G. ***Court of Appeals in Mobil Pipe Line Company Proceeding Overturns Results of Netback Cost Study***

In the Mobil Pipe Line Company proceeding, the Commission was faced with the unique situation of a small pipeline with the only transportation route in an origin market to a lucrative wholesale destination market. The Commission in 2010 concluded through its netback analysis approach that there were no good alternatives to Mobil's pipeline in terms of cost. The D.C. Circuit Court of Appeals reversed in April 2012, however, relying in large part on Trial Staff's testimony and positions before the Commission. The court found that the broad market indicators, which showed that Mobil had only a three percent market share in the transportation of the total production in the relevant basin, clearly indicated that Mobil did not have market power in the origin market. And while not specifically overruling the Commission's detailed cost analysis approach to determining good cost alternatives, the court pointed out the areas in that analysis that were faulty. The Commission recently outlined in detail the implications of this decision on its market-based rate methodology and modified the requirements necessary to show that alternative sources are viable in terms of cost.

1. *Commission Finds Mobil Lacks Market Power in Gulf Coast Destination Market but Sets Upper Midwest Origin Market for Hearing*

Mobil Pipe Line Company requested market based rates for its Pegasus pipeline, which transported almost entirely heavy sour Western Canadian crude oil from a single receipt point in Patoka, Illinois (south of Chicago) to a sole destination point in Nederland, Texas (the Beaumont/Port Arthur area of the U.S. Gulf Coast).[503] The crude oil reached Mobil's single receipt point from a production area in Western Canada by other pipelines.[504]

Mobil proposed for its destination market either a vast area of the Gulf Coast that included portions of Texas, Louisiana, Mississippi, and Alabama, or a somewhat more limited area from Houston to Lake Charles.[505] There were no specifically articulated protests or evidentiary supported contentions against Mobil's lack of market power in its destination market.[506] The Commission found that even for the more narrowly tailored Houston to Lake Charles geographic market, the market power statistics were well below what would cause concern.[507] In addition, the Commission found that waterborne crude deliveries accounted for a significant portion of demand in this destination market citing *Williams*' waterborne presumption of a lack of market power.[508] Therefore, the Commission determined that Mobil lacked market power in its more narrowly defined Houston to Lake Charles destination market.[509]

For its origin market, Mobil proposed an "Upper Midwest Origin Market" that contained its Patoka receipt point and a conglomeration of at least eight separate BEAs in seven states

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[503] *Mobil Pipe Line Co.*, 121 FERC ¶ 61,268, at P 4 (2007).
[504] *Id.*
[505] *Id.* P 5.
[506] *Id.* P 16.
[507] *Id.*
[508] *Mobil*, 121 FERC ¶ 61,268 at P 16 (*citing Williams*, Opinion 391-A, 71 FERC ¶ 61,291 at 62,138).
[509] *Id.*

(Minnesota, Wisconsin, Michigan, Illinois, Indiana, Ohio, and Kentucky).[510] The intervenors contested the origin market as overly broad and unsupported by a netback cost analysis.[511] The Commission cited the required netback analysis articulated in *Colonial*, and found that there was no cost based evidence in the record to determine Mobil's market power in the origin market.[512] Therefore, the matter was set for hearing.[513]

2. *Netback Analysis Reveals Mobil Has No Competition*

The Commission affirmed the judge's finding that Mobil had market power in its Upper Midwest origin geographic market even though the Pegasus pipeline transported only a small portion of the relevant product from the origin market. The finding was based on the netback cost analysis that found that shippers had no good alternatives to Mobil's pipeline in terms of netback price. The cost study found a high netback price for Mobil because it provided transportation service from the Upper Midwest to the Gulf Coast destination market, which offered a significantly higher wholesale price than other destination markets. At the time, Mobil was the only pipeline transportation option from the Upper Midwest to the Gulf Coast. In addition, the threshold price increase used to compare potential alternative sources of transportation was calculated from the benchmark of Mobil's transportation tariff, which was arguably well below the competitive rate as evidenced by the significant excess demand that existed for transportation services on the pipeline. Therefore, the Commission found that Mobil was a monopolist from its lone access to the Gulf Coast market and its ability to significantly raise its price above its current transportation rate.

