Market-Based Rates

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Agenda for Today

- Overview of Market-Based Rates (MBR)
- Basis in Economic Theory
- Background
- FERC Standards
- Recent and Pending MBR cases
- Future Developments

MBR: Overview

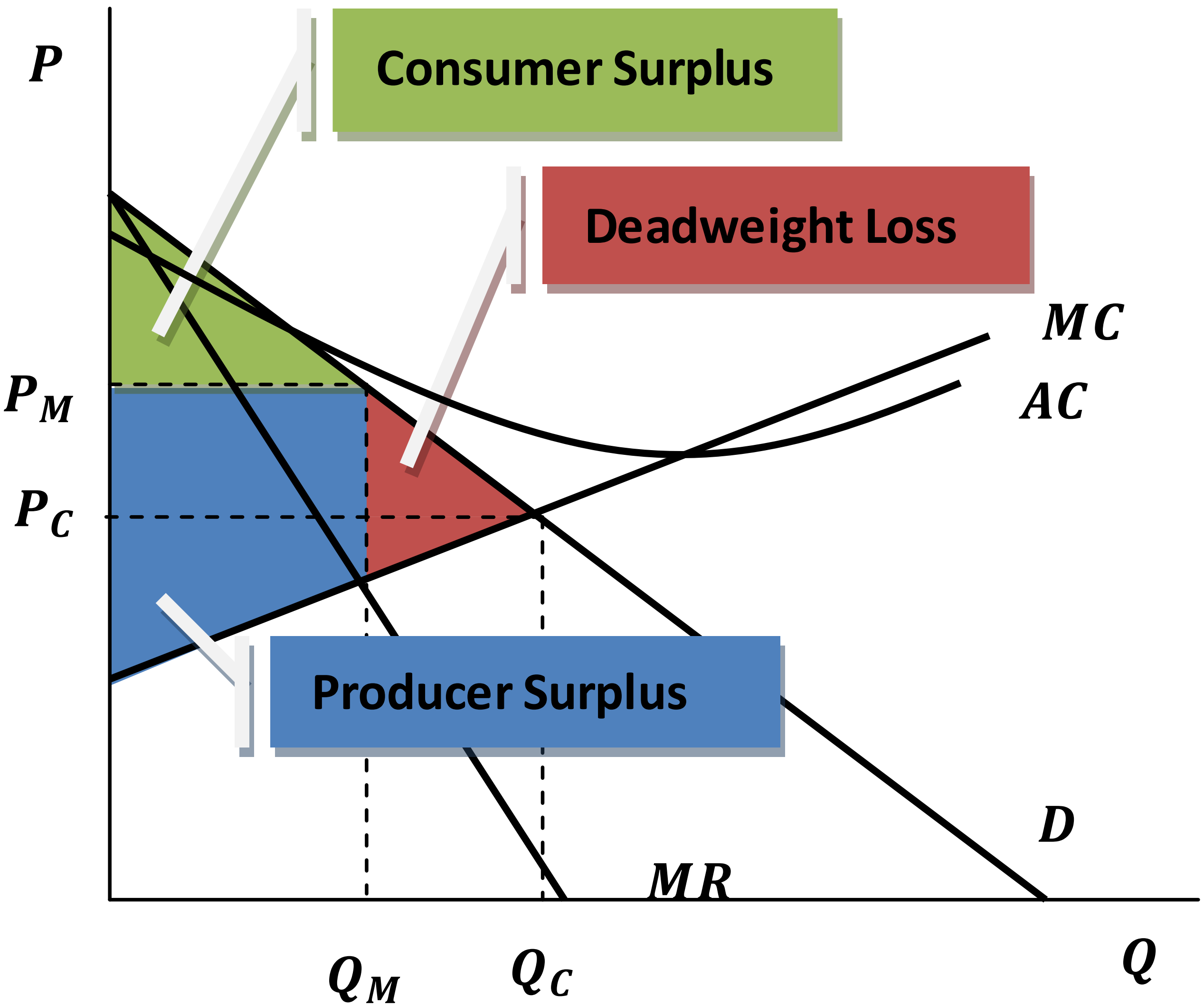
- Market-based rates are . . .
  - Tariff rates that can be changed regardless of the index and without having to justify the rate change on a settlement or cost-of-service basis.
- Market-based rates can be charged . . .
  - Only after FERC determines that shippers have sufficient competitive alternatives to the pipeline to restrain it from raising its rates above competitive levels.
- Advantages of MBR authority are . . .
  - Greater flexibility in tariff rate structures and ability to set rates based on the market.
  - No need to make cost-of-service rate filings or get shipper agreement to increase rates above index ceiling.
  - Fostering of efficient allocation of pipeline resources, resolving problems associated with capacity constraints and pipeline prorationing.

