

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners, L.P.
and Enbridge Inc.

§ Docket No. OR12-4-000

REPLY COMMENTS OF JOINT SHIPPERS

Pursuant to the Order Granting Rehearing for the Purpose of Reconsideration issued herein by the Commission on June 28, 2012, intervenors Suncor Energy Marketing Inc., Canadian Natural Resources Limited, Continental Resources, Inc. and Husky Marketing and Supply company (collectively “Joint Shippers”) hereby submit the following reply comments in response to the initial comments submitted herein by applicants Enterprise Product Partners, L.P. and Enbridge Inc. (“Applicants”) and by intervenor Association of Oil Pipe Lines (“AOPL”). As explained below, Applicants and AOPL have failed to show that the Commission did not properly interpret and apply the decision of the United States Court of Appeals for the District of Columbia circuit in *Mobil Pipe Line Co. v. FERC*, 676 F.3d 1098 (2012) (“*Mobil*”) in the Commission’s Order on Application for market Power Determination, 139 FERC ¶ 61,099 (2012) issued in this proceeding (“Seaway Order”). These reply comments also demonstrate that the “reasonably available” standard proposed by Applicants and AOPL for evaluating potential competitive alternatives will not effectively safeguard against the exercise of market power.

SUMMARY

The initial comments of Applicants and AOPL propose a sweeping and radical interpretation of the *Mobil* decision which would override years of market power analysis and essentially eliminate consideration of price from the analysis of market power. The impact of such an approach would be to allow market share and market concentration measures to be based on assumed competition or the mere existence of alternatives without regard for whether such alternatives are good competitive alternatives. Such a radical interpretation is not supported by the text of the *Mobil* decision, is contrary to the rationale underlying the Commission's market-based rate regulations, and is inconsistent with basic principles of antitrust analysis. The Applicant's interpretation would allow pipelines to obtain market based rates by merely submitting a blanket list of alternatives without any further analysis or consideration whatsoever of price, availability, quality to determine whether such alternatives would serve to prevent a party from exercising market power. Applicants' initial comments do not provide, or offer to provide, any additional evidence or factual information. Accordingly, these reply comments will demonstrate that:

- The *Mobil* decision did not eliminate the need to justify competitive alternatives in terms of price;
- The "reasonably available" standard proposed by applicants and AOPL will not prevent the exercise of market power;
- There is no evidence that the crude oil price differentials between Seaway's origin and destination markets are short-term or temporary price variations;

- Some of the origin market alternatives identified by Applicants are not actually available to shippers on Seaway;
- Applicants and AOPL distort the Merger Guidelines and basic principles of antitrust analysis; and
- Applicants' request for waiver of the Commission's regulations should be denied.

BACKGROUND

In *Mobil*, the court of appeals reviewed the Commission's order denying an application by Mobil Pipe Line Company ("Mobil") for authority to charge market-based rates on its Pegasus crude oil pipeline. *Mobil Pipe Line Co.*, 133 FERC ¶ 61,291 (2010) ("*Mobil* Order"). The court concluded that the *Mobil* Order was unreasonable on the specific facts of that case. The court vacated the Commission's order and remanded the case to the Commission for further proceedings consistent with the court's decision. *Mobil* at 1105.

In the Seaway Order, the Commission denied the application ("Application") of the Applicants for authority to charge market-based rates as initial rates on the reversed system of Seaway Crude Oil Pipeline Company ("Seaway"). The Commission ruled that Applicants, in order to justify the Seaway origin market, must show that each alternative outlet is a good alternative in terms of price for each shipper in the market. Because Applicants admitted that such an analysis could not be conducted in the absence of an established tariff rate, the Commission denied the Application. Seaway Order at P 38.

As explained in the initial comments of the Joint Shippers submitted herein, the Seaway Order appropriately addressed the findings and rulings of the court in *Mobil*.

The Commission noted that the court recognized the Commission's definition of market power as "the ability profitably to maintain prices above competitive levels for a significant period of time" which analysis by necessity requires an assessment of alternatives in terms of price. Seaway Order at P 31. The Commission further observed that the court's rejection of the regulated tariff rate as an appropriate proxy for the competitive rate in that particular case did not mean relevant price data or an adequate proxy for the competitive rate are no longer necessary or relevant under the Commission's regulations governing market power for oil pipelines. *Id.* at P 32. The Commission concluded, based on *Mobil*, that a pipeline must still present price data in order to determine good alternatives for inclusion in the geographic market. *Id.* The analysis by the Commission is consistent with and in accordance with: (a) long-standing FERC precedent; (b) Department of Justice and Federal Trade Commission's Merger Guidelines; and (c) antitrust principles.

The rationale behind of maintaining price comparisons as an indispensable part of market analysis is patently obvious: in the absence of including and reviewing such price data, any market power analysis would be virtually meaningless from the perspective that such analysis would be conducted in a vacuum without regard to the actual influence or implications of the existence of the proposed alternatives. Put another way, based on basic principles, alternatives which are not good alternatives in terms of price simply by definition cannot constrain, influence or impact the market power of a party whereas alternatives that present good alternatives in terms of price have the exact opposite affect of constraining market power of a party.

The initial comments submitted by Applicants and AOPL claim that the Seaway Order did not properly interpret and apply the *Mobil* decision. The comments of AOPL include an affidavit by Dr. Michael J. Webb. Applicants, AOPL, and Dr. Webb maintain that a netback price analysis or other price analysis should not be used to determine whether alternatives which are currently used or reasonably capable of being used are competitive. Applicants' Comments at 18; AOPL Comments at 9-15, Webb Affidavit at P 27. Applicants argue that *Mobil* holds that currently-used and reasonably available alternatives are by definition "good" alternatives. Applicants' Comments at 18. AOPL proposes that the Commission adopt a standard which would include an alternative in the relevant geographic market or product market if the alternative is "reasonably available," meaning that the alternative is being used or is reasonably capable of being used. AOPL Comments at 17.

REPLY COMMENTS

I. The *Mobil* Decision Did Not Eliminate the Need to Justify Competitive Alternatives in Terms of Price.

Contrary to Applicants and AOPL, the *Mobil* Decision did not reject the Commission's long established requirement that competitive alternatives must be good alternatives in terms of price. To do so would require a clear and unequivocal express rejection by the court of the long established approach and principles reflected in historical FERC precedent, the Merger Guidelines, as well as general antitrust principles. The position advanced by Applicants' essentially seeks to overturn such principles by suggesting that *Mobil* implicitly rejects price analysis. Such a profound and dramatic

change in market power analysis should not occur in the absence of clear, express and unequivocal language. Since 1984, the criteria in the Merger Guidelines for identifying competitive alternatives have included comparable price, terms of sale, and customer willingness or ability to substitute products. 1984 Merger Guidelines, Section 2.31; 1992 Merger Guidelines, Section 1.21; 2010 Merger Guidelines, Section 4.2.

As explained in the initial comments of Joint Shippers, the court decision in *Mobil* recognized various long-standing principles that directly or indirectly embrace the traditional market power analysis, including the following: (a) the economic consideration of shippers is the delivered price; (b) market power is the ability to profitably to maintain prices above competitive levels for a significant period of time; (c) market power analysis is based on well settled economic and competition principles; (d) the appropriate test was whether Mobil could profitably raise rates on Pegasus above competitive levels for significant period of time because of a lack of competition; (e) market power analysis focuses on whether there are alternatives to a firm's services that constrain its ability to profitably charge prices above the competitive levels for a significant period of time; and (f) the inquiry examines the alternatives reasonably available to consumers and the cross-elasticity of demand – that is, the extent to which consumers will respond to an increase in the price of one good by substituting or switching to another.

Based on the foregoing, it is clear from the *Mobil* decision that: (a) an analysis in respect of alternatives must be conducted; and (b) an analysis as to whether a party could profitably raise its prices above competitive levels for a significant period of time is

required. All of the foregoing by their nature require an analysis of whether the alternatives are good alternatives in terms of price, in the absence of which it would be impossible to discern whether a party could profitably raise its prices over a sustained period. The court considered crude oil differentials between the origin and destination markets, finding them potentially consistent with competition to the extent they are temporary in nature. *Id.*

As the Seaway Order recognized, the *Mobil* decision analyzed whether Mobil could raise Pegasus' rates above the competitive level, thus requiring some consideration of delivered price or netback price. *Mobil* at 1100, 1102. The court ruled that the regulated tariff rate used by the Commission in that particular case was not a proper proxy for the competitive rate level. *Id.* at 1103-04. However, as the Seaway Order observed, this does not mean that relevant delivered price or netback price data are no longer necessary under the Commission's market-power regulations. Seaway Order at P 32.

While the *Mobil* decision found that the competitive benchmark price relied upon by the Commission was erroneous, the court did not dispute the significance or value of a properly conducted netback price analysis. As Applicants recognize, the court rejected the Commission's netback analysis because it used the applicant pipeline's regulated rate as a proxy for the competitive rate." Applicants' Comments at 7. The court did not suggest that a valid delivered price or netback price analysis is not necessary or useful in considering potential competitive alternatives.

Moreover, the court of appeals did not question, comment on or reject the three-pronged test adopted by the Administrative Law Judge (“ALJ”) and affirmed by the Commission for assessing whether an outlet in a proposed geographic origin market is a good alternative. As articulated by the Commission, the three requirements for a good alternative are that it must be (1) readily available; (2) comparable in quality, and (3) comparable in price. *Mobil* Order at P 31. The Commission observed that Staff (whom the court relied upon heavily) endorsed the foregoing three requirements for a good alternative. *Id.*

In *Mobil*, the court of appeals essentially adopted the analysis of market power presented by the Commission Trial Staff, which was premised in part on the three-pronged test, including the requirement of comparability in price. The lead-off witness for Staff at hearing was Dr. David W. Savitski, whose purpose was to review the Commission’s market power analysis framework and to review Commission precedent for guidance in applying that framework. Exh. No. S-1 at 3-4. In his prepared testimony, Dr. Savitski specifically endorsed the three-pronged test for good alternatives which was subsequently adopted by the Commission:

Q. What are the characteristics of a “good alternative?”

A. A good alternative must be readily available, be of comparable quality, and offer comparable service at approximately the same price as the applicant, here Pegasus.

Exh. No. S-1 at 12. At hearing, Staff witness Savitski confirmed that all three requirements (availability, quality, and price) must be satisfied in order for an outlet to qualify as a good alternative. Tr. 1999. This endorsement by Staff of the three

requirements for a good alternative, including comparability in terms of price, was in the record on which the court of appeals based its adoption of the Staff's market power analysis and was not questioned or criticized by the court.

Applicants cite the testimony of Staff witness Boner that it is "without precedent" to exclude currently used alternatives, regardless of variation in price or netback. Applicants' Comments at 10. However, Applicants fail to mention the contrary record evidence, cited by the ALJ, that Staff in two prior oil pipeline market-based rate cases had performed netback analyses and had excluded used alternatives from the origin markets where they were not good alternatives to the applicant pipeline in terms of price. *Mobil Pipe Line Co.*, 128 FERC ¶ 63,008 at P 178 (2009) ("*Mobil I.D.*").

As AOPL recognizes, the court made clear in *Mobil* that a market power analysis examines cross-elasticity of demand – that is the extent to which consumers will respond to an increase in the price of one good by substituting or switching to another. AOPL Comments at 10; *Mobil* at 1102. The attached Affidavit of Daniel S. Arthur explains that a netback price analysis provides relevant information required to assess on cross-elasticity of demand, or the willingness of shippers to shift volumes to an alternative in response to a rate increase by the applicant pipeline. Arthur Affidavit at P 33. Thus, the court's emphasis on cross-elasticity of demand is a further indication that the court did not intend to exclude the consideration of price from the identification of competitive alternatives.

II. The Proposed “Reasonably Available” Standard for Identifying Competitive Alternatives Will Not Prevent the Exercise of Market Power.

The attached affidavit of Dr. Arthur addresses the proposal by Applicants and AOPL that an alternative be considered competitive with the applicant pipeline if the alternative is “reasonably available” to shippers. In Dr. Arthur’s view, the ultimate question is whether the *Mobil* decision (1) requires a market-power framework which identifies competitive alternatives for inclusion in market share and market concentration measures based upon all alternatives in a geographic area which are used or capable of being used or (2) allows competitive alternatives to be identified based on being comparable to the applicant pipeline in terms of availability, quality, and price. Dr. Arthur demonstrates that an analysis which identifies competitive alternatives in terms of price should remain an indispensable part of the calculation of market share and market concentration measures, as the Commission found in the Seaway Order. Through the use of hypothetical examples, Dr. Arthur shows that market share and market concentration statistics based on all used or potentially used alternatives can erroneously indicate a lack of market power when, in fact, the exact opposite is true. Arthur Affidavit at P 6.

A. Relevant Market Power Definition

Dr. Arthur applies the definition of market power applied by the Commission in the *Mobil* Order and endorsed by the court of appeals in *Mobil*. That definition is the ability to sustain a small but significant price increase above the competitive level for a significant period of time. The very essence and definition of market power in of itself requires the consideration of price in respect to the identification of good competitive alternatives, as alternatives which are not good alternatives in terms of price could not

impact the ability of a party to sustain a small but significant price increase above a competitive level. Dr. Arthur emphasizes that the meaning of the terms (1) “competitive price level,” (2) “small but significant price increase,” and (3) “significant period of time” need to be clearly defined. Otherwise, as Dr. Arthur’s examples illustrate, failure to identify the relevant competitive price level, for example, can create situations where any observed transportation rate could be considered a competitive price level by its mere existence when, in fact, the rate is above the competitive level and is the result of an exercise of market power. Arthur Affidavit at P 15.

1. Competitive Rate Level

Based on prior Commission and D.C. Circuit decisions, Dr. Arthur explains that a long-run competitive rate is the relevant benchmark for a “competitive price” when analyzing whether an oil pipeline applying for market-based rates can sustain a small but significant rate increase above the competitive rate for a significant period of time. He also explains that a long-run competitive rate is fundamentally tied to the cost of providing service, including a reasonable return on investment. Thus, the long-run marginal cost, which is equal to the long-run average cost of providing transportation services, is central to determining whether a pipeline can sustain a rate above the long-run competitive rate and earn an extraordinary return on investment. Arthur Affidavit at PP 16-18.

While regulated cost-of-service rates are designed to approximate a long-run competitive rate, Dr. Arthur notes that regulated cost-based rates may in some circumstances differ from rates determined in a competitive market. For example,

regulated cost-based rates are typically dependent upon the original book value of assets and provide for a specific pattern of capital recovery, usually based on a depreciating rate base. A competitive rate, on the other hand, will be independent of the vintage of the assets of any specific competitor. Arthur Affidavit at P 19.

2. Small But Significant Rate Increase

Dr. Arthur concludes that a 15-percent increase above the relevant competitive rate is reasonable to use as a threshold rate increase. While the Commission has not specified a standard rate increase level as a standard to determine competitive alternatives, the Commission has applied a 15-percent rate increase in prior proceedings for purposes of market power analyses. Arthur Affidavit at P 22; *see, e.g., Buckeye Pipe Line Co. L.P.*, 53 FERC ¶ 61,473, 62,666 (1990). The Merger Guidelines state that, in most contexts, a five-percent increase lasting for the foreseeable future should be used in evaluating whether a merger would decrease competition. 1992 Merger Guidelines, Section 1.11. However, the Merger Guidelines also state that the hypothetical price increase will depend on the industry being examined and may be greater or less than five percent. Dr. Arthur concludes the use of the 15-percent as a threshold rate increase is conservative and consistent with the use of a percentage greater than five percent for intermediate products, such as transportation. *Id.*

3. Significant Period of Time

Dr. Arthur proposes a period of two years as a “significant period of time” to sustain a rate increase above the competitive level for purposes of this proceeding, consistent with the 1992 and 2010 Merger Guidelines. He explains that it is sustaining

rate increase above the long-run competitive rate that is in the relevant market power concern in the case of oil pipeline analysis for market-based rates. Arthur Affidavit at PP 23-26. While the Merger Guidelines do not explicitly define a “significant period of time,” the 1992 Merger Guidelines use a two-year period to determine whether entry into a market is timely. *Id.*; 1992 Merger Guidelines, Section 3.2.

Dr. Arthur recognizes that short-run or seasonal deviations from a long-run competitive price are not the relevant market power concern. Rather, it is a sustained deviation of price above a long-run competitive price that is the relevant concern. Seasonal or other temporary deviations in price above a long-run competitive price level are consistent with a workably competitive market, which the Commission recognized in *Explorer Pipeline Co.*, 87 FERC ¶ 61,374, 62,394 (1999). Arthur Affidavit at PP 26-27.

B. Hypothetical Scenarios

Dr. Arthur presents three hypothetical scenarios to examine whether the inclusion of all used alternatives in a market power analysis would accurately detect the ability to exercise market power. Each scenario includes six pipelines (Pipelines AB through AG) transporting oil from a single origin (Origin A) to six different destinations (Destinations B through G). Pipeline AB is assumed to be the applicant pipeline. Each pipeline is assigned a long-run marginal cost (“LRMC”) and is assumed to have a transportation rate equal to the LRMC. Arthur Affidavit at PP 29-35.

1. First Scenario - - No Market Power

In the first scenario, depicted in Figure 1 of the Arthur Affidavit, there are no capacity constraints on any of the pipelines. Under this scenario, competition in the

commodity markets will cause the difference in commodity prices at the origin and destination locations to equal the transportation rate between the origin and destination. If applicant Pipeline AB implements a small but significant rate increase, the other pipelines would be comparable in price because they would be offering a higher netback price. Thus, all of the five other pipelines should be considered competitive alternatives and should be included in the calculation of market share and market consideration measures as such alternatives would serve to constrain any market power exercised by the applicant Pipeline AB. In this scenario, the same market share and market concentration statistics would result by simply assuming all existing alternatives are competitive or by systematically comparing alternatives in terms of price. Arthur Affidavit at PP 36-39.

2. Second Scenario - - Market Power

In the second scenario, depicted in Figure 2 of the Arthur Affidavit, applicant pipeline AB increases its long-run competitive rate by 15 percent. Because of a higher commodity price at Destination B, Pipeline AB continues to offer a substantially higher netback price than the other five pipelines such that shippers on Pipeline AB have no incentive to shift to any of the alternative lines. Thus, the netback analysis provides evidence that Pipeline AB can exercise market power. In contrast, the proposed “reasonably available” standard would treat the other five pipelines as competitive alternatives and would erroneously suggest that Pipeline AB would not be able to sustain a rate increase above a long-run competitive rate level. The implication is that the “reasonably available” standard is incapable of distinguishing between the first scenario,

where Pipeline AB cannot exercise market power, and the second scenario, where Pipeline AB can exercise market power. Arthur Affidavit at PP 40-46.

3. Third Scenario - - Market Power

The third scenario, depicted in Dr. Arthur's Figure 3, is the same as the second scenario, except that Pipeline AB's increases its rate by the full amount of the locational commodity price differential between Origin A and Destination B. That rate increase is five times greater than the long-run marginal cost of Pipeline AB. If the increased rate is erroneously assumed to be the relevant competitive rate and is used to calculate a netback price for Pipeline AB, the netback price for Pipeline AB would be equal to the netback price for all of the other pipeline alternatives, suggesting that the alternatives are comparable to Pipeline AB in terms of price. However, if Pipeline AB was able to sustain the large rate increase, it would recover its long-run marginal cost plus an extraordinary return on its investment, which reflects an exercise of market power. Thus, an increase which captures the full locational differential in commodity price is not a reasonable proxy for the long-run competitive rate. Arthur Affidavit at PP 47-49.

