Ratemaking Beyond the Basics: Market Based Rates

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Topics We Will Cover

- Introduction to Market-Based Rates
- Theoretical Basis of Market-Based Rates
- History of Market-Based Rates
- Legal Standards Associated with Market-Based Rates
- Pending Market-Based Rate cases
- The current “state-of-play”

Market-Based Rates: Introduction

- What are Market-Bases Rates?

  Tariff rates that can be changed without having to justify the rate change on a negotiated or cost-of-service basis.

- Who can charge Market-Based Rates?

  Market-based rates may be charged only after the FERC has made a determination that a pipeline has sufficient competitive alternatives to restrain it from raising its rates above competitive levels.

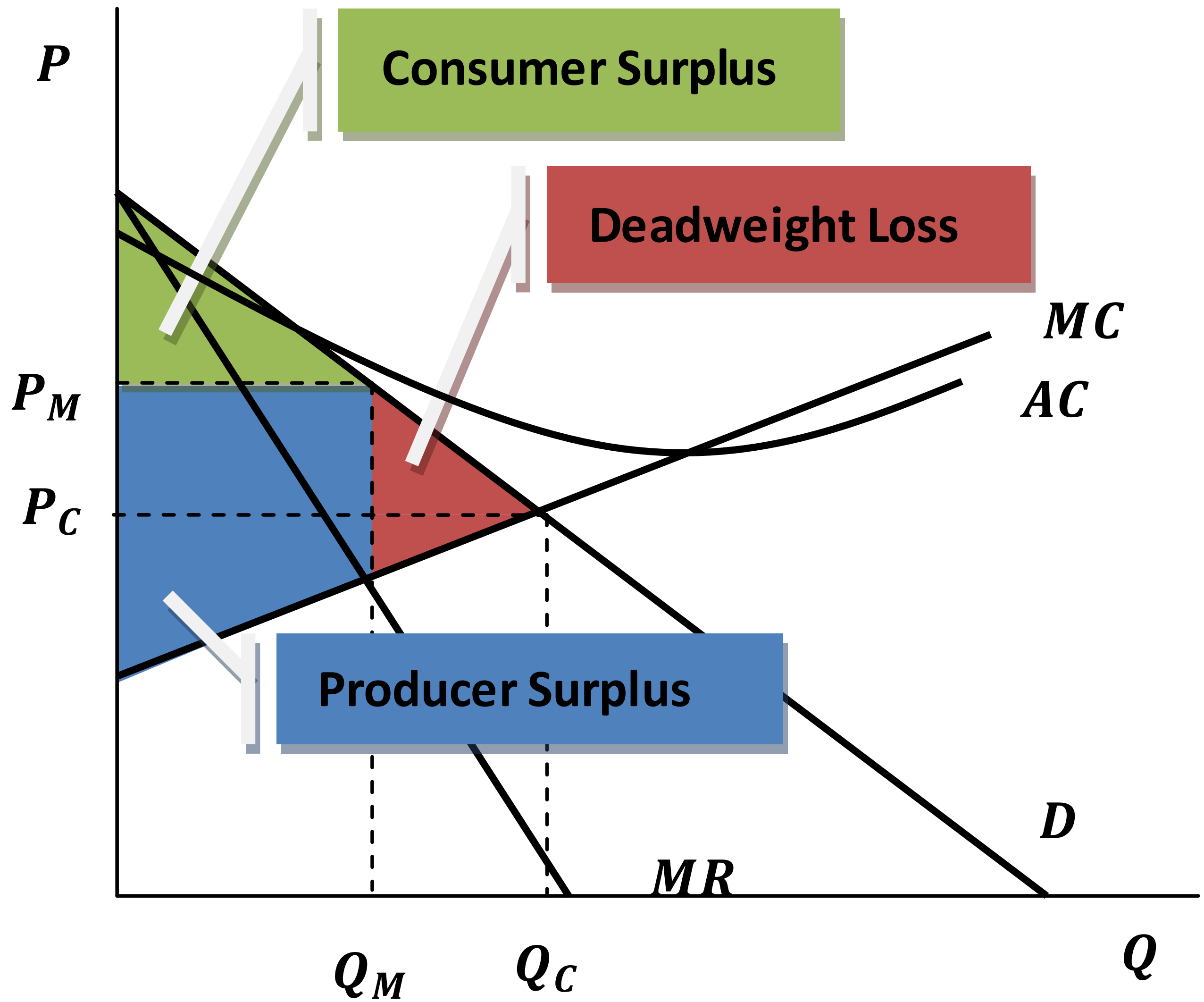
- What are some benefits of Market-Based Rate-Making Authority?
  - Market-based rates allow for greater flexibility in tariff rate structures.
  - No need to make cost of service rate filings or get shipper agreement to increase rates above index ceiling.
  - Market-based rates can facilitate the efficient allocation of pipeline resources, resolving problems associated with capacity constraints and pipeline prorationing.

