Crude by Rail, Option Value, and Pipeline Investment

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Abstract

Unconventional petroleum reserves are located far from major refining centers, so as shale output grows, an increasing quantity of U.S. crude oil travels long distances before it is consumed. Until recently, the vast majority of crude oil transportation occurred via pipelines, which are inflexible but have low average per-barrel cost. Railroads have now emerged as an alternative with relatively high per-barrel costs but also flexibility that allows shipments to respond to oil price shocks. At the same time, crude-by-rail has additional environmental and accident externalities that drive a wedge between its private and social cost. Motivated by these unpriced externalities, we ask how the availability of crude-by-rail affects equilibrium pipeline investment. We develop a model that illustrates how private markets allocate capacity between flexible and inflexible technologies and then calibrate it to crude oil transportation out of North Dakota. Under conservative assumptions on pipeline economies of scale, we find that the elasticity of pipeline capacity to railroad transportation costs lies between 0.27 and 0.64, depending on parameters such as the upstream oil supply elasticity. Our results imply that crude-by-rail is an economically significant long-run substitute for pipeline transportation and that increases to railroad transportation costs—such as those stemming from environmental or safety regulation—would substantially increase pipeline investment and decrease crude-by-rail flows.

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1 Introduction

From 2010 through 2014, transportation of crude oil by railroad (“crude-by-rail”) in the United States grew from less than forty thousand barrels per day (bpd) to nearly one million bpd. At its peak, crude oil shippers moved more than 10% of total domestic production by rail. This development has no recent precedent: the last large-scale use of crude-by-rail we are aware of dates back to World War II, prior to the advent of large-diameter, long-distance pipelines (Johnson (1967), p. 327). The resurrection of crude-by-rail is puzzling in light of its relatively high cost per barrel (relative to amortized per-barrel pipeline costs) and provision by a rail industry widely believed to exercise market power in access pricing (Busse and Keohane (2007), Hughes (2011)). In this paper, we try to understand the economic factors behind crude-by-rail—emphasizing the flexibility it provides to crude oil shippers—and quantify how crude-by-rail has affected investment in crude oil pipelines.

Why would crude oil shippers elect to use railroads rather than pipelines, given their greater cost?\(^1\) One simple explanation is that the remarkable oil production growth in the Bakken, Niobrara, and other shale formations in the upper Midwest outpaced the speed at which new pipeline capacity could be built, so that producers effectively had no choice. The delays experienced by recent pipeline projects such as the Dakota Access Pipeline (DAPL, completed in June, 2017) and the Keystone XL project (awaiting permits), are consistent with this story. Another explanation—not necessarily exclusive of the “delay” story—is that the flexibility offered by crude-by-rail makes it an attractive transportation option, in spite of its higher cost. Because rail infrastructure already exists between the upper Midwest and nearly every major refining center in the country, the cost of shipping crude by rail is largely variable, so that rail shippers can avoid costs by choosing to not ship. Pipeline shippers do not have this ability, since pipeline construction costs are entirely sunk. Moreover, rail allows shippers to decide not just whether but where to move crude oil, so that they can actively respond to changes in upstream and downstream oil prices. Industry observers often make this point. For instance, a 2013 Wall Street Journal article attributed the lack of shipper interest in a proposed crude oil pipeline from West Texas to California to a preference for the flexibility afforded by crude-by-rail transportation (Lefebvre, 2013).

This paper examines the economic importance of crude-by-rail’s flexibility by modeling and quantifying the extent to which crude-by-rail depresses incentives to invest in pipeline capacity. Specifically, we evaluate the substitutability of these two technologies by assessing how an increase in the cost of railroad transportation would affect equilibrium pipeline

\(^1\)Throughout this paper, we follow transportation industry terminology by referring to pipeline and rail customers as shippers. The pipelines and railroads themselves are known as carriers, not shippers.
investment. We find effects that have economically meaningful magnitudes, consistent with an interpretation that crude-by-rail adds value to shippers beyond being merely a “stopgap” while pipelines are permitted and constructed.²

Beyond documenting the economic forces driving one of the most significant developments in the U.S. oil industry in decades, our analysis speaks to policy questions stemming from the environmental and safety externalities of crude-by-rail. Clay, Jha, Muller and Walsh (2017) estimates that air pollution damages associated with railroad transportation of crude oil from the Bakken to the Gulf Coast are $2.02 per barrel, on average, owing primarily to freight locomotives’ \( \text{NO}_x \) emissions.³ Overall, Clay et al. (2017) estimates that air pollution damages from crude-by-rail are nearly twice those from pipeline transportation and are also much larger than damages from spills and accidents. Our results inform estimates of the impacts of policies that target these externalities—and thereby raise the cost of rail transport—on investments in pipeline capacity and on the volume of oil flow that will substitute away from rail to pipelines.⁴

More broadly, the model we develop captures intuition that is applicable to other settings in which a low-cost but inflexible investment can substitute for a high-cost, flexible one. For instance, the logic by which relative costs and future demand uncertainty affect pipeline investment also applies to investments in infrastructure such as urban light rail (which substitutes with more flexible buses), natural gas distribution lines (which substitute with more flexible heating oil delivery), and baseload electric power stations (which substitute with

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²In spite of the analysis presented here, there are several reasons why crude-by-rail did not occur at large scale between World War II and the shale boom. First, U.S. crude oil production declined in essentially all major producing basins from the early 1970s until 2008, so that existing pipeline capacity was sufficient to convey production until the shale boom. (Exceptions include the Alaska North Slope and the deepwater Gulf of Mexico, where rail infrastructure does not exist. See https://www.eia.gov/dnav/pet/pet_crd_crpdn_adc_mbbld_p_a.htm and https://www.eia.gov/naturalgas/crudeoilreserves/top100/pdf/top100.pdf for data.) Second, while U.S. oil production grew steadily between WWII and 1970, a number of factors in that era favored pipelines over rail. Policies such as oil import restrictions and state-level control of production levels (especially by the Texas Railroad Commission) actively worked to maintain U.S. oil price stability, reducing incentives to use flexible transportation (see p.68-9 of Cookenboo (1955); pp.377, 427-8, and 475 of Johnson (1967); and p.12-3 of Smiley (1993)). Pipelines were primarily owned by vertically integrated oil majors rather than independent carriers, since federal regulators interpreted common carry regulation as forbidding third-party capacity contracts (see pp.368-70, 462, 471, and 476 of Johnson (1967) and pp.113-4 of Makholm (2012)). Independent shippers did use oil pipelines at posted tariff rates; however, rate regulators during this area are widely believed to have let pipelines earn excess returns (see pp.99 and 111-12 of Cookenboo (1955); pp.407-12, 450, and 473 of Johnson (1967); pp.90-97 of Spavins (1979); and p.116 of Makholm (2012)). These excess returns would in turn generate incentives to invest in excess capacity (Averch and Johnson, 1962). Finally, rail service prior to the 1980 Staggers Act was tightly federally regulated, with generally higher rates and lower-quality service than is the case today (Burton, 1993; Winston, 2005).

³See table 2 in Clay et al. (2017), noting that there are 42 gallons in a barrel.

⁴In fact, a 2008 EPA rule requires a large reduction in emission rates from newly-built locomotives beginning in 2015 (Federal Register, 2008).
more flexible gas-fired peaker units). These tradeoffs between cost and flexibility also have a parallel in the finance literature that examines the relative returns of investments in illiquid versus liquid assets (see, for instance, Amihud and Mendelson (1986) and Pástor and Stambaugh (2003)).

To quantify the impact of crude-by-rail on pipeline investment, we build a model in which crude oil shippers can either build a pipeline or use a railroad to arbitrage oil price differences between an upstream supply source, where the volume of oil production is sensitive to the local oil price, and downstream markets, where the oil price is stochastic. Pipeline transportation has large fixed costs with potentially significant economies of scale and negligible variable costs. This cost structure is similar to many other “natural monopoly” industries, and as a result the maximum tariff that pipelines can charge to shippers is regulated by the Federal Energy Regulatory Commission under cost-of-service rules with common carrier access. Shippers finance pipeline construction by signing long-term (e.g., 10-year) “ship-or-pay” contracts that commit them to paying a fixed tariff per barrel of capacity reserved, whether they actually use the capacity or not, thereby allowing the pipeline to recover its capital expense. Importantly, pipeline shippers must make this commitment knowing only the distribution of possible downstream prices that may be realized during the duration of the contract. If the realized downstream crude oil price is sufficiently high to induce enough upstream production to fill the line to capacity, the resulting wedge between the upstream and downstream prices is the pipeline shippers’ reward for their commitment.

In our model, rail provides non-pipeline shippers with a means to arbitrage upstream versus downstream price differences without making a long-term commitment. Instead, rail shippers simply pay a variable cost of transportation (that exceeds the pipeline tariff) whenever they ship crude by rail, which they can decide to do (or not) after they observe the realized downstream price. This flexibility generates option value, which is further enhanced by the ability of railroads to reach multiple destinations, not just the destination served by the pipeline. A key insight from our model is that the ability to arbitrage crude oil price differences via rail limits the returns that can be earned by pipeline shippers, since spatial price differences become bounded by the cost of railroad transportation. Thus, the

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5 Prior work, such as Borenstein (2005), has studied the equilibrium allocation between baseload and peaker electric generation, though without building the intuition developed here.

6 An alternative, “reduced form” strategy for evaluating the impact of crude-by-rail on pipeline construction would be to collect data on pipeline investments and then run regressions to estimate how geographic or temporal variation in railroad transportation costs and railroad use have affected investment. This strategy is impractical, however, since: (1) pipeline investments are infrequent and lumpy (for instance, there have only been three de novo pipelines constructed out of the Bakken since the shale boom: Enbridge Bakken, Double H, and Dakota Access (North Dakota Pipeline Authority, 2017)); and (2) variation in railroad costs and utilization is driven by many of the same variables that impact pipeline investment (upstream and downstream crude oil prices, for instance) and is therefore endogenous.
availability of the rail option reduces shippers' incentive to commit to pipeline capacity.

Pipeline capacity in our model is determined by an equilibrium condition in which the marginal shipper is indifferent between committing to the pipeline and relying on railroad transportation. Because the returns to pipeline investment are decreasing in the pipeline's capacity (since a larger pipeline is congested less frequently), the model yields a unique equilibrium level of capacity commitment. We show that the equilibrium capacity increases with the cost of railroad transportation, and we derive an expression that relates the magnitude of this key sensitivity to estimable objects such as the distribution of downstream oil prices, the upstream oil supply curve, the cost of pipeline investment, and the magnitude of railroad transportation costs.

We use our model to quantify the impact an increase in rail transportation costs would have on pipeline investment, using the Dakota Access Pipeline (DAPL) as a case study. DAPL first received firm commitments from shippers in June, 2014 and was completed in June, 2017, with a capacity of 520,000 bpd. We calibrate the model to economic conditions prevailing in June, 2014 and ask how pipeline capacity commitments would have changed in a counterfactual in which crude-by-rail were more costly.

We calibrate our model using data from a variety of sources and previous work in the literature. We use data on downstream crude prices on the U.S. West, Gulf, and East Coasts to estimate the future distribution of crude prices that shippers faced. We obtain data on crude-by-rail flows from the U.S. Energy Information Administration and show that these flows are responsive to price differentials, albeit with a lag of several months to two years. This lag motivates a specification of our model in which rail movements use short-term contracts rather than flow freely on spot markets. We obtain railroad cost data from the U.S. Surface Transportation Board and from Genscape (a private industry intelligence firm) to estimate railroad transportation costs as a function of volumes shipped. These cost data show that rates charged for rail transportation, rail car leases, and possibly other services (such as terminal fees) co-vary with shipping volumes, consistent with the presence of scarcity rents or market power in these markets. Finally, to obtain an upstream supply curve for Bakken crude oil, we use elasticity estimates from the literature on shale oil and gas (Hausman and Kellogg (2015), Newell, Prest and Vissing (2016), Bjørnland, Nordvik and Rohrer (2017), Newell and Prest (2017), and Smith and Lee (2017)).

Given these inputs, we validate our model by solving for the pipeline tariff that is implied by an equilibrium in which shippers choose to commit to the actual DAPL capacity. The

\footnote{This result echoes results from Busse and Keohane (2007) and Hughes (2011) showing evidence of market power and price discrimination in the provision of railroad transportation services for coal and ethanol, respectively.}
implied tariffs from our model are quite close to the actual published DAPL tariff of $5.50–
$6.25/bbl for 10-year committed shippers (Gordon, 2017), depending on the specification
used and on assumed parameters.

Our calibrated model indicates that crude-by-rail has likely had economically meaningful
effects on pipeline investment. We find that a $2 per barrel increase in the cost of rail
transportation, consistent with internalization of the externalities estimated in Clay et al.
(2017), results in an increase in equilibrium pipeline capacity of between 64,000 and 150,000
bpd, relative to the actual DAPL capacity of 520,000 bpd (and total Bakken pipeline export
capacity of 1.283 million bpd). These effects are likely to be lower bounds, as they do not
account for economies of scale in pipeline construction. Moreover, we show that these capac-
ity changes are associated with large decreases in rail shipments: the estimated elasticity of
rail volumes to the cost of crude-by-rail ranges from -0.87 to -2.19 across our specifications.
In contrast, this elasticity takes a value of only about -0.2 when we hold pipeline capacity
fixed.

Overall, our analysis suggests that crude-by-rail will be more than a “stopgap” trans-
portation option in the U.S. crude oil market. Instead, we find that the option value offered
by railroads can erode the incentive to invest in pipeline capacity. Policies that increase the
cost of rail transport—such as regulation targeting rail’s environmental externalities—may
therefore increase pipeline investment and induce economically significant long-run substitu-
tion from railroads to pipelines.

The remainder of the paper proceeds as follows. Section 2 presents our model of pipeline
investment in the presence of a crude-by-rail option. Section 3 then describes our data and
model calibration. Section 4 follows with a discussion of the empirical relationship between
crude-by-rail flows and oil price differentials, and it then describes how we use this relation
to inform a version of our model in which rail shipments require short-term contracts. We
discuss the validation of our model in section 5, and we present our main results in section
6. Section 7 concludes.

2 A model of pipeline investment in the presence of a
rail option

This section presents a model that captures what we believe are the essential tradeoffs
between pipeline and railroad transportation of crude oil. The central tension in the model
is the balance between the low cost of pipeline transportation and the flexibility afforded by
rail. Our aim is to capture how factors such as transportation costs and expectations about
future prices for crude oil affect firms’ decisions, on the margin, to invest in pipeline capacity versus rely on the railroads.

We begin by building intuition with a simple version of our model in which there is only a single destination that can be reached by pipeline or rail. We then expand the model to allow for the possibility that rail can be used to flexibly deliver crude to alternative destinations when those destinations yield higher netbacks.