MBR: Overview

- MBR represents light-handed regulation, not deregulation.
- MBR pipelines
  - Continue to publish their rates in tariffs and remain subject to all ICA and Elkins Act standards – no secret discounting or rebates.
  - Continue to prepare and file annual FERC Form 6 reports.
  - Remain subject to FERC oversight and to protests or complaints of discrimination, unlawful practices, etc.
- FERC may revisit the evaluation of market power should competitive circumstances change.

Basis in Economic Theory

- Basic microeconomic theory teaches that a firm with a monopoly will sell fewer goods for a higher price than a firm operating in a competitive market.
- Limiting a firm's profits through cost-based regulation provides a potential solution to this problem.



P
Consumer Surplus
Deadweight Loss
MC
AC
P_M
P_C
Producer Surplus
D
MR
Q_M
Q_C
Q

Limited Competition

- Standard economic theory suggests that an unregulated monopoly may result in “allocative” inefficiency.
- Other research suggests that firms operating in a market with limited competition will generate some degree of allocative inefficiency—albeit to a lesser degree than a pure monopoly.
- Therefore society has chosen to regulate certain industries that exhibit tendencies to monopoly.

Costs of Cost-Based Rates

- If the allowed rate of return differs substantially from the market rate of return, inefficiency will result.
- Setting rates for pipelines with different levels of competition may present challenges.
- Setting cost-based rates when demand varies significantly over time may present challenges.

Why Incur These Costs?

- These challenges are not insurmountable, but they are also not cost-free.
- The costs are probably worth incurring in the case of a true monopoly.
- Incurring these costs in a competitive market makes much less sense.
- The basic concept and a series of events in the 1980s caused the FERC to begin allowing market-based ratemaking.

MBR: Background

In 1986, DOJ issued key "Report on Oil Pipeline Deregulation"

- Analyzed the ability of oil pipelines to exercise market power and concluded that all crude pipelines (except TAPS) and many products pipelines should be deregulated. Also recommended that all newly-built oil pipelines should not be subject to rate regulation.

- Using principles from DOJ Merger Guidelines, the DOJ Report established the basic analytical framework for oil pipeline market power determinations that FERC uses today.

MBR: Background

Buckeye **case and "light-handed" regulation**

- Buckeye filed a general rate increase in 1987; drew protests.
- On the basis of D.C. Circuit *Farmers Union II* decision, the pipeline argued that non-cost factors, such as competition or lack of market power, may warrant departure from strict cost-of-service rate review of rate filings. FERC agreed and allowed the pipeline to defend its rates on the basis of a showing that its rates were constrained by competitive forces.

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MBR: Background

Buckeye case and "light-handed" regulation

- In Opinion No. 360, issued in 1990, FERC found that Buckeye lacked market power in 15 markets but found that it possessed market power in five markets and issued no finding as to the New York City market.
- Commission granted Buckeye's proposal to implement an "experimental" market-based rate program under which its rates would be controlled by certain rate caps.
- In Opinion No. 391, issued in 1994, Williams granted MBR authority in the majority of its markets, not subject to caps as in Buckeye.

