



October 10, 2014

By E-mail – QERComments@hq.doe.gov

Office of Energy Policy and Systems Analysis
EPSA-60
QER Meeting Comments
U.S. Department of Energy
1000 Independence Avenue, S.W.
Washington, D.C. 20585-0121

Re: Comments on Quadrennial Energy Review

Airlines for America (“A4A”)¹ welcomes the opportunity to provide these comments in connection with the Quadrennial Energy Review (“QER”) convened by the U.S. Department of Energy (“DOE”) at the direction of the President. A4A commends DOE for this initiative aimed at shaping the nation’s energy policy and for its focus on the nation’s infrastructure for transporting, transmitting, storing and delivering energy. A4A submits these comments and the attached, detailed white paper to highlight the critical importance of an effectively regulated pipeline industry to maintaining and expanding the U.S. crude oil and product pipeline infrastructure in order to meet the energy needs of the U.S. airline industry and the commerce of the United States.

The U.S. airline industry moves some 2 million passengers and 50,000 tons of cargo each day. Annually, commercial aviation helps drive nearly \$1.5 trillion in U.S. economic activity and more than 11 million U.S. jobs. A4A member airlines and their affiliates transport more than 90 percent of all U.S. airline passenger and cargo traffic. We need a cohesive national energy policy that will support the integral role the nation’s airlines play in connecting people and goods globally, spur economic growth and create more high-paying jobs. Without one, our nation’s airlines and the U.S. companies and communities they serve face significant headwinds competing in the increasingly connected global economy.

Timely availability of jet fuel at the airport is critical to the reliability of airline flight operations. The proper fuel requirement must be met for every flight within a very specific window to allow time to fuel the next flight. Unlike many goods and services, there are no backorder or parts deferral options for the fuel load.

¹ A4A is the principal trade and service organization of the U.S. scheduled airline industry. A4A members and affiliates transport more than 90% of U.S. airline passenger and cargo traffic. The members of A4A are: Alaska Airlines, Inc.; American Airlines Group (American Airlines and US Airways); Atlas Air, Inc.; Delta Air Lines, Inc.; Federal Express Corporation.; Hawaiian Airlines; JetBlue Airways Corp.; Southwest Airlines Co.; United Continental Holdings, Inc.; and United Parcel Service Co. Air Canada is an associate member.

Given the critical nature of safely and timely supplying jet fuel to every flight, and the need to ensure that the fuel delivered meets stringent technical specifications, the airline industry invests tens of millions of dollars every year in airport fuel infrastructure. However, this infrastructure is ineffective without a robust interstate pipeline system not only to move crude oil to the refinery, but, importantly, to move the fuel from the refinery and intermediate storage terminals to the airport.

U.S. airlines consume some 1.2 million barrels of jet fuel a day, of which an estimated 85 percent is shipped via interstate, multiproduct pipelines. These pipelines are essential to supplying fuel at U.S. airports and ensuring commercial air service to hundreds of communities, including for shipments of heavy freight and high-value, time-sensitive goods. As an industry with significant entry barriers and natural powerful monopoly characteristics,² interstate pipelines are regulated by the Federal Energy Regulatory Commission (the “Commission” or “FERC”). The Commission, in turn, has a statutory responsibility to ensure that pipeline rates are “just and reasonable.”³

Effective regulation of the nation’s interstate crude and product pipelines is an important component of a national energy policy. Effective rate regulation promotes investment in the infrastructure required to support a thriving, efficient pipeline industry and a thriving, affordable commercial aviation system. Ineffective regulation, on the other hand, under which pipelines continually achieve excessive returns, distorts market forces and creates barriers to needed infrastructure investment.

The consolidation of the pipeline industry in recent years and the Commission’s regulation of that industry has, in fact, become a significant disincentive for investment in major pipeline infrastructure projects, especially where existing pipelines and infrastructure are aging, inefficient and inadequate for future demand. This is because the rate of return on aging infrastructure can be so high that pipeline companies have no incentive to invest in new infrastructure that could subject them to lower, reasonable rates of return. This problem is a particular concern with respect to product pipelines serving highly congested urban areas, where the need for new capacity to serve growing demand at airports is greatest. Because of aviation’s dependence on the pipelines and because fuel is the airline industry’s largest expense, the actions (or inactions) of the Commission have a significant impact on the airlines’ everyday business and, consequently, that of our customers.

