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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

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 briefs 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. Also related is *Canadian Association of Petroleum Producers v. FERC*, No. 05-1382, which the Court has held shall be scheduled for argument on the same day as this appeal, and also concerns the Commission's Policy Statement on Income Tax Allowances, 111 FERC ¶ 61,139 (2005).

Lona T. Perry
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October 19, 2006

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GLOSSARY

ALJ	Administrative Law Judge
AOPL	*Association of Oil Pipe Lines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996)
Arizona Grocery	*Arizona Grocery v. Atchison, T. & S.F. Ry.*, 284 U.S. 370, 384 (1932)
EPAct	Energy Policy Act of 1992
Farmers Union I	*Farmers Union Central Exchange v. FERC*, 584 F.2d 408 (D.C. Cir. 1978)
Farmers Union II	*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
ICC	Interstate Commerce Commission
Opinion No. 154-B	*Williams Pipe Line Co.*, Opinion No. 154-B, 31 FERC ¶ 61,377 (1985)
Opinion No. 435	*SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 (1999)
Opinion No. 435-A	*SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135 (2000)
Opinion No. 435-B	*SFPP, L.P.*, Opinion No. 435-B, 96 FERC ¶ 61,281 (2000)

GLOSSARY (cont'd)

Order No. 561	*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 at 30,943 (1993)
Order No. 561-A	*Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561-A, FERC Stats. & Regs. [Regs. Preambles, 1991-1996] ¶ 31,000 (1994)
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
Valero	Valero Marketing and Supply Company, Valero Energy Corporation, and Ultramar, Inc.

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RESPONDENTS.

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

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

STATEMENT OF THE ISSUES

1. Whether the Federal Energy Regulatory Commission ("Commission" or "FERC") reasonably determined that a regulated utility partnership is eligible for an income tax allowance in its regulated rates.

2. Whether the Commission reasonably determined that shippers of refined petroleum products on the East Line of SFPP, L.P. ("SFPP") are not entitled to rate reparations after August 1, 2000, the effective date of just and reasonable East Line rates established by the Commission in another proceeding.

3. Whether the Commission reasonably determined if there were substantially changed circumstances to the economic basis for SFPP's West, North, and Oregon Line rates, justifying reexamination of those rates. [However, on July 24, 2006, the Commission requested a voluntary remand of this issue, having concluded, on review of the initial briefs, that the Commission's numerical calculations used to make its determinations on whether there were substantially changed circumstances could not be defended. Therefore, this brief addresses only the income tax allowance and East Line reparations issues.]

STATUTORY AND REGULATORY PROVISIONS

The pertinent statutes and regulations are contained in the Addendums of Petitioners.

STATEMENT OF JURISDICTION

On August 13, 2004, the Commission filed a motion seeking dismissal of this appeal on the ground that the order then challenged, *ARCO Products Co. v. SFPP, L.P.*, 106 FERC ¶ 61,300 (2004) ("Order on Initial Decision"), JA 2585, was not a final order but rather only reviewed the Initial Decision of the Administrative Law Judge on certain threshold issues presented in Phase I of the OR96-2 rate proceeding. By order of December 20, 2004, this Court referred the motion to the merits panel.

Following the issuance of the last order under review, *SFPP, L.P.*, 111 FERC ¶ 61,334 (2005) ("Remand Order"), JA 2637, on remand from this Court, the Commission and SFPP on August 26, 2005 jointly filed a motion to hold this consolidated case in abeyance, on the ground that the challenged orders had reached no final decision with regard to SFPP's income tax allowance. Generally, challenged orders would not be considered final if they did not dispose of all issues as to all parties. *See, e.g., Commonwealth of Massachusetts v. NRC*, 924 F.2d 311, 322 (D.C. Cir. 1991). By order of December 1, 2005, the Court denied the motion to hold this case in abeyance.

The Commission's Policy Statement on Income Tax Allowances is at issue in this appeal. Following the Court's denial of the August 2005 motion to hold this case in abeyance, the Commission has operated under the assumption that the Court viewed the issue of the Commission's income tax allowance policy as ripe for immediate review, even though no final determination has been made under that policy as to whether a tax allowance would be afforded to SFPP. Petitioners appear to have the same impression, as no arguments were raised in their briefs regarding the finality of the challenged orders or the ripeness of the tax allowance issue.

Indeed, in its July 24, 2006 motion for partial voluntary remand, the Commission specifically requested that the income tax allowance issue be permitted to go forward, given its broad-reaching consequences for many matters pending before the Commission. In this regard, the issue of finality here is like that raised in *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1500, 1502 (D.C. Cir. 1984) ("*Farmers Union II*"), in which the Court heard an appeal of an order establishing oil pipeline ratemaking principles, even though no final rate had yet been determined.

INTRODUCTION

This appeal is a continuation of ongoing rate litigation between SFPP and its shippers, which was previously before this Court in *BP West Coast Products, LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004). The orders challenged in this appeal are: *ARCO Products Co. v. SFPP, L.P.*, 92 FERC ¶ 61,244 (2000); Order on Initial Decision, 106 FERC ¶ 61,300; and Remand Order, 111 FERC ¶ 61,334. Those orders address certain threshold issues that must be decided prior to a final Commission determination on SFPP's challenged rates.

The first issue, which was first addressed by this Court in *BP West Coast*, is whether a regulated utility partnership is eligible to receive an income tax allowance as part of its rates. Following this Court's remand in *BP West Coast*, the

Commission issued a *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139, *reh'g dismissed*, 112 FERC ¶ 61,203 (2005), *appeal pending, Canadian Association of Petroleum Producers v. FERC*, No. 05-1382 ("Policy Statement"). Although no final decision has been reached in this proceeding regarding affording SFPP an income tax allowance, the Commission anticipates making that determination by applying the Policy Statement. Shipper petitioners here challenge the income tax allowance policy adopted in the Policy Statement.

The second threshold issue addressed in this appeal is whether the Commission reasonably found that East Line shippers are not entitled to rate reparations after August 1, 2000. That is the effective date of just and reasonable East Line rates that will ultimately be determined by the Commission at the conclusion of the FERC Docket No. OR92-8 proceeding. The Commission held here that the August 1, 2000 rate was a Commission-determined rate that, under the Interstate Commerce Act ("ICA"), could only be changed prospectively, thereby precluding reparations under *Arizona Grocery*.[1]

A third issue was raised in this appeal concerning the grandfathering of certain SFPP rates under the Energy Policy Act of 1992[2] ("EPAct"). However,

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[1] *Arizona Grocery v. Atchison, T. & S.F. Ry.*, 284 U.S. 370, 384 (1932).

[2] Pub. L. No. 102-486, § § 1801-1804, 106 Stat. 2776, 3010-12 (1992), *reprinted in* 42 U.S.C. § 7172 note (1994).

upon review of the initial briefs on appeal, the Commission determined that it must seek a voluntary remand of this issue to permit further Commission consideration of the criticisms of the underlying calculations, raised for the first time on appeal (as there is no rehearing requirement in the ICA). Accordingly, no defense of the Commission's determinations on this issue is presented here.