2.1 Setup of single destination model

The simplest version of our model involves a single “upstream” destination that supplies crude oil and a single “downstream” destination where oil is demanded. Transportation decisions are made by shippers who purchase crude oil at the upstream location, pay for pipeline or railroad transportation service, and then sell the oil at the downstream location. The essential difference between the two modes of transportation is that construction of the pipeline—the cost of which is completely sunk and must be financed by pipeline shippers’ commitments—must occur before the level of downstream demand is realized. Railroad shippers, on the other hand, can decide whether or not to use the railroad after observing downstream demand.

The model assumes that rail shippers use spot crude and transportation markets, so that rail volumes respond immediately to price variation. As we show in sections 3.3 and 4, however, rail flows in practice follow price movements with a lag of up to two years, owing to contracts among shippers and transporters. In section 4.3 we discuss how we augment the model presented here to account for these contracts.

We model shippers as atomistic, so that they are price takers in both the upstream and downstream crude oil markets, and in the market for transportation services. This assumption is motivated by the large number of potential parties who may act as shippers: upstream producers, downstream refiners, and speculative traders. The equilibrium level of pipeline investment is then governed by an indifference condition in which, on the margin, shippers’ expected per-barrel return to committing to the pipeline equals the amortized per-barrel cost of the line (which is then the pipeline’s tariff for firm capacity).

We now derive this equilibrium condition and examine the forces that govern it. Begin with the following definitions:

- Let $S(Q)$ denote the upstream inverse net supply curve for crude oil. $Q$ denotes the total volume of oil exported from upstream to downstream. In the context of North Dakota, this curve represents supply of crude oil from the Bakken formation net of local crude demand. $S'(Q) > 0$. (For brevity, we henceforth refer to $S(Q)$ as the
supply curve rather than “inverse net supply”. Let \( P_u = S(Q) \) denote the upstream oil price.

- The downstream market at the pipeline terminus (e.g., a coastal destination that can access the global waterborne crude oil market) is sufficiently large that demand is perfectly elastic at the downstream price \( P_d \). \( P_d \) is stochastic with a distribution given by \( F(P_d) \), with support \([P, \bar{P}]\).\(^8\)

- \( K \) denotes pipeline capacity. The cost of capacity is given by \( C(K) \), with \( C'(K) > 0 \) and \( C''(K) \leq 0 \). Shippers that commit to the pipeline must pay, for each unit of capacity committed to, the average cost \( C(K)/K \), thereby allowing the pipeline to recover its costs (\( C(K) \) implicitly includes the regulated rate of return). Given capacity, the marginal cost of shipping crude on the pipeline up to the capacity constraint is zero.\(^9\)

- Let \( Q_p \) denote the volume of crude shipped by pipe, and let \( Q_r \) denote the volume of crude shipped by rail. \( Q = Q_p + Q_r \).

- The marginal cost of shipping by rail is given by \( r(Q_r) \), where \( r_0 \equiv r(0) > 0 \) and \( r'(Q_r) \geq 0 \).

Given a pipeline capacity \( K \), the pipeline and rail flows \( Q_p \) and \( Q_r \) are determined by the realization of the downstream price \( P_d \). For very low values of \( P_d \), little crude oil is supplied by upstream producers, and the pipeline is not filled to capacity (\( Q = Q_p < K \)). Arbitrage then implies that \( P_u = P_d \). Because the upstream supply curve is strictly upward-sloping, increases in \( P_d \) lead to increases in quantity supplied, eventually filling the pipeline to capacity. Let \( P_p(K) = S(K) \) denote the minimum downstream price such that the pipeline is full.

For downstream prices \( P_d > P_p(K) \), no more oil can flow through the pipeline, but rail may be used. Crude oil volumes will move over the railroad only to the extent that the differential between \( P_d \) and \( P_u \) covers the marginal cost \( r(Q_r) \) of railroad transport. Define \( P_r(K) \) as the minimum downstream oil price such that railroad transportation is used. This price is defined by \( P_r(K) = P_p(K) + r_0 \). Thus, there is an interval of downstream prices, \([P_p(K), P_r(K)]\), for which pipeline flow \( Q_p = K \), rail flow \( Q_r = 0 \), and the upstream price is fixed at \( P_p(K) \). For downstream prices that strictly exceed \( P_r(K) \), railroad volumes will be

\(^8\)In some specifications we implement, we also allow for uncertainty in upstream supply. See section 3.5.

\(^9\)This zero marginal cost assumption reflects the fact that the marginal cost of pumping an additional barrel of oil per day through a pipeline is quite small relative to the amortized cost of constructing a marginal barrel per day of pipeline capacity.
strictly positive and determined by the arbitrage condition \( P_u = S(K + Q_r) = P_d - r(Q_r) \). This arbitrage condition implies a function \( Q_r(P_d) \) that governs how rail flows increase with \( P_d \) when \( P_d > P_r(K) \).

### 2.2 Equilibrium pipeline capacity in the single destination model

Consider a simple two-period version of our model. In period 1, prospective shippers decide whether to make ship-or-pay commitments to the pipeline. Then in period 2, the pipeline is completed with a capacity equal to the total commitment, \( P_d \) is realized, and shippers can decide whether to also ship crude by rail.

Prospective shippers will be willing to make the up-front investment in the pipeline if the expected return from owning the right to use pipeline capacity meets or exceeds the investment cost. This cost, on the margin, is simply given by the average per-barrel cost \( C(K)/K \). The expected return to pipeline capacity is given by the expected basis differential \( P_d - P_u \). Figure 1 provides the intuition for how this expected return depends on capacity \( K \), the rail cost function \( r(Q_r) \), and the distribution \( F(P_d) \). When the downstream price \( P_d \) is less than \( P_p(K) \), the return to capacity is zero because the pipeline is not full and \( P_u = P_d \). For \( P_d \in [P_p(K), P_r(K)] \), the return \( P_d - P_u \) falls on the 45° line, since rail flows are zero and \( P_u \) is therefore fixed at \( P_p(K) \). Finally, for \( P_d > P_r(K) \), the basis differential is simply equal to the cost of railroad transportation \( r(Q_r) \), since arbitrage by rail shippers equates \( P_d - P_u \) to \( r(Q_r) \). When \( P_d > P_r(K) \), the differential \( P_d - P_u \) strictly increases with \( P_d \), as shown in figure 1, iff \( r'(Q_r) > 0 \).

The expected return to pipeline shippers is then given by the shaded area in figure 1, weighted by the probability distribution \( F(P_d) \). The equilibrium capacity \( K \) will balance this expected return (which decreases in \( K \)) against the pipeline investment cost of \( C(K)/K \).

Figure 1 also illustrates how the presence of the option to use rail transportation weakens the incentive to increase pipeline capacity: absent rail, the expected return to a pipeline of capacity \( K \) would be the entire triangle between the horizontal axis and the 45° line, rather than just the shaded trapezoid shown in the figure.

Formally, the condition that governs the equilibrium capacity level is given by equation (1), where the first term on the right-hand side captures returns to pipeline shippers when the pipeline is at capacity but rail is not used, and the second term captures returns when \( P_d \) is sufficiently high that the pipeline is at capacity and rail flows are strictly positive:

\[
\frac{C(K)}{K} = \int_{P_p(K)}^{P_r(K)} (P_d - P_p(K)) f(P_d) dP_d + \int_{P_r(K)}^{P_r(P_d)} r(Q_r(P_d)) f(P_d) dP.
\]

\(^{10}\)The relation between \( P_d - P_u \) and \( P_d \) need not be affine, as shown in the figure.
Figure 1: Expected return achieved by pipeline shippers

Return per barrel shipped via pipeline

Note: $P_d$ denotes the downstream price, with distribution $F(P_d)$. $Q_p$ and $Q_r$ denote crude oil pipeline and rail flows, respectively. $r_0$ denotes the intercept of the rail marginal cost function $r(Q_r)$. The shaded area, probability-weighted by $F(P_d)$, represents the expected return to a pipeline with capacity $K$. See text for details.

Even though we assume that shippers are atomistic, the equilibrium pipeline investment implied by equation (1) will differ from the socially optimal investment if there are returns to scale in pipeline construction. Social welfare is maximized when the expected return to shipping crude oil via pipeline is equated to the marginal cost of construction $C'(K)$, not average cost $C(K)/K$. In the presence of scale economies, $C'(K) < C(K)/K$ so that the optimal pipeline capacity $K^*$ is strictly greater than the equilibrium capacity from equation (1). This divergence between market and socially optimal investment in the presence of increasing returns to scale is driven by average-cost regulation of pipeline tariffs and is emblematic of rate regulation in many natural monopoly settings.

Our model illuminates the comparative static of primary interest in this paper: how does pipeline capacity investment respond to changes in the cost of rail transportation? Figure 2 provides the intuition. Consider a pipeline project that, facing a railroad cost curve with intercept $r_0$, would attract equilibrium commitments from shippers for a capacity of $K$. Now suppose that the rail cost intercept were instead $r'_0 > r_0$. This increase in rail
Figure 2: Comparative static: equilibrium capacity varies with rail cost intercept $r_0$

Note: $P_d$ denotes the downstream price, with distribution $F(P_d)$. $K$ denotes equilibrium pipeline capacity when the rail cost curve has intercept $r_0$; $K'$ denotes equilibrium pipeline capacity when the rail cost curve has intercept $r'_0$. See text for details.

transportation cost increases the basis differential realized by pipeline shippers whenever rail transportation is used, as indicated in the upper, striped area. This increase in expected return then increases shippers’ willingness to commit to capacity, so that equilibrium pipeline capacity must increase. The new capacity level $K'$ balances the increase in expected return when rail is used against the decrease in expected return caused by the decrease in the probability that the pipeline is fully utilized (represented by the lower shaded area in figure 2).

Formally, we obtain the comparative static $dK/dr_0$ by applying the implicit function theorem to equation (1).\footnote{To derive equation (2), we also apply the implicit function theorem to the arbitrage condition $S(K + Q_r) = P_d - r(Q_r)$ that defines the rail flow function $Q_r(P_d)$.} To simplify the problem, we assume that the railroad marginal
cost function is affine: \( r(Q_r) = r_0 + r_1 Q_r \). We then obtain:

\[
\frac{dK}{dr_0} = \frac{1 - F(P_r(K))}{\int_{P^p(K)}^{P^s(K)} f(P_d)dP_d} \frac{1}{\int_{P^p(K)}^{P^s(K)} f(P_d)dP_d} \frac{1}{P^s(K)}.
\]

First, note that in the simple case in which \( r_1 = 0 \) and \( C(K) \) exhibits constant returns to scale, this expression reduces to:

\[
\frac{dK}{dr_0} = \frac{1 - F(P_r(K))}{\int_{P^p(K)}^{P^s(K)} f(P_d)dP_d}.
\]

In words, \( dK/dr_0 \) is then the ratio of the probability rail is used and the probability that the pipeline capacity constraint binds but rail is not used, multiplied by the inverse of the slope of the supply curve at \( K \). The intuition for this expression is that: (1) if rail is likely to be used, shocks to \( r_0 \) are costly, so the optimal \( K \) will be sensitive to such shocks; (2) if there is a low probability that the pipe is full but no rail is being used, the returns to capacity do not rapidly diminish in \( K \), so shocks to \( r_0 \) can yield large changes in the optimal \( K \); and (3) if the upstream supply curve is steep, then the response of supply to transportation cost shocks is low, so that increases in \( r_0 \) do not call for large increases in \( K \).

Second, note that the terms involving \( r_1 \) reduce the numerator of equation (2) and increase the denominator, so that if railroad transportation costs are sensitive to railroad transportation volumes, the sensitivity of \( K \) to \( r_0 \) is reduced. Intuitively, large values of \( r_1 \) reduce the option value of rail transportation, so that pipeline economics are then less sensitive to shocks to railroad transportation costs. Third, and finally, when there are increasing returns to scale, so that \( d(C(K)/K)/dK < 0, dK/dr_0 \) will be larger than in the case of constant returns.

Expression (2) also clarifies that the following information is required to obtain an estimate of \( dK/dr_0 \):

1. The distribution \( F(P_d) \) of downstream crude oil prices at the time that shippers make commitments.

2. The slope (or elasticity) of the upstream crude oil supply curve \( S(Q) \).

3. The parameters \( r_0 \) and \( r_1 \) that govern the railroad transportation cost function \( r(Q_r) \).

4. The cost structure of pipeline construction; i.e., \( C(K) \).

\[\text{Note that the term involving the derivative of } P^p(K) \text{ is equal to zero, and the terms involving the derivative of } P_r(K) \text{ cancel.}\]
Section 3 discusses our calibration of these parameters, which uses estimates from our own calculations as well as estimates from prior studies. Our numerical implementation of the model also models each month of the 10-year shipper commitment as a separate period, thereby allowing the distribution $F(P_d)$ to vary over the life of the commitment. Our calculation of the expected return to pipeline shippers is then the average of the expected returns over all 120 months of the commitment period. As a consequence, we evaluate the derivative $dK/dr_0$ numerically rather than use equation (2) directly. Appendix E provides details on the computation of the model.

### 2.3 Modeling multiple railroad destinations

This section considers how the spatial option value afforded by railroads affects the tradeoff shippers face between pipeline and railroad transportation. We augment the model described above by allowing for multiple downstream destinations at which crude oil prices are imperfectly correlated with $P_d$, the price at the location served by the pipeline. Railroad shippers can deliver crude to these locations after observing the realized price at each, whereas shippers on the pipeline can only deliver crude to the pipeline destination.

Specifically, we make the following changes to the model presented in section 2.1:

- Let $\tilde{P}$ denote the maximum of the set of prices across all downstream locations (demand for Bakken crude is perfectly elastic at each location), and let $F(\tilde{P} | P_d)$ denote the distribution of $\tilde{P}$ conditional on $P_d$ (where $P_d$ again denotes the downstream price at the destination served by the pipeline). By construction, $\tilde{P} \geq P_d$.

- Assume that the cost of shipping by rail to any location is identical and given by $r(Q_r)$ as described in section 2.1. This assumption implies that rail shippers will send all rail volumes to the downstream location with the highest price and thereby obtain $\tilde{P}$. We discuss violations of this prediction in our data in section 4.

- Assume that $\tilde{P} - P_d$ is bounded above by $r_0$. This assumption implies that there will be no railroad shipments to any location whenever the pipeline does not operate at full capacity. This assumption substantially simplifies the model. We discuss its empirical validity in section 3.2.3.

Appendix C presents a derivation of the conditions that determine the equilibrium pipeline capacity $K$ and its sensitivity to $r_0$ in this multiple rail destination model. Because

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13As discussed in section 3.2, from the perspective of shippers at the time of the commitment, $P_d$ is more uncertain at the end of the commitment period than it is at the beginning of the commitment period.