To address these problems, A4A has consistently called for enhanced transparency of cost and revenue information in certain required pipeline filings in order to aid shippers (like airlines) and the FERC in preventing pipelines from over-recovering their costs and achieving excessive returns. Such over-recovery creates a disincentive to replace or upgrade aging infrastructure. More transparent pipeline financial reports also would eliminate the current ability that pipelines exercise routinely to force shippers to give up their rights to just and reasonable rates on those existing facilities in exchange for promises to build new or expanded capacity.

Attached hereto is a detailed paper entitled “A4A Issue Brief: Regulation of Interstate Product Pipelines and Implications for Jet-Fuel Shipments, Prices and Infrastructure Development (October 2014).” This paper describes in detail the deficiencies discussed above and provides straightforward

² Per “Regulation Of Natural Monopoly” (Ben W.F. Depoorter, Center for Advanced Studies in Law and Economics, University of Ghent, Faculty of Law): “Under perfect competition prices of goods equal marginal cost, as firms engage in a competitive bidding process. Under conditions of monopoly, the profit-maximizing behavior of the incumbent firm will lead to a higher price charged to consumers and a lower output. It enables the seller to capture much of the value that would otherwise be attained by consumers. Monopoly pricing thus results in a wealth transfer from consumers of a product to the seller.”

³ Interstate Commerce Act § 1(5), 49 U.S.C. App. § 1(5) (1998); *see also* “Regulation Of Natural Monopoly”: “Allowing regulated firms to acquire a total sum that consist of annual expenditure plus a reasonable profit on capital investment, the so-called “fair” rate of return, was constructed by American courts and the regulating bodies in order to meet constitutional demands of utilities to set prices on a “just and reasonable” level.”

actions to correct these deficiencies. Implementation of our recommendations would transform the incentives to promote pipeline infrastructure investment in order to meet the energy needs facing the Nation. And they would help FERC ensure, as required by the Interstate Commerce Act, that rates are, in fact, just and reasonable.

Thank you for considering the views of A4A and its members. Please contact us if we can provide any further information for the QER process.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'JP Heimlich', written over a light gray rectangular background.

John P. Heimlich
Vice President & Chief Economist

Attachment



A4A Issue Brief: Regulation of Interstate Product Pipelines and Implications for Jet-Fuel Shipments, Prices and Infrastructure Development (October 2014)

BACKGROUND

U.S. airlines, which consume some 1.2 million barrels of jet fuel per day, transport an estimated 85 percent of that volume to U.S. airports via interstate pipelines. These pipelines are essential to supplying fuel at U.S. airports and ensuring service to hundreds of communities. As natural monopolies, interstate pipelines are regulated by the Federal Energy Regulatory Commission (“the Commission” or FERC). Because fuel is the airline industry’s largest expense, the actions of the Commission have a significant impact on the airlines’ everyday business.

Any developments that increase the airline industry’s fuel expense and hinder its operational reliability could potentially result in diminished frequency of flights and/or increased airfares. In terms of supplying our nation’s airports via pipeline, moving fuel from the Gulf Coast to the New York Harbor costs more than two dollars per barrel. To move fuel from Texas or Los Angeles to Arizona costs well over a dollar per barrel. Even before the refined products are moved on those pipelines there are costs associated with the movement of crude oil to the refineries. In the aggregate, directly or indirectly, the airline industry spends an estimated \$375 million annually on pipeline transportation of jet fuel.

Although the pipeline industry has consolidated substantially **since the Commission first instituted its rules in 1995 to index tariff rates, there has been no systematic review of individual rates and services.** During this period, tariff rates have climbed on average 75 percent and many pipelines have consistently reported excessive returns on existing assets.