C. Non-Corridor Analysis.

Applicants and AOPL erroneously claim that a netback analysis should not be used in measuring market power because it can "devolve into" or "produce results similar to" a "corridor" market analysis. Applicants Comments at 15; AOPL Comments at 29-30; Weber Affidavit at P 23-25. In Dr. Arthur's second scenario, the applicant Pipeline AB offers a netback price substantially greater than the other five pipelines. Consequently, none of the other alternative pipelines is competitive in terms of price with

the applicant pipeline. Because Pipeline AB serves Destinations B and the alternative pipeline serves five different destinations, the analysis is not a “corridor” analysis, even though the result is that there are no alternatives to Pipeline AB in terms of price. Arthur Affidavit at P 45.

To further illustrate that a netback price analysis is not a corridor analysis, Dr. Arthur assumes that one of the other pipelines, Pipeline AG, is the applicant. In that case, all of the other pipelines would be competitive with Pipeline AG in terms of price because each would be offering higher netback prices after a small but significant increase in rate by Pipeline AG. Because all alternatives are examined regardless of destination, the netback price analysis is not a “corridor” analysis whether Pipeline AB or Pipeline AG is the applicant. *Id.*

D. Cross-Elasticity of Demand

As AOPL recognizes, the *Mobil* decision made clear that a market power analysis examines cross-elasticity of demand – that is the extent to which consumers will respond to an increase in the price of one product by substituting or switching to another. AOPL Comments at 10; *Mobil* at 1102. However, AOPL does not explain how it’s proposed “reasonably available” standard would provide any information on the cross-elasticity of demand among alternatives. As Dr. Arthur explains, a netback price analysis provides information on cross-elasticity of demand, or the willingness of shippers to shift volumes to an alternative in response to a rate increase by the applicant pipeline. Arthur Affidavit at PP 35-37.

If an applicant pipeline is operating in a market with several alternatives which are comparable in price, shippers would have a high positive cross-elasticity of demand (*i.e.*, an increase in demand for transportation on an alternative pipeline in response to a rate increase by the applicant pipeline). Arthur Affidavit at PP 35-37. On the other hand, if the applicant pipeline is operating in a market with few alternatives comparable in price, even where there are “reasonably available” alternatives, shippers would have low elasticity of demand (*i.e.*, limited incentive or ability to switch to alternatives in response to a rate increase by the applicant pipeline). *Id.* In this case, Applicants have provided no evidence or information which could be used to measure the cross-elasticity of demand.

III. There Is No Evidence that Crude Oil Price Differentials between Seaway’s Origin and Destination Markets Are Short-Term or Temporary Price Variations.

Applicants contend that a netback price analysis should not be used where there are “short-term” differentials in the price of the commodity transported. Applicants’ Comments at 12. Applicants rely on the court’s ruling in *Mobil* that short-term price variations are consistent with competition. *Mobil* at 1104. However, Applicants have provided no evidence to establish that the crude oil price differentials between the origin and destination markets of Seaway are short-term or temporary price variations.

In fact, the attached affidavit of John Van Heyst demonstrates that there is a significant and sustained price differential between crude oil sold in inland Canadian and U.S. markets compared with the same types of crude oil at the Gulf Coast due to an oversupply of crude oil at the inland markets. Mr. Van Heyst explains that the Gulf

Coast market value of light sweet crude oil is based on the price of a benchmark light crude oil known as Louisiana Light Sweet (“LLS”). Mr. Van Heyst shows that the average price differential between LLS and WTI at Cushing for the period August 2010 through July 2012 was \$16.26 per barrel. Van Heyst Affidavit at P 12. With the reversed Seaway pipeline in service, the price differential was \$14.73 per barrel in June 2012 and \$17.86 per barrel in July 2012. *Id.*

Mr. Van Heyst also explains that the Gulf Coast market value of heavy crude oil is based on the price for a benchmark heavy crude oil imported from Mexico known as “Maya.” He shows that the average price differential between Maya and the benchmark heavy crude oil known as Western Canadian Synthetic (“WCS”) for the period August 2010 through July 2012 was \$20.07 per barrel. Van Heyst Affidavit at P 13. With the reversed Seaway pipeline in service, the price differential was \$29.35 per barrel in June 2012 and \$24.39 per barrel in July 2012. *Id.*

IV. Some of the Origin Market Alternatives Identified by Applicants Are Not Actually Available to Shippers on Seaway.

As explained in the attached Affidavit of John Van Heyst, some of the three pipelines and 11 refineries identified by Applicants as alternatives to Seaway in the origin market are not actually available to shippers. This constitutes a material deficiency in the Application under the “availability” requirement of the Commission three-pronged test for competitive alternatives or under the “reasonably available” standard proposed by Applicants and AOPL.

Mr. Van Heyst explains that some of the refineries identified by Applicants are not be usable alternatives because of physical barriers or impediments. For example, the WTI production in and around Cushing is not physically connected to several of the areas identified in the Application, including the U.S. Rocky Mountain refineries, Western Canadian refineries, and pipelines serving those refining areas. Van Heyst Affidavit at P 5.

Another physical barrier is the actual ability of a refinery to process or a pipeline to transport different types of crude oil. For example, heavy sour crude runs can be limited by physical constraints of both the refinery and pipeline including, but not limited to, finished product quality limitations, sulfur handling ability, and process unit capabilities and limitations. Without proper equipment, a refinery cannot process heavy sour crude oil. *Id.* at P 6.

Another consideration affecting the types of crude oil that a refinery will use is the optimum crude oil slate which a refinery needs to produce the desired slate of finished products. Each refinery will determine the optimum crude slate for the refinery at any particular point in time. This optimization is highly dependent on finished product market netbacks, refinery constraints, and related crude oil values, and may change seasonally. The Application does not take into account the different individual refinery usage of different types of crude oil which, again, does not reflect the reality of refinery operations. *Id.* at P 7.

V. Applicants and AOPL Distort the Merger Guidelines and Basic Principles of Antitrust Analysis.

A. Proper Role of the SSNIP Test

Under the Merger Guidelines, the “SSNIP” test considers whether an applicant can sustain a small but significant and non-transitory increase in price. 2010 Merger Guidelines, Section 4.1.1. Applicants claim the Merger Guidelines provide that all firms currently earning revenue in a market are considered and that the SSNIP test is used to expand the pool of alternatives to include potential competitors. Applicants’ Comments at 10-11. The attached Affidavit of Barry E. Sullivan explains that Applicants’ claim is highly misleading because, under the Merger Guidelines, the SSNIP test is used to define the relevant product and geographic markets.

The 2010 Merger Guidelines state that all firms which currently earn revenues in the relevant market are considered market participants. Section 5.1. A similar provision is contained in the 1992 Merger Guidelines. Section 1.31. In order to define the relevant product and geographic markets, however, the Merger Guidelines require that the “hypothetical monopoly test” be used. 2010 Merger Guidelines, Sections 4.1.1 and 4.2; Sullivan Affidavit at P 6. The hypothetical monopoly test considers whether a hypothetical monopolist can impose a SSNIP. 2010 Merger Guidelines at 4.11; Sullivan Affidavit at P 7

The methodology of the Merger Guidelines is an iterative process. It starts with the smallest possible market and expands the geographic market until there are no firms that can prevent the hypothetical monopolist from imposing a SSNIP. What Applicants misunderstand or ignore is that there may be firms outside the boundary that sell the

relevant product but cannot prevent the hypothetical monopolist from imposing a SSNIP. Those sellers are excluded from the relevant geographic market. Thus, all sellers in the general area that are making sales of the relevant product are not necessarily included in the relevant geographic market. Sullivan Affidavit at P 8.

B. Response by Refineries

Applicants claim that refineries in the Cushing origin market will respond to higher netback prices on Seaway by bidding up the price of crude oil, which will reduce or eliminate the price differential. Mr. Sullivan explains that this claim does not make economic sense under current and foreseeable crude oil market conditions at Cushing. There is a major excess supply of crude oil at Cushing and the crude oil transportation market is constrained. Even after the reversal of Seaway, the spread between crude oil prices for WTI (Cushing) and LLS (Gulf Coast) remains significant. Under these conditions, refineries at Cushing would have no incentive to bid up the price of crude oil, which is a major input cost to the refinery, and lower the refinery's profit on refined petroleum products. Sullivan Affidavit at P 9.

C. Status as New Market Entrant

Applicants' erroneously claim that a netback approach should not be used where the applicant pipeline is a new entrant into an already competitive market and that an entrant into a competitive market typically makes the market more competitive not less competitive. Applicants' Comments at 17. There has been no demonstration that the existing transportation market at Cushing is competitive. As Dr. Arthur explains, robust competition in a commodity market does not suggest that a pipeline serving the market

lacks market power in the transportation market. Arthur Affidavit at P 49. Moreover, Applicants' claim reflects a fundamental misunderstanding of how to define the relevant market in a market power analysis. As Mr. Sullivan explains, the Merger Guidelines approach to market definition is specific to the merging parties. Good alternatives are identified based on whether they are good alternatives to the specific applicant. Sullivan Affidavit at P 10.

In a market power analysis, the market is defined based on the applicant's transportation service and whether there are good alternatives to the applicant's service. This is consistent with the Merger Guidelines and the hypothetical monopoly test. The analysis of entry is limited to the possible entry of alternatives. The applicant is not an entrant. Rather, the applicant provides the basis for identifying good alternatives. 1992 Merger Guidelines, Section 3.1; Sullivan Affidavit at P 11.

D. Crude Oil Production Basin

Applicants erroneously claim that the geographic definition of a crude oil origin market is dictated by the location and shape of the crude oil basin that produces the oil transported out of the origin market. Applicants' Comments at 24-25. Applicants cite no authority or precedent for using a crude oil production basin as the relevant geographic origin market for a pipeline. In a proper market power analysis, Mr. Sullivan explains that the origin market is defined by identifying good alternatives to the applicant pipeline. The origin of the applicant's transportation service and the location of the good alternatives to that service will delineate the relevant geographic market. The location of a crude oil production basin is only relevant if it contains good alternatives to the

applicant's transportation service. A proper analysis must therefore start with the location of good alternatives; it cannot assume that all alternatives in a crude oil production basin are good alternatives to the transportation service on Seaway. Sullivan Affidavit at P12.

In this case, the proper starting point for an origin market analysis is the origin of Seaway's transportation service at Cushing. Justification must be provided to broaden the market beyond this area. In Order No. 572, the Commission stated that it does not require any particular geographic market definition, but that it expects oil pipelines to propose BEAs as their geographic markets. "If the pipeline uses BEAs, it must show that each BEA represents an appropriate geographic market." Order No. 572 at 31,180. Although Applicants use counties instead of BEAs, they fail to demonstrate how each individual county in its geographic market contains a good alternative to Seaway's proposed transportation service out of Cushing. Sullivan Affidavit at P 13.

E. Incentive for Investment

As Mr. Sullivan explains, AOPL has failed to demonstrate that the Commission's policies and regulations lead to an under investment in oil pipeline facilities. AOPL Comments at 5-6; Sullivan Affidavit at P 14. Current regulation by the Commission provides for full recovery of a pipeline's cost of facilities, including a return on investment. Therefore the regulated rate is sufficient to cover all of the pipeline's costs, including a reasonable rate of return on investment.

In fact, the granting of market-based rate authority may actually create a disincentive for the development of additional pipeline infrastructure. In situations where

excess demand exists, market-based rate authority would allow a pipeline to increase the return on its existing investment by increasing its rates, without the construction of additional pipeline infrastructure. On the other hand, the Commission has found that a cost-of-service rate ceiling encourages investment in additional pipeline facilities to serve excess demand. Order No. 712 at P 82-85.

In Order No. 637, the Commission explained how regulated rates actually create an incentive for additional pipeline infrastructure. When a pipeline is subject to cost-of-service regulation, investment in new capacity to meet demand increases the pipeline's revenue by increasing the rate base on what the pipeline earns a return. Order No. 637 at 31,270-71. Thus, cost-of-service regulation protect against a pipeline's exercise of market power by limiting the incentive to withhold capacity in order to increase price and by creating a positive incentive for a pipeline to add capacity needed by the market. *Id.*; Sullivan Affidavit at P 15.

F. The *Brown Shoe* Case

Dr. Webb relies heavily on the 50-year-old U.S. Supreme Court case *Brown Shoe Co. v. United States*, 370 U.S. 294 ("Brown Shoe") to support the theory that used alternatives must be good alternatives. Webb Affidavit at 4-6. As Mr. Sullivan explains, Dr. Webb's reliance on *Brown Shoe* is misplaced. That decision, issued in 1962, predates even the first set of Department of Justice Merger Guidelines, issued in 1968, which offered guidance on market definition. The Merger Guidelines have been revised through the years and last updated by the Department of Justice and Federal Trade Commission in 2010. Sullivan Affidavit at P 16.

Since 1984, the Merger Guidelines delineate product and geographic markets by utilizing a test that starts by imposing a small but significant and non-transitory increase in price (SSNIP) of the merging firm's product. If a customer, after a significant and non-transitory increase in price of the merging firm's product, would choose another firm's product, the other firm's product or location is included in the relevant product or geographic market. While Dr. Webb relies on *Brown Shoe* to insist that price plays no role in product market definition, it is clear that the Department of Justice and Federal Trade Commission for the last 28 years have considered price comparability using the SSNIP test to be an integral part of market definition for antitrust purposes. Sullivan Affidavit at P 17.

Dr. Webb acknowledges that *Brown Shoe* involved the definition of the product market. However, he fails to demonstrate how the principles used to define the product market apply to defining the geographic market. Nor does Dr. Webb explain which alternatives help to define the geographic market and which alternatives are included in the market share or market concentration statistics. Sullivan Affidavit at P 18.

G. Economic Market vs. Antitrust Market

Mr. Sullivan also explains that Dr. Webb inappropriately uses a traditional economic concept of the market when defining the relevant market. Webb Affidavit at 14-15; Sullivan Affidavit at P 19. A traditional economic market is designed to suggest how the market price will change in response to changes in market demand and market supply. Demand factors include the price of the product, consumer income, consumer taste (or preferences), and the price of related products. Supply factors include the price

of the product, the price of the inputs, technology, and the number of firms in the market. A traditional economic market includes all consumers and all sellers of the product, and the consumers are not associated with any particular seller. The sellers are not necessarily price comparable. *Id.*

What Applicants and Dr. Webb fail to recognize or ignore is that an antitrust market -- not an economic market -- is required to conduct a proper market power analysis. In an antitrust market, the buyers and sellers are narrowly defined: (1) the relevant buyers or customers are the customers of the seller under investigation (the applicant), and (2) the relevant sellers (or “market participants”) are firms that are good alternatives to the applicant. This market concept is referred to as an “antitrust market.” 2010 Merger Guidelines, Section 4. In a proper market power analysis, the market definition focuses on the customers’ ability to substitute away from the applicant’s product to another in response to a price increase by the applicant. The Merger Guidelines recognize that an antitrust market may not conform to what members of the industry consider to be the “market”. Sullivan Affidavit at P 20; 2010 Merger Guidelines, Section 4.

In contrast to an economic market, all sellers that make sales in the area are not necessarily “participants” (*i.e.*, good alternatives) in an antitrust market. Similarly, all customers of the sellers in the economic market are not necessarily in the antitrust market. Thus, the number of sellers (and customers) in the antitrust market is generally smaller than the economic market. In particular, alternatives to the applicant which are not good alternatives are excluded from the antitrust market. Customers located in the

market area that are not customers of the applicant are also excluded from the antitrust market. Thus, there may be numerous alternatives that are “used alternatives” in the area, but if they are not good alternatives to the applicant, they are not relevant to the market power analysis. Sullivan Affidavit at P 21.

Another difference between an economic and an antitrust market is in the analysis of entry. In an economic market, the impact of a new entrant can be suggested by analyzing the market before and after entry. In an antitrust market, however, the applicant cannot be analyzed as an entrant. The reason is that prior to the proposed entry by the applicant, there is no antitrust market. Without the applicant, the other sellers in the antitrust market cannot be identified. That is, in an antitrust market, the only sellers that matter are the sellers who represent good alternatives to the applicant. Thus, it is a fundamental flaw in a market power analysis to argue that prior to the applicant entering the market, the relevant market was competitive. Sullivan Affidavit at P 22.

VI. Applicants’ Request for Waiver of the Commission’s Regulations Should be Denied.

The initial comments of Applicants effectively request a double waiver of the Commission’s regulations. Applicants are asking the Commission to waive (1) the regulation at 18 C.F.R. § 342.2 which does not allow market-based rates to be used as initial rates for a new service and (2) the provisions in Order No. 572 and Order No. 572-A which do not allow market-based rate authority to justify rates in effect while an application for market-based rates is under consideration. *Market-Based Ratemaking for*

Oil Pipelines, FERC Stats. & Regs. ¶ 31,007, 31,178 (1994); FERC Stats. & Regs. ¶ 61,412, 62,501 (1994). Both requested waivers should be denied.

There is no basis for departing from the Commission's regulations by allowing Seaway to use market-based rates as initial rates for a new service. In Order No. 561-A, the Commission considered and explicitly rejected the use of market-based rates to justify an initial rate. The Commission concluded that an initial rate should be established either on a cost-of-service basis or on a negotiated basis. The Commission was concerned that a pipeline might be able to exercise market power to establish an initial rate that was unjust and unreasonable. *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, Order No. 561-A, FERC Stats. & Regs. ¶ 31,000, 31,105 (1994). As such, the Commission's regulations make no provisions for establishing initial rates as market-based rates, as Applicants request.

Contrary to Applicants, it is not illogical to require a hearing on Seaway's initial cost-of-service rates while the Application for market-based rate authority is pending. The Commission addressed the scenario of concurrent market-based and cost-based rate proposals in Order No. 561:

If the pipeline files a cost-of-service justification along with its market-power showing, it may charge whatever the cost-of-service showing would permit. The Commission retains the authority under the ICA to suspend the effectiveness of such rates to the maximum extent allowed by law and to require the pipeline to collect its increased rates subject to refund.

FERC Stats. & Regs. ¶ 30,985, 30,558 (1993). In the present case, the concurrent market-based and cost-based rate proceedings for Seaway fit the above scenario

described in Order No. 561. Thus, the concurrent proceedings are entirely logical and are entirely consistent with the intent of the Commission's regulations.

Although the Commission has previously granted market-based rates for initial services, the principles of those cases are inapplicable here. In *Longhorn Partners Pipeline, L.P.*, the only protest to the application for market-based rates failed to challenge Longhorn's assertion that it did not have market power in either the origin or destination markets. 83 FERC ¶ 61,345, 62,380 (1998). Further, no challenge was made to Longhorn's request for waiver of section 342.2 of the Commission's regulations. *Id.* In *Wolverine Pipe Line Co.*, the pipeline filed a tariff for an initial service with market-based rates, requesting waiver of section 342.2 of the Commission's regulations. Wolverine had also filed a separate application for market-based rate authority which was protested and subject to Commission review. However, the origins and destinations covered by the Wolverine tariff were not protested as part of the separate market-based rate application, and no protests were made to the tariff filing. Therefore, the Commission granted the waiver and conditionally allowed the initial rates as set forth in the tariff filing to go into effect, pending the ultimate determination on Wolverine's separate application for market-based rate authority. 90 FERC ¶ 61,001, 61,001-02 (2000).

