

133 FERC ¶ 61,192
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Marc Spitzer, Philip D. Moeller,
John R. Norris, and Cheryl A. LaFleur.

Mobil Pipe Line Company

Docket No. OR07-21-000

ORDER AFFIRMING INITIAL DECISION

(Issued December 1, 2010)

1. This order affirms the Presiding Administrative Law Judge's (ALJ) August 5, 2009 initial decision¹ recommending that Mobil Pipe Line Company's (Mobil) application for market-based rates be denied.

Background

2. On August 24, 2007, Mobil filed an application for a market power determination seeking authority to charge market-based rates on its existing Pegasus pipeline system (Pegasus) for the transportation of crude oil from Pegasus' origin at Patoka, Illinois (south of Chicago), to its destination at Nederland, Texas (the Beaumont/Port Arthur Area on the U.S. Gulf Coast). The proposed destination market consisted of 30 counties in Texas, 38 parishes in Louisiana, 6 counties in Mississippi, and 2 counties in Alabama (Gulf Coast market). In the alternative, Mobil proposed a narrower destination market consisting of 21 counties in Texas and 2 parishes in Louisiana (Houston to Lake Charles market). Mobil also sought permission to charge market-based rates on Pegasus from the Upper Midwest Origin Market, which contains Pegasus' receipt point at Patoka and includes the states of Minnesota, Wisconsin, Michigan, Illinois, Indiana, Ohio, and Kentucky.

3. On December 20, 2007, the Commission issued an order finding that Mobil lacks significant market power in its Houston to Lake Charles destination market.² The December 20, 2007 order also found that the evidence presented by Mobil and the

¹ *Mobil Pipe Line Company*, 128 FERC ¶ 63,008 (2009).

² *Mobil Pipe Line Company*, 121 FERC ¶ 61,268 (2007) (Hearing Order).

protesters was insufficient for the Commission to determine whether Mobil lacks market power in the defined origin market. The order established a hearing to define the appropriate origin market and to determine whether Mobil lacks significant market power in that market as so defined. The order also stated that Mobil's application for a market power determination seeks authority to charge market-based rates in one origin market and one destination market joined by only the single Mobil pipeline. The Commission concluded that it cannot ensure just and reasonable market-based rates for transportation over the Mobil pipeline by considering market power in either the origin market or the destination market independent of the other market. Therefore, the Commission ruled that it would not permit Mobil to charge market based rates for transportation of crude oil until it is determined that Mobil lacks significant market power in both its origin and destination markets.

4. On August 5, 2009, the ALJ issued an initial decision. The ALJ found that Mobil failed to establish that there are currently any good economic alternatives to Pegasus' services in the origin market that would check rates to reasonable levels. Thus, ALJ concluded that Mobil had not shown it lacked significant market power in the defined origin market and further, had not shown the origin market was sufficiently or workably competitive such that authority to charge market based transportation rates will result in just and reasonable rates. The ALJ recommended the Commission deny Mobil's application for market-based rates.

5. Briefs on exceptions were filed on September 18, 2009, and briefs opposing exceptions were filed on October 22, 2009. Briefs were filed by Mobil, Commission Trial Staff, Suncor Energy Marketing, Inc. and Canadian Natural Resources Limited (Suncor/CNRL), and the Canadian Association of Petroleum Producers (CAPP).

Discussion

Introduction

6. Order No. 572 establishes the foundation for the Commission's analyses of market-based rate applications.³ The requirements set forth in Order No. 572 are found in the Commission's Regulations at 18 C.F.R. § 348.1(c) (2010). Section 348.1(c) of the Commission's regulations requires an oil pipeline seeking a market power determination and authority to charge market-based rates to: (1) define the relevant product and geographic markets, including both destination and origin markets; (2) identify the

³ *Market-Based Ratemaking for Oil Pipelines*, Order No. 572, FERC Stats. & Regs. ¶ 31,007, at 31,180, *order on reh'g*, Order No. 572-A, 69 FERC ¶ 61,412 (1994), *pet. for rev. denied*, *AOPL v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996).

competitive alternatives for shippers, including potential competition and other competition constraining the pipeline's ability to exercise market power; and (3) compute the market concentration and other market power measures based on the information provided about competitive alternatives. The Commission in Order No. 572 refused to adopt specific standards on how to conduct a market power analysis, ruling instead that it would approach market-based rate applications on a case-by-case basis.⁴

7. Before we address the ALJ's decisions on the various aspects of the market power analysis, it is important to recognize some general principles concerning market-based rates and some common themes running through the briefs of Mobil and Staff, the parties who disagree with the ALJ's decision. Oil pipelines have the ability to seek approval for market-based rates but do not have a right to them. The burden of proof is on the pipeline to establish that it lacks significant market power in the relevant origin and destination markets through its petition, and when necessary, through the presentation of evidence and witnesses at trial. It is not the Commission's job to determine ways in which a pipeline can establish market-based rates. Nor is it the job of opposing parties to show that a pipeline possesses market power. A pipeline's ability to charge market-based rates does not mean it can charge whatever rate it wants unchecked and raise its rates to what would be considered unjust and unreasonable. Rather, as recognized by the courts and discussed by the ALJ in this case, market-based rates are still within the zone of reasonableness because a finding of a lack of market power would mean that market forces would constrain a pipeline from raising its rates above a just and reasonable level. If a pipeline were to raise rates above a just and reasonable level, shippers would still have other options to move their oil.