It is in the interest of all consumers of liquid fuels – including the flying and shipping public – for the Commission to increase the transparency of pipeline filings, tariffs and rate-making processes. Such transparency is especially critical within a regulatory framework that relies heavily on the shippers themselves to police pipeline rates and initiate administrative actions to ensure that rates and services are provided on a just and reasonable basis.

PIPELINE ISSUES FOR AIRLINES AND OTHER SHIPPERS/CONSUMERS

Issues involving pipeline rate-making and transparency have important implications, not only for airlines but also for their customers and communities. In addition, many of these issues have impacts that reach well beyond the flying public, to **direct and indirect consumers** of gasoline, diesel, propane and home heating oil, many of whom **lack the resources to monitor and contest pipeline rates and services.**

Issue 1: Lack of Commission Oversight, Current Indexing Methodology and Market-Based Rates

Since the mid-1990s, the Commission has allowed pipelines to adjust their rates each year based on an inflation-adjusted index tied to the U.S. Producer Price Index (PPI) for finished goods. On May 23, 2011, over the objections of many shippers, the Commission established a new pipeline index level of PPI plus 2.65 percent for July 1, 2011 through June 30, 2016 (the highest percentage increase over the PPI level ever set). The index rate increase of 6.8819 percent (PPI plus 2.65 percent) for July 1, 2011 through June 30, 2012 added billions of dollars to existing pipeline overrecoveries and significant additional costs to shippers and consumers. On May 15, 2012, the Commission published a new index rate increase of 8.6011 percent (PPI plus 2.65 percent) for July 1, 2012 through June 30, 2013. On May 15, 2013, the

Commission published a further index increase of 4.5923 percent (PPI plus 2.65 percent) for July 1, 2013 through June 30, 2014. Most recently, on May 14, 2014, the Commission published an index increase of 3.8895 percent (PPI plus 2.65 percent) for July 1, 2014 through June 30, 2015. Thus, **between June 30, 2011 and July 1, 2015, the cumulative increase was 26.1 percent.** These recent increases will greatly exacerbate existing overrecoveries and add significant additional costs to shippers and consumers.

The most fundamental problem with current regulation of interstate pipelines is the lack of Commission oversight combined with the current FERC indexing methodology. The Commission has chosen to allow pipelines to increase their rates each year through automatic indexing adjustments while relying solely on shippers to challenge rates. Pipelines are not required to show that rates are just and reasonable prior to increasing those rates by the index – the increase is automatic. On the other hand, to challenge an index increase, shippers must show not only that the resulting rates are not just and reasonable but also, by an extra-legal regulatory fiction, that there is a substantial divergence from the last approved rate increase.

This regulatory framework effectively allows pipeline owners to systematically charge rates that overrecover costs and consistently achieve excessive returns on existing assets. **This framework, in turn, creates a disincentive for investment in expansion and/or upgrade of existing interstate pipeline networks because such projects will dilute the return from existing pipeline assets.**

These effects are compounded with respect to pipelines for which the Commission has granted authority to charge market-based rates. **Once the Commission determines that a market is competitive and allows the pipelines in that market to charge market-based rates, it essentially abandons oversight of those rates.** While shippers may still bring complaints against such rates, the Commission has not plainly articulated the standards by which it will evaluate such complaints, and shippers have consequently been reluctant to expend the resources required to challenge market-based rates. Because of this limited oversight and insulation from challenge, pipelines have increasingly sought market-based rate authority, often supporting their applications with “alternatives” that are not, in practice, useful substitutes for the pipeline’s services. The Commission rarely rejects an application that is not protested, so it is, once again, incumbent on shippers to protest and point out the deficiencies in market-based rate applications. Shippers, however, are hindered by inadequate disclosure of information by pipelines.