14We weight each period’s expected return by its discount factor back to the date of the commitment.
rail transportation is more valuable when it can service destinations other than the pipeline terminus—and thereby reach prices that may be higher than $P_d$—equilibrium pipeline capacity is smaller than in the case in which rail can only serve a single destination. In addition, the sensitivity of pipeline capacity to the cost of railroad transportation, $dK/dr_0$, is larger than in the single destination model, since there is a reduced probability that the pipeline is full but rail is not used.

This model requires additional calibration relative to the single destination model. Beyond just needing the distribution of the pipeline downstream price $F(P_d)$, we also require the distribution of best rail price conditional on that price: $F(\tilde{P} | P_d)$. We discuss the estimation of this distribution in section 3.2.3. Computational details are provided in appendix E.2.

## 3 Data and calibration

To quantify the economic impact of crude-by-rail’s flexibility on equilibrium pipeline capacity, we calibrate our model of pipeline investment to the recently constructed Dakota Access Pipeline (DAPL). Using the reported pipeline capacity and estimates of the distribution of future downstream prices anticipated by shippers, the cost function for crude-by-rail, and the upstream supply elasticity, we compute the average-cost tariff at which a marginal shipper would commit to the pipeline and then estimate the sensitivity of the pipeline’s size to the cost of railroad transportation.

### 3.1 Dakota Access Pipeline facts

We calibrate our model to fit market conditions in June, 2014, when DAPL received firm commitments from its eventual customers (Energy Transfer Partners LP, 2014a). At this time, the Brent crude oil price was $111.87/bbl and expected to remain high: the three-year Brent futures price was $99.19/bbl.\(^{15}\) Per Biracree (2016) and North Dakota Pipeline Authority (2017), existing local refining capacity was (and remains) 88 thousand bpd (mbpd), and other Bakken export pipeline capacity was 763 mbpd (including a planned 24 mbpd expansion of the Double H pipeline that was completed in 2016).

DAPL was put into service in June, 2017 with a capacity of 520 mbpd and at a reported construction cost of $4.78 billion (Energy Transfer Partners LP, 2017).\(^{16}\) It is difficult to be

\(^{15}\)We use futures price data from Quandl, downloaded from https://www.quandl.com/collections/futures/ice-brent-crude-oil-futures. Contracts were not actively traded at horizons beyond three years.

\(^{16}\)Construction cost includes $1 billion for the Energy Transfer Crude Oil Pipeline (ETCO) from Patoka, IL to Nederland, TX on the Gulf Coast.
certain, however, of the volume of capacity to which shippers committed in June, 2014. For one, the official June 2014 announcement of the successful open season stated a volume of 320 mbpd (Energy Transfer Partners LP, 2014a), though by September 2014 DAPL announced executed precedent agreements with shippers supporting a capacity of 450 mbpd (Energy Transfer Partners LP (2014b) and Phillips 66 (2014)). Second, back in 2012 a competing project, the Sandpiper Pipeline, had secured shipper commitments for a 225 mbpd line from the Bakken to Lake Superior (Enbridge Energy Partners LP (2012) and Enbridge Energy Partners LP (2015)). This project was beset by environmental permitting delays in Minnesota and was postponed indefinitely in September, 2016 after Enbridge (Sandpiper’s main owner) and Marathon (Sandpiper’s “anchor shipper”) invested in DAPL and cancelled their Sandpiper shipping agreement (Shaffer (2014), Marathon Petroleum Corporation (2016), and Darlymple (2016)). It is not clear to what extent Sandpiper’s demise was foreseen in June, 2014, when shippers initially committed to DAPL. The reference case calibration of our model assumes a committed capacity of 520 mbpd, equal to the DAPL capacity actually constructed and approximately equal to the total DAPL plus Sandpiper capacity that had been announced by June, 2014 (320 mbpd for DAPL and 225 mbpd for Sandpiper).17 As sensitivities, we will also examine results based on assumed capacities of 320, 450, and 570 mbpd.18

3.2 Crude oil prices

3.2.1 Price data

We obtained data on spot market crude oil prices from Bloomberg and Platts.19 We use the price of Bakken crude at Clearbrook, MN as the “upstream” market price, and we use prices for Brent, Louisiana Light Sweet (LLS), and Alaska North Slope (ANS) as benchmark prices for U.S. East Coast, Gulf Coast, and West Coast “downstream” destinations, respectively. These downstream pricing points are located in the EIA’s “Petroleum Area for Defense Districts” (PADDs) 1, 3, and 5, respectively, as shown in figure 3. Finally, we also use the price of West Texas Intermediate (WTI) at Cushing, OK as another destination. Both Cushing and Clearbrook are located in PADD 2.

Figure 4 plots these spot price data, aggregated to the monthly level. Panel (a) shows

17The increase in DAPL capacity to 520 mbpd occurred following a supplemental open season held in early 2017 (Energy Transfer Partners LP, 2017).
18DAPL was built with the ability to expand to 570 mbpd and initiated an open season on the incremental 50 mbpd in March, 2018 (Darlymple (2016) and Energy Transfer Partners LP (2018)).
19We use Bloomberg prices for Brent, WTI, ANS, and LLS; and we use Platts prices for Clearbrook. Though Bloomberg does publish a Clearbrook price series, the Clearbrook series from starts 5 months earlier than the series from Bloomberg.
that prices at the three coastal destinations are very tightly correlated, typically differing by no more than a few $/bbl over the last 20 years. Moreover, no single destination has a consistent price advantage over another. In contrast, panel (b) shows that the PADD 2 pricing locations at Clearbrook and Cushing were substantially discounted relative to coastal destinations prior to mid-2014.\textsuperscript{20} In addition, both panels of figure 4 clearly illustrate the substantial decrease in crude oil prices that occurred during the second half of 2014.

Because Bakken crude oil is quite light relative to ANS, the ANS benchmark may understate the value of Bakken crude on the West Coast.\textsuperscript{21} Because LLS and Heavy Louisiana Sweet (HLS) are comparable to Bakken and ANS, respectively,\textsuperscript{22} we add the historic price difference between LLS and HLS, equal to $0.53/bbl, to the ANS price series in all of our calculations.\textsuperscript{23}

### 3.2.2 Calibration of downstream oil price distribution for pipeline shippers

To calculate the expected return to pipeline shippers, our model requires an estimate of the distribution $f(P_d)$ of future downstream prices that these shippers face over the duration

\textsuperscript{20}Note that the Clearbrook price series does not begin until May 4, 2010.

\textsuperscript{21}ANS crude is 32 API and 0.96\% sulfur, and Bakken is 43.3 API and 0.07\% sulfur (S&P Global Platts, 2017).

\textsuperscript{22}LLS crude is 38.4 API and 0.388\% sulfur, and HLS crude is 33.4 API and 0.416\% sulfur (S&P Global Platts, 2017).

\textsuperscript{23}This price difference is calculated over the entire period for which both prices are available from Bloomberg: January 6, 1988 to March 31, 2017.
Figure 4: Crude oil spot prices

(a) ANS, Brent, and LLS prices

(b) Brent, Clearbrook, and WTI prices

Source: Bloomberg. “WTI” refers to West Texas Intermediate, “ANS” refers to Alaska North Slope, and “LLS” refers to Louisiana, Light, Sweet. See text for details.

of their ship-or-pay commitments, which extend 13 years into the future (covering the 10-year commitments and a 3-year construction period). We assume a lognormal distribution for \( f(P_d) \), which requires us to specify a mean and variance for each month of shippers’ commitment period. Although DAPL sends oil to the U.S. Gulf Coast, where the relevant price is LLS, we use the three-year Brent (East Coast) futures price of $99.19/bbl to measure the expected price \( E[P_d] \) faced by DAPL shippers throughout their commitment period, since there is no LLS futures market and since the Brent and LLS prices have historically been quite close (figure 4).

We use three approaches to estimate the variance of \( f(P_d) \) for each month \( t \) of shippers’ commitment, where \( t \) ranges from 37 months (the start of pipeline service) to 156 months (13 years; i.e., contract expiration). We briefly summarize these approaches here; appendix B.1 provides details. In our baseline specification, we assume that shippers’ expected price volatility over a \( t \)-month horizon is given by the historic Brent oil price volatility over a \( t \)-month horizon (we continue to use Brent rather than LLS to be consistent with our use of futures prices for \( E[P_d] \) and because Brent is historically the most liquidly traded waterborne crude price). We calculate historic volatility at each horizon \( t \) by taking the standard deviation of \( t \)-month differences in historic logged Brent prices. Figure 10 in appendix B shows that historic volatility increases substantially over the 37 month to 13 year horizon,

\[24\] We use three-year futures price to measure the long-run expected price 10 years in the future, rather than extrapolate or forecast long-run price changes, because the literature on long-run oil-price forecasting suggests that the martingale assumption typically leads to the smallest forecast errors (Alquist, Kilian and Vigfusson, 2013).
from 45% to 129%.

Our other two approaches provide lower and upper bounds on future price volatility; we plot these bounds in appendix B.1, figure 10. As a lower bound, we use implied volatility from crude oil futures options markets, as in Kellogg (2014).\footnote{Implied volatility data are available from the EIA’s monthly Short Term Energy Outlook. See https://www.eia.gov/outlooks/steo/special/pdf/2009_sp_05.pdf for a description of the EIA implied volatility data.} Implied volatility in June, 2014 (when DAPL firm contracts were signed) was low relative to the historical average, so these volatility estimates are lower than in our baseline specification. We interpret the volatilities from this method as plausible lower bounds, since they assume that volatility (at any time horizon) will not eventually revert back up to its long-run mean after June, 2014.\footnote{As we show in appendix B.1, application of a GARCH(1,1) model to monthly spot price data suggests substantial mean reversion.} To obtain an upper bound, we take the historic one-month horizon Brent volatility from our baseline approach and extrapolate it to longer time horizons under the assumption that oil prices follow a random walk, so that volatility increases with the square root of the time horizon. Because the empirical relationship between long-run volatility and the time horizon increases at a rate less than that from the random walk assumption (as shown in our baseline volatility forecast in B.1, figure 10), the volatilities from this approach are larger than our baseline volatilities.

3.2.3 Calibration of downstream oil price distribution for rail shippers

We use the history of daily prices for Brent, LLS, WTI, and ANS to compute $\tilde{P}$ (the maximum of the downstream prices accessible by rail) and its empirical conditional density $f(\tilde{P} \mid P_d)$, now treating $P_d$ as the LLS price. Though the model from section 2.3 assumes that shipments to all rail destinations face a common cost $r_0$, our cost data, discussed in section 3.4, show some differences on the order of a few dollars per barrel. To incorporate these differences in shipping costs, we revise our definition of what rail shippers earn to $\tilde{P} = \max_i \{P_i - r_0, i\}$. Thus, $\tilde{P}$ is the best netback (as opposed to best downstream price) a rail shipper could receive. We then define the pricing difference $D = \tilde{P} - (P_d - r_{0,d})$, which is the amount by which the best rail netback exceeds a rail netback to LLS (the pipeline terminus).

Appendix B.2 discusses our non-parametric procedure for estimating the density $f(D \mid P_d)$, which includes a point mass at $D = 0$ (which occurs whenever the best netback is to LLS). Recall that our model from section 2.3 assumes that $D \leq r_{0,d}$, so that committed pipeline shippers would never prefer to use rail instead of the pipeline. In our 20 years of spot price data, this assumption holds for all but 8 days, so we estimate $f(D \mid P_d)$ only for
\( D \in [0, r_{0,d}] \) and exclude those 8 days from the estimation procedure. Appendix B.2, figure 11 presents the density estimates. Consistent with the raw price series presented in figure 4, our estimate of \( f(D \mid P_d) \) implies that \( D \) is often zero and rarely takes on a value exceeding a few \$/bbl. For instance, at \( E[P_d] = \$99.19/bbl \), our estimate of \( E[D \mid P_d] \) is \$2.15/bbl.

### 3.3 Crude-by-rail flows

Data on monthly PADD-to-PADD flows of crude-by-rail were obtained from the EIA.\(^{27}\) Figure 5 presents data on crude oil shipments from PADD 2 to PADDs 1, 2, 3, and 5.\(^{28}\) Volumes are dominated by shipments to the coastal destinations rather than intra-PADD 2 shipments, according with both the depressed WTI price early in the sample and the fact that rail transport to Cushing competed with pipelines, whereas transportation to the coasts did not. Shipments to the coasts rise substantially beginning in 2012, plateau in late 2014, and then begin to fall substantially in late 2015. The rise and fall of crude-by-rail is consistent with the rise and fall in spatial price differentials shown in panel (b) of figure 4, though changes in rail volumes follow changes in price differentials with a non-trivial lag. This lag is consistent with the presence of contracting in the crude-by-rail market; section 4 will use these data to make inferences about the average contract duration and then develop a version of our pipeline investment model that accounts for crude-by-rail contracts.

### 3.4 Railroad transportation costs

#### 3.4.1 Railroad cost data

We obtained data on the cost of transporting crude by rail from the U.S. Surface Transportation Board (STB) and from Genscape, a private industry intelligence firm. The STB is the United States’s regulator of interstate railroads, and we were able to obtain a data use agreement for the STB’s restricted-access waybill sample datasets for 2009–2015. These data contain detailed information on volumes and carrier revenues for a sample of shipments of crude oil and many other commodities.\(^{29}\)

We use the STB data to examine the time series variation in transportation rates charged to shippers of crude oil. For each month of our sample,\(^{30}\) we calculate the total revenue...
Figure 5: Crude-by-rail monthly volumes from PADD 2, by destination PADD

![Graph showing crude-by-rail monthly volumes from PADD 2, by destination PADD.](image)

Source: EIA

(across all shipments originating in PADD 2 and delivered to PADDs 1, 2, 3, or 5) earned by railroad carriers and divide by the total number of bbl-miles of crude oil shipped. Figure 6, panel (a), presents the resulting time series of average revenue per bbl-mile. This figure shows that railroad transportation rates were roughly constant around $5 per thousand bbl-mile from 2011–2014 before falling by approximately $1 per thousand bbl-mile in 2015. This decrease in transportation rates follows the sharp drop in crude oil prices that began in late 2014 (figure 4) and coincides with a decrease in crude-by-rail volumes (figure 5). The 2015 rate decrease does not appear to merely reflect a compositional change in shipments: figure 6, panel (b) shows that it persists after controlling for destination PADD, distance travelled, the number of carrying railroads, and the number of cars.

The STB dataset also includes information on whether each shipment was under a “tariff” or “contract” rate. Tariff shipments are charged a publicly-posted tariff that is available to any shipper under common-carry regulation. Contract shipments are under negotiated rates.

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31 The revenue measure we use is the sum of total freight line-haul revenue with fuel surcharges. Our understanding from industry experts is that this revenue includes compensation for back-haul of empty rail cars; i.e., there are no separate, additional back-haul charges (personal communications with Kenneth Boyer (Michigan State University) and Justin Kringstad (NDPA)). We obtain total revenue and bbl-miles across all shipments each month using expansion factors that account for variation in sampling rates for shipments of different sizes.

