

Stranded Gas Hearings (0407281445 Minutes)

Access Under Current Law vs. Access Under Proposed Changes to Federal Law

Robert "Bob" Loeffler, Senior Partner, Morrison & Foerster, for Dept. of Law, July 28, 2004.

MR. ROBERT H. LOEFFLER, Morrison and Foerster LLP, gave the following testimony.

In my June 2004 testimony to the committee, I discussed the general methodology and standards that the FERC utilizes to set gas pipeline rates. Mr. Ives of the Lukens Group discussed access issues associated with initial pipeline capacity, in particular FERC's open season process. Today I want to address another pipeline issue that looms potentially large and important, namely, the law that governs expansions of an Alaska Gas Pipeline after it is initially sized and built. I will first address the law on expansion as it stands today and then turn to the provisions of the Energy Act of 2003 that for the first time gave the FERC the power to order expansion.

Based on information provided in the various Stranded Gas Act applications, the Alaska Gas Pipeline could be sized to carry anything from 2.6 to 5 BCF per day, with expansion capability designed in of up to 6 BCF. Any expansion would be accomplished not by replacing the original pipe with larger diameter pipe, but rather by adding additional compression – that is additional compressors at existing stations or building new compressor stations – and/or looping. That is adding smaller diameter pipe parallel to the main pipe in particular places. The question is whether the Alaska Gas Pipeline owners can be forced to expand the pipeline in the event they do not voluntarily agree to do so. Under current law, the short answer is no. Let me explain that.

We have to turn to the Natural Gas Act [NGA] and it does not use the word expansions. Instead, it prohibits enlargements but gives the FERC the authority to order extensions. Simply stated, while the FERC has the power to order extensions or improvements, it does not have the power to order enlargements to pipeline facilities.

What's the difference? It turns out there's no bright line, but the courts and the FERC have interpreted this language in a manner that treats expansions as prohibited enlargements. It took awhile after the act was passed in 1938 for the courts to get to this and by 1949 the courts were saying, literally, the act nowhere defines these terms and it's somewhat baffling to determine when and under what circumstances an extension or improvement of facilities ceases to be such and becomes enlargement.

The commission could see that in court way back in 1949 that it does not have the authority to compel enlargement by a natural gas company of a pipeline. Yet I think the language of the court is instructive. It says in light of section 7(a), we are compelled to conclude that Congress meant to leave the question whether to employ additional capital enlargement of its pipeline facilities to the unfettered judgment of the stockholders and directors of each natural gas company involved. So, what you're dealing with is really the belief that private people are building a project and you cannot force them to put more money into a project if they don't want to. And that really is the standard under existing law.

Very recently the commission reaffirmed this position and said it has the authority to order a pipeline to construct new interconnects or [indisc.] connections are made, but it also said that it cannot compel pipelines to expand capacity on their systems. Interconnects are literally the physical connection between two pipelines - if you wanted a lateral coming in or a lateral going off – that's an interconnect. And even there where it does have authority to order interconnects, the commission said in this particular case, 'The Commission emphasizes that this new policy, which relates only to the construction of new interconnections, does not require a pipeline to expand its facilities, to construct any facilities leading up to an interconnection, or even to construct the interconnection itself....' This modified interconnection policy seeks only to ensure that when pipelines respond to requests for interconnections, they do so in a manner that causes no undue

discrimination and furthers the commission's policies favoring competition across the national pipeline grid.

Well, in short, a state and any private party who wanted expansion would be in a tough position to rely on the existing law to get an Alaska gas pipeline expanded by the FERC. The good news is that Section 375 of the so-called Alaska Natural Gas Pipeline Act, which is the subtitle of the Energy Policy Act of 2003, would grant the FERC the authority to order expansions subject to certain conditions. The bad news, of course, is the legislation is languishing in Congress.

Section 375, if it becomes law, would be the first time the FERC has been given the power to order expansion for any pipeline. This represents the recognition by Congress of the unique circumstances of an Alaska gas pipeline, and namely that it is likely to be the only road to market for North Slope resources. This provision was fashioned after much discussion and compromise of present and future North Slope producers, pipeline owners in the Lower 48, would-be pipeline owners of Alaska and the State of Alaska. Some urged that the FERC be given greater powers for expansion; others urged that there be no change at all. As you will see by reading the language, FERC's new powers do not extend to interstate gas pipelines in the Lower 48. This is a solution for an Alaska gas pipeline and only for that pipeline.

