **Question:** What is the proper accounting treatment for costs incurred in hydrostatic testing of gas mains and pipelines to meet the requirements of the USAS N31.8, 1968 Code, which became Federal standards under legislation passed by Congress August 12, 1968?
>
> **Answer:** Costs incurred under a planned maintenance program which meet the standards of USAS B31.8, 1968 Code, should be treated as regular maintenance expenses. When a utility had constructed a pipeline and its initial tests did not meet the requirements of the Code[,] making it necessary to retest so that the full capacities could be utilized[,] such costs could be capitalized. When such costs are capitalized all prior testing costs related to the specific property should be retired in accordance with Gas Plan Instruction 10. Testing costs on future construction should be capitalized provided that such testing meets the then[-]prevailing required standards.

hydrostatic testing incurred as part of a one-time pipeline reconditioning project. *See id.* n.3, JA 4; Letter Order, *Northwest Pipeline Corp.*, FERC Docket No. AC94-149-000 (Apr. 30, 1996) (copy attached in Addendum). In both instances, FERC's officials, acting pursuant to delegated authority in orders never reviewed by the full Commission, considered the purpose of the testing costs, which were both connected to a specific construction or rehabilitation project and finite in scope.

Here, by contrast, the Commission properly understood that the pipeline testing activities are not merely ancillary to, but are in fact a central feature of the pipeline integrity management program: "The pipeline integrity management program as implemented by the [OPS] Regulations incorporates a process for continual evaluation and assessment or inspection, along with remediation, so as to maintain the integrity of the pipeline." Accounting Order at P 21, JA 36; *see also* OPS Final Rule at 69,788 ("The rule requires gas transmission pipeline operators to perform ongoing assessments of pipeline integrity, to improve data collection, integration, and analysis, to repair and remediate the pipeline as necessary, and to implement preventive and mitigative actions.").

Furthermore, the testing process is not a one-time occurrence — indeed, its very purpose is to be ongoing: "[S]ince the integrity management program provides for a process of *continual evaluation and assessment* it can not be

considered analogous to those one-time major rehabilitation projects where we have allowed capitalization of assessment costs in the past." Accounting Order at P 22 (emphasis added), JA 36. *See also* Rehearing Order at P 13 ("These additional safety measures are not one-time events, but are scheduled on a *routine and re-occurring basis into the foreseeable future* . . . .") (emphasis added), JA 79; OPS Final Rule at 69,788 (program requires "*ongoing assessments* of pipeline integrity") (emphasis added).

INGAA further contends that the initial baseline assessments will offer benefits over many years to come and should therefore be viewed as "one-time" events. Br. 28. But distinguishing the benefits offered by the baseline assessment from the benefits offered by subsequent assessments is untenable because the benefits are the same. Any time a segment of pipeline is tested the benefit is "to provide assurance as to the operational safety of pipeline segments." Rehearing Order at P 13, JA 79; *see also id.* at P 10 (baseline assessments are performed "to insure that assets are being operated within established safety parameters"), JA 78; Accounting Order at P 21 ("Broadly speaking, pipeline assessment activities provide information about the condition of existing facilities to ensure that operation of the pipeline remains within established safety parameters."), JA 36.

Similarly, the Commission properly rejected INGAA's premise that the

baseline assessment under the OPS Regulations is conceptually different from subsequent assessments merely because it is the first. There is no material difference between the type of testing to be performed during the remaining years in the baseline period and that to be done in subsequent years. The Commission found that "[t]he pipeline assessments and related activities conducted during the baseline period are the first instance of many other similar assessments and activities to be conducted into the foreseeable future." Rehearing Order at P 13, JA 79. The testing activities — *i.e.*, hydrostatic testing, smart pigging, and other methods of assessing pipeline integrity — will be the same whether performed in year 1 of the program, year 5, or year 20. As the Commission stated, "[t]he activities incurred during the baseline period[] are not materially different, if different at all, from the same category of costs that INGAA does not object to expensing after the baseline period." *Id.* Though INGAA contends it was "not appropriate" for the Commission to consider for itself the nature of the required activities (Br. 30), INGAA never actually disputes the functional similarity of the testing activities to be undertaken during the baseline period and afterward.

Because neither the substance of nor the benefits from the testing differ, and because the OPS Regulations establish an ongoing process rather than a discrete undertaking, the Commission reasonably found "no reason why the same accounting standard should not be applied to each cost category[,] whether the cost

is being incurred for the first time or a subsequent time." Rehearing Order at P 13, JA 79.

