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FERC Reaffirms Sanctity of Committed Shipper Contracts and Arm's-Length Bargaining

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The Federal Energy Regulatory Commission (FERC) reaffirmed its policy permitting oil pipelines to set contractual committed rates through an open season process in *Seaway Crude Pipeline Company LLC* (*Seaway II*). In a February 1 Order on Initial Decision on Remand, FERC reversed significant portions of an Administrative Law Judge's (ALJ) initial decision on remand (Remand ID) that had rejected FERC's open season policy. *Seaway II* marks the second time that FERC reversed one of its ALJ's decisions and confirmed that committed shipper contracts cannot be abrogated, and that their rates cannot be challenged and changed, in a rate case proceeding to set initial *uncommitted* shipper rates.

Seaway II is notable for its sharply worded rebuke of the ALJ's assertion of judicial independence from following agency precedent. Additionally, *Seaway II* is noteworthy for the substantive ratemaking positions FERC took to review the lawfulness of the pipeline's uncommitted, non-contractual rates. Specifically, FERC tackled the controversial issues of a pipeline's inclusion of an acquisition premium in rates.

FERC's order is a victory for the oil pipeline industry. *Seaway II* again affirmed that contracts underpinning infrastructure projects would not be disturbed by the regulatory process. Additionally, FERC rejected arguments that the inclusion of large acquisition premiums in rates was inherently suspect, and found in favor of encouraging energy companies to re-purpose existing infrastructure. These rulings are particularly favorable for the industry in an era with low commodity prices, with declining demand for long-term transportation services, and when permitting new construction has become increasingly difficult.

Background

A detailed discussion of the *Seaway II* procedural background can be found in a May 2014 Van Ness Feldman Alert published after the Remand ID issued. Briefly, Seaway Crude Pipeline Company LLC (Seaway) proposed to repurpose its pipeline facilities and reverse the pipeline's flow to carry crude oil south from Cushing, Oklahoma to the U.S. Gulf Coast. Seaway held an open season and offered contract rates to committed shippers to help finance the reversal project, and proposed uncommitted rates as well.

Seaway did not file a petition for declaratory order (PDO) to get FERC's approval of its committed shipper contract rates, rate design, and tariff structure. Instead, in April 2012, it directly filed a tariff to put the reversed pipeline in service and charge its proposed contract and uncommitted rates. The tariff filing was protested, and FERC set the matter for hearing. FERC Trial Staff's testimony challenged Seaway's contract rates. Thus, in December 2012, Seaway filed an emergency PDO to seek affirmation of FERC's contract rate policy. While FERC denied the declaratory order on grounds that the case already had been assigned to an ALJ and a hearing was underway, it explained that its policy on contract rates was consistent with the spirit of its regulations. In September 2013, the presiding ALJ's initial decision (ID) rejected FERC's contract rate policy, and found that a pipeline's committed rates must be cost-based, thereby opening up Seaway's contract rates to scrutiny. In *Seaway I*, FERC reiterated its policy and remanded the case back to the ALJ. On remand, the ALJ again rejected FERC's contract rate policy, which then led to FERC's *Seaway II* decision.

FERC's Contract Rate Policy

FERC's authority to regulate oil pipelines comes from the Interstate Commerce Act (ICA). ICA pipelines, which also include transporters of natural gas liquids, and petroleum products, are considered common

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carriers. Traditionally, this has meant that they cannot enter into contracts with their shippers for transportation services, but must offer services to everyone under the same published tariff rates. In recent years, FERC has relaxed its policy against contract rates. While it has no regulations directly permitting them, FERC has used the PDO process to interpret its regulations as permitting them if they resulted from a valid open season process. A "valid" open season is one that is fair and transparent, and provides all shippers that would want to enter into the contracts the opportunity to do so. Contract rates that meet this criteria are presumed just and reasonable and do not need to be cost-based.

Basis of Review

Seaway II explained that whether a rate is just and reasonable is a question of law, not of fact. This finding countered the Remand ID's conclusion that the ALJ could adjudicate the contract rates' justness and reasonableness, despite FERC's contract rate policy, simply because Seaway would be able to over-collect its cost-of-service. FERC reiterated that the ALJ's role was limited to reviewing whether the open season process was fair; the ALJ's role does not extend to the right to review underlying contract rates. FERC explained that oil pipeline rates can be "just and reasonable" even if they allow the pipeline to over-collect its cost-of-service because FERC policy does not mandate cost-based rates for oil pipelines. The *Seaway II* decision constitutes an outright rejection of the Remand ID's assertion that Seaway's over-collection of its cost-of-service represented an "unprecedented factual circumstance" and issue of first impression that necessitated a departure from prior FERC policy.

Explaining the Meaning of an "Independent Judiciary" in the FERC Context

The Remand ID was particularly bold in its criticism of FERC's contract rate policy. Among other things, it suggested that *Seaway I* bowed to an "industry propaganda machine." It also asserted that a presiding ALJ should be "free from pressure" of the officials in the agency they serve, and claimed that FERC has no authority to order an ALJ to change her findings as to the merits of an issue.

