

124 FERC ¶ 61,153
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

BP Pipelines (Alaska) Inc.	Docket Nos.	IS06-466-004
ConocoPhillips Transportation Alaska, Inc.		IS06-467-004
ExxonMobil Pipeline Company		IS06-468-004
Koch Alaska Pipeline Company, LLC		IS06-469-004
Unocal Pipeline Company		IS06-470-004

ORDER ON REMAND GRANTING REHEARING

(Issued August 8, 2008)

1. In this proceeding, certain protesters¹ objected to tariff sheets filed by the TAPS Carriers, the owners of the Trans Alaska Pipeline System (TAPS), to comply with Commission orders involving the TAPS Quality Bank.² The Federal Energy Regulatory Commission (Commission) accepted the tariff sheets in two prior orders in this

¹ Flint Hills Resources Alaska, LLC (Flint Hills) and Petro Star, Inc. (Petro Star) are referred to jointly as protesters.

² *Trans Alaska Pipeline System*, 113 FERC ¶ 61,062 (2005) (Opinion No. 481), *order on reh'g*, 114 FERC ¶ 61,323 (2006) (Opinion No. 481-A), *order on reh'g*, 115 FERC ¶ 61,287 (2006) (Opinion No. 481-B) (collectively, Opinion No. 481), *aff'd sub nom. Petro Star Inc. v. FERC*, No. 06-1166, 2008 U.S. App. LEXIS 5328 (D.C. Cir., Mar. 6, 2008).

proceeding.³ This proceeding is now before the Commission on voluntary remand from the United States Court of Appeals for the District of Columbia Circuit (Court).⁴ As discussed below, the Commission responds to the protesters' arguments concerning the *OXY USA, Inc. v. FERC*, 64 F.3d 679, 693 (D.C. Cir. 1995) (*OXY*), consistency requirement and grants rehearing.

Background

2. The factual background and procedural history for this case is described in previous Commission orders. However, it will be helpful to make a fuller factual exposition of certain matters relating to the specific issue addressed in this order, specifically the application of *OXY* to this proceeding.

3. In *OXY*, the Court affirmed the Commission's order⁵ adopting the "distillation" methodology for the Quality Bank. The methodology divides each petroleum stream entering TAPS into eight components or "cuts" based on the temperature at which particular petroleum products boil out of the stream. Each of the eight cuts are individually valued, and then combined to determine the stream's value.

4. The lighter cuts, those with the lowest boiling point, such as propane, are valued at published market prices for those products. Because there are no readily available market prices for the heaviest cuts, namely distillate and residual fuel oil (Resid), one must use as proxies for these cuts market prices of similar products adjusted to account for product differences.

5. The orders under review in *OXY* required the Quality Bank to value light distillate at the market price of jet fuel and heavy distillate at the market price of No. 2 fuel oil, the finished products into which those cuts are often refined. Since there is no market price for Resid, the heaviest cut with a boiling point higher than 1050 degrees is valued at the price of fuel oil 380 (FO-380), while the lighter Resid with a boiling point between 1000 and 1050 degrees is valued at the more expensive No. 6 fuel oil.

³ *BP Pipelines (Alaska) Inc.*, 116 FERC ¶ 61,208 (2006) (Compliance Order), *order on reh'g*, 118 FERC ¶ 61,056 (2007) (Rehearing Order), *appeal pending sub nom. Flint Hills Resources Alaska, LLC v. FERC*, D.C. Cir. Nos. 06-1361, *et al.*

⁴ *Flint Hills*, D.C. Cir. No. 06-1361 (Jan. 22, 2008) (Remand Order).

⁵ *Trans Alaska Pipeline System*, 65 FERC ¶ 61,277 (1993).

6. The Court agreed with petitioners' arguments in *OXY* that the valuation of the distillate cuts was flawed because the market proxies used to value the cuts are refined product prices that require refiners to process the cuts. Conversely, the products refined from the lighter cuts require little or no processing. Thus, the Commission overvalued the distillate cuts relative to other cuts in the common stream because it failed to reduce the proxy prices for these processing costs.

7. The Court stated that it would not hold the Commission to an impossibly high standard when valuing different quality of oils, especially in the case of products without a readily ascertainable market price, "[B]ut if the agency chooses to value some cuts of petroleum at the prices they command in the market without the benefit of processing, as it appears to have done, it must attempt, to the extent possible, to value all cuts at the price they would command without processing. It cannot, consistent with the requirement of reasoned decision-making, value some cuts precisely and other haphazardly."⁶ Rather, the *OXY* court found that "FERC must accurately value all cuts – not merely some or most of them – or it must overvalue all cuts to approximately the same degree."⁷

8. The Court in *OXY* also rejected the Resid cut proxies. Specifically, the Court rejected use of FO-380 as the proxy for the Heavy Resid because there was no evidence to suggest that the proxy of the cut "have equal or even near-equal market values,"⁸ and rejected the No. 6 fuel as the proxy for the Light Resid because there was no evidence to show that its proxy price bore a close relationship to that cut. The Court remanded the valuation of the distillate and resid cuts for further consideration by the Commission.