Market-Based Rates Introduction (Cont' d.)

- Market-based rates are not deregulation.
- Oil pipelines must continue to publish market-based rates in tariffs and remain prohibited from secret discounting or rebates.
- Oil pipelines must also continue to prepare and file annual FERC Form 6 reports.
- The Commission maintains oversight and will continue to entertain protests or complaints of discrimination, unlawful practices, etc.
- The Commission may revisit the evaluation of market power should competitive circumstances change.

Theoretical Basis of Regulation

- 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 firms profits through cost-based regulation provides a potential solution to this problem.


Consumer Surplus
Deadweight Loss
Producer Surplus
P
P_M
P_C
MC
AC
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 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 costless.
- 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.

Market-Based Rates
Historical Background and Development

- The 1986 U.S. Department of Justice "Report on Oil Pipeline Deregulation" analyzed the ability of crude and petroleum products 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.

Market-Based Rates
Buckeye and "Light-handed" Regulation

- Buckeye is a petroleum products pipeline extending across numerous states, primarily in the Midwest/Great Lakes region. Filed a general rate increase applicable to all of its lines in 1987 that was protested.

- On the basis of the D.C. Circuit's *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.

- In Opinion No. 360, FERC found that Buckeye lacked market power in 15 markets but found that it possessed market power in five markets. Commission granted Buckeye's proposal to implement an experimental program by which its rates would be controlled by certain rate caps.

- In subsequent order, Opinion No. 391, the Commission granted Williams market-based rate authority in some of its markets.

Market-Based Rates Energy Policy Act of 1992 and Order No. 572

- In the Energy Policy Act of 1992, Congress directed FERC to promulgate regulations to provide a simplified and generally applicable ratemaking methodology for oil pipelines and to streamline procedures in oil pipeline proceedings.
- In response, FERC issued Order No. 561, which established indexing, and Order No. 572, in which FERC continued its policy of allowing an oil pipeline to attempt to show that it lacks significant market power in markets in which it proposes to charge market based-rates.
- Order No. 572 sets forth procedural requirements applicable to market-based rate applications, but the FERC declined to adopt substantive requirements (*e.g.*, particular HHI thresholds).
- Order No. 572 allows a market-based rate applicant to make use of the record (*e.g.*, HHI statistics about a particular market) in a prior market-based rate proceeding if that information is public and not out-of-date.

Market-Based Rates Applications Approved Without a Hearing

- On numerous occasions, FERC has issued orders approving market-based rate applications without requiring a hearing.
  - Explorer (granted application over protests)
  - Kaneb
  - Longhorn (also granted petition to charge MBRs as initial rates)
  - West Shore
  - Colonial (granted after protests withdrawn)

Market-Based Rates
MBR Applications Withdrawn or Modified

- On other occasions, often as the result of a protests, an applicant has withdrawn or modified the original application.
  - TEPPCO (1999 application was protested, and the parties ultimately reached a settlement)
  - Wolverine (1999 application was protested, MBR authority was granted in uncontested markets, and the application was ultimately approved in modified form)
  - Marathon Ashland (2000 application was modified and then approved)

Market-Based Rates MBR Applications Withdrawn or Modified (Cont'd.)