STATEMENT OF FACTS

I. STATUTORY AND REGULATORY BACKGROUND

In 1906, Congress amended the Hepburn Act and extended the definition of common carrier under the ICA to oil pipelines and required that their rates be just and reasonable. *See* 49 U.S.C. § 1(5). In 1913, the ICA was further amended through the Valuation Act, which passed when the Supreme Court "appeared to require ratemaking to proceed from some type of valuation base." *Farmers Union Central Exchange v. FERC*, 584 F.2d 408, 413 n. 8 (D.C. Cir. 1978) ("*Farmers Union I*"). As a result, the Interstate Commerce Commission ("ICC") adopted a valuation rate base under which carriers earned a return on the present "fair value" of property devoted to the public interest. *Id*. at 411 n. 3.

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). The traditional standards governing rate regulation under the ICA were not modified.

In *Williams Pipe Line Company*, Opinion No. 154, 21 FERC ¶ 61,260 at 61,597 (1982), the Commission concluded that ratemaking for oil pipelines should only "restrain gross overreaching and unconscionable gouging" to keep rates within the zone of commercial reasonableness. This Court remanded, holding that the ICA required oil pipeline rates to be just and reasonable, and that an inquiry into costs was a "useful and reliable" starting point for rate regulation. *Farmers Union II*, 734 F.2d at 1500, 1502. In response, the Commission established a fairly traditional cost-of-service methodology for determining oil pipeline rates. *Williams Pipe Line Company*, Opinion No. 154-B, 31 FERC ¶ 61,377 at 61,833 (1985).

Following Opinion No. 154-B, adjudicated proceedings for oil pipelines, although few in number, 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 at 30,943 (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) ("*AOPL*"). Accordingly, in 1992 Congress passed the EPAct, requiring

FERC to simplify its ratemaking methodology and streamline its ratemaking procedural rules "in order to avoid unnecessary costs and delays." *Id*. at 30,944. Toward this end, the EPAct established a baseline of historically-effective rates that were deemed just and reasonable under the ICA. Order No. 561-A at 31,091.

Section 1803 of the EPAct limits the ability of shippers to challenge pipeline rates deemed just and reasonable, or "grandfathered," under the statute. *BP West Coast*, 374 F.3d at 1271. Rates that qualify for grandfathering under the EPAct are "categorically immune" from challenge in a complaint proceeding under ICA § 13, 49 U.S.C. app. § 13(1) (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." EPAct § 1803(b)(1)(A).

II. THE PROCEEDINGS UNDER REVIEW

This appeal addresses three Commission orders issued in the protracted rate dispute between SFPP and customers shipping over its East, West, North and Oregon Lines. The East and West Lines transport petroleum products to points in Arizona, the East Line from El Paso, Texas, and the West Line from Los Angeles, California. The North Line transports petroleum products from San Francisco,

California, to Reno, Nevada, and the Oregon Line serves interstate shipments from Portland to points elsewhere in Oregon.

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. The Opinion No. 435 orders concluded that SFPP's 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 the West Line rates. Accordingly, the EPAct protected the challenged West Line rates from review.

SFPP's East Line rates were not grandfathered under the EPAct, and the Commission found them to be unjust and unreasonable. *See also SFPP, L.P.*, 97 FERC ¶ 61,138 (2002). In connection with establishing just and reasonable East Line rates, the Commission addressed a number of cost issues, including SFPP's

income tax allowance, and shipper eligibility for reparations on the East Line. The Opinion No. 435 orders were appealed to this Court in *BP West Coast*.

B. The Docket No. OR96-2 Proceedings

While the appeal of the Opinion No. 435 orders was pending, the Commission addressed a subsequent series of complaints against the rates for SFPP's East, West, North, and Oregon Line rates. These complaints were filed between late 1995 and August 2000 and were consolidated in FERC Docket No. OR96-2. Because SFPP's West, North and Oregon Line rates were grandfathered under the EPAct, the Commission lacked jurisdiction to adjudicate just and reasonable rates for those lines unless there was a showing of substantially changed circumstances to the economic basis for those rates. *See* EPAct § 1803(b); *BP West Coast*, 374 F.3d at 1271-72, 1279.

In March 2004, in the Order On Initial Decision, the Commission ruled upon the Initial Decision[3] issued by the Administrative Law Judge in Phase I of the OR96-2 proceeding. Order on Initial Decision, 106 FERC ¶ 61,300, JA 2585. The Commission found that complainants had established that there were substantially changed circumstances for the rates to specific West Line delivery points

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[3] *Texaco Refining and Marketing, Inc., v. SFPP, L.P.*, 103 FERC ¶ 63,055 (2003), JA 869.

beginning in 1995 and 1997, but did not find changed circumstances with regard to the North Line and Oregon Line rates. *Id*. PP 52-53, 61-62, 76, JA 2593-95, 2597-98. Thus, the West Line rates were no longer grandfathered under EPAct § 1803(a) (*i.e*. they were no longer immune from rate review), but the Oregon and North Line rates remained so.

C. The *BP West Coast* Remand

On July 20, 2004, this Court affirmed many of the conclusions in 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, it rejected the Commission's existing *Lakehead* doctrine,[4] which provided that a partnership would be afforded an income tax allowance in proportion to the partnership interests owned by corporations, but would deny an income tax allowance in proportion to the partnership interests owned by non-corporate partners. *Id*. at 1285-1292.

[4] *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).

On May 4, 2005, in response to the *BP West Coast* remand, following an extensive comment period, the Commission issued the Policy Statement, 111 FERC ¶ 61,139, JA 2795. The Policy Statement overruled the Commission's previous *Lakehead* doctrine and concluded that, regardless of corporate ownership, a regulated partnership would be afforded an income tax allowance if it could establish that its 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. 111 FERC ¶ 61,334, JA 2637. The Commission addressed several remanded points involving the reasonableness of the East Line rates, *id*. at PP 41-51, 2646-48, and reaffirmed its prior rulings on whether there were substantially changed circumstances to the economic basis of the West, North, and Oregon Line rates. *Id*. at PP 37-40, 2645-46.

The Remand Order also held that SFPP would be permitted to include an income tax allowance in its East and West Line rates *if* SFPP could establish later that its partners would incur an actual or potential income tax obligation from SFPP's regulated income, incorporating the central rationale of the Policy Statement. 111 FERC ¶ 61,334 at PP 21-27, JA 2641-43.

D. Subsequent Proceedings

A subsequent order issued December 16, 2005 provided guidance on the specifics for establishing any possible income tax allowance. *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005) at PP 21-34, 44-47 ("December 2005 Compliance Order"). That order is not, however, on review here. Rather, it is pending review before this Court in another appeal, *ExxonMobil Oil Corp. v. FERC*, Nos. 06-1008 *et al*. (consolidated). In any event, the December 2005 Compliance Order did not determine that SFPP is entitled to an income tax allowance. That issue remains pending before the Commission.

In the December 2005 Compliance Order, the Commission also directed SFPP to make a compliance filing and to file new interim rates for the East and West Lines. *Id*. at PP 133-135. SFPP made its compliance and rate filings on March 7, 2006. The parties agreed to defer judicial review of the December 2005 Compliance Order until completion of the compliance phase, which addresses the details of the income tax allowance and certain cost of service issues related to the East and West Lines. *See* pending June 14, 2006 Consent Motion to Hold Appeal Nos. 06-1008, *et al*. in Abeyance.