8. These general principles lead to the concept of economic or scarcity rent discussed by the ALJ and is a recurring theme throughout the briefs of Mobil and Staff. In this proceeding, because of the oil price differential between the Upper Midwest and the Gulf Coast and the scarcity of pipeline capacity on Pegasus, there is the opportunity to profit through arbitrage. Here the economic or scarcity rent is the price to the shipper after all costs of delivery, i.e., the netback differential. Mobil, and to a lesser extent Staff, essentially argue the pipeline should capture the economic rent rather than the shippers because the pipeline owns the scarce asset, and the way to do this is to allow Mobil to charge market-based rates. The idea that the economic rent rightfully belongs to the pipeline pervaded the analysis put forth by Mobil and Staff. This led Mobil and Staff to engage in what the ALJ labeled as circular reasoning. Boiled down to its essence, the main argument is that because the shippers are capturing the netback differential the current rate cannot be a competitive rate; a competitive rate is one where the netback

⁴ *Id.* at 31,185.

differential to the shippers is eliminated and the economic rent is captured by Mobil; market-based rates would allow Mobil to raise rates to what it deems the competitive level; and Mobil cannot possibly possess market power if the rates are merely raised to the competitive level. The problem with this theory is that it simply focuses on allocation of economic rent between the pipeline and the shippers without analyzing the relevant market to determine the causes of the scarcity rent, i.e., whether Mobil possesses significant market power.

9. Because of the reasoning with respect to economic rent, Mobil filed exceptions to virtually every aspect of the ALJ's decision. Mobil argued that the ALJ either applied the wrong test or standard in analyzing market power or when applying the correct standard engaged in a faulty analysis resulting in a wrong determination. While Staff has not filed exceptions to every aspect of the ALJ's decision, its argument is that the ALJ's analysis is tainted because she began with an incorrect baseline for the market power analysis. As we will see from the discussion below, the ALJ engaged in a thorough analysis and appropriately determined that Mobil's Pegasus pipeline possesses market power and that the Commission should deny authority for Mobil to charge market-based rates.

10. With respect to a procedural matter, we recognize that Suncor/CNRL and CAPP filed exceptions to certain aspects of the ALJ's decision. These parties agree with the ALJ's decision to recommend the Commission deny Mobil's application for market-based rates. However, the exceptions are essentially contingent in nature and would apply to the extent that certain aspects of the ALJ's decision were reversed leading to a determination that Mobil lacks market power and its application for market-based rates should be approved. Since, the Commission here affirms the ALJ's finding and ultimate determination, Suncor/CNRL's and CAPP's exceptions need not be addressed.

11. The following discussion concentrates on the briefs on exceptions filed by Mobil and Staff since they argue that the ALJ erred in determining that Pegasus has market power. Since Suncor/CNRL and CAPP agree with the ALJ's decision to deny Mobil's application for market-based rates and oppose the exceptions taken by Mobil and Staff, for purposes of brevity we will not repeat these arguments.

The Definition and Test for Market Power

12. The 1992 DOJ-FTC Merger Guidelines (Merger Guidelines), which the Commission has used for guidance in applying the framework of Order No. 572 to analyze market power, defines market power as "the ability profitably to maintain prices above competitive levels for a significant period of time." To evaluate whether an oil pipeline has market power, the Commission and the Merger Guidelines considered whether the pipeline, if granted market-based rate authority, could profitably sustain a "small but significant and nontransitory increase in price" (SSNIP test). The participants in this proceeding agreed on the definition of market power and the propriety of the SSNIP test, quoted above. However, they disagreed on the meaning of some of the

terminology contained within the definition of market power and the SSNIP test, particularly the terms “competitive levels” and “small increase.” These contrasting interpretations are major reasons why the participants obtained dramatically different results when they applied the framework of Order No. 572 to Pegasus’ relevant origin market. To properly evaluate the validity of the participants’ market power analyses, the ALJ first determined more precisely the concepts that underlie market power and the SSNIP test.