B. The Commission Reasonably Found That The Increased Testing Is A Maintenance Activity And Is Not Sufficiently Tied To Future Economic Benefits To Support Capitalizing The Costs As Assets

INGAA also insists that, notwithstanding similarities to other pipeline maintenance activities, the increased testing required by the OPS Regulations is so onerous that it exceeds the bounds of ordinary maintenance and *must* be — that is, given INGAA's heavy burden here, can *only reasonably* be — considered something entirely different, separate from other pipeline safety requirements imposed by OPS:

> [FERC's] notion that the purpose of the pipeline testing required by OPS is to ensure that the pipeline remains within established safety parameters confuses the primary purpose of the existing OPS ordinary safety maintenance regulations under 49 [C.F.R. Part] 192[,] Subpart M with the new regulations under Subpart O. The ordinary maintenance ensures assets are operated within existing parameters; compliance with the baseline testing and related requirements under Part O establishes the new "integrity management" parameters.

Br. 31; *see also* Br. 28. INGAA offers nothing, beyond OPS's organization of regulatory subparts, to support a meaningful distinction between the same kinds of testing activities performed for "ordinary safety maintenance" and for monitoring pipeline integrity in accordance with the OPS Regulations.

The Commission reasonably found the difference to be only in degree; simply put, maintenance is maintenance, and its nature and purpose remain the

same even when a pipeline operator does more of it. OPS's decision to raise the bar for pipeline assessment, whether characterized as "accelerated" maintenance (*see* Br. 27) or as additional maintenance,[5] does not change the essential fact that the mandated tests are still maintenance activities:

> *The Commission understands that the [OPS] Regulations have changed what was once considered to be normal operation and maintenance of pipeline assets.* The changes brought about by the [OPS] Regulations were needed to address the fact that a higher level of assurance was needed to protect high consequence areas. Accordingly, the [OPS] Regulations require pipeline operators to undertake additional safety measures beyond those previously required and have effectively broadened what is considered routine maintenance. *However, an increase in the required level of maintenance does not change the fact that the work remains a maintenance activity.*

Rehearing Order at P 12 (emphases added), JA 79.

INGAA further contends that all costs related to integrity management programs should be capitalized because the costs of accelerated testing under integrity management programs can be linked to future benefits. Br. 27-28, 30. In particular, INGAA argues that such programs extend the useful lives and improve the efficiency of the pipeline assets by identifying problems sooner. *Id.* Of course, the costs of remedial and mitigation actions taken to address such problems, once identified, are *already* permitted be capitalized in accordance with FERC's

[5] *See* Br. 28 (asserting that OPS Regulations "exceed the standards of ordinary maintenance programs" and "'will impose a change in th[e] level of activity'") (citing INGAA's comments on Accounting Release).

accounting rules regarding the addition or replacement of plant. *See supra* Section II.A.3. The Commission, however, found that linking pipeline testing and recordkeeping costs to future economic benefits was too speculative to support capitalizing those costs as well:

> [I]t is generally recognized that in many instances a conceptual basis that links a cost to a future benefit may not be sufficient to permit capitalization as an asset. . . . [T]he fact that the [OPS] regulations *could* result in increases in pipeline operating pressure involves circumstances where realization of the potential economic benefits is too speculative to support capitalization of the costs.

Rehearing Order at P 9 (emphasis in original), JA 78. Businesses routinely undertake activities that abstractly can be linked to future economic benefits, but that alone is not enough to warrant capitalizing expenses. For example, "advertising and research and development costs are expensed when incurred even when management's intent in incurring these costs is to enhance future economic benefits available to the entity." *Id.* In those instances, as here, "the realization of the potential future economic benefits is too uncertain or speculative to support recognition of the costs as an asset." *Id.*[6]

The Commission also properly rejected INGAA's contention that the testing

[6] INGAA's own Brief betrays the speculative nature of its claims. *See, e.g.*, Br. 27-28 (OPS Regulations "*can* produce savings by identifying problems earlier and avoiding a higher level of costs that *might* otherwise have been incurred later under the pre-existing maintenance regime") (citing INGAA witness's testimony) (emphases added); Br. 38 ("'these . . . costs *might in any case* have been incurred in later periods'") (quoting INGAA testimony) (emphasis added).

costs amount to "prepaid expenses" for later maintenance. *See* Br. 38 (arguing the OPS Regulations "effectively accelerate future pipeline expenditures for efficient management to the earlier baseline testing periods"). As the Commission explained,

> A prepaid expense is an asset to a business because it is the unamortized cost for the right to receive a future service or a resource.[] As such, we do not see how the baseline assessments or the related activities provide a pipeline company with the right to receive a future service or resource.

Rehearing Order at P 10 (footnote omitted), JA 78.