Product Market. The Commission affirmed the judge's determination to limit the product market to the "transportation of Western Canadian heavy sour crude oil."[514] The judge and the Commission focused their inquiry, as was done in *Buckeye*, on substitution factors, "i.e., whether alternatives are available that would constrain the exercise of market power by [Mobil] in the event it attempted to raise its rates."[515] Mobil contended that it was capable of transporting all types of oil and the product market should not be so narrowly limited.[516] Trial Staff also supported Mobil's broader product market definition to include the transportation of all crude oil.[517]

The Commission found that substitution for the transportation of other types of crude oil was not practically possible when viewed from an economic and operations standpoint. "Shippers have made a choice to ship Western Canadian heavy sour crude oil on the pipeline, which accounts for 98 percent of the volumes…."[518] Further, there was no evidence that Mobil could ship "sufficient amounts of non-heavy crude oil that would provide an ongoing business

[510] *Id.* P 19.
[511] *Id.* P 10.
[512] *Id.* PP 22-23.
[513] *Mobil*, 121 FERC ¶ 61,268 at P 24.
[514] *Mobil*, 133 FERC ¶ 61,192 at PP 27-29.
[515] *Id.* P 28.
[516] *Id.* P 29.
[517] *Id.* P 28.
[518] *Id.*

opportunity for shippers."[519] Therefore, the Commission affirmed the narrowly defined product market because other forms of crude oil were not practical substitutes to Western Canadian heavy sour crude.[520]

Geographic Market and Alternative Sources of Transportation. The judge used a "threshold netback analysis," which first established a threshold netback price to compare all potential alternative sources of transportation.[521] The threshold netback price was calculated by subtracting the netback payment shippers would receive on Mobil by a threshold price increase.[522] The judge used a 15 percent increase in Mobil's transportation tariff rate as the threshold increase.[523] An alternative was considered a "good alternative" if it offered "shippers a netback greater than or equal to the threshold netback."[524]

Mobil and Trial Staff contested each of the inputs into this netback analysis, and the use of a netback analysis at all under the circumstances of the case. First, they contended that Mobil's transportation tariff rate should not serve as the "competitive benchmark" from which to calculate the threshold price increase.[525] They asserted that Mobil's transportation rate could not be the competitive rate because there was excess demand on the pipeline (suggesting the tariff transportation rate was too low).[526] The Commission agreed with the judge that excess demand in and of itself was not proof that the prevailing rate was unjust and unreasonable "because it would essentially eliminate the use of the tariff rate as the competitive rate…."[527] The Commission reasoned that excess demand was likely to be present for any pipeline seeking market-based rates because an oil pipeline was unlikely to go through the exercise of seeking market-based rates unless there was some excess demand that would allow it to raise its rates above the cost-of-service or index rate.[528]

Mobil also contested the use of the 15 percent increase in its transportation rate as the threshold price increase, and instead advocated for a 1-2 percent increase in the delivered product price as the appropriate threshold increase.[529] The Commission stated that the initial decision in *Buckeye*, subsequently affirmed by the Commission, adopted a 15 percent increase in the pipeline's tariff as the appropriate measure of market power.[530] The contention that *Buckeye*'s finding as to market power was concerned with an increase in the delivered product

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[519] *Mobil*, 133 FERC ¶ 61,192 at P 28.
[520] *Id.*
[521] *Id.* P 14.
[522] *Id.* PP 14-15.
[523] *Id.*
[524] *Mobil*, 133 FERC ¶ 61,192 at P 14. Specifically, and for illustrative purposes, the judge calculated a netback price for the sale of Western Canadian crude on the Gulf Coast via Mobil's pipeline to average $51.27 per barrel for the first 10 months of 2007. *Id.* P 34. Mobil's transportation tariff rate of $1.218 multiplied by 15 percent would equal $0.1827 and serve as the threshold price increase. *Id.* P 15. Therefore, if an alternative provided a netback price equal to or greater than $51.0873 per barrel ($51.27 minus $0.1827) it would be considered a good alternative and included in the market power statistics.
[525] *Id.* P 17.
[526] *Id.*
[527] *Mobil*, 133 FERC ¶ 61,192 at P 20.
[528] *Id.*
[529] *Id.* P 23.
[530] *Id.* P 24 (*citing Buckeye*, 50 FERC ¶ 63,011 at 65,049; *Buckeye*, Opinion No. 360, 53 FERC 61,473 at 62,666).

price, not transportation rates, was disregarded. The Commission determined that netback prices or delivered product prices are used in the netback or laid-in cost study to determine viable alternatives, but the transportation rate must be used for the threshold price increase component of those detailed cost studies.[531] The Commission reasoned that "[s]ince an oil pipeline can only increase its transportation rates, tying the increase to any other benchmark would not make any sense."[532] Further, linking the threshold price increase to the commodity price of oil as opposed to the transportation rate "would essentially allow pipelines to make massive price increases [if granted approval to charge market-based rates by the Commission] because transportation rates are a small portion of the overall delivered product price."[533]

In addition, Mobil and Trial Staff contested the use of a netback analysis at all, and instead advocated as was argued in *Explorer* and *Sunoco* for example, for the inclusion of all alternative suppliers that were actually used by current Mobil shippers.[534] Mobil and Trial Staff contended that used alternatives necessarily had to be profitable from their use.[535] The Commission found that it "must use a netback analysis to determine whether an alternative was comparable in terms of price…" as opposed to the actual used alternative approach.[536] The Commission determined that even if an alternative was used, and therefore, provided at least some positive netback, it may not provide enough of a netback price to serve as a check on an increase in rates reflective of market power.[537] The Commission found that only through a netback analysis could that be definitively established.[538]

