Alaska Gas Pipeline
Building a Pipeline Tariff
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There are some general principles that apply to building a gas pipeline tariff. Over the years, there have been a number of different methodologies used to create gas pipeline tariffs in the United States and Canada. My testimony will focus primarily on a cost-of-service methodology which is the traditional form for a new long pipeline system with high risks. At the end of my testimony, I will discuss a couple of alternatives that could be utilized for a project such as the Alaska gas pipeline.

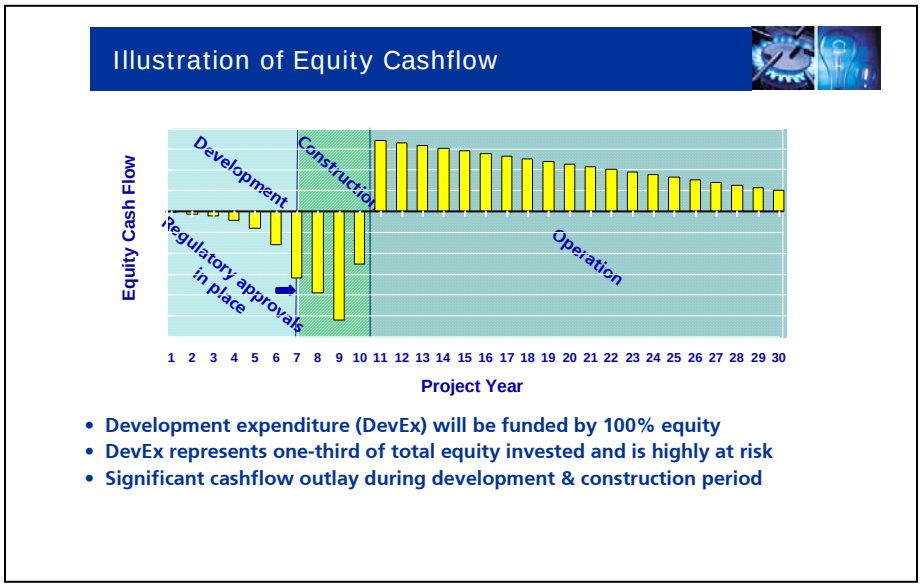
The initial pipeline from Alaska can be expected to remain regulated by U.S. and Canadian Governments. It will be highly capital intensive with route specific investments that cannot readily be redirected to serve other purposes. The inherent business risks for the pipeline include development risk, construction and completion risks, reserves risk, and credit risk. The pipeline will be a contract carrier that will assign its capacity to those shippers that execute contracts with the pipeline company. The terms of the pipeline's transportation contracts will also contain risks for the pipeline owners.

Pipeline regulation - Interstate pipelines in the United States are regulated by the Federal Energy Regulatory Commission (FERC) and inter-provincial pipelines in Canada are regulated by the National Energy Board (NEB) for commercial matters. These regulators determine the types and levels of tariffs which a pipeline company may charge its customers for the services it provides and also the terms and conditions of service. The approved tariffs and terms and conditions attempt to balance the interests of the shippers, consumers and the pipeline investors. The terms and conditions of service are an integral part of the tariff and must be considered in conjunction with the tariffs.

Natural gas pipelines are highly leveraged businesses with significant financial risk and lower business risk than many other large corporations. The debt capital to construct a pipeline is sourced from bond holders, banks or other debt instruments and the equity is cash contributed by investors/owners. The Alaska gas pipeline can be expected to commence operations with a high debt ratio in order to minimize the pipeline tariff. This level of debt will require a properly secured contract with low business risk. The proposed U.S. Energy Bill provisions for the Alaska project stipulate that the U.S. Government would provide loan guarantees for up to 80% of the capital cost of the project. Such a loan guarantee would assist the pipeline owners in obtaining the multibillion dollars in debt financing and improve the interest rate and loan terms to the benefit of all project stakeholders. In order to obtain financing, the pipeline must demonstrate the ability to make payments on its debt (both principal and interest)

generally through long-term shipping commitments from creditworthy customers and by meeting certain debt-service coverage covenants and other loan conditions.

