

C. *Energy Policy Act of 1992 and Rulemaking Order No. 572 on Oil Pipeline Market-Based Rates*

In the Energy Policy Act of 1992, Congress ordered the Commission to formulate a “simplified and generally applicable ratemaking methodology for oil pipelines” and a “final rule to streamline procedures...relating to oil pipeline rates in order to avoid unnecessary regulatory costs and delays.”<sup>314</sup> The legislative history demonstrates that Congress intended to remedy perceived problems it felt characterized the methodology and procedure of oil pipeline ratemaking.<sup>315</sup> In response, the Commission issued a series of three related rulemaking proceedings, the principal provisions of which took effect on January 1, 1995.<sup>316</sup>

In Order No. 572, the Commission permitted the continued use of market-based rates on a case-by-case basis and set forth the procedure and filing requirements for a pipeline requesting market-based rates. The Commission adhered to its approach of defining the product and geographic markets, and then analyzing a number of factors to assess the pipeline’s market power in those defined markets. The Commission did not alter in Order No. 572 the substantive findings on its market power analysis developed in the *Buckeye* and *Williams* proceedings, except notably where it added the requirement that the applicant pipeline define and establish a lack of market power in its geographic origin markets in addition to its destination markets.

1. *Order No. 561 Establishes Indexing as the Generally Applicable Ratemaking Tool and Order No. 571 Permits Cost-of-Service Rates in Defined Circumstances*

First, in Order No. 561, the Commission enshrined an indexing mechanism as the generally applicable oil pipeline ratemaking tool.<sup>317</sup> In summary, the Commission determined that for existing pipelines the percentage movements of an automatic index (the Producer Price Index—Finished Goods, minus 1 percent, which was subsequently increased) would serve as a cap on individual pipeline rates for particular transportation movements.<sup>318</sup> The initial ceiling applicable to each pipeline rate would be set at the level of the pipeline’s rate on December 31, 1994 (as adjusted by the index published by the Commission in May 1994).<sup>319</sup> This ceiling rate then rises and falls annually by the percentage change in the index.<sup>320</sup> Having determined the cap, the pipeline may, but is not compelled to, raise its rates up to the ceiling rate applicable to

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<sup>314</sup> Pub. L. No. 102-486, 106 Stat. 2776, 3010 (1992), reprinted in 42 U.S.C. § 7172 note.

<sup>315</sup> See Steven Reed & Pantelis Michalopoulos, *Oil Pipeline Regulatory Reform; Still in the Labyrinth?*, 16 ENERGY L.J. at 74 (citing 138 CONG. REC. H3489 (daily ed. May 20, 1992) (statement of Rep. Brewster)).

<sup>316</sup> As with the EPAct, the new rules do not apply to the Trans Alaska Pipeline System (TAPS) or any pipeline that delivers oil into TAPS. See Order No. 561, FERC Stats. & Regs. ¶ 30,985 at 30,961.

<sup>317</sup> The provisions of Order No. 561 discussed herein were memorialized in 18 C.F.R. §§ 342.0-342.4, 343.0-343.5.

<sup>318</sup> Order No. 561, FERC Stats. & Regs. ¶ 30,985 at 30,952; 18 C.F.R. § 342.3. However, the Commission also instituted a five-year review process: every five years the Commission will review the selection of the index and re-assess how well it has tracked industry costs, as evidenced from Form 6 data. Order No. 561, FERC Stats. & Regs. ¶ 30,985 at 30,952. Subsequently, the index has been changed by rulemaking to the Producer Price Index—Finished Goods, plus 2.65 percent. *Five-Year Review of Oil Pricing Index*, 133 FERC ¶ 61,228, at P 1 (2010). Therefore, the ceiling rate for each pipeline rises and falls every year in correlation with the percentage increase and decrease in the Producer Price Index for Finished Goods plus 2.65 percent.

<sup>319</sup> Order No. 561, FERC Stats. & Regs. ¶ 30,985 at 30,953-54.

