Allocating Pipeline Capacity: Navigating Priority Service and Proration Policies

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SEPTEMBER 27, 2018

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Introduction and Overview

- Allocation and the Tension it Creates
- Standard Approaches
- Best Practices
- New Capacity and Preferential Capacity Rights
- Several Cases

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Allocation and the Tension it Creates

- Prohibition Against Undue Discrimination
  - Section 2(1) of the Interstate Commerce Act states, "It shall be unlawful for any common carrier… to make, give or cause any undue or reasonable preference or advantage to any particular person…"
- All Rates Must be Just and Reasonable
  - Section 1(5) of the Interstate Commerce Act states, "All charges made for any service … shall be just and reasonable, and every unjust and unreasonable charge … is prohibited and declared to be unlawful."

Allocation and the Tension it Creates: the obvious cases

- Charging different rates to shippers who are in every way alike constitutes "undue discrimination."
- Rates for liquids transportation service must be just and reasonable.
- The interplay between these two requirements creates tension, particularly in contrast to unregulated firms.

Unregulated Firms in a Time of Excess Demand

- When an unregulated firm faces excess demand, it will ration its goods in various ways.
- It may:
  - Raise prices
  - Offer priority to particularly loyal customers
  - Sell options to purchase service in times of high demand
- Most of these approaches would run afoul of either the requirement to charge just and reasonable rates or the prohibition against undue discrimination if not implemented carefully.

What Options Are Available

- The Interstate Commerce Act does not forbid all discrimination: it only forbids undue discrimination.
- Therefore, offering priority based on some legitimate differentiating factor (*e.g.*, past shipments) is typically permissible.
- Just and reasonable does not require a cost-basis.
- Negotiated rates may exceed cost but still fall within the "zone of reasonableness."

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Standard Approaches to Allocation

- Typically two standard approaches have existed to allocate capacity in times of high demand.
- Nomination Based: All shippers receive their pro-rata share of their nomination.
- Historical: All shippers receive their pro-rata share of their historical shipments (typically with a 10% set-aside for new shippers).

Standard Approaches: Imperfections

- The nomination-based allocation approach (implicitly) assumes that shippers will truthfully state their needs.
- If shippers overstate their true needs they can “game” the system.
- The historical approach avoids this problem but may lock in existing patterns.
- Neither approach leads to the perfectly efficient outcome.

Best Practices

- Allocation will necessarily create “winners” and “losers”.
- The perfectly efficient solution would allocate space to the shippers who value it most.
- Allowing pipelines to charge what the market would bear would allocate space to the shippers who value it most, but in cases where the pipeline has market-power could run afoul of the just and reasonable rate requirement.

Best Practices: Continued

- Parties will find rhetorically plausible justifications for their preferred approach.
  - Shippers favoring a historical approach will emphasize their investment in complimentary infrastructure.
  - Shippers favoring a nominations-based approach will emphasize a changing market.
- A principles-based approach gets away from this rhetorical dead-end.

Best Practices: Principles

- Minimize Incentives for Inefficient Actions
- Minimize Undue Preference in Effect
- Align Apportionment to Need
- Minimize Lock-In of Current Market Conditions
- Minimize Overall Apportionment Levels

Examples of Incentives for Inefficient Actions

- Nominations-based apportionment models provide an incentive to nominate well above actual need.
- A short historical window may provide an incentive to avoid infrastructure investments.
- A desire to maintain history on a pipeline may cause firms to ship when they do not really “need” to.

Examples of Undue Preference in Effect

- If a pipeline has multiple segments, and allocates each segment separately, long-haul shippers may be more severely allocated than short-haul shippers.
- If a pipeline does not require binding nominations when apportionment is imminent, shippers with the ability to quickly fill unused space may have an advantage.

Examples of Failing to Align Apportionment with Need

- A nominations-based approach may provide space to shippers who place a relatively low value on the space.
- On the other hand, in a changing market, an historic approach may prevent new shippers engaged in more valuable activity from getting space on the line.

Examples of Lock-In

- A strictly historic apportionment policy would significantly lock in current market conditions.
- For this reason, the FERC typically requires at least 10% of a pipeline's space to be set aside for new shippers.
- Calculating History based on a rolling average rather than a point in time also mitigates this issue.

Examples of Minimizing Apportionment Levels

- A desire to maintain history may cause shippers to ship even in times of low demand, thereby increasing the frequency of apportionment.
- Alternatively, a desire to maintain history may cause shippers to ship at “off peak” times thereby decreasing the severity of apportionment.
- As this example shows, applying these principles is a fact intensive process.
- Many of these issues have a different tone when considering “New Capacity”.