32 To protect the confidentiality of individual carriers’ rates, we are unable to present results that are disaggregated (either spatially or temporally) beyond the monthly level. We are also unable to present data prior to 2011.
Figure 6: STB average revenue per bbl-mile shipped

(a) Raw data

(b) Residualized data

Note: Data cover sampled waybills from PADD 2 to PADDs 1, 2, 3, and 5. Data from February, April, and July 2011 are omitted to protect the confidentiality of carriers’ rates; data from months before July 2011 are therefore plotted as points rather than a line. Panel (b) plots date fixed effects (relative to the January, 2011 observation) from a waybill-level regression of revenue per 1000 bbl-mile on date FE, PADD FE, distance shipped, the number of carrying railroads, and the number of cars, weighted by bbl-miles. See text for details.

that may include volume commitments or discounts, and typically have a term of 1-2 years, according to industry participants. The STB data indicate that 87.0% of crude oil moves on contract rates and that contract shipments enjoy an average discount of $0.52 per 1000 bbl-mile relative to tariff rates.\footnote{We calculate both of these numbers using the same sample of waybills as was used to generate figure 6. To obtain the contract discount, we regress revenue per 1000 bbl-mile on a tariff vs contract dummy variable and on month-of-sample fixed effects, distance travelled, the number of carrying railroads, and the number of cars, while weighting the regression by bbl-miles. $0.52 is the regression coefficient on the tariff vs contract dummy variable. If we do not include any control variables, we obtain a $0.71 contract discount.}

Our data from Genscape complement the STB data by providing information on the cost of leasing rail cars—which are provided by third parties, not the railroads themselves—as well as other elements of crude oil transportation, such as loading and unloading terminal fees. Unlike the STB data, Genscape’s data are cost assessments rather than actual transaction data: each week, Genscape surveys shippers to determine their estimates of the cost of making a spot crude shipment to a particular destination. The Genscape data series begins in October, 2013.

Panel (a) of figure 7 presents Genscape’s assessments of leasing rates for rail cars. Lease rates rise in the first part of the sample, when the oil price is high and transportation volumes
Source: Genscape. Rail car lease rates are not PADD-specific. PADD 2 to PADD 3 decomposition assumes that rail cars are 30,000 gallons and complete 1.75 round trips per month. See text for details.

are growing, and then fall late in the sample, when the oil price is low and transportation volumes are falling. This pattern is consistent with scarcity rents or market power during the “boom” period that then dissipated when oil prices fell.\(^{34}\)

Figure 7, panel (b) shows how Genscape’s assessments of freight costs (monies paid to the railroad, equivalent in principle to the STB revenue data), rail car lease costs, and other costs (primarily terminal fees) come together to form the total cost of shipping crude by rail, using the PADD 3 destination as an example. Genscape’s freight cost assessment is constant for most of the sample at a level that is roughly consistent with the STB data shown in figure 6, given an average trip distance to the gulf coast of about 1,900 miles (Clay et al. (2017)). Panel (b) of figure 7 also indicates that charges such as terminal fees are economically significant, exceeding $2/bbl even at the end of the sample when the price of crude oil is low. The substantial jump in “Other” costs in late 2015 is observed in all PADDs in the Genscape data and reflects the removal of gathering costs from Genscape’s assessments rather than an actual change in costs.

3.4.2 Calibration of the crude-by-rail cost function

We use the Genscape rail cost dataset, as well as two measures of crude-by-rail flow, to calibrate values of \(r_0\) and \(r_1\) for our model of pipeline investment. Though these data are not ideal, in that they reflect cost assessments and surveyed flows, we do not believe hard private transaction data are systematically collected by any entity.

\(^{34}\)See Tita (2014) and Arno (2015) for discussions of the boom and bust in railcar lease rates.
We estimate $r_{0,i}$ for each destination $i$ as the minimum all-in rail cost for transportation between the Bakken and $i$. For most destinations, this minimum price occurs in the spring of 2016, after: (a) millions of bbls/day of loading and unloading capacity had been constructed; (b) rail car lease prices had fallen as a glut of new tanker cars became available; and (c) global oil prices had roughly halved since 2014. We select the minimum reported costs because these costs coincide with both fully constructed rail capacity and limited use of that capacity, which we view as a reasonable analogue to the model’s notion of $r_0$.\footnote{These costs are: $13.00$/bbl for PADD 1, $8.54$ for PADD 2, $10.94$ for PADD 3, and $9.23$ for PADD 5.}

We estimate $r_1$ by projecting the two sources of crude-by-rail costs for which we have a credible time series, STB freight rates and Genscape tanker car lease rates, onto contemporaneous aggregate crude-by-rail flows.\footnote{We use STB flows as well as the EIA’s own estimates of these flows. The results are similar.} We normalize each of these cost series so that the units on the coefficients in the regressions are dollars per bbl per million bbl per day (mmbpd). The results, shown in table 6 in appendix A, are consistent with an upward-sloping rail services supply curve, both in freight services and in tanker car leasing, though confidence intervals admit a wide range of “total” $r_1$ values. These coefficients are identified off of time series variation in the aggregate use of crude-by-rail that occurs over a relatively short panel, so these estimates are best interpreted as reflecting short term costs.

We ultimately use several values for $r_1$ in our model. At the low end, we assume $r_1 = 0$, consistent with the facts that rail loading and unloading capacity now far exceeds rail flows of oil and that tanker cars should be viewed as commodities in the medium to long term. At the high end, we assume $r_1 = $6/bbl per mmbpd, which is well within the confidence interval of the sum of our two estimated components. These high costs, however, likely reflect short-run constraints in rail terminals and tank cars that would be unlikely to persist over the multi-year horizon relevant to the pipeline customers considered by our model. We therefore view $r_1 = $6/bbl per mmbpd as an upper bound and focus most of our attention on calibrations of the model that use an intermediate value of $r_1 = $3/bbl per mmbpd.

### 3.5 Upstream oil supply

Our model of pipeline investment includes a static supply curve for Bakken crude oil production. This construct is inherently strained given that oil is an exhaustable resource; we adopt it here both to maintain our model’s tractability and because estimation of a dynamic model of Bakken drilling and production has not been done in the literature and is beyond the scope of this paper. Due in part to this shortcoming, we ultimately calibrate our model’s crude oil supply curve using a range of elasticities.

Rather than estimate the Bakken supply elasticity ourselves, we rely on the literature that...
has endeavored to estimate supply curves for U.S. shale oil and gas. Bjørnland et al. (2017) finds that monthly Bakken production does not respond essentially at all to contemporaneous price shocks, consistent with Anderson, Kellogg and Salant (2018)’s work showing that changes in oil supply come from drilling of new wells rather than changes in production from existing wells (which experience production declines that are invariant to price). We therefore turn to estimates of the drilling elasticity of U.S. shale wells. However, drilling elasticity estimates are likely to be substantial over-estimates of the impact of oil prices on upstream production over the 13-year time horizon relevant to shippers in our pipeline model, for two reasons. First, production from newly drilled wells is pooled with production from pre-existing wells, so that the percentage change in production after a price shock is substantially smaller than the percentage change in drilling for many years, until production from pre-existing wells declines to nearly zero. Second, as explained by Smith and Lee (2017), wells drilled following an increase in the price of oil will tend to be less productive than wells drilled previously.

Newell and Prest (2017) finds a drilling elasticity of roughly 1.6 for all U.S. shale oil, using a quarterly panel of drilling rates and crude oil prices.\textsuperscript{37} For shale gas, Hausman and Kellogg (2015) estimates a price elasticity of about 0.8, using instrumental variables regressions of gas drilling rates on lagged gas prices. Newell et al. (2016) uses similar methods and estimates an elasticity of about 0.7. For our model, we roughly halve these drilling elasticity estimates to obtain a range of Bakken supply elasticities between between 0.4 and 0.8.\textsuperscript{38}

To calibrate the supply curve intercept, we use the North Dakota Pipeline Authority expected production forecast from April, 2014 (North Dakota Pipeline Authority, 2014).\textsuperscript{39} This forecast provides monthly expected production volumes throughout (and beyond) the ten-year pipeline contract; average expected production during the ten-year period is 1,616 thousand bpd (mbpd). The production forecast, supply elasticity, and expected oil price together pin down a supply intercept for each month of the contract.

In an alternative set of specifications, we allow for uncertainty in upstream supply by letting the supply intercept be stochastic. In addition to its expected production forecast, the NDPA also provides a conservative (“case 2”) forecast that is, on average, about 200

\textsuperscript{37}Newell and Prest (2017)’s model includes three quarterly lags of oil prices and instruments for the oil price using prices of other commodities.

\textsuperscript{38}A gross minimum for this elasticity would be about 0.3: this value comes from the decrease in North Dakota production from a peak of 1,178 mbpd in September 2014 to a trough of 940 mbpd in December 2016 (just more than two years later), relative to an oil price that roughly halved (data from EIA at https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&ks=MCRFPND2&f=M; accessed March 18, 2018). Use of an elasticity higher than 0.8 would cause our model to estimate responses of pipeline capacity to crude-by-rail costs that are even larger than those presented in section 6.

\textsuperscript{39}We use the NDPA’s “case 1” forecast, which represents expected production under the prevailing EIA oil price forecast (personal communication from Justin J. Kringstad at NDPA (June, 2018)).
mbpd lower than the expected production path. We construct an “optimistic” forecast that is symmetric to this conservative forecast (i.e., in each month our optimistic forecast exceeds the baseline forecast by the same amount that the conservative forecast falls short) and solve for the series of supply intercepts that are consistent with each of these two scenarios. We then, in alternative specifications, run a version of the pipeline investment model in which prospective shippers face stochastic supply (in addition to the stochastic downstream price), where we assign probabilities of 1/3 to each of the three production paths.\(^{40}\)

### 3.6 Pipeline economies of scale

Finally, we consider the extent to which there are increasing returns to scale in pipeline construction; i.e., we calibrate the \(d(C(K)/K)/dK\) term in equation (11). As a conservative baseline, we simply assume that the construction of DAPL has constant returns to scale, so that this derivative is zero. As an alternative, we assume that the pipeline’s cost is a constant elasticity function of capacity, and we obtain an elasticity estimate from Soligo and Jaffe (1998)’s study of Caspian Basin oil export pipelines.\(^{41}\) The elasticity implied by Soligo and Jaffe (1998) is 0.59, indicating substantial scale economies.\(^{42}\) Other work on U.S. natural gas pipelines suggests an even lower elasticity: Rui, Metz, Reynolds, Chen and Zhou (2011) obtains a sample of U.S. natural gas pipeline costs and regresses log(cost) on the log of pipeline diameter (along with controls for length and geography). That paper obtains an elasticity of pipeline cost with respect to diameter of 0.49, but because pipeline capacity is convex in diameter (the cross-sectional area of a pipe increases with diameter squared), the elasticity with respect to capacity is even lower. To be conservative, we use the elasticity of 0.59 from Soligo and Jaffe (1998).

### 4 Crude-by-rail flows and contracting

The model from section 2 assumes that rail shippers will, in every month: (a) select the destination with the highest upstream price, net of transportation costs; and (b) fluidly adjust the magnitude of these shipments as upstream prices rise and fall. In practice, however, crude-by-rail shipments violate both of these assumptions: figure 5 shows that every destination has positive rail flows in every month, starting in 2012, and figures 5 and 4 together

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\(^{40}\)These probabilities are arbitrary; the NDPA does not assign probabilities to its production forecast cases.

\(^{41}\)We were not able to find a study of scale economies in U.S. oil pipelines.

\(^{42}\)We obtain this elasticity using the engineering cost estimates presented in table 2 of Soligo and Jaffe (1998). We regress log(cost) on log(capacity) and route fixed effects.
suggest that rail volumes follow price movements with a lag.

A likely driver of the deviations of rail flows from assumptions (a) and (b) is the presence of contracts between shippers, railroads, end users, and logistics providers. These contracts are frequently mentioned in industry press and publications, such as Hunsucker (2015), and may contain provisions that guarantee minimum volumes or provide volume discounts, over time horizons of several months to more than a year. Although we do not have access to individual private shipping contracts, we know from the STB data (discussed in section 3.4) that most crude-by-rail shipments are on contracts, typically at a discount to spot rates. In this section, we first endeavor to learn about average contract durations by empirically examining the aggregate response of rail flows to price differentials, using two empirical strategies. We then develop an alternative version of our pipeline investment model that requires rail shipments to use contracts rather than operate on a spot basis.

4.1 Descriptive relationship between rail flows and crude prices

We begin by estimating the correlation of the destination shares of Bakken crude with the contemporaneous and lagged oil prices at those destinations. To compute the destination shares, we combine data from the North Dakota Pipeline Authority (NDPA) on the monthly share of each transportation mode (local consumption, crude-by-rail, pipeline, and truck) with data from the EIA on the monthly share of each rail destination for shipments originating in PADD 2. Because our data end in 2016, in advance of the completion of DAPL, we assume that the pipeline share corresponds to pipeline shipments that reach Cushing, OK and not the Gulf Coast. We divide the total rail share from the NDPA data into destination-specific crude-by-rail shares using the EIA data. The combined data yield the share of North Dakota crude oil production that is refined locally, transported by truck to Canada, transported by pipeline to Cushing, OK, and transported by rail to each of PADDs 1, 2, 3, and 5.

Because refined consumption is empirically at or just below the reported capacity for refineries in North Dakota during the entire time period, we subtract it from total production and focus on the destinations that appear to be unconstrained. We assume shippers to PADD 1 earn the Brent price for their cargoes, shippers to PADD 2 earn WTI, shippers to PADD

43Simultaneous multi-destination flow may also be explained in part by: (1) destination-specific marginal shipping costs that are strictly increasing; or (2) destination-specific demand for Bakken crude that is strictly decreasing.

44There were at least two distinct pipeline routes to Cushing: the Enbridge Mainline and Spearhead systems, which travel east into Minnesota and Illinois and then southwest into Cushing, and the Butte and Double H pipeline systems, which connect to the Guernsey, Wyoming trading hub, which in turn is connected to the Platte, Pony Express and White Cliffs pipeline systems that connect to Cushing. We are not aware of any pipeline routes to other major pricing centers.
3 earn LLS, and shippers to PADD 5 earn ANS. There is no publicly available light oil benchmark for any central Canadian trading hub, so we assume that truck shipments earn the local Clearbrook price.