13. The ALJ determined that the proper benchmark for the market power analysis in this case is the long-run competitive price and that Pegasus’ prevailing tariff rate is a reasonable approximation of the long-run competitive price. The ALJ held that the Commission has accepted Pegasus’ prevailing rate as a just and reasonable rate, and a just and reasonable rate is designed to approximate the long-run competitive price. The ALJ found the evidence demonstrates that Pegasus’ prevailing tariff rate reasonably reflects - and perhaps somewhat overstates - Pegasus’ long-run average costs. The ALJ also determined that Mobil and Staff had not propounded a proxy for the long-run competitive price applicable to Pegasus for use in a market power analysis that the Commission has accepted as just and reasonable or that could be concluded as such. Thus, the ALJ concluded that Pegasus’ prevailing rate is the only appropriate estimate on the record of the long-run competitive price.

14. The ALJ stated the parties also disagreed about what constitutes “a small but significant nontransitory increase in price” above the competitive level. Moreover, the ALJ concluded that determining an appropriate SSNIP is a crucial part of a netback analysis, which involves comparing the netbacks that shippers receive by using the applicant pipeline with the netback that shippers obtain using other alternatives.⁵ The ALJ stated that subtracting the appropriate SSNIP, the “threshold price increase,” from the netback on the applicant pipeline yields the “threshold netback.” The ALJ noted that when using a netback analysis in a market power determination, an alternative is considered a good economic alternative if it offers shippers a netback greater than or equal to the threshold netback. The ALJ determined that, according to this model, a good economic alternative would check the applicant pipeline from increasing its rates by more than the SSNIP above the competitive level.

15. The ALJ found that, based on the Hearing Order’s requirement that good alternatives must be determined in terms of price, it was necessary to establish a specific rate increase to perform a proper netback analysis. In the absence of an acceptable SSNIP presented by the applicant or by Staff, the ALJ adopted Suncor/CNRL’s 15 percent test. Given the Merger Guidelines, the decisions by the

⁵ The netback is the price to the shipper after all costs of delivery.

Commission and by the ALJ in *Buckeye Pipe Line Co.*,⁶ as well as the Commission Staff's practices in prior cases, the ALJ found that a 15 percent threshold test was appropriate. Under the circumstances, using the prevailing rate of \$1.218 per barrel, and the 15 percent threshold thereof, the ALJ determined that the magnitude of the SSNIP is \$0.1827 per barrel.

16. The ALJ also determined that the 15 percent threshold price increase should apply only to Pegasus' prevailing rate and not to the entire transportation chain of pipelines that move crude oil from Alberta to the Gulf Coast. The ALJ found that applying a percentage threshold increase to the entire transportation path, where the applicant pipeline is only one segment of that path, can lead to erroneous results. The ALJ determined that aggregating Pegasus' rate with the rates of its source pipelines could potentially lead to the inclusion of alternatives that are not good for purposes of determining a workably competitive environment for Pegasus' services in a market power determination.

Commission Decision

17. Mobil and Staff assert the ALJ erred in determining that Pegasus' tariff rate was the appropriate competitive benchmark for purposes of performing the market analysis. They argue the tariff rate cannot be a competitive rate because there is excess demand on Pegasus and the market is in disequilibrium. They further argue that a competitive market clearing rate would be one that would eliminate the existing netback differential. It was also argued that the prevailing tariff rate was not determined to be a just and reasonable rate because it was only an uncontested negotiated rate filing.

18. Mobil and Staff are incorrect that Pegasus' prevailing tariff rate is not a just and reasonable rate because it was an uncontested negotiated rate filing. The Commission's acceptance of an oil pipeline's negotiated rate without conditions is necessarily a determination that the rate is just and reasonable. The parties seemed to have incorrectly applied certain regulations under the Federal Power Act which indicate that permission for a rate to become effective does not constitute approval of the rate. Such regulations do not apply here.

19. Mobil and Staff also fail to recognize that "[s]ince under competition firms set their prices to recover costs, including a reasonable return, a regulated rate is designed to replicate that competitive situation."⁷ This reasoning equally applies to Mobil's

⁶ 50 FERC ¶ 63,011, at 65,049, *order on initial decision*, 53 FERC ¶ 61,473, at 62,666 (1990) (*Buckeye*).

⁷ *SFPP, L.P.*, 121 FERC ¶ 61,240, at P 14 (2007).

negotiated rate, which is the prevailing tariff rate in this proceeding, since it is unlikely that Mobil would agree to a rate that would not recover its long run average costs.

20. Contrary to the arguments of Mobil and Staff, the Commission also agrees with the ALJ that the argument that excess demand on a pipeline in and of itself is proof that the prevailing rate is not just and reasonable is too sweeping and subjectively conclusive because it would essentially eliminate the use of the tariff rate as the competitive rate. As the ALJ correctly determined, an oil pipeline is unlikely to undertake the exercise of filing an application for market-based rates unless there is some excess demand that would allow it to raise its rates above the maximum permitted rate under a cost-of-service ratemaking regime.