New Capacity and Preferential Capacity Rights

- Origin and Basis
  - *Sea-Land Service, Inc. v. ICC*, 738 F.2d 1311 (D.C. Cir. 1984)
    - Contract rates are not per se violations of the common carrier duty of non-discrimination.
    - Contract rates are not inherently discriminatory provided that the carrier makes the contract rates available to all similarly-situated shippers of like commodities.
  - *Sea-Land*, along with Sections 2 and 3(1) of the Interstate Commerce Act, lead to FERC's focus on:
    - whether shippers with differing rates and/or terms and conditions of service are similarly-situated
    - whether the pipeline held or will hold an open season making the proposed rates and/or terms and conditions of service available to potential shippers.

New Capacity and Preferential Capacity Rights

- Origin and Basis
  - Express Pipeline Partners, Docket No. OR96-11
    - FERC approved the pipeline's proposed 5-, 10-, and 15-year term commitments, with tiered rate discounts corresponding to the length of commitment.
    - FERC found no undue discrimination or undue preference.
      - Committed shippers were not similarly-situated with uncommitted shippers.
      - Different types of committed shippers were not similarly-situated with each other.
      - Differing rates and terms reflected differences in the circumstances of different types of customers.

New Capacity and Preferential Capacity Rights

- Origin and Basis
  - Caesar, Proteus, and Enbridge
    - In 2003 and 2006, the Commission granted petitions for declaratory orders to proposed oil pipelines located solely on the Outer Continental Shelf, stating that each such pipeline would be allowed to:
      - function as a contract carrier,
      - hold an open season,
      - enter into long-term transportation contracts reflecting contract carriage principles,
      - give those contracts precedence in allocating capacity, and
      - contract for capacity that remains available after the open season closes on a first-come, first-served basis.
    - FERC's ruling was based on its then-current interpretation of its authority under Outer Continental Shelf Lands Act.

New Capacity and Preferential Capacity Rights

- Current Status – Petitions for Declaratory Order
  - The Caesar and Proteus petitions for declaratory order and resulting orders led to a new wave of requests for regulatory assurances from FERC related to new and expanding liquids pipeline capacity. These are now the industry norm.
  - In one FERC proceeding—Southern Lights—the Presiding Judge relied heavily on the declaratory order and used it to generally reject most claims raised by uncommitted shippers.
  - It is better to seek FERC approval from the outset rather than in a complaint or protest context because the pipeline's greatest leverage occurs prior to the infrastructure being operational and its greatest risk occurs after.

New Capacity and Preferential Capacity Rights

- Current Status – Petitions for Declaratory Order
  - It may be risky for a pipeline to rely on another pipeline's declaratory order unless the facts in both cases are precisely the same. FERC has made clear that its rulings are made on a case-by-case basis and that these filings are evaluated as a package.
  - It is important to remember that the types of preferential capacity rights FERC is approving in the context of these declaratory orders has not been reviewed by the courts; the courts could find these arrangements to be inconsistent with the ICA.

New Capacity and Preferential Capacity Rights

- Current Status – Open Seasons
  - A pipeline must hold an open season if it intends to award preferential capacity rights to shippers making term and volume commitments.
    - FERC views the open season process as important to its determination as to whether there is undue discrimination or undue preference.
    - An open season allows the carrier to demonstrate that potential shippers are provided with an equal opportunity to commit to particular types of service and/or rates offered by the pipeline.

New Capacity and Preferential Capacity Rights

- Current Status – Open Seasons
  - A pipeline must hold an open season if it intends to award preferential capacity rights to shippers making term and volume commitments.
    - Wide publication of the existence of the open season ensures that potential shippers are aware of the opportunity to make the commitments offered.
    - FERC Staff expects press releases, regardless of whether the pipeline views these as generating any shipper interest.
    - The mere fact that a pipeline has held an open season is not enough to ensure FERC approval of different rates or classes of service for different shippers—For example, an open season tailored, with no commercial basis, to be available to only a single shipper would probably not withstand scrutiny.