To measure the correlation of destination shares with destination prices, we estimate a multinomial logit choice model. Formally, let $u_{ijt}$ be the indirect utility that an atomistic shipper $i$ experiences when shipping to destination $j$ during month $t$. We assume that $u_{ijt}$ is a linear combination of current and lagged prices at destination $j$, a fixed effect for that destination, a time-varying unobserved mean utility shock specific to $j$ and $t$, and an iid type-1 extreme value “taste” shock specific to $i$, $j$ and $t$:

$$u_{ijt} = \sum_{l=0}^{L} \beta_{t-l} p_{j,t-l} + \delta_{j} + \xi_{jt} + \epsilon_{ijt}$$

Under the assumption that shippers choose the destination with the highest indirect utility, the fraction of crude oil production that is shipped to destination $j$ during period $t$ is given by the standard logit formula:

$$s_{jt} = \frac{\exp \left( \sum_{l=0}^{L} \beta_{t-l} p_{j,t-l} + \delta_{j} + \xi_{jt} \right)}{\sum_{k} \exp \left( \sum_{l=0}^{L} \beta_{t-l} p_{k,t-l} + \delta_{k} + \xi_{kt} \right)}$$

To estimate this model, we treat pipeline transportation as the “outside good” and use the Berry (1994) logit inversion formula to correlate the log odds ratios of the destination shares with the destination-specific prices:

$$\log s_{jt} - \log s_{0,t} = \sum_{l=0}^{L} \beta_{t-l} (p_{j,t-l} - p_{0,t-l}) + \delta_{j} - \delta_{0} + \xi_{jt} - \xi_{0t}$$

(4)

Table 1 presents OLS estimates of equation (4) using contemporaneous destination prices and price lags of order 3 to 24 months. In general, the coefficient on the oldest price realization in each specification has the most positive value. This pattern holds for specifications including lags of up to 18 months (column 7) and is consistent with a model in which a large fraction of shippers sign contracts that require or otherwise provide incentives for consistent shipments over one to two years.\(^{45}\)

Another pattern in Table 1 is the negative and precisely estimated coefficients on contemporaneous prices. These negative coefficients likely reflect standard supply/demand en-

\(^{45}\)For example, if all shippers signed $T$-month contracts, then the price vector driving month $t$’s destination shares would be $p_{t-T}$.\)
Table 1: Multinomial logit shipment destination share regressions

<table>
<thead>
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<th></th>
<th>(1)</th>
<th>(2)</th>
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</table>

R²     | 0.00  | 0.07  | 0.14  | 0.23  | 0.34  | 0.41  | 0.46  | 0.43  | 0.37  |
| Adj. R² | -0.01 | 0.06  | 0.13  | 0.21  | 0.33  | 0.39  | 0.44  | 0.40  | 0.34  |
| N      | 400   | 397   | 386   | 371   | 356   | 341   | 326   | 311   | 296   |

Note: Table presents multinomial logit regressions of monthly shipment destination shares onto current and lagged monthly destination prices. PADD 2 pipeline shipments are the outside good. Shipments by truck to Canada are priced using Bakken Clearbrook, whose price series starts in May, 2010. Thus, in specifications with longer lags of price, there are fewer observations for shipments by truck to Canada than for other destinations. All specifications include destination fixed effects. Newey-West standard errors in parentheses, with a maximum lag of 4 months. R² values are calculated “within” each destination.
Figure 8: Actual vs predicted rail shares under 18 month lagged model

Note: PADD 2 pipeline transportation is the outside option. Because predicted PADD 2 rail shipments are constant at the estimated fixed effect, their actual and predicted values are excluded from this figure.

dogeneity: if $\xi_{jt}$ constitutes a supply shock (e.g., the unobserved opening of a new loading or unloading facility) and local crude demand is downward-sloping, contemporaneous prices at destination $j$ will be negatively correlated with the shock. Thus, the coefficient on contemporaneous prices will be biased downwards.

Despite the simplicity of this destination-share model, it fits the data reasonably well. Figure 8 plots actual and fitted time series of the log odds ratios for each destination. There are two patterns to match: rail shipments increase to parity with pipeline shipments by early 2014 and then decline, and truck shipments gradually diminish until they begin growing again in 2016. The empirical model is able to match both of these patterns, suggesting an important role for contracting in determining rail flows and bolstering the fundamental concept underpinning our model that rail flows respond to oil price shocks, even if those responses occur with a non-trivial lag.

4.2 A destination share model with explicit rail contracts

To better infer average rail contract durations, we modify the empirical destination share model from section 4.1 to explicitly account for rail contracts. Our goal is to decompose current rail flows to destination $i$ during month $t$, which we denote by $R_{i,t}$, into new flows, which we hypothesize respond to contemporaneous price shocks, and old flows, or previously
contracted flows, which should be the result of previous price shocks. In the notation below, \(M_t\) is the total output of North Dakota crude during month \(t\) and \(q_{i,t}\) is the share of “un-contracted” crude oil at month \(t\) that goes under contract to location \(i\). The parameter \(s\) represents the share of previously contracted flows that are still under contract in the next month. Equation 5 formalizes this idea:

\[
R_{i,t+1} = sR_{i,t} + q_{i,t+1} \left( M_{t+1} - s \sum_j R_{j,t} \right)
\]

If we view individual contracts as infinitesimal claims to the total flow \(M_t\) that do not retire between periods \(t\) and \(t+1\) with probability \(s \in (0,1)\), then the average contract length will be \(\frac{1}{1-s}\). Our goal is to estimate \(s\) and therefore \(\frac{1}{1-s}\).

We must first specify a model for \(q_{i,t+1}\), the share of available production that goes under contract to destination \(i\) in period \(t+1\). We adopt a random utility choice model. Atomistic shippers observe a vector of crude price differentials \(X_{i,t+1}\) and destination fixed effects \(\delta_i\) that account for shipment cost differences or other fixed factors. They then choose the location with the highest value of indirect utility \(X_{i,t+1}\beta + \delta_i + \epsilon_{i,t+1}\), where \(\epsilon_{i,t+1}\) is an i.i.d. logit shock. Following algebra that we ensconce in Appendix D, we can then re-write the contracting model as equation (6), in which \(R_{0,t+1}\) denotes flow to the non-contracted outside good, which we assume is rail transport to Cushing:

\[
R_{i,t+1} = sR_{i,t} + R_{0,t+1} \exp (X_{i,t+1}\beta + \delta_i). \tag{6}
\]

Our data on \(R_{i,t}\) are likely measured with error, since they are computed by the EIA from the STB’s sample of waybills, in which sampling rates can be below 10\%.\(^{46}\) To account for this issue, let \(\mu_{i,t}\) be an iid measurement error that is orthogonal to \(R_{i,t}\), so that observed flows are \(R^*_{i,t} = R_{i,t} + \mu_{i,t}\). A feasible version of our estimating equation is then:

\[
R^*_{i,t+1} = sR^*_{i,t} + R_{0,t+1} \exp (X_{i,t+1}\beta + \delta_i) + \mu_{i,t+1} - s\mu_{i,t}. \tag{7}
\]

Because the measurement error \(\mu_{i,t}\) is mechanically correlated with \(R^*_{i,t}\), we instrument for \(R^*_{i,t}\) using the second and third lags of destination price differences, in levels, squares and

\(^{46}\)This measurement error precludes using a standard log transformation to estimate the equation \(\log (R_{i,t+1} - sR_{i,t}) = \log R_{0,t+1} + X_{i,t+1}\beta + \delta_i + \xi_{i,t+1}\). In this specification, \(s\) must be sufficiently small such that the term inside the left-hand-side logarithm is strictly positive for all observations. With measurement error in the \(R_{i,t}\), however, especially in the early part of the sample when rail flows are small, we have found that \(s\) then cannot be greater than roughly 0.1, implying an average contract length of only a month or two.
cubes, as well as a Nevo (2001) style measure of the average value of $R_{i,t}^*$ across destinations $j \neq i$. Lagged prices should influence $R_{i,t+1}^*$ through contracting forces but will be uncorrelated with sampling-based measurement error in the EIA data, and average lagged flows at other destinations will capture aggregate demand shocks but not location specific demand shocks. The instrument set also includes $R_{0,t+1}$ and destination dummy variables.\footnote{We do not use contemporaneous price differences in order to avoid bias from standard supply/demand endogeneity of the price differences $X_{i,t+1}$.} We estimate this model off of rail flows to PADD’s 1, 2, 3 and 5 using GMM and approximately-optimal instruments in the spirit of Chamberlain (1987).\footnote{Specifically, we construct our instruments in four steps. First, we use nonlinear least squares to get a (biased) estimate of the model’s parameters. Second, we regress our three endogenous variables onto our instrument set and recover their predicted values. Third, we compute a version of the conditional moment function implied by equation 7 using the predicted values, other exogenous variables in the model, and the NLLS parameter estimates. Finally, we use as instruments the gradients of this function with respect to $s$, $\beta$, and the $\delta$’s.}

The results of estimating equation (7) are in presented in table 2. The point estimate on $s$ is 0.96, which implies an average contract length of 24 months. The coefficient on downstream prices is positive, consistent with the latent shipping choices being driven by variation in netbacks, and the point estimates on the location dummies are all negative, consistent with rail transportation to far away destinations being more expensive than rail transportation to PADD 2, which North Dakota is a part of. Though the destination dummies are economically large and imprecisely estimated, relative to the estimated price coefficient $\hat{\beta}$, we cannot reject a null hypothesis that shippers have economically sensible preferences. For example, the data do not reject a hypothesis that PADD 1 is preferred to PADD 5 and PADD 5 is preferred to PADD 3, each by a few dollars per barrel. However, the confidence intervals around these parameters are wide enough to support many possible shipper preferences, including ambivalence (i.e., the $\delta$’s are equal).

4.3 Embedding rail contracting into the pipeline investment model

To address the importance of contracting in the crude-by-rail (CBR) market, we develop an alternative version of the model from section 2 by requiring rail shippers to use contracts rather than a spot market for rail services (see appendix E.3 for computational details). Because we do not observe individual rail contracts, we do not know the extent to which these contracts allow the shippers to retain flexibility in when to ship (as in the case of volume discount agreements) or completely foreclose flexibility (firm ship-or-pay commitments). As a bounding exercise on the importance of CBR contracts, we examine how the incentives of both rail and pipeline shippers change when rail shipments require firm ship-or-pay commitments.
Table 2: GMM estimates of the rail contract model

<table>
<thead>
<tr>
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<th>Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>$s$</td>
<td>0.96 (0.03)</td>
</tr>
<tr>
<td>$\beta$</td>
<td>0.06 (0.08)</td>
</tr>
<tr>
<td>$\delta_1$</td>
<td>-2.07 (1.87)</td>
</tr>
<tr>
<td>$\delta_3$</td>
<td>-2.66 (2.09)</td>
</tr>
<tr>
<td>$\delta_5$</td>
<td>-3.28 (1.87)</td>
</tr>
</tbody>
</table>

Criterion function 0.00
Num. obs. 231

Note: Table presents estimates of equation (7). $s$ denotes the share of contracted flows that do not expire each month, and $\beta$ is the coefficient on destination $i$’s oil price differential relative to Cushing. The $\delta$’s are fixed effects for each rail destination PADD. The outside good is shipment to Cushing by rail. Two-step GMM HAC standard errors in parentheses. See text for details.

Informed by our estimated average contract length from section 4.2, we impose that rail shippers must sign 24-month ship-or-pay commitments in order to access the railroad. During the contract period, rail shippers then hold the option to ship crude volumes up to the committed capacity level, at no additional marginal cost. Thus, every 24 months, beginning with the in-service date of the pipeline, prospective rail shippers face a problem similar to that faced by pipeline shippers: they must decide whether to commit to rail capacity, even though there is uncertainty regarding the future downstream crude price over the life of the contract.

Once their 24-month contracts expire, rail shippers can decide the quantity of rail capacity to renew, based on the current downstream price. Over the 10-year commitment period for firm pipeline shippers, there are five rail contracting “cycles”. This modeling approach therefore diminishes the flexibility of CBR. Instead of being able to freely adjust volumes shipped on a monthly basis in response to downstream price shocks, rail shippers may only adjust their capacity limit every 24 months. In addition, we assume that the 24-month ship-or-pay commitments signed by rail shippers are location-specific, so that they can no longer take advantage of transitory price differences across downstream locations. Thus, rail shippers in the contracting version of the model can only realize the downstream price $P_d$ at the pipeline terminus.

The fact that rail shippers cannot immediately increase shipment volumes in response to an increase in $P_d$ means that pipeline shippers enjoy higher shipping margins following large realizations of $P_d$, relative to the baseline model.\textsuperscript{49} Thus, pipeline shippers are willing

\textsuperscript{49}Pipeline shippers also suffer from lower margins following low realizations of $P_d$, since rail shippers will ship at margins less than the (sunk) cost of rail. However, margins cannot fall below zero (for pipeline or
to commit to more pipeline capacity in the rail contracting version of the model, all else equal. Because ship-or-pay contracts are maximally restrictive (relative to volume discounts or rebates), we believe that this rail contracting model generates a lower bound on the value of CBR and an upper bound on rail shippers’ willingness to pay for capacity.

Finally, we do allow rail shippers to enjoy a reduced shipping rate relative to the baseline model. Per our estimates from the STB data (section 3.4), we reduce the value of $r_0$ in the contracting model by $0.52 per 1000 bbl-miles relative to the baseline model to account for contract discounts.\textsuperscript{50}

\section{Validation}

Given the inputs discussed above, we validate our model by calculating the expected return for shippers who signed ten-year firm shipping agreements on DAPL, given the pipeline’s actual capacity of 520 mbpd (which increased total Bakken pipeline export and local refining capacity to 1,371 mbpd). We then compare this expected return—which in equilibrium should equal the average per-bbl cost of the pipeline—to the actual DAPL tariff for long-term shippers of $5.50–$6.25/bbl (Gordon, 2017).

Table 3 presents the implied average per-bbl cost of DAPL from our model, covering a range of assumptions on the upstream supply elasticity, the responsiveness of crude-by-rail (CBR) costs to rail flow ($r_1$), and the spatial and temporal flexibility of CBR (note that the implied cost is not affected by assumptions about pipeline returns to scale). Costs implied by our baseline (single-destination, spot CBR) model are given in the third column of table 3.

The implied cost generally decreases with the Bakken supply elasticity because, given oil price expectations in June, 2014, total Bakken production was expected to exceed total pipeline export and local refining capacity. The risk that oil prices might fall so far as to decongest the pipeline, thereby leaving pipeline shippers with zero return, is therefore increasing in the supply elasticity.\textsuperscript{51} The implied cost increases with $r_1$ because higher values of $r_1$ increase the margin earned by pipeline shippers when CBR volumes are large.