E. The Issues on Appeal

The Order on Initial Decision and Remand Order were appealed to this Court in this Docket No. 04-1102, *et al*. proceeding, along with a third order issued September 22, 2000, *ARCO Products Co.*, 92 FERC ¶ 61,244, JA 2580. The sole issue raised by that order is whether the *Arizona Grocery* doctrine applies to the East Line rates that were established in the Opinion No. 435 orders, as those rates will be revised pursuant to the Court's remand once the instant compliance phase is completed. *Arizona Grocery* holds that once the Commission prescribes a lawful just and reasonable rate, such a rate may only be changed prospectively. *See BP West Coast*, 374 F. 3d at 1304. At bottom, the September 2000 order stated that, once a revised East Line rate is established for the calendar year 1994 and indexed forward, any further changes to that rate would be prospective only. 92 FERC at 61,780-81, JA 2583-84. This ruling limited reparations available for complaints filed against the East Line rates after August 1995.

Thus, the briefs on appeal here address three general issues: (1) whether a regulated partnership can have an income tax allowance as a matter of law; (2) whether the Commission properly applied the *Arizona Grocery* doctrine to the new East Line rates established by the Opinion No. 435 orders and precluded reparations after the effective date of the OR92-8 just and reasonable East Line

rates; and (3) whether the Commission correctly determined if there were substantially changed circumstances to the economic basis for SFPP's West, North, and Oregon Line rates.

On July 24, 2006, the Commission requested a voluntary remand of the last issue, having concluded on review of the initial briefs that it could not defend the numerical calculations it has used to make its determinations on whether there were substantially changed circumstances.[5] Therefore this brief addresses only the income tax allowance and East Line reparations issues.

[5] The challenges to the Commission's calculations were first raised in this appeal, not before the Commission, as the ICA does not contain a mandatory rehearing requirement. In light of the fact that they were not made before the Commission, it is unclear whether they would be properly before the Court. *See, e.g., Time Warner Entertainment Co., L.P. v. FCC*, 144 F.3d 75, 81-82 (D.C. Cir. 1998). That point need not be decided, however, if the motion to remand is granted.

SUMMARY OF ARGUMENT

This appeal is a continuation of ongoing rate litigation between SFPP and its shippers, which was previously before this Court in *BP West Coast*. The challenged orders addressed certain threshold issues that must be decided prior to a final Commission determination on SFPP's challenged rates.

One threshold issue is whether a regulated utility partnership can be afforded an income tax allowance as part of its rates. Here, the Commission is applying its Policy Statement, adopted in response to *BP West Coast*, in which the Commission concluded that a regulated partnership could be afforded an income tax allowance if it could establish that its partners had actual or potential income tax liability arising from the partnership's income.

Shippers contend that the Policy Statement permits a tax allowance based upon "phantom" taxes, as partnerships have no income tax liability, and fails to distinguish between costs of the regulated entity and costs of investors in the entity. The Commission rejected these arguments because, while the partnership itself pays no income tax, the income of the partnership is attributed directly to its owners which have actual or potential income tax liability on that income, just as a corporation has actual or potential income tax liability on income from the public utility assets it controls. Thus, the income taxes on revenues generated from the

regulated operations of a partnership are comparable to the taxes generated from the regulated operations of a utility corporation, rather than comparable to the taxes generated by the payment of dividends to shareholders. The Commission further rejected the argument that a partnership income tax allowance would result in excessive returns, finding instead that the failure to provide partnership income tax allowances would result in partnership returns below those of corporations investing in the same assets.

The Commission also rejected arguments that *BP West Coast* precluded granting a partnership income tax allowance. Nothing in the Court's mandate required the Commission to reach a particular result on this issue. Rather, the Court remanded this issue because there was no supportable rationale for the income tax allowance policy applied in *BP West Coast*. Further, *BP West Coast* did not rule that SFPP was not entitled to a full income tax allowance, and therefore the "law of the case" doctrine does not apply.

Another issue is whether shipper complainants in the OR96-2 proceeding can obtain reparations after August 1, 2000, which is the effective date of the just and reasonable East Line rates being determined by the Commission in OR92-8. Shippers contend that they should be entitled to reparations after August 1, 2000 because the OR92-8 rates have not yet been finalized following the remand of

certain cost issues in *BP West Coast.* Nevertheless, the fact remains that the just and reasonable OR92-8 rates ultimately established will have an effective date of August 1, 2000, as affirmed by *BP West Coast,* and the interim OR92-8 rates established in the meantime are subject to refund. Accordingly, prospective from August 1, 2000, East Line shippers will have the benefit of a Commission-determined just and reasonable rate which, under *Arizona Grocery,* can only be changed prospectively. The fact that rates for subsequent years were indexed in accordance with Commission regulations does not alter the fact that the underlying base rate is a Commission-determined just and reasonable rate.

Further, although shippers contend that the OR92-8 rate is based upon a "stale" 1994 test year and therefore cannot be prospectively applied, *BP West Coast* affirmed the use of the 1994 test year as the basis for just and reasonable OR92-8 rates.

ARGUMENT

The briefs filed by Petitioners in this appeal concern three principal issues: (1) whether the Commission reasonably determined that a regulated utility partnership is eligible for an income tax allowance; (2) whether the Commission reasonably determined that shippers challenging SFPP's East Line Rates are not entitled to reparations after August 1, 2000; and (3) whether the Commission correctly determined if there were substantially changed circumstances to the economic basis for SFPP's West, North, and Oregon Line rates. However, as the Commission has requested voluntary remand of the third issue, by motion of July 24, 2006, this brief addresses only the income tax allowance and East Line reparations issues.

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). *AOPL*, 83 F.3d at 1431. 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 Manufacturer's Ass'n v. State Farm Mutual Automobile Ins. Co.*, 463 U.S. 29, 43 (1983). Where the subject under review involves ratemaking, and thus an agency decision involves "complex

industry analyses and difficult policy choices," the court "will be particularly deferential to the Commission's expertise." *AOPL*, 83 F.3d at 1431.

II. THE COMMISSION REASONABLY CONCLUDED THAT A JURISDICTIONAL PARTNERSHIP SUCH AS SFPP MAY BE AFFORDED AN INCOME TAX ALLOWANCE IN ITS RATES.

A. Background of the Income Tax Allowance Issue

Under cost-of-service ratemaking, Commission-approved rates "must yield 'sufficient revenue to cover all proper costs,' and provide an appropriate return on capital." *BP West Coast*, 374 F.3d at 1286 (quoting *City of Charlottesville v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985)). Where the regulated entity is organized as a corporation, a tax allowance is included in the pipeline's rates to assure that the regulated entity has the opportunity to earn its allowed return on equity. *Id.* The issue presented here is the appropriate treatment of a tax allowance where the regulated entity is a partnership that itself incurs no tax liability. The Remand Order concluded that a regulated partnership may be afforded an income tax allowance if its partners have an actual or prospective income tax liability on the regulated income of the partnership.

In *Lakehead*, the Commission determined that regulated entities organized as partnerships should receive a tax allowance for income taxes attributable to corporate partners because "the tax cost will be passed on to the corporate owners

who must pay corporate income taxes on their allocated share of income directly on their tax returns." *Lakehead*, 71 FERC at 62,314-15. In contrast, no tax allowance was permitted for taxes attributable to individual partners because those partners do not pay a corporate income tax. *Id*. at 62,315. In the Opinion No. 435 proceeding, the Commission applied *Lakehead* and denied SFPP, a limited partnership, any income tax allowance for taxes attributable to partners that were not corporations. Opinion No. 435, 86 FERC at 61,102.

BP West Coast vacated and remanded the determination on SFPP's income tax allowance, finding that the Commission had not established that its *Lakehead* policy was the product of reasoned decision-making. 374 F.3d at 1285. Because SFPP, as a limited partnership, is exempt from taxation, the Court was concerned that any income tax allowance in its cost-of-service would be based upon a "phantom tax." *Id*. at 1288. The Court rejected the justification that *Lakehead* compensates for the double-taxation of profits to corporate partners. *Id*. at 1288-89.

