Advanced Topics in Market-Based Rates

- **Amy Hoff**, CBL Energy Law, PLLC
- **Ainur Rodgers**, Regulatory Economics Group, LLC
- **Bob Van Hoecke**, Regulatory Economics Group, LLC

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Agenda

- Overview of Market-Based Rates (MBR)
- Identifying Good Competitive Alternatives
  - Used Alternative Test
  - Good economic alternative
    - Netback Analysis (origin)
    - Delivered Price Analysis (destination)
    - DCF Analysis (potential new entrant)
- Pass-Through Markets
  - Prior Commission Concerns
  - Relevant Market Metrics

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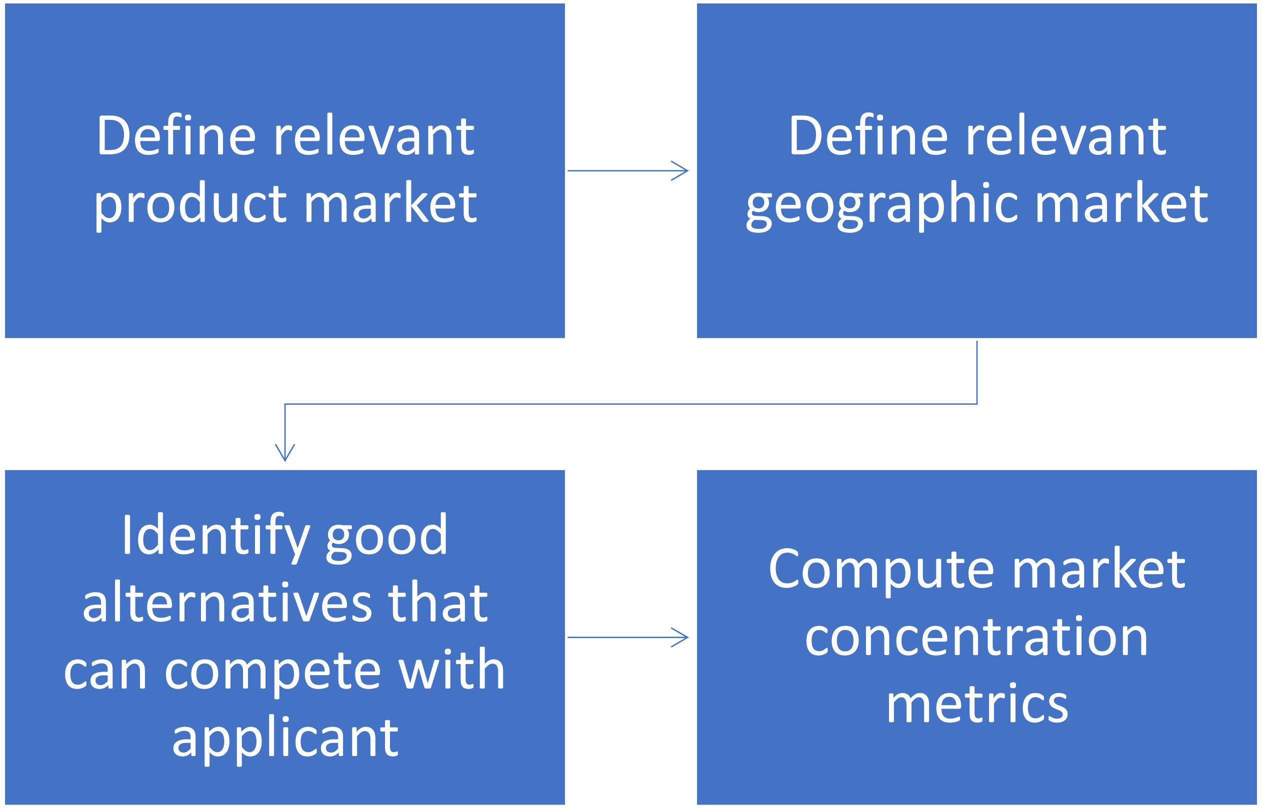
Analytical Framework Overview

Analytical Framework Overview



Analytical Framework Overview

- Per Order 572, FERC has elaborated standards on a case-by-case basis.
- 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 the level of market concentration (competition) – *i.e.*, how many good alternatives exist to the pipeline in the relevant product and geographic markets?