Unlike the situations in *Longhorn* and *Wolverine*, here the Joint Shippers are challenging the definitions of the relevant product market and geographic markets proposed in the Application, are disputing the claims that Seaway lacks market power in the origin and destination markets, and are expressly objecting to the request for waiver

of the Commission's regulations governing initial rates. As such, those precedents cited by Applicants in support of the requested waiver are inapplicable.

Nor is Applicants' waiver request supported by the Commission's orders in *Wolverine Pipe Line Co.*, 87 FERC ¶ 61,376 (1999) and *TE Products Pipeline Co., L.P.*, 87 FERC ¶ 61,377 (1999). Those cases involved waivers of the Commission's indexing regulations, they did not involve waiver of the Commission's regulations governing initial rates or market-based rates.

CONCLUSION

For the foregoing reasons, the Commission should not adopt the radical interpretation of the *Mobil* decision suggested by Applicants and AOPL and should not use the proposed "reasonably available" standard to identify good competitive alternatives. The Commission should once again recognize that the court of appeals did not overturn the Commission's established criteria for measuring market power. Accordingly, the Commission should continue to follow the Merger Guidelines and established principles of antitrust analysis, including the SSNIP test. In identifying competitive alternatives, the Commission should continue to require that good alternatives be justified in terms of (1) availability, (2) quality, and (3) price.

In the present case, the Commission should reaffirm the Seaway Order denying the Application for market-based rate authority. The Commission should also clarify or modify the Seaway Order by expressly denying Applicants' request for a waiver of the regulations governing initial rates and market-based rates and by including the failure to

comply with those regulations as an explicit basis for denial or rejection of the Application.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this 2nd day of August, 2012, served the foregoing Reply Comments of Joint Shippers by email on each person designated on the official service list compiled by the Secretary of the Commission in this proceeding.

/s/ Frederick G. Jauss IV
Frederick G. Jauss IV

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.,
and Enbridge Inc.

§

Docket No. OR12-4-000

AFFIDAVIT OF DANIEL S. ARTHUR

I. BACKGROUND

1. My name is Daniel S. Arthur. I am a Principal at *The Brattle Group*, an economic and management consulting firm located at 44 Brattle Street, Cambridge, Massachusetts. I have presented testimony in prior proceedings before the Federal Energy Regulatory Commission (the "Commission") regarding pipeline applications to charge market-based rates, including testimony in the Shell Pipeline Company L.P.,¹ Sunoco Pipeline LP,² Mobil Pipe Line Company,³ Magellan Pipeline Company, L.P.,⁴ and Enterprise TE Products Pipeline Company LLC⁵ proceedings. Additional details of my professional and educational background and a list of my publications are provided in my curriculum vitae appended to this affidavit as Attachment A.

II. INTRODUCTION AND SUMMARY OF CONCLUSIONS

2. I have been asked by Continental Resources, Inc. ("Continental"), Husky Marketing and Supply Company ("Husky"), Suncor Energy Marketing, Inc. ("Suncor"), and Canadian Natural Resources Limited ("CNRL") to respond to the initial comments submitted by Enterprise Products Partners L.P. ("Enterprise") and Enbridge Inc. ("Enbridge")⁶ and by the Association of Oil Pipelines ("AOPL")⁷ in response to the Commission's order granting rehearing of its prior order⁸ ("Seaway Order") denying the application for authority to charge market-based rates for the reversed service by Seaway Crude Oil Pipeline Company LLC ("Seaway"). In this connection, I have reviewed the Seaway Order and the decision of the U.S. Court of Appeals for the D.C. Circuit in *Mobil Pipe Line Company v. FERC*, 676 F.3d 1098 (2012) ("*Mobil*").

¹ *Shell Pipeline Co. L.P.*, Docket No. OR02-10-000 (2004).

² *Sunoco Pipeline L.P.* Docket No. OR05-7-000 (2005).

³ *Mobil Pipe Line Company*, Docket No. OR07-21-000 (2010).

⁴ *Magellan Pipeline Co., L.P.*, Docket No. OR10-6-000 (2011).

⁵ *Enterprise TE Products Pipeline Company LLC*, Docket No. OR11-6-000 (2011).

⁶ Initial Comments of Enterprise Products Partners L.P. and Enbridge Inc. in Response to Order Granting Rehearing, Docket No. OR12-4-000, July 18, 2012 ("Enterprise/Enbridge Comments").

⁷ Motion for Leave to Intervene Out of Time and Initial Comments of Association of Oil Pipe Lines, Docket No. OR12-4-000, July 18, 2012 ("AOPL Comments"), including the Affidavit of Michael J. Webb on Behalf of Association of Oil Pipe Lines, Attachment A to the AOPL Comments filed July 18, 2012 in Docket No. OR12-4-000 ("Webb Affidavit").

⁸ *Enterprise Products Partners L.P. and Enbridge, Inc.*, 139 FERC ¶ 61,255 (2012)

3. In the Seaway Order, the Commission stated that “price data remain an indispensable part” of the Commission’s market power analysis after the *Mobil* decision,⁹ and that in order to identify alternatives to include in an analysis of market share and market concentration, the alternative must be shown to be a good alternative in terms of price.¹⁰ The Commission also stated that:

Although parties may dispute whether the proxy used by a pipeline adequately reflects the competitive price level, the pipeline must still present such price data in order to determine good alternatives for inclusion in the geographic market. Otherwise, market shares and market concentration measures, such as those relied upon by the court in *Mobil*, simply cannot be calculated.¹¹

4. The Enterprise/Enbridge Comments and the AOPL Comments, including the Webb Affidavit, claim that a netback price analysis or other analysis should not be used to determine whether currently-used or reasonably available alternatives are competitive, and rather that all currently-used, or reasonably capable of being used, alternatives are by definition competitive alternatives.¹² Thus, a currently-used, or reasonably capable of being used, alternative appears to be equivalent to an existing good alternative. The Enterprise/Enbridge Comments state:

The Commission should not use the *Pegasus* netback approach or other similar formulaic analysis to assess whether currently-used and reasonably available competitive alternatives are “good alternatives.” As *Mobil* makes clear, currently-used and reasonably available alternatives are by definition “good alternatives.”¹³

5. The AOPL Comments state:

Under this [“reasonably available”] standard, an alternative to the applicant pipeline is “reasonably available” and should be considered in an assessment of market power if it is being used, or if it is reasonably capable of being used, in the relevant geographic and product markets.

AOPL further submits that the netback pricing approach employed by the Commission in *Pegasus* – or its equivalent in a destination market,

⁹ Seaway Order, at P 32.

¹⁰ *Id.*

¹¹ *Id.*

¹² Enterprise/Enbridge Comments at 18; AOPL Comments at 9-13; Webb Affidavit at P 27.

¹³ Enterprise/Enbridge Comments at 18.

a delivered price test – should no longer be utilized by the Commission because it produces misguided results ...¹⁴

6. Ultimately, the question is whether the D.C. Circuit’s *Mobil* decision (1) requires a market power framework that identifies competitive alternatives to include in market share and market concentration measures based upon all used, or reasonably capable of being used (existing), alternatives in a geographic area *or* (2) allows competitive alternatives to be identified based on being comparable in terms of availability, quality, and price. As the Commission concluded in the Seaway Order, the *Mobil* decision did not overturn the Commission’s historical framework for market power analysis and price comparability remains an “indispensable part” of the Commission’s market power framework. In my opinion, an analysis that identifies “good” competitive alternatives in terms of being comparable in terms of availability, quality, and price is a critical and “indispensable part” of the identification of competitive alternatives to include in market share and market concentration measures. As the discussion and examples provided below illustrate, without an analysis of alternatives being comparable in terms of availability, quality, and price, market share and market concentration measures based on all existing or potential alternatives can erroneously indicate a lack of market power when, in fact, the opposite is true.
7. In discussing why the identification of competitive alternatives should examine whether alternatives are comparable in terms of availability, quality, and price, it is important to consider the basis for regulating price for oil pipelines, and what is the relevant market power concern when determining whether market-based rates will result in just and reasonable rates for oil pipelines. In order to determine whether market-based rates will result in just and reasonable rates, a benchmark for the relevant competitive price must be identified and that benchmark will identify the relevant alternatives and the relevant geographic area in the market power analysis. Without identifying the relevant benchmark for a competitive price, the entire market power analysis is compromised, the market shares and corresponding HHIs can be misleading and meaningless, and the presence or lack of market power cannot be

¹⁴ AOPL Comments at 17.

reliably determined.

8. As discussed below, consistent with Commission and D.C. Circuit precedent, the relevant benchmark competitive price for oil pipeline market-based rates is a long-run competitive price, which is fundamentally tied to cost and includes a reasonable return on investment. Further, the relevant market power concern, and the basis for regulating an oil pipeline's price, is the potential for a sustained increase of price above a long-run competitive price level. The ability to sustain a price increase above a long-run competitive price results from barriers to entry and slow expansion of capacity in response to changes in demand, a characteristic of the oil pipeline industry.¹⁵
9. First, I address the relevant definition of market power and the relevant competitive price that is the benchmark for just and reasonable market-based rates. Second, I present examples of the potential ability to exercise market power by sustaining an increase in price above the relevant competitive price level. These examples illustrate that the failure to identify competitive alternatives on the basis of being comparable to the applicant pipeline in terms of availability, quality, and price can lead to conclusions that the applicant pipeline lacks market power when, in fact, the opposite is true. These examples also illustrate scenarios where market conditions could permit nontransitory deviations of price from the relevant competitive price level, which is the relevant market power concern for an oil pipeline being granted market-based rates.

III. RELEVANT MARKET POWER DEFINITION AND RELEVANT COMPETITIVE PRICE

10. It is necessary to specify and understand the concepts of the relevant definition of market power and the relevant competitive price in order to evaluate whether the market power analysis will correctly determine whether an oil pipeline applying for

¹⁵ *Farmers Union Cent. Exch. Inc. v. FERC*, 734 F.2d 1486 at 1509 n.51 (D.C. Cir. 1984) (*Farmers Union II*). Without barriers to entry in the form of large capital investments that are difficult and costly to convert to other services (referred to as “extremely high sunk costs” in *Farmers Union II*), it would be difficult to sustain a price increase above a long-run competitive price level, and any basis for price regulation would be significantly lessened.

market-based rates can exercise market power. An evaluation of the relevant definition of market power will determine (1) whether a market power analysis that simply assumes that all existing or potential alternatives in a geographic area are competitive alternatives to an applicant pipeline consistently produces reasonable results, or (2) whether, as the examples below illustrate, the same market power analysis is likely to produce erroneous conclusions. An evaluation of the relevant definition of market power also considers whether a methodology that includes a reasonable proxy for the competitive price as an integral part of the analysis will produce reasonable conclusions.

11. For oil pipelines seeking market-based rates, the relevant definition of “market power” is the ability to profitably sustain a small but significant price increase above a competitive price level for a significant period of time. This is the definition of market power referenced in the D.C. Circuit’s *Mobil* decision,¹⁶ the 1992 Department of Justice’s and Federal Trade Commission’s Merger Guidelines,¹⁷ as well as prior Commission decisions.¹⁸
12. To evaluate whether a pipeline possesses market power, the Commission can examine whether a pipeline, if granted market-based rates, could profitably sustain a “small but significant and nontransitory increase in price,” which is referred to as the “SSNIP test.”¹⁹ This test in of itself by necessity requires a careful analysis and consideration of the alternatives available and whether such alternatives by virtue of price would serve to constrain a party’s ability to charge prices above a competitive level for a significant period of time. As stated by the D.C. Circuit in its *Mobil* decision,

Market-power analysis focuses on whether there are alternatives to a firm’s services that constrain its ability to profitably charge prices above competitive levels for a significant period of time. The inquiry examines

¹⁶ *Mobil Pipeline Co. v. FERC*, 676 F.3d 1098 at 1100 (D.C. Cir. 2012).

¹⁷ U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines,” April 2, 1992, Section 0.1. (“1992 Horizontal Merger Guidelines”).

¹⁸ See, e.g., *Explorer Pipeline Co.*, 87 FERC ¶ 61,374 at 62,392 (1999); *SFPP, L.P.*, 84 FERC ¶ 61,338 at 62,497 (1998).

¹⁹ There are several prior Commission decisions that refer to the SSNIP test. See, e.g., *Colonial*, 92 FERC ¶ 61,144 at 61,534, n.20 (2000); *Williams*, 68 FERC ¶ 61,136 at 61,657-59 (1994); *Buckeye*, 53 FERC ¶ 61,473 at 62,666 (1990).

the alternatives reasonably available to consumers and the cross-elasticity of demand – that is, the extent to which consumers will respond to an increase in the price of one good by substituting or switching to another.²⁰

13. If an applicant oil pipeline is operating in a market with several competitive or “good” alternatives that are available to shippers on that pipeline, then if the applicant pipeline were to increase its price above a competitive level, shippers would have the ability to switch to the competitive alternatives, causing the pipeline to lose sufficient volumes such that its profits would decrease as a result of its attempt to raise price. In such a case, shippers would have a high positive cross-elasticity of demand (an increase in demand for transportation on an alternative pipeline in response to an increase in the transportation rate by the applicant pipeline) and the applicant pipeline would *not* have the ability to profitably sustain a price increase.
14. In contrast, if the pipeline is operating in a market with few competitive or “good” alternatives available to shippers on the applicant pipeline, shippers would have limited ability to switch to alternatives in the event of a rate increase (low cross-elasticity of demand), and the applicant pipeline would maintain sufficient volumes to prevent its price increase from resulting in a decrease in profits. Therefore, the number (and size) of competitive alternatives available indicates whether the pipeline would be able to profitably sustain a small but significant and nontransitory price increase.
15. Based on the relevant definition of market power being *the ability to sustain a small but significant price increase above a competitive price level for a significant period of time*, to understand whether an analysis of market power is properly identifying competitive alternatives, which are the alternatives consumers, or shippers on an oil pipeline, would switch to in response to a small but significant price increase above a competitive price level for a significant period of time, the meaning of the terms (1) “a competitive price level,” (2) “a small but significant price increase,” and (3) “a significant period of time” need to be clearly defined. Otherwise, as the examples below illustrate, failure to identify the relevant “competitive price level,” for example, can create situations, particularly in the presence of capacity constraints, where any

²⁰ *Mobil Pipeline Co. v. FERC*, 676 F.3d 1098 at 1102 (D.C. Cir. 2012) (“*Mobil*”).

observed transportation rate could be claimed to be “a competitive price level,” while, in fact, the rate is above the relevant competitive price level and is the result of an exercise of market power.

16. Meaning of “a competitive price level”

17. A competitive price is fundamentally tied to the cost of producing the product in question, which, in the case of an oil pipeline applying for market-based rates, is crude oil or refined products transportation service.²¹ Order No. 572²² states, quoting *Tejas Power Corp. v FERC*:

In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that the price is close to marginal cost, such that the seller makes only a normal return on its investment.²³

18. The reference to the competitive price being “close to marginal cost, such that the seller makes only a normal return on its investment” in Order No. 572 and *Tejas* refer to a long-run competitive price that includes a normal or reasonable return on investment.²⁴ A long-run competitive price is close to the long-run marginal cost of the marginal supplier, and includes a normal or reasonable return on a pipeline’s fixed costs, which are investments in pipeline assets.²⁵

²¹ Because natural gas liquids pipelines are also regulated by the Commission under the same regulations as crude and refined products pipelines, the relevant transportation service of a pipeline applying for market-based rates could also be the transportation of natural gas liquids, or a particular natural gas liquid.

²² *Market-Based Ratemaking for Oil Pipelines*, Order No. 572, FERC Stats. & Regs., ¶ 31,007 at 31,180 (1994).

²³ *Tejas Power Corp. v. FERC*, 908 F.2d. 998, 1004 (D.C. Cir. 1990).

²⁴ Note that a short-run marginal cost is the incremental cost of producing one more unit in the short-run, when factors of production are fixed. In the case of a crude oil pipeline, the short-run marginal cost would be the incremental cost of pumping one more barrel of crude oil through the pipeline, and would not include any costs related to the actual carrier property asset, which are fixed in the short-run. Thus, if price were close to short-run marginal cost for a pipeline, that price would not be sufficient to provide a reasonable, or normal return on investment and Order No. 572 and *Tejas* cannot be referring to a short-run marginal cost.

²⁵ *Koch Gateway Pipeline Company*, 85 FERC ¶ 61,013, at 61,045-6, (“An appropriate base price in a market power evaluation of this type is the long-run competitive price. The long-run transportation price between given points in a competitive market will be determined by the long-run marginal cost for the marginal supplier of building and operating transportation facilities ...”) Note that at a long-run competitive equilibrium price, the long-run marginal cost is also equal to the long-run average cost, so the long-run average cost of production could also provide useful information in attempting to estimate a long-run competitive price.

19. Similar to the language in Order No. 572 and *Tejas*, the D.C. Circuit noted in *Farmers Union II* that for rates to be “just and reasonable,” there exists a zone of reasonableness wherein rates can be neither “less than compensatory” nor “excessive.”²⁶ A rate within the zone of reasonableness is a rate that is high enough to “both maintain the producer’s credit and attract capital,” while low enough to prevent “exploitation” by the pipeline.²⁷ This definition of “just and reasonable,” which applies to market-based rates determined by competition, is also consistent with a long-run competitive price that is close to long-run marginal cost (and long-run average cost), and includes a normal or reasonable return on investment.
20. Regulated cost-of-service based rates are designed to approximate a long-run competitive price.²⁸ As the D.C. Circuit noted in *ExxonMobil*, “[i]t is certainly reasonable for FERC to use a cost-of-service computation as an approximation for a pipeline’s economic circumstances; the purpose of a cost-of-service rate, after all, is to simulate what a pipeline’s economic behavior would be in a competitive market.”²⁹ Note that regulated cost-based rates may differ from rates determined in a competitive market. For example, regulated cost-based rates are typically dependent upon the original book value cost of assets and provide for a specific pattern of capital recovery based on a depreciating rate base. A competitive rate, however, will be independent of the vintage of the assets owned by any specific competitor. But in the long run, the competitive rate must still provide a level of return sufficient to reasonably compensate the owner for its investment in the assets. Thus a competitive

²⁶ *Farmers Union Cent. Exch. Inc. v. FERC*, 734 F.2d 1486 at 1501-02 (D.C. Cir. 1984) (*Farmers Union II*).

²⁷ *Id.* at 1502.

