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Seaway Initial Decision on Remand Spurns FERC Holding on Committed Shipper Rates and Finds them Subject to Modification

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A Federal Energy Regulatory Commission (FERC) Presiding ALJ issued an initial decision on remand in *Seaway Crude Pipeline Company LLC* (Remand ID) on May 9, 2014. The Remand ID reaffirms the ALJ's previous legal rationale in a September 2013 initial decision (Initial ID) that the FERC may modify a negotiated rate agreement with committed shipper rates to prevent a crude oil pipeline from over-recovering its cost-of-service. The FERC had reversed and remanded the Initial ID in February 2014 based on a determination that it incorrectly assumed that contract rates were at issue in the hearing and subject to modification (Remand Order). The Remand ID either exposes, through a dispute between an ALJ and the FERC about the extent of an ALJ's right to exercise independent judgment in the absence of specific precedent, an ambiguity about the extent of FERC's authority to review negotiated rates under the ICA or may simply be a proceeding to force the FERC to provide more explicit guidance about rate review authority. The decision will reverberate in an industry that otherwise lacks FERC regulatory assurances over the sanctity of its contracts.

Background

Seaway Crude Pipeline Company LLC (Seaway) is one of the many infrastructure projects built or modified in recent years to accommodate the new locations of North American crude oil production. Seaway was originally built to flow south-to-north from the U.S. Gulf Coast to Cushing, Oklahoma. In April 2012, Seaway filed a tariff with FERC to initiate a flow reversal and transport crude north-to-south. The tariff set forth Committed and Uncommitted Shipper rates. Committed Shipper rates are a common rate design for new crude oil pipeline projects that require significant shipper commitments to attract financing. Protestors challenged the rates and the details of the Committed Shipper rate design. FERC set the proposed transportation rates for hearing for Seaway "to produce a cost of service justification for its rates" in accordance with FERC regulations (Hearing Order). FERC acknowledged its preference for addressing non-rate issues, such as the Committed/Uncommitted shipper rate design, in a petition for declaratory order (PDO) proceeding prior to a pipeline tariff filing. FERC explained that the PDO process permits it to provide advance "definitive guidance." However, because Seaway had not filed for a PDO, FERC set the non-rate and rate design matters for hearing as well.

The lack of "definitive guidance" sowed confusion in the Seaway hearing docket. There was disagreement early on as to which of the initial rates had been set for hearing. Seaway proceeded under the assumption that FERC regulations required it to provide a cost-of-service justification for only the initial Uncommitted Shipper rates. FERC Trial Staff filed testimony proposing cost-based rates for both the committed and uncommitted shippers that would reduce the committed rates by nearly eighty percent. Seaway then filed an emergency PDO in December 2012 asking FERC to "affirm its policy of honoring" Committed Shipper rates. In March 2013, the Commission denied the PDO because the matter was already set for hearing and needed to take its normal course before the ALJ (PDO Order). However, to remove uncertainty, FERC clarified its policy that Committed Shipper rates would be upheld and applied during the term of their contracts as long as they were entered into during a valid open season. It clarified that the protested Uncommitted Shipper rates remained subject to a cost-of-service justification in the hearing.

When the Initial ID issued in September 2013, the ALJ found that FERC's clarification of its policy honoring Committed Shipper contracts was not dispositive. Accordingly, the Initial ID ordered modification of the contracts' rates because a clause in the contracts contemplated FERC modification. The ALJ reasoned that modifying the rates "honored" the contracts specifically because they contemplated this modification. In addition, modification was necessary because the Hearing Order had called explicitly for a cost-of-service justification for Seaway's rates and the contract rates were not cost-based. Numerous industry stakeholders responded with motions to intervene out-of-time decrying the Initial ID's impact on the sanctity of contracts if it was affirmed.

FERC reversed the Initial ID in its February 2014 Remand Order. FERC was highly critical of the ALJ's reasoning. The Remand Order stated that the Hearing Order had not required the Committed Shipper rates to be cost-justified. FERC also emphasized that its PDO Order explicitly stated that only the uncommitted rates needed to be supported by cost data. Seaway's failure to seek an advance PDO prior to making its initial tariff filing left the Committed/Uncommitted rate structure subject to hearing but not the rates themselves, unless there was evidence that the open season had not been valid. The Initial ID made no such finding. FERC criticized the Initial ID for ignoring its policy on oil pipeline contract rates without any finding that the underlying open season process was unfair or that the Committed Shipper rates harmed third-parties. FERC found this error to be central to the entire Initial ID and reversed and remanded the ID in its entirety. The ALJ was directed to issue a new decision limited to the issues set forth in the Hearing Order without reopening the record. Hence, the ALJ could review the uncommitted shipper rates and the overall rate design, but go no further.