I'm going to quickly go through critical terms. The way it works is that one or more people would have to request the FERC to order the expansion of the pipeline. Before it could do so, it would have to satisfy eight conditions and they're stated at page 8 of my testimony. The first condition deals with the rates – will they be rolled in or incrementally priced for expansion - make sure rates do not require existing shippers to subsidize expansion – find that a proposed shipper will comply with the tariff that exists as of the date of the expansion – find that the proposed facilities will not adversely affect the financial viability of the project – find that the proposed facilities will not adversely affect the overall operations – find that the proposed facilities will not diminish the contract rights of existing shippers to previously subscribed capacity – ensure that all necessary environmental reviews have been completed – and find that adequate downstream facilities exist outside of Alaska to deliver the Alaska natural gas.

Now I want to comment on some of the details of these provisions that could affect the issues the committees are concerned with. The language of this new provision does not mandate how expansion capacity will be priced by the FERC. It gives the FERC power to use either rolled in price treatment or incremental price treatment. This is an issue of consequence to unaffiliated explorers because they want to know what the cost of transportation on an expanded pipeline would be.

A parallel provision requires that the rates for expansion capacity not require that existing shippers subsidize expansion shippers. Of course, what's a subsidy rise in the eye of the beholder? In some circles what is called a subsidy is viewed as an entitlement or a natural right by others.

Today, under existing law, the FERC has a clear policy on how expansion should be priced. It's changed its policy a number of times but its most current policy is that an expansion should be paid for by those demanding the expansion unless there is a system-wide benefit. A system-wide benefit would mean that when the costs of the expansion are rolled into the existing costs of operation, the costs of transportation for all is lowered. This is technically possible in some circumstances depending on engineering and throughput matters. If, however, the average transportation cost increases due to the expansion, then the expansion shippers, under current policy, would pay a different and higher rate to ship on expansion space. The rationale, simply put, is that those who cause the expansion should pay for it. Informed observers have noted that there is a 'heads I win, tails you lose' aspect to this policy. If expansion lowers the cost per unit for everyone, then those causing an expansion lose that benefit to the system as a whole. If, on the other hand, expansion costs are higher per unit than they were before, the expansion shippers

are forced to bear the higher cost. Time will tell how this works out on an Alaska gas pipeline and I repeat that the legislation tosses that issue back to the FERC saying it can use either incremental or rolled in pricing.

There are other limitations in Section 375 worthy of mention. Parties in the legislative process were concerned that expansion not affect the financial underpinnings of the project. Certainly the language in Section 375(b)(4) would give financial institutions, who presumably will loan vast sums for this project, a voice in any expansion proceedings at the FERC. Similarly, the rights of those who have already contracted to ship on the pipeline are not to be diminished by any mandated expansion. I suspect that this means, at least, that there cannot be any reduction in existing shippers' shares of initial capacity.

Two other aspects of Section 375 are worthy of comment. First, the FERC is required to examine whether there are adequate downstream facilities, mainly outside of Alaska, for new gas that would be shipped through the expanded facilities. This stands in marked contrast to the process spelled out for certificating the pipeline in the first place under this new statute. There Congress directs the FERC not to look at whether adequate downstream capacity exists, but to presume it. Second, subsection 375(c) requires that the party who requests an expansion at FERC execute a firm transportation agreement within a time to be set by FERC, a reasonable time, after an expansion order issues or lose the expansion rights. This, in plain language, is a put up or shut up clause. The expansion order becomes void unless the parties who sought the order sign a binding contract to ship on the expanded capacity.

There are other requirements in the proposed legislation concerning non-adverse findings on financial, economic, and operational grounds. On their face, these provisions appear to provide fertile ground for an opponent of expansion. They certainly invite litigation.