When $r_1$ takes values of $0$ or $3$/bbl per million bpd (mmbpd), the average cost of DAPL rail) because shippers are not obligated to ship. This convexity of returns as a function of $P_d$ leads to greater expected returns for pipeline shippers in the contracting model.\textsuperscript{50}

\textsuperscript{51} Given the 1,900 mile distance from the Bakken to the Gulf Coast, the overall contract discount is roughly $1/bbl.\textsuperscript{51}

\textsuperscript{51} More precisely, for a larger supply elasticity, the oil price does not have to decrease as far below the expected price in order to decongest the line. For values of $r_1 > 0$, the implied cost can increase with the supply elasticity because large CBR volumes increase the return to pipeline shippers, and the magnitude of this effect can outweigh that from the increased probability that the pipeline is uncongested.
Table 3: Model validation

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Implied average cost per bbl</th>
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<tbody>
<tr>
<td></td>
<td>Baseline model</td>
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<td>Supply elasticity</td>
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<tr>
<td>0.8</td>
<td>6</td>
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Note: The actual DAPL tariff for ten-year committed shippers is between $5.50/bbl and $6.25/bbl. All rows assume $r_0 = 11/bbl. $r_1$ is in units of $/bbl per million barrels per day (mmbpd). The baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. The multiple destination model allows rail to reach the Gulf, East, or West coasts, using the spot market. The crude-by-rail (CBR) contract model allows rail to reach a single destination and constrains rail to use 24-month ship-or-pay contracts. See text for details.

The implied cost exceeds this range when we let $r_1 = 6/bbl per mmbpd, consistent with this large value of $r_1$ reflecting short-run capacity constraints during 2013–2014 rather than the long-run rail capacity responses that would be of interest to shippers signing long-term contracts (see the discussion in section 3.4.2).

In the model that allows rail shippers to enjoy spatial option value, shown in the fourth column of table 3, the implied cost is roughly 10% lower than in the baseline model. This fall in implied cost is driven by the decrease in shipping margin that occurs when rail shippers increase their volumes—commensurately increasing upstream production and the upstream price—in response to realized high prices at downstream locations other than the pipeline terminus. The modest difference in implied cost between the spatial and baseline models is consistent with small historical price differences across the U.S. Gulf, West, and East Coasts (see figure 4).

In contrast, when CBR shipments require 24-month ship-or-pay contracts, shown in the right-most column of table 3, the value of CBR diminishes and the expected margin to pipeline shippers increases. The expected margin, and thus the implied average cost of DAPL, exceeds $6.25/bbl in all specifications, and substantially so when the upstream supply elasticity is 0.4 or when $r_1 > 0$. We believe that the 24-month ship-or-pay contracts we model...
are overly restrictive relative to actual CBR contracts, so that the “true” model for expected shipper returns lies between the fully flexible spatial model and the CBR contract model.

Table 7 in the appendix presents implied costs using the baseline model with alternative values for DAPL’s capacity. For capacities of 450 mbpd or 570 mbpd, implied costs are similar to those shown in table 3 (which uses the actual installed DAPL capacity of 520 mbpd), but costs are substantially higher if one assumes that only 320 mbpd of new Bakken export capacity were committed to in June, 2014. Table 9 presents implied costs using alternative values for price volatility (discussed in section 3.2.2) and allowing for supply uncertainty (discussed in section 3.5). Different assumptions about price volatility, which change the model’s implied average cost by $0.58–$1.27/bbl, depending on specification, are more important than allowing for supply uncertainty, which decreases DAPL’s implied cost by only a few cents per barrel.

6 Results: the sensitivity of pipeline investment to rail costs

Table 4 presents results from the baseline model, with no spatial option value or crude-by-rail (CBR) contracting, and assuming constant returns to scale in pipeline construction. The top third of this table uses $r_1 = 0$ per mmbpd, consistent with an assumption that over the long run, CBR exhibits constant returns to scale. Under this assumption, our estimates of $dK/dr_0$ range from 40.8 thousand bpd (mbpd) per $/bbl (for an upstream supply elasticity of 0.4) to 60.7 mbpd per $/bbl (for an elasticity of 0.8). Given the actual DAPL capacity of 520 mbpd (and total Bakken pipeline export capacity $K$ of 1,283 mbpd), these values translate to elasticities of total pipeline export capacity $K$ with respect to $r_0$ that range from 0.35 to 0.52. Because estimated air pollution externalities from rail transportation exceed $2/bbl (Clay et al. (2017)), these estimates imply substantial long-run substitution from rail to pipeline capacity in the event that CBR’s externalities are addressed through regulation.

The middle and bottom sections of table 4 display results when we use values for $r_1$ of $3 and $6/bbl per mmbpd, respectively. Our estimates of $dK/dr_0$ decrease modestly with $r_1$, and our smallest estimate is $dK/dr_0 = 31.8$ mbpd per $/bbl (with an upstream elasticity of 0.4 and $r_1 = 6/bbl per mmbpd). Because this estimate neglects railroad spatial option value, railroad contracting, and pipeline economies of scale, and because letting $r_1 = 6/bbl per mmbpd yields an implied average cost of DAPL that substantially exceeds the actual tariff, we view it as a strong lower bound on the effect of the cost of railroad transportation
Table 4: Sensitivity of pipeline capacity and expected rail flow to the cost of crude-by-rail: results from baseline model

<table>
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<th>Input parameters</th>
<th>Impacts of a change in ( r_0 ) on ( K ) and ( E[Q_r] )</th>
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<td>Elasticity of</td>
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<td>( K ) w.r.t. ( r_0 )</td>
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<td>( r_1 )</td>
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<tr>
<td>0.4</td>
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<td>0.6</td>
<td>6</td>
</tr>
<tr>
<td>0.8</td>
<td>6</td>
</tr>
</tbody>
</table>

Note: All rows assume constant returns to scale in pipeline construction and that \( r_0 = $11/bbl \). Capacity \( K \) and expected rail flows \( E[Q_r] \) are in thousands of barrels per day (mbpd). \( r_1 \) is in units of $/bbl per mmbpd. The baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. See text for details.

on pipeline capacity.

Appendix table 8 shows how our estimates vary with the assumed size of the June, 2014 DAPL pipeline capacity commitment \( K_d \). The results do not substantially deviate from baseline results in table 4 for values of \( K_d \) between 450 mbpd and 570 mbpd. For \( K_d = 320 \) mbpd and an upstream supply elasticity of 0.4, however, the estimate of \( dK/dr_0 \) is nearly double its value in the baseline model.\(^{52}\) Appendix table 10 shows that our results are not highly sensitive to alternative assumptions about price volatility or supply uncertainty: these alternatives yield estimates of \( dK/dr_0 \) that vary by at most 25% from our baseline estimates in table 4, and often by much less than that.

The fifth column of table 4 shows how expected rail flows, \( E[Q_r] \), are impacted by a change in \( r_0 \). Across the specifications, \( dE[Q_r]/dr_0 \) has a smaller magnitude than does \( dK/dr_0 \), since for low downstream oil price realizations, rail flows will be zero regardless of the value of \( r_0 \).\(^{53}\) Expressed as an elasticity, however, the estimated impact of rail costs on

\(^{52}\)Under these assumptions, the implied cost of DAPL is $10.03/bbl (appendix table 7), so that the cost of pipeline shipment is similar to the cost of rail shipment (\( r_0 = $11/bbl \)). Pipeline and rail transport are therefore close substitutes, inflating the estimate of \( dK/dr_0 \).

\(^{53}\)Moreover, \( dE[Q_r]/dr_0 \) is not very sensitive to the upstream supply elasticity because this elasticity has two countervailing effects on \( dE[Q_r]/dr_0 \). First, large supply elasticities increase \( dK/dr_0 \), which will tend to increase the magnitude of \( dE[Q_r]/dr_0 \). Second, large supply elasticities increase the probability that \( E[Q_r] = 0 \), which will tend to decrease the magnitude of \( dE[Q_r]/dr_0 \).
Table 5: Sensitivity of pipeline capacity and expected rail flow to the cost of crude-by-rail: alternative models for rail flexibility and pipeline economies of scale

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Impacts of a change in $r_0$ on $K$ and $E[Q_r]$</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$dK/dr_0$</td>
</tr>
<tr>
<td>Supply elasticity</td>
<td>$r_1$</td>
</tr>
<tr>
<td>Baseline model</td>
<td>0.4 3</td>
</tr>
<tr>
<td></td>
<td>0.6 3</td>
</tr>
<tr>
<td></td>
<td>0.8 3</td>
</tr>
<tr>
<td>Multiple rail destination model</td>
<td>0.4 3</td>
</tr>
<tr>
<td></td>
<td>0.6 3</td>
</tr>
<tr>
<td></td>
<td>0.8 3</td>
</tr>
<tr>
<td>CBR contracting model</td>
<td>0.4 3</td>
</tr>
<tr>
<td></td>
<td>0.6 3</td>
</tr>
<tr>
<td></td>
<td>0.8 3</td>
</tr>
<tr>
<td>Baseline model, increasing returns to scale</td>
<td>0.4 3</td>
</tr>
<tr>
<td></td>
<td>0.6 3</td>
</tr>
<tr>
<td></td>
<td>0.8 3</td>
</tr>
</tbody>
</table>

Note: Baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. Multiple destination model allows rail to reach the Gulf, East, or West coasts, using the spot market. Crude-by-rail (CBR) contract model allows rail to reach a single destination and constrains rail to use 24-month ship-or-pay contracts. Increasing returns to scale model assumes pipeline cost has a constant elasticity of 0.59 with respect to capacity. Capacity $K$ and expected rail flows $E[Q_r]$ are in thousands of barrels per day (mbpd); $r_1$ is in units of $/bbl per mmbpd. All rows assume $r_0 = $11/bbl. See text for details.

expected rail flows is large, ranging from -0.87 to -1.49.\textsuperscript{54} The right-most column of table 4 compares these elasticities to those from counterfactual calculations of $dE[Q_r]/dr_0$ that hold pipeline capacity $K$ constant. Absent the response of pipeline capacity, CBR volumes are quite insensitive to changes in rail transportation costs: the elasticity of $E[Q_r]$ to $r_0$ is only -0.20. Thus, our results indicate that the main channel by which environmental regulation (or Pigouvian taxation) will reduce CBR volumes is substitution to investment in pipeline capacity.

Table 5 presents results from models allowing for multiple rail destinations, rail contracting, and pipeline economies of scale. We focus on the case with $r_1 = $3/bbl per mmbpd (rather than $r_1 = 0$) in order to obtain conservative estimates of $dK/dr_0$. When CBR can

\textsuperscript{54}The elasticity of $E[Q_r]$ with respect to $r_0$ decreases in the upstream supply elasticity because $E[Q_r]$ increases with the upstream supply elasticity.
flow to multiple destinations, the sensitivity of both pipeline capacity and expected rail flows to changes in $r_0$ is uniformly greater (by roughly 15%) than in the single-destination baseline model, reflecting the intuition discussed in section 2.3. When we require CBR to use 24-month ship-or-pay contracts, our estimates are substantially larger than in the baseline model: the estimated $dK/dr_0$ ranges from 61.1 to 74.8 mbpd per $/bbl, depending on the upstream supply elasticity. These increased magnitudes reflect the fact that requiring CBR to use ship-or-pay contracts makes CBR more similar to pipeline transportation, from the point of view of shippers. Thus, the effective elasticity of substitution between these two technologies is large in this model, at least locally to $r_0 = $11/bbl. Recall that the ship-or-pay contracting framework for CBR used in this model is likely too restrictive for shippers relative to rail contracts that are used in practice. Thus, we view our results from the CBR contracting model as an upper bound, and the results from the baseline model as a lower bound, on the effects of increasing $r_0$, conditional on the assumed parameter values and constant returns to scale in pipeline construction.

The bottom-most section of table 5 presents results that allow for increasing returns to scale in pipeline construction, using the baseline model for CBR flows. Here, the values of $dK/dr_0$ and $dE[Q_r]/dr_0$ are substantially amplified relative to the constant returns case, especially when the upstream supply elasticity for crude oil is 0.8.

Finally, we explore counterfactuals in which rail becomes prohibitively expensive, even for large crude oil price spreads. Figure 9 presents counterfactual capacities for DAPL as $r_0$ is increased from its baseline value of $11/bbl to an extremely high value of $50/bbl. For each assumed supply elasticity, capacity $K$ is concave in $r_0$, a consequence of the fact that as $K$ increases, larger and larger downstream prices are required to congest the pipeline, but the probability of these price realizations becomes lower and lower. Nonetheless, effectively removing rail from the option set has substantial effects on pipeline investment. Even when the supply elasticity is just 0.4 and there are no scale economies in pipeline construction, increasing the rail cost intercept to $r_0 = $50/bbl causes DAPL’s capacity to increase from 520 mbpd to 925 mbpd. With a supply elasticity of 0.8, DAPL’s capacity reaches 1,230 mbpd. These extrapolations should be interpreted with caution because increases in $K$ at large values of $r_0$ are governed by supply responses at very high oil prices, where the supply elasticity is likely lower than that within the span of the data (Smith and Lee, 2017).

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These counterfactuals implicitly assume that, as rail becomes prohibitively expensive, other alternative transportation modes such as trucks also become prohibitively expensive.
Figure 9: Counterfactual DAPL capacity vs rail cost intercept $r_0$.

Note: “Elasticity” refers to upstream crude oil supply elasticity. Calculations assume constant returns to scale in pipeline construction, $r_0 = $11/bbl, and $r_1 = $3/bbl per million bpd (mmbpd). Capacity is in thousands of barrels per day (mbpd). All calculations use the baseline model that allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. See text for details.

7 Conclusions

The development of the Bakken shale was associated with an unprecedented boom in crude-by-rail transportation. Since the late-2014 fall in oil prices, however, crude-by-rail volumes have fallen substantially. One interpretation of these recent shifts is that crude-by-rail was merely a transitory phenomenon, and that pipelines will henceforth convey nearly all overland crude oil flows. This paper emphasizes an alternative view of these events. We see the rise and fall of crude-by-rail volumes as underscoring the option value provided by rail transportation: rail enables shippers to vary shipment volumes and destinations in response to crude oil price shocks. This flexibility contrasts with pipelines that require long-term, binding ship-or-pay contracts in order to underwrite their large up-front costs. The model of pipeline investment versus railroad shipping that we develop in this paper illuminates why, even though rail volumes may ebb and flow over time, the existence of the rail option can durably reduce the incentive to invest in pipeline capacity. Moreover, calibration of our model to recent oil market data suggests that this effect is economically significant.

Even under conservative assumptions, our model implies that policies that increase crude-
by-rail’s cost by addressing its environmental and safety externalities will have substantial implications for pipeline investment. Clay et al. (2017) finds that railroad air pollution externalities alone exceed $2 per barrel shipped. Our results imply that, had policies caused rail transporters to internalize a $2/bbl externality at the time of DAPL’s investment decision, DAPL’s capacity would have been at least 64,000 bpd larger than its actual 520,000 bpd capacity. Under more aggressive but plausible assumptions on input parameters, the impact could have been greater than 150,000 bpd.