²⁸ *SFPP, L.P.*, 121 FERC ¶ 61,240 at P 14 (2007) (“[c]ost-of-service rate making seeks to replicate a competitive rate. Since under competition firms set their prices to recover costs, including a reasonable return, a regulated rate is designed to replicate that competitive situation. Thus it is reasonable to view a rate in a cost context even if negotiation or other market factors were involved in constructing the rate.”) As discussed above, the reference to “under competition firms set their prices to recover costs, including a reasonable return” can only be referring to a long-run competitive price because a short-run competitive price for an oil pipeline that is equal to short-run marginal cost would not include a reasonable return on investment. Also note that index-based rate changes are also designed to be related to costs. As the Commission stated in Order No. 561-A, “[t]he indexing methodology adopted in the final rule and affirmed here is fundamentally based upon costs.” Order No. 561-A, FERC Stats. & Regs. ¶ 31,000 (1994), *aff’d*, *Association of Oil Pipelines v. FERC*, 83 F.3d 1424 (D.C. Cir. 1996). Index-based rate changes are tied to the inflation index Producer Price Index for Finished Goods (“PPI”) plus a percentage adjustment that has been examined every five years with the intent to have an index that “most closely approximates the actual cost changes experienced by the oil pipeline industry.” *Id.*

²⁹ *ExxonMobil Oil Corporation v. FERC*, 487 F.3d 945, 961 (D.C. Cir. 2007) (“*ExxonMobil*”).

rate may be expected to involve a different pattern of capital recovery over time compared to a cost-of-service based rate, but still produce a net present value of cash flows that would be expected to equal the capital investment.

21. In addition, a competitive rate will ultimately be determined by the firms offering to sell in a market, and the costs incurred by those firms. As Dr. Alfred Kahn stated, “[t]he marginal costs against which competitive rates should be judged are the costs of the company quoting or proposing to quote those rates, not the costs of their competitors.”³⁰ In a competitive market, lower-cost firms will reduce their prices to take business away from higher cost firms, and hence, the long-run competitive price will always be less than or equal to the long-run marginal costs of any firm offering to sell product into the market. In discussing the central role of long-run marginal costs in the context of regulated rate making in the presence of competition, Dr. Kahn also states:

Apart from possible noneconomic considerations, society’s interest is in having transportation, energy, or communications provided at the lowest possible cost, with due allowance for possible differences in the quality of services supplied or the costs imposed on the users. And economic efficiency requires, additionally, that no business be turned away that covers the cost to society of providing that service. These basic goals are served by permitting rates to be set at long-run marginal costs. The consequence will be that, after consumers have made allowance in their choices for possible differences in the quality of service, the competing company with the lowest long-run marginal costs will get the business; and the services will thus be provided by those companies which, in so doing, will impose the minimum opportunity costs on the economy at large.³¹

22. As the prior Commission and D.C. Circuit decisions discussed above state, a long-run competitive price is the relevant benchmark for “a competitive price” when analyzing whether an oil pipeline applying for market-based rates can sustain a small but significant rate increase above a competitive rate for a significant period of time. In

³⁰ Alfred E. Kahn, *The Economics of Regulation*, Volume I, Economic Principles, Chapter 6, Rate Making in the Presence of Competition, page 164. The surrounding discussion in this section relates to different producers of a product potentially having different costs, and effective competition requires that lower-cost firms reduce their prices to take business away from higher-cost firms. The long-run competitive price will always be less than or equal to long-run marginal costs of any firm offering to sell product into the market.

³¹ Alfred E. Kahn, *The Economics of Regulation*, Volume I, Economic Principles, Chapter 6, Rate-Making in the Presence of Competition, pages 160-161 (footnotes omitted).

addition, a long-run competitive price is fundamentally tied to the *cost* of providing service, including a reasonable return on investment. Thus, the long-run marginal cost, which is equal to the long-run average cost at a long-run competitive price,³² of providing transportation service is central to determining whether a pipeline can sustain a rate above a long-run competitive rate and earn an extraordinary return on investment.

23. Meaning of “a small but significant price increase”

24. With respect to the meaning of “a small but significant price increase” in the relevant definition of market power, in my opinion, a 15 percent price increase above the relevant competitive price is reasonable to use as a threshold price increase. While it is my understanding that the Commission has not specified a standard rate increase level to use as a threshold to determine competitive alternatives,³³ the Commission has applied a 15 percent rate increase in prior proceedings for purposes of a market power analysis.³⁴ The Department of Justice’s and Federal Trade Commission’s Merger Guidelines focus on the question of a “small, but significant, nontransitory increase in price” as a mechanism to define the relevant product and geographic markets.³⁵ The Department of Justice’s and Federal Trade Commission’s Merger Guidelines state that in most contexts, a 5 percent increase lasting for the foreseeable future should be used in evaluating whether a merger would decrease competition, and that the hypothetical price increase would be applied to the price of the product at the stage of the industry being examined. However, the Merger Guidelines also state that ultimately, the hypothetical price increase will depend on the industry being examined and the relevant price increase to use may be greater or less than 5

³² The microeconomic textbook “Microeconomic Theory” by Gould and Ferguson (fifth edition) states in section 8.6.c., “Long-run equilibrium for a firm in perfect competition occurs at the point where price equals minimum long-run average cost. At this point minimum short-run average total cost equals minimum long-run average total cost, and the short- and long-run marginal costs are equal. The position of long-run equilibrium is characterized by a ‘no profit’ situation – the firms have neither a pure profit nor a pure loss, only an accounting profit equal to the rate of return obtainable in other perfectly competitive industries.” Knowing that at a long-run competitive price, the long-run average cost is equal to long-run marginal cost, estimating long-run average cost may be easier than estimating long-run marginal cost in some situations.

³³ *Williams Pipe Line Company*, 68 FERC ¶ 61,136 (1994).

³⁴ *See, e.g. Buckeye Pipe Line Company, L.P.*, 53 FERC ¶ 61,473, at 62,666 (1990).

³⁵ U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines,” April 2, 1992, Sections 1.0 through 1.22.

percent.³⁶ In my opinion, the use of 15 percent as a threshold rate increase is conservative and reflects the rationale that it may be appropriate to use a percentage greater than 5 percent for intermediate products, such as transportation, that contribute to the price ultimately paid by the end consumer.

25. Meaning of “a significant period of time”

26. With respect the meaning of “a significant period of time” in the relevant definition of market power, in my opinion, a period of two years is “a significant period of time” to sustain a rate increase above the competitive rate level in a definition of market power in this proceeding, consistent with the 1992 and 2010 Merger Guidelines.³⁷ It is sustaining rate increases above a *long-run* competitive rate (which will equal *long-run* average price) that is the relevant market power concern for oil pipelines applying for market-based rates. As stated by Professors Areeda, Hovencamp, and Solow;

Thus, the substantial market power that concerns antitrust law arises when the defendant [the firm whose market power is questioned] (1) can profitably set prices well above its costs and (2) enjoys some protection against a rival’s entry or expansion that would erode such supracompetitive prices and profits. These two prerequisites for durable market power express short- and long-run elements. The ability to raise prices above cost in the short run indicates the defendant’s immediate stream of monopoly profits. High entry barriers or other impediments to rivals’ entry or expansion bear on the long-run duration of that stream.³⁸

27. While the Department of Justice’s and Federal Trade Commission’s Merger Guidelines³⁹ do not explicitly define what “a significant period of time” is, they do provide general guidelines on what should be viewed as a significant period of time. The 1992 Merger Guidelines, when discussing the timeliness of potential entry, state:

In order to deter or counteract the competitive effects of concern, entrants quickly must achieve a significant impact on price in the relevant market. The Agency generally will consider timely only those committed entry

³⁶ *Id.*, at Section 1.11.

³⁷ 1992 Merger Guidelines, Section 3.2; 2010 Merger Guidelines, Section 9.1.

³⁸ Areeda, Hovencamp, & Solow, *Antitrust Law: An Analysis of Antitrust Principles and Their Application*, Aspen Law & Business, 2002, Chapter 5, section 501.

³⁹ U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines,” April 2, 1992, Section 0.1.

alternatives that can be achieved within two years from initial planning to significant market impact. Where the relevant product is a durable good, consumers, in response to a significant commitment to entry, may defer purchases by making additional investments to extend the useful life of previously purchased goods and in this way deter or counteract for a time the competitive effects of concern. In these circumstances, if entry only can occur outside of the two-year period, the Agency will consider entry to be timely so long as it would deter or counteract the competitive effects of concern within the two-year period and subsequently.⁴⁰

28. In this discussion of the timeliness of potential entry, the 1992 Merger Guidelines are discussing entry that would serve to counteract (or decrease) a price increase by an existing seller. Here, the 1992 Merger Guidelines are in general looking for potential entry that would achieve a significant impact on price in the relevant market within two years. This reference to “two years” indicates that if a price increase could be sustained for a period beyond two years, entry would not be considered “timely,” and entry would not be considered a mitigating factor for a market power concern. In this context, the 1992 Merger Guidelines indicate that a significant period of time to sustain a rate increase is generally two years when examining market power. While the 2010 Merger Guidelines do not explicitly state a time period, they provide a broad statement that “[i]n order to deter the competitive effects of concern, entry must be rapid enough to make unprofitable overall the actions causing those effects and thus leading to entry, even though those actions would be profitable until entry takes effect.”⁴¹ It should be noted that entry or expansion, particularly by oil pipelines, could be difficult or slow, which gives rise to market power concerns because prices can be sustained above a long-run competitive price, or a long-run average cost level.⁴²

⁴⁰ U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines,” April 2, 1992, Section 3.2 (footnote omitted).

⁴¹ U.S. Department of Justice and Federal Trade Commission, “Horizontal Merger Guidelines,” August 19, 2010, Section 9.1.

⁴² As discussed in Areeda, Hovencamp, & Solow, *Antitrust Law: An Analysis of Antitrust Principles and Their Application*, Aspen Law & Business, 2002, Chapter 4, section 420a. (footnote omitted), “An ‘entry barrier’ is any factor that permits firms already in the market to earn returns above the competitive level while deterring outsiders from entering. In the perfectly competitive model, prices above the competitive level attract entry until the newcomers restore total market output to the competitive level, thus bringing about competitive performance. Indeed, if entry is both costless and instantaneous, the equilibrium price will be at long-run marginal cost, the competitive level, no matter how concentrated the market.” Note that this passage defines “the competitive level” as the long-run marginal cost level, which will equal long-

29. Short-run, or seasonal, deviations of price from a long-run competitive price are not the relevant market power concern for oil pipelines seeking market-based rates.⁴³ As discussed above, it is sustained deviations of price from a long-run competitive price that are the relevant concern. Seasonal or other temporary deviations in price above a long-run competitive price level are consistent with workably competitive industries, and signal the need for expansion of capacity or new entry. As the Commission stated in *Explorer*:

The Commission recognizes that there may be some increase in some of Explorer's rates if it is authorized to utilize market-based rates. However, the protesting parties' arguments that there should not be an increase in rates to reflect the tightening of capacity in peak periods is inconsistent with the Commission's recent recognition that at least some differential pricing, *i.e.* pricing based on demand, is lawful and appropriate in the oil pipeline industry. Differential 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. CITGO's statement that it must reserve off-peak capacity to obtain peak capacity reflects the use of pro-rationing rather than pricing to allocate capacity in periods of relative shortage. This is a reflection of the current inefficient pricing that is occurring on the constrained sections of Explorer's system.⁴⁴

30. In its *Explorer* decision, the Commission is referencing seasonal, or temporary increases in price, and not sustained increases in price for a significant period of time. In the *Longhorn* proceeding, given the lack of contesting the market share and market concentration statistics presented in Longhorn's application for market-based rates, there also does not appear to be a concern regarding Longhorn's ability to *sustain* a

run average costs at long-run equilibrium as discussed above. Therefore, when there are barriers to entry, it is possible for prices to be greater than the long-run average cost level and the long-run competitive price that would result in a perfectly competitive model.

⁴³ Short-run competitive prices can be significantly different from long-run competitive prices. As discussed above, in the long-run, the long-run competitive price should equal the long-run average cost of producing (or supplying) the product. This is because competing firms will profitably enter the market if prices are greater than their long-run average cost of producing the product – which will increase supply and decrease prices. Similarly, unprofitable firms will exit the market if prices are less than their long-run average cost of producing the product, which will decrease supply and increase prices. This expansion and contraction of supply over the long-run works to move the long-run competitive price towards the long-run average cost of producing the product, whereby the long-run average cost of producing the product includes a reasonable return on investment.

⁴⁴ *Explorer Pipeline Co.*, 87 FERC ¶ 61,61,374, at 62,394 (1999).

price increase above a competitive level for a significant period of time.⁴⁵ Seasonal increases in price above a long-run competitive price level is not the relevant market power concern. However, when price increases above a long-run competitive level are sustained, those prices are no longer “close to marginal cost, such that the seller makes only a normal return on its investment” as referred to in Order No. 572 and *Tejas*,⁴⁶ are above the relevant benchmark competitive price, and result in “excessive” returns on investment.⁴⁷

31. As discussed above, the relevant market power concern for an oil pipeline applying for market-based rates is the ability to sustain a price increases above a long-run competitive price, which is tied to the cost of providing transportation service (including a reasonable return on investment), for significant period of time such as two years. With the concepts of the relevant market power concern and the relevant competitive price in mind, the next question to address is how could it be possible for an oil pipeline to exercise market power, and what is a reasonable method to evaluate whether a pipeline could exercise market power.

IV. POSSIBLE SCENARIOS FOR A SUSTAINED INCREASE IN RATE ABOVE A LONG-RUN COMPETITIVE RATE LEVEL

32. As discussed above, the framework of identifying the relevant market power concern also provides a basis for evaluating whether a methodology for identifying competitive alternatives to an applicant pipeline produces a reliable indication of whether the applicant pipeline possesses market power. Competitive alternatives to an applicant pipeline are the alternatives that shippers on the applicant are likely to switch to in response to a rate increase above the relevant competitive level,⁴⁸ which is a long-run competitive rate.⁴⁹

⁴⁵ See *TE Products Pipeline Co.*, 92 FERC ¶ 61,121, at 61,466-67 (2000).

⁴⁶ *Market-Based Ratemaking for Oil Pipelines*, Order No. 572, FERC Stats. & Regs., ¶ 31,007 at 31,180 (1994), quoting *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990).

⁴⁷ *Farmers Union Cent. Exch. Inc. v. FERC*, 734 F.2d 1486 at 1501-02 (D.C. Cir. 1984) (*Farmers Union II*).

⁴⁸ *Mobil Pipeline Co. v. FERC*, 676 F.3d 1098 at 1102 (D.C. Cir. 2012) (“*Mobil*”).

⁴⁹ The question of whether shippers would shift their volumes in response to a rate increase on the applicant pipeline turns on the question of whether one or more of the potential alternatives would be a true economic alternative (*i.e.*, the alternative is available, comparable in quality, and would offer an equivalent or better delivered (or netback) price than the one available on the applicant pipeline after a small but

33. Given the relevant market power concern, scenarios can illustrate where a pipeline has the ability to exercise market power, and a methodology for identifying competitive alternatives that *fails* to indicate that a pipeline could exercise market power given the scenario should not be considered a reasonable, or reliable, methodology for determining whether an applicant pipeline can exercise market power. These scenarios also illustrate that systematically identifying competitive alternatives based on whether the alternatives are comparable in terms of availability, quality, and price such that shippers are likely to switch to the alternative in response to a rate increase by the applicant pipeline yields market share and market concentration statistics that reasonably indicate the presence or absence of a market power concern.
34. Based on long-run competitive prices being determined by long-run marginal cost, including a reasonable return on investment, scenarios can illustrate the conditions where a price increase can be sustained at a level greater than long-run marginal cost. As a barrier to entry is required for there to be the ability to sustain a price increase above a long-run competitive price level, the withholding of capacity from the market is one way to exercise market power. Another possibility is a capacity constraint between locations, which creates locational pockets of commodity oversupply or shortages and locational differences in commodity prices. In both situations of withholding of capacity and capacity constraints, it is possible for a rate increase to be sustained because it takes time for alternative suppliers to enter the market or expand capacity and compete price down to a long-run marginal cost level. As discussed above, if entry and expansion were not costly and slow, there would be little, if any,

significant increase in the applicant pipeline's transportation price). Assuming the existence of multiple competitive alternatives, if the applicant pipeline were to increase its rates, the presence of multiple competitive alternatives would render unprofitable any attempt to increase the transportation rate by the applicant pipeline because existing shippers would shift volumes to other competitive alternatives. In this case, a large enough decrease in volumes would lead to a decrease in revenue, despite the increase in rates, causing a decrease in profit compared to the revenue resulting from the rates and volumes prior to the increase. (There could also be changes in the pipeline's costs that are related to volumes, such as fuel and power expenses, that should also be considered in any evaluation of change in profit due to a rate increase.) Therefore, it is appropriate to examine the alternatives that would be competitive on the applicant pipeline, not only at a long-run competitive price level, but also after the rate on the applicant pipeline were increased. Assuming the absence of competitive alternatives, if the applicant pipeline were to increase its rate above a long-run competitive price level, it could sustain the rate increase because existing shippers would not have an incentive to shift volumes to other alternatives.

- basis to regulate the price of oil pipelines because competition would push rates to long-run marginal cost levels, and it would not be expected that any oil pipelines could sustain a rate increase above a long-run competitive price level for a significant period of time. Below I present examples of market power resulting from capacity constraints that are created by changes in supply and demand in competitive commodity markets that create locations of commodity oversupply or shortages.
35. In an oil pipeline market power analysis, the relevant question is whether the applicant pipeline is likely to be able to exercise market power by sustaining a small but significant increase in rate above a long-run competitive rate level for a significant period of time given existing and likely future market conditions. A competitive alternative to the applicant pipeline is an alternative that shippers would switch to in response to a rate increase by the applicant pipeline above a long-run competitive rate. If enough shippers would switch to other alternatives, then the rate increase by the applicant pipeline would not be profitable and it could not profitably sustain the rate increase (a high positive cross-elasticity of demand). However, if enough shippers are not able to switch to other alternatives in response to a rate increase above a long-run competitive price (low cross-elasticity of demand), then the applicant pipeline will be able to profitably sustain a rate increase by exercising market power, and earning extraordinary returns.
36. One method to evaluate whether a pipeline is likely to be able to exercise market power is to examine all existing alternatives, assume that all the existing alternatives are competitive, and if there are multiple existing alternatives, to infer that applicant pipeline is operating in a workably competitive market and is therefore unlikely to be able to exercise market power. An alternative method to determine whether alternatives are competitive is to examine whether the alternatives are comparable in terms of availability, quality, and price, and to include only the alternatives that are comparable in terms of availability, quality, and price in computing market share and market concentration statistics to infer whether an applicant pipeline is likely to be able to exercise market power. As the scenarios in Figures 1, 2, and 3 will show, the method of simply assuming that all existing alternatives are competitive alternatives *fails* to reliably indicate the existence of market power and does not examine any

information on shippers' cross-elasticity of demand, whereas determining competitive alternatives in terms of availability, quality, and price *does* reliably indicate the presence of market power when it exists, and includes an analysis incorporating cross-elasticity of demand as stated in *Mobil*.⁵⁰ Note that the AOPL Comments reference the statement in *Mobil* that a market power analysis includes an examination of the cross-elasticity of demand,⁵¹ but do not explain how an analysis that simply assumes all existing (or "reasonably available") alternatives are competitive includes any information on the cross-elasticity of demand between alternatives.⁵² As will be discussed further below and illustrated in the scenarios, a netback price (or delivered price analysis) factors information on shippers' cross-elasticity of demand, or willingness to shift volumes to an alternative pipeline in response to a rate increase by the applicant pipeline above a long-run competitive price level, into the market power analysis. A netback price (or delivered price) analysis only considers alternatives competitive if shippers have an economic incentive to shift volumes to the alternatives in response to a rate increase by the applicant pipeline above a long-run competitive price level (a high cross-elasticity of demand).

