Opinion No. 154-C

Williams Pipe Line Company
33 FERC ¶ 61,327 (1985)

Opinion No. 154-C, 33 FERC ¶ 61,327 (1985), is the Federal Energy Regulatory Commission's order denying in part a rehearing application of Opinion No. 154-B. It also modifies that Opinion, clarifies it, and denies a stay on the effectiveness of the Opinion.

In Opinion No. 154-C, the Commission addressed the Department of Justice's objection to the method adopted in Opinion No. 154-B for determining the interest expense deduction when calculating a pipeline's income tax allowance. The Commission stated in Opinion No. 154-C that since the trended original cost (TOC) methodology included an equity write-up, an interest calculation based on a TOC rate base would not produce a proper interest expense deduction. The Commission had said in Opinion No. 154-B that the solution was to require the use of a pipeline's actual interest expense. However, in Opinion No. 154-C, the Commission stated that the proper solution is to use the same actual capital structure for both the interest expense deduction and the allowed interest return. (Id. at 61,639, 61,640). The Commission cited Arkansas Louisiana Gas Company, a Division of Arkla, Inc., 31 FERC ¶ 61,318 (1985), in support of its position.

The Commission also clarified several questions raised by the Department of Justice on capital structure, rate of return, and depreciation. (33 FERC at 61,640, 62,641).

Finally, the Commission refused to stay the effectiveness of Opinion No. 154-B, as requested by Association of Oil Pipelines (AOPL). The Commission denied the stay because the AOPL had not identified the nature and extent of any injury. (33 FERC at 61,641).

Opinion No. 154-C

Williams Pipe Line Company,
Order Denying Rehearing in Part, Modifying
Opinion No. 154-B in Part, Clarifying That
Opinion, and Denying Stay
33 FERC ¶ 61,327 (1985)

[¶ 61,327]

Williams Pipe Line Company, Docket Nos. OR79-1-026, -027, -028, -029, -030 and -031

Opinion No. 154-C; Order Denying Rehearing in Part, Modifying Opinion No. 154-B in Part, Clarifying That Opinion, and Denying Stay

(Issued December 5, 1985)

Before Commissioners: Raymond J. O'Connor, Chairman; A. G. Sousa, Charles G. Stalon, Charles A. Trabandt and C. M. Naeve.

[Note: Opinion No. 154-B, issued June 28, 1985, appears at 31 FERC ¶ 61,377.]

[Opinion No. 154-C Text]

On June 28, 1985, the Commission issued Opinion No. 154-B. [1] In that Opinion, the Commission established principles pursuant to which it will test the reasonableness of oil pipeline rates. On July 26, 1985, Marathon Pipe Line Company (Marathon) filed a request for rehearing. On July 29, 1985, the Association of Oil Pipe Lines (AOPL), [2] ARCO Pipe Line Company (ARCO), and the United States Department of Justice (Justice) filed requests for rehearing. Justice also asked for clarification of the order. [3] On July 29, 1985, the Mid-Continent Shippers petitioned for reconsideration. Most of the arguments raised by the petitioners are not new and have been fully addressed in Opinion No. 154-B. Except for those matters dealt with herein, the Commission finds that no facts or principles of law have been presented which warrant modification of Opinion No. 154-B.

Summary of Opinion No. 154-B

In Opinion No. 154-B, the Commission:

(1) adopted net depreciated trended original cost (TOC) as the form of rate base and stated that only the equity portion thereof would be trended;

(2) concluded that rate of return should be determined on a case-by-case basis by the usual approach of using embedded debt costs and setting a risk-related equity rate of return;

(3) stated that as a general policy the proper capital structure to use was the pipeline's or its parent's actual capital structure, depending on how capital was raised [4];

(4) adopted a starting rate base for existing assets consisting of the sum of a pipeline's debt ratio times book net depreciated original cost and the equity ratio times the reproduction cost portion of the valuation rate base depreciated by the same percentage as the book original cost rate base has been depreciated;

(5) ruled that oil pipelines should use their actual interest expense in computing their income tax allowance in their cost-of-service;

(6) adopted normalization as the proper treatment for book and tax timing differences in the recognition of certain expenses and noted that oil pipelines must exclude all deferred tax amounts from their rate bases; and

(7) removed the previously imposed limitations on the suspension of unprotested oil pipeline rate filings and on the participation of Commission staff in oil pipeline rate cases.

