

Stranded Gas Hearings

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Original and Expansion Capacity: What Volumes, When, on What Terms, and at What Price?

Pete Frost, Director of Regulatory Affairs, Gas & Power Marketing Group, ConocoPhillips, on behalf of producers BP, ConocoPhillips, and ExxonMobil, July 28, 2004.

MR. JOE MARUSHACK, Vice President, ConocoPhillips, Gas Development, said his sole objective today is to establish a common link between the Alaska efforts here and pipeline access and expansion. He introduced Pete Frost, an engineer for ConocoPhillips, who knows that mechanical and technical reality must fit into regulatory and political policy. He has also spent many years working gas from development to marketing to regulation; so, he has a broad background into all the issues inherent in this business. Finally, he is part of ConocoPhillips' core Alaska gas team and is familiar with federal legislation and the challenges this project faces - and is trying to help them overcome.

MR. PETE FROST, Director, Regulatory Affairs, Gas and Power Marketing Corporation, ConocoPhillips on behalf of BP, ConocoPhillips and ExxonMobil (referred to as the sponsor group), offered a brief overview of the FERC's policies dealing with access to initial capacity, how expansion capacity might be offered and a summary of the sponsor group's preliminary estimate and toll estimates. He would also address how FERC's policies and procedures work to insure that all parties have equal and fair access to pipeline capacity. His primary background is in interstate gas pipeline procedures, rate making and tariffs and the role of the FERC and his comments were designed to provide insights into FERC's approach in establishing gas pipeline tariffs and rates as well as its procedures for obtaining access both for initial capacity and expansions that will be required of the Alaska natural gas pipeline.

Interstate gas pipelines are required to operate as open-access contract carriers. Capacity on the Alaska pipeline will be offered and allocated based upon long-established FERC regulations and precedence. Access to pipeline capacity needs to be viewed in four contexts:

1. Initial access to a proposed new pipeline
2. Initial access to pipeline expansions
3. Access to pipeline capacity that may become available because of contract termination or exploration and
4. Access as a result of temporary or permanent capacity release

In each of these contexts, any credit-worthy party that is willing to make the necessary long-term shipping commitment has an equal opportunity to acquire pipeline capacity. For those of you who are primarily familiar with the Trans Alaskan Pipeline System (TAPS) it is important to remember that the procedures for allocation of capacity are different for gas pipelines than for oil pipelines. On gas pipelines, gas is allocated through an open season process that allows all perspective shippers to review the preliminary rates, terms and conditions and to bid for capacity on the pipeline.

The open season process is instrumental to the pipeline's ability to establish the economic viability for the project and to determine the optimum size of the pipeline. The open season process is designed to insure nondiscriminatory allocation of pipeline capacity and significant case law and precedent exists to insure that no shipper that is prepared to make the long-term shipping commitment has any advantage in taking pipeline capacity from another similarly situated shipper. In the United States, the FERC oversees this process, which must be open and transparent.

Although the FERC allows reasonable flexibility in the design of open seasons, significant precedent defines the open season process. Typically, open season processes are conducted as follows:

5. The pipeline will often engage in preliminary discussions with the marketplace and will sometimes use non-binding open seasons or solicitations of interest. This process helps the pipeline to judge the extent of the market support and to insure that the pipeline is neither too large nor too small for the apparent demand for the transportation services.
6. The pipeline then issues a public notice to announce its open season. The open season must be of sufficient duration to allow all interested shippers an opportunity to respond. The open season documentation will also outline the rules under which the pipeline will evaluate its bids. The pipeline's open season package typically includes significant information about the project including receipt and delivery points, route, timing, services, pro-forma agreements, a proposed precedent agreement and estimated rates.
7. If there's insufficient capacity to satisfy all the bids, the pipeline's open season package will specify the type of tie-breaker that will be employed to allocate the available capacity.
8. Once capacity has been allocated through the open season process, the shippers will normally enter into binding precedent agreements with the pipeline, which demonstrate the need and support for the project. The pipeline company uses these agreements to justify the project at the FERC and to underpin the financing of the construction of the pipeline. Pipeline owners and financial lenders require these long-term contracts for firm capacity to ensure repayment of the capital cost of building the pipeline. Without these commitments, gas pipeline projects, which by their nature involve a longer payout than typical oil pipeline projects, could not be financed. Shippers need a contractual commitment from the pipeline to ensure capacity is available to support their own needs.