Following the *BP West Coast* remand, the Commission recognized that this issue had implications far beyond the SFPP proceedings, to other proceedings and other regulated utilities. Policy Statement P 6, JA 2796. Investors in the natural gas pipeline and electric utility industries use partnerships and other pass-through

entities pervasively. *See Trans-Elect NTD Path 15, LLC*, 115 FERC ¶ 61,047 P 21 (2006) (citing Policy Statement P 31 & n. 30, in which the Commission notes the record evidence in the Policy Statement proceeding evidencing billions of dollars of existing investment potentially affected by that proceeding).

Accordingly, the Commission issued a Notice of Inquiry requesting comments on when, if ever, it is appropriate to provide an income tax allowance for partnerships holding interests in a regulated public utility. Policy Statement P 1, JA 2795. FERC received 42 sets of comments, from all sectors of the energy utilities subject to FERC regulation. Upon consideration of those comments, the Commission concluded that an income tax allowance should be permitted on all partnership interests if the owner of that interest has an actual or potential income tax liability on the public utility income earned through that interest. *Id.* The Commission reprised the same rationale in the Remand Order under review here, concluding that SFPP would be afforded an income tax allowance if it could establish in subsequent proceedings that its partners had actual or potential income tax liability on SFPP's regulated income.[6] Remand Order PP 21-27, JA 2641-43. The issue of whether SFPP should receive an income tax allowance is now pending before the Commission. *See* December 2005 Compliance Order PP 133-34. The

Commission's policy on partnership income tax allowances is reasonable and fully consistent with *BP West Coast*, as discussed below.

B. The Commission Fully Justified Providing Partnerships with Income Tax Allowances.

In cost-of-service ratemaking, tax obligations attributable to regulated operations are included in the revenue requirement because "[t]he objective is to allow a fair profit, after taxes, ascertained after taking into account a variety of factors, such as the risks of the business, [and] the necessity of attracting capital." *City of Chicago v. FPC*, 385 F.2d 629, 633 (D.C. Cir. 1967) (citations omitted). Financial investment decisions are based on the real return realized from a business, and income taxes have an important impact on the realized return. Ignoring the tax effect lowers the realized return and discourages investment.

The Commission thus properly allowed recovery of taxes attributable to the operations of a regulated utility, regardless of the corporate form of that utility. Remand Order PP 23-24, JA 2642. The fundamental cost allocation principle concerns what costs, including tax costs, are attributable to regulated service. *Id.* P 22, JA 2642. While a partnership entity does not actually pay taxes itself, there is a tax obligation arising from the income from the operations of the regulated

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[6] SFPP, L.P. is the operating partnership. There are several intermediary partnerships between SFPP, L.P. and the ultimate limited and general partners.

partnership. *Id*. PP 23-24, JA 2642. This is a financial cost to the partnership of raising capital, and that tax obligation of those owning the capital of the enterprise must be recognized in ratemaking. *Id*.

Each partner in a partnership incurs tax liability on its distributive share of partnership income, gain, loss, deduction or credit, whether or not any amount is actually distributed to the partner. Remand Order P 17, JA 2641. *See* Section 61(a)(13) of the Internal Revenue Code of 1986, as amended; Treas. Reg. § 1.702-1(a). Net partnership income is determined at the partnership level and is submitted to the Internal Revenue Service on an information return, Form 1065 (U.S. Return of Partnership Income). Remand Order P 17, JA 2641. The partnership then reports to each partner its share of the partnership income, generally on Schedule K-1. The partnership income is then reported on, and any actual tax liability paid by means of, the returns of the partners. *Id*.

Thus, while the partnership entity does not itself pay income taxes, the partners of that partnership pay income taxes on the utility income generated by the assets they own via the device of the partnership. *Id*. P 23, JA 2642. As such, the taxes paid by the owners of the partnership are just as much a cost of acquiring and operating the assets of the entity as if the utility assets were owned by a corporation. *Id*.

C. Shippers' Arguments to the Contrary are Without Merit.

Shippers contend that the Policy Statement is continuing to grant an allowance for "phantom" taxes, and fails to make the distinction between the costs of the regulated entity, which are includable in its costs of service, and the costs of investors. Shipper Br. 17. Shippers liken the income tax expense to partners in a partnership to income tax expenses attributable to dividends received by shareholders in a regulated corporation. *Id*.

The Commission rejected the argument that the Policy Statement was based on a phantom tax on fictitious public utility income. Remand Order PP 22-23, JA 2642. Rather, the public utility income of partnerships is attributed directly to the owners of such entities and the owners have an actual or potential income tax liability on that income. *Id*. Just as a corporation has an actual or potential income tax liability on income from the public utility assets it controls, so do the owners of a partnership on the assets and income that they control by means of the partnership. *Id*. PP 24-25, JA 2642. Thus, the Policy Statement allowed for the recognition in rates of actual or potential income tax liability attributable to regulated utility income, which will facilitate important public utility investments. *Id*. P 26, JA 2642-43 (citing *Trans-Elect NTS Path 15, LLC*, 109 FERC ¶ 61,249 (2004), *reh'g denied*, 111 FERC ¶ 61,140 (2005)).

Thus, in the case of a pipeline partnership, the partners incur tax on their allocable portion of regulated activities, regardless of whether or not they have received any distribution from the partnership. The pipeline partnership simply acts as a conduit to the partners of the tax obligations arising from income from regulated operations.

Shippers incorrectly contend that "[t]he appropriate comparisons under *BP West* are between the regulated corporate pipeline and the regulated pipeline partnership (the regulated entities), and then between the corporate shareholders and the partners (the investors)." Shipper Br. 20. *See also* Shipper Br. 17.

To the contrary, the income taxes on the revenues generated from the regulated operations of a partnership are comparable to the taxes generated from the regulated operations of a utility corporation, rather than to the taxes generated by the payment of dividends to shareholders. Remand Order PP 17, 24, JA 2641-42; Policy Statement P 34, JA 2801. For both corporations and partnerships, income is not necessarily distributed, and cash distributions may be made irrespective of whether there is income or profits to distribute. In the case of a corporation, the corporation pays in the first instance the income tax on the income

from corporate operations (a first-tier tax).[7] Policy Statement P 34, JA 2801. If the corporation distributes cash by paying a dividend, a shareholder in the corporation generally is taxed on the amount of the dividend received (a second-tier tax). *Id*. P 38, JA 2802. Partnership income is taxable to the partners based on their distributive share of that income regardless of whether cash distributions are made. *Id*. P 33 & n. 29, JA 2801. Thus, the tax paid by the partner is a first-tier tax on the income of the partnership rather than a second-tier tax on cash distributed to the partner. *Id*. P 38, JA 2802. Partners incur second-tier tax liability for cash distributions from the partnership when the partner's basis has been reduced to zero or the partner's interest is sold and ordinary or capital gains income is recognized at the time of sale. *See id*. P 38 n. 35, JA 2802. The Commission's failure to distinguish between first and second tier taxation of income led to the double taxation rationale that was rejected in *BP West Coast*. *Id*. P 38, JA 2802.

Further, as Shippers recognize, the return necessary to attract investors is measured by the return an investor could obtain from investments having commensurate risks. Shipper Br. 22 (citing *BP West Coast*, 374 F.3d at 1286,

[7] A first-tier investment is defined as an investment in the assets that are generating the public utility income. Policy Statement P 22, JA 2799.