MBR: Background

From *Buckeye* "experiment" to formal standards – Orders 561 & 572

- Following on the heels of the lengthy *Buckeye* and *Williams* cases, Congress passed the Energy Policy Act of 1992, which directed FERC to provide a simplified and generally applicable ratemaking methodology for oil pipelines and to streamline oil pipeline proceedings.
- In response, FERC issued Order 561, establishing indexing as the default mechanism for adjusting oil pipeline rates.
- However, FERC acknowledged that rates set by indexing "do not function well to signal individuals how to efficiently respond to changes in market conditions."

MBR: Background

From *Buckeye* "experiment" to formal standards – Orders 561 & 572

- FERC issued Order No. 572 in 1994, continuing its policy of allowing oil pipelines to show a lack of significant market power to qualify for MBR authority.
- Order 572 sets forth procedural requirements applicable to MBR applications, but FERC declined to adopt substantive requirements, leaving that to case by case development.

MBR: FERC Standards

From *Buckeye* "experiment" to formal standards – Orders 561 & 572

- Elements of an application under Part 348 regs:
  - Statement A—geographic market. This statement must describe the geographic markets in which the carrier seeks to establish that it lacks significant market power.
  - Statement B—product market. This statement must identify the product market or markets for which the carrier seeks to establish that it lacks significant market power.

MBR: FERC Standards

- Elements of an application (cont'd):
  - Statement C—the carrier's facilities and services.
  - Statement D—competitive alternatives. Describe available transportation alternatives in the relevant markets and other competition constraining rates in those markets.
  - Statement E—potential competition. Describe potential competition in the relevant markets. To the extent available, the statement must include data about the potential competitors, including their costs, and their distance in miles from the carrier's terminals and major consuming markets.

MBR: FERC Standards

- Elements of an application (cont'd):
  - Statement F—maps.
  - Statement G—market power measures. Market concentration of relevant markets using the Herfindahl-Hirschman Index (HHI). Set forth carrier's market share based on receipts in its origin markets and deliveries in its destination markets.
  - Statement H—other factors.
  - Statement I—prepared testimony. Serves as carrier's case-in-chief if the Commission sets application for hearing.

MBR: FERC Standards

- Per Order 572, FERC has elaborated standards case by case:
- Pipeline must demonstrate that it lacks market power in its product and geographic markets.
  - FERC defines market power as "the ability profitably to maintain prices above competitive levels for a significant period of time."
  - To measure that ability, FERC assesses competition – *i.e.*, how many good alternatives exist to the pipeline in the relevant product and geographic markets?

MBR: FERC Standards

- How does FERC measure market concentration?
  - Uses the HHI – sum of the squares of the market shares of competitors in the market.
  - In theory, can range from 0 (low concentration) to 10,000 (pure monopoly).
  - HHI of 2500 is bellwether – 4 firms w/ 25% shares
  - Measures both the number of firms and their size relative to market demand.
  - Useful in determining the portion of the market historically controlled by a specific supplier.
  - Measures the probability that a single firm has the ability to exercise market power.

MBR: FERC Standards

- How does FERC measure market concentration?
  - Pipeline must identify "good alternatives" to be weighed in the market concentration, FERC may look to the SSNIP – Small, Significant, Non-transitory Increase in Price.
  - In response to a SSNIP, which alternatives could respond to constrain the price increase?
  - Issue remains subject to debate. Not defined in regulations.
  - Defining the "competitive price" to measure SSNIP is particularly important.
    - Is a regulated rate a good proxy for a "competitive price?"
  - More recently, FERC has held that if an alternative is being used by shippers, by definition it is a good alternative in terms of price.

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MBR: FERC Standards

- So, based on that case development, what factors support a determination that a market is sufficiently competitive?
  - Market's HHI is less than 2,500, with likelihood of approval increasing with HHIs below 1,800.
  - Carrier's delivery-based market share below 50 percent.
  - Waterborne movements into the market are equal to or greater than 10 percent of total consumption in the market.
  - Convincing explanation of why market forces will not allow pipeline to charge prices at supra-competitive levels.
  - Discussion of the commercial realities of the market.