<sup>320</sup> 18 C.F.R. § 342.3(d).

that index year.<sup>321</sup> If, on the other hand, the index decreases, and the rate exceeds the new ceiling as a result, the pipeline must decrease its rate to the new ceiling.<sup>322</sup> Order No. 561 provided that the initial rate for new pipeline services (subsequently subject to the index cap) is to be set either by filing a cost of service submission, or by filing a rate with the support of one non-affiliated shipper (subject to being supported by cost of service submissions should protests be filed).<sup>323</sup>

The principal effect of indexing is to preserve the value of existing rates in real (i.e. inflation-adjusted) terms.<sup>324</sup> The perceived benefits of the indexing system are simplicity, increased incentives for efficiency, protection of shippers against rate increases in excess of inflation,<sup>325</sup> the ability to “change rates rapidly to respond to competitive forces,” and the reduction in the “time and expense traditionally associated with filing rate cases.”<sup>326</sup>

In a separate rulemaking proceeding, Order No. 571 established that cost-of-service rate filings would remain relevant outside of setting the initial rate, but only as an alternative to indexing and only under certain defined circumstances.<sup>327</sup> An oil pipeline may charge rates through cost-of-service filings if it demonstrates “that there is a substantial divergence between the actual costs experienced by the carrier and the rate resulting from application of the index” such that the index ceiling rate would be unjust and unreasonable.<sup>328</sup> Likewise, a shipper can challenge rate changes within the index ceiling by raising reasonable grounds that the rates from indexing are substantially in excess of recovering actual costs incurred by the pipeline.<sup>329</sup> Once a party makes the showing entitling it to cost-of-service review, the orders contemplate no substantive change in the Opinion No. 154-B methodology.<sup>330</sup> Therefore, indexed rates are presumptively just and reasonable, and although the presumption can be rebutted in some instances based on cost-of-service data, those instances are narrowly defined.

## 2. Order No. 572 Establishes Filing Requirements and Procedures for Market-Based Rates

Order No. 572 provided that market-based rates would remain an option for oil pipelines. Order No. 572 also outlined the filing requirements for oil pipelines that seek to charge market-based rates and provided procedures applicable to those filings.<sup>331</sup> The order did not alter the substantive analysis of its market power inquiry as developed in the *Buckeye* and *Williams* proceedings discussed above, except in a few limited circumstances. Likewise, contrary to proposals submitted by various commenters, the Commission refrained from endorsing any generally applicable definitions for the product or geographic markets, and again declined to adopt numerical thresholds or benchmarks of market power. Generally applicable definitions of

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<sup>321</sup> 18 C.F.R. § 342.3(a).

<sup>322</sup> Order No. 561-A, FERC Stats. & Regs. ¶ 31,000 at 31,099; 18 C.F.R. § 342.3(e).

<sup>323</sup> 18 C.F.R. § 342.2.

<sup>324</sup> Order No. 561, FERC Stats. & Regs. ¶ 30,985 at 30,950.

<sup>325</sup> *Id.* at 30,948-49.

<sup>326</sup> *Id.* at 30,950-51.

<sup>327</sup> Order No. 571, FERC Stats. & Regs. ¶ 31,006.

<sup>328</sup> 18 C.F.R. § 342.4(a).

<sup>329</sup> 18 C.F.R. § 343.2(c)(1).

<sup>330</sup> See Steven Reed & Pantelis Michalopoulos, *Oil Pipeline Regulatory Reform; Still in the Labyrinth?*, 16 ENERGY L.J. at 84-85.

<sup>331</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007.

the product and geographic markets and numerical benchmarks of market power would come through the adjudicatory process. Primarily, Order No. 572 outlined the information a pipeline must submit with its application for market-based rates—information which measures the pipeline’s market power in its relevant markets.

First, the Commission explained why market-based ratemaking is needed. The Commission noted that market-based ratemaking comports with the “spirit” of the Energy Policy Act “by retaining a light-handed regulatory method to complement the indexing approach adopted as the generally applicable ratemaking methodology.”<sup>332</sup> In addition, market-based ratemaking “will be of use...where the oil pipeline needs the flexibility to...engage in competitive pricing in order to react to changes in market conditions....”<sup>333</sup> Therefore, market-based rates provide an oil pipeline flexibility to change prices in response to market conditions either quicker than or in excess of the rate allowed by indexing. Further, the Commission found that market-based rate pricing would be “both efficient and just and reasonable” because when neither the buyer nor the seller have market power it is rational to assume the terms of their voluntary exchange are reasonable and the seller makes only a normal return on its investment.<sup>334</sup> The Commission also explained that it was not adopting market-based ratemaking as the primary ratemaking methodology because it “is not generally applicable.”<sup>335</sup> Instead, the application of market-based rates is pipeline specific, and as directed in *Farmers II*, “the existence of competition or that a competitive price will be within a just and reasonable range” cannot be presumed or implied.<sup>336</sup>