The Commission also affirmed the judge's exclusion of certain origin markets because the proposed alternative transportation sources in those markets were not good alternatives in terms of availability. Reiterating the capacity availability criterion articulated in *SFPP*, the Commission found that an alternative must have excess capacity and there must be an accessible route for shippers to reach that alternative.[539]

The judge calculated a netback price based on ten months of data for the alternatives located in the Upper Midwest region and compared them to Mobil's netback price from the Gulf Coast.[540] The judge concluded there were no good alternatives to Mobil's pipeline in terms of price.[541] Therefore, the judge determined the HHI was 10,000 with Mobil controlling a 100 percent market share.[542] Based on its affirmance of the judge in most material respects, the Commission affirmed the determination that Mobil had market power in its origin market.

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[531] *Id.*
[532] *Mobil*, 133 FERC ¶ 61,192 at P 24.
[533] *Id.*
[534] *Id.* P 32.
[535] *Id.*
[536] *Id.* P 41.
[537] *Mobil*, 133 FERC ¶ 61,192 at P 41.
[538] *Id.*
[539] *Id.* P 39.
[540] *Id.* P 34.
[541] *Id.* Specifically, the judge calculated a netback price of $46.77 per barrel for alternatives in the Upper Midwest, well below the threshold netback price of $51.0873 per barrel. *See Mobil*, 133 FERC ¶ 61,192 at PP 14-15, 34.
[542] *Id.* P 35.

Potential Competition and Broad Indicators of Market Power. The Commission rejected consideration of broad indicators that suggested Mobil did not have market power. For instance, Mobil and Trial Staff contended that Mobil could not exercise market power because of the small amount of Western Canadian crude oil that it actually transported relative to what was produced.[543] Similarly, Mobil and Trial Staff contended that Mobil's entry into an already competitive market would prevent Mobil from exercising any market power.[544] In addition, Trial Staff contended that the netback price differential in this case was simply the result of supply and demand of crude oil in the Midwest and Gulf Coast, not anything related to Mobil's transportation rate.[545] Finally, Mobil contended that potential competition should impact the market power analysis.[546] The Commission rejected the consideration of potential competition and the other cited broad indicators of a lack of market power as "only appropriate in a close case" and unnecessary given Mobil's clear market power in its origin market under the netback analysis.[547]

Therefore, the Commission affirmed the judge's netback analysis that calculated alternatives to the Midwest in comparison to Mobil's Gulf Coast destination. Given the large netback differential from the disparity in the wholesale price of crude, the judge and the Commission found there were no good alternatives to Mobil's transportation route to the Gulf Coast.

3. *D.C. Circuit Court of Appeals Finds Broad Market Indicators Clearly Evidence Mobil Lacked Significant Market Power*

In reviewing the Commission decision in *Mobil*, the D.C. Circuit Court of Appeals found that the broad market indicators, including Mobil's mere three percent market share in the transportation of Western Canadian crude and its entry into an already competitive market, clearly evidenced a lack of market power. Therefore, the court vacated the Commission's denial of Mobil's application for market-based rate authority as unreasonable. The court did not, however, directly overrule the Commission's requirement for a detailed cost analysis to justify the cost competitiveness of proposed alternative sources of transportation.

The court began with a brief description and history of Mobil's Pegasus pipeline. Until April 2006, Pegasus transported about 66,000 barrels of crude oil each day from the Gulf Coast to the Midwest.[548] Development of Western Canadian oil sands, however, caused Mobil to reverse the direction of the pipeline to transport Western Canadian crude southward.[549] "Importantly, Pegasus transports only about 66,000 barrels of Western Canadian crude oil each day—which is about three percent of the 2.2 million barrels of Western Canadian crude oil produced each day."[550] The court also recounted the procedural history of the case, and quoted

[543] *Id.* P 50.
[544] *Id.* P 51.
[545] *Id.* P 52.
[546] *Mobil*, 133 FERC ¶ 61,192 at P 48.
[547] *Id.* at P 54.
[548] *Mobil*, 676 F.3d at 1100.
[549] *Id.*
[550] *Id.* at 1100-01.