Nor is OPS's cost-benefit analysis dispositive of the proper accounting treatment of compliance costs. In INGAA's view, OPS's determination, in promulgating the OPS Regulations, that integrity management programs could potentially increase efficiency and capacity established that such programs provide future benefits that warrant capitalizing their costs as assets. *See* Br. 27, 30.[7] But OPS considered only whether the potential benefits of imposing heightened safety requirements sufficiently counterbalanced the costs to justify taking regulatory

---

[7] *Cf.* U.S. Department of Transportation, Research and Special Programs Administration, Docket RSPA-00-7666-356, *Final Regulatory Evaluation, Pipeline Integrity Management in High Consequence Areas (Gas Transmission Pipelines)* at 30, *available at* http://dmses.dot.gov/docimages/pdf89/295030_web.pdf ("[T]his rule *could provide a basis* under which [OPS] *could approve operation* of some natural gas transmission pipelines at higher pressures than are presently allowed. (The particular circumstances of each area would need to be taken into account in deciding whether operation at increased pressures is acceptable).") (emphases added).

action. *See* OPS Final Rule at 69,813-14 ("[OPS] considers these costs reasonable to realize the benefits associated with this rule. . . . Publishing this final rule, and requiring that gas transmission pipeline operators comply, is clearly the appropriate course of action."); *see also id.* at 69,813 (noting advisory committee had "unanimously concluded that the expected benefit in terms of improved public confidence in pipeline safety is substantial and justifies the expected costs"). That analysis has no bearing on the appropriate characterization of the financial costs for accounting, and thus for ratemaking, purposes — a judgment that is exclusively the province of FERC. INGAA cites no authority for the proposition that a regulatory cost-benefit analysis by another agency precludes FERC from independently exercising its statutory authority to prescribe accounting rules for FERC-jurisdictional pipelines.

C. The Commission Reasonably Concluded That Generally Accepted Accounting Principles Do Not Support Capitalizing Pipeline Testing Costs

INGAA contends that capitalization is supported by the framework set forth by the Financial Accounting Standards Board's Emerging Issues Task Force in the context of asbestos and environmental clean-up costs, because that guidance addresses legally mandated activities. *See* Br. 35-36. In the FERC proceeding, various commenters, including INGAA, cited Emerging Issues Task Force Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination* ("EITF 90-

8") (copy attached hereto), for the proposition that generally accepted accounting principles ("GAAP") support capitalizing costs, including testing costs, that are directly related to pipeline repairs that extend the life, increase the capacity, and improve the safety or efficiency of the pipeline. *See* Accounting Order at PP 12, 20 (summarizing comments), JA 33-34, 36; R. 14 at 12 (INGAA's comments regarding EITF 90-8), JA 21. On rehearing, INGAA instead raised Emerging Issues Task Force Issue 89-13, *Accounting for the Cost of Asbestos Removal* ("EITF 89-13"), JA 62, which it argued is more relevant than EITF 90-8 because it permits capitalizing costs of an activity that is required by law, without the requisite direct connection to extending life, increasing capacity, or improving safety or efficiency. *See* Rehearing Order at PP 4, 14, JA 76-77, 79-80; R. 20 at 15, JA 59.

The Commission, however, disputed INGAA's interpretation because it "fail[s] to fully acknowledge the rationale underlying the EITF's decision, which can only be found by examining EITF 90-8 . . . . [, which] provides a rationale for expensing or capitalizing environmental contamination treatment costs." Rehearing Order at P 14, JA 79-80. In fact, EITF 90-8 contains an implementation example regarding asbestos removal. *Id.* Specifically,

> EITF 90-8 explains that the costs to remove asbestos may be capitalized because removing the asbestos *improves the building's safety over its original condition* since the environmental contamination (asbestos) existed when the building was constructed or

> acquired. Likewise, other environmental contamination treatment costs may be capitalized if the costs extend the life, increase the capacity, or improve the safety or efficiency of property owned *as compared with the condition of that property when originally constructed or acquired*.

Id. (emphases added); *accord*, EITF 90-8 at 10; *cf.* EITF 89-13 at 2 (noting relation to EITF 90-8), JA 63. In short, INGAA misinterprets EITF 89-13 as requiring no connection between the costs and the improvement of an asset, so long as the costs were incurred in complying with laws. *See* Br. 35-36. For that reason, EITF 89-13, taken alone, does not provide "a framework that can be used in determining the proper accounting for [OPS] Regulation costs." Rehearing Order at P 14, JA 79.