21. Mobil and Staff's advocacy of a hypothetical competitive rate as the benchmark for the market analysis is undermined by the fact that it was not determined through an independent analysis but was inextricably intertwined with the market analysis attempting to prove that Mobil lacked market power. For example, Staff itself recognized it would be extremely difficult to determine with any certainty what the competitive price would be in this proceeding but it would be one that would eliminate the netback differential. *Id* P 53. As the ALJ correctly recognized, Mobil and Staff engaged in circular reasoning in attempting to establish their hypothetical competitive rate. The essence of the ALJ's decision and the weakness of Mobil and Staff's position is accurately captured by the following quote from P 76 of the initial decision:

Clearly, the market power analysis should not begin with that very potential outcome: the benchmark price should not be based on the as yet unproven assumption - indeed the presumption - that the rate Pegasus would be able to charge if granted market-based authority would necessarily result from a truly workably competitive market. *See* CAPP RB at 23-24. Here the Staff's presumption assumes the conclusion of its analysis. *See id.* Relying on this assumption would short-circuit the market power analysis.

22. The ALJ therefore found that Mobil and Staff had failed to propound a proxy for the competitive price for use in a market power analysis that either the Commission found to be just and reasonable or she could conclude as such. Therefore, the ALJ determination that Pegasus' prevailing tariff rate was the only appropriate estimate on the record of the long-run competitive price was correct and is hereby affirmed.

23. On exceptions, Mobil argues the 15 percent threshold price increase is not appropriate and asserts the test should amount to 1-2 percent of the delivered product price. Mobil also argues that if the 15 percent threshold it used should apply to the entire transportation chain and not only Pegasus' rates.

24. The Commission rejects the arguments made by Mobil and affirms the decision of the ALJ to use a 15 percent threshold price increase for purposes of the market power analysis. The ALJ found that Mobil and Staff both acknowledged that a 15 percent price increase is the one most often used in market power analysis for market-based rates for oil pipelines. Also, contrary to the assertions of Mobil, the Commission rejected the 1-2 percent test it advocates in *Buckeye* and affirmed a 15 percent price increase in transportation rates adopted by the ALJ.⁸ Mobil attempts to undermine the ALJ's finding by arguing the *Buckeye* decisions referred to price increases applied to delivered product prices and not transportation rates. As the ALJ found, such an argument improperly links the transportation rate increase with the commodity price of oil and would essentially allow pipelines to make massive price increases because transportation rates are a small portion of the overall delivered product price. Further, Mobil's attempt to obscure the meaning of the *Buckeye* decision was aptly summarized by Suncor/CNRL in its brief opposing exceptions. There they recognized that while the Commission compares delivered product prices in comparing alternatives (i.e. through a netback analysis) because that is the real economic concern of shippers, in calculating the appropriate threshold price increase it uses transportation rates. Since an oil pipeline can only increase its transportation rates, tying the increase to any other benchmark would not make any sense.

25. The Commission also agrees with the ALJ's decision that the 15 percent price increase can only apply to Pegasus' transportation rates and not to all the transportation rates of all pipelines in the transportation chain from the Upper Midwest to the Gulf Coast. The ALJ correctly found that it is only the applicant for market-based rates whose rates are to be analyzed and the determination of the whether the price increase exceeds the threshold is specific to Pegasus' business enterprise. To suggest that the price increase should apply to the entire transportation chain does not take into account the fact that the market power analysis is only concerned with whether Pegasus can exercise market power over its shippers. If Pegasus were granted market-based rates, it is only Pegasus, not another pipeline who could capture the economic rent derived from the netback differentials, and it is only Pegasus' shippers who would pay the transportation rate increase.

26. Accordingly, the ALJ was correct in adopting the 15 percent threshold price increase for Pegasus because there were no acceptable alternatives presented by Mobil or Staff.

⁸ *Buckeye*, 50 FERC ¶ 63,011 at 65,049, *order on initial decision*, 53 FERC ¶ 61,473 at 62,666.

The Relevant Product Market

27. The ALJ found that the relevant product market in this case should be limited to the transportation of Western Canadian heavy sour crude oil.⁹ The ALJ stated the Commission's decision in *Buckeye* makes clear that the relevant product market includes the product or products that have been shown to have the ability to constrain the exercise of market power by the applicant.¹⁰ The ALJ stated that the record demonstrates that nearly all of the crude oil transported on Pegasus since its reversal in April 2006 is Western Canadian heavy sour crude oil.¹¹ The ALJ held that the transportation of only Western Canadian heavy sour crude can check the possible exercise of market power by Mobil; other crude oils moved by Pegasus comprise too little volume to do so. The ALJ found that a potential alternative that cannot transport or process this specific type of crude oil therefore cannot provide Pegasus' shippers with a service that is comparable in quality, and cannot check Pegasus' rates.