Issue 2: Many Shippers Lack Knowledge and Resources to Challenge the Establishment

Many shippers lack adequate and transparent information regarding pipeline operations, financial performance and assets. Airlines are among few end-users that have engaged in Commission proceedings. In effect, airlines are the most significant voice of the shipper/consumer in FERC proceedings involving the transportation of liquid fuels. **The Commission has entrusted to shippers the job of ensuring that pipeline rates and services are just and reasonable.**

Unfortunately, the only publicly available information is annual/quarterly pipeline reports, designated as Form 6. Currently, little can be gleaned from the FERC Form 6: “Annual/Quarterly Report of Oil Pipeline Companies.” Page 700 of Form 6, “Annual Cost of Service Based Analysis Schedule,” has undergone only minimal revisions since 2000, despite multiple shipper requests for additional changes. In 2013, to facilitate the determination of a pipeline’s realized return on equity, the Commission directed pipelines to provide some additional information regarding individual cost elements. However, as discussed further below, shippers do not yet have access to all the necessary information to determine whether specific rates on individual systems or segments are just and reasonable. Since the Commission relies on shippers to monitor whether rates are just and reasonable, it is only fair that the Commission facilitates the process by providing them with all the information and tools necessary to undertake this task.

FERC has simplified and expedited the pipelines’ ability to obtain automatic rate increases but the ability of shippers to determine if the resulting rates are just and reasonable has not kept pace. Since the indexing rules were instituted in 1995, the pipeline industry has consolidated further, resulting in

larger and more complex entities filing (in many instances) a single combined Form 6 for all pipelines, systems and distinct segments operating within their company. This information aggregation has thus, unfortunately, made the task of monitoring and challenging rates on individual systems more difficult and, in some cases, impossible. The inability to determine whether rates on individual systems are just and reasonable also creates cross-subsidies between systems where rates on one system lie significantly beyond any zone of reasonableness.

Issue 3: The Current Regulatory Construct Inherently Favors Pipelines

Not only has the pipeline industry consolidated and become more complex – it also has begun to transfer terminaling, storage and other assets out of the pipeline entities to so-called “non-jurisdictional entities.” These developments raise questions as to whether **assets that are an integral part of transportation, increasing the efficiency of operation and capacity of the pipeline, are being improperly used to create additional revenues for the parent company of pipelines at significant additional costs to the shippers/consumers – costs that were previously covered by FERC-regulated rates.**

Even if pipeline filings were adequate and transparent with respect to operations, financial performance and assets, the Commission should not be passive and leave to shippers the responsibility to ensure that rates are just and reasonable. **Many shippers have conflicts or other interests that prevent them from challenging rates.** One concern is that many shippers can reach settlements that mainly benefit them through incentive rates or new services while remaining shippers are left with excessive rates. Another concern is that many shippers, or their affiliates, also have an ownership interest in interstate pipelines. Yet another is that many shippers on petroleum-product pipelines simply pass along pipeline costs to consumers such as individual motorists or truckers. Furthermore, in a given destination market, some shippers have alternative sources of local supply, meaning that they might actually benefit from higher rates on a given line. For instance, if a refinery is located in an area that requires fuel to be brought in from out of state, the local market must reach a price equilibrium that will attract fuel from another state. When the cost of moving fuel from another state increases, the price equilibrium must increase, enabling the local supplier to sell its fuel at the higher price.

Finally, small shippers and new entrants are competitively disadvantaged because they lack the scale, sophistication and/or financial wherewithal to effectively monitor and challenge pipeline rates and services. This diffusion of interests contrasts sharply with the large integrated oil and product pipelines, which have substantial financial wherewithal and, under the Commission’s current rules, can recover their legal costs through their rates. Until the shippers, who must pay their own legal costs, can get the Commission to act, these pipelines enjoy the benefit of unjust and unreasonable rates.

RECOMMENDATIONS FOR THE FEDERAL ENERGY REGULATORY COMMISSION

Recommendation 1: Increase Transparency of Pipeline Data Submissions

The Commission should take two actions to increase the transparency of pipeline data submissions:

1. Require entities reporting financial and rate data on more than one regulated oil or petroleum product pipeline, system or distinct segment in a single Form 6 to disaggregate cost, volume and revenue information for each regulated pipeline, system or distinct segment and provide a separate Page 700 for each oil pipeline, system or distinct segment included in the report. In addition to enhancing transparency and preventing cross-subsidization, requiring pipelines to disaggregate costs and revenues by pipeline, system or distinct segment will ensure that Form 6 requirements are internally consistent.