Despite FERC's instructions, the Remand ID still found that it would not be possible to review the cost of service justification and adjust the Uncommitted Shipper rates accordingly without also adjusting the Committed Shipper rates and that the Hearing Order did not prohibit that approach. It found that because the revenue collected from the Committed Shipper rates exceeded Seaway's cost of service revenue requirement, the Uncommitted Shippers would need to be assigned a negative rate or a true-up mechanism to reallocate excess revenues between the pipeline and its shippers. However, the Remand ID rejected a revenue crediting mechanism proposed by Seaway to accomplish this true-up because it failed to conform to the Hearing Order's requirement that Seaway produce cost-justified rates. Yet, the Remand ID resulted in no finding on the actual rates. It reiterated the Initial ID's refusal to determine the appropriate level of Uncommitted or Committed shipper rates, finding the evidentiary record insufficient to support one.

The Remand ID also made findings on two additional issues on which the Initial ID had sought FERC guidance, but which the Remand Order declined to provide, the inclusion of an acquisition premium in rate base and the appropriate depreciation rate. The Remand ID found that an acquisition premium was unlawful because the transaction leading to Seaway's current ownership structure had not been at arms-length. It also set a depreciation rate for the regulated facilities.

Implications of *Seaway* on the Oil and Liquids Pipeline Industry

The Remand ID's criticism of FERC lays bare to an unusual degree a disconnect within the FERC about the extent of rate review authority in a rapidly changing industry. The Remand ID went so far as to suggest that FERC's holding on the sanctity of committed shipper rates arose from external industry and political pressure. It labels FERC's holding that only uncommitted shipper rates were at issue "a post-hoc rationalization for excluding committed shipper rates from the presiding judge's consideration." The Remand ID's response to industry's intervention in *Seaway* is unsympathetic. It refers to "industry propaganda machine" and labels the "outrage and panic" that ensued as industry concerns that it would be unable to collect "excessive and unjustified rates."

If the Remand ID leaves industry nervous, it should not be solely for its harsh tone. It exposes a vulnerability faced by pipelines regulated by FERC under the Interstate Commerce Act (ICA) (i.e., crude oil, refined products, and natural gas liquids, collectively "ICA Pipelines"). Since the issuance of *Express*

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Pipeline Partnership in 1996, FERC has been using the PDO process to affirm the legality of ICA Pipeline contract rate structures without any actual statutory or regulatory language explicitly permitting contract rates. Rather, FERC has used analogies to its regulations and interpretations of court precedent to craft its current policy. Its orders recognize that older interpretations of the ICA limiting contract rates would preclude necessary infrastructure development in an era of increased crude oil production in unconventional geographic locations. Therefore, FERC and industry rely on the PDO process to create certainty that contracts underpinning significant financial investments in new or converted infrastructure will be honored. However, PDOs are decided on a case-by-case basis and, therefore, are not a regulatory substitute. These proceedings, including *Seaway*, analogize Committed Shipper rates to the Commission's regulatory scheme governing natural gas pipelines under the Natural Gas Act (NGA), which permits non-cost-based negotiated rate agreements when tariff rates, also known as "recourse rates," are available alternatives.

The Remand ID reinforces the lesson of *Seaway* that an ICA Pipeline should always seek affirmance of a Committed/Uncommitted shipper rate structure in a PDO prior to filing an initial tariff. Seaway did not file a PDO in advance of filing its tariff. And, the Remand ID found Seaway's factual circumstances to be unprecedented and therefore the body of PDO precedent supporting unmodified contract rates, inapplicable. It engaged in a strict reading of FERC regulations, which would require all initial tariff rates, committed and uncommitted, to be cost-based.

Failure to follow the PDO process does not mean that contract modification is inevitable. It is common for FERC to clarify its holdings in later orders. The Remand Order clarified that the Committed Shipper rates did not need to be cost-based, a finding that could also be made in a PDO proceeding. The Remand ID nevertheless found that the Hearing Order required Seaway to provide a cost-of-service justification for all of its rates. In doing so, the Remand ID may have over-stated FERC's mandate to enforce just and reasonable rates under the ICA. Its focus on cost-based regulation relies on court precedent interpreting the NGA and its counterpart in the wholesale electric industry, the Federal Power Act (FPA). Although based on the ICA, FERC views the NGA and FPA as comprehensive consumer protection statutes while FERC views oil pipelines as requiring lighter handed regulation. This is consistent with the Remand Order's reference to the Seaway Committed Shippers as sophisticated businesses capable to negotiating fair rates and terms. The Remand ID suggests that this distinction either was missed or misinterpreted by the ALJ.

Whether or not the Remand ID is reversed, its impact extends much further than Seaway. The Remand ID suggests the need for further clarification from FERC concerning its regulatory role in the oil and liquids pipeline industry and its authority to sanction Committed Shipper rates under the ICA.

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