37. Brief descriptions of comparability in terms of availability, quality, and price are as follows. First, the alternative must be readily available. For a shipper, an alternative pipeline or other transportation mode must have the capacity and capability to take on additional volumes. If an alternative is not readily available, then it cannot serve as an alternative to which volumes could be shifted in response to a small but significant rate increase by the applicant pipeline. Second, the alternative must be comparable in quality to the pipeline applying to charge market-based rates. If the alternative is not similar in quality, then a shipper's ability to shift volumes will be limited or non-

⁵⁰ *Mobil*, 676 F.3d at 1102.

⁵¹ AOPL Comments at 10, 22.

⁵² The only mention of "cross-elasticity of demand" in the Webb Affidavit is in a referenced quote from a decision by the U.S. Supreme Court in *Brown Shoe Co. v. United States*. Webb Affidavit at P 8. However, while Dr. Webb claims that the referenced quote and others from the *Brown Shoe* support his claim that "a used alternative, even if less than a perfect substitute for certain consumers, should be considered a reasonably available alternative," (*Id.*) Dr. Webb does not explain how an analysis that simply assumed all existing (or used or "reasonably available") alternatives are competitive includes any examination of, or information on, the cross-elasticity of demand between the alternatives.

existent, or the shipper will likely incur an additional cost to shift volumes to the alternative. Third, the alternative should be comparable in terms of price, whereby the economic impact of switching to the alternative is low (high cross-elasticity of demand). For an origin market, a netback analysis can be used to determine the penalty for switching shipments from one alternative to another. In an origin market analysis, it is the netback price to the shipper (achieved commodity price to shipper in an origin market after all costs of delivery) that should be compared to the competitive or benchmark netback in determining whether proposed alternatives are good alternatives in terms of price. For a destination market, a delivered price analysis can be used to determine the penalty for switching purchases of product from one alternative to another.⁵³ Moreover, a proxy for the relevant competitive price of the transportation on the applicant pipeline is required to reliably determine alternatives that are comparable in terms of price and should be an integral part of the market power analysis.

38. It is also important to recognize that changes in supply and demand in the commodity markets at an origin or destination can have a significant impact on the demand for transportation on a particular pipeline, and on the rate a pipeline with market-based rates can charge given the presence of barriers to entry, causing entry and expansion to be slow. These changes in supply and demand in the commodity markets at an origin or destination can cause the rate a pipeline is able to charge to increase while volumes transported on the pipeline also increase. When a pipeline reaches capacity, the rate a pipeline can charge can increase significantly as oversupply develops in an origin market or shortages develop in a destination market, even if the pipeline is transporting a small portion of the total commodity traded in an origin or destination. It should be noted that there can be robust competition in the commodity markets at an origin or a destination, but a pipeline can have market power (*i.e.*, the ability to sustain a rate above long-run marginal cost and a long-run competitive rate) due to capacity constraints in markets where the entry or expansion of transportation alternatives that would alleviate the capacity constraints are costly and slow.

⁵³ For simplicity, I address the comparison of alternatives in terms of price from an origin market perspective in the scenarios presented below. However, a similar analysis and corresponding scenarios could be presented based on a destination market perspective.

39. Figure 1 depicts an applicant Pipeline AB transporting between Origin A and Destination B, as well as alternative pipelines transporting from the same Origin A to different destinations, labelled Destinations C through G. In this scenario, all pipelines are flowing below capacity and have prices consistent with long-run competitive levels, which is pricing at long-run marginal cost.⁵⁴ Note that each pipeline transports to a different destination, and due to such factors as differences in distance between Origin A and the destination served by the pipeline, or terrain traversed, the pipelines can have differences in long-run marginal cost. Thus the pipelines are not providing homogeneous service and their long-run marginal costs would not be expected to be equal and direct comparison of the long-run marginal cost of pipelines providing transportation between different locations may be of limited value. As discussed above, the long-run competitive price for transportation between any two locations should be equal to or less than the long-run marginal cost of any alternative providing transportation between the two locations. Or in other words, the long-run competitive price for the transportation service provided by the applicant pipeline should be equal to or less than its long-run marginal cost. Thus, the applicant pipeline's long-run marginal cost should provide an upper bound on a long-run competitive price for the transportation service it is providing.⁵⁵
40. In Figure 1, applicant Pipeline AB's long-run marginal cost (labelled "LRMC" in Figure 1) is \$2.00/bbl,⁵⁶ its existing capacity is assumed to be 1,000 MBD and average volume transported is 950 MBD. In this scenario, applicant Pipeline AB is assumed to be charging a rate equal to its long-run marginal cost of \$2.00/bbl, thereby

⁵⁴ Pricing at long-run marginal cost could be due to competitive pressures or regulatory mandate in this scenario, which wouldn't impact the analysis or the conclusions.

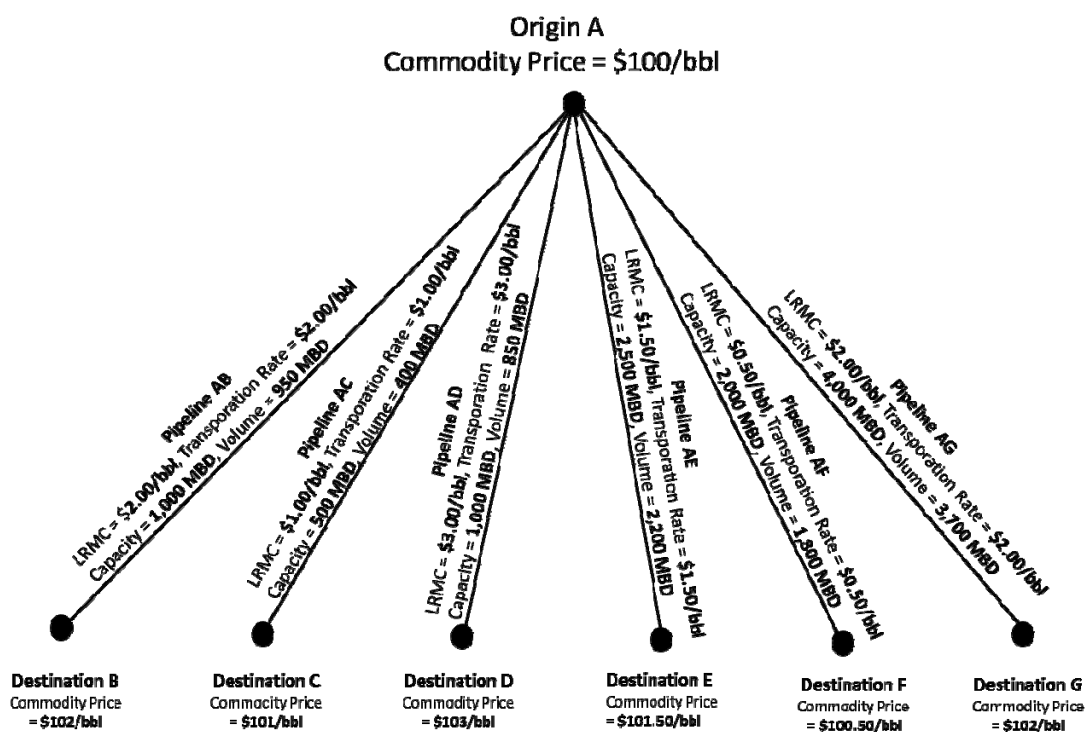
⁵⁵ Note that a long-run competitive price for the transportation service provided by the applicant pipeline is relevant for the specific transportation service between an origin and destination that it provides. However, when determining competitive alternatives to an applicant pipeline, all alternatives transporting from an origin regardless of destination should be considered in the origin market analysis, and all alternatives delivering into a destination regardless of origin should be considered in a destination market analysis, as opposed to performing a corridor analysis that would only consider alternatives between the same origin and destination served by the applicant pipeline.

⁵⁶ In all of these examples, I assume that the long-run marginal cost of the pipelines is known. Because in a long-run competitive equilibrium, long-run marginal cost is equal to long-run average cost, the figures could refer to long-run average cost. I also assume for simplicity that long-run marginal cost is constant. As discussed above, data on the applicant pipeline's costs of existing and expansion transportation service would provide information on its long-run marginal cost and an upper bound for the long-run competitive rate.

recovering its costs including a normal return on investment. All other pipelines are also assumed to be transporting a volume less than their capacity and charging a rate equal to their long-run marginal cost. If the commodity markets are competitive at the origin and destination markets and there are no capacity constraints on any of the pipelines, then competition in the commodity markets should cause the difference in the commodity prices at the origin and destination locations to equal the transportation rate between the origin and destination. Therefore, if the commodity price is \$100/bbl in the Origin A market, the commodity price in the Destination B market would be \$102/bbl given a transportation rate of \$2.00/bbl between Origin A and Destination B on Pipeline AB. Similarly, the commodity price in Destination C would be \$101/bbl, where Pipeline AC has a rate and long-run marginal cost of \$1.00/bbl.

Figure 1

**Multiple Pipelines Serving Origin A
Pipeline Rates = LRMC
No Capacity Constraints**



42. Figure 1 depicts a scenario where all pipelines are charging a rate equal to their long-run marginal costs, and the commodity price differentials between locations equal the transportation rates.⁵⁷ Therefore, each pipeline yields a netback price to a shipper originating product at Origin A equal to \$100/bbl, which is the commodity price in the destination less the transportation price from Origin A to the destination. If one compared the netback price attainable on applicant Pipeline AB, after a hypothetical small but significant increase in its transportation rate, relative to the netback price attainable on the alternative pipelines, the alternatives would be good alternatives in terms of price because the alternatives would be offering equal or higher netback prices (after an increase in price by applicant Pipeline AB). Note that in this scenario, there would be a high cross-elasticity of demand for the alternatives in response to a rate increase by the applicant pipeline as shippers would have the incentive to shift volumes to the alternatives in response to a rate increase by the applicant pipeline above a long-run competitive price level. If the alternatives are also comparable in terms of quality, and do not have any availability constraints, then all pipelines should be considered competitive alternatives to applicant Pipeline AB and included in calculations of market share and market concentration measures.⁵⁸
43. In the specific scenario depicted in Figure 1, the same market share and market concentration statistics would result from simply assuming all existing alternatives are competitive relative to applicant Pipeline AB as well as by systematically identifying competitive alternatives based on being comparable in terms of availability, quality, and price. Shippers on applicant Pipeline AB would likely switch to the multiple other alternatives that would offer higher netback prices if applicant Pipeline AB attempted to increase its rate above its long-run marginal cost, which is an upper bound on its long-run competitive price level, thereby making

⁵⁷ If the commodity markets are competitive at the origin and destination markets and without capacity constraints, then competition in the commodity markets should cause the difference in the commodity prices at the two locations to equal the transportation rate between markets.

⁵⁸ Note that there are five existing alternative pipelines to the applicant pipeline included in the scenario depicted in Figure 1, but the number of alternative pipelines could be expanded to a number greater than five that are, like the five alternatives depicted, not capacity constrained and currently have a rate equal to long-run marginal cost. The additional alternative pipelines like the five currently depicted would be additional competitive alternatives in terms of price if those pipeline yield similar netback prices to the applicant pipeline.

- applicant Pipeline AB likely to lose enough volume that its rate increase would not be profitable or sustainable.
44. Figure 2 illustrates a situation where there is an increase in production of the commodity at Origin A relative to the scenario depicted in Figure 1 above. As production of a commodity (supply) at an origin increases, without a corresponding increase in demand at the origin, the price of the commodity at the origin will fall. As the commodity price at an origin falls, absent transportation capacity constraints, the commodity price at destinations should also fall as arbitrage works to equalize locational differences in commodity prices to the cost of transporting between locations. As the commodity price at destinations (or areas of consumption) falls, it would be expected that there would be some increase in the quantity consumed at the destination, and a corresponding increase in the demand for transportation between the origin and destination.⁵⁹ In Figure 2, due to an increase in production at Origin A, the commodity price at Origin A has decreased from \$100/bbl (in Figure 1) to \$80/bbl (in Figure 2), and as the commodity price at Origin A decreased, the commodity prices at Destinations B through G also fell which leads to an increase the amount of commodity consumed in Destinations B through G and an increase in the volume transported to each of the destinations. However, in the case of a commodity such as crude oil, the consumption at a destination is limited by refining capacity, and while refineries may substitute one type of crude for another as the price falls, there may be limitations on the amount of one type of crude that the refineries can process. Thus, as the commodity price falls at one location due to increasing supply relative to demand, the amount of consumption of the commodity at that location may not increase significantly for some period of time.⁶⁰
45. In Figure 2, the volume transported on each pipeline increases relative to Figure 1,

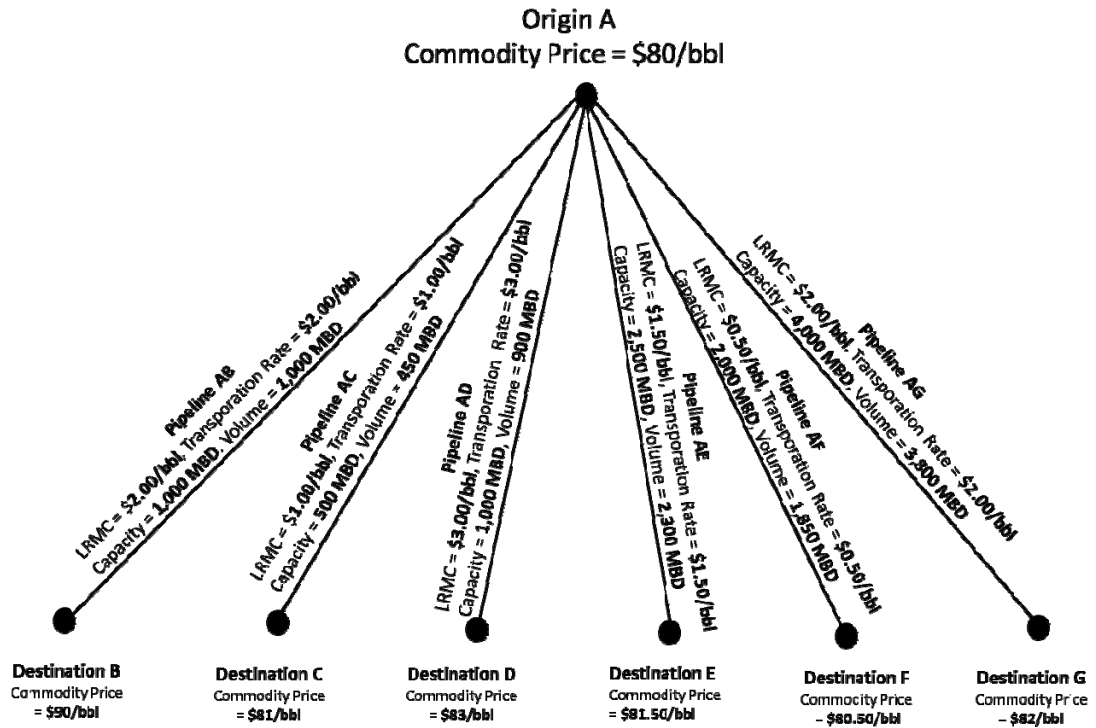
⁵⁹ The increase in demand at a destination due to a lower price would be a result of moving down the demand curve (a higher volume traded at a lower price), which would also be expected to result in some movement down the demand curve at the origin (a higher volume traded at a lower price).

⁶⁰ Note that it is possible for a commodity oversupply situation to develop at an origin even though the pipeline transportation alternatives to some destinations (where there is not a large increase in demand as a result of the commodity price decreasing) are not at capacity. In that case, the ultimate demand by entities at a destination such as refineries receiving crude, and the capacity constraints at the refineries to receive a type of crude, could be the limiting capacity to receive the commodity at a destination, not the pipeline capacity between the origin and destination.

but only the volume transported on Pipeline AB reaches its capacity of 1,000 MBD. As the commodity price at Origin A decreases, the commodity price at Destination B also falls which leads to an increase in the amount of commodity consumed in Destination B and an increase in the volume transported on Pipeline AB from 950 MBD (in Figure 1) to 1,000 MBD (in Figure 2), which is the capacity of Pipeline AB. As Pipeline AB reaches capacity, oversupply at Origin A can develop, as well as shortages at Destination B, which can cause the commodity price differential between the two locations to increase above levels without capacity constraints. As the commodity price differential between Origin A and Destination B increases, the transportation rate that Pipeline AB can charge increases. In Figure 2, relative to Figure 1 the commodity price in Origin A has decreased to \$80/bbl, the volume transported on Pipeline AB has increased to its capacity of 1,000 MBD, and the commodity price in Destination B has decreased to \$90/bbl relative to the prices and volumes in the scenario in Figure 1. As the volume transported on Pipeline AB reached its capacity, the commodity price differential between Origin A and Destination B increased to \$10.00/bbl, which is the transportation rate that Pipeline AB could charge given a transportation volume of 1,000 MBD and the commodity price differential between Origin A and Destination B. If entry by other alternatives is slow and expansion by Pipeline AB is slow, Pipeline AB would be able to exercise market power by sustaining a price of \$10.00/bbl, which is greater than its \$2.00/bbl long-run marginal cost, and earn extraordinary returns for a significant period of time.⁶¹ This is the relevant market power concern.

⁶¹ Note that in this scenario, the volume transported on Pipeline AB increased as well as the price it could charge relative to the volumes and prices depicted in Figure 1 and it could be claimed that Pipeline AB is not “withholding” capacity. However, the capacity required to decrease the locational difference between the commodity prices at Origin A and Destination B is greater than Pipeline AB’s capacity, and by not expanding to the volume necessary to bring price back to a long-run marginal cost level, Pipeline AB is “withholding” capacity from the market.

Figure 2
Multiple Pipelines Serving Origin A
Pipeline Rates = LRMC
Capacity Constraint on Pipeline AB
Pipeline AB Has Ability to Increase Rate above LRMC



46.

47. Given the proxy for the long-run competitive rate of \$2.00/bbl for applicant Pipeline AB, in the scenario depicted in Figure 2, the netback price on the applicant pipeline would be \$88/bbl. With a small but significant increase in price of 15% of the applicant pipeline's rate, the netback price on applicant Pipeline AB would be \$87.70/bbl.⁶² The netback price on the other five pipeline alternatives in the scenario in Figure 2 is \$80.00/bbl.⁶³ Therefore, given a small but significant rate increase by applicant Pipeline AB over the long-run competitive rate level of \$2.00/bbl, shippers would not switch to the other pipeline alternatives because they would still be achieving a higher netback price on applicant Pipeline AB than the other alternatives.

⁶² A 15% increase in applicant Pipeline AB's rate of \$2.00/bbl would be \$0.30/bbl. At a price of \$2.30/bbl, the netback price attainable on Pipeline AB given the scenario in Figure 2 would be \$87.70/bbl.