Specifically, this change would conform the reporting requirements for total cost, revenue and throughput information to the practice of requiring pipelines to segregate information on carrier

property, depreciation rates and crude-oil and product movements. Additionally, this change should require that pipelines with market-based *and* nonmarket-based rates provide separate Page 700s for each set of rates in order for shippers and the Commission to determine whether there is any cross-subsidization.

2. Require pipelines to make available to shippers (upon request) work papers that fully support the data reported on Form 6, Page 700, including the total cost-of-service calculations. Despite shipper requests, the Commission recently declined to make Page 700 work papers available to shippers when revising its Page 700 reporting rules, meaning that pipelines are still only required to make this information available to Commission staff on a confidential basis.

Recommendation 2: Increase Oversight of Overrecoveries and Excessive Returns

As in the natural gas industry, the Commission should require pipelines showing overrecoveries or excessive returns on their Form 6 to show cause why their rates should not be considered unjust and unreasonable. For many years, dozens of pipelines that have filed for index rate increases reported cost overrecoveries or excessive returns on their Form 6 annual/quarterly reports. And, a number of other companies that did not file for an index adjustment, or which maintain market-based rates, are reporting cost overrecoveries or excessive returns. This is a clear signal that the rates are excessive and warrant investigation. Under circumstances like these, the Commission should exercise its authority under the *Interstate Commerce Act* to require pipelines to show cause why their rates should not be found unjust and unreasonable.

Also, the Commission should require pipelines to file a complete Form 6 before they file for an index rate increase. This is simply a matter of good governance. In the past, a number of pipelines who “qualified” for an automatic index rate increase did not even file or filed incomplete annual reports. Further, the Commission should revise the FERC interest rate for refunds and reparations as provided in 18 CFR §340.1(c)(2)(i) to reflect, at a minimum, the pipeline’s rate of return (i.e., weighted average cost of capital) as reported on Form 6, Page 700 [or preferably a rate that reflects the shipper’s cost of capital, almost certainly higher than the pipeline’s cost of capital]. Otherwise, the pipeline will continue to be rewarded for charging unreasonable rates and for delaying final Commission action by all means available.

Finally, the Commission should monitor the rates charged by pipelines with market-based rate authority to ensure these rates remain within a just and reasonable range. The Commission grants pipelines the authority to charge market-based rates on the theory that, where there are sufficient alternatives to the services provided by a pipeline, competitive forces will restrict the pipeline’s ability to increase its rates above just and reasonable levels. But because the nature and effect of competition within a market cannot be predicted in advance with perfect accuracy, it is important to continue to monitor market-based rates to ensure that the market forces are having the effect the Commission expected when it allowed the pipeline to charge market-based rates. In the absence of such oversight and freed from cost-based regulations, pipelines may increase their rates far above just and reasonable levels. These increases are particularly problematic as the Commission has not established clear standards for challenging market-based rates through a complaint proceeding.

Recommendation 3: Recognize Airlines and Consumers as Key Constituents

To ensure adequate investment in our pipeline infrastructure and fair costs for shippers, the Commission needs to be proactive on issues affecting airlines and other shippers/consumers. In this regard, it should expedite review of pipeline rates where overrecoveries or excessive returns persist and, like the Commission’s policy with respect to complaints against rates charged by natural-gas pipelines, it should treat all complaints against oil and product pipeline rates on an expedited basis.

The Commission also should use its oversight jurisdiction to determine whether pipelines have improperly disaggregated certain pipeline transportation in functions such as terminaling and storage to generate

significant additional revenues to the detriment of shippers/consumers. Overall, the Commission should factor into its actions the reality that many shippers and consumers, as a practical matter, simply are not capable of monitoring and challenging rates.