MBR: FERC Standards

- Pipeline must identify “good alternatives” to be weighed in the market analysis.
  - Good alternative in terms of price, quality, availability
- How does FERC measure market concentration?
  - Uses the HHI – sum of the squared market shares of each of the competitors in the market – as primary factor.
  - HHI of 2,500 is bellwether – 4 firms w/ 25% market shares
  - Measures both the number of firms and their size relative to market demand.
  - Measures the probability that a single firm could exercise market power.

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Identifying Good Competitive Alternatives

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MBR: Good Economic Alternative

Frequently litigated: Is a detailed price analysis required to demonstrate the competitiveness of a proposed geographic market?

- At times the development of the relevant markets or the alternatives that operate therein may require an evaluation of how shippers would react in response to a SSNIP (Small but Significant Non-transitory Increase in Price).
    - SSNIP typically defined as 15% above the *competitive price*
    - In response to a SSNIP, which alternatives could shippers turn to and avoid the SSNIP, thereby constraining the price increase?
- Defining the "competitive price" to measure SSNIP is particularly important.
    - In market-based applications the "competitive price" is generally considered the margin price in the market.
    - When evaluating existing market-power authority the Commission has expressed concern with assuming the existing marginal price is the competitive price especially when the margin supplier is the subject carrier.
- "Used Alternative" Test - In the context of an MBR application, FERC has held that if an alternative is being used by shippers, revealed preferences suggest that tit is a good alternative.

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MBR: Basic concept

How much profit will a shipper earn going to different markets (netback analysis) or coming from different markets (delivered price analysis)?

- Example (origin market - netback):
  - 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 (profit) will be $4, $5, and $9, respectively.

Market	Market Price	Producing Area	Transportation Cost	Netback
A	$85	($80)	($1)	$4
B	$86	($80)	($1)	$5
C	$90	($80)	($1)	$9

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MBR: Good Economic Alternative

- Pipelines have argued that as long as the alternatives in a market are <u>used</u> by shippers, the netback pricing analysis is unnecessary; FERC accepted this argument (in the context of an MBR application) in the *Seaway* Rehearing Order.
- Shippers contend that pipelines going to these different markets operate as 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?

MBR: Key Decisions

Mobil Pipe Line Company – Pegasus ("Mobil")

- Pegasus transported crude oil from Patoka, IL to Nederland, TX.
- August 2007: Mobil (owner/operator of Pegasus) filed an MBR application that was protested and the issue of whether Mobil had 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.
- Key issue was <u>market definition</u> – whether and how to use a proxy rate and netback pricing in determining "good alternatives" in the market – *i.e.*, setting the scope of market.

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MBR: Key Decisions

Mobil

- August 2009: ALJ's Initial Decision concluded that Mobil possessed market power in the origin market.

- December 2010: The Commission affirmed the Initial Decision.

- FERC had found that, if MBR were granted MBR authority, Mobil could increase its then current rates 15% or more and therefore possessed market power,
  - The Court later rejected this as wrongly premised on Mobil's regulated rate, demonstrating only that the regulated rate is below the competitive rate.

MBR: Key Decisions

Mobil

- Mobil petitioned to the 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.

- April 2012: D.C. Circuit rejected FERC's ruling that Pegasus possessed a 100% market share in its origin market, finding producers / shippers have numerous competitive alternatives.

- August 2012: On remand, FERC adhered to the 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 a potentially disputed issue.

MBR: Key Decisions

Enterprise TEPPCO

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

- After hearing, the ALJ found that Enterprise TEPPCO failed to meet its burden to prove that it could not exercise market power in the three markets.

- March 2014: The Commission affirmed the ALJ's ID in Opinion No. 529.

MBR: Key Decisions

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: Key Decisions

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.

MBR: Key Decisions

Seaway

- December 2011: prior to the reversal of Seaway to transport crude oil from Cushing to Houston, Enterprise and Enbridge filed MBR application, which was protested.

- Protestants generally argued that a netback pricing analysis would show that Seaway could raise rates, and therefore it possessed market power.

- 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.

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

MBR: Key Decisions

Seaway

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

- 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.

- February 2014: the Commission issued an Order on Rehearing.

MBR: Key Decisions

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 due to absence of operational data.

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

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MBR: Key Decisions

Seaway I

- December 2014: Seaway filed a second MBR application, which was protested.
- A key issue was defining good alternatives
- <u>Competitive Alternatives</u>:
  - Proximity alone is insufficient to establish that a competitor is a good alternative.
  - Price is a relevant consideration if it is not shown that the alternative is currently 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 detailed pricing analysis is necessary.
    - A key question in a delivered price analysis involves the ability to raise price above the *competitive level*.
    - Using a price below this level results in improper analysis.
  - How do we determine the competitive price level?