In the end, the proposed legislation allows, but does not mandate or require FERC to order an expansion. That's a better situation than the status quo but it's not perfect. I do not have to be a prophet to make the observation that in granting expansion rights to the FERC for, and only for, an Alaska Gas Pipeline, the legislation would lay a careful path with several potential hurdles to clear. How high those hurdles will be is left to the informed discretion of FERC. Based on everything else connected with this project, the first time around and again now, I would not expect the expansion proceeding to be short, uncomplicated, and uncostly. Nonetheless, the power to order expansion would exist for the first time. That alone will influence how parties approach expansion on a voluntary basis because the prospect of involuntary expansion lurks in the background.

I'm going to add a couple of points that are not in my prepared testimony that I thought would be of interest to the committee. If you recall, in June I commented on how the legislation would require the FERC to adopt quickly to situations that would govern open seasons on an Alaska Gas Pipeline. These regulations would not apply, that is they would not apply to any mandatory expansion of the pipeline. For reference, that's Section 373(e)(3). They would apply only to involuntary expansion of the pipeline. The rationale of Congress, I suspect, is that an expansion order would be sought by a specific shipper or group of shippers that had been unable to convince the pipeline to expand voluntarily. In those circumstances, those seeking expansion would have to convince the FERC to order this one-of-a-kind expansion and they would be responsible for signing binding contracts for the expanded capacity. Thus this appears to be a different kettle of fish than the normal allocation of capacity and open season process. FERC still might want to hold some kind of open season to see if anyone behind those seeking expansion also desire capacity in the event this pipeline is expanded. But it's not required to. It's [indisc.] from the normal open season requirements and we have to wait and see how the FERC interprets these provisions.

Second, the legislation also addresses access for in-state users. In Sections 375(g), Congress

requires the applicant for FERC authorization under the Natural Gas Act, to demonstrate that the holder has conducted a study of Alaska's in-state needs, including tie-in points along the Alaska natural gas transportation project for in-state access. I believe the state would expect the study to cover access at least two to three points along the pipeline route in Southcentral Alaska. Second, the special provision in Section 373 uses language that addresses access for royalty gas. That provision requires the FERC, after a hearing, to provide reasonable access to the State of Alaska for shipment of the state's royalty gas for the purpose of meeting local consumption needs within Alaska. The language is specially designed to ensure that Alaska royalty gas could be used for in-state needs. The absence of new federal legislation does not necessarily mean there will be no expansion requirements for an Alaska gas pipeline. As I indicated a few moments ago, the expansion language in the pending federal legislation reflected a consensus that was reached among interested parties. These parties thought they could live with the expansion concept in specific conditions attached there, too. It would appear there would be no insurmountable obstacle to interested parties contracting to the very same terms contained in the proposed legislation, or even different ones. It is a fair bet to say that the existence of the compromise language, whether adopted or not, will also provide a framework for voluntary expansion negotiations.

The ongoing Stranded Gas Development Act contracting process could serve as one vehicle to ink an expansion agreement. Another contracting opportunity will arise in the negotiations attendant to the various ownership agreements. If the state is not a pipeline owner, its interests will probably not be directly represented in those ownership negotiations.

Would FERC honor such contractual agreements? I see no reason why the FERC would reject an agreement that required the owners to seek expansion authorization from the FERC after negotiations in the event that certain agreed upon conditions or events were to occur. So long as FERC remained free to make its normal certificate inquiry about the public interest, I think it would likely applaud rather than disapprove a voluntarily reached expansion agreement.

That concludes my presentation. I appreciate the ability to do this by teleconference and I'd be happy to entertain any questions.

SENATOR WAGONER asked if there is any chance of action being taken on the Alaska Gas Pipeline Act before the November election.

MR. LOEFFLER said there is a slim chance it will be brought up as a rider or on a special basis, but only a slim chance.

SENATOR WAGONER asked his opinion of action after that time.

MR. LOEFFLER said he believes it will come up again in the same exact form because a lot of people worked long and hard to compromise and there is no known opposition to the enabling provisions that contain this expansion authority.

CO-CHAIR OGAN asked what the best-case scenario is.

MR. LOEFFLER said the best case would be if something happened before the November election. He believes it is much more likely that something will happen next Spring, but no one knows who the president will be or who will be in Congress.