Importantly, the Commission should focus on terms and conditions of service that affect the airlines and other shippers/consumers. It is critical that the Commission recognize the real operational and financial impact that these issues have on airlines, as well as on the customers and communities they serve.

CONCLUSION

Pipelines play a critical role in supplying the jet fuel used by our nation's airlines and ensuring commercial air service to small and large communities. In a deregulated, highly competitive industry like the airline industry, where costs are not easily passed on to consumers, we depend on regulators to ensure that cost inputs for critical, regulated resources are just and reasonable. Because of aviation's dependence on the pipelines and because fuel is the airline industry's largest expense, the actions and inactions of the Commission have a significant impact on the airlines' everyday business.

The Commission today has a great opportunity to recognize and adapt to the substantial consolidation in the pipeline industry that has occurred since the indexing rules came online in 1995. Since 1995, many pipelines have consistently reported excessive returns on existing assets and yet there has been no systematic review of individual rates and services. Further, since 1995 pipelines have removed many assets and services from their FERC jurisdictional rates and drastically increased the costs for the use of those assets and services, with little or no review.

Accordingly, in the interest of the flying and shipping public and other consumers of liquid fuels, Airlines for America calls on the Federal Energy Regulatory Commission to increase oversight to eliminate and prevent overrecoveries and excessive returns. The Commission also should increase the transparency of pipeline data submissions and recognize the airlines and other shippers/consumers as key constituents.

As set forth in the preceding issue brief, it is in the interest of all consumers of liquid fuels for the Commission to increase the transparency of pipeline filings, tariffs and ratemaking processes. Such transparency is especially critical within a regulatory framework that relies heavily on the shippers themselves to ensure that rates and services are provided on a "just and reasonable" basis. The following supplement demonstrates that the current regulatory framework, as applied by the Commission, creates a disincentive for pipeline companies to invest in the infrastructure needed to ensure that airlines and airports can meet the needs of the traveling and shipping public. It also shows that some pipelines are excluding critical infrastructure from regulatory oversight. These cases illustrate why FERC should play a more active role in ensuring that pipelines earn just and reasonable – not excessive – returns. We respectfully urge the Commission to implement the aforementioned recommendations.

A4A Supplement: Case Studies in Regulation and Infrastructure Development

A4A and its member airlines prepared this supplement to the preceding issue brief as further support for recommendations to enhance information and transparency in certain pipeline filings and to avoid overrecovery of costs by pipelines. As natural monopolies, these pipelines are regulated¹ by the Federal Energy Regulatory Commission (FERC), which in turn has a statutory responsibility to ensure that rates are “just and reasonable.”² Situations in which pipelines continually achieve excess recoveries distort market forces and create barriers to needed infrastructure investment. Greater and clearer information will enable effective regulation of the nation’s interstate crude and product pipelines and promote investment in the infrastructure required to support a thriving, efficient pipeline industry and a thriving, affordable commercial aviation system.

A4A and its member airlines believe that interstate pipeline’s persistent overrecovery of ongoing costs and excessive returns on legacy assets are significant factors reducing the flow of capital into new petroleum pipeline assets, especially for pipelines serving highly congested urban areas. Importantly for the United States, this problem is discouraging upgrades or expansion of critical infrastructure, a consequence that is likely antithetical to the aims of the Commission.

To illustrate the disincentives to investment that these situations create – and the power that regulated entities have to exclude related revenues, A4A and its member airlines present three case studies below. Although the specific pipelines are not identified, these are real-world examples where needed investments were not made.

CASE STUDY 1: THE WRONG INCENTIVES ARE IN PLACE

An efficient and customer-focused pipeline company is earning revenues significantly above its costs and is at constant risk of losing these premiums if a customer were to complain to the Commission. The pipeline has achieved these revenues partially by expanding capacity proactively and efficiently, by creating services to enable customers to better manage risks and by ensuring that resources, such as over-subscribed line space on the pipeline, are allocated fairly. Even with this positive track record, the pipeline has invested in very few, if any, new services. Why? Because without customer guarantees and commitments that provide a very high, risk-free return, the pipeline company is concerned that 1) new investments would not increase its returns given the extraordinary returns it already earns on existing investments, and 2) it would remain at risk of a customer filing a complaint with the Commission.