Once capacity is awarded through the open season and binding precedent agreements are executed, a shipper's contractual right to the reserved capacity is protected. A shipper's economics are founded on the availability of this contracted capacity. In exchange for the pipeline's commitment to reserve a specified quantity of capacity for a shipper, the shipper agrees to pay a monthly reservation charge that is due regardless of whether gas is actually shipped. A pipeline must have sufficient binding precedent agreements or executed transportation contracts prior to filing its FERC application. If the pipeline overbuilds, it is at risk for all unsubscribed capacity and cannot recover those costs from the contracted shippers.

The open season process is critical to determining the ultimate capacity of the pipeline. When additional gas is committed to the project, a larger physical pipeline may be justified (if operationally feasible), which may yield economies of scale that benefit all shippers.

In some unique cases in the offshore Gulf of Mexico, pipelines have offered a pre-subscription open season to attract sufficient base volumes to underpin the pipeline. In these cases, the anchor shippers were pre-assured access to some of the pipeline's capacity in the open season consistent with the risk associated with their large capital investments in related production facilities. It should be noted, however, that in all of these distinctive cases any party meeting the base requirements could be an anchor shipper and a meaningful portion of the total pipeline capacity was still made available to any interested shipper in a non-discriminatory open season. FERC has approved this anchor shipper concept in order to facilitate types of unusual project development requirements.

As proposed, the Alaska pipeline can be expanded to allow substantial additional capacity. Under FERC precedent, potential shippers are assured of fair and equal access to the pipeline expansion capacity without undue discrimination through an open season.

The current process for the allocation of expansion capacity is very similar to that described earlier for the allocation of initial pipeline capacity. However, prior to the expansion open season, FERC policy requires that the pipeline poll current shippers regarding their willingness to turn

back their own capacity prior to the binding open season. An existing shipper does not have priority or right of first refusal for expansion capacity, but is treated the same as anyone else trying to obtain expansion capacity. All potential shippers must bid on expansion capacity during the open season and similarly situated shippers must be afforded the same rates, terms and conditions. When a project is economically and technically viable, this process allows a pipeline to efficiently identify customer requirements and to implement cost-effective expansions.

It should also be noted that the FERC has very specific regulations that deal with the relationship between interstate pipelines and all of their energy related affiliates. Under these regulations, known as Order 2004, pipelines may not treat their affiliates in a preferential manner. These regulations include strict limitations on information flow, shared employees and corporate structure. Virtually every pipeline employee must now be specifically trained in these affiliate regulations. The penalties for violation are severe.

If a pipeline is expanded, the resulting rate treatment is dictated by established FERC policy. The expansion rates are determined based upon the incremental costs of the expansion. If the resulting expansion results in a lower overall rate, then the cost is rolled in or basically included in the rate base of the pre-expansion pipeline. In this case, the existing shippers and the expansion shippers all pay a lower rate. If the expansion would result in an increase in rates to the existing shippers who hold the initial capacity, then the expansion rate will be incrementally priced. In this case, the existing shipper continues to pay their previous rate and the expansion shippers pay a rate based on the higher incremental costs to expand the system. The actual costs of an expansion will depend upon the design of the pre existing facilities and the specifics of the proposed expansion.

It should also be noted that the proposed federal enabling legislation has unique and unprecedented language allowing FERC to require an expansion upon request if the shipper requesting this service meets the requirement outlined in the legislation. These requirements include:

9. No subsidization of expansion shippers by existing shippers;
10. No adverse effect on the financial viability, economic viability or operations of the pipeline and
11. No diminution of the contract rights of existing shippers to previously subscribed certificated capacity.