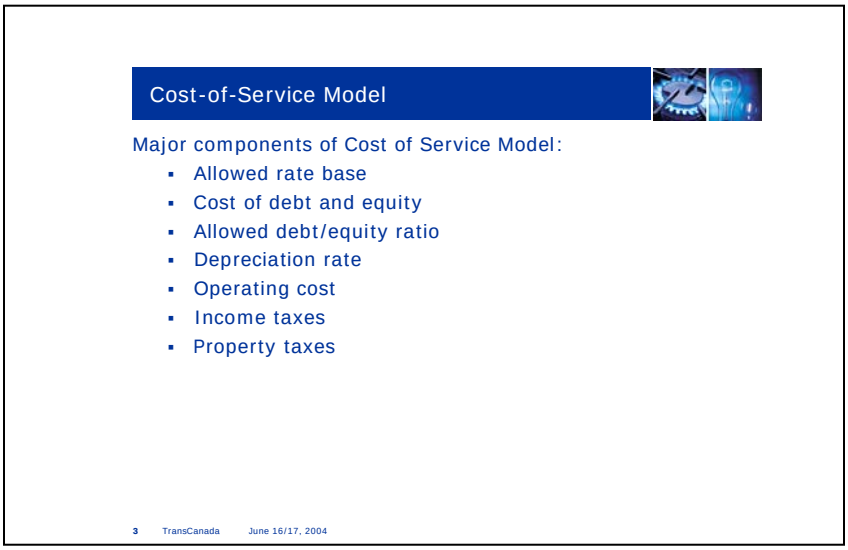
The equity cash flow schematic illustrates the risk capital advanced by equity investors early in the project and recovered over the life. Although the project will be highly leveraged with debt, it is the equity investors that advance their monies first in the riskiest portion of the project.



Most new pipelines in North America have been structured on a cost-of-service basis. The cost-of-service methodology allows the pipeline company to recover all prudently incurred costs for providing transportation service including a fair return on capital investment. This usually results in an efficient use of capital with the lowest possible tariffs. These low tariffs are achieved by minimizing the business risks to the pipeline company. The tariffs are subject to full discovery and are completely transparent to all stakeholders for each component of the cost of service.

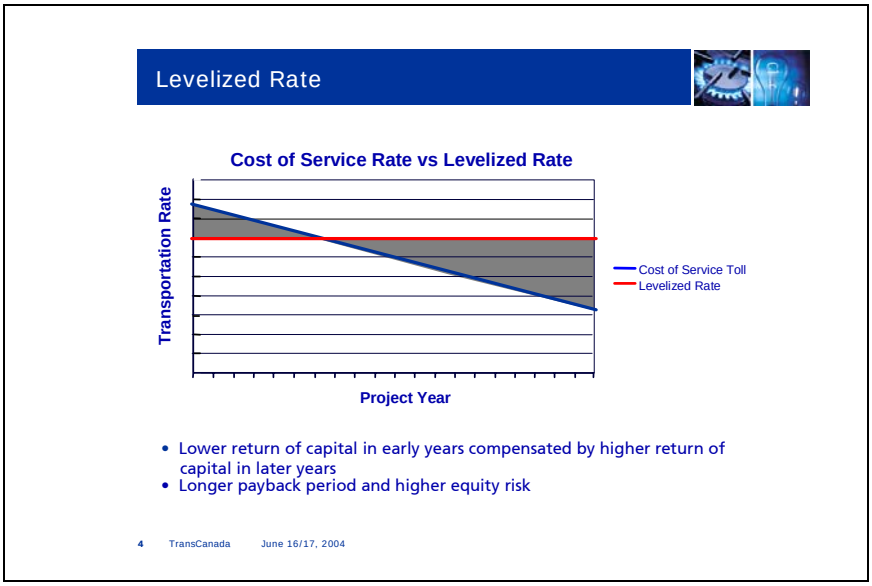
The cost-of-service model allows the pipeline company to recover its fixed costs in a demand charge to its customers (i.e., unrelated to the actual volumes transported on any particular day) and its variable costs through a commodity charge for actual volumes shipped. Fixed costs include debt, principal and interest, equity return of capital (depreciation), return on equity, income taxes, municipal or property taxes and operating costs for maintenance, staffing, and upkeep. Variable costs often include fuel usage for the compressors and other modest cyclical costs.