Meanwhile, another pipeline company takes the opposite approach. Tariffs on one of the company’s systems have been challenged multiple times in the past decade. Rather than reduce and keep tariffs at rates that would prevent overrecovery, the company prefers to maintain rates well above the reported cost-of-service levels, defend itself against complaints, and eventually settle with the few shippers that understand the process and can afford both the legal costs and the management time associated with a complaint. The unintended consequence is that shippers who simply sell their fuel at the pipeline destination have no incentive to challenge the rate adjustments, since these costs are often a direct pass-through to the customer. They know they are paying too much to ship their fuel, but they also know that they will be able to recover the shipping costs through the wholesale price of fuel at the destination. They know this because the market frequently sets prices at the destinations based on the wholesale price at the origin plus the existing tariff to the destination.

¹ Per “Regulation Of Natural Monopoly” (Ben W.F. Depoorter, Center for Advanced Studies in Law and Economics, University of Ghent, Faculty of Law): “Under perfect competition prices of goods equal marginal cost, as firms engage in a competitive bidding process. Under conditions of monopoly, the profit-maximizing behavior of the incumbent firm will lead to a higher price charged to consumers and a lower output. It enables the seller to capture much of the value that would otherwise be attained by consumers. Monopoly pricing thus results in a wealth transfer from consumers of a product to the seller.”

² *Ibid.* “Allowing regulated firms to acquire a total sum that consist of annual expenditure plus a reasonable profit on capital investment, the so-called ‘fair’ rate of return, was constructed by American courts and the regulating bodies in order to meet constitutional demands of utilities to set prices on a ‘just and reasonable’ level.”

Even when a shipper files a complaint that is eventually settled – years later – for a cash refund payment, the shipper receives its confidential portion of the overrecovery back and is able to pocket the savings. The purchaser of wholesale product at the destination never receives any of the excess tariff. Even a savvy consumer who has bulk purchasing power, but is not a shipper, cannot fully recover its share of the overrecovery because the settlements remain confidential and because there is no incentive for a supplier to pass through any settlement monies.

Despite their divergent customer policies, neither of the above pipeline companies can make new investments in its systems with confidence that the current regulatory environment alone will enable it to recover its costs and earn the kind of return its shareholders have grown to expect. It is true that the new investment will raise their respective cost bases and the amount that they can earn, but their shareholders and executives expect them to continue to achieve returns consistent with their existing capital base and risk profile. Under that set of expectations and the current regulatory culture, new investments simply cannot gain approval without the throughput-and-deficiency agreements that enable the pipeline companies to achieve desired returns and eliminate the risk of shipper-initiated challenges filed with the Commission. The current system provides tremendous leverage to the pipelines based on their natural monopoly position and the limited [cost and revenue] information pipelines must file combined with remarkably light regulatory oversight of rates and services.

CASE STUDY 2. EXCESSIVE RETURNS ON EXISTING CAPITAL BASE DISCOURAGES INVESTMENT

At an airport that traditionally had depended on two separately owned pipelines, one pipeline was required by the U.S. Department of Transportation to shut down. Over several years, the airlines engaged in dialogue with the owners of these two pipelines to explore numerous alternatives. Eventually the airlines decided to rely solely on the only existing pipeline even though it was buried deeply below a river and could be subject to significant interruption because it would take months to repair a problem.

The owners of the shutdown pipeline would build a new replacement line only via a guaranteed throughput-and-deficiency agreement of at least five years. The airlines offered to commit 100 percent of airport demand to the new replacement pipeline, which exceeded the pipeline's minimum volume commitment and would have allowed the pipeline to earn more than 100 percent of its capital investment within five years.