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MBR: FERC Standards

- Frequently litigated: Is a netback analysis required to demonstrate the competitiveness of an oil pipeline origin market?
  - Basic concept: How much profit will a shipper earn going to different markets?
- Example:
  - Price of crude oil in a producing area is $80.
  - Crude oil in destination A sells for $85.
  - Crude oil in destination B sells for $86.
  - Crude oil in destination C sells for $90.
  - Pipeline transportation to each market is $1.
  - So netback will be $4, $5, and $9 respectively.

MBR: FERC Standards

- Pipelines have argued that as long as the alternatives in a market are used by shippers the netback pricing is unnecessary and FERC seems to have accepted this argument in the *Seaway* Rehearing Order.
- Shippers contend that pipelines going to these different markets operate in separate markets and therefore possess monopoly power, particularly if one or more pipelines appears to have the ability to raise rates.
- How has this played out in recent cases?

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MBR: Recent and Pending Cases

Mobil Pipe Line - Pegasus

- Pegasus transports crude oil from Patoka, IL to Nederland, TX.
- Mobil filed an MBR application which was was protested, and the issue of whether Mobil has market power in Pegasus' origin market was set for hearing.
- First litigated MBR application by a crude oil pipeline, and FERC observed, in setting it for hearing, that it raised "novel" issues.

MBR: Recent and Pending Cases

Mobil Pipe Line – Pegasus

- ALJ's Initial Decision concluded that Mobil possesses market power in origin market. FERC affirmed the Initial Decision in December 2010.
- Mobil petitioned to D.C. Circuit, challenging FERC's reliance on a netback analysis and determination that a pipeline's ability to capture a regional price differential demonstrates market power.

MBR: Recent and Pending Cases

Mobil Pipe Line - Pegasus

- April 2012: D.C. Circuit vacated/remanded FERC decision.
- Key issue was <u>market definition</u> – *i.e.*, whether and how to use proxy rate and netback pricing in determining "good alternatives" in that market – *i.e.*, setting the scope of market.
- D.C. Circuit rejected FERC's ruling that Pegasus possessed a 100% market share in origin market, finding producers/shippers have numerous competitive alternatives.

MBR: Recent and Pending Cases

Mobil Pipe Line - Pegasus

- D.C. Circuit was persuaded by FERC Staff testimony
  - Court noted that, if one excludes Pegasus from the analysis and finds origin market competitive, then economic logic suggests that adding a small player like Pegasus to competitive market will not render the market less competitive.
- While FERC had found that, if MBR were granted, Mobil could increase its rates 15% or more, Court rejected this as wrongly premised on Mobil's regulated rate, demonstrating only that the regulated rate is below the competitive rate.

MBR: Recent and Pending Cases

Mobil Pipe Line – Pegasus

- On remand, on August 3, 2012, FERC adhered to D.C. Circuit's rulings and granted Mobil MBR authority.

- The D.C. Circuit's ruling, and its application in subsequent MBR applications, continues to be an issue.

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MBR: Recent and Pending Cases

Enterprise TEPPCO

- Enterprise TEPPCO applied for MBR in three products markets in Louisiana and Arkansas. The application was protested.

- After hearing, FERC ALJ found that Enterprise TEPPCO failed to meet its burden to prove that it could not exercise market power in the three markets. The Commission affirmed the ALJ's ID in Opinion No. 529 (March 5, 2014).

MBR: Recent and Pending Cases

Enterprise TEPPCO – Key issues

- Whether a proxy competitive rate was necessary and, if so, what rate to use?
  - Enterprise TEPPCO opposed use of SSNIP test based on the pipeline's rates, arguing that it was unreliable and arbitrary – cannot be known in the absence of market-based rates.
  - If the existing tariff rate was already aligned with competitive price, then why would anyone file for MBR?

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MBR: Recent and Pending Cases

Enterprise TEPPCO

- Enterprise TEPPCO relied on D.C. Circuit's *Mobil* opinion.
- Shippers and Staff advocated SSNIP using Enterprise TEPPCO's existing rates.
- FERC concluded SSNIP test should be used, distinguishing *Mobil*.
- According to FERC, pipeline must show that, if granted MBR authority, it could not increase its rates such that its delivered price would significantly exceed that of the marginal supplier for a significant period of time.