⁶³ The commodity price at Destinations C through G less the transportation rate on each pipeline from Origin A to the destination is \$80.00/bbl.

It would not be until the rate charged by applicant Pipeline AB reached \$10.00/bbl that the netback price attainable on applicant Pipeline AB would be equal to the netback prices attainable on the alternative pipelines. If the rate charged by applicant Pipeline AB can increase to \$10.00/bbl before shippers would switch to an alternative, and the market conditions giving rise to the existing netback prices attainable on alternatives is expected to persist (given that entry and expansion of pipeline infrastructure is slow), then applicant Pipeline AB would be able to exercise market power by sustaining a small but significant price increase above the long-run competitive price level and earn extraordinary profits. This is the relevant market power concern.

48. Note that, as shown in the scenario in Figure 2, the ability of Pipeline AB to sustain a small but significant increase in price above a long-run competitive price level is known because there is a reasonable proxy for the long-run competitive price, which is the long-run marginal cost of Pipeline AB. That proxy for the long-run competitive price is a reasonable transportation rate to use in a netback price analysis to determine whether other alternatives are price comparable to applicant Pipeline AB. With a proxy for the long-run competitive rate (\$2.00/bbl in Figure 2), it is clear that Pipeline AB would be able to charge a price significantly greater than the proxy for the long-run competitive rate (\$10.00/bbl in Figure 2) before shippers would switch to an alternative pipeline. Note that in this scenario, there would be a low (or zero) cross-elasticity of demand for the alternatives in response to a small but significant rate increase by the applicant pipeline above the long-run competitive price as shippers would have no incentive to shift volumes to the alternatives in response to a small but significant rate increase such as 15% by the applicant pipeline. If Pipeline AB could sustain higher rate levels up to \$10.00/bbl, it would be exercising market power and earning extraordinary returns. By identifying that the other five pipelines are not good alternatives in terms of price to applicant Pipeline AB, the market share and market concentration statistics would indicate that there are no competitive alternatives to Pipeline AB that shippers would switch to in response to a rate increase above the relevant competitive level by Pipeline AB, which indicates Pipeline AB is able to exercise market power.

49. In contrast, a methodology for determining competitive alternatives that simply assumes that all existing alternatives are competitive alternatives would assume all five alternatives to applicant Pipeline AB in Figure 2 are competitive alternatives, erroneously indicate that there are numerous competitive alternatives to Pipeline AB, and that Pipeline AB would not be able to sustain a price increase above a long-run competitive price level.⁶⁴ The methodology of simply assuming all existing alternatives are competitive alternatives is *incapable* of distinguishing between the scenarios presented in Figures 1 and 2 and *incapable* of indicating that Pipeline AB has the ability to increase price above a long-run competitive price in the scenario presented in Figure 2. Simply assuming all existing alternatives are competitive alternatives does not reliably indicate when a pipeline could sustain a rate increase above a competitive level because it does not use a proxy for a competitive rate to identify competitive alternatives and does not examine how shippers will respond to an increase in the transportation rate by the applicant pipeline above a long-run competitive level.⁶⁵ Comparing alternatives in terms of price by using a reasonable proxy for the competitive price is one requirement for properly identifying competitive alternatives. It permits the recognition of situations where shippers would not switch to an alternative in response to a small but significant rate increase by the applicant pipeline above a long-run competitive rate level (low or zero cross-elasticity of demand), which are situations where a pipeline can exercise market power.
50. The Enterprise/Enbridge Comments and the AOPL Comments erroneously claim that a netback analysis should not be used in a market power analysis because it can “devolve into” or “produce results similar to” a “corridor” market analysis.⁶⁶ In the discussion above regarding the scenario presented in Figure 2, the applicant pipeline is assumed to be Pipeline AB, which yields a netback price of \$87.70/bbl (after a

⁶⁴ Note that there are five existing alternative pipelines to the applicant pipeline included in the scenario depicted in Figure 2, but the number of alternative pipelines could be expanded to a number greater than five that are, like the five alternatives depicted, not capacity constrained and currently have a price equal to long-run marginal cost.

⁶⁵ In other words, simply assuming all existing alternatives are competitive alternatives does not involve any examination of shippers’ cross-elasticity of demand for other alternatives in response to a small but significant rate increase by the applicant pipeline above the relevant [long-run] competitive price level.

⁶⁶ Enterprise/Enbridge Comments at 15; AOPL Comments at 29-30; Webb Affidavit at P 23-25.

SSNIP) relative to the netback price of \$80/bbl attainable on the other five pipelines. Consequently none of the other alternatives are competitive in terms of price with Pipeline AB because shippers would have no incentive to switch to the alternatives in response to a small but significant increase in rate above the long-run competitive rate level of \$2.00/bbl by the applicant pipeline (assumed to be Pipeline AB in the above discussion). In Figure 2, if the applicant pipeline is Pipeline AB, because all alternatives regardless of destination were examined, the analysis is not a “corridor” analysis even if it is determined there are no competitive alternatives in terms of price to Pipeline AB. In contrast, a “corridor” analysis would not even consider the possibility that any of the other pipelines could be competitive alternatives simply because they did not provide transportation between the same origin and destination (Origin A and Destination B in Figure 2 if the applicant pipeline is Pipeline AB).⁶⁷ To further illustrate that a netback price analysis is not a corridor analysis, instead of assuming Pipeline AB is the applicant pipeline in Figure 2 as in the above discussion, assume any other pipeline such as Pipeline AG is the applicant pipeline. If Pipeline AG were the applicant pipeline in the scenario depicted in Figure 2, all other alternatives would be competitive alternatives in terms of price to Pipeline AG because all would be offering equal or higher netback prices after a hypothetical small but significant increase in rate by Pipeline AG and shippers would have an incentive to shift volumes away from Pipeline AG to other alternatives.⁶⁸ Note that all alternatives regardless of destination are being examined in terms of price and the netback analysis is clearly not a “corridor” analysis whether Pipeline AB or Pipeline AG is considered to be the applicant pipeline.

51. Having a reasonable proxy for the relevant competitive price also avoids situations

⁶⁷ Note that a “corridor” analysis would incorrectly conclude that there are no competitive alternatives to applicant Pipeline AB in the scenario depicted in Figure 1 because none of the other alternatives provide transportation service between the same origin and destination.

⁶⁸ After a small but significant increase in rate by Pipeline AG of 15%, or \$0.30/bbl, to a rate of \$2.30/bbl, the netback price attainable on Pipeline AG would initially fall to \$79.70/bbl (a destination price of \$82/bbl less a transportation rate of \$2.30/bbl). Pipeline AB would have a netback price of \$88/bbl, and Pipelines AC, AD, AE, and AF would have netback prices of \$80/bbl. In the case of Pipeline AG being the applicant pipeline, note that while Pipeline AB would be a competitive alternative in terms of price to Pipeline AG, Pipeline AB would not be a competitive alternative in terms of availability because it is operating at capacity and volumes could not shift from Pipeline AG to Pipeline AB in response to a rate increase by Pipeline AG.

where a prevailing rate based on shippers' value for transportation as determined by locational differentials in commodity prices is erroneously assumed to be the relevant long-run competitive price. As discussed above, the Commission's Order No. 572, quoting *Tejas Power Corp. v. FERC*, identifies the relevant competitive price (that market-based rates for oil pipelines seek to emulate) to be the long-run competitive price that is based on long-run marginal cost (including a reasonable return on investment).⁶⁹ As the scenario of Pipeline AB in Figure 2 illustrates, when capacity constraints exist, the "value" of transportation can be significantly different from the long-run marginal cost of transportation and the relevant long-run competitive rate. In these situations, having a reasonably proxy for the relevant long-run competitive rate avoids erroneously identifying alternatives as competitive alternatives when, in fact, they are not competitive alternatives.

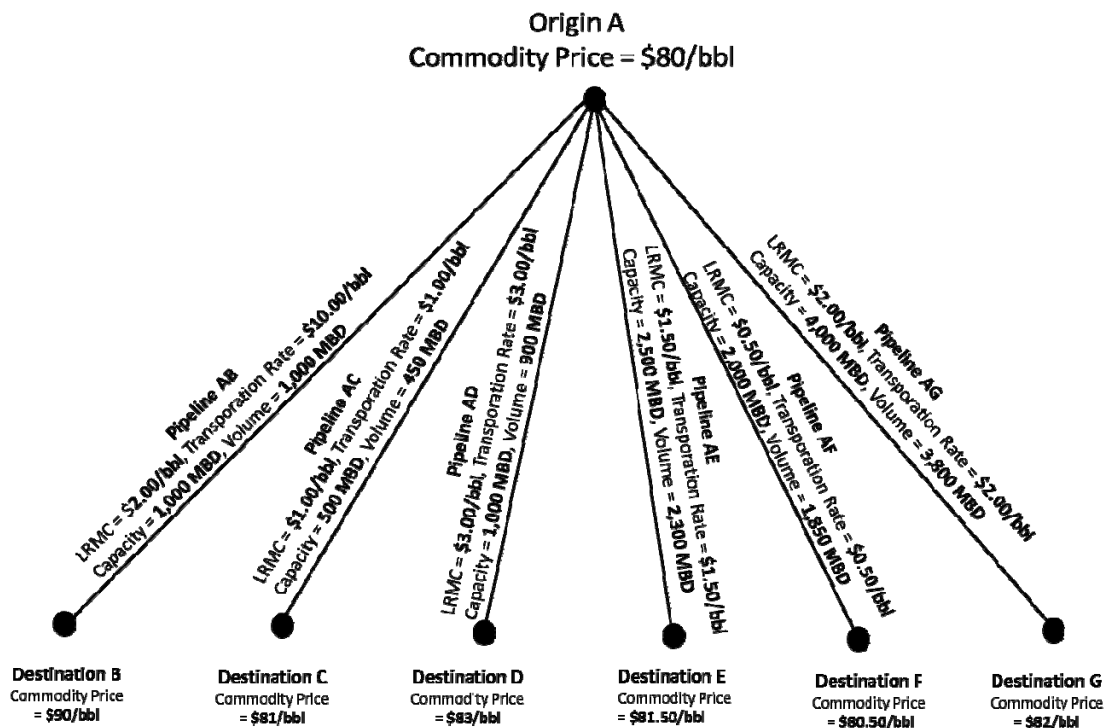
52. Without including a reasonable proxy for the long-run competitive rate in a market power analysis for oil pipelines seeking market-based rates, erroneous conclusions can be reached even when performing a netback analysis if the rate used to calculate the netback prices is not a reasonable proxy for the long-run competitive rate. Figure 3 depicts the scenario presented in Figure 2 with one change – the transportation rate being charged by applicant Pipeline AB is \$10.00/bbl instead of \$2.00/bbl as shown in Figure 2. The \$10.00/bbl transportation rate is equal to the locational differential in the commodity price between Origin A and Destination B. If the \$10.00/bbl rate for Pipeline AB is erroneously assumed to be the relevant competitive rate and used to calculate a netback price for Pipeline AB, the netback price for Pipeline AB after a hypothetical SSNIP would be equal to or less than to the netback price of all the other five pipeline alternatives depicted in Figure 3,⁷⁰ suggesting that the alternative pipelines are price comparable to Pipeline AB. However, if Pipeline AB were to sustain the rate of \$10.00/bbl, it would recover its costs plus earn an extraordinary return on its investment. In this case, because Pipeline's AB long-run marginal cost

⁶⁹ *Market-Based Ratemaking for Oil Pipelines*, Order No. 572, FERC Stats. & Regs., ¶ 31,007 at 31,180 (1994), quoting *Tejas Power Corp. v. FERC*, 908 F.2d. 998, 1004 (D.C. Cir. 1990).

⁷⁰ In the scenario depicted in Figure 3, after a small but significant increase in rate by Pipeline AB of 15%, or \$1.50/bbl, to a rate of \$11.50/bbl, the netback price attainable on Pipeline AB would initially fall to \$78.50/bbl (a destination price of \$90/bbl less a transportation rate of \$11.50/bbl) while the other alternatives had netback prices of \$80/bbl, and shippers on Pipeline AB would have an incentive to shift volumes to the other alternatives offering a higher netback price.

is \$2.00/bbl, a rate of \$10.00/bbl is not a reasonable proxy for a long-run competitive rate, which reflects an exercise of market power by Pipeline AB. A reasonable proxy for a long-run competitive rate should be an integral part of a market power analysis for an oil pipeline applying for market-based rates.

Figure 3
Multiple Pipelines Serving Origin A
Pipeline AB's Rate > LRMC
Capacity Constraint on Pipeline AB
Pipeline AB's Rate is not a Reasonable Proxy
For Long-Run Competitive Price



53.

54. In these examples where a pipeline can exercise market power (by being able to sustain a rate above a long-run competitive rate), comparison of the rate to long-run marginal cost, or a long-run competitive rate level, provides proof that the pipeline is exercising market power. Because the relevant “competitive” rate must be tied to long-run marginal cost, it is clear that in the scenario depicted in Figure 3, Pipeline AB would be exercising market power by sustaining a rate of \$10.00/bbl that is significantly greater than its long-run marginal cost of \$2.00/bbl and earning an

extraordinary return.

55. However, notice that in the scenario depicted in Figure 3 that there can be robust competition in the commodity markets at Origin A and Destination B, with numerous buyers and sellers of the commodity that are competitively determining the commodity price in both locations based on the market supply and demand conditions at the specific location. The relative levels of the commodity prices at the two locations determine a shipper's "value" of transportation between the two locations. The value of transportation to a shipper, however, cannot be used to suggest that the pipeline lacks market power. Pipeline AB would be exercising market power in this scenario if it sustained a rate of \$10.00/bbl because that rate is significantly greater than a long-run competitive rate, which is less than or equal to Pipeline AB's long-run marginal cost of providing transportation. The rate of \$10.00/bbl fits the definition of "market power" discussed above which is "the ability to profitably sustain a small but significant price increase above a competitive price level for a significant period of time." In short, the transportation rate, such as the \$10.00/bbl transportation rate in Figure 3, can represent the "value" to shippers that is determined by robust competition in commodity markets at an origin and a destination, but it can also be a rate that results from market power in a *transportation* market, which is created by the capacity constraint on Pipeline AB *and* barriers to entry and expansion by other alternatives that would change the supply and demand balance in the commodity markets at either the origin or the destination.⁷¹

V. CONCLUSIONS AND SUMMARY

56. For oil pipelines seeking market-based rates, the relevant definition of "market power" is the ability to profitably sustain a small but significant rate increase above a competitive rate level for a significant period of time. Within this definition, the relevant "competitive rate level" is a long-run competitive price referenced in Order

⁷¹ Entry or expansion of pipeline alternatives at an origin or destination would change the supply and demand balance at either the origin or destination by alleviating an oversupply situation in the origin market or a shortage situation in the destination market, which in turn would affect the commodity price level in the origin or destination and would affect the locational differential between the origin and destination, thereby pushing the transportation rate between the origin and destination to a long-run competitive price level.

No. 572 and *Tejas*⁷² that is “close to [long-run] marginal cost, such that the seller makes only a normal return on its investment.” The relevant “small but significant rate increase is a level such as 15% above the long-run competitive price level.”⁷³ The relevant “significant period of time” is a period such as two years and does not include short-term deviations of price from a long-run competitive price such as those contemplated in *Explorer*.⁷⁴

57. Consistent with the relevant market power concern, scenarios can illustrate where a pipeline has the ability to exercise market power, and a methodology for identifying competitive alternatives that *fails* to indicate that a pipeline could exercise market power given the scenario should not be considered a reasonable, or reliable, methodology for determining whether an applicant pipeline can exercise market power. As the discussion and examples provided above illustrate, without an analysis of alternatives being comparable in terms of availability, quality, and price, market share and market concentration measures based on all existing alternatives can erroneously indicate a lack of market power when market power is likely to exist. These scenarios also illustrate that systematically identifying competitive alternatives based on whether the alternatives are comparable in terms of availability, quality, and price such that shippers are likely to switch to the alternative in response to a price increase by the applicant pipeline (high cross-elasticity of demand) yields market share and market concentration statistics that reasonably indicate the presence or absence of a market power concern.

⁷² *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1004 (D.C. Cir. 1990).

⁷³ As discussed above, a long-run competitive rate level will equal long-run marginal costs, and the long-run average cost level in equilibrium. Thus long-run average costs as well as long-run marginal costs have relevant for a long-run competitive price level.

⁷⁴ *Explorer Pipeline Co.*, 87 FERC ¶ 61,613,74, at 62,394 (1999).

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

**Enterprise Products Partners L.P.,
and Enbridge Inc.**

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Docket No. OR12-4-000

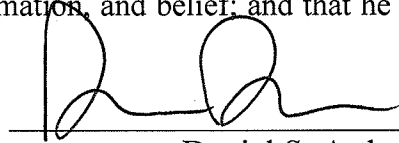
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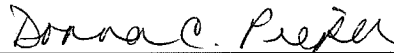
ss.

Daniel S. Arthur, being first duly sworn, deposes and says he is the same Daniel S. Arthur, whose Affidavit accompanies this Affidavit of Daniel S. Arthur, that such testimony was prepared by him; that he is familiar with the contents thereof; and the facts set forth herein are true and correct to the best of his knowledge, information, and belief; and that he does adopt the same as his sworn testimony in this proceeding.



Daniel S. Arthur

On this 31st day of July, 2012, before me, the undersigned notary public, personally appeared Daniel S. Arthur, proved to me through satisfactory evidence of identification, which were DRIVER'S LICENSE to be the person whose name is signed above, and who swore or affirmed to me that the contents of the document are truthful and accurate to the best of his knowledge and belief.



Notary Public

My commission expires JUNE 30, 2014

**Donna C. Pieper
Notary Public, District of Columbia
My Commission Expires 6/30/2014**

DANIEL S. ARTHUR

Principal

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Dr. Daniel Arthur is an economist consulting and providing litigation support primarily in the natural gas and oil industries. His economic areas of specialty include antitrust, pricing and ratemaking, and regulatory economics. Dr. Arthur holds both an M.A. and a Ph.D. in Economics from Northwestern University. He also has a B.S. in Business (Finance and Economics) and a B.S. in Mathematics and Statistics from Miami University. Prior to joining *The Brattle Group*, Dr. Arthur worked at Indiana University, where he worked on a team performing research in health economics. Dr. Arthur joined *The Brattle Group* in 1997.