At the insistence of the airlines, the pipeline company offered to allow the airlines to buy the new pipeline after five years of operation. However, the pipeline's best offer included a premium of 80 percent of the estimated original cost of construction at the end of five years and ignored all of the capital recovery that would occur over the five-year period. In short, the pipeline refused to take on any investment risk. It could take this position because the project would have been dilutive to its existing capital base. In other words, since FERC policy allowed the company to collect millions per year of tariffs on a completely depreciated pipeline that ran from one side of the river to the other, it was in the company's financial interest to do nothing rather than to take prudent risks and earn returns below expectations set in their legacy businesses.

CASE STUDY 3. CRITICAL INFRASTRUCTURE HAS BEEN CARVED OUT FROM FERC OVERSIGHT

There are many circumstances around the country where pipeline companies have re-classified storage and terminals as non-jurisdictional, meaning that the rates and charges are no longer subject to regulatory oversight even though the pipeline cannot operate without their use. This provides the pipeline companies with unfair leverage and the ability to shift profits to an unregulated entity. Presumably this is allowed because, at a minimum, potential for competition exists. However, the following cases demonstrate instances where 1) carve outs have been granted despite the absence of meaningful (i.e., economically equivalent) competition or 2) carve outs remain in effect after consolidation of assets has resulted in elimination of competition.

In one circumstance, a western U.S. airport was entirely dependent on one pipeline, which happened to be approaching full capacity. Accordingly, the airlines serving this particular airport agreed to pay an additional fee – above and beyond the regulated tariffs – for two storage tanks to be built at a nearby terminal owned by an “unregulated affiliate” of the pipeline company. This construction would enable the same pipeline company to use another pipeline segment to deliver to the airport from another direction.

Further blurring the lines between the regulated and non-regulated businesses, the pipeline charged the airlines a surcharge over 10 years to completely reimburse the pipeline’s sister company for the cost of the tanks. Even though the airlines had agreed to these terms, the pipeline company nonetheless refused to allow shippers to nominate deliveries to the two new tanks, insisting that the pipeline would utilize the tanks only when the capacity of the original pipeline configuration became inadequate.

The 10-year period of the airlines’ agreement with the pipeline, and the fees charged, were negotiated to provide for the complete reimbursement of the original cost of the two tanks. However, upon expiration of the agreement, instead of simply allowing the tanks to remain in service of the pipeline to access the airport, the unregulated terminal affiliate insisted that the airlines would have to pay a new fee to the unregulated affiliate to lease these same two tanks. The pipeline also refused to allow the airlines to use the tanks as they wished. The unregulated terminal affiliate insisted it could use the tanks for other purposes, meaning that the airport would again be completely dependent upon the original configuration of the pipeline that utilized a single smaller pipeline to make deliveries to the airport, which by this time had become both less reliable and less efficient, taking up to three times longer to ship products the same distance. Fearing the loss of infrastructure and recognizing that it would take too long to build a new terminal to compete with the existing one, the airlines agreed to pay the new lease fees to the unregulated terminal affiliate upon expiration of the original agreement with the pipeline company.

Meanwhile, on the opposite side of the country, an unregulated terminal operator owned by a parent that also operates a regulated pipeline that was the sole source of petroleum products delivered to the unregulated terminal was allowed to purchase the only other terminal supplied by the pipeline in the vicinity. These terminals are located in a densely populated corridor where there is little chance of building competing terminals that can access the pipeline. One major U.S. airport is completely dependent upon these terminals and pipeline for its supply. There is no other conceivable way to deliver jet fuel to the airport that would receive the necessary environmental and governmental approvals in a reasonable period of time, if ever. In order to deliver fuel to this airport, the pipeline first delivers product to the unregulated terminal upstream of the airport, whereby a shipper must have an agreement with the unregulated terminal to pay fees to enable the pipeline to restage its fuel for the last short pipeline segment to the airport. In addition, the regulated pipeline imposes a re-injection charge to reach the airport in addition to requiring the shipper to pay its sister company for use of the terminal. Of course, all revenues collected by the unregulated terminal have been treated by the unregulated terminal as non-jurisdictional and thus beyond the regulatory reach of the Commission.