Finally, we believe that our model is the first to illustrate how the presence of a costly but flexible transportation option—crude-by-rail—adversely affects investment in infrastructure that requires large up-front commitments but has a relatively low amortized cost. The intuition and basic structure of our model readily apply to other settings involving tradeoffs between technologies that differ in the extent to which their costs are sunk versus variable. For instance, urban transportation planners must often choose whether to invest in dedicated light rail lines, which have large sunk costs that can translate to low per-passenger costs given sufficient ridership, or flexible bus networks. As another example, electricity is generated by both “baseload” plants (such as nuclear plants that have nearly zero marginal cost) and “peaker” plants that have low sunk but high marginal costs and can help serve stochastic electricity loads (Borenstein (2005)). Our model provides a framework that can be used to evaluate and intuitively understand how tradeoffs between these technologies are affected by factors such as relative costs, scale economies, and demand uncertainty.

References


Federal Register, “Control of Emissions of Air Pollution From Locomotive Engines and Marine Compression-Ignition Engines Less Than 30 Liters per Cylinder; Republication,” 2008.


A Additional results tables

Table 6: Components of $r_1$

<table>
<thead>
<tr>
<th></th>
<th>Freight</th>
<th>Tanker</th>
<th>Freight</th>
<th>Tanker</th>
</tr>
</thead>
<tbody>
<tr>
<td>STB Flows</td>
<td>1.36</td>
<td>4.50</td>
<td>(0.40)</td>
<td>(0.71)</td>
</tr>
<tr>
<td>EIA Flows</td>
<td></td>
<td></td>
<td>0.69</td>
<td>4.02</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.37)</td>
<td>(1.29)</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.17</td>
<td>0.61</td>
<td>0.06</td>
<td>0.27</td>
</tr>
<tr>
<td>Num. obs.</td>
<td>57</td>
<td>28</td>
<td>57</td>
<td>28</td>
</tr>
</tbody>
</table>

Regressions of freight rates and tanker lease rates onto total crude-by-rail flows, as measured using STB and EIA data. Freight rate data are monthly from January, 2011 to December, 2015, while tanker lease data are monthly from September, 2013 to December, 2015. Freight and tanker rates are scaled so that the units on the flow coefficients are dollars per bbl per million bbl per day.

Table 7: Expected margin for pipeline shippers: baseline model with alternative values for committed DAPL capacity $K_d$

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Implied average cost per bbl</th>
</tr>
</thead>
<tbody>
<tr>
<td>$r_1$</td>
<td>$K_d = 320$</td>
</tr>
<tr>
<td>$$/bbl / mmbbl/d$</td>
<td>$10.03$</td>
</tr>
<tr>
<td>0.4</td>
<td>$8.68$</td>
</tr>
<tr>
<td>0.6</td>
<td>$7.93$</td>
</tr>
</tbody>
</table>

Note: The actual DAPL tariff for ten-year committed shippers is between $5.50/bbl and $6.25/bbl. All rows assume $r_0 = $11/bbl. $r_1$ is in units of $/bbl per million bpd (mmbpbd). Baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. See text for details.
**Table 8:** Sensitivity of pipeline capacity and expected rail flow to the cost of crude-by-rail: baseline model with alternative values for committed DAPL capacity $K_d$

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Impacts of a change in $r_0$ on $K$ and $E[Q_r]$</th>
<th>Elasticity of $E[Q_r]$ w.r.t. $r_0$, $K$ fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$dK/dr_0$</td>
<td>$dE[Q_r]/dr_0$</td>
</tr>
<tr>
<td>Supply elasticity</td>
<td>$r_1$</td>
<td>$dK/dr_0$</td>
</tr>
<tr>
<td>Baseline model, DAPL capacity = 320 mbbl/d</td>
<td>0.4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.6</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
<td>3</td>
</tr>
<tr>
<td>Baseline model, DAPL capacity = 450 mbbl/d</td>
<td>0.4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.6</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
<td>3</td>
</tr>
<tr>
<td>Baseline model, DAPL capacity = 520 mbbl/d (main results in paper)</td>
<td>0.4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.6</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
<td>3</td>
</tr>
<tr>
<td>Baseline model, DAPL capacity = 570 mbbl/d</td>
<td>0.4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.6</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
<td>3</td>
</tr>
</tbody>
</table>

Note: All rows assume constant returns to scale in pipeline construction and that $r_0 = $11/bbl. Capacity $K$ and expected rail flows $E[Q_r]$ are in thousands of barrels per day (mbpd). $r_1$ is in units of $/bbl per mmbpd. Baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. See text for details.
### Table 9: Expected margin for pipeline shippers: baseline model with alternative values for price volatility and supply uncertainty

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Implied average cost per bbl</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Supply elasticity $/bbl / mmbbl/d</td>
</tr>
<tr>
<td></td>
<td>0.4</td>
</tr>
<tr>
<td></td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td>0.8</td>
</tr>
</tbody>
</table>

Note: The actual DAPL tariff for ten-year committed shippers is between $5.50/bbl and $6.25/bbl. All rows assume $r_0 = $11/bbl. $r_1$ is in units of $/bbl per million bpd (mmbblpd). Baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. Baseline volatility uses Brent history of long differences. High volatility case uses Brent history of one-month differences, extrapolated to longer time horizons under a random walk assumption. Low volatility case uses 18-month implied volatility in June, 2014, extrapolated to longer time horizons using a random walk assumption. Supply uncertainty case uses baseline price volatilities and an uncertain intercept for the upstream oil supply function. See text for details.
**Table 10:** Sensitivity of pipeline capacity and expected rail flow to the cost of crude-by-rail: baseline model with alternative values for price volatility and supply uncertainty

<table>
<thead>
<tr>
<th>Input parameters</th>
<th>Impacts of a change in $r_0$ on $K$ and $E[Q_r]$</th>
<th>Elasticity of $E[Q_r]$ w.r.t. $r_0$, $K$ fixed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supply elasticity</td>
<td>$dK/dr_0$</td>
<td>Elasticity of $E[Q_r]$ w.r.t. $r_0$, $K$ fixed</td>
</tr>
<tr>
<td>Baseline model, baseline volatility (main results in paper)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.4</td>
<td>3</td>
<td>35.8</td>
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<tr>
<td>0.6</td>
<td>3</td>
<td>42.5</td>
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<tr>
<td>0.8</td>
<td>3</td>
<td>49.8</td>
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<tr>
<td>Baseline model, high volatility case</td>
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<tr>
<td>0.4</td>
<td>3</td>
<td>40.9</td>
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<td>0.6</td>
<td>3</td>
<td>51.9</td>
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<td>0.8</td>
<td>3</td>
<td>62.3</td>
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<tr>
<td>Baseline model, low volatility case</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.4</td>
<td>3</td>
<td>34.2</td>
</tr>
<tr>
<td>0.6</td>
<td>3</td>
<td>36.6</td>
</tr>
<tr>
<td>0.8</td>
<td>3</td>
<td>41.2</td>
</tr>
<tr>
<td>Baseline model, baseline price volatility with supply uncertainty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.4</td>
<td>3</td>
<td>37.0</td>
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<td>0.6</td>
<td>3</td>
<td>43.3</td>
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<td>0.8</td>
<td>3</td>
<td>50.3</td>
</tr>
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Note: All rows assume constant returns to scale in pipeline construction and that $r_0 = $11/bbl. Capacity $K$ and expected rail flows $E[Q_r]$ are in thousands of barrels per day (mbpd). $r_1$ is in units of $/bbl per mmbpd. Baseline model allows rail to reach a single destination (Gulf Coast) and allows rail transport to proceed on a spot market. Baseline volatility uses Brent history of long differences. High volatility case uses Brent history of one-month differences, extrapolated to longer time horizons under a random walk assumption. Low volatility case uses 18-month implied volatility in June, 2014, extrapolated to longer time horizons using a random walk assumption. Supply uncertainty case uses baseline price volatilities and an uncertain intercept for the upstream oil supply function. See text for details.
B Estimation of downstream oil price distributions

B.1 Brent oil price volatility

In our baseline specifications, we estimate the volatility of the future downstream oil price that will be realized by pipeline shippers at each time horizon $t$ by estimating the historic long-run volatility of the Brent crude spot price. To do so, we estimate the standard deviation of $t$-month long differences in logged monthly Brent prices, for $t \in [37, 156]$. For instance, the standard deviation of 37-month differences in log(price) yields the expectation, taken at the time of commitment (June, 2014), of price volatility in the first month of pipeline service. 13-year differences yield expected price volatility in the month in which the 10-year shipping commitments expire.

We calculate price volatilities for all horizons using Brent price data from May, 1996 (the first observation for which a 13-year lag is available in the data) through May, 2014 (the last full month before shippers committed to DAPL). We find that uncertainty over the future price of Brent increases substantially over the 3-year to 13-year horizon, from a volatility of 45% at 37 months to 129% at 13 years. Figure 10 presents the full sequence of these baseline volatilities from 37-month to 13-year horizons.\footnote{Volatility in figure 10 does not monotonically increase with the time horizon due to finite sample variation in the Brent price history. Noise in the relationship between volatility and time horizon is effectively averaged out when the pipeline investment model calculates the expected return to pipeline shippers over the full duration of their 10-year commitments.}

Our second approach to estimating the price volatility faced by shippers uses implied volatilities from crude oil futures options, as in Kellogg (2014). This approach allows shippers’ volatility expectations in June, 2014 to differ from the long-run historical average. Implied volatility data for time horizons of up to 18 months are available from the EIA via its monthly Short Term Energy Outlook; futures options are generally not liquidly traded at longer time horizons. The 18-month future price volatility in June, 2014 was 19.7%; we extrapolate this volatility through the 13-year pipeline horizon under the assumption that oil prices follow a random walk, so that volatility increases with the square root of the time horizon. Because the June, 2014 18-month implied volatility is much smaller than the historical average 18-month volatility from our baseline forecast (45.6%), this approach produces lower price volatilities throughout the ten-year pipeline contract than does our baseline method, as shown in figure 10. We interpret the volatilities from this method as plausible lower bounds, since they assume that volatility (at any horizon) will not eventually revert back up to its long-run mean after June, 2014. This assumption is strong: when we estimate a GARCH(1,1) model on the monthly return on Brent spot prices, we find evidence of substantial historic mean reversion of volatility to its long-run average.\footnote{Our GARCH model assumes an AR1 process for Brent monthly returns, which is sufficient to eliminate serial correlation in the residuals (at up to six lags using Breusch-Godfrey tests). A GARCH(1,1) is then sufficient to eliminate one lag of serial correlation in the unexplained variance of the residuals.}

The estimated GARCH equation (combining the ARCH and GARCH terms) is $V_t = 0.0071 + 0.0733V_{t-1}$, where $V_t$ is variance in month $t$. The coefficients imply a long-run one-month volatility of 9.1% (naturally close to the historic one-month average volatility of 9.3% in our baseline forecast),\footnote{We obtain 9.1% as 100 * (exp(\sqrt{0.0071/(1-0.0733)}) - 1).} and the small coefficient on $V_{t-1}$ implies rapid reversion back to this long-run volatility.
Figure 10: Brent price volatility estimates at horizons up to 13 years

Note: Baseline volatilities are calculated from standard deviations of long differences in historic logged Brent crude prices. Lower bounds are calculated by extrapolating the June, 2014 18-month implied volatility to longer time horizons assuming a random walk. Upper bounds are calculated by extrapolating the historic Brent one-month volatility to longer time horizons assuming a random walk. Volatilities in percent are calculated for each horizon by exponentiating the standard deviation, subtracting one, and multiplying by 100. See text for details.

mean after a volatility shock. For instance, if volatility at \( t = 0 \) were 4.0%, volatility would reach 9.1% by only \( t = 2 \).

Finally, to generate an upper bound on downstream price volatility, we take the long-run historic one-month horizon Brent volatility (9.3%) and extrapolate it via the square root of the time horizon. Because the empirical relationship between historic volatility and the time horizon increases at a rate less than that from the square root assumption (as is apparent in figure 10), the volatilities from this final approach are larger than our baseline volatilities.

B.2 Estimation of downstream price distribution for rail shippers

We non-parametrically estimate the conditional density \( f(D \mid P_d) \) in two steps. First, we estimate \( Z(P_d) = \Pr(D = 0 \mid P_d) \), the probability that \( P_d \) is the best downstream rail destination. We estimate \( \Pr(D = 0 \mid P_d) \) by running a locally quadratic regression of an indicator for whether \( D \) is zero onto \( P_d \).\(^{59}\) Second, we estimate \( f(D \mid P_d, D > 0) \), using local linear conditional density estimation methods in Hyndman and Yao (2002).\(^{60}\) Subsequently, in our simulations we compute realizations of \( \tilde{P} \), conditional on \( P_d \), by taking binomial draws

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59We use the nprobust R package, provided by Calonico, Cattaneo and Farrell (2017).
60We use the hdrcde R package.
Figure 11: Conditional distribution of downstream prices

(a) Probability that \( D = 0 \), Conditional on LLS

<table>
<thead>
<tr>
<th>Probability</th>
<th>LLS Price ($/bbl)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0</td>
<td>25</td>
</tr>
<tr>
<td>0.2</td>
<td>50</td>
</tr>
<tr>
<td>0.4</td>
<td>75</td>
</tr>
<tr>
<td>0.6</td>
<td>100</td>
</tr>
<tr>
<td>0.8</td>
<td>125</td>
</tr>
</tbody>
</table>

(b) Density of \( D \) Conditional on LLS, \( D > 0 \)

Source: Bloomberg, Platts, Genscape. \( D \) is the difference between the highest rail netback and the LLS rail netback. Solid lines indicate conditional means. In panel (a), dashed lines indicate 95% confidence intervals. In panel (b), dashed lines indicate the 2.5% and 97.5% quantiles of the estimated conditional density.

with probability \( Z(P_d) \). If a draw equals zero, we assign rail shipments to LLS and pay them the LLS netback \( P_d - r_{0,d} \). If a draw equals one, we take a draw of \( D \) from \( f(D | P_d, D > 0) \) and pay rail shipments that draw plus the LLS netback.

Figure 11 shows the estimated conditional distribution of \( D \) given \( P_d \). Panel (a) shows that the probability that \( P_d \) is the best rail destination is generally increasing in \( P_d \), though there is a departure from monotonicity when LLS prices are between $90–$105 per barrel. LLS prices in this range occurred frequently during 2011–2014, and rarely before. For the 20 or so years prior to 2011, Brent usually traded at discount to LLS of a few dollars per barrel. Starting in 2011, however, this discount frequently became a premium, sometimes by as much as $10 per barrel.\(^{61}\) Thus, despite high LLS prices, prices on the East Coast were even higher, and by an amount that exceeded the difference in shipping costs. This pattern largely ceased with the relaxation of the U.S. crude oil export ban in January 2015.

Panel (b) of figure 11 shows the density of \( D \), conditional on \( D > 0 \) and \( P_d \). For most values of \( P_d \), this density is concentrated around just a few dollars per barrel, with a downward trend in the mode except at values of \( P_d \) in excess of roughly $80/bbl.