9. In response to *OXY*, in December 1997 the Commission accepted a contested settlement on the remanded cuts. The settlement⁹ established, prospectively, the value for the Light Distillate cut as the Waterborne Jet Fuel price less 0.5 cents per gallon (cpg) to reflect processing costs, and established the value of the West Coast Heavy Distillate

⁶ *OXY*, 64 F.3d at 694.

⁷ *Id.* at 693.

⁸ *Id.*

⁹ The Parties submitted three different settlement proposals to an Administrative Law Judge (ALJ). The ALJ certified one settlement based upon the evidence submitted in support of the settlement.

cut as the West Coast Waterborne Gasoil price less 1 cpg for processing costs.¹⁰ The settlement based this cost adjustment on testimony supporting the settlement by witness John O'Brien. The settlement also established a method for valuing Resid through specified proxies subject to certain adjustments.

10. Since the processing cost adjustment reflected the cost to process the cut to the proxy's specification at a specific time, the settlement provided that the Quality Bank Administrator (QBA) would revise the agreed upon cost adjustment each year by projecting the inflation of those costs for the year in question based upon the average inflation trend during the preceding two years. Thus, to account for annual inflation, the settlement provided that, beginning January 1, 1998, "the adjustments to the prices . . . shall be revised in accordance with changes in the NFI (Operating Indexes Refinery)[¹¹] . . . by multiplying the adjustments or costs for the previous year by the ratio of (a) the average of the monthly indexes that are then available for the most recent 12 consecutive months to (b) the average of the monthly indexes for the previous (i.e., one year earlier) 12 consecutive months." Accordingly, the TAPS Carriers incorporated this method into their tariffs.

11. In *Exxon Co. U.S.A. v. FERC*, 182 F.3d 30 (D.C. Cir. 1999) (*Exxon*), the Court affirmed the Commission order accepting the settlement provisions relating to the Light and Heavy Distillate cuts. However, the Court again found fault with the valuation of the Resid cut because it had not been shown that "the chosen proxy [bore] a rational relationship to the actual market value of resid,"¹² and remanded the valuation of the Resid cut to the Commission.

12. In January 1998, the TAPS Carriers filed their first Quality Bank tariffs after the 1997 Commission order, which reflected the revisions in the remanded cuts. The tariffs revised the Light Distillate 0.5 cpg adjustment in accordance with the N-F Index to 0.5082 cpg. Subsequent tariffs revised it to 0.4987 cpg in 1999, and then to 0.4906 cpg

¹⁰ *Trans Alaska Pipeline System*, 81 FERC ¶ 61, 319 (1997).

¹¹ The *Oil & Gas Journal* publishes the Nelson-Farrar Index monthly. It tracks, compares and reflects overall refinery operating costs rather than those costs' individual components. It is regularly corrected for the productivity of labor, changes in the amounts of fuel used, productivity in the design and construction of refineries and the amounts of chemicals and catalysts employed. See Gerald L. Farrar, *How Nelson Cost Indexes are Compiled*, *Oil & Gas J.*, December 30, 1985 at 145.

¹² *Exxon*, 182 F.3d at 42.

in 2000. The QBA then revised the adjustment annually using the N-F Index so that by 2006 the adjustment had risen to 0.6287 cpg. We note here that the valuation of the Light Distillate cut was not an issue in the Opinion No. 481 proceeding.

13. On November 24, 1999, the QBA notified the Commission of a change in the published proxy price used to value the Heavy Distillate component. On February 9, 2000, the Commission issued an order accepting Platt's West Coast LA Pipeline LS No. 2 (0.05 percent) as the appropriate proxy for the West Coast Heavy Distillate cut. The parties agreed upon a new proxy but not the amount of the processing cost adjustment, which became an issue in the Opinion No. 481 proceeding where the valuation of the Resid cut was also at issue. In the Opinion No. 481 proceeding, the parties stipulated that the Resid cut value would be subject to a processing cost, adjusted by the N-F Index and defined that index as follows:

Nelson Farrar Index is the ratio of: (a) the Nelson Farrar Index (Operating Indexes Refinery) for the year in which the value is being determined to (b) the Nelson Farrar Index (Operating Indexes Refinery) for the base year. The Eight Parties have proposed a base year of 1996 and ExxonMobil Tesoro have proposed a base year of 2000.

Joint Stipulation of the Parties, filed October 3, 2002 at 3.