MBR: Key Decisions

Seaway I– <u>Competitive Alternatives</u>

- The applicant's 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 supplier (*i.e.*, the most expensive supplier in a market who still has business).
- The marginal netback is the alternative that produces the lowest netback and is still used. The marginal delivered price is the alternative that produces the highest delivered price and is still used.
- May 2018: the Commission granted MBR authority to Seaway.

Pass-Through Markets

MBR: Pass-Through Markets

In recent proceedings, parties have raised concerns regarding the proper way to define the geographic market or measure market concentration when there are "pass-through volumes"—that is, volumes that "pass through" a market but do not originate from the market and are not delivered to the market.

- In the *Mobil* proceeding, participants disagreed on the definition of the origin market for the Pegasus pipeline. Shippers argued that there are no good alternatives and limited their definition to Pegasus alone. CAPP asserted that the geographic market was the Patoka, IL crude hub.
- When challenging the Cushing Origin Market in *Seaway*, shippers asserted that the Western Canadian Sedimentary Basin should be evaluated as the origin for Canadian crude that subsequently passes through Cushing on its way to the Gulf Coast.
- Shippers in *MPLX Ozark* asserted that volumes MPLX transported through Wood River to Patoka should be ignored in an effort to restrict the MPLX destination market to Wood River/Roxana, Illinois.
- FERC Staff asserted that the effective capacity-based HHI methodology was inappropriate in *WTG* for the proposed Tyler, Texas destination market due to significant excess pipeline capacity and pass-through volumes.
- Recently, in *Plains*, the Commission expressed concerns due to the level of pass-through volumes delivered into the Wichita Falls destination market, where consumption is zero.

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MBR: Pass-Through Markets

Mobil

- April 2012: The Court in *Mobil* found when there are barrels that originate outside of a particular origin market and pass through that market while *en route* to their destination, the appropriate origin market analysis focuses on whether producers and shippers in the remote origin markets <u>must rely so heavily on the applicant</u> for transportation of their product that the applicant can be said to possess market power over the barrels that are produced in remote areas.
  - The Pegasus pipeline transports almost exclusively Western Canadian crude oil.
  - The *Mobil* decision cited Trial Staff's definition consisting of the competitive alternatives available for producers and shippers of Western Canadian crude oil to transport or sell their crude oil.
- August 2012: The Commission granted MBR authority to Mobil.

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MBR: Pass-Through Markets

Seaway

Another Key Issue was <u>Geographic Market</u>

- 2012 - *Seaway I*, the Commission found:

  "[i]n certain origin markets where inbound pipelines provide crude oil from other production fields that is then shipped on the applicant pipeline, such fields may also be included in the geographic market."

- 2016 - *Seaway ID*:
  - The number of options available to shippers in remote markets cannot be less than those at Cushing.
  - ALJ concluded that since Seaway lacked market power in the Oklahoma Market, it was not necessary to define and analyze remote production basins.
- 2018 – Seaway Opinion No. 563
  - The Commission affirmed Seaway ID's definition of the geographic market.

MBR: Pass-Through Markets

MPLX Ozark Pipe Line LLC (“MPLX Ozark”)

- December 2018: MPLX Ozark filed an MBR application for the transportation of all crude oil from an origin market consisting of the State of Oklahoma to a destination market consisting of the counties located in BEA160 (St. Louis-St. Charles-Farmington, MO-IL).
- The application was protested.
  - Protestants challenged the competitiveness of BEA 160 and proposed an alternate destination market based on location of their refinery in Lima, Ohio.
- June 2019: the Commission granted the application as to the origin market and set for hearing the issues of the product market and destination market.

MBR: Pass-Through Markets

MPLX Ozark

- September 2020: The Presiding Judge issued an ID and recommended denial of MPLX Ozark's MBR application.
- ID found that the appropriate product market was transportation of all grades of crude oil (largely uncontested).
- Found the appropriate geographic market should be restricted to Wood River/Roxana, Illinois.
  - Rejected MPLX Ozark's argument that Patoka should be included in the destination market because a substantial volume moving on the pipeline did not stop in Wood River, but rather were delivered to Patoka via an affiliated pipeline.
  - Existence of affiliate relationships was a significant issue in the proceeding.
  - ALJ rejected MPLX Ozark's trucking/refinery analysis demonstrating that heavy crude oil could be economically trucked from Patoka to Wood River in response to a supra-competitive price increase.