\(^{61}\)See, for example Blas (2013) and Hunsucker (2013).
Equilibrium in the pipeline investment model when rail can flow to multiple destinations

As in section 2.1, define $P_p(K)$ as the minimum $P_d$ such that the pipeline is full. Again, we have $P_p(K) = S(K)$. Similar to section 2.1, define $P_r(K)$ as the minimum $\tilde{P}$ such that rail is used. Again, we have $P_r(K) = S(K) + r_0$.

We now derive the equilibrium relationship governing the pipeline capacity built. As before, the marginal committed shipper must pay $C(K)/K$ regardless of the realization of $P_d$ or $\tilde{P}$. By committing, the pipeline shipper can again earn returns in two states of the world: (1) the pipeline is full but no rail is used; and (2) the pipeline is full and rail is being used.

If the pipeline is full but rail is not used, the upstream price is simply given by $P_p(K)$, and shippers earn $P_d - P_p(K)$. This situation occurs when $P_d \geq P_p(K)$ and $\tilde{P} \leq P_r(K)$. Thus, the expected value for committed shippers that accrues when the pipe is full but rail is not used is given by:

$$\int_{P_p(K)}^{\tilde{P}} \left[ \int_{P_d}^{P_r(K)} (P_d - P_p(K)) f(\tilde{P} \mid P_d) d\tilde{P} \right] f(P_d) dP_d. \quad (8)$$

When rail is used (and the pipeline is therefore full), the upstream price is given by $S(K + Q_r(\tilde{P}))$, and pipeline shippers earn $P_d - S(K + Q_r(\tilde{P}))$. This situation occurs when $P_d \geq P_p(K)$ and $\tilde{P} \geq P_r(K)$. Thus, the expected value for committed shippers that accrues when rail is used is given by:

$$\int_{P_p(K)}^{\tilde{P}} \left[ \int_{P_r(K)}^{\tilde{P}} (P_d - S(K + Q_r(\tilde{P}))) f(\tilde{P} \mid P_d) d\tilde{P} \right] f(P_d) dP_d. \quad (9)$$

Equilibrium capacity $K$ is therefore given by equation (10), which collapses to the single-destination equilibrium equation (1) if $\tilde{P}$ is always equal to $P_d$.

$$\frac{C(K)}{K} = \int_{P_p(K)}^{\tilde{P}} \left[ \int_{P_d}^{P_r(K)} (P_d - P_p(K)) f(\tilde{P} \mid P_d) d\tilde{P} \right] f(P_d) dP_d$$

$$+ \int_{P_p(K)}^{\tilde{P}} \left[ \int_{P_r(K)}^{\tilde{P}} (P_d - S(K + Q_r(\tilde{P}))) f(\tilde{P} \mid P_d) d\tilde{P} \right] f(P_d) dP_d. \quad (10)$$

For a given capacity $K$, each term on the right-hand side of equation (10) will be smaller than the corresponding term on the right-hand side of equation (1). Thus, the equilibrium pipeline capacity in the presence of multiple rail destinations will be smaller than the case in which rail can only serve a single destination.
We now apply the implicit function theorem to determine $dK/dr_0$:\(^{62}\)

$$
\frac{dK}{dr_0} = \frac{\int_{P_p(K)}^{P} \left[ \int_{P_d}^{P_r(K)} \left( 1 - \frac{r_1}{S'(K+Q_r(P))} \right) f(P) dP \right] f(P) dP}{\int_{P_p(K)}^{P} \left[ \int_{P_d}^{P_r(K)} S'(K) f(P) dP \right] f(P) dP + \int_{P_p(K)}^{P} \left[ \int_{P_d}^{P_r(K)} \frac{r_1 S'(K+Q_r(P))}{S'(K+Q_r(P)) + r_1} f(P) dP \right] f(P) dP}
$$

(11)

The most important difference between equations (11) and (2) is that the presence of multiple rail destinations decreases the probability that the pipe is full but rail is not used. This change causes the second term in the denominator of (11) to be smaller than the corresponding term in (2), thereby increasing the sensitivity $dK/dr_0$ of pipeline capacity to the cost of rail transport.\(^{63}\)

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\(^{62}\)Note that the terms involving $P_p(K)$ are equal to zero, and the terms involving $P_r(K)$ cancel.

\(^{63}\)When $r_1 > 0$ the impact of multiple rail destinations on the final terms in the numerator and denominator of equation (11) is ambiguous, so that the overall comparison of $dK/dr_0$ between equations (11) and (2) is also ambiguous. Nonetheless, we find in practice that $dK/dr_0$ is larger when we evaluate our model allowing for crude-by-rail to flow to multiple destinations.
D Derivation of the destination share model with rail contracting

Recall that the contract model is:

\[ R_{i,t+1} = \left( sR_{i,t} \right) \left( M_{t+1} - s \sum_j R_{j,t} \right) + q_{i,t+1} \]

old flows still contracted

new flows available to be contracted

To turn this into an estimable expression, first define an accounting identity for \( R_{0,t+1} \), the quantity of “outside” flows (via pipeline to Cushing) at time \( t + 1 \):

\[ R_{0,t+1} = M_{t+1} - \sum_i R_{i,t+1} \]

\[ = M_{t+1} - \sum_i (sR_{i,t} + q_{i,t+1}(M_{t+1} - s \sum_j R_{j,t})) \]

\[ = M_{t+1} - \sum_i (sR_{i,t} + q_{i,t+1}(M_{t+1} - s(M_t - R_{0,t}))) \]

\[ = M_{t+1} \left( 1 - \sum_i q_{i,t+1} \right) - s \sum_i (R_{i,t} - q_{i,t+1} (M_t - R_{0,t})) \]

\[ = M_{t+1} \left( 1 - \sum_i q_{i,t+1} \right) - s \sum_i R_{i,t} + s (M_t - R_{0,t}) \sum_i q_{i,t+1} \]

\[ = M_{t+1} \left( 1 - \sum_i q_{i,t+1} \right) - s (M_t - R_{0,t}) + s (M_t - R_{0,t}) \sum_i q_{i,t+1} \]

\[ = M_{t+1} \left( 1 - \sum_i q_{i,t+1} \right) - s (M_t - R_{0,t}) \left( 1 - \sum_i q_{i,t+1} \right) \]

\[ = (M_{t+1} - s (M_t - R_{0,t})) \left( 1 - \sum_i q_{i,t+1} \right) \]

This expression relates outside flows in period \( t + 1 \), \( R_{0,t+1} \), to “available” production and the share of it that is not contracted.

Also recall that we have assumed shares are given by a logit random utility model:

\[ q_{it} = \frac{\exp(X_{it} \beta + \delta_i)}{1 + \sum_j \exp(X_{jt} \beta + \delta_j)} \].

By the standard properties of these models, the outside share in the expression for outside flows above is \( (1 - \sum_j q_{j,t+1}) = \frac{q_{i,t+1}}{\exp(X_{i,t+1} \beta + \delta_i)} \) for any choice \( i \).
We can use these relationships to write an estimable version of the contracting model:

\[
R_{i,t+1} = sR_{i,t} + q_{i,t+1}(M_{t+1} - s \sum_j R_{j,t}) \\
= sR_{i,t} + q_{i,t+1}(M_{t+1} - s(M_t - R_{0,t})) \\
= sR_{i,t} + q_{i,t+1} \frac{R_{0,t+1}}{1 - \sum_j q_{j,t+1}} \\
= sR_{i,t} + R_{0,t+1} \exp (X_{i,t+1} \beta + \delta_t)
\]
E  Numerical implementation of pipeline investment model

This appendix provides details on how the pipeline investment model presented in section 2 is implemented numerically. We begin with the baseline model and then discuss the models involving multiple railroad destinations and railroad contracting.

E.1 Baseline model

The primary output of the model is a calculation of the expected return to pipeline shippers over the duration of a ten-year shipping commitment, given input parameters. This calculation, which then feeds into a calculation of the derivative $dK/dr_0$, proceeds using four broad steps:

1. For each month $t$ of the commitment period, derive the upstream oil supply curve and compute $P_p(K)$ and $P_r(K)$, the minimum downstream prices $P_d$ at which the pipeline is full and rail is used, respectively.

2. For each $t$ and for each realization of $P_d$, calculate pipeline flows, rail flows, and the pipeline shipping margin $P_d - P_u$.

3. For each $t$, calculate the expected return at $t$ using the shipping margins calculated in step 2 and the distribution $f_t(P_d)$.

4. Compute the overall expected return to committed shippers across all $t$.

At each $t$, we compute the upstream supply curve intercept using the assumed value for the supply elasticity, the June, 2014 expectation of a long-run $99.19/bbl oil price, and the NDPA oil production forecast for month $t$. $P_p(K)$ at $t$ is then given by the upstream inverse net supply curve for oil at an output level equal to the pipeline capacity $K$.\footnote{Net” supply is net of local refining capacity of 88 mbpd.} $P_r(K)$ is then given by $P_p(K) + r_0$.

Given a value $P_d$, pipeline flows $Q_p$ are either $K$ if $P_d \geq P_p(K)$ or given by the upstream net supply curve at $P_d$ for $P_d < P_p(K)$. Rail flows $Q_r$ are zero if $P_d \leq P_r(K)$. Otherwise, $Q_r$ is the solution to $S_t(K + Q_r) = P_d - r_0 - r_1 Q_r$, which is analytic for $r_1 = 0$ or can otherwise be easily solved numerically. The margin for pipeline shippers is then $P_d - S_t(Q_p + Q_r)$.

In commitment month $t$ (where $t$ ranges from 37 months to 156 months), the standard deviation of the lognormal distribution $f_t(P_d)$ is calculated as discussed in section 3.2. $E[P_d]$ is $99.19/bbl for all $t$. The expected margin for pipeline shippers in month $t$ is then the integral of $P_d - S(Q_p + Q_r)$ over $f_t(P_d)$. We compute the integral using Simpson’s Rule with 1000 nodes.\footnote{We distribute the nodes evenly over the unit interval and then map the nodes to $\mathbb{R}^+$ using an inverse lognormal distribution that has a standard deviation given by the standard deviation of $f_t(P_d)$ at the end of the shipping commitment period (month 156). We drop the last node, which has $P_d \rightarrow \infty$. We use Simpson’s Rule rather than quadrature so that the nodes on $P_d$ are the same for all $t$ even as the standard deviation of $f_t(P_d)$ varies, saving computation time.}
Finally, to obtain the expected return over all $t$ we multiply each expected return by the discount factor $\delta^t$, sum over these products, and then divide by the sum of the $\delta^t$. $\delta$ is based off an annual discount rate of 0.1 (Kellogg, 2014), so that $\delta = 1/(1.1^{1/12})$.

To calculate the derivative $dK/dr_0$, we increment $r_0$ by $0.10/bbl and solve for the new equilibrium pipeline capacity $K$ such that the pipeline’s average cost equals the expected shipping margin. Let $M_0$ denote the expected margin we calculate for the true DAPL and total export capacities, denoted by $K_{d0}$ and $K_0$, respectively (i.e., $M_0$ denotes the values presented in table 3). Assuming that pipeline construction has no scale economies, the average cost is constant at $M_0$ regardless of the new capacity $K$. Otherwise, given a guess of $K$, the average cost is given by $((K - K_0 + K_{d0})/K_{d0})^{e_c-1}$, where $e_c$ is the elasticity of the pipeline’s total cost with respect to capacity. The calculation of the expected pipeline shipping margin given $K$ and the incremented $r_0$ proceeds as discussed above. For the parameters used in our calibration, the expected shipping margin decreases more quickly with $K$ than does average cost, so that it is straightforward to solve numerically for the unique $K$ that satisfies equilibrium at the incremented $r_0$. We repeat this process for a decrement of $r_0$ by $0.10/bbl and then obtain $dK/dr_0$ using a two-sided derivative.

E.2 Multiple destination model

When rail can flow to multiple destinations, the only change from appendix E.1 is to the calculation of $Q_r$. Rail earns the downstream price $\tilde{P}$, which is distributed on $f(\tilde{P} | P_d)$. Whenever $\tilde{P} > P_r(K)$, $Q_r$ is then the solution to $S(K + Q_r) = \tilde{P} - r_0 - r_1Q_r$. Otherwise, $Q_r = 0$. For each $P_d$, we then compute the expected return to pipeline shippers by integrating the pipeline shipping margin $P_d - S(Q_p + Q_r)$ over the distribution $f(\tilde{P} | P_d)$.

E.3 Railroad contracting model

When rail flows on 24-month contracts, as discussed in section 4.3, several changes are required to our computations. We now proceed as follows:

1. Compute $P_p(K)$ as in appendix E.1.

2. Within each 24-month rail contract cycle, and given a rail contract volume $K_r$, compute rail flow $Q_r$ and the expected shipping margin for each value of $P_d$.

3. At the start of a 24-month cycle, and at each initial downstream price $P_d$, compute the equilibrium volume of rail contracts $K_r$ and the expected margin for shippers over the life of the rail contract.

4. Compute the overall expected return to pipeline shippers across all five rail contract cycles.

Within each month $t$ of a 24-month cycle, and given capacities $K$ and $K_r$, there is a critical price $P_c(K, K_r) = S_t(K + K_r)$ such that the pipe is full and all contracted rail capacity is used. Whenever $P_d > P_c(K, K_r)$, the margin earned by both pipeline and rail shippers is simply $P_d - P_c(K, K_r)$, pipeline flows $Q_p$ equal $K$, and rail flows $Q_r$ equal $K_r$. If $P_d \in [P_p(K) + r_0, P_c(K, K_r)]$, then the shipping margin is zero, $Q_p = K$, and $Q_r$ is the
solution to $S_t(K + Q_r) = P_d$. And if $P_d \leq P_p(K)$, then the shipping margin is zero, $Q_p$ is given by $S_t(Q_p) = P_d$, and $Q_r = 0$.

Just before a 24-month cycle, rail shippers will commit to an equilibrium capacity $K_r$ such that the marginal capacity cost $r_0 + r_1 K_r$ equals the expected shipping margin over the 24 months, given an initial price $P_d$ that is observed when the contracts are signed. Given $P_d$ and a guess of $K_r$, calculation of this expected margin follows steps 3 and 4 discussed in appendix E.1, but using $f_t(P_d)$ for $t \in [1, 24]$, the expected supply intercepts corresponding to the 24 months of the cycle, and margins obtained via the calculations discussed in the above paragraph. Because the expected margin over the 24-month contract strictly decreases in $K_r$, we can solve for the unique $K_r$ that satisfies the equilibrium condition at each initial price $P_d$.

There are five rail contracting cycles over the life of pipeline shippers’ 10-year commitment. The present value (at the pipeline commitment date) of the expected margin for a cycle beginning at date $t$ is given by the integral of the expected margins obtained in step 3 over the distribution of initial prices $f_t(P_d)$, multiplied by the discount factor $\delta^t$. We then sum these margins across the five cycles and divide by the sum of the $\delta^t$. 