14. Opinion No. 481 affirmed the ALJ's rulings in the Initial Decision (ID)¹³ that determined that the processing cost adjustment for Heavy Distillate and the capital investment cost adjustment for Resid, based upon O'Brien's 1996 costs, needed adjusting to a 2000 base year using the N-F indices, effective February 1, 2000.¹⁴

15. On July 3, 2006, the TAPS Carriers filed identical tariffs to comply with Opinion No. 481. The filings included a memorandum from the QBA who stated he used the N-F indices to convert 1996 based capital investments to a year 2000 basis for the Resid and Heavy Distillate cost adjustments, as required by Opinion No. 481. Specifically, the compliance filings converted the 1996 Resid and Heavy Distillate cost adjustments to year 2000 by dividing the average N-F Index for the calendar year 2000 by the average N-F Index for the calendar year 1996. Thereafter, the QBA adjusted the costs annually

¹³ *Trans Alaska Pipeline System*, 108 FERC ¶ 63,030, at P 1254 and P 1449 (2004).

¹⁴ *Id.* P 1258 and P 1450.

based on the tariff methodology of using the N-F Index and the most recent 12-months of data available in January of each year.

16. On September 1, 2006, the Commission issued the Compliance Order accepting the identical tariff sheets, effective November 1, 2005. Petro Star filed a request for rehearing of the Compliance Order. On January 26, 2007, the Commission issued an order denying rehearing.

Protests

17. Protesters challenged the Commission's acceptance of the compliance filings on two bases. The first contention was that the two-step proposal results in double counting of inflation from September 1, 1999, through December 31, 2000, because the base year and annual adjustments both include inflation for that period.

18. Protesters' second challenge, the disparity claim, concerns the fact that the methodology approved to adjust the 1996 processing costs to 2000 costs for Resid and Heavy Distillate differs from the methodology applied to adjust the Light Distillate processing costs for that period, resulting in different inflation levels for the Resid and Heavy Distillate cuts relative to the Light Distillate cut. Protesters argued that this violates the requirement in *OXY*, that "FERC must accurately value all cuts – not merely some or most of them – or it must overvalue all cuts to approximately the same degree."¹⁵

19. The Compliance and Rehearing Orders rejected the double counting claim,¹⁶ and responded to the disparity claim as follows:

Petro Star's other argument concerns the inconsistency between the inflation factor applied to the Resid and Heavy Distillate cuts under the [Quality Bank Administrator]'s calculations, and the inflation factor applied to the Light Distillate cut. However, Petro Star's argument is flawed because it ignores the fact that [the] processing cost adjustment for Light Distillate was set at 0.5 cpg by the 1997 Settlement. Thus, the escalation in the Light Distillate cut processing costs would not include any inflation prior to that

¹⁵ *OXY*, 64 F.3d at 693.

¹⁶ See Compliance Order at P 10-11; Rehearing Order at P 18-20.

time, while the escalation in the costs for the Resid and Heavy Distillate cuts covers the period from 1996 on.

Rehearing Order at P 21.

Discussion

20. After further reviewing Petro Star's request for rehearing based on the holding in *OXY*, the Commission finds that the basis on which it rejected the disparity claim did not address the question presented since there was only minimal inflation during the period from 1996 to 1998. Accordingly, the Commission addresses this matter, grants rehearing and directs the QBA to recalculate the processing costs based on the tariff methodology for the reasons explained below. Since we are granting rehearing, the double counting issue is moot.

21. Protesters claim that from 1996 to 2006, the Resid and Heavy Distillate cost adjustments rose almost ten percent more than the Light Distillate cost adjustment, which violates the directive of *OXY* to value all cuts accurately, or adjust the cuts to the same degree. In support, protesters point out that the QBA escalated the Resid and Heavy Distillate cost adjustments by a factor of 1.377 from the 1996 base year to 2006, but for that same period, he escalated the Light Distillate cost adjustment by a factor of 1.257.¹⁷

22. The crux of the protesters' argument is that the cost adjustments for Resid and Heavy Distillate are improperly inflated from 1996 to 2000 and therefore significantly higher than the adjustment applied to the Light Distillate cut during that period, resulting in Resid and Heavy Distillate being undervalued relative to Light Distillate. The cost adjustments for Resid and Heavy Distillate were positively inflated by 1.0742 from 1996 to 2000. The processing cost adjustment for Light Distillate was negatively inflated by 0.9812 from the 1997 settlement amount to 2000. Thus, while the Light Distillate cost adjustment was deflated by 0.9812, the Resid and Heavy Distillate cost adjustments were inflated by 1.0742.

23. Although the QBA explained why he converted the 1996 values to the year 2000 basis in a different manner than the tariff methodology, we find that the proffered reason does not overcome the *OXY* requirement to value the cuts in a consistent manner.