Commission Decision

28. Mobil and Staff argue that the initial decision erroneously defined the relevant product market and should have included the transportation of all types of crude oil. The ALJ properly focused her decision concerning the relevant product market on substitution factors, i.e., whether alternatives are available that would constrain the exercise of market power by Pegasus in the event it attempted to raise its rates. Under this analysis, if Pegasus were to raise its rates, a shipper would have potential alternatives that could transport or process the specific type of crude transported by Pegasus. The record in this proceeding shows that nearly all of the crude transported on Pegasus since its reversal in 2006 was Western Canadian heavy sour crude oil. Less than two percent of the crude

⁹ As crude oil is a mixture of thousands of compounds, crude oils are distinguished between "heavy" and "light" based on their relative abundance of heavier or lighter hydrocarbon molecules which occur in varying ratios and in different configurations. The "weight" of a crude oil is generally expressed by its API gravity or specific gravity. "Sweet" crude oil contains 0.5 percent sulfur or less, while "sour" crude oil contains more than 0.5 percent sulfur.

¹⁰ *Buckeye*, 53 FERC ¶ 61,473 at 62,663-664

¹¹ The principal crude oil currently shipped on Pegasus is Western Canadian heavy sour crude oil, such as Cold Lake crude oil, which is a blend of diluent and bitumen and is derived from Western Canadian tar sands. Cold Lake crude oil constitutes about 92 percent of Pegasus' volumes.

transported was a different type of oil and a major shipper of the other type of crude was an affiliate of Mobil.

29. Mobil attempts to argue that it is capable of transporting all types of oil and that the Commission should not limit the relevant product market to Western Canadian heavy sour crude oil. This argument, however, does not take into account the economics of the market and the physical operations on Pegasus. As the ALJ found, shippers have made a choice to ship Western Canadian heavy sour crude oil on the pipeline, which accounts for over 98 percent of the volumes on Pegasus. Mobil itself stated that “Pegasus was developed to allow the transportation of primarily heavy sour Western Canadian crude oil to the U.S. Gulf Coast refiners.”¹² With respect to operations, Suncor/CNRL point out that no evidence establishes that Pegasus can ship sufficient amounts of non-heavy crude oil that would provide an ongoing business opportunity for shippers. They state that when they shipped non-heavy crude oil when Pegasus was first reversed, they were told to discontinue because of contamination issues. Suncor/CNRL also points out that because there is limited segregated storage, any type of batch shipments would result in contamination of the heavy sour crude yielding a lower price in the destination market because the refinery customers of Pegasus’ shippers have not experienced a need for non-heavy sour crude oil. To include other types of crude oil in the relevant product market would not provide Pegasus’ shippers with meaningful transportation or refining alternatives in the event Pegasus were to raise its rates. Accordingly, the ALJ’s determination on the relevant product market is affirmed.

The Relevant Geographic Market

30. The ALJ stated that to establish that Pegasus lacks significant market power in the origin market. The Commission’s regulations require that Pegasus describe and justify the relevant geographic market in which it seeks market-based rate authority and explain why its method for selecting the geographic market is appropriate. 18 C.F.R. § 348.1(c)(1) (2010). The ALJ stated that the analysis of the proper origin market begins with the recognition of a geographic area or region where the pipeline and the potential alternatives operate. From there the potential alternatives to the pipeline’s services are reduced to include only the options which are determined to be “good” alternatives to the pipeline being analyzed. The ALJ stated that good alternatives are those which can be proven to assist in the prevention of the exercise of potential market power by the applicant pipeline, or in other words, they are the true competitors to the pipeline. Further, these competitors must provide a service which is comparable to that of the applicant.

¹² Suncor/CNRL Brief Opposing Exceptions at 39 (citing CAP IB at 35-37; Exh. No. MPL-2 at 141).

31. Suncor/CNRL and Staff agreed on the three requirements of a good alternative: it must be (1) readily available; (2) comparable in quality; and (3) comparable in price. Mobil disagrees with the three-pronged test and focuses its analysis on excess capacity and used alternatives. Nevertheless, Mobil asserted the alternatives in its defined origin market satisfy each of the three requirements. The ALJ adopted the three-pronged test propounded by Suncor/CNRL and Staff to assess whether an alternative in a proposed geographic origin market is a good alternative. The ALJ found the shippers' behavior provides the best guidance in an analysis of market power, and it is rational for shippers to consider these aspects of comparability in their choice of which provider or competitor to use for delivery of their crude oil volumes. The ALJ held these concepts provide a desirable framework for the Commission to recognize and assess potential good alternatives in an overall market power analysis.

32. After analyzing the various origin markets proposed by the parties, the ALJ determined she would focus the analysis on Mobil's defined Upper Midwest origin. Other proposed origin markets presented problems because they did not satisfy the requirements that potential alternatives to Pegasus be comparable in terms of quality and availability. The ALJ also had to determine whether alternatives in the origin market were good alternatives in terms of price. Mobil and Staff advocated recognizing all alternative suppliers of the same product that are available to and used by the current Pegasus shippers from the same injection point in the producing region. These alternatives are referred to as "used alternatives." The ALJ rejected Mobil's and Staff's theory that a used alternative is necessarily a good economic alternative relative to the applicant. The ALJ found that Mobil and Staff's theory recognizes that when an alternative is used, said enterprise or alternative has been reasonably shown to be profitable. However, the ALJ determined that the fact that it is "used" (and profitable) does not and cannot show with any clarity its ability to compete effectively with Pegasus who is the applicant seeking market based rate authority.