Seaway II rejected the entire premise of the ALJ's argument. FERC explained that an ALJ is a creature of statute, subordinate to the agency on matters of policy and interpretations of law. An agency ruling on a given matter is not open for "reargument" by the ALJ. To the contrary, an ALJ is bound to follow FERC's instructions on remand. FERC also explained that an ALJ's independence is limited to specific matters unrelated to FERC's policy and interpretations of law, such as compensation, promotion, and tenure.

When an Acquisition Premium and Goodwill Can Be Collected in Rates

Generally, FERC ratemaking principles prohibit the recovery of an acquisition premium in rates. An acquisition premium is the amount that a new owner may pay above the assets' depreciated original cost in order to purchase the assets. The exception to this rule is for assets that are being put to a new use and provide substantial benefits to ratepayers (i.e. assets that meet the "substantial benefits" test). Seaway sought recovery of an acquisition premium paid by Enbridge Inc. (Enbridge) when it purchased a 50-percent ownership in the pipeline in 2011, prior to reversing the flow. The other 50-percent ownership remained with Enterprise Products Partners L.P. (Enterprise), who had been an owner when the pipeline still flowed from south-to-north.

The Remand ID found that Seaway met the "substantial benefits" test because the reversal of flow constituted a new use and the acquisition price of $585 million was less than the cost to build a new pipeline. However, the Remand ID concluded that Enterprise would experience a windfall if Seaway collected the acquisition premium in rates because its ownership in the pipeline had not changed. Further, the ALJ found that the acquisition premium could only be attributed to Enbridge, not to Seaway itself. Finally, the Remand ID found that the partnership between Enterprise and Enbridge was not an arms' length transaction, but a "scheme" to override cost-based ratemaking and increase the cost of service to the customers. Therefore, the ALJ rejected the inclusion of the acquisition premium in rates.

Seaway II rejected the Remand ID's arms' length transaction analysis. FERC explained that arm's length transactions are not shams simply because they result in an acquisition premium or upstream benefits to the parties. The "hallmark" characteristic is whether they are "negotiated rigorously, selfishly and with an adequate concern for price." The facts in the record supported a finding that Enbridge's acquisition of its 50-percent interest in Seaway was arms-length. FERC also rejected the notion that the premium could not be collected because it was paid by Enbridge as opposed to Seaway. *Seaway II* explained that

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the relevant test was whether the arm's length purchase of the paper ownership interest allowed the pipeline to be put to a new use and to provide substantial shipper benefits.

FERC also reversed the Remand ID's decision that Goodwill should be excluded from the acquisition premium. Goodwill is the excess of the purchase price paid for an acquired entity and the amount of the price not assigned to acquired assets and liabilities. It arises when an acquirer pays a high price to acquire another business. The ALJ argued for the exclusion of Goodwill because it is an "intangible value' that is not directly related to the acquired asset's original cost. Although FERC precedent is somewhat muddled in this area, FERC clarified that if an asset passed the "substantial benefits" test for an acquisition premium, that test also applied to Goodwill.

Implications of *Seaway II* on the Regulated Energy Infrastructure Industry

Seaway II once again reaffirmed FERC's contract rate policy for regulated oil pipelines. The order did not, however, provide closure for the uncommitted shipper rates. It provided Seaway with the parameters with which to calculate the uncommitted shipper rates, and ordered the pipeline to make a compliance filing with that calculation in light of the decision. FERC did not clarify how Seaway should calculate the uncommitted shipper rate design, given that those rates are required to be cost-based and Seaway presumably will recover its entire cost-of-service through the contract rates themselves. While this vagueness provides Seaway with considerable discretion, it also ensures that the litigation over Seaway's uncommitted shipper rates may not be finished.

While the reiteration of FERC's committed rate policy is important for the industry, it must be considered in context. The PDO process to get FERC's approval of a pipeline's proposed committed shipper contract rates, rate design, and tariff structure generally takes three to six months to adjudicate. It has taken Seaway, which did not follow the PDO process, over three and a half years to get to the *Seaway II* decision. Thus, this timeline lends itself to the conclusion that a pipeline governed by the ICA should seriously consider seeking FERC's approval through the PDO process instead of directly making a tariff filing, especially when the financial stakes are high.

The importance of *Seaway II* extends beyond the purview of the ICA's pipeline regulation. It provides some of the strongest words on FERC's primacy over its ALJs' decision-making authority. It also provides important precedent on ratemaking principles that have an impact on the natural gas and wholesale electric transmission industries, particularly with regard to acquisition premiums. In an era where FERC is under increasing pressure by landowners, environmentalists, and local governments to more strictly scrutinize its permitting of "greenfield" infrastructure projects, it is in FERC's interest to continue to encourage the efficient re-use of existing infrastructure to meet energy demands. FERC appears to be cognizant of this tension. It apparently does not want to penalize developers with a policy that would collect full cost-recovery for new development, but limit the recovery of costs for repurposed existing infrastructure to the asset's depreciated original cost.

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