24. The 0.5 cpg cost adjustment for the Light Distillate cut was the 1997 settlement amount. The N-F Index was applied to the 0.5 cpg amount starting in 1998, and each

¹⁷ See Rehearing Order at P 13.

year thereafter, since there was no issue concerning the Light Distillate cost adjustment after *Exxon*. In addition, there was no need to make any adjustment for any pre-1998, pre-settlement period.

25. The QBA revised the Light Distillate cost adjustment, using the tariff methodology, which uses the most recent N-F indices available at that time, since the N-F indices are reported on a four-month lag. Thus, to calculate the processing cost adjustment for the 2000 tariff, effective for February 2000 through January 2001, the QBA first calculated the escalation ratio based on the average index for the months September 1998 through August 1999 compared to the average index for the months September 1997 through August 1998. The QBA then multiplied that ratio by the processing cost adjustment used from February 1999 through January 2000.

26. In converting the 1996 cost adjustments for Resid and Heavy Distillate¹⁸ to the year 2000 the QBA used a different methodology. The QBA converted the cost adjustments for Resid and Heavy Distillate from 1996 to 2000 by a factor of 1.0742, the ratio of the average of the N-F Index for calendar year 2000 to the average of the N-F index for calendar year 1996. As a result of using this approach for the Heavy Distillate and Resid cuts, the actual months included in the calculation of the escalation for these cuts differs from the months included in the calculation of the escalation for Light Distillate. The N-F indices for the months in 2000 were higher than the N-F indices for the comparable months in the previous year. These months were not included in calculating the year 2000 cost adjustment for Light Distillate, using the tariff methodology, effective February 1, 2000. Therefore, the Resid and Heavy Distillate cost adjustments for 2000 would necessarily be higher than the Light Distillate cost adjustment for 2000, since calculating the processing cost adjustment for the Light Distillate cut, to be effective February 1, 2000, does not use year 2000 data.¹⁹ Protesters did not take issue with the processing cost adjustment calculations for the tariff filings effective February 1, 2001, and thereafter, since for those filings they “agree with the

¹⁸ The Commission notes that for the first years after the 1997 Commission order accepting the settlement, the QBA revised the cost adjustment for the Heavy Distillate and Light Distillate in the same manner. However, once the 1997 settlement amount no longer governed the Heavy Distillate cut, when Platts discontinued reporting the existing proxy in 1999, it was necessary to determine the amount of the processing cost to the new proxy, effective February 1, 2000, when that new proxy became effective.

¹⁹ See *supra* P 24 for the calculation and tariff methodology.

approach taken by the QBA as it is applied to costs originally expressed in terms of a 1996 base year.”²⁰

27. The QBA explained in a subsequent memorandum sent to all interested parties²¹ why he did not use the tariff methodology for the conversion. He stated that in the Opinion No. 481 proceeding, the ALJ accepted witness O’Brien’s values for determining the cost adjustments, and that O’Brien based the costs on the overall year 1996. However, in the Opinion No. 481 proceeding the base year was 2000, and the 1996 values needed converting to 2000 values using the N-F indices. No specific direction was given how to use these indices to make this conversion. The QBA concluded that since “Mr. O’Brien’s values were based on the overall year 1996 and they were to be converted to the overall year 2000 basis, it seems logical to use a ratio of the annual average 2000 index to the annual average 1996 index.”²²

28. In this case, there was an agreed-upon method for escalating the processing cost adjustments, the tariff methodology. That method was applied to escalate the adjustment for the Light Distillate cut. Thus, unless there was some overriding reason why the same tariff methodology could not be applied to the Heavy Distillate and Resid cuts, and none was shown, the QBA did not have the authority to ignore the *OXY* requirement to value all cuts in a consistent manner. Since the QBA used a different methodology to convert the 1996 processing cost adjustments for the Resid and Heavy Distillate cuts to year 2000 costs than the tariff methodology, and this resulted in a difference between the escalation factors for the Resid and Heavy Distillate cuts compared to the Light Distillate cut, this violated the *OXY* standard. Therefore, to be consistent with *OXY*, the Resid and Heavy Distillate cost adjustments in 1996 must be escalated to 2000 using the same annual revisions applied to the Light Distillate, i.e., the tariff methodology.

29. For the reasons discussed above, we direct the QBA to recalculate the processing cost adjustments for Resid and Heavy Distillate using the tariff methodology. We also direct the TAPS Carriers to make a compliance filing consistent with the QBA’s recalculated processing costs and this order.

²⁰ July 18, 2006 Protest of Petro Star n.16.

²¹ July 5, 2006 Memorandum of QBA, Petro Star’s July 18, 2006 Protest at Appendix I.

²² July 5, 2006 Memorandum of QBA at 1.

The Commission orders:

(A) Petro Star's rehearing request is granted, as discussed in the body of this order.

(B) The TAPS Carriers are directed to make the required compliance filing within thirty days of this order.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.