1290; *FPC v. Hope Natural Gas*, 320 U.S. 591, 603 (1943)). Shippers reference the comparison made in *BP West Coast* between investment in a regulated partnership and investment in an unregulated company, where investors would have no expectation of a tax allowance. *Id*. (citing *BP West Coast* at 1290-91).

However, risks come from the nature of the business and its operations and not from whether the enterprise is operated in corporate or partnership form. Commission rate policy must produce comparable outcomes for a regulated partnership engaged in the same business as a corporation. Policy Statement P 37, JA 2802. The basic regulatory premise that a utility must earn a comparable return refers to the after-tax, not pre-tax return to the investor, regardless of the form of ownership. *See Charlottesville*, 774 F.2d at 1207; Policy Statement P 24, JA 2799. Thus, if the after-tax return must be 12 percent to attract capital, then all first tier investors in the utility assets must have a reasonable opportunity to earn a 12 percent after-tax return if the utility is to attract capital. *Id*. If partnerships are not permitted a tax allowance on utility income, then cash will not be generated to pay the taxes due on that utility income, and the partnership form of ownership would not be competitive with the corporate form. *Id*.

D. A Partnership Income Tax Allowance Will Not Result in Excessive Returns.

Shippers contend that providing regulated partnership entities with an

income tax allowance will result in returns "far in excess of the allowed level determined to be needed to attract investors." Shipper Br. 21. Shippers contend that the gross-up calculation used to compute the income tax allowance would increase the return of a limited partnership by 54 percent. *Id*.

Shippers' position is unsupported. The 54 percent they reference comes from a hypothetical in the Policy Statement. *See* Policy Statement P 21 n. 20 & P 25, JA 2799. Assuming that $100 is the amount required to attract capital, the income of a corporation would have to be grossed-up to $154 (or by 54 percent) in order to generate the cash flow to pay the tax. *Id*. P 25, JA 2799. However, the after-tax return remains $100. *Id*. Shippers' assumption that this gross-up of 54 percent would result in over-recovery for partnerships ignores the first-tier tax liabilities of the partnership owners, and wrongly implies that a utility's return, as opposed to its pre-tax income, would rise by 54 percent under the Policy Statement.

To the contrary, the Commission's numerical examples established that the return to partnerships will be reduced *below* that of corporations investing in the same assets if such entities are *not* afforded an income tax allowance on their public utility income. Policy Statement P 33, JA 2801; Remand Order P 23, JA 2642.

One example compared the after-tax return of the corporation earning $100 in the above example (which is $154 pre-tax and $100 after-tax), Policy Statement P 25, JA 2799, to a limited partnership. If a partnership is permitted an income tax allowance, the result is the same because the maximum personal income tax allowance, like the corporate allowance, is 35 percent, and the partners would have an after-tax return of $100. *Id*. P 26, JA 2799. However, if no income tax allowance is permitted, then the partners must pay a $35 income tax on $100 of utility income, leaving them with only an after-tax return of $65. *Id*. Thus, partnerships must be granted an income tax allowance to make the partnership and corporate business forms equally attractive. *Id*.

In another example, assuming that a return of 12 percent is required to attract capital, a corporate tax allowance would increase the regulated entity's pre-tax return to 18.5 percent, which, after application of the 35 percent tax rate, results in a 12 percent equity return. *Id*. P 14, JA 2797. In contrast, in the absence of a tax allowance, the regulated entity subject to the 35 percent tax would only pay out dividends of 7.8 percent of net income (instead of 12 percent) which is insufficient to attract equity investment. *Id*. PP 13-14, JA 2797.

Finally, Shippers argue that SFPP should not be afforded an income tax allowance because the partnership's allowed equity return, as determined through

the Commission's discounted cash flow methodology, already has a tax allowance embedded in it. Shipper Br. 22-23. This technical argument addresses the relationship between the allowed regulatory return of the partnership, any tax allowance, and the possible increase in the actual return a partner may receive from the income and loss allocation provisions of a specific partnership. This point is before the Commission in the compliance phase commenced by the December 2005 Compliance Order and will be addressed there, along with the other criticisms of the more technical issues addressed by the December 2005 Compliance Order, 113 FERC ¶ 61,277.

E. Application of the Policy Statement to SFPP Is Not Precluded By *BP West Coast.*

In an effort to avoid application of the Policy Statement, Shippers raise several arguments contending that *BP West Coast* precludes the granting of an income tax allowance in this case. None of these arguments has merit.

In the first instance, Shippers contend that *BP West Coast* precludes the award of any tax allowance to SFPP. Shipper Br. 16-18. However, nothing in the Court's mandate required the Commission to reach a particular result on the tax allowance issue. *See Charlottesville*, 774 F.2d at 1212-13. Rather, the Court vacated and remanded the issue of the income tax allowance based upon the absence of a supportable rationale in the Commission's *Lakehead* order or in the

orders on review. *See BP West Coast*, 374 F.3d at 1285 ("Because FERC has not established that its 42.7% income tax allowance is the product of reasoned decisionmaking and indeed has provided no rational basis for this part of its order, we find that allowance to have been erroneous and we vacate."); *id*. at 1288 (concluding FERC's rationale "does not support its conclusion,"); *id*. (concluding that "on the record before us" SFPP was entitled to no income tax allowance).

Accordingly, on remand, FERC "had the discretion to reconsider the whole of its original decision." *Southeastern Michigan Gas Co. v. FERC*, 133 F.3d 34, 38 (D.C. Cir. 1998). *See also SEC v. Chenery Corp*., 332 U.S. 194, 200-01 (1947) (upon remand "the Commission was bound to deal with the problem afresh, performing the duty delegated to it by Congress"); *FPC v. Idaho Power Co*., 344 U.S. 17, 20 (1952) ("[T]he guiding principle is that the function of the reviewing court ends when an error of law is laid bare. At that point the matter once more goes to the [agency] for reconsideration.")

Shippers also contend that the Court's rejection of SFPP's demand for a full income tax allowance in *BP West Coast* is "law of the case," precluding retroactive application of the Policy Statement. Shipper Br. 23-24. However, for the prudential law of the case doctrine to apply on remand, an issue actually must have been decided in the first appeal. *Maggard v. O'Connell*, 703 F.2d 1284, 1289

(D.C. Cir. 1983). Here, *BP West Coast* made no final ruling that SFPP was not entitled to a full income tax allowance. While *BP West Coast* did reject the arguments SFPP advanced in support of a full income tax allowance, *BP West Coast*, 374 F.3d at 1291, the court did not finally reject the concept of a full income tax allowance in favor of a partial allowance. To the contrary, the Court observed that "SFPP may well be correct that if such an allowance were allowable at all, it should have been allowed for the imputed taxes potentially incurred by all unit holders who realized taxable income from the untaxed profits of the limited partnership of the pipeline." *Id*.

Instead, the Court rejected SFPP's demand for a full income tax allowance because the Court found it had been provided no reasoned basis for *any* income tax allowance. *Id*. As discussed above, remand for failure to adequately support a result provides the Commission an opportunity on remand to review the problem afresh.