Next, the Commission explained that it was not yet adopting substantive standards, guidelines, or numerical thresholds to be used in determining whether a pipeline has market power. Several commenters requested that the Commission allow a pipeline to use the relevant BEA as the geographic market without further justification, and define the product market for refined petroleum products as “delivered pipelineable petroleum products.”<sup>337</sup> Commenters also proposed certain HHI and market share numbers that would establish rebuttable or irrebuttable screens of market power.<sup>338</sup> The Commission rejected these requests and proposals. First, there was a lack of consensus from the participants on what those standards and thresholds should be.<sup>339</sup> Second, the Commission believed that it still lacked the necessary experience to adopt specific definitions for the product and geographic markets or adopt thresholds for market power.<sup>340</sup> But, the Commission stated that “as more experience is gained, precedent can serve as well as presumptions to provide guidance.”<sup>341</sup> This would ultimately be the case, as the Commission established in later adjudicatory proceedings a presumption in favor of BEAs as the geographic market for refined petroleum pipelines and indicated certain market power statistics that would cause it to find market power.

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<sup>332</sup> *Id.* at 31,179.

<sup>333</sup> *Id.* at 31,179-80.

<sup>334</sup> *Id.* at 31,180.

<sup>335</sup> *Id.* at 31,183.

<sup>336</sup> *Id.*

<sup>337</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,185-86.

<sup>338</sup> *Id.* at 31,185.

<sup>339</sup> *Id.* at 31,179.

<sup>340</sup> *Id.* at 31,185.

<sup>341</sup> *Id.*

Form of Lighthanded Regulation. The Commission proposed in the Notice of Proposed Rulemaking that once a lack of significant market power was established there would be no generic constraints on price levels, over their duration, nor any ongoing mechanism to monitor the rates.<sup>342</sup> Several commenters requested that price caps and term limits be imposed on market-based rates similar to those used in *Buckeye*.<sup>343</sup> The Commission concluded that there was no need to set generic rules constraining price or duration that would apply to all market-based rate proceedings.<sup>344</sup> Instead, all such issues could be considered in the context of individual cases in light of the circumstances in those matters.<sup>345</sup>

The Commission did establish specific filing requirements applicable to requests for market-based rate authority. These specific requirements are set forth in nine required statements detailed below that the pipeline must submit along with its application for market-based rates. “The Commission is requiring the oil pipelines to essentially file the same information as the Commission has analyzed in the past in oil pipeline proceedings with respect to market power determinations.”<sup>346</sup>

Geographic Markets. Statement A requires the pipeline to “describe the geographic markets in which the carrier seeks to establish that it lacks significant market power” and “explain why the carrier’s method for selecting the geographic market is appropriate.”<sup>347</sup> Again, the Commission did not mandate or presume the use of BEAs as the geographic market, and required that if BEAs are used, the pipeline “must show that each BEA represents an appropriate geographic market.”<sup>348</sup> It also posited that something other than a BEA could be used, such as a “given radius around [an oil pipeline’s] terminals.”<sup>349</sup> The “burden will be on the oil pipeline to explain why its use of BEAs or any other definition of the geographic market is appropriate.”<sup>350</sup>

Of particular note and one of the substantive changes implemented, the Commission added the requirement that the oil pipeline include origin markets in its evidentiary presentation in addition to destination markets. Specifically, “[t]he carrier must include the origin market and the destination market related to the service for which it proposes to charge market-based rates.”<sup>351</sup> “This will provide interested parties with complete information about competition at the supply and delivery ends of the pipeline system.”<sup>352</sup> The Association of Oil Pipelines contested the inclusion of origin markets because analyzing each end of point-to-point service would significantly increase the burden on oil pipelines even though there was little concern of

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<sup>342</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,186.

<sup>343</sup> *Id.* at 31,186-87.

<sup>344</sup> *Id.* at 31,187.

<sup>345</sup> *Id.*

<sup>346</sup> *Id.*

<sup>347</sup> 18 C.F.R. § 348.1(c)(1).

<sup>348</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,188.

<sup>349</sup> *Id.*

<sup>350</sup> *Id.*

<sup>351</sup> 18 C.F.R. § 348.1(c)(1).