- Chase (2001 application was withdrawn)
- Rocky Mountain (2002 application withdrawn after it was protested and set for hearing)
- Sunoco (2005 application was protested, MBR authority was granted in uncontested markets, and the application was ultimately approved in a modified form)

Market-Based Rates Recent/Pending Applications

- Mobil Pipe Line Company
  - Pegasus pipeline was reversed in 2006 and now transports crude oil from Patoka, IL to Nederland, TX. In connection with a proposed capacity expansion, MPLCO filed an application in 2007 seeking market-based rates. Application was protested, and the issue of whether MPLCO has market power in Pegasus' origin market was set for hearing.
  - This is the first litigated MBR application by a crude oil pipeline, and the Commission observed, in setting it for hearing, that the application raised "novel" issues.
  - Initial Decision by Administrative Law Judge was issued on August 5, 2009 and concluded that MPLCO possesses market power in Pegasus' origin market. FERC affirmed the Initial Decision on December 3, 2010.
  - MPLCO filed a petition for review with the D.C. Circuit in June 2011, challenging the Commission's reliance on a netback analysis, and its determination that a pipeline's ability to capture a regional price differential is conclusive evidence of market power. Oral argument was conducted on November 17, 2011.

Market-Based Rates Recent/Pending Applications

- Mobil Pipe Line Company
  - On April 17, 2012, the Court vacated the FERC's decision and remanded it back to the FERC.
  - The Court held that the mere ability of an oil pipeline to raise prices does not suggest that an oil pipeline possesses monopoly power.
  - The Court found that Mobil's extremely low market share (around 3%) proved that it did not possess market power.
  - The Court disagreed with the Commission's assumption that the prevailing tariff rate was the appropriate "competitive rate" for use in a netback analysis.
  - On August 3, 2012 the Commission granted market-based ratemaking authority to Mobil.

Market-Based Rates Recent/Pending Applications (Cont'd.)

- Magellan
  - On June 2, 2009, Magellan filed a market-based rate application for transportation of petroleum products from its Houston origin to its Tulsa destination.
  - In its application, Magellan noted that the Commission had previously found both markets to be competitive and has granted market-based rate authority to other pipelines in those markets.
  - No interventions or protests were filed.
  - Commission granted market-based rate authority on September 25, 2009.

Market-Based Rates Recent/Pending Applications (Cont'd.)

- Magellan
  - On January 15, 2010, Magellan filed a market-based rate application for transportation of petroleum products on its Mountain System from the McPherson-El Dorado, Kansas origin market to the Denver destination market.
  - Frontier Oil and Sinclair Oil protested the application.
  - On July 7, 2010, the Commission set for hearing the issue of whether Magellan has market power in its origin market.
  - After the submission of two rounds of testimony, the pipeline and protestants entered into settlement negotiations.
  - On July 1, 2011, Magellan and Frontier filed a joint offer of settlement to resolve all issues.
  - FERC Trial Staff filed comments in opposition to the settlement, which is currently pending.

Market-Based Rates Recent/Pending Applications (Cont' d.)

- Enterprise TEPPCO
  - On March 1, 2011, Enterprise TEPPCO filed an application for authority to charge market-based rates for products transportation to three destinations – Arcadia, Louisiana; Little Rock, Arkansas; and Jonesboro, Arkansas.
  - Lion Oil and Chevron Products challenged the application and argued it should be summarily dismissed.
  - The Presiding Judge rejected these claims.

Market-Based Rates
Recent/Pending Applications (Cont' d.)