The cases cited by Shippers support this result. In *Alliance for Cannabis Therapeutics v. Drug Enforcement Administration*, 15 F.3d 1131, 1134 (D.C. Cir. 1994), and *Indianapolis Power & Light Co. v. NLRB*, 898 F.2d 524-528-29 (7th Cir. 1990) (cited Shipper Br. 24 n. 38), the law of the case doctrine was applied where the agencies' interpretation of a broad no strike clause (*Indianapolis*) or

interpretation of the Controlled Substances Act (*Alliance*) had been previously *affirmed* on appeal. *Alliance*, 15 F.3d at 1134; *Indianapolis*, 898 F.2d at 528. In contrast, *Chicago & North Western Transportation Co. v. United States*, 574 F.2d 926, 930 (7th Cir. 1978) (cited Shipper Br. 24 n. 39), recognized that, when an agency order is subject to remand, "ordinarily a court may not direct an administrative agency to reach a particular result but may only determine an error of law and remand to the administrative agency for further proceedings." This leaves the agency free on remand to reach the same result on different grounds, *id*. n. 5, or, as here, to reach a new result. In *Chicago*, the law of the case doctrine operated to preclude railroad arguments challenging an agency order compelling reparations, on the ground that the arguments had all been decided adversely to the railroads in the proceeding prior to remand. *Id*. at 929.

As there is no "law of the case" on the issue of an income tax allowance, the Commission's decision on remand here has full retroactive effect. *See Chenery*, 332 U.S. at 200. In *Chenery*, the Court initially remanded the case to the agency for failure, as here, to provide a reasoned explanation for its actions. Thus, the Court found, "when the case left this Court, the problem . . . still lacked a final and complete answer." *Id*. at 200. The administrative process had taken an erroneous rather than a final turn, and therefore upon remand "the Commission was bound to

deal with the problem afresh." *Id*. at 200-01. The fact that the agency had not previously set out a general prospective rule dealing with the problem did not eliminate the agency's ability to perform its statutory duty in that particular case. *Id*. at 201-02. "To hold that the Commission had no alternative in this proceeding but to approve the proposed transaction, while formulating any general rules it might desire for use in future cases of this nature, would be to stultify the administrative process. That we refuse to do." *Id*. at 202.

III. THE COMMISSION'S EAST LINE RATES REPARATIONS DETERMINATIONS ARE REASONABLE AND CONSISTENT WITH *ARIZONA GROCERY*.

A. Opinion No. 435, OR92-8 Remedies

The Opinion No. 435, Docket No. OR92-8, proceeding concerned complaints filed against SFPP's East Line rates between November 1992 and August 7, 1995. *ARCO Products Co.*, 92 FERC ¶ 61,244, JA 2580. In that proceeding, the Commission addressed two different forms of rate relief – reparations for past unjust and unreasonable rates charged to complainants, and prospective rate relief applicable to all East Line shippers.

1. Reparations

Under the ICA, reparations are the remedy for challenges to the justness and reasonableness of an existing rate, and are available only to parties that have filed a

complaint. The period for potential reparations in OR92-8 included two years prior to the filing of the complaint, up to the effective date of revised East Line rates determined in the OR92-8 proceeding. Opinion No. 435 at 61,113; Opinion No. 435-A at 61,516.

To determine the reparations due, the first step is to determine the proper rate level. Opinion No. 435-A at 61,516. This was done by developing the cost of service for the test year, in this case 1994,[8] and dividing the costs by the relevant test year volumes for each class of service. *Id*. This results in a just and reasonable unit rate that replaces the previous unit rate that the Commission determined to be unjust and unreasonable. *Id*.

In the Opinion No. 435, OR92-8 proceeding, the Commission determined that SFPP's rates were unjust and unreasonable based on the 1994 test year. Opinion No. 435 at 61,084; Remand Order P 58, JA 2650. To award reparations to complainants, the Commission first determined what the just and reasonable rates should be for the year 1994. Remand Order P 58, JA 2650. The resulting rates were then indexed forward under the Commission's index regulations to the August 1, 2000, effective date of the OR92-8 rates. *Id*.

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[8] 1993 was rejected as the test year because 1994 was found to be more representative, particularly with regard to throughput. Opinion No. 435 at 61,084.

This determined what the just and reasonable East Line rates should have been for each of the years 1994 through August 1, 2000. *Id*. To the extent that any complainant paid East Line rates that were higher than the rates so determined, the complainant was awarded reparations for the relevant years. *Id*.

Following this Court's remand in *BP West Coast*, the 1994 cost-of-service and resulting just and reasonable rates must be revised in the compliance proceeding now before the Commission (*See* December 2005 Compliance Order, 113 FERC ¶ 61,277). Following the calculation of a new just and reasonable rate for 1994, that rate will again be indexed forward to August 1, 2000 to establish revised just and reasonable East Line rates as of that date.

2. Prospective Rate Relief

On August 1, 2000, SFPP made a filing in compliance with Opinion No. 435-A, and proposed FERC Tariff 60.[9] Opinion No. 435-B, at 62,075. On August 16, 2000, the Commission accepted and suspended proposed Tariff 60 to be effective August 1, 2000, subject to refund. *Id*. *BP West Coast*, 374 F.3d at 1305, found that the Commission had authority under ICA §§ 8, 9 and 16(1) to award damages in an ICA § 13 complaint case, and also had authority under ICA § 15(1) to direct

[9] This was the first tariff filing in the OR92-8 proceeding as Opinion No. 435 did not require a tariff filing. *SFPP, L.P.*, 100 FERC ¶ 61,353 P 2 n. 4 (2002).

SFPP to file interim rates subject to suspension and refund, if there is a possibility that the final rates will be lower than the interim rates.

If an East Line shipper was not a complainant in the Opinion No. 435 proceedings, that shipper will receive the benefit of any lower rates set prospectively in that proceeding, but will not receive retroactive reparations in that proceeding regardless of when the current compliance proceeding is completed. Remand Order P 58, JA 2650. *See BP West Coast*, 374 F.3d at 1310 (affirming finding that a shipper's right to reparations is dependent upon and limited by its complaint).

Thus, in the Opinion No. 435, OR92-8 proceeding, the Commission set an effective date of August 1, 2000 for the just and reasonable prospective rates set in that proceeding. *See BP West Coast*, 374 F.3d at 1304. Although the Commission issued orders subsequently modifying that rate, further compliance filings under those orders remained effective as of August 1, 2000. *Id*.; Remand Order P 55, JA 2649. This approach had the benefit of providing relief to all East Line shippers as of August 1, 2000, not just to those shippers that had filed complaints and would therefore be entitled to reparations if the Commission delayed setting new East Line rates until all cost issues had been resolved. Remand Order P 55, JA 2649. Since August 1, 2000, all East Line shippers have had the benefit of lower East

Line rates while the Commission worked out the nuances of SFPP's compliance filings. *Id*. P 56, JA 2649. They will continue to do so once revised East Line rates are established as of August 1, 2000, in response to this Court's remand.

B. OR96-2 Remedies

The OR96-2 proceeding concerns Shipper complaints filed against the East Line rates after August 7, 1995, through August of 2000. *See* Order on Initial Decision P 9, JA 2586. For prospective rate relief, the Commission's methodology employed in OR96-2 is the same as that employed in OR92-8. *See SFPP, L.P.*, 114 FERC ¶ 61,136 P 6 (2006). In OR96-2, the Commission will establish a test year cost-of-service for 1999, and index that rate forward to the rate effective date of May 1, 2006. *Id*. As of that date, the new just and reasonable rate will be prospectively applied, and will only be subject to change prospectively under *Arizona Grocery*.[10] *Id*.

