Testimony by
Bruce W. Heine,
Director Government and Media Affairs
Magellan Midstream Partners

Before the United States Senate Committee on Finance

Airfields and Alternative Fuels: Exploring Rural America's Transportation Infrastructure

August 27, 2007

Good morning Ranking Member Grassley, members and staff of the Committee. Thank you for inviting Magellan to testify on the important subject of alternative fuels and transportation infrastructure. Magellan owns and operates the nation's longest refined product pipeline system along with eighty-one petroleum distribution terminals in twenty-two states. In Iowa, we have distribution terminals here in Dubuque, Des Moines, Ft. Dodge, Iowa City, Sioux City, Waterloo, Milford and Mason City from which we distribute the majority of fuel consumed in the state.

Our nation's demand for liquid energy continues to grow. As domestic and international refineries expand to produce more gasoline, diesel and jet fuel, domestic pipeline infrastructure needs to expand to accommodate the growth. As ethanol and biodiesel production continues to grow, pipeline companies like Magellan are exploring technical solutions to current barriers which may lead to commercial opportunities to transport ethanol and biodiesel blended fuels via existing pipelines. In the meanwhile, we are continuing to invest in traditional ethanol and biodiesel storage and blending infrastructure at our terminals. Today, I will focus my remarks on (1) biofuels and pipelines, (2) biodiesel blending, (3) managing the integrity of Ultra Low Sulfur Diesel and (4) the importance of energy infrastructure publicly traded partnerships.

Biofuels and Pipelines

We do not transport ethanol, ethanol blends, biodiesel or biodiesel blends in our multi-products pipeline system today. However, pipelines are an efficient, safe, economic and

reliable way to transport large volumes of liquid fuels. To achieve the Senate's biofuels goal in HR6, opportunities may develop to transport ethanol or ethanol-blended gasoline via pipeline in the United States. However, there are a number of operational, technical and economic issues associated with the potential transportation of ethanol in a multi-products system pipeline. These include the practices and equipment to minimize water content and impurities, compatibility of existing seals and gaskets used in the valves and pumps and the potential for "stress corrosion cracking" of pipelines and tanks. Substantial research into the causes of and solutions for these items, particularly the stress corrosion cracking issue, will be necessary before we are comfortable in considering ethanol transportation by pipeline.

It is our responsibility to prevent pipeline leaks and to protect the environment. Under the leadership of the Association of Oil Pipelines, our industry is currently studying the technical issues associated with the transportation of ethanol blends via pipeline. In addition, we need your assistance in determining the cause and solution to stress corrosion cracking. To this end, we urge the passage of provisions in both the House and Senate Energy bills which provide funding to study the technical, siting, regulatory and financial issues associated with transportation of ethanol via pipeline.

It is conceivable that limited opportunities to transport 10% ethanol blends may prove to be technically feasible due to the low concentration of ethanol in the product. However, we believe the most likely opportunity to transport fuel grade ethanol will be in a dedicated pipeline built for that specific purpose. This position is based on the assumption that the solutions to the technical issues described earlier may be cost prohibitive with an existing multi-products pipeline.

We face a number of commercial issues when considering a dedicated pipeline for the transportation of ethanol. A line from the Midwest to the East Coast could be a billion dollar or more project. Key variables in a project of this nature include (1) the reliable volume of ethanol that would be required on the line to provide an economic business case, (2) aggregation systems and connections to plants, (3) delivery points and (4)

market dynamics. Since we have not conducted a comprehensive study, we do not yet have answers to these important questions.

Conversion to Ultra Low Sulfur Diesel (ULSD)

The increased supply and demand for ULSD for on and off road purposes has allowed us to discontinue transporting and storing High Sulfur (500ppm) diesel at a number of our terminals. During our successful conversion to ULSD, we took a number of steps to protect the integrity of ULSD by separating it from jet fuel which can contain as much as 2000ppm sulfur.

Pipeline Services

Generally, we prefer fewer grades of fuel to transport on the pipeline system. The greater the "fungibility", the greater the efficiencies which helps to keep costs low for our shippers. We operate an "open-stock" system for no-lead gasoline and ULSD. This allows us to receive barrels from a shipper in Houston and simultaneously give the shipper access to barrels in Des Moines. We do, however, serve several markets which offer or require "boutique fuels"…e.g. Kansas City and Tulsa and we transport several segregated, lower volume products.

We are in the transportation and service business and we strive to meet our shipper's needs. If a shipper asked us to transport an alternative type of jet fuel which met Magellan's and ASTM specifications, we would assess commercial and operational variables. For example, we would assess the (1) volume and available line space, (2) special handling and compatibility requirements and (3) our ability to store the product at an origin and destination terminal. We are constantly evaluating the product grades on our system to meet shipper expectations.

Energy Infrastructure Publicly Traded Partnerships

A number of pipeline companies, like Magellan, are structured as publicly traded partnerships (PTPs). For the past twenty years, partnership tax treatment has been available to PTPs earning at least 90% "qualifying income", that is interest, dividends,

real estate rents, capital gains, commodities and income from “natural resource activities”. An example of a natural resource activity is the transportation of gasoline, diesel and jet fuel via pipeline.

Congress created this tax structure for those entities interested in raising and investing capital for large scale energy infrastructure projects. Magellan is a perfect example of a PTP which has made significant investments in transportation infrastructure for refined products and terminal distribution infrastructure for renewable fuels.

When Congress amended the IRS code in 1987 and implemented the 90% income requirement, income from the transportation of ethanol blends via pipeline when feasible was not included as qualifying income. In 1987, U.S. ethanol production was 46,000 barrels per day. Today, U.S. ethanol production exceeds 419,000 barrels per day. Congress did not envision the need to transport ethanol via pipeline, nor the possibility that ethanol blends could be transported via pipeline in the near future. If we can resolve certain technical issues, it may be practical and economical to transport ethanol blends via pipeline in the short-term. The successful transportation of ethanol blends via pipeline would virtually eliminate the need for costly rail offloading infrastructure in developing ethanol markets. However, under the existing IRS code the revenue generated from the transportation and storage of an ethanol blended fuel via pipeline is not qualifying income although revenue generated from blending ethanol into gasoline would be qualifying income.

We believe the Finance Committee has taken a positive step by passing the Energy Advancement and Investment Act of 2007 tax amendments which would treat income from the transportation of ethanol blends via pipeline as qualifying income. The proposed change simply allows the income generated from the transportation of non-petroleum based fuels by pipeline to be included in “qualifying income” for PTPs. The provision would not create any new class of business. Rather, the provision would allow existing PTPs to transport the ethanol blended fuels across the country once the technology allowing such transportation is achieved.

Lastly, the Committee's "Energy Advancement and Investment Act of 2007" contains provisions to alter the IRS code for biodiesel and biodiesel mixtures. One proposal adds qualified biodiesel mixtures to the definition of taxable fuel as a type of diesel fuel. We support the Committee's approach.

Thank you again for the opportunity to comment on these important subjects and I would be pleased to answer questions.