New Capacity and Preferential Capacity Rights

- Current Status – Cost of Service Elements
  - FERC has on occasion approved specific cost-of-service elements but generally avoids doing so.
  - FERC has generally declined to provide assurances regarding specific returns on equity and specific capital structures.
  - FERC has provided assurances regarding depreciation rates.
  - Concerns regarding how the pipeline's revenue requirement is apportioned between committed and uncommitted shippers have prompted requests for assurances in this area.
  - FERC has approved the use of the depreciated original cost methodology rather than the trended original cost methodology typically used by oil pipelines since the issuance of Opinion No. 154-B.

New Capacity and Preferential Capacity Rights

- Current Status - Access to Capacity
  - Several pipelines have sought assurance that they can provide preferential capacity rights to shippers making long-term commitments that support construction.
  - Long-term commitments provide the financial underpinning for construction and often for securing financing.

New Capacity and Preferential Capacity Rights

- Current Status - Access to Capacity
  - FERC has approved preferential capacity arrangements for committed shippers under certain circumstances.
  - FERC has ruled that new and expanding pipelines can provide firm service, not subject to prorationing under normal operating conditions, provided that the committed shippers pay a premium rate in relationship to the rate for uncommitted shippers.
  - If a shipper pays a discount rate or a rate equal to the uncommitted rate, it is not permissible to provide firm service.

New Capacity and Preferential Capacity Rights

- Current Status – Access to Capacity - How "Premium" Must a Rate Be to Permit Firm Service
  - In OR11-22, Sunoco Pipeline sought a premium rate for committed shippers that would be 1 cent higher than the rate for uncommitted shippers. FERC approved this request.
  - In a Magellan order, OR12-7, Magellan requested that one of its three tiers of committed shippers pay a rate equal to the uncommitted rate for service not subject to prorationing.
  - FERC rejected the request, citing premium rate orders.

New Capacity and Preferential Capacity Rights

- Current Status – Access to Capacity - "Semi-Firm" Prorationing Policy
  - An historical prorationing model where committed shippers are deemed to be have shipped their volume commitment during the base period – *i.e.*, when the pipeline becomes operational, the committed shippers are regular shippers with access to a significant amount of capacity; uncommitted shippers are new shippers and must build a history of shipments during the base period.
  - Committed shippers are further protected from apportionment, though not fully, because they are deemed for prorationing purposes to have shipped the greater of their actual shipments during the base period or their volume commitment.

New Capacity and Preferential Capacity Rights

- Current Status – Access to Capacity - “Semi-Firm” Prorationing Policy – Cont.
  - FERC has approved this type of prorationing policy on multiple occasions.
  - A recent proceeding – BP v. Sunoco – has examined whether a prorationing policy like this provides sufficient preferential capacity rights such that an open season is required for lawful implementation.
  - The Initial Decision found, among other things, that this type of policy requires an open season. The Commission has not yet ruled on the Initial Decision.

New Capacity and Preferential Capacity Rights

- Current Status – Access to Capacity
  - FERC may allow unprorationed access to capacity for committed shippers during normal operating conditions – rate must be at least 1 cent above the uncommitted rate.
  - FERC will consider how much capacity is available to uncommitted or new shippers. The industry norm is to provide at least 10 percent of available capacity for uncommitted or new shippers.

New Capacity and Preferential Capacity Rights

- Current Status – Access to Capacity
  - FERC will look at the totality of the circumstances; other factors, such as rate design for committed and/or uncommitted shippers, might affect FERC's view of requests for unprorationed access.

New Capacity and Preferential Capacity Rights

- *Explorer Pipeline Co.*, Docket No. OR12-10
  - Unique request, now replicated by a number of pipelines, is that committed shippers receive discounted rates during periods when the pipeline is not in apportionment; committed shipper rates change to premium rates when the pipeline is in apportionment and the committed shippers are then not subject to apportionment.
  - The Commission granted Explorer's petition on August 1, 2012.

New Capacity and Preferential Capacity Rights

- *Shell Pipeline Company*, LP, Docket No. OR12-11
  - Unique request, now replicated by a number of pipelines, is that volume commitments in excess of available capacity will be allocated on a net present value basis.
  - Ultimate result is that a shipper with a very long commitment and a high rate could push others off the system and obtain very strong preferential capacity rights to the exclusion of all others.
  - The Commission granted Shell's request on June 21, 2012.
  - The uncommitted shippers challenged various aspects of the rate, but the case ultimately settled.

Enbridge North Dakota - Summary

- Enbridge (North Dakota), like other pipelines originating in the Bakken region, began experiencing significant increases in crude oil volumes starting around 2006.
- By 2012, the pipeline was both in prorationing and experiencing over-nominations, a proliferation of new shippers, and gaming of its prorationing policy by shippers with insufficient capacity to move their desired volumes.