As in OR92-8, reparations may be available for shippers in OR96-2, including reparations dating back two years from the filing of any complaint against the East Line rates. *See* Opinion No. 435-B at 62,073-74; Order on Initial Decision P 82, JA 2599. However, because all East Line shippers have the benefit

[10] *Arizona Grocery* bars retroactive changes to a final rate prescribed by the Commission under its rate-making authority. *BP West Coast*, 374 F.3d at 1304.

of just and reasonable rates on the East Line from August 1, 2000, no reparations are available to East Line shippers in OR96-2 after that date. Order on Initial Decision P 11, JA 2587. Thus, after August 1, 2000, any complaint is constrained by the lawful rate the Commission establishes as of August 1, 2000. Remand Order P 59, JA 2650.

C. Shippers' Challenges to the Commission's Reparations Findings Are Without Merit.

On brief, Shippers challenge the Commission's determination that reparations are unavailable in OR96-2 after the OR92-8 just and reasonable rates were set effective August 1, 2000. *See* Shipper Br. 53-70. In their view, the August 1, 2000 rates are not final prescribed rates under *Arizona Grocery*, and, thus, under *BP West Coast*, 374 F.3d at 1304-05, reparations are not barred.

However, the rates filed August 1, 2000 were made subject to refund, and subsequent rate filings are interim rates subject to correction as the case progresses. Accordingly, Shippers will receive refunds of any amounts paid in excess of the ultimately determined just and reasonable East Line rates as of August 1, 2000. The issue, therefore, is not whether Shippers will receive redress for unjust and unreasonable East Line rates, but rather whether the Commission employed the proper mechanism for providing such relief. Shippers' challenges to the Commission's determinations are without merit, as demonstrated below.

1. *BP West Coast* Affirmed that the OR92-8 Just and Reasonable Rate Would Be Final Effective August 1, 2000.

Because of the Court's remand in *BP West Coast*, the OR92-8 East Line rates, effective August 1, 2000, still have not been finalized. As SFPP's compliance rate filings are still interim filings, and the OR92-8, August 1, 2000, rate has not been finalized, Shippers contend that the August 1, 2000, rate is not a final *Arizona Grocery* rate that would preclude the award of reparations after that date.[11] Shipper Br. 57.

The determinative fact, however, is not that the OR92-8 rates are still pending before the Commission, but the fact that those rates remain interim rates, subject to refund. When the final OR92-8 rates are determined pursuant to the Court's remand, those revised East Line rates will be final rates effective as of August 1, 2000. Remand Order P 56, JA 2649. From that date forward, East Line shippers will be paying a Commission-determined just and reasonable rate which, under *Arizona Grocery*, can only be changed prospectively. *Id*. P 57, JA 2650.

[11] Although shippers in footnote 47 refer to a subsequent ruling regarding OR96-2 reparations in the December 2005 Compliance Order, 113 FERC ¶ 61,277, that order is not before the Court and therefore is beyond review in this proceeding. That order is pending appellate review in *ExxonMobil Oil Corp. v. FERC*, Nos. 06-1008, *et al*. (consolidated) (D.C. Cir.).

Indeed, in *BP West Coast*, 374 F.3d at 1304-05, the Court affirmed the Commission's use of interim rates, subject to refund, and the selection of August 1, 2000, as the effective date for the OR92-8 rates. Thus shippers' argument must be rejected. As this Court found, "nothing in [ICA] Section § 15(1) prohibits FERC from directing a pipeline to file an interim rate, subject to suspension and refund, if there is a possibility that the final rates will be lower than the interim rates." *BP West Coast*, 374 F.3d at 1305 (citing *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631, 654-56 (1978); *FPC v. Tenn. Gas Transmission Co*., 371 U.S. 145, 146 (1962); *FPC v. Natural Gas Pipeline Co*., 315 U.S. 575, 585 (1942)).

In *Trans Alaska*, the Interstate Commerce Commission suspended an initial rate under ICA § 15(7) and, during the suspension period, fixed interim tariff rates which went into effect during the suspension period, and required refunds of any amounts collected that were found to be unlawful. *Id*. at 633. The petitioners contended that the Commission had no authority to require them to refund amounts collected under the interim rates before the final just and reasonable rates were determined. *Id*. at 654. The Court rejected that contention, finding that extended adjudicatory proceedings would be required to resolve the question of fair rates, and that interim rates subject to refund were necessary to permit the Commission to protect the public pending a final determination of just and reasonable rates. *Id*. at

655. Similarly in *Tennessee Gas*, the Court upheld Commission authority to issue an interim order requiring a rate reduction, and to require a refund retroactive to the effective date of the proposed increased rates, before a final determination was made of just and reasonable rates. 371 U.S. at 144-45. *See also Natural Gas*, 315 U.S. at 585 (upholding Commission authority under § 5 of the Natural Gas Act, 15 U.S.C. § 717d, to issue interim rate orders even though the statute authorized the Commission to set just and reasonable rates to be "thereafter observed.")

Thus, the Commission's authority to issue interim rate orders, and order refunds retroactive to the effective date of the challenged rates, is well established, and shippers' challenges must be rejected. *See* Shipper Br. 60. Because the Commission's ability to make the rate effective as of August 1, 2000 has been affirmed, there is likewise no merit to Shippers' argument that the OR92-8 rates, because they are retroactively applied, cannot be protected by *Arizona Grocery* because they were not paid contemporaneously with the shipments at issue. Shipper Br. 51-52.

2. *BP West Coast* Affirmed The Test Year Approach to Setting Just and Reasonable East Line Rates.

The August 1, 2000, OR92-8 rates were calculated based upon a 1994 cost-of-service, with the resulting 1994 just and reasonable rate indexed forward under the Commission's index regulations to the August 1, 2000, effective date. Remand

Order P 58, JA 2650. Shippers contend the August 1, 2000, rates cannot be given prospective effect because the 1994 cost-of-service is outdated. Shipper Br. 56. In Shippers' view, "[a] record that reflects only cost and other data for a period substantially in the past (1994) can support a determination regarding the lawfulness of a rate for the past, but does not provide a substantial evidentiary record to support such a finding for the future." *Id*.

Again, this issue was decided in *BP West Coast*. In the Opinion No. 435 series, the Commission ordered SFPP to calculate East Line reparations by using the 1994 test year cost of service. *BP West Coast*, 374 F.3d at 1307 (citing Opinion No. 435-A, 91 FERC at 61,516). SFPP challenged this directive, arguing that using a historical test period as the basis for reparations was error because it assumes no appreciable change in SFPP's cost of service over a period of years. *Id*.

The Court affirmed the Commission's use of the 1994 test year for SFPP's reparations calculations. *Id*. The Court found that a test year is a reasonable proxy for actual costs, and that the use of a test period to set the cost of service to rates intended to span a number of years is well established. *Id*.

3. The Commission Intended that the August 1, 2000, Rates Would Have Prospective Effect.

Shippers assert that the Commission never intended the August 1, 2000, rate

to be prospective in application. Shipper Br. 56-58. In setting the OR96-2 complaints for hearing, Shippers argue that the Commission acknowledged that the SFPP's East Line rates after the 1994 test year may not be just and reasonable. Shipper Br. 57. Shippers also contend that the Commission's ruling is inconsistent with a statement made in Opinion No. 435-B concerning the ability of shippers to determine the cost-of-service for years subsequent to 1994 in the OR96-2 proceeding. Shipper Br. 55-56 (quoting Opinion No. 435-B, 96 FERC at 62,073).