33. The ALJ found that a profitable alternative may yield a positive netback that certain shippers are willing to accept, but this netback may be below the threshold netback, indicating that the alternative is not a good economic alternative to the applicant in question. The ALJ stated that a profitable alternative is not necessarily a good alternative in terms of price because the alternative must be able to check an applicant's ability to unreasonably raise its rates (assuming it is granted market-based rate authority), thereby effectively controlling potential market power abuses. The ALJ held that if the alternative cannot be shown to do so, it must not be included in the defined origin market and correspondingly it must not be included within the calculated market power statistics. The ALJ stated that the distinction between an alternative that is profitable and one that is truly a good alternative in terms of price can only be demonstrated through detailed cost comparisons as recognized by the Commission and here this has only been shown clearly through the use of a netback analysis.

34. The netback analysis compared the average netbacks Pegasus' shippers receive from selling Western Canadian crude oil on the Gulf Coast with the average netbacks to shippers by the alternatives in Mobil's defined Upper Midwest origin market. Mexican Maya, a similar type of crude oil, was used as a proxy for Cold Lake crude in determining the price at the Gulf Coast. The netback calculations were made with respect to the shipping of heavy crude oil from Hardisty, Alberta, where shippers would decide whether to ship on Pegasus to the Gulf Coast or sell or ship the crude in the local Upper Midwest markets. Taking into account certain factors for price risk and the time value of money, the ALJ determined that the average netback price from the sale of Cold Lake crude on the Gulf Coast yielded an average netback price of \$51.27 per barrel for the first 10 months of 2007, the period under analysis in this proceeding. The ALJ determined that \$46.77 per barrel is an appropriate calculation of the netback at Hardisty from the sales of Cold Lake to the Upper Midwest. The ALJ then subtracted the \$46.77 per barrel average netback in the Upper Midwest from the \$51.27 average netback at the Gulf Coast to yield a netback differential of \$4.50 per barrel. The ALJ concluded that differential is considerably above the SSNIP of \$0.1827 per barrel. The ALJ also made three additional calculations using updated information and still found that the netback differential was above the threshold price increase.

35. The ALJ concluded there are no alternatives to Pegasus that are good alternatives in terms of price, and that Pegasus' origin market was properly limited to only Pegasus itself. Therefore, Pegasus has a 100 percent market share and an HHI of 10,000. The ALJ found that granting Pegasus the authority to charge market-based rates would allow it to capture scarcity rent through a dramatic price increase that would not result in just and reasonable rates.

36. The ALJ found that there is overwhelming supporting evidence on the record of a significant and persistent netback differential since Pegasus' reversal in April 2006.¹³ The ALJ stated that this evidence proves beyond doubt that Mobil's conclusion that there has been no significant netback differential is completely without merit.

Commission Decision

37. Mobil and Staff disagree with the ALJ's determination with respect to the relevant geographic market and her determination that Mobil has market power. The disagreements relate to the availability requirement and the comparable price requirement of the three-pronged test for geographic markets adopted by the ALJ. With respect to the availability requirement, Mobil's differences with the ALJ's decision arise from how one should determine excess capacity. With respect to the comparable price requirement,

¹³ Initial Decision at P 275.

Mobil and Staff's differences with the initial decision are based on whether comparable prices are determined based on used alternatives as advocated by Mobil and Staff, or on the netback analysis advocated by Suncor/CNRL and adopted by the ALJ in her decision. Further, although Mobil disagrees with the use of a netback analysis to determine price comparability, it did engage in a netback analysis for the Upper Midwest origin market. However, Mobil disagrees with the calculations adopted by the initial decision to determine the netback differential between the Upper Midwest origin market and the Gulf Coast for purposes of determining whether Pegasus could raise its rates above the threshold price discussed above.

38. The Commission finds that the ALJ properly excluded certain proposed origin markets because they were not comprised of good alternatives in terms of availability. Mobil confuses the availability requirement, which is used to identify good alternatives, with an excess capacity ratio, which reflects the market as a whole and can be considered as a mitigating factor when market share and HHI statistics indicate a market power concern.

39. Mobil's position on the availability of alternatives was not supported because it calculated statistics based on the market as a whole rather than whether a specific pipeline or refinery was an available alternative to Pegasus. As the ALJ found at P 134:

[T]o be considered available a specific refinery must have excess capacity and there must be an accessible route for Pegasus' shippers to that refinery; whether the market as a whole has excess capacity may be irrelevant. The reason is simple: if the refinery does not have excess capacity or there is no feasible route to the refinery, crude oil from Pegasus cannot be diverted to that refinery. Thus, that alternative could not serve as a check on Pegasus' rates and should not be included in the market concentration statistics.

