Oil Pipeline Ratemaking Methodologies

Michele Joy
Association of Oil Pipe Lines

May 18, 2004

Pipeline's Goal

To meet competition and to capitalize on business opportunities.

Regulator’s Goal

To promote competition and to protect shippers from the exercise of undue market power.

Our Goal Today

To understand the content and intent of the law so as to achieve the regulator's objectives while meeting the pipeline's goal.

FERC Mandate

- 1906 Interstate Commerce Act
  - Interstate oil pipelines must be common carriers (with a few minor exceptions)
  - Rates must be just and reasonable
  - Undue discrimination & preferences are prohibited
  - Carriers must file and post tariffs
- Politics work against deregulation

Status of Oil Pipeline Regulation Pre-Energy Policy Act of 1992

- Uncertainty regarding Opinion 154-B
- *ARCO* experience
- Some companies earning above Opinion 154-B revenue levels
- Uncertainty regarding market-based option
- *Buckeye* experience
- Exposure in the event of complaints

The Energy Policy Act of 1992 (EPAct)

- All existing and unchallenged rates are deemed just and reasonable (“grandfathered rates”).
- Those rates can only be challenged upon a demonstration of “substantially changed circumstances.”
- The Commission is told to introduce new procedures.

The Energy Policy Act of 1992 (EPAct) (cont.)

- Congress orders the Commission to establish a “simplified and generally applicable ratemaking methodology”

The Result: Four alternatives for *existing* rates

- Indexation
- Settlement Rates
- Cost-based Rates
- Market-based Rates
- *Plus* Security Cost Recovery Surcharge

The Result:
At least two ratemaking options for *new service*

- Negotiated Rates
- Cost-of-Service
- *Market-Based Rates*

Indexation

The good news:

–It’s simple

–It’s usually optional

–Challenges are limited

The bad news:

–It’s been negative

–Negative is mandatory

Indexation

- Index applies to pipeline’s ceiling rates
- Actual rates may be less than ceiling rate
- Ceiling rate may be re-set if alternatively set rate accepted
- If existing rate above new ceiling rate, it must go down or alternative rate justification must apply

Index Adjustment

- To be reviewed every five years
- First review left index unchanged
- Court of Appeals found analysis flawed
- FERC revised index from 2001 to PPI
- FERC plans to review index again in 2006
- Court of Appeals affirms revised index

Settlement Rates

- *All* current shippers using that service must agree to the new rates.

- If settlement rate is challenged, the pipeline may defend the rate on either a cost-of-service or competitive basis.

Cost-of-Service

- This option is not automatically available
  - First, the carrier's costs must "substantially diverge" from revenues the carrier is capable of earning under indexed rates.
  - The costs must then be justified using the Opinion No. 154-B model.

The Opinion No. 154-B Model

- Cost-of-Service showing for oil pipelines differs from other FERC regulated industries in two principal respects
  - Starting Rate Base
  - Trended Original Cost (TOC)

Starting Rate Base

The formula looks like this: SRB = O(d) + R(e)

where:

SRB = Starting Rate Base

O = book net depreciated original cost as of 12/31/83

R = net depreciated cost of reproduction new from 1983 valuation

d = debt ratio as of 6/28/85

e = equity ratio as of 6/28/85

Trended Original Cost

			DOC	TOC
A	Nominal Rate of Return (ROR)		16.00%	16.00%
B	Inflation Rate		n/a	7.00%
C	Real ROR	A-B	n/a	9.00%
D	Rate Base		$1,000	$1,000
E	Return on Rate Base			
	Nominal for DOC	A	16.00%	
	Real for TOC	C		9.00%
F	Current earnings	DxE	$160	$90
G	Inflation Rate		n/a	7.00%
H	Deferred earnings	GxD	n/a	$70

Compare - Security Cost Surcharge

- No substantial divergence test
- Costs must be linked to enhanced security post 9/11/01
- Both capital and operating costs may be recovered
- Confidentiality will be maintained if warranted

Market-Based Rates

- Requires a mini-antitrust showing.
- The carrier must demonstrate that there is adequate competition in both the *origin* and the *destination* markets.
- Finding made that individual pipeline lacks market power in each market examined.

Carrier's case must at least do the following:

- Define the relevant geographic (origin and destination) and product market.
- Identify competitive alternatives.
- Compute the market concentration.