The major components of a cost-of-service model include the allowed rate base, the cost of debt and equity, allowed debt/equity ratio, depreciation rate, income taxes, property taxes and operating costs.



Cost of Service Components – The allowed rate base includes the total capital investments, net of accumulated depreciation, in pipeline infrastructure that were prudently incurred. The cost of debt and equity reflects the cost of borrowing; i.e., the interest rate on debt and the rate of return on equity commensurate with returns on investments of similar risk. The allowed debt/equity ratio is set to ensure the pipeline company is financially capable to meet all its debt obligations. Operating costs cover the annual operating and maintenance costs for the pipeline. Income and property taxes reflect the annual income taxes payable to federal state/provincial and municipal governments.

The depreciation rate normally reflects the economic life of the pipeline and it allows the recovery of capital (equity and debt) invested in the pipeline over that life. The traditional model had depreciation rates established on a straight line basis collecting an even amount of depreciation each year over the life of the project.



For large new pipelines that need to compete in the marketplace with existing infrastructure, depreciation rates are sometimes modified to levelize the overall tariff. This means a lower collection of depreciation in the early years of the project and a higher collection in the later years, much like a residential mortgage schedule for principal repayment. This method increases the risk for a pipeline company.

There are a number of other methodologies that have been used over the years instead of cost of service for gas pipelines. Forms of incentive regulation have been introduced that apply some degree of sharing between shippers and pipeline owners for both capital costs and operating costs, and occasionally debt costs. Other forms of negotiated rates include a fixed toll model with some or all of the components of cost of service fixed for the shipper for some period of time. This methodology provides toll certainty for the customer but significantly increases the risk for the pipeline company. Changes in inflation, interest rates, equity returns for investments of similar risk, capital cost overruns, or operating or tax variations may not be fully passed through to the customer as would be the case with a cost of service methodology.

There are merits to different tariff methodologies that can be considered for the Alaska gas pipeline by project stakeholders. A traditional cost-of-service methodology with terms negotiated between the pipeline company and its shippers and ultimately approved by regulators will usually result in the lowest tariff over the life of the project as it should have the lowest business risk for the pipeline company, assuming solid transportation contracts with strong creditworthy customers. However, this methodology increases the risk allocation for the shipper and may not provide the highest value to the shipper. If actual costs differ from estimated costs, then all these changes will be fully borne by the

customer. For example, with current interest rates at extremely low levels, an estimated cost-of-service tariff would likely use today's low interest rates. If the actual interest rates are several percentage points higher at the time the pipeline were actually financed, a cost of service methodology would ensure that 100% of those increased costs would be passed through to the customer in their tariff.

A fixed toll model or other incentive mechanism shifts some or all of the inflation, interest rate, return on equity, operating costs, capital costs and capital recovery risks onto the pipeline company. Capital recovery shifts can imply the pipeline company is bearing the gas reserves risk in the case where proven gas reserves are insufficient to fill the pipeline over a term beyond the initial shipper contracts. This shifting of risk can be beneficial to a shipper that cannot, or will not, bear the risks inherent in a cost-of-service tariff. A fixed tariff with commensurate lower risks may provide higher value to the shipper, despite a higher nominal tariff than would be applied with a cost-of-service methodology. The shippers and pipeline companies negotiate which methodology is best for both parties. North American regulators have been cooperative in recent years in approving a negotiated methodology if sophisticated parties have negotiated the arrangement on both the shipper and pipeline side.

TransCanada has significant experience in cost-of-service models as well as negotiated or other incentive methods. We are ready to negotiate with shippers on the tariff model which best suits the project, that provides a reasonable reward commensurate with risks for the pipeline and a clear regulatory path to an early in-service date.

Thank you for the opportunity to appear at this proceeding. I am available to respond to your questions on this issue.