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MBR: Recent and Pending Cases

Enterprise TEPPCO

- Defining the product market.
  - Enterprise TEPPCO argued that relevant market should include "all pipelineable refined petroleum products" – consistent with past cases – recognizing easy substitution in transit.
  - Others argued for separate markets for each product.
  - FERC found in Enterprise TEPPCO's favor.

MBR: Recent and Pending Cases

Enterprise TEPPCO

- Defining geographic market.
  - Enterprise TEPPCO proposed a Delivered Product Price Test to identify alternatives whose delivered product price at Enterprise TEPPCO terminal was within 1-2% above the lowest delivered price to that county.
  - Shippers and Staff proposed a Tariff Rate Increase Test, which compared the delivered prices in counties to Enterprise TEPPCO delivered price after a 15% increase in Enterprise TEPPCO's rates.
  - FERC rejected both proposals and found Enterprise TEPPCO failed to meet its burden.

MBR: Recent and Pending Cases

Seaway

- Late 2011: Enterprise and Enbridge announce reversal of Seaway to transport crude oil from Cushing to Houston.
- File MBR application; protested.
- Protestants generally argued that a netback pricing analysis would show that Seaway could raise rates, and therefore it possessed market power.

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MBR: Recent and Pending Cases

Seaway

- Seaway filed for summary judgment and, following the D.C. Circuit's *Mobil* Pegasus opinion, filed to urge FERC's adherence to those rulings in its case.

- In May 2012, FERC rejected Seaway's application for failing to consider netback pricing.

- After Seaway filed for D.C. Circuit review, in June 2012, FERC granted rehearing *sua sponte* and sought comments on the proper treatment of the *Mobil* decision in Seaway and the Commission's broader regulations.

MBR: Recent and Pending Cases

Seaway

- July 2012: Numerous comments filed, including by AOPL.
- AOPL argued that FERC should preserve its existing procedures of analyzing competitors actually operating in the market.
- Shippers generally argued that the ability to raise price was indicative of market power and pricing tests were required.
- On February 20, 2014, the Commission issued an Order on Rehearing.

Seaway

- On rehearing, the Commission accepted Seaway's argument that a used alternative is a good alternative finding that "usage" becomes the "proxy" for determining whether an alternative is a good alternative in terms of price, and data concerning usage satisfies the Commission's requirement … that price data be provided to demonstrate that an alternatives is a good alternative in terms of price.

- However, Seaway's application was denied (without prejudice) for failure to present appropriate price evidence.

- The Commission found that the D.C. Circuit's *Mobil* decision did not fundamentally alter its MBR regime.

Seaway: Geographic Markets

- For crude oil pipelines, the geographic origin market is the location where the oil derives.
- This may include fields where crude is produced, in addition to where the pipeline originates.
- This may include other inbound pipelines.
- Applicant has the burden to establish the appropriate definition.

Seaway: Product Markets

- Commission (citing *Brown Shoe*) recognized that the product market consists of those products with sufficient cross-elasticity to constitute effective substitutes.

- What does this mean?
  - Requires an examination of the functioning of the market.
  - Ideally, the applicant will be able to show how composition of product consumption changes as relative prices change.

- Product Market definition may become a fact intense exercise.

- The appropriate product market must be justified by the applicant.

Seaway: Competitive Alternatives

- Proximity is insufficient to establish that a competitor is a good alternatives.
- Price is a relevant consideration if it is not shown that the alternative is being used by shippers.
- However, a simple price comparison is insufficient.
  - A shipper may pay a high pipeline transportation rate to get to a desirable market.
  - Consequently a netback analysis is necessary.
  - A key question in a netback analysis involves the ability to raise price above the *competitive level*.
  - Using a price below this level results in improper netback analysis.
- How do we determine the competitive price level?