There are other methods of allocating capacity. Any shipper who is paying the pipeline's maximum rate under a firm transportation contract that is 12 months or longer is granted a conditional right to extend its contract at the expiration of the primary terms. As a matter of FERC policy, this right of first refusal (ROFR) exists only at the end of the primary contract term and allows the shipper the ability to retain all or a portion of its contract subject to the expiring capacity if he is willing to pay the pipeline's maximum filed rate for the greater of one year or the term offered by a third party. This contract right of first refusal is not a right to obtain capacity in either an initial open season or an expansion open season.

The pipeline is also required to allocate capacity that comes available as a result of contract expiration on a nondiscriminatory basis. This can be done through an open season or by posting the capacity on the pipeline's public bulletin board. In any event, the FERC approved tariff will provide the procedures consistent with FERC precedent and regulations for the nondiscriminatory allocation of such available pipeline capacity.

Any method by which a shipper can obtain firm capacity is by obtaining capacity released by a firm shipper. This release can be for a temporary term or can be a permanent release. The FERC

has established criteria that ensure such capacity is allocated to the party who values the capacity the most (subject to the FERC approved maximum recourse rate).

As has been previously communicated in other forums by the sponsor group, the total capital cost of the Alaska gas pipeline has been estimated at approximately \$20 billion in 2001 dollars. This figure would be somewhat higher in today's dollars accounting for inflation since 2001. The figures that I'll be sharing with you will be quoted in 2001 dollars because they refer back to the joint \$125 million feasibility study that was completed by the sponsor group in the 2011 - 2002 timeframe. That study evaluated the feasibility of constructing a pipeline from Alaska's North Slope to Lower 48 U.S. markets by way of either a northern route or a southern route with the conclusion that the project was technically feasible, but that the commercial risks outweighed the potential rewards. Because current state law prohibits the state from issuing a right-of-way for a northern route until a southern route is built, the cost estimates have focused on the southern route.

The southern route project was estimated to cost approximately \$19.4 billion with an accuracy of +/-20%. This capital cost estimate resulted in an estimated toll to the market of \$2.39/MCF. This toll is merely a preliminary estimate of a toll that might ultimately be approved by FERC [Federal Energy Regulatory Commission] and the NEB [National Energy Board] for an Alaska gas pipeline. The ultimate toll will not be known for some considerable time, that is, until the pipeline is completed and the actual costs are known and better estimates will require more work as the project is further developed.

The process of developing and gaining regulatory approval of this toll and having it approved by the necessary regulatory authorities is well-established in both the U.S. and Canada. Pipeline tariff rates are a direct result of the cost of constructing and operating the pipeline. The actual formulation of the toll, indeed the entire tariff structure, of which the toll is one component, is subject to well-established regulatory standards with oversight provided by the FERC in the U.S. and the NEB in Canada.

The rate that gas pipelines will charge for transporting gas is based on what is referred to as the cost of service. This cost of service includes components such as operating expense, maintenance, taxes, depreciation and a fair and reasonable return on capital investment consistent with the specific risks of the project.

The FERC and NEB processes offer an opportunity to all interested and affected parties, such as the State of Alaska, to actively participate in the establishment of just and reasonable rates on pipelines in which they have an interest for both initial capacity and for expansion capacity. All parties have the ability to intervene in this process and have the opportunity to comment on the proposed pipeline's tariffs prior to regulatory approval. The FERC will consider all such comments before it approves the pipeline's rates or specific tariff language. Once these tariffs have been approved by the FERC, the provisions would generally be applicable to all shippers. Furthermore, FERC staff is charged with representing consumer interest to ensure that these rates are just and reasonable. The FERC has outstanding resources and expertise and furthermore, is also permitted to audit the records of all regulated pipelines.