Interest Expense Deduction

ARCO and Justice object to the method adopted in Opinion No. 154-B for determining the interest expense deduction in calculating a pipeline's income tax allowance.

In Opinion No. 154-B, the Commission held:

> [One] . . . tax issue is the determination of the interest expense deduction to use in calculating a pipeline's tax allowance. The usual method is to multiply the company's weighted cost of debt times its rate base. This will not work for oil pipelines. This is so because under the TOC [Trended Original Cost] methodology adopted in this opinion the rate base includes an equity write-up. The Commission holds, therefore, that oil pipelines should use their actual interest expense. [5]

Both ARCO and Justice argue that the interest expense deduction for determining the tax allowance should be the same as the interest produced by the capital structure adopted for rate of return purposes. The Commission agrees that, as a general rule, tax and return interest should be the same. The problem here, as stated in Opinion No. 154-B and as recognized by ARCO, is that the TOC methodology adopted in Opinion No. 154-B includes an equity write-up. Hence, the usual method of multiplying the company's weighted cost of debt times its rate base will not produce a proper interest expense deduction. The Commission's solution to this problem was to require the use of a pipeline's actual interest expense. The Commission is now persuaded that the better solution is to use the same actual capital structure for both the interest expense deduction and the allowed interest return. This is in accord with our decision in *Arkansas Louisiana Gas Company, a Division of Arkla, Inc.*,[6] in which we expressed a general preference for using actual capital structures rather than hypothetical capital structures when determining gas pipelines' rates of return. That decision assumed that the interest expense deduction would be the same as the debt return produced by the capital structure. We see no reason why this should not also be the case for oil pipelines, if the equity write-up can be eliminated. At this time, therefore, subject to re-examination on a case-by-case basis, it appears appropriate for an oil pipeline to determine its interest expense deduction by multiplying its weighted cost of debt times its net depreciated original cost rate base.

Capital Structure, Rate of Return and Depreciation

Justice asks for clarification or modification of several aspects of the capital structure principles established by Opinion No. 154-B. The first clarification concerns the date to be used in determining the capital structure. For pipelines whose rates are not currently under investigation by the Commission or whose rates may have been set for investigation after issuance of Opinion No. 154-B, the capital structure to be used in determining the starting base is as of the date of Opinion No. 154-B (June 28, 1985). If a pipeline has a case pending before the Commission in which rates are being collected subject to refund, the capital structure to be used is that in existence on the date the rates under investigation became effective. [7]

The second issue raised by Justice is whether the parent's actual capital structure includes or excludes non-guaranteed debt issued by subsidiaries. We believe this question should be resolved on a case-by-case basis. [8]

Third, Justice argues that the capital structure used to determine the starting rate base should be permanent for the service life of the property. If changes to the debt-equity ratios are permitted, states Justice, pipelines will be able to manipulate their returns. We disagree. The starting rate base freezes only the dollars in that base. As with other regulated companies, capital structure may change from time to time.

Fourth, Justice asks whether the Commission intended that a real rate of return, once determined, would be used without change unless altered in a later rate case. Justice is correct. Our reference to changes in the real rate was meant to indicate that the risks of the pipeline could be reexamined. One mechanism for doing this would be to derive a new nominal rate and subtract therefrom the inflation rate using whatever inflation index is finally established.