40. Another problem with Mobil's analysis on available alternatives is that it is backwards and does not always focus on true alternatives to Pegasus. As the ALJ stated at P 137, at times Mobil focused on whether shippers could divert oil from refineries to Pegasus rather than whether shippers could divert oil nominations on Pegasus to refineries in the Midwest in the event of a price increase by Pegasus. Because of the weakness of Mobil's evidence, the ALJ correctly determined that it was unclear from the record precisely which refineries have excess capacity and whether there was needed excess capacity on the pipeline routes that transport oil to each of the refineries.

41. The next issue is whether the comparable price requirement for a good alternative can be proven through evidence of used alternatives as advocated by Mobil and Staff, or through a netback analysis as adopted by the ALJ. The Commission finds that the ALJ was correct in determining that the Commission must use a netback analysis to determine whether an alternative was comparable in terms of price and rejecting Mobil and Staff's approach of used alternative, i.e., alternative suppliers of the same product that are

available to and used by Pegasus' shippers. The Commission finds that a used alternative is not necessarily a good alternative because while a used alternative may be a profitable alternative yielding a positive netback that certain shippers are willing to accept, it may be below the threshold netback. In other words, even though a used alternative may be profitable, it may not be one that can check the pipeline's ability to raise rates if the Commission were to grant market-based rate authority.

42. The Commission agrees with the ALJ that Staff's analysis engaged in circular reasoning to prove that used alternatives are good alternatives. At P 184 the ALJ stated that "Staff has applied the assumption that all used alternatives are good alternatives to conclude that the short-run market clearing rate is competitive, and it has applied the assumption that the short-run market clearing rate is competitive to conclude that all used alternatives are good alternatives." To accept Staff's approach "would completely eviscerate the Commission's requirement that a good alternative be comparable in terms of price." *Id* P 186.

43. Nothing raised in the briefs on exceptions persuades us to change the ALJ's determination that whether an alternative is comparable in terms of price can only be demonstrated through a detailed cost analysis and that in the absence of a rational or workable means to evaluate competitive choices presented by Mobil or Staff, a netback analysis was required.

44. The final issue on exceptions with respect to the geographic market is Mobil's disagreement with the ALJ's calculations of the netback differentials between the Upper Midwest origin market and the Gulf Coast. Under Mobil's approach, adjustments to the price of crude in both the Upper Midwest and Gulf Coast locations and the consideration of other factors would essentially eliminate the netback differential between the Upper Midwest and Gulf Coast and would on average yield netbacks below the threshold price increase of 15 percent above the prevailing transportation rate.

45. The Commission finds that the ALJ's calculation of the prices of crude oil in the Upper Midwest and the Gulf Coast, and the resulting netback differential are reasonable and should be affirmed. The ALJ appropriately made certain downward adjustments to the price that shippers of Western Canadian crude oil would receive on the Gulf Coast to take into account the price risk and time value of money, as well as the fact that Mexican Maya crude oil, which was used as a proxy for Western Canadian crude on the Gulf Coast, yielded slightly higher prices than actual sales of Western Canadian crude. The ALJ rejected Mobil's higher downward adjustments because the time period did not correspond to the time periods examined in the initial decision and there was no evidence to support a higher downward adjustment. The ALJ also correctly rejected Mobil's higher downward adjustment for price risk because they were estimates and an afterthought since they were not included in Mobil's original netback calculations.

46. The Commission finds that the ALJ properly rejected Mobil's netback calculations which would have essentially all but eliminated the netback differential between the Upper Midwest and the Gulf Coast. One of the major differences between the calculations adopted by the ALJ and those proposed by Mobil is whether to account for certain refinery outages which Mobil claims depressed the price of Western Canadian crude and therefore increased the netback differential between the Upper Midwest and the Gulf Coast. The ALJ determined that objective market data should be used and certain events are normal fluctuations which the market takes into account. She further found that what Mobil proposed was essentially a manipulation of the data by using two discrete events while not taking into account other events that occurred in the market. For example, she noted that there were certain impacts on the Mexican Maya price due to residual fuel oil prices that would also have to be taken into account but Mobil did not. The Commission agrees with the ALJ's decision not to go down the path of selectively manipulating the otherwise objective evidence. As the ALJ stated at P 244 of the initial decision, Mobil's calculations were an elaborate hypothetical exercise with many moving parts containing numerous assumptions and data machinations some of which were improper.

47. In addition, Mobil's calculations were contrary to both Staff's and Mobil's acknowledgment that there was a persistent netback differential between the Upper Midwest and the Gulf Coast. Both Staff and Mobil maintained in this proceeding that there was disequilibrium in the market evidenced by the netback differentials and that further this was an issue of the allocation of economic rent in the form of netback differentials which should go to Mobil. Mobil cannot on the one hand argue that there are netback differentials and it should be allocated this form of economic rent through market-based rate authority, and on the other hand, when its overall theory of the case is rejected by the ALJ, argue there is actually no netback differential between the Upper Midwest and the Gulf Coast.