MBR: Pass-Through Markets

MPLX Ozark

- July 2022: The Commission reversed the ID in Opinion No. 578.
  - **The Commission held that the geographic market must be expanded "based on where shippers may look for alternatives in the event of a price increase."**
  - The Commission rejected the protestant's claim that the marginal supplier must be the pipeline applicant, because it was the only one that served that **route**.
- June 2024: The DC Circuit Court upheld the FERC decision to combine Wood River and Patoka as a relevant destination market for MPLX Ozark.

MBR: Pass-Through Markets

West Texas Gulf Pipe Line Company LLC and Permian Express Partners LLC ("WTG / PEP")

- May 2019: WTG filed an MBR application for the transportation of crude oil from its origin market in the Permian Basin to its destination markets in the Gulf Coast and East Texas (Tyler, Texas area).
  - The application drew protests from several parties
  - Protestants challenged the product market, one of the destination markets, and proposed two alternative destination markets—the Lima Refinery and the Toledo Refineries in Ohio
- August 2019: PEP filed an MBR application for the transportation of crude oil from three origin markets – the Permian Basin, the Fort Worth Basin, and the Haynesville production area – to two destination markets, the Gulf Coast and East Texas (Tyler, Texas) (same destination markets proposed in WTG application). Proceedings consolidated.

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MBR: Pass-Through Markets

WTG / PEP

- ID issued March 18, 2022
  - The “Tyler Destination Market” based on 75-mile trucking radius is an appropriate geographic destination market for the Tyler, Texas region.
  - Accepted Staff’s narrowed “Nederland Destination Market” and “Anchorage Destination Market” as the relevant geographic destination markets over WTG’s use of Gulf Coast area (previously approved by the Commission).
  - Concluded that Applicants may be granted market-based rates for their delivery points in the Nederland and Anchorage Destination Markets but may not be granted them in the Tyler Destination Market.
- Sept. 2023: the Commission affirmed the ID in Opinion No. 584.

MBR: Pass-Through Markets

WTG / PEP

- Trial Staff raised concerns with the use of the Effective Capacity Method in Tyler Market, as more volumes passed through the market than were consumed within the market.
  - Staff's proposed effective capacity method reflects an assumption that:
    - shippers would not transport more crude oil than the market is able to consume, or
    - that a pipeline's capacity which is above market consumption would be used to control the market.
  - Tyler is an intermediate market and consumption in the market (by a sole refinery) is far less than total deliveries to the market, the large majority of which travel further downstream to the Gulf Coast and other markets.
  - Trial Staff argued that capping each competitive alternative's capacity at the capacity of the Tyler Refinery may lead to an understated HHI.
- The Commission acknowledged Staff's concern but found that the record was insufficient to adopt any of the alternative methods presented by the Staff.

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MBR: Pass-Through Markets

Plains Pipeline, L.P. and Sunrise Pipeline LLC (together, Plains):

- June 2023: Plains filed an MBR application for the transportation of crude oil on Basin Pipeline and Sunrise II Pipeline from origin points in the Permian Basin and Fort Worth Basin to destinations in Northern Texas and Oklahoma (Application).
- August 2024: the Commission issued an Order granting Plains MBR authority for the proposed Permian Basin origin market, Fort Worth Basin origin market, Cushing destination market, and Duncan destination market.
- Additional information was necessary to evaluate the proposed Wichita Falls destination market.
- Paper hearing procedures are ongoing.

MBR: Pass-Through Markets

Plains:

- The Commission expressed concern that market concentration statistics computed using the effective capacity method may be understated for an intermediate market that does not contain local refinery consumption.
  - This treatment results in proposed HHI and market share figures of zero and suggests that perfect competition exists in the Wichita Falls destination market.
- The Commission requested an alternative delivery-based HHI and delivery-based market shares, an alternative capacity-based HHI and capacity-based market share for the Wichita Falls destination market.
- The Commission further indicated that "Applicants may propose a broader geographic market for Applicants' Wichita Falls delivery points and provide additional evidence and support for the Commission to adopt such market" or "additional information or arguments addressing the Commission's concerns discussed in the order."

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