Setting the OR96-2 complaints for hearing does not change the fact that the August 1, 2000, OR92-8 rates are Commission-established *Arizona Grocery* rates that can only be changed prospectively. *See ARCO Products*, 92 FERC at 61,781, JA 2584. Indeed, any new just and reasonable East Line rates established in OR96-2 will have an effective date of May 1, 2006. December 2005 Compliance Order, 113 FERC ¶ 61,277 P 113.

The cited passage from Opinion No. 435-B does not concern the ability of complainants to challenge the August 1, 2000 rates. Rather, the Commission recognized that some OR96-2 complainants may not have filed a complaint against East Line rates before August 7, 1995 (the cut-off date for complaints in OR92-8). Such shippers would not have received reparations for the period between August 7, 1995, and August 1, 2000, since they were not complainants in the OR92-8

proceeding. *See BP West Coast*, 374 F.3d at 1310-11 (affirming the Commission's refusal to award shipper Valero reparations in the OR92-8 proceeding because Valero filed its complaint in 1997, and therefore was not entitled to the same reparations as shippers who filed in 1994, since its reparations will be determined based upon a different test period and cost factors, and would be limited to the two year period prior to the filing of Valero's complaint). Thus, the cited reference to Opinion No. 435-B refers to the years between 1994 and August 1, 2000, and does not speak to the ability to relitigate rates after August 1, 2000. *See* Opinion No. 435-B at 62,073.

Accordingly, East Line shippers were at liberty to pursue complaints for reparations for the years after August 7, 1995 (the cut-off date for OR92-8 proceeding complaints) up to the August 1, 2000, effective date to cover this additional relief based on a cost-of-service for the intervening years. As for the August 1, 2000 rates, complainants must show that there are circumstances warranting a new determination as to whether the OR92-8 rates are just and reasonable, and any change in those rates would be prospective only under *Arizona Grocery*. *ARCO*, 92 FERC at 61,781, JA 2584; Remand Order P 57, 59, JA 2650. There is no merit to the contention that the Commission did not intend the August 1, 2000, rates to have prospective effect.

4. The Commission Reasonably Selected August 1, 2000 As the Rate Effective Date.

The Commission selected August 1, 2000, as the effective date for the just and reasonable OR92-8 East Line rates because that is the date on which SFPP made its first tariff filing in compliance with Opinion No. 435-A, and proposed FERC Tariff 60. Opinion No. 435-B at 62,075. In accordance with its normal procedures, the Commission accepted and suspended proposed Tariff 60 to be effective August 1, 2000, subject to refund. *Id*.

The Commission accordingly rejected the argument, *see* Shipper Br. 69-70, that it was arbitrary and capricious for the Commission to choose August 1, 2000, as the date that the new East Line rates will become lawful rates as the Commission chose the August 1, 2000, effective date in the normal course of its proceedings. Remand Order P 57, JA 2650. Accordingly, no East Line shipper would be entitled to reparations for changes to the East Line rates after August 1, 2000, because, after that date, there were new just and reasonable rates established on the East Line. *Id*. P 59, JA 2650. Although no final rate has yet been set, all East Line shippers are entitled to refunds which will ensure that they ultimately pay no more than the just and reasonable rate.

This does not mean, however, that retroactive reparations are precluded for complaints filed after August 1, 2000, based simply on the date on which the

complaint was filed, provided such complaints expressly challenged rates that were in effect before that date. To the contrary, the Commission had recognized that OR96-2 East Line shippers could be eligible for reparations pre-dating the August 1, 2000, just and reasonable rate. *See* Opinion No. 435-B at 62,073-74; Order on Initial Decision P 82, JA 2599. Further, where the Commission limited reparations based upon the August 1, 2000, effective date, the Commission was discussing reparations for challenges to rates effective on and after August 1, 2000, not before. *See* Order on Initial Decision P 11, JA 2587; Remand Order PP 54-55, JA 2649.

In a footnote in their brief, Shippers reference a later Commission order that may limit OR96-2 reparations based upon other concerns. Shipper Br. n. 47 (citing December 2005 Compliance Order, 113 FERC ¶ 61,277 P 111). However, that order is not before the Court in this appeal. That order is pending appellate review in *ExxonMobil Oil Corp. v. FERC,* Nos. 06-1008, *et al*. (consolidated) (D.C. Cir.), which is subject to a pending consent motion to hold the case in abeyance pending completion of Commission proceedings.

5. Indexing Does Not Alter The Application of *Arizona Grocery* to the Base Rate.

Shippers contend that, even if FERC prescribed rates for future applicability as of August 1, 2000, subject to *Arizona Grocery*, *Arizona Grocery* ceased to apply

as soon as SFPP chose to exercise its right to index those rates under the Commission's regulations. *See* 18 C.F.R. §§ 342.3 & 342.4. Shipper Br. 60-62. However, in Opinion No. 561-A, the Commission rejected arguments that filing indexed rates opened the entire rate. Opinion No. 561-A at 31,104. Rather, it is necessary to limit challenges under indexing to the increment of the rate increase in order to preserve protection for grandfathered rates under the EPAct, and such a limitation is consistent with the differing burdens of proof under ICA §§ 15(7), 13(1) and 15(1). Existing rates that are not grandfathered remain subject to the complaint process set forth in ICA § 13(1). Opinion No. 561-A at 31,104.

Thus, in a proceeding on SFPP's indexed rates, only the incremental increase, and not the underlying rate, is subject to review. *SFPP, L.P.*, 96 FERC ¶ 61,332 (2001). Accordingly, contrary to Shippers' argument, indexing does not render the underlying rate a "carrier-made" rate that is not subject to *Arizona Grocery*. Shipper Br. 62 (citing *Eagle Cotton Oil Co. v. Southern Ry. Co.*, 51 F.2d 443 (5th Cir. 1931), and *City of Danville v. Chesapeake & O. Ry. Co.*, 34 F. Supp. 620, 631-33 (W.D. Va. 1940)). SFPP's indexing of its rates does not change the fact that the underlying base rates are Commission-prescribed and subject only to prospective change under *Arizona Grocery*.

Shippers finally assert that the settled law of *Arizona Grocery* can be disregarded here based upon the passage of time, Shipper Br. 63-66, or based upon the passage of the EPAct. *Id*. at 66-69. However, the EPAct never applied to the East Line rate complaints, because the East Line rates were not subject to grandfathering under that Act. Accordingly, this Court affirmed the Commission's conclusion that East Line rate complainants are governed by "the traditional standards of the ICA." *BP West Coast*, 374 F.3d at 1306 (quoting *SFPP, L.P.*, 68 FERC ¶ 61,306 at 61,582 (1994)). Further, Shippers argue that Supreme Court precedent would permit FERC to question the holding of *Arizona Grocery*, and promulgate its own interpretation of the ICA. Shipper Br. 63-65. Even assuming that remarkable proposition to be true, Shippers can point to nothing that would *require* the Commission to reject the long-standing precedent of *Arizona Grocery* to pursue a novel interpretation of the ICA. Accordingly, Shippers arguments provide no basis to overturn FERC's orders regarding East Line reparations.

CONCLUSION

For the reasons stated, the Commission's orders should be affirmed except with regard to the one issue as to which the Commission has requested voluntary remand.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

In accordance with Circuit Rule 28(d)(1), and this Court's Order of March 21, 2006, I hereby certify that this brief contains 11,138 words, not including the tables of contents and authorities, the glossary, the certificate of counsel and this certificate.

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