- Enterprise TEPPCO
  - Both sides filed several rounds of pre-filed testimony.
  - A hearing was conducted before Deputy Chief Judge McCartney.
  - The case is currently in the briefing stage.

Seaway

- In late 2011, Enterprise and Enbridge announced the reversal of Seaway pipeline to transport crude oil from Cushing to Houston.
- On December 2, 2011 Enterprise/Enbridge filed an application for market-based ratemaking authority.
- On February 14, 2012 numerous shippers filed protests of this application.
- Their arguments generally revolved around the assertion that a netback pricing analysis would show that Seaway could raise rates, and therefore it possessed market power.

Seaway Cont.

- Seaway filed a response and motion for summary judgment on February 29, 2012.
- Seaway filed a supplemental motion on May 2, 2012 asking the Commission to consider the *Mobil* decision issued a few days earlier.
- On May 7, 2012 the Commission issued an order rejecting Seaway's application for failing to consider netback pricing.
- On June 28, 2012 , the Commission issued an order seeking additional comments on the proper role of the *Mobil* decision in both Seaway and the Commission's broader regulations.

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Seaway Cont.

- On July 18, 2012 a number of parties, including AOPL, filed motions to intervene.
- As discussed below, AOPL argued that the Commission 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.

Market-Based Rates
The Application of 18 C.F.R. §348

- If a carrier wishes to establish that it lacks significant market power in a market it serves, it must file an application with the Commission that:
  - Defines the relevant geographic market(s)
  - Defines the relevant product market
  - Identifies its facilities and services
  - Identifies competitive alternatives
  - Identifies potential competition
  - Calculates market power measures

Market-Based Rates
Evaluating Market Concentration

- The FERC has relied upon the Herfindahl Hirschman ("HHI") indices to measure market concentration, market share, and other relevant factors, such as excess capacity, to estimate market power.
- The HHI examines both the number of firms and their size relative to market demand.
- A market-share calculation is useful in determining the portion of the market historically controlled by a specific supplier.
- These statistical measures are used to evaluate the probability that a single firm has the ability to exercise market power.

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Market-Based Rates
The Herfindahl Hirschman ("HHI") Index

- The HHI is the sum of the squared percentage market shares.
- HHI values range in value from 0 (least concentration/most competition) to 10,000 (absolute monopoly).

Market-Based Rates Competitive Markets

- Factors that support a determination that a market is sufficiently competitive include:
  - The market's HHI is less than 2,500, with the likelihood of approval increasing substantially for markets with HHIs below 1,800.
  - The carrier's delivery based market share is less than 50 percent.
  - Waterborne movements into the market are equal to or greater than 10 percent of total consumption in the market.
  - The carrier has provided a convincing explanation of why market forces will not allow the pipeline to charge prices at supra-competitive levels.
  - The carrier has provided a convincing explanation of why securing market-based rates and setting rates on the basis of market forces is critical to the viability of the pipeline.
- Is a netback analysis required to demonstrate the competitiveness of an oil pipeline origin market?

On Netbacks

- The basic concept of a netback is how much profit will a shipper earn going to different markets.
- Example:
  - The 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.
  - In this hypothetical example, the netback will be $4, $5, and $9 respectively.

On Netbacks cont.

- AOPL's position would be that as long as pipelines going to each of these markets is used the netback pricing is irrelevant.
- The shippers position would be 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.

On Netbacks Cont.

- This shippers in *Mobil* used this technique to generate a result that he DC Circuit said was unreasonable.
- This approach tends to produce very narrow markets that often resemble “corridors”; The Commission has rejected corridor analyses for almost 20 years.
- This approach tends to suggest that the least expensive pipeline going to the best market has a monopoly.
- It also sometimes suggests that a new entrant possesses market-power.
- The *Mobil* Court found this last outcome baffling and rejection of the idea that new entry can *reduce* competition appears to have formed at least part of the basis for vacating the FERC’s decision.

Conclusion

What have we learned?

Questions

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