Seaway: Competitive Alternatives

- The pipelines' tariff rate may represent the competitive price.
  - Excess demand may provide evidence that the tariff is not the competitive price.
  - The tariff may be far below the competitive price.
- The competitive price is determined by the marginal price of the marginal seller (*i.e.*, the most expensive seller in a market who still has business).
- The marginal netback is the alternative that produces the lowest netback and is still used.
  - Other pipelines?
  - Railroads?
  - Trucks?
  - Barges?

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Seaway: Competitive Alternatives

- This conclusion recognizes a critically important economic fact: if the applicant is the *inframarginal* supplier it may have the ability to raise price.

- If the Commission adheres to this conclusion, it will grant MBR authority to pipelines who face competition and deny authority to those who do not face competition.

Seaway: Implications

- Example:
  - Price of crude oil in a producing area is $80.
  - Crude oil in destination A sells for $85.
  - Crude oil in destination B sells for $86.
  - Crude oil in destination C sells for $90.
  - Pipeline transportation to each market is $1.
  - So netback will be $4, $5, and $9 respectively.
- If shippers are shipping to all three markets pipelines going to all markets are competitors.

MBR: Recent and Pending Cases

What positions and theories are in play post-Pegasus and pre-Seaway?

- What appears to be happening in Cushing since Seaway came into service?
  - WTI-Brent spread has narrowed somewhat as Seaway capacity opens.
  - Spread had been in $20/bbl or higher (i.e. >20%).
  - As Seaway has added capacity, spread dropped below $10, lowest level since January 2012, and was recently as low as $3-$5 (albeit with lower overall oil prices).

MBR: Recent and Pending Cases

- On December 16, 2014, Osage Pipeline filed an application for market-based ratemaking authority for crude oil originating in Cushing and delivered in El Dorado, KS.
- On April 30, 2015, the Commission set both the origin and the destination markets for hearing.
- The Osage case settled before hearing.

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MBR: Recent and Pending Cases

- On October 15, 2013, PBF and Guttman filed a complaint against Buckeye's market-based rates.
- The Commission accepted the complaint on May 2, 2014 and set it for hearing.
- Hearings occurred in October 2015.
- The ALJ issued an initial decision generally upholding Buckeye's market-based rates except at the Harrisburg destination.
- Both sides filed briefs on and opposing exceptions at the Commission in 2016. A Commission order is pending.

MBR: Recent and Pending Cases

- On December 9, 2014, Seaway filed a second application for market-based ratemaking authority.
- On September 15, 2015 the Commission set the case for hearing.
- Trial Staff concluded that Seaway does not have significant market power at its origin market.
- Following a hearings, the Presiding Judge issued an Initial Decision in December 2016 granting Seaway market-based rate authority.
- Briefs on exception were filed in the spring of 2015. A Commission decision is pending.

MBR: Recent and Pending Cases

- *Wood River Pipe Line LLC*
- On May 7, 2017 WRPL, owned by Buckeye, filed an application for market based ratemaking authority for refined products movements from St. Louis to various Midwestern destinations.
- P66 protested the application on July 7, 2017.
- WRPL responded on August 7, 2017.
- We are awaiting Commission action.

MBR: Recent and Pending Cases

- *West Texas LPG Pipeline*
- On August 4, 2017, West Texas LPG Pipeline filed an application to charge market-based rates on its system from Texas and New Mexico origins to Mont Belvieu, Texas.
- This is the first NGL pipeline to file a market-based rate application.

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MBR: Future Developments

- <u>NGL Pipelines</u>
  - Additional NGL Pipelines may seek market-based rates.
  - There are origins and destinations that may qualify.
  - Competitive alternatives to pipeline transportation might include processing plants.

MBR: Future Developments

- Future Crude Oil Applications
  – Pegasus and Seaway show that crude pipelines are increasingly interested in market-based rates.
  – Several origin and destination markets have not been tested (*e.g.*, Bakken and West Texas origins, Midwest destinations).
  – Crude oil market-based rate applications are likely to increase as transportation contracts used to build/expand pipelines expire.

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