Fifth, Justice requests clarification on how equity depreciation for existing pipelines will be treated. While it is true, as stated by Justice, that under TOC, the original cost of equity is not a component of the starting rate base, we intend that the equity, as well as the debt, depreciation component for cost-of-service purposes will be based on original cost. [9]

Last, Justice asks us to place on pipelines the burden of going forward with evidence that a pipeline's investors had relied on the future recovery of deferred earnings under the valuation methodology. Opinion No. 154-B permitted participants challenging the starting rate base to prove that investors had not relied upon the previous rate base method. Justice states that participants raising such challenge would have to engage in years of discovery to prove that there was no reliance.

However, Justice then implicitly contradicts itself when it argues that *prima facie* evidence of earnings in past years, higher than those allowed under valuation, should be sufficient to require the pipeline to come forward with evidence of its reliance. Evidence of such earnings obviously does not take years of discovery to obtain and is clearly one avenue for participants to pursue in showing that a pipeline was not relying on future earnings under the valuation methodology.

The other issues raised by Justice, such as the appropriate inflation index, are better addressed and resolved in the context of particular cases.

This is also true for the question raised by the Mid-Continent Shippers of whether a parent should be compensated for its guarantees of a pipeline's debt when the parent's capital structure is used for rate of return purposes. [10] Opinion No. 154- B has provided the basic framework for oil pipeline ratemaking; certain matters, however, are more appropriately fleshed-out in a specific pipeline setting.

Request for Stay

The AOPL asks that the Commission stay the effectiveness of Opinion No. 154-B pending judicial review. The AOPL states that it has made a strong showing that it is likely to prevail on the merits of its appeal and is concerned about the potential waste of resources if the court of appeals vacates Opinion No. 154-B. The Mid-Continent Shippers oppose the AOPL's request. They state that under the criteria established in *Washington Metropolitan Area Transit Commission v. Holiday Tours, Inc.*, 559 F.2d 841 (D.C. Cir. 1977), the petitioner for stay is required to show that without such relief, it will be irreparably injured. They state that the AOPL has not identified the nature or extent of any injury. Hence, the AOPL has not shown irreparable injury. The Mid-Continent Shippers also observe that the Commission has left some matters to a case-by-case determination. Thus, application of the principles of Opinion No. 154-B will clarify and elaborate those principles. Furthermore, since Opinion No. 154-C provides guidance as to the methodology the Commission intends to apply in all pending and future rate cases, but allows changes to this methodology on a case-by-case basis, the members of AOPL will not be harmed if the stay is denied.

The Commission agrees with the Mid-Continent Shippers. Although the Commission will grant a stay when "justice so requires," [11] here the public interest is best served by letting the oil pipeline industry begin the business of applying the generic principles enumerated in Opinion No. 154- B without further delay. Moreover, the Commission believes that moving forward in those cases will have the salutary effect of enabling the Commission to fine-tune those principles.

The Commission orders:

(A) All requests for rehearing and clarification are denied except as described in the body of this order.

(B) AOPL's request for a stay is denied.

— Footnotes —

[1] *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985).

[2] The AOPL included in its filing verified statements of certain individuals as matters relied upon in its request for rehearing.

[3] The AOPL and Phillips Pipe Line Company filed responses in opposition to the motion for clarification by Justice.

[4] If a parent guarantees debt issued by its pipeline subsidiary, the parent may be considered to be the issuer of the debt.

[5] 31 FERC at p. 61,837.

[6] 31 FERC ¶ 61,318 (1985).

[7] 31 FERC at p. 61,839, nn. 43 and 45. The reason the Commission referenced 1983 valuations is that the only cases in which rates are currently subject to refund concern pipelines whose tariff filings were made prior to 1983.

[8] *See Tennessee Gas Pipeline Co., a Division of Tenneco Inc.*, 33 FERC ¶ 61,[illegible] (1985).

[9] *Id.* n. 41.

[10] *See, id.* n. 50.

[11] Administrative Procedures Act, 5 U.S.C. § 705 (1982).