AREAS OF EXPERTISE

- ♦ *Antitrust*
- ♦ *Pricing and Ratemaking*
- ♦ *Regulatory Economics*

EXPERIENCE

Antitrust

For numerous clients, Dr. Arthur has been involved in antitrust and market power cases before the Federal Energy Regulatory Commission, the Federal Trade Commission, and civil antitrust cases. Dr. Arthur's antitrust work includes the analysis of horizontal and vertical market power that would result from a proposed merger as well as the historical review of pricing behavior to determine whether market power was in fact exercised by an entity (or entities). Some of Dr. Arthur's consulting experience includes:

- ◆ On behalf of an oil refiner, Dr. Arthur presented testimony before the Federal Energy Regulatory Commission analyzing the market power held by a refined petroleum products pipeline seeking market based rates. Dr. Arthur's analysis focused on the competitiveness of alternatives to the pipeline from the refiner's perspective and the ability of the pipeline to increase prices in its destination markets. This analysis focused on the competitiveness of several geographic markets as well as how contracting between entities affects the substitutability of alternatives in the market.
- ◆ For a hearing before the Federal Energy Regulatory Commission and subsequent civil litigation, Dr. Arthur analyzed the market power resulting from control of natural gas pipeline capacity. The analysis involved defining the relevant markets, examining the anti-competitive behavior of holders of capacity to the destination market, and examining affiliate operations in the upstream market. One area of focus in this case was the impact of capacity constraints on the definition of the relevant market as well as the substitutability of alternatives to purchasing delivered natural gas. Analysis included examining the pricing behavior of market participants as well as examining the physical withholding of transportation capacity from the market.
- ◆ As the result of a settlement in a civil antitrust case, Dr. Arthur assessed the damages to entities consuming natural gas and electricity due to anti-competitive behavior in the natural gas transportation market. These damage estimates were performed at the class and individual entity level for numerous types of consumers and were used as the basis for the division of over \$1 billion in settlement funds.
- ◆ On behalf of a natural gas pipeline involved in an antitrust suit, Dr. Arthur analyzed whether the pipeline was (or is) a monopolist within a specific market. His analysis focused on defining the relevant product and geographic markets and assessing which firms competing within the relevant markets possessed market power. Analysis for this case focused on three factors in defining what the alternatives available in the relevant market are: (1) the impact of capacity constraints; (2) natural gas pipelines' ability to expand; and (3) the substitutability of purchasing the right to pipeline capacity on the secondary release market to contracting directly with the pipeline for primary capacity rights.
- ◆ Dr. Arthur assisted in the development of expert testimony regarding the evaluation of market power and allegations of a conspiracy to monopolize by a gas gathering, processing and natural gas liquids transportation company in Texas. Analysis in this case involved: (1) a detailed comparison of the cost of entry into the natural gas processing market to the prices charged for the service; (2) the contracting behavior of purchasers of natural gas gathering and processing

services; and (3) the relationship between the regulated natural gas liquids pipeline's rate and its underlying cost structure.

- ◆ Dr. Arthur assisted in the evaluation of whether a crude oil pipeline possessed market power in the context of a market based rates application before the Federal Energy Regulatory Commission. The primary issue in this case was how the substitutability of different grades of crude oil from a refiner's perspective affects the ability to use alternative pipeline transportation.
- ◆ On behalf of an electric utility, Dr. Arthur was part of a team which assessed the state of intrastate transmission, storage, and distribution services of the natural gas utilities in California, focusing on the aspects of the market that were functioning well under current regulations, where there existed or the potential existed for market power abuse, and made recommendations for restructuring or changing regulatory policy.
- ◆ On behalf of an owner of a natural gas pipeline, Dr. Arthur analyzed the antitrust implications of the owner's acquisition of another natural gas pipeline in the geographic area. This analysis was performed prior to making the decision on whether to acquire the pipeline and assisted the client in determining how the Federal Trade Commission would view the proposed transaction.
- ◆ Dr. Arthur assisted in the development of expert testimony on vertical market power relating to a proposed merger of a gas distribution company and an electric utility, examining the relationship between the natural gas and electric markets. Analysis focused on determining what the relevant product and geographic markets are and the incentives that would result from the proposed merged entity, as well as an assessment of whether behavioral or structural remedies would be necessary to alleviate potential market power concerns.
- ◆ Dr. Arthur analyzed the anti-competitive incentives that would result from the combination of two general partners of partnerships involved in natural gas liquids processing, fractionation, transportation, and trading. This analysis included examining the incentives to manipulate the availability of infrastructure to influence the commodity price, as well as the extent of the information regarding competitors' and customers' market positions that would be obtained as a result of the proposed combination.

Pricing and Ratemaking

Dr. Arthur's experience includes participation in several ratemaking proceedings for crude oil pipelines, refined petroleum products pipelines, natural gas pipelines, and natural gas liquids pipelines. Some of Dr. Arthur's areas of analysis in these proceedings include:

- ◆ Rate Base Determination: Dr. Arthur's analysis in several proceedings includes the issue of what is a reasonable rate base level when there are historical contracts that provided for the recovery of capital associated with the initial investment in the facilities.
- ◆ Income Tax Allowance: A contested issue in numerous proceedings, Dr. Arthur has been involved in the determination of the level of income tax allowance that should be provided to the unitholders of the master limited partnership that owns the regulated pipeline.

- ◆ Allocation of Unallocated Overhead Expenses to the Regulated Pipeline: Dr. Arthur has analyzed what a reasonable allocation is of unallocated overhead expenses from the parent organization to the regulated pipeline subsidiary using methodologies employed at the Federal Energy Regulatory Commission.
- ◆ Rate Design: Dr. Arthur's work regarding costs associated with pipeline expansions includes analyzing the question of whether to allocate the expansion costs to a subset of the pipeline system's customers, or to roll-in the costs with the rest of the system's costs and allocate the costs across all customers based on volumes and distances.
- ◆ Volume Level for Going-Forward Rates: Dr. Arthur's analysis for determining just and reasonable rates to be established on a going-forward basis includes examining what a representative level of volumes to be used to derive rates is. Proceedings where this issue has been particularly relevant is when there has been a recent capacity expansion or pro-rationing has been occurring due to operational restrictions that are expected to be lifted in the future.
- ◆ Analysis of Changed Circumstances: Dr. Arthur assisted in the development of expert testimony in an oil pipeline ratemaking proceeding before the Federal Energy Regulatory Commission, addressing the establishment of substantially changed circumstances in the economic basis of the rates in order for a shipper to successfully challenge an existing pipeline rate.

Other Economic Analysis

- ◆ On behalf of electric utilities owning nuclear generation plants and for testimony filed in Federal court, Dr. Arthur developed an empirical model of a trading market for rights to remove spent nuclear fuel. The model determined when individual utilities could expect their spent nuclear fuel to be removed if a trading market for rights existed.
- ◆ For a proposed gas pipeline expansion, Dr. Arthur analyzed whether there existed sufficient market demand to justify the expansion, and the impact of the proposed expansion on existing pipelines and producers.
- ◆ For an arbitration, Dr. Arthur assisted in the determination of the underlying events that caused a refined products pipeline to enter into bankruptcy protection. Dr. Arthur's analysis included an examination of the pipeline's changing financial position through time, sources of financing, requests for regulated rate changes, and the required pipeline integrity management program.

PUBLICATIONS

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TESTIMONY

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Company, ConocoPhillips Company, Southwest Airlines Co., and Valero Marketing and Supply Company, Docket No. IS09-437-000, March 2010.

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Before the Federal Energy Regulatory Commission, *SFPP, L.P.*, on behalf of America West Airlines, Inc., Continental Airlines, Inc., Northwest Airlines, Inc., Southwest Airlines Co., US Airways, Inc., Chevron Products Company, and ConocoPhillips Company, and Valero Marketing and Supply Co., Docket No. OR03-5-000, June 2008, October 2008.

Before the Federal Energy Regulatory Commission, *SFPP, L.P.*, on behalf of Chevron Products Company and ConocoPhillips Company, Docket No. OR03-5-001, April 2008.

Before the Federal Energy Regulatory Commission, *Mobil Pipe Line Company*, on behalf of Suncor Energy Marketing Inc. and Canadian Natural Resources Limited, Docket No. OR07-21-000, October 2007, November 2007, April 2008, July 2008.

Before the Federal Energy Regulatory Commission, *SFPP, L.P.*, on behalf of Chevron Products Company, ConocoPhillips Company, and Valero Marketing and Supply Company, Docket Nos. OR96-2-012, *et al.*, April 2007.

Before the Federal Energy Regulatory Commission, *Mid-America Pipeline Company, LLC*, on behalf of National Propane Gas Association, AmeriGas Propane, L.P., CHS, Inc., ConocoPhillips Company, Ferrellgas, L.P., and Targa Liquids Marketing and Trade, Docket Nos. IS05-216-003, *et al.*, March 2007.

Before the Federal Energy Regulatory Commission, *SFPP, L.P.* on behalf of ConocoPhillips Company, Docket Nos. OR96-2-000 *et al.*, April 2006.

Declarations before the Superior Court of the State of California in support of Ex Parte Applications for Entry of Third and Fourth Distribution Orders in Natural Gas Antitrust Cases I, II, III, and IV [J.C.C.P. Nos. 4221, 4224, 4226 and 4228], April 2005, May 2005, December 2005.

Before the Federal Energy Regulatory Commission, *Sunoco Pipeline L.P.* on behalf of ConocoPhillips Company, Docket No. OR05-7-000, June 2005, August 2005.

Before the Federal Energy Regulatory Commission, *Shell Pipeline Company L.P.* on behalf of ConocoPhillips Company, Docket No. OR02-10-000, January 2004, March 2004.

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.
and Enbridge Inc.

§

Docket No. OR12-4-000

AFFIDAVIT OF JOHN VAN HEYST

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.
and Enbridge Inc.

§

Docket No. OR12-4-000

AFFIDAVIT OF JOHN VAN HEYST

The undersigned, John Van Heyst, does hereby state as follows:

1. I hold the position of Manager, Marketing Logistics for Suncor Energy Marketing Inc. (“Suncor”). My business address is 150 - 6th Avenue SW, Calgary, Alberta, Canada T2P 3E3.
2. I am submitting this Affidavit in support of the reply comments of Suncor, Canadian Natural Resources Limited, Continental Resources, Inc., and Husky Marketing and Supply Company to the initial comments submitted by Enterprise Products Partners L.P. and Enbridge Inc. (collectively “Applicants”) in response to the Commission’s order granting rehearing of its prior order denying the application for authority to charge market-based rates for the reversed service by Seaway Crude Oil Pipeline Company LLC (“Seaway”).
3. I have more than 27 years of experience in the oil and gas industry. Recently I have been involved in the arrangement of pipeline transportation throughout North America of crude oil produced in Western Canada. I am familiar with the technical, logistical, and economic considerations involved in the transportation and marketing of crude oil in North America.
4. The information contained in this Affidavit is based on my personal knowledge

and understanding of petroleum production, transportation, and refining. It is also based on publicly-available crude oil price information published by Platts and Argus Media.

Limited Availability of Alternatives

5. The Applicants renew their position that many alleged competitive alternatives exist to Seaway, but many of these alternatives are not actually available to shippers, especially if the various types of crude oil are taken into account.

6. For example, the Application identifies West Texas Intermediate (“WTI”) as a type of crude oil that will be shipped on the Seaway pipeline. WTI is produced in and around Cushing, Oklahoma. The WTI production area is not physically connected to several of the areas that are identified in the Application, including the U.S. Rocky Mountain refineries, Western Canada refineries and the pipelines serving those refining areas.

7. Another physical barrier is the actual ability of a refinery to process and of a pipeline to transport different types of crude oil. For example, heavy sour crude oil runs can be limited by physical constraints of both refineries and pipelines, including but not limited to, finished product quality limitations, sulfur handling ability, and process unit capabilities and limitations. Without proper equipment, a refinery cannot process heavy sour crude oil, but the Applicants do not identify which refineries are able to process heavy sour crude oil. A refinery cannot be an alternative to the shipment of heavy sour crude oil on Seaway if it cannot refine heavy sour crude oil.

8. Pipelines also often limit access to different grades of crude oil because of operational issues related to capacity, segregation and contamination. A pipeline cannot

be an alternative to the shipment of heavy sour crude oil on Seaway if it cannot transport heavy sour crude oil.

9. Another consideration affecting the types of crude oil that a refinery will use is the optimum crude oil slate which a refinery needs to produce the desired slate of finished products. Each refinery will determine the optimum crude oil slate for the refinery at any point in time, typically using a linear program. The purpose of this is to maximize the profitability of the refinery operation. The crude oils used will be determined by the finished product outputs required by the refinery and the refinery process unit constraints for the period that the crude oil is being purchased. This optimization is highly dependent on finished product market netbacks, refinery constraints and related crude oil values, and may change seasonally. An example of this is asphalt production, which typically occurs more in the summer months, and which therefore often results in a higher consumption of heavier crude oils at some refineries in those months. The Applicants do not take into account the different individual refinery usage of different types of crude oil.

Significant and Sustained Price Differential

10. There is a significant and sustained market price differential between crude oil sold in inland Canadian and US markets compared to the same types of crude oil at the Gulf Coast due to an oversupply of crude oil in these inland markets. This oversupply resulted primarily from increased crude oil production in both Canada and the United States and the limited infrastructure connecting the inland markets to the Gulf Coast.

11. As a result, similar grades of crude oil sell at the international market price on

the Gulf Coast compared to the discounted price available at the inland markets. The Gulf Coast differs from the inland markets because it has many domestic and international crude oil sources. There is limited access to the Gulf Coast for crude oil produced in Canada and the United States inland markets. This results in crude oil pricing on the Gulf Coast differing substantially from crude oil pricing at Cushing. For example, Cushing is the clearing market for WTI, a light, sweet crude oil, and is the only transparent market for WTI. For all destinations for WTI, in all regions except the Gulf Coast, the price is based on the market price at Cushing. The various inland refineries typically contract for crude oil based on the price at Cushing, plus transportation costs to arrive at the “landed price”. The cost of transportation is subtracted from the “landed price” to yield the netback to the seller, which equals the price at Cushing. Given that the transportation cost is effectively a wash, the netback is the same for all refinery locations even though the respective transportation costs are different based upon the refinery locations. Accordingly, the netback price to the WTI seller is still the Cushing price.

12. The same analysis applies to the pipelines identified by the Applicants as alternatives to Seaway that transport crude oil from Cushing. The BP pipeline to Whiting, Indiana, the Enbridge Ozark pipeline to Wood River, Illinois, and the Occidental Centurion pipeline to Slaughter, Texas all serve refineries in their destination markets. Like the refineries identified by the Applicants, the refineries served by these pipelines typically contract for WTI based on the price at Cushing, plus the cost of transportation.

13. Similarly, Hardisty, Alberta is the clearing market in the Western Canadian

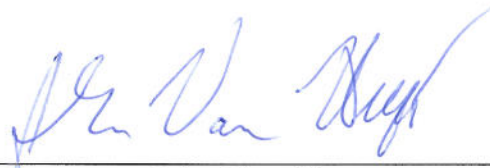
production region for a benchmark Canadian heavy crude oil known as Western Canadian Synthetic (or “WCS”) and is the only transparent market for WCS. For all destinations for WCS, in all regions except the Gulf Coast, the market is based on the pricing at Hardisty because the refineries purchasing WCS will typically pay the price at Hardisty plus the applicable transportation costs to reach their refinery.

14. The Gulf Coast market value of light crude oil is based on the price for a benchmark light crude oil known as Louisiana Light Sweet (“LLS”). Attachment A to this Affidavit calculates the differential in prices between LLS and WTI. Attachment A shows that the average differential between the Gulf Coast markets and the inland alternatives for the period August 2010 through July 2012 was \$16.26 per barrel. This is important because WTI transported on the reversed Seaway pipeline could be purchased at the WTI price at Cushing, but sold on the Gulf Coast at a price based on LLS. With the reversed Seaway pipeline in service, the price differential was \$14.73 per barrel in June 2012 and \$17.86 per barrel in July 2012.

15. The Gulf Coast market value of heavy crude oil is based on the price for a benchmark heavy crude oil imported from Mexico known as Maya. Attachment A to this Affidavit calculates the differential in prices between Maya and WCS. Attachment A shows that the average differential for the period August 2010 through July 2012 was \$20.07 per barrel. This is important because WCS transported on the reversed Seaway pipeline could be purchased at the WCS price at Hardisty, but sold on the Gulf Coast at a price based on Maya. With the reversed Seaway pipeline in service, the price differential was \$29.35 per barrel in June 2012 and \$24.39 per barrel in July 2012.

Conclusion

16. For the reasons I have set forth above, there is no basis for assuming that the three pipelines and 11 refineries identified by Applicants in the proposed origin market are actually available to shippers as practical or feasible alternatives to Seaway. In addition, the differential in crude oil prices between the origin market and the destination market served by the reversed Seaway Pipeline are significant and sustained price differentials, not short-term or temporary price variations.



John Van Heyst

August 2, 2012

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.
and Enbridge Inc.


§ Docket No. OR12-4-000

VERIFICATION

PROVINCE OF ALBERTA ss:

Before me, Curtis Serra, a notary public, on this day personally appeared John Van Heyst, known to me as the person whose name is subscribed to the foregoing Affidavit, and known to me as the Manager, Marketing Logistics for Suncor Energy Marketing Inc., and stated to me that the facts contained in said Affidavit are true and correct to the best of his knowledge and belief.

Given under my hand and seal this 2nd day of August, 2012.



Notary Public
Province of Alberta

CURTIS W. SERRA
Barrister and Solicitor

Pricing Differentials									
	Heavy			Light					
	Argus Maya USGC Dated	Argus Hardisty WCS month 1	Maya @ USGC minus WCS @ Hardisty	Platts WTI Cushing Month 1	Platts LLS St James Month 1	St James to Houston Estimate barge Fee ¹	LLS @ Houston	LLS @ Houston minus WTI @ Cushing	
Date	Close	Close		Close	Close				
8/1/2010	67.96	56.44	11.52	76.62	79.77	2.17	81.94	5.32	
9/1/2010	67.80	53.05	14.76	75.17	80.14	2.17	82.31	7.14	
10/1/2010	72.80	67.03	5.77	81.89	85.23	2.17	87.40	5.51	
11/1/2010	74.57	69.79	4.78	84.20	88.16	2.17	90.33	6.13	
12/1/2010	79.55	70.54	9.01	89.08	94.31	2.17	96.48	7.40	
1/1/2011	81.83	65.94	15.89	89.38	97.83	2.17	100.00	10.62	
2/1/2011	86.91	65.44	21.47	89.57	106.21	2.17	108.38	18.81	
3/1/2011	99.13	84.37	14.76	102.99	117.41	2.17	119.58	16.59	
4/1/2011	108.05	94.36	13.70	109.89	126.03	2.17	128.20	18.31	
5/1/2011	101.33	84.60	16.74	101.22	116.44	2.17	118.61	17.40	
6/1/2011	100.43	77.26	23.17	96.21	113.17	2.17	115.34	19.13	
7/1/2011	102.61	79.25	23.36	97.26	115.86	2.17	118.03	20.77	
8/1/2011	95.85	73.20	22.65	86.30	109.29	2.17	111.46	25.16	
9/1/2011	97.31	75.13	22.19	85.55	112.67	2.17	114.84	29.29	
10/1/2011	99.73	76.08	23.66	86.45	111.82	2.17	113.99	27.54	
11/1/2011	106.39	85.20	21.19	97.17	112.04	2.17	114.21	17.05	
12/1/2011	104.23	84.06	20.17	98.58	108.62	2.17	110.79	12.21	
1/1/2012	106.03	79.90	26.13	100.36	110.81	2.17	112.98	12.62	
2/1/2012	108.65	72.52	36.13	102.29	120.59	2.17	122.76	20.47	
3/1/2012	112.01	76.92	35.09	106.31	127.39	2.17	129.56	23.25	
4/1/2012	108.43	85.36	23.08	103.35	122.51	2.17	124.68	21.33	
5/1/2012	101.01	78.14	22.87	94.63	108.00	2.17	110.17	15.54	
6/1/2012	87.73	58.38	29.35	82.33	94.90	2.17	97.07	14.73	
7/1/2012	92.65	68.27	24.39	87.81	103.49	2.17	105.66	17.86	
Average	94.29	74.22	20.07	92.69	106.78	2.17	108.95	16.26	

¹From Seaway Application Table D.11 assuming cost is the same in either direction

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.
and Enbridge Inc.