All parties including the State of Alaska, the pipeline, gas producers and other shippers benefit by ensuring that all gas has access to the pipeline on reasonable terms. Existing FERC policies and procedures ensure that all parties have a fair and equal opportunity to access pipeline capacity. Moreover, these policies and procedures help to ensure that no one class of shipper can be required to directly subsidize or guarantee access for another. In fact, this approach advances the national interest in encouraging future investment in natural gas pipelines. FERC recognizes that parties who have the potential to accept significant risks and make substantial investments in natural gas transportation systems will not do so if the benefits can be transferred to other third parties.

And so, to summarize, I'd like to offer these closing comments. First, unlike oil pipelines, interstate gas pipelines operate as open access contract carriers. This means capacity must be awarded to shippers in a fair, equal and non-discriminatory manner. These shippers, however, must be willing and able to make the necessary contractual commitments to pay for the capacity. This open access requirement is met on a new pipeline through an open season. Once capacity is awarded, a shipper's contractual right to the reserved capacity is protected. Existing shippers, however, have no preferential rights to capacity on an expansion. Further expansion capacity is allocated under a non-discriminatory open season process similar to that which is used to allocate the pipeline's initial capacity. All parties, including the State of Alaska, the pipeline, gas producers and consumers benefit by ensuring that all gas has access to the pipeline on reasonable terms. Among other things, this means pipelines generally are prohibited from allowing one class of shippers to directly subsidize another class or from guaranteeing one class of shipper's preferential access over another class. In addition, FERC has regulations that ensure a pipeline owner operates independently from its other energy affiliates. FERC Order 2004 recently expanded these regulations to include all energy affiliates, including producer affiliates. This concludes my prepared remarks. I'd be happy to try and answer any questions you might have.

CO-CHAIR OGAN said he quoted figures from 2001 and that the benefits outweighed the risks at that time, but this is 2004 and he has heard projections at different conferences that the gas market has changed. He assumed the producers were recrunching their numbers.

MR. FROST responded that the sponsor group is continuing the analysis and efforts are under way to define the parameters of the project and the cost.

REPRESENTATIVE LES GARA said he understands that FERC allows a fair amount of flexibility in the rules for access. The amount of revenue the state takes in is dependent on the transportation costs for the particular amount of gas that gets deducted. So, gas that is 400 miles away from the main pipeline stem may make the state less revenue than gas that is five miles away from the pipeline stem. If there is an open season and two competing proposals for the same amount of gas are coming from one company that owns gas 300 miles away and another company whose gas is much closer and would make the state much more money, he asked if the state would have some sort of discretion to choose the access so that legislators could uphold the state's interest in getting the maximum revenue possible.

MR. FROST replied that the proposed pipeline would be regulated by the FERC, a federal agency. The enabling legislation includes a specific provision that requires the FERC within 120 days of signing the act to promulgate specific open season regulations that would define how the particular open season process would be conducted by the Alaska gas pipeline. During the promulgation of the rule-making all interested parties would participate.

REPRESENTATIVE GARA focused Mr. Frost back to his question of how the state would choose the company with gas located 5 miles away rather than 300 miles, because it would make more money that way.

MR. FROST replied that the open season process by FERC would have to be conducted in context with existing case law, which require that all open seasons be conducted on a non-discriminatory, open access basis. The FERC wouldn't view any party with a preference in that process. The parties would bid on the section that's available. No particular source or shipper has any preference to capacity.

SENATOR KIM ELTON said it seemed that for an initial open season, the producers would have somewhat of an advantage, because they have knowledge of where reserves are versus independents who would make a bid on undiscovered reserves. He asked him to comment on that situation. MR. FROST replied that FERC regulations have no requirement on when an open season is to be conducted. A number of precedents define how it should be structured – how long it should be open, how long prior to the opening should the notice occur, etc. The decision for when the open season takes place is a

commercial decision about when the pipeline feels it has sufficient support from potential shippers to move a project forward. FERC regulations and precedents dictate that certain things have to happen before the application is submitted to it.

When the open season is made, all parties who have an interest in participating in a open season have an equal opportunity to bid at the time it is conducted. Different parties will be in a different position to participate in an open season to develop a pipeline. To the extent that parties are not able to participate in one open season, the project sponsors could expand the pipeline and have an expansion open season. An explorer could force an expansion under FERC rules at a time later than the initial open season. The pipeline always has an economic incentive to expand and many expansions result in a lower rate for all parties.