Enbridge North Dakota – Summary Cont.

- Enbridge (North Dakota) filed changes to its prorationing policy to:
  - Create two classes of shippers, historical and new, in place of the prior shipper classes;
  - Expand the scope of shippers viewed as “cooperating” in order to reduce the use of affiliated and unaffiliated shippers to obtain additional capacity allocations;
  - Prohibit affiliates of historical shippers from being new shippers, for the same reason;
  - Implement a lottery mechanism for new shippers, when there are more new shippers than there are minimum batches available;

Enbridge North Dakota – Summary Cont.

- Enbridge (North Dakota) filed changes to its prorationing policy to:
  - Set capacity for historical shippers at no greater than 95% (meaning 5% of capacity available for new shippers; 10% after expansions);
  - Prevent new shippers from rolling into the historical shipper pool if doing so would result in any historical shipper being allocated less than the minimum batch size;
  - Prohibit historical shippers from increasing their allocation rights through acquisitions, mergers, etc. with new shippers;
  - Make certain calculation adjustments.

Enbridge North Dakota – Summary Cont.

- Enbridge (North Dakota) sought significant input from its shippers on the revisions to its prorationing policy.
- Nonetheless, one shipper protested and another sought clarification.
- FERC found the proposed changes to be just and reasonable and accepted the Enbridge (North Dakota) tariff filing.

Enbridge North Dakota – Takeaways

- FERC relied on the unique circumstances Enbridge (North Dakota) was experiencing, such as:
  - Proliferation of new shippers;
  - Gaming of prorationing policy;
  - Problems related to minimum batch sizes.
- FERC "commend[ed]" Enbridge North Dakota for working with its shippers on the prorationing proposal and appeared to give weight to this cooperation in finding the tariff changes to be just and reasonable.

Colonial (2014) Summary

- Colonial has frequently been in apportionment.
- News articles in the trade press frequently discuss parties paying for space on Colonial.
- In 2014 Colonial filed a PDO seeking permission to reserve a portion of its existing space for shippers willing to pay a premium rate.
- The Commission rejected Colonial's request at 146 FERC 61,206.

Colonial (2014) Takeaways

- The Commission expressed concern about giving priority on existing space absent and expansion.
- The key takeaway seems to be that pipelines have less flexibility to develop innovative allocation approaches with existing space.

BP v. Sunoco Summary

- Sunoco operated a line with three shippers, BP, Marathon and PBF.
- The line was in prorationing since 2008.
- In 2010/12 Marathon and PBF entered into throughput and deficiency agreements ("TDAs") with Sunoco.
- Sunoco did not conduct an open season *per se*.
- In 2010 Sunoco changed its prorationing policy so that space would be allocated based on the greater of actual volumes or deficiency volumes.
- In 2015 BP filed a complaint.

BP v. Sunoco Summary Cont.

- In 2017 the ALJ ruled against Sunoco.
- The Judge found that the TDAs violated *Colonial* by giving a preference to shippers who had signed contracts on existing space.
- The Judge further found that the TDAs violated the Interstate Commerce Act.
- The Judge voided the contracts and ordered Sunoco to pay damages.
- The Judge's decision is currently awaiting Commission review.

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BP v. Sunoco Takeaways

- If the Commission upholds the ALJ it will be critically important to evaluate contract rates that were not developed during an open season.
- This case further highlights the importance of PDOs.
- The ALJ's decision would seem to suggest that the ability to enter TDAs on existing space is strictly limited if not *per se* prohibited.
  - This was a major focus of Sunoco's brief on exceptions to the Commission.
  - However, the Commission has since approved the entering into TDAs on existing capacity, but without preferential capacity rights (see OR17-7).

Belle Fourche – OR17-7

- The Commission has since approved a pipeline's Petition for Declaratory Order suggesting that the BP v. Sunoco Initial Decision is too restrictive.
- Belle Fourche and Bridger held an open season to obtain acreage dedication commitments in the form of a transportation services agreement and memorandum of dedication.
- Given uncertainty in production levels, the pipelines sought assurance that it could enter into the TSAs and charge discounted rates to its committed shippers but provide preferential capacity rights only if the pipelines constructed expansion(s) in order to serve the dedicated production.
- FERC approved this request.