<sup>352</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,188.

monopsony power in origin markets.<sup>353</sup> The Commission, however, concluded that it was still concerned about the possibility of monopsony power.<sup>354</sup>

In a related finding, the Commission stated that a protestant in response to an application to charge market-based rates could come forward with evidence that a point-to-point corridor approach should be used in a particular case.<sup>355</sup> The Commission did not, however, require the oil pipeline to file a market analysis of each point-to-point corridor at the initial filing stage.<sup>356</sup> In addition, the Commission recognized, as was done in *Williams*, that a point-to-point corridor approach may provide an inaccurate picture of market concentration and could improperly exclude competitive alternatives.<sup>357</sup>

Product Market. Oil pipelines are required in Statement B to “identify the product market or markets for which the carrier seeks to establish that it lacks significant market power.”<sup>358</sup> The Commission reiterated that it was not requiring a specific definition of the product market, but left it to the pipeline to explain and establish the appropriateness of its proposal.<sup>359</sup> At a minimum, however, the Commission required the product market to be distinguished between the transportation of crude oil and the transportation of refined petroleum products.<sup>360</sup> Opening the door to revisit the finding in *Buckeye* and *Williams* that the relevant product market for refined petroleum is all pipelineable petroleum products, the Commission stated that “products transportation could be delineated by type, such as motor gasoline, distillates, or jet fuel.”<sup>361</sup> Likewise, the Commission offered that “[c]rude oil transportation could further be divided to include transportation of natural gas liquids...” for example.<sup>362</sup>

Description of Facilities and Services. In Statement C, the pipeline “must describe the carrier’s own facilities and services in the relevant markets identified in statements A and B....”<sup>363</sup> The Commission provided that Statement C should include all pertinent data about the pipeline’s facilities and services, and provided a non-exhaustive list of relevant information:

For example, without limitation, the oil pipeline would have to include data on the capacity of its facilities, on its throughput, on its receipts in its origin markets, on its deliveries in its destination markets and to its major consuming markets, and the mileage between its terminals and its major consuming markets. Data should be supplied for each commodity carried, such as jet fuel, gasoline, etc.<sup>364</sup>

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<sup>353</sup> *Id.*

<sup>354</sup> *Id.* at 31,189.

<sup>355</sup> *Id.* at 31,188.

<sup>356</sup> *Id.*

<sup>357</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,188.

<sup>358</sup> 18 C.F.R. § 348.1(c)(2).

<sup>359</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,189.

<sup>360</sup> *Id.*

<sup>361</sup> *Id.*

<sup>362</sup> *Id.*

<sup>363</sup> 18 C.F.R. § 348.1(c)(3).

<sup>364</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,190-91.

Similarly, in Statement F, the oil pipeline is required to submit maps showing the details of its transportation facilities, terminals, and markets, along with the location of any proposed transportation alternatives.<sup>365</sup>

Alternative Sources of Transportation. In Statement D, the pipeline “must describe available transportation alternatives in competition with the carrier in the relevant markets and other competition constraining the carrier’s rates in those markets.”<sup>366</sup> To the extent available, the pipeline must include “data similar to that provided for its own facilities and services in Statement C, including cost and mileage data in specific reference to the oil pipeline’s terminals and major consuming markets.”<sup>367</sup> The Commission noted that possible transportation alternatives would include “[o]ther pipelines, including private pipelines and those passing through the geographic market but without terminals, pipelines passing near the geographic market, barges, trucks, and refineries within the geographic market.”<sup>368</sup>

In assessing possible alternatives, the Commission implied that a cost comparison between the applicant pipeline and alternatives based on delivered product price as opposed to just the transportation rate component of the product price would most likely be necessary:

Under the ICA, the Commission regulates the transportation of oil by pipeline. In a market power analysis, the Commission must determine the oil pipeline’s ability to exercise market power over this transportation service. However, a market power analysis in general cannot be made solely in the context of transportation rates. Where competitive alternatives constrain the applicant’s ability to raise transport prices, the effect of such constraints are ultimately reflected in the price of the commodity transported. Hence, the delivered commodity price (relevant product price plus transportation charges) generally will be the relevant price to be analyzed for making a comparison of the alternatives to a pipeline’s services. However, in some instances such as for origin markets or crude oil pipelines, it may be appropriate to make a case based only on transportation rates. A pipeline may elect to file such a case and a protestant may argue that such a case is appropriate.<sup>369</sup>

In Statement E, the oil pipeline “must describe potential competition in the relevant markets. To the extent available, the statement must include data about the potential competitors, including their costs, and their distance in miles from the carrier’s terminals and major consuming markets.”<sup>370</sup>

Market Concentration and Market Share. Statement G requires the pipeline to “set forth the calculation of the market concentration of the relevant markets using the Herfindahl-Hirschman Index.”<sup>371</sup> The HHI calculation “must include the oil pipeline and the competitive

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<sup>365</sup> *Id.* at 31,192; *see also* 18 C.F.R. § 348.1(c)(6).