Potential Competition and Other Factors

48. Order No. 572 requires oil pipeline applicants for market-based rate authority to describe potential competition in the relevant markets. Potential competition refers to new entry. Arguments were made that potential competition would impact the market power analysis. The ALJ recognized that the Commission certainly has not granted any oil pipeline market-based rate authority solely on the premise that a future competitor will challenge an existing applicant's market power to the extent necessary to ensure just and reasonable rates. The ALJ stated that neither, for that matter, would it be appropriate to use data of any potential competitor to show the market within which the applicant operates is workably competitive. The ALJ determined that consideration of potential competition is merely an ameliorating or mitigating aspect in the overall market power analysis. The ALJ held that, as such, it is like a tiebreaker in a close call on that very judgment. The ALJ found that there is no doubt to the conclusion that Mobil possesses

significant market power in the defined origin market, as there are no good alternatives to Pegasus' services. The ALJ stated that the overall market power analysis and testing bear out this conclusion.

49. The ALJ stated that Order No. 572 allows an applicant pipeline to describe "other factors" that bear on the issue whether it lacks significant market power in the relevant market. The ALJ stated that, as with the consideration of potential competition, the consideration of other factors serves like a tiebreaker when the question of whether an applicant has market power is a close decision. Since the ALJ found that Mobil clearly possessed market power, she only presented a summary overview of the other factors presented by Mobil and Staff.

50. Mobil and Staff argued Pegasus cannot exercise market power because of its small size in relation to the overall market. The ALJ held that the proper consideration is not whether Mobil can exert market power over the overall Upper Midwest market but whether it can exert market power over Pegasus' shippers. Further, the ALJ stated that the Merger Guidelines make clear that the test for market power is not whether Pegasus can affect the crude oil commodity market, but whether it can maintain an increase in its rate above the competitive level. The ALJ stated that it is Pegasus' shippers who pay the Pegasus rate, and it is this rate that must be just and reasonable. The ALJ determined that in this case, netback analyses demonstrate that if Mobil were granted market-based rate authority, it would be able to raise rates beyond what is just and reasonable.

51. Mobil and Staff argued that Pegasus' status as a new entrant into an already competitive origin market would prevent Mobil from exercising market power. The ALJ held that the alternatives in an applicant's origin market must be comparable to the applicant in terms of price, and the "used-equals-good" theory as applied in Pegasus' circumstances does not demonstrate that this requirement is satisfied. The ALJ found that the fact that the alternatives in the market may have been competitive with one another before Pegasus' reversal does not necessarily demonstrate that they remain good competitive alternatives to Pegasus. The ALJ found that whether Pegasus is a new entrant to the market is irrelevant to the relevant market power analysis.

52. Staff argued the netback differential is a function of supply and demand of crude oil and is not determined by Pegasus. The ALJ stated that netback analyses demonstrate a significant and persistent netback differential, which generates high demand for Pegasus' services. The ALJ stated that the netback differential is the reason Pegasus has been oversubscribed every month since its reversal. The ALJ held that if the Commission granted Mobil market-based rate authority, this differential would in turn allow Mobil to profitably raise Pegasus' rate above competitive levels without the loss of volumes. Thus, the ALJ found that under a market-based rate regime, it is not Pegasus who would be at the mercy of crude oil producers; it is Pegasus' shippers who would be at the mercy of Mobil.

53. Mobil and Staff argue that Mobil lacks market power because there will be no reduction in the output of Pegasus' transportation capacity if the Commission grants Mobil market-based rate authority. The ALJ stated that she found this argument overlooks one key fact: the scarcity constraint in the form of a lack of adequate pipeline capacity between the Upper Midwest and the Gulf Coast. The ALJ stated that this scarcity constraint creates a natural restriction of output in the marketplace. Further, the ALJ determined that it was clear from the record that Pegasus' recent expansion will not be sufficient to eliminate the scarcity constraint. Thus, the ALJ concluded, if Mobil were granted market-based rate authority, it would not need to restrict its own output to maintain its rates above competitive levels.

Commission Decision

54. The ALJ determined that Mobil definitively possessed market power in the relevant origin market. Although the ALJ briefly addressed the impact of potential competition and other factors on the market power analysis for Mobil, she determined that such factors were only used in the event of a close call and were unnecessary to the ultimate determination of whether Mobil lacks market power. The Commission finds that the ALJ properly determined that the impact of potential competition and other factors were only appropriate in a close case and were unnecessary here since Mobil clearly possessed market power in the relevant origin market. Accordingly, the Commission affirms the initial decision as to the weight given potential competition and other factors.

The Commission orders:

For the reasons discussed above, the Commission affirms the ALJ's initial decision recommending that Mobil's application for market-based rate authority be denied.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.