Therefore, the Commission did not "effectively treat[] the EITF 90-8 as overruling [EITF] 89-13" (Br. 36 n.9), or even find EITF 90-8 "more appropriate" than EITF 89-13 (Br. 36). Rather, it simply recognized that the two EITF decisions are interrelated: one explains the rationale underlying the other and thus they must be read together. Accordingly, the GAAP analysis links capitalization of costs to betterment of an asset beyond its original condition. Based on that rationale, the Commission concluded that GAAP does not support capitalizing pipeline assessment costs because they do not "increase or extend the life, capacity, safety, or efficiency of a pipeline *beyond its original construction or acquisition state*." Rehearing Order at P 14 (emphasis added), JA 80. That the

Commission, upon its careful consideration of both EITF issues, came to a different conclusion than INGAA's witness does not mean it failed to engage in reasoned decisionmaking.

Nor did the Commission "change[] its capitalization standard" by "impos[ing] a new requirement that there be an improvement over the original condition of the pipeline." Br. 36. The Commission, having already determined that its own standards did not support capitalization, was explaining why the GAAP guidance cited by INGAA was inapposite. Moreover, there is no inconsistency between the Commission's determination, on the one hand, that GAAP does not support capitalization of pipeline *testing* costs in this instance, and the Commission's ruling, on the other hand, that *additions or modifications to plant* should be capitalized in accordance with FERC's accounting rules regarding additions or modifications to plant. *See* Accounting Order at PP 26-28, JA 38.[8] Again, the Commission reasonably applied the existing categories under its accounting rules.

---

[8] INGAA ignores the distinction between the act of testing and the act of making a repair identified through testing. *See* Br. 37 ("Where baseline assessments reveal a need for repair or replacement, it is easy to see that new technology and materials that go into the process would make such an improvement. . . . [T]he resulting modification or replacement will extend the life of the pipeline beyond its original projected time span.").

D. The Tax Cases On Which INGAA Relies Were Not Raised Below And Are Inapposite

In its Brief, INGAA prominently relies on tax cases (*see* Br. 29, 30, 35, 37 n.10, 38) that it did not raise before the Commission on rehearing and thus cannot now raise on appeal. *See* NGA § 19(b), 15 U.S.C. § 717r(b); *Domtar Me. Corp. v. FERC*, 347 F.3d 304, 312 (D.C. Cir. 2003) (rejecting Petitioners' reliance on FERC decision not cited on rehearing). In any event, those cases are inapposite, as they did not involve any kind of testing, inspection, planning, or recordkeeping. In addition, they involved particular provisions of the Tax Code, not FERC's Uniform System of Accounts; for purposes of the former, the distinction between capitalizing and expensing costs determines deductibility against current income, whereas for purposes of the latter, the distinction affects FERC's ratemaking. Furthermore, the cited cases do not support INGAA's contentions.

Smith v. Commissioner, 300 F.3d 1023 (9th Cir. 2002), concerned whether the repair of physical plant was an ordinary and necessary business expense deductible under 26 U.S.C. § 162(a), or a capital expenditure depreciable under 26 U.S.C. § 263. In that case, the court focused on the relative importance of a component part of a physical asset, not (as INGAA suggests at Br. 29) of a "component part" of an inspection regime such as that required by the OPS Regulations. 300 F.3d at 1031-33. Similarly, in *Smith* the relative size of the expenditure (*see* Br. 35) was relevant only because it indicated the relative

importance of a physical part — in that case, the importance of the carbon lining of a reduction cell in an aluminum smelting facility. 300 F.3d at 1032; *see also id.* at 1033 ("this relining process effectively rebuilt the cell"); *id.* at 1031 (drawing analogy to distinction between replacing car engine and replacing tires). The court ruled that the costs were capital expenditures because the repairs increased the functional and material value of the plant. *See id.* at 1037. The court did not, as INGAA implies (Br. 35), discuss — or even mention — the GAAP.

Nor does the decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), support INGAA's argument. There, the Supreme Court affirmed the lower courts' rulings that professional expenses incurred in connection with a merger were not deductible, based on the specific factual findings of the Tax Court, "amply supported by the record," that the transaction produced "significant benefits . . . beyond the tax year in question . . . ." *Id.* at 88; *see also id.* at 89 (also relying on prior case law holding that expenses incurred to change corporate structure for benefit of future operations are not deductible). In contrast, the Commission here reasonably concluded that, on the record before it, the asserted economic benefits were too uncertain and speculative to support capitalization of *all* pipeline safety costs.

CONCLUSION

For the reasons stated, the petition should be denied and the challenged FERC Orders should be affirmed in all respects.

Respectfully submitted,

John S. Moot
General Counsel

Robert H. Solomon
Solicitor

Carol J. Banta
Attorney

Federal Energy Regulatory
Commission
Washington, DC 20426
TEL: (202) 502-6433
FAX: (202) 273-0901

August 23, 2006
Final Brief: September 27, 2006