Trial Staff's testimony at length on the reasons why Staff supported a finding that Mobil lacked market power in its origin market.[551]

Since Pegasus transported almost exclusively Western Canadian crude oil, the court found that the proper market to consider was the transportation of all Western Canadian crude oil.[552] Therefore, the court held that the proper inquiry was:

> [W]hether producers and shippers of Western Canadian crude oil must rely so heavily on Pegasus for transportation of their crude oil that Pegasus can be said to possess market power—that is, whether Mobil could profitably raise rates on Pegasus above competitive levels for a significant period of time because of a lack of competition.[553]

The court found that potential competitive alternatives included "pipelines that transport crude oil out of the area" and "local refineries."[554]

The court concluded that the answer to whether Mobil had market power was an "emphatic no," given that Pegasus transported only three percent of the Western Canadian crude oil produced each day.[555] "As the staff noted, the critical statistic is that about 97 percent of Western Canadian crude oil gets to refineries by means other than Pegasus."[556] The court also highlighted the fact that Pegasus was a new entrant into an already competitive market. Again citing Trial Staff, the court found that logic dictated that a further entrant would increase competition, not render the market uncompetitive.[557]

While not overruling the Commission's requirement for a detailed cost study to justify alternative sources of transportation, the court pointed out faulty areas in that analysis. First, the court noted that the Commission's analysis showed that Mobil could raise its rates 15 percent above its current transportation tariff rate if it was allowed to charge market-based rates. The court found this revelation unremarkable, and determined the Commission's error was in using Mobil's regulated tariff rate as the competitive benchmark:

> As FERC's expert staff explained, the 15 percent figure demonstrates only that Pegasus's regulated rate is below the competitive rate. The regulated rate does not reflect Pegasus's full value to Western Canadian crude oil producers and shippers. Therefore, the possibility that the market rate might be higher than the regulated rate does not show that Pegasus possesses market power.[558]

Therefore, similar to the findings by the Commission in the *Williams* and *Explorer* proceedings, the court found that the ability to increase price was not necessarily indicative of market power.

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[551] *Id.* at 1101-02.
[552] *Id.* at 1102.
[553] *Mobil*, 676 F.3d at 1102.
[554] *Id.* at 1102-03.
[555] *Id.* at 1102.
[556] *Id.* at 1103.
[557] *Id.*
[558] *Mobil*, 676 F.3d at 1103-04.

Likewise, the court found that the short-term price variation between the Gulf Coast and the Midwest, "which may temporarily make Gulf Coast refineries (and thus Pegasus) an attractive outlet," did not result in a finding of market power.[559] Rather, taking advantage of differential pricing was consistent with competition and an efficient market.[560] To make the point, the court cited the Commission in *Explorer,* that "[d]ifferential pricing, when constrained by effective competition, can materially improve the efficiency of transportation markets by allocating capacity to those shippers who value it the most, particularly in markets involving different degrees of geographic or seasonal variation."[561] The implication is that a price differential is not evidence per se of market power. Instead, it improves competition by signaling that more pipeline investment is needed to reduce the wholesale price differential, while also allocating transportation capacity among shippers who can make the most profit from that differential.

Therefore, the court concluded that "the Commission jumped the rails by treating the Pegasus pipeline as the rough equivalent of a bottleneck or essential facility for transportation of Western Canadian crude oil."[562] The court concluded that the Commission's denial of Mobil's application to charge market-based rates was unreasonable.[563] In doing so, the court relied on the broad market indicators of Mobil's mere three percent market share in the transportation of Western Canadian crude oil and its new entry into an already competitive market.

4. *Market-Based Rates Granted on Remand*

On remand, in August 2012, the Commission granted Mobil's application to charge market-based rates.[564] Separately, in March 2013, the Commission denied the intervenors' request to reopen the record to demonstrate the price differential between the Midwest and Gulf Coast was not temporary, and to calculate a competitive rate different from the tariff rate to use as a benchmark in the netback analysis.[565] The Commission found these new factual determinations would not undermine the findings in *Mobil* that the pipeline lacked market power from its small market share of the total Western Canadian crude production.[566] "[T]he underlying conclusion of the court is that Pegasus is so small with so many competitors that it would be unable to charge anything but the competitive rate, thus negating the need to calculate a competitive rate to replace the regulated rate used by the Commission as a benchmark."[567] Therefore, the Commission stated that a detailed cost analysis was unnecessary, at least under the facts in *Mobil*.

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[559] *Id.* at 1104 (*citing Longhorn,* 83 FERC ¶ 61,345 at 62,380 ("[A]ny price differential between the origin and destination markets does not confer monopolistic power upon [the pipeline], but rather it promotes competition.").
[560] *Id.*
[561] *Id.* (*citing Explorer,* 87 FERC ¶ 61,374 at 62,394).
[562] *Id.*
[563] *Mobil*, 676 F.3d at 1105.
[564] *Mobil Pipe Line Co.*, 140 FERC ¶ 61,104, at P 6 (2012).
[565] *Mobil Pipe Line Co.*, 142 FERC ¶ 61,175, at PP 13-16 (2013).
[566] *Id.* P 15.
[567] *Id.*