Frontier Summary of Case

- Frontier did not have a prorationing policy on file with FERC or posted on its website.
- When the system went into prorationing, the pipeline attempted to work with its shippers but could not obtain complete agreement.
- The pipeline filed a pro rata prorationing policy with FERC, and certain shippers filed protests on grounds that the pro rata policy favored the pipeline's affiliate.

Frontier Summary of Case Cont.

- The pipeline raised a number of responses, including that pro rata allocation methodologies have long been accepted by the Commission and for a number of years were considered FERC's default policy.
- The Commission accepted shipper challenges and set the matter for hearing and settlement negotiations.

Frontier Summary of Case Cont.

- Certain of the challenging shippers claimed that there should be an adjustment embedded in the allocation methodology to account for the gravity of the crude being shipped (hydraulic adjustment factor).
- One of the shippers alleged that the adjustment factor was appropriate because heavy crude takes up more pipeline capacity than light crude, all else equal. This concept is common in prorationing policies for similar pipelines moving multiple gravities of crude.
- The case was ultimately resolved by settlement.

Frontier Takeaways

- All common carrier interstate pipelines should have a prorationing policy on file and/or posted on their publicly-available websites.
- If a pipeline ships crude oil of varying gravities, the pipeline should consider whether a hydraulic adjustment factor is appropriate.

Bridgetex Summary of Case

- Bridgetex built a new crude pipeline from West Texas to the Gulf.
- Occidental Energy Marketing, Inc. ("OEMI") entered into a TSA obligating it to ship certain volumes, or pay deficiency payments.
- In 2017 Bridgetex conducted a second open season Bridgetex II, which OEMI claims would result in lower rates for Bridgetex II shippers.
- Bridgetex also sought to allocate this expansion capacity differently.

Bridgetex Summary of Case Cont.

- OEMI claims:
  - That it underwrote the construction of the pipeline.
  - That charging a lower rate to shippers committing in the new open season is discriminatory.
  - That allocating expansion space separately is discriminatory.
  - That its TSA gives it rights to expansion space.
- Bridgetex disagrees.
- The case is currently in hearing.

Bridgetex: Takeaways

- This case has major implications regarding the flexibility available to pipelines conducting expansions.
- Some TSAs contain most favored nation (“MFN”) clauses.
- OEMI appears to be trying to imply an MFN into its TSA.
- This case will also provide important insight on drafting TSAs.

Transmountain: An NEB Case

- Transmountain transports crude oil from Alberta to Vancouver and Seattle.
- The pipeline has been apportioned for years.
- In 2013/14 the pipeline sought to shift from a nomination-based approach to a historic volume approach.
- Different shipper interests proposed different methodologies.

Transmountain Cont.

- Key issues included:
  - Whether to allocate base on a rolling average usage versus peak usage.
  - Whether to allocate the whole pipeline or the Canadian and the US Segments separately.
  - Whether to include shipments under an auction program.
- Certain parties presented principles similar to those outlined above to evaluate different proposals.
- The NEB largely accepted these principles.

Transmountain Results

- The NEB ruled that space should be apportioned on
  (1) A rolling average based on a 24 month time period,
  (2) The entire system, not a separate Canadian and US segment.
  (3) Auction barrels should be included as a signal of "need".
- This case demonstrates that there are no perfect allocation methodologies.
- The case also demonstrates the value of a "principles" approach.

CCPS – Summary of Case

- CCPS filed a PDO seeing approval to re-contract capacity currently subject to firm service commitments and under contracts expiring in 2019.
- CCPS made clear that the capacity of the pipeline would not change and that the re-contracting would not impact capacity currently available to uncommitted shipper or the rates paid by those uncommitted shippers.
- CCPS states that it would award capacity to shippers in the open season processing using a net present value methodology.

CCPS – Summary of Case Cont.

- The terms and conditions of the new open season were not the same as those applicable to the contracts expiring in 2019 (for example, the new contracts had priority and non-priority service for committed shippers with premium and discount rate structures).

CCPS – Takeaways

- It has long been an open question about whether and to what extent a pipeline can enter into contracts to replace expiring contracts, whether to committed shippers without renewal rights or to new shippers in an open season process.
- The scope of the CCPS order is not yet certain, but it could indicate that committed shippers may renew open season-based transportation agreements, even if such agreements do not have renewal rights.

CCPS – Takeaways Cont.

- The order also suggests that, for space made available due to expiring TSAs of committed shippers, the pipeline may hold a new open season and offer the space up at rates and terms and conditions of service that differ from those originally offered.