§

Docket No. OR12-4-000

AFFIDAVIT OF BARRY E. SULLIVAN

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Enterprise Products Partners L.P.
and Enbridge Inc.

§

Docket No. OR12-4-000

AFFIDAVIT OF BARRY E. SULLIVAN

I. INTRODUCTION

1. My name is Barry E. Sullivan. I am the President of Brown, Williams, Moorhead & Quinn, Inc. (“BWMQ”), an energy consulting company. My business address is 1155 15th Street, N.W. Suite 400, Washington, D.C. 20005. BWMQ offers technical, economic, and policy assistance to the various segments of the oil pipeline industry, natural gas pipeline industry, and the electric utility industry on business and regulatory matters.
2. Over the past 32 years, I have filed testimony in over 40 pipeline rate and market power proceedings at the Federal Energy Regulatory Commission (“FERC or Commission”). I have been employed at BWMQ for the past six years and before my employment with BWMQ, I was an employee at the Commission for 26 years. I have previously submitted an affidavit in this proceeding which includes my *curriculum vitae*.
3. I have been asked by Continental Resources, Inc. (“Continental”), Husky Marketing and Supply Company (“Husky”), Suncor Energy Marketing, Inc.

(“Suncor”), and Canadian Natural Resources Limited (“CNRL”) to respond to the initial comments submitted by Enterprise Products Partners L.P. (“Enterprise”) and Enbridge Inc. (“Enbridge”) (collectively “Applicants”) and by the Association of Oil Pipelines (“AOPL”) in response to the Commission’s order granting rehearing of its prior order (“Seaway Order”) denying the application for authority to charge market-based rates for the reversed service by Seaway Crude Oil Pipeline Company LLC (“Seaway”). In this connection, I have reviewed the Seaway Order and the decision of the U.S. Court of Appeals for the D.C. Circuit in *Mobil Pipe Line Company v. FERC*, 676 F.3d 1098 (2012) (“*Mobil*”). My affidavit will respond to specific issues raised in Applicants’ comments (Seaway Comments), and AOPL’s comments (AOPL Comments) and the attached affidavit of Dr. Webb (Webb Affidavit) in AOPL’s Comments. My affidavit is complimentary to the affidavit of Daniel S. Arthur which directly addresses the issue of why the Commission’s netback or delivered price test continues to be a vital and indispensable element in a market power investigation.

4. In the Seaway Order, the Commission stated that “price data remain an indispensable part” of the Commission’s market power analysis after the *Mobil* decision,¹ and that in order to identify alternatives to include in an analysis of market share and market concentration, the alternative must be shown to be a good alternative in terms of price.² The Commission also stated that:

¹ Seaway Order at P 32.

² *Id.*

Although parties may dispute whether the proxy used by a pipeline adequately reflects the competitive price level, the pipeline must still present such price data in order to determine good alternatives for inclusion in the geographic market. Otherwise, market shares and market concentration measures, such as those relied upon by the court in *Mobil*, simply cannot be calculated.³

5. Dr. Arthur's affidavit addresses the Seaway Comments, AOPL Comments, and Webb Affidavit, which argue that a netback price analysis or other analysis should not be used to determine whether currently-used or reasonably available alternatives are competitive, and rather that all currently-used, or reasonably capable of being used, alternatives are by definition competitive alternatives. Dr. Arthur explains why a netback analysis (or delivered price test in destination markets) is a critical element in a market power analysis. Dr. Arthur explains and provides examples that demonstrate why an analysis of alternatives must consider availability, quality, and price, in determining market share and market concentration measures when evaluating market power. These scenarios also illustrate that systematically identifying competitive alternatives based on whether the alternatives are comparable in terms of availability, quality, and particularly price, is a critical element in a market power proceeding. Absent information on availability, quality and particularly price, it is impossible to assess whether shippers are able to switch or likely to switch to an alternative in response to a price increase by the applicant pipeline. And without the same

³ *Id.*

information it is impossible to assess appropriate market share and market concentration statistics that reasonably indicate the presence or absence of a market power concern.

II. RESPONSE TO COMMENTS OF APPLICANTS AND AOPL

A. Proper Role of the SSNIP Test

6. Applicants' claim that the Merger Guidelines consider all firms currently earning revenue in the market and that the SSNIP⁴ is used to expand the pool of alternatives to include potential competitors. Seaway Comments at 10-11. Applicants' claim is highly misleading, and it does not support the "used alternatives are good alternatives" approach. The 2010 Merger Guidelines state that "all firms that currently earn revenues **in the relevant market** are considered market participants." Section 5.1. The 1992 Merger Guidelines state: "The Agency's identification of firms that participate in the relevant market begins with all firms that currently produce or sell **in the relevant market**." Section 1.31. However, the Merger Guidelines require that the "hypothetical monopolist test" be used to define the relevant product and geographic market for antitrust analysis. 2010 Merger Guidelines, Sections 4.1.1 and 4.2.
7. Applicants' claim that the SSNIP test is only used to identify other firms that might be expected to enter the market that are not currently in the market reflects a misunderstanding of the hypothetical monopoly test. Seaway Comments at 10.

⁴ SSNIP is a small but significant and non-transitory increase in price. 2010 Merger Guidelines, Section 4.1.1.

To define the relevant product and geographic market, the hypothetical monopoly test considers whether the hypothetical monopolist can impose a SSNIP. 2010 Merger Guidelines at 4.11.

8. The methodology of the Merger Guidelines is an iterative process. It starts with the smallest possible market (*i.e.*, the location of the merging parties) and expands that market boundary if alternatives located outside the initial boundary would prevent the hypothetical monopolist from imposing a SSNIP. If there are such firms, the boundary is expanded to include those firms and the test is applied again. 2010 Merger Guidelines at Section 4.1.1 and Section 4.2. The SSNIP test determines when the iterative process stops. That is, it determines when there are no firms outside the geographic boundary that can prevent the hypothetical monopolist from imposing a SSNIP. What the Applicants position fails to recognize is that there may be firms outside the boundary that sell the relevant product but cannot prevent the hypothetical monopolist from imposing a SSNIP. Those sellers are required to be excluded from the relevant geographical market. Thus, all sellers in the general area that are making sales of the relevant product should not be automatically included in the relevant geographic market in the absence of the foregoing analysis.

B. Response by Refineries

9. Applicants claim that refineries in the Cushing origin market will respond to higher netbacks on Seaway by bidding up the price of crude oil, which will reduce or eliminate the price differential. Seaway Comments at 13. This claim

is unfounded and does not make economic sense given current and foreseeable crude oil market conditions at Cushing. There is a major excess supply of crude oil at Cushing and the crude oil transportation market is heavily constrained. Even after the reversal of Seaway, the spread between crude oil prices for WTI (Cushing) and LLS (Gulf Coast) remains significant, as explained in the accompanying affidavit of Mr. John Van Heyst. Under these conditions (even after the reversal of Seaway), the refineries at Cushing would have no incentive to bid up the price of crude oil, which is a major input cost to the refinery, and lower the refinery's profit on refined petroleum products.

C. Status as New Market Entrant

10. Applicants erroneously claim that a netback approach should not be used where the applicant pipeline is a new entrant into an already competitive market and that an entrant to a competitive market typically makes the market more competitive not less competitive. Seaway Comments at 17. There has been no demonstration that the existing transportation market at Cushing is competitive. The Applicants confuse the mere existence of pipelines with a true competitive market. Moreover, Applicants' claim reflects a fundamental misunderstanding of how to define the relevant market in a market power analysis. The Merger Guidelines approach to market definition is specific to the merging parties. The only firms considered to be market participants in the relevant market are the good alternatives to the merging party.

11. In a proper market power analysis, the market is defined based on the applicant's transportation service and whether there are good alternatives to the applicant's service. This is consistent with the Merger Guidelines and the hypothetical monopoly test. The analysis of entry is limited to the possible entry of alternatives. The applicant is not an entrant. Rather, the applicant provides the basis for identifying good alternatives. The 1992 Merger Guidelines at Section 3.1: Entry Alternatives state:

The Agency will examine the timeliness, likelihood, and sufficiency of the means of entry (**entry alternatives**) a potential entrant might practically employ, without attempting to identify who might be potential entrants.⁵

D. Crude Oil Production Basin

12. Applicants erroneously claim that the geographic definition of a crude oil origin market is dictated by the location and shape of the crude oil basin that produces the oil transported out of the origin market. Seaway Comments at 24-25. Applicants cite no authority or precedent for using a crude oil production basin as the relevant geographic origin market for a pipeline. In a proper market power analysis, the origin market is defined by identifying good alternatives to the applicant's pipeline. The origin of the applicant's transportation service and the location of the good alternatives to the applicant's service will delineate the relevant geographic market. The location of crude oil production basins is only

⁵ Note that Section 3.1 is entitled "Entry Alternatives," reflecting the fact that the entry analysis is limited to the alternatives to the applicant. The Merger Guidelines are clear that the analysis of entry does not require the *identification of the entrant*, again suggesting that the applicant is not an entrant. *Id.*

relevant if it contains good alternatives to the applicant's transportation service. A proper analysis must therefore start with the location and identification of good alternatives – it cannot assume that all alternatives in a crude oil production basin are good alternatives to transportation service on Seaway.

13. In this case, the proper starting point for an origin market analysis is the proposed origin of Seaway's transportation service at Cushing. Justification must be provided to broaden the market beyond this area. In Order No. 572, the Commission stated that it does not require any particular geographic market definition, but that it expects oil pipelines to propose BEAs as their geographic markets. "If the pipeline uses BEAs, it must show that each BEA represents an appropriate geographic market." Order No. 572 at 31,180. Although the Applicants use counties instead of BEAs, they fail to demonstrate how each individual county in its geographic market contains a good alternative to Seaway's proposed transportation service out of Cushing.

E. Incentive for Investment

14. AOPL has failed to demonstrate that the Commission's policies and regulations lead to an under investment in oil pipeline facilities. AOPL Comments at 5-6. Current regulation by the Commission provides for full recovery of a pipeline's cost of facilities, including a reasonable return on investment. Therefore the regulated rate is sufficient to cover all of the pipeline's costs, including a reasonable rate of return on investment. In fact, the granting of market-based rate authority may actually create a disincentive for the development of additional

pipeline infrastructure. In situations where excess demand exists, market-based rate authority would allow a pipeline to simply increase the return on its existing investment by increasing its rates, without investing in additional pipeline infrastructure. On the other hand, the Commission has found that a cost-of-service rate ceiling encourages investment in additional pipeline facilities to serve excess demand. Order No. 712 at P 82-85.

15. In addition, the Commission has previously expressly rejected similar arguments to AOPL's. In Order No. 637, the Commission explained how regulated rates actually create an incentive for additional pipeline infrastructure:

Because pipeline rates are regulated, however, there is little incentive for a pipeline to [not expand capacity], because even if it creates scarcity, it cannot charge rates above those set by its cost-of-service. Since pipelines cannot increase revenues by [not expanding capacity], rate regulation has the added benefit of providing pipelines with a financial incentive to build new capacity when demand exists. The investment in new capacity increases a pipeline's revenue because the new investment increases the pipeline's rate base on which the pipeline earns a rate of return. Thus, annual rate regulation protects against the pipeline's exercise of market power by limiting the incentive of a monopolist to withhold capacity in order to increase price as well as creates a positive incentive for a pipelines to add capacity when needed by the market.

Order No. 637 at 31,270-271.

F. The *Brown Shoe* Case

16. Dr. Webb relies heavily on the 50-year-old U.S. Supreme Court case *Brown Shoe Co. v. United States*, 370 U.S. 294 ("*Brown Shoe*") to support the theory that used alternatives must be good alternatives. Webb

Affidavit at 4-6. Dr. Webb's reliance on *Brown Shoe* is misplaced. The *Brown Shoe* decision, issued in 1962, predates even the first set of Department of Justice Merger Guidelines which offered guidance on market definition, issued in 1968. The Merger Guidelines have been revised through the years and last updated by the Department of Justice and Federal Trade Commission in 2010.

17. Since 1984 the Merger Guidelines delineate product and geographic markets by utilizing a test that starts by imposing a small but significant and non-transitory increase in price (SSNIP) of the merging firm's product. If a customer, after a significant and non-transitory increase in price of the merging firm's product, would choose another firm's product, the other firm's product or location is included in the relevant product market. While Dr. Webb relies on *Brown Shoe* to insist that price plays no role in product market definition, it is clear that the Department of Justice and Federal Trade Commission for the last 28 years have considered price comparability using the SSNIP test to be an integral part of market definition for antitrust purposes.
18. Dr. Webb admits that the *Brown Shoe* case involved the definition of the product market. However, he fails to demonstrate how the principles used to define the product market apply to defining the geographic market, or to explain which alternatives help to define the geographic market and which alternatives are included in the market share and HHI analysis.

G. Economic Market vs. Antitrust Market

19. Dr. Webb inappropriately uses a traditional economic concept of the market when defining the relevant market⁶ Webb Affidavit at 14-15. A traditional economic market is designed to suggest how the market price will change in response to changes in market demand and market supply. Demand factors include the price of the product, consumer income, consumer taste (or preferences), and the price of related products. Supply factors include the price of the product, the price of the inputs, technology, and the number of firms in the market. The traditional economic market includes all consumers and all sellers of the product, and the consumers are not associated with any particular seller. The sellers are not necessarily price comparable.
20. What Applicants and Dr. Webb fail to recognize or simply ignore is that an antitrust market -- not an economic market -- is required to conduct a proper market power analysis. In an antitrust market, the buyers and sellers are narrowly defined: (1) the relevant buyers or customers are the customers of the seller under investigation (the applicant), and (2) the relevant sellers (or “market participants”) are firms that are good alternatives⁷ to the applicant. This market concept is referred to as an “antitrust market.” 2010 Merger Guidelines, Section

⁶ An economic market is the market concept found in introductory economics textbooks. *See, e.g.*, Paul A. Samuelson, *Economics*, 9th ed., McGraw-Hill Book Company, 1973; C.E. Ferguson, *Microeconomic Theory*, 3rd ed., Richard D. Irwin, Inc, 1972; Robert B. Ekelund, Jr. and Robert D. Tollison, *Economics*, 5th ed., 1997. For this reason, an economic market is sometimes referred to as a textbook market.

⁷ The Commission defines a good alternative as “an alternative that is available soon enough, has a price that is low enough, and has a quality that is high enough to permit customers to substitute the alternative” for the *Applicant’s service*. 1996 *Policy Statement* at 61,231, citing *Koch Gateway Pipeline Company*, 66 FERC ¶ 61,385 at 62,299 (1994) (emphasis added).

4. In a proper market power analysis, the market definition focuses on the customers' ability to substitute away from the applicant's product to another in response to a price increase by the applicant. *Id.* The Merger Guidelines recognize that an antitrust market may not conform to what members of the industry consider to be the market:

Relevant antitrust markets defined according to the hypothetical monopoly test are not always intuitive and may not align with how the industry members use the term "market."

2010 Merger Guidelines, Section 4.

21. In contrast to an economic market, all sellers that make sales in the area are not necessarily "participants" (*i.e.*, good alternatives) in an antitrust market. Similarly, all customers of the sellers in the economic market are not necessarily in the antitrust market. Thus, the number of sellers (and customers) in the antitrust market is generally smaller than in the economic market. In particular, alternatives to the applicant which are not good alternatives are excluded from the antitrust market. Customers located in the market area that are not customers of the applicant are also excluded from the antitrust market. Thus, there may be numerous alternatives that are "used alternatives" in the area, but if they are not good alternatives to the applicant, they are not relevant to the market power analysis.

22. Another difference between an economic and an antitrust market is in the analysis of entry. In an economic market, the impact of a new entrant can be

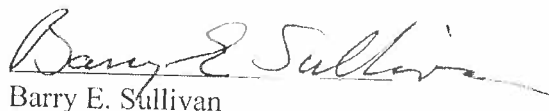
suggested by analyzing the market before and after entry. In an antitrust market, however, the applicant cannot be analyzed as an entrant. The reason is that prior to the proposed entry by the applicant, there is no antitrust market. Without the applicant, the other sellers in the antitrust market cannot be identified. That is, in an antitrust market, the only sellers that matter are the sellers who represent good alternatives to the applicant. Thus, it is a fundamental flaw in a market power analysis to argue that prior to the applicant entering the market, the relevant market was competitive.

H. “Revealed Preferences” Principle

23. The “revealed preferences” principle cited by Dr. Webb adds nothing to the market power analysis in this case and does not justify the “reasonably available” standard for identifying competitive alternatives. Webb Affidavit at 7-8. Because the Cushing origin market is saturated with crude oil and transportation options out of the market are constrained, producers and other shippers are forced to dispose of crude oil in the market at depressed prices. Those parties use the alternatives identified by Applicants because access to the higher-priced Gulf Coast market is limited. Producers use the origin market alternatives to Seaway simply to avoid curtailing production, not because they prefer the less profitable alternatives over the more profitable Gulf Coast market.

III. CONCLUSION

24. For the foregoing reasons, the Commission should not adopt the radical interpretation of the *Mobil* decision suggested by Applicants and AOPL and should not use the proposed “reasonably available” standard to identify good competitive markets. The Commission should recognize that the court of appeals did not overturn the Commission’s established criteria for measuring market power but merely found that those criteria were erroneously applied in the Pegasus case. Accordingly, the Commission should continue to follow the Merger Guidelines and established principles of antitrust analysis, including the SSNIP test. In identifying competitive alternatives, the Commission should continue to require that good alternatives be justified in terms of (1) availability, (2) quality, and (3) price.


Barry E. Sullivan

August 2, 2012

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

In the Matter of)
)
ENTERPRISE PRODUCTS PARTNERS LP)
AND ENBRIDGE INC.)


DOCKET NO. OR12-4-000

DISTRICT OF COLUMBIA)
) ss:
DISTRICT OF COLUMBIA)

AFFIDAVIT

Barry E. Sullivan, being first duly sworn, on oath, states that he is the Barry E. Sullivan whose Affidavit in the above-entitled proceeding accompanies this Affidavit.

Barry E. Sullivan further states that the information contained in the accompanying affidavit is true and accurate to the best of his knowledge and belief.

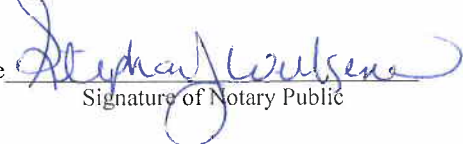

Barry E. Sullivan

State of District of Columbia
County of District of Columbia



My Commission expires June 30, 2014

Subscribed and sworn to (or affirmed) before me on this 31st day of July, 2012 by Barry E. Sullivan, proved to me on the basis of satisfactory evidence to be the person who appeared before me.

Signature 
Signature of Notary Public