Markets the Commission has Considered

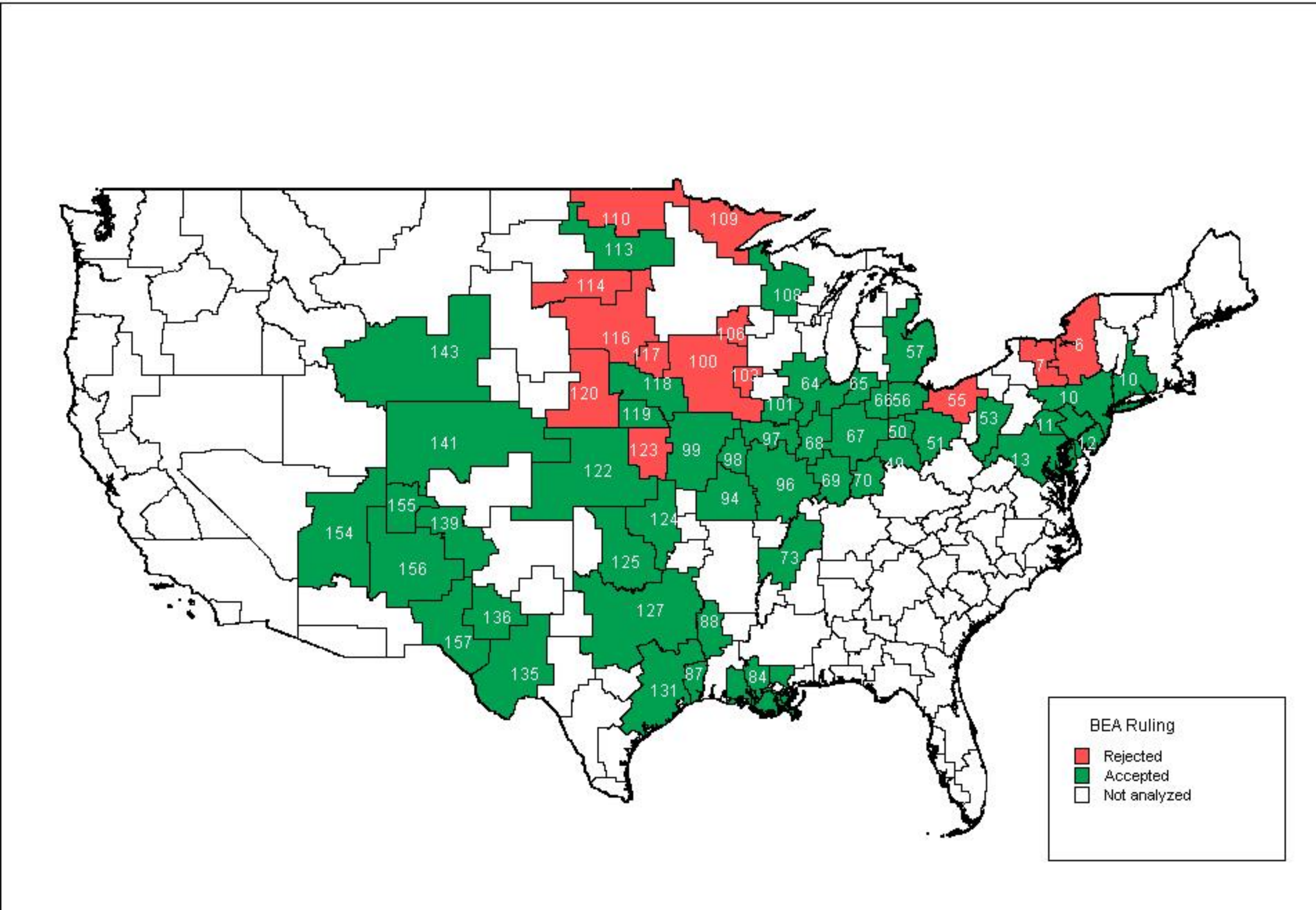
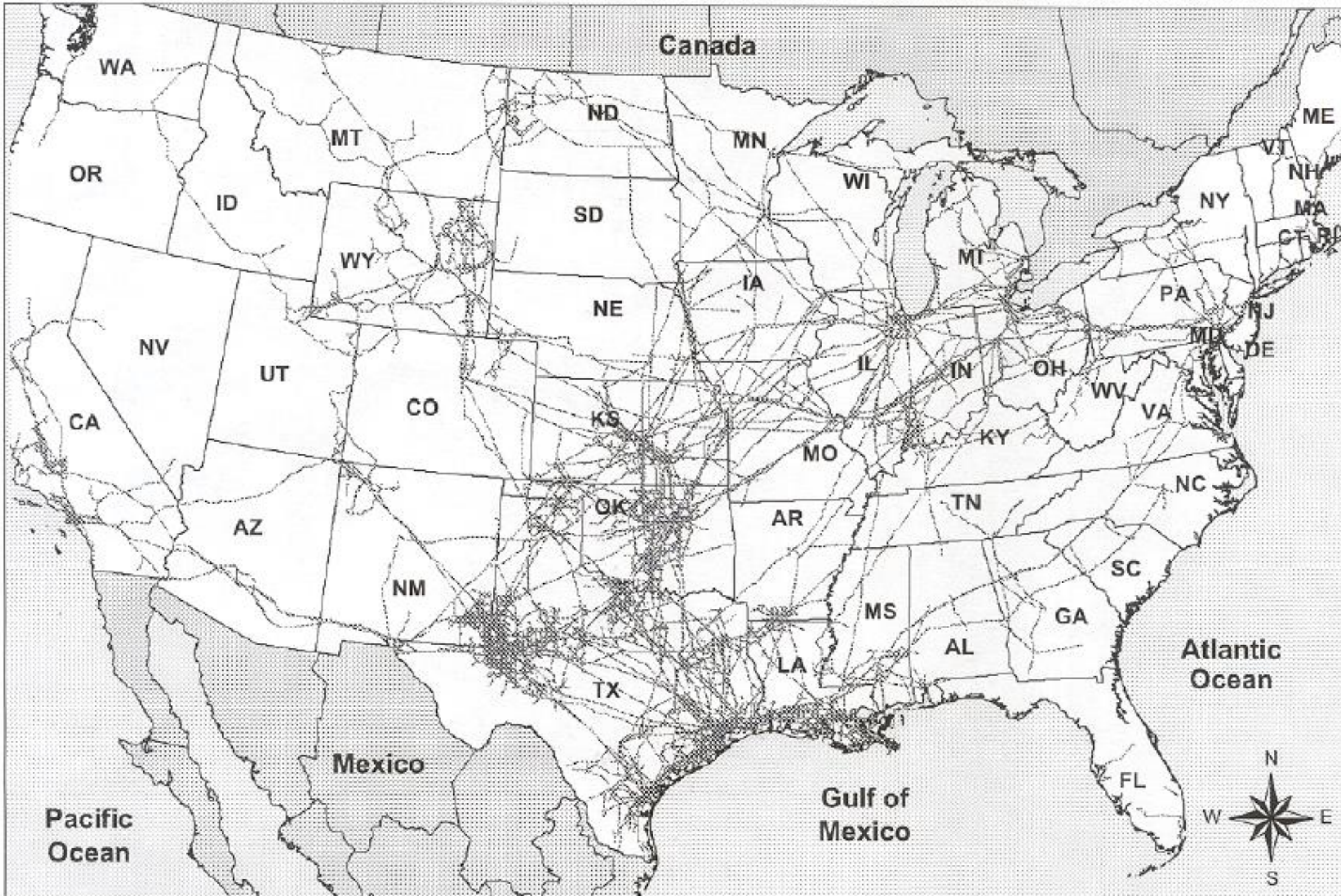


Figure 9: Locations of Hazardous Liquid Pipelines



Source: OPS, based on data from MAPSearch Services.

Questions about market-based rates

- Market-based rates are only permitted in markets where a pipeline is found to lack market power.
- Uncertainty on how to set rates in less competitive markets.
- Only guidance has been to avoid cross subsidization.

Initial Rates

- Requires agreement of at least one unaffiliated shipper, or
- Rate must be justified using cost-of-service methodology.
- Even if the unaffiliated shipper agrees, the rate may be challenged by anyone with an economic interest.
- Pipeline must then defend using cost-of-service method, unless Commission approved alternative.

Alternatives for Initial Rates

- Special contractual agreements (Express)
- Market power showing (Longhorn)

Conclusions

- The regulations allow rates to be set using four different methodologies
- This flexibility in rate setting reflects the history and competitiveness of the industry
- Industry players must understand the regulations to structure business deals appropriately
- The Commission must understand the business drivers in order to foster pipeline growth while protecting shippers