<sup>366</sup> 18 C.F.R. § 348.1(c)(4).

<sup>367</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,191.

<sup>368</sup> *Id.*

<sup>369</sup> *Id.* at 31,189.

<sup>370</sup> 18 C.F.R. § 348.1(c)(5).

<sup>371</sup> 18 C.F.R. § 348.1(c)(7).

alternatives set forth in Statements D and E” and the “burden is on the oil pipeline to justify the individual market shares used in calculating the HHIs.”<sup>372</sup>

Statement G also requires the pipeline to set forth its market share in the relevant markets.<sup>373</sup> The Commission requires the pipeline to submit market share statistics that provide both actual delivery and capacity information found favorable in the *Williams* proceeding. Therefore, the market share calculation must be “based on [the applicant pipeline’s] receipts in its origin markets and its deliveries in its destination markets” if the HHIs are not based on actual receipts and deliveries, but some other factor like capacity shares.<sup>374</sup> “For example, if the destination HHIs are based on capacity determined market shares, the oil pipeline would have to submit a calculation showing its share of the market based on deliveries in the respective destination markets.”<sup>375</sup>

Statement G “must also set forth the calculation of other market power measures relied on by the carrier.”<sup>376</sup> In conformance with the presumption of competitiveness from significant and expandable waterborne alternatives found in *Williams*, Opinion No. 391-A, the Commission stated this could include “evidence about water transportation as an indication that the oil pipeline lacks significant market power.”<sup>377</sup>

Excess Capacity, Competition from Vertically Integrated Companies, Buyer Power, and Profitability. Statement H requires the pipeline to “describe any other factors that bear on the issue of whether the carrier lacks significant market power in the relevant markets.”<sup>378</sup> As non-exclusive examples, the Commission cited excess capacity, competition with vertically integrated companies, the pipeline’s profitability, and buyer power.<sup>379</sup>

Proposed Testimony and Procedural Requirements. The Commission also adopted certain procedural requirements in connection with market-based rate applications. Statement I requires the pipeline to “include the proposed testimony in support of the application” that will serve “as the carrier’s case-in-chief, if the Commission sets the application for hearing.”<sup>380</sup> Protests must be submitted within sixty days after the application is filed setting forth detailed grounds for opposing an application.<sup>381</sup> This includes “responding to [the pipeline’s] statement of position and information, and, if the protestant desires, presenting information of its own pursuant to Statements A-I.”<sup>382</sup> Neither the pipeline’s application, nor the protests, will have the benefit of any discovery. “The Commission believes that the oil pipeline and the protestants

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<sup>372</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,192.

<sup>373</sup> 18 C.F.R. § 348.1(c)(7).

<sup>374</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,192.

<sup>375</sup> *Id.*

<sup>376</sup> 18 C.F.R. § 348.1(c)(7).

<sup>377</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,192-93.

<sup>378</sup> 18 C.F.R. § 348.1(c)(8).

<sup>379</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,193.

<sup>380</sup> 18 C.F.R. § 348.1(c)(9).

<sup>381</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,194; *see also* 18 C.F.R. § 348.2(g)-(h).

<sup>382</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,194; *see also* 18 C.F.R. § 348.2(g)-(h).

should have sufficient information available from public sources or their own experience to submit their cases.”<sup>383</sup>

“The Commission, after examination of the oil pipeline’s application and any protests, will issue an order in which it will rule summarily on the application or, if appropriate, establish additional procedures and the scope of the investigation. Additional procedures may or may not involve a hearing before an administrative law judge.”<sup>384</sup> The Commission adopted regulations 18 C.F.R. §§ 348.1 and 348.2 to memorialize these filing and procedural requirements.

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<sup>383</sup> Order No. 572, FERC Stats. & Regs. ¶ 31,007 at 31,196.

<sup>384</sup> *Id.* at 31,194; *see also* 18 C.F.R. § 348.2(i).