SENATOR ELTON asked if it is very likely that an independent could become an anchor shipper under an undiscovered resources scenario.

MR. FROST replied:

Maybe. If any shipper has reserves that are known and confirmed enough to support their desire to participate in an open season, they could participate as an anchor shipper. The anchor process is open to all parties....

SENATOR RALPH SEEKINS asked what he meant by the pipeline, as proposed.

MR. FROST answered that he was speaking generically. He was referring to any pipeline with an open season.

SENATOR SEEKINS asked if a gasline from Alaska to Canada to a hub versus one that went all the way through Canada to the Lower 48 would be treated the same.

MR. FROST replied yes. "The Alaska pipeline will be constructed under federal regulation and will be subject FERC regulation.

SENATOR SEEKINS said if the sponsor group built the pipeline, the only advantage for them would be based on making a profit on the construction and operation of the pipeline.

MR. FROST replied that construction of the pipeline would be first and foremost to move gas from the North Slope to the marketplace – to access the market. There is also an expectation that there will be a separate pipeline corporate entity. "In that sense it has a profit center of its own."

SENATOR SEEKINS mused if a person owned the pipe himself, he could see an advantage in keeping construction prices a little high to keep other people out.

REPRESENTATIVE MIKE CHENAULT asked if it was true that one had to be an owner to be able to sit at the table and negotiate rates and if Alaska is not an owner of the project, where would it be able to negotiate tariff rates, including in the future.

MR. FROST answered the FERC regulatory process allows all interested parties to participate.

It is the norm for the individual state public utility commissions and their staff to regularly participate in these types of proceedings, because of the fact that the outcome of these proceedings impact the state and the state consumers. The state of Alaska would very much have an opportunity to participate in all regulatory proceedings at the FERC, both initial open season, initial application, and any subsequent regulatory proceedings at the FERC.

REPRESENTATIVE CHENAULT asked if it would be in Alaska's best interest to have more say at these meetings if it was part-owner of the project versus not being an owner.

MR. FROST replied, "If the State of Alaska is an owner in the pipeline, then they have a slightly different role. They are not a user of the pipeline; they are part of the pipeline, itself. The pipeline, of course, does

represent its own interests at the FERC. And so, the State of Alaska, conceivably, would have two roles – one role as an owner of the pipelines that would be proposing applications at the FERC and one in your role as representing the consumers within the State of Alaska, itself.

CO-CHAIR SAMUELS asked if who builds the pipeline should be irrelevant to the producers.

MR. FROST answered:

From a regulatory perspective at the FERC, the FERC is going to view the pipeline as a corporate entity in and of itself. The FERC doesn't particularly care who owns this pipeline. All of the procedures, all of the regulations, all of the case precedent, all of the judicial case law that has been developed over the last 80 years in the natural gas industry is going to apply to that pipeline regardless of who the owner is.

REPRESENTATIVE BETH KERTTULA said that tariffs are affected by the costs. "If you control the costs, you can control the tariff."

MR. FROST responded:

There are various aspects of the cost. There are operating costs and capital costs. Speaking of capital costs, when the pipeline files its application, the capital cost will be a major component of the tariffs that are ultimately reviewed and approved by the FERC. The FERC has a statutory obligation to insure that the rates that come out of the application process are just and reasonable and they take their role very seriously. There is a whole host of people at the FERC in Washington, D.C. who tear those costs apart line by line and argue over literally dollars and cents. Their role is to insure those costs, all costs, are just and reasonable. One of the guidelines is to insure that the costs have not been imprudently incurred.

SENATOR SEEKINS asked if all costs are reasonable, what is the percentage of return on capital that FERC allows the owner of the pipeline.

MR. FROST answered that there is no specific number.

It depends on a number of factors, one of which is the risk associated with the pipeline. The FERC has recognized a direct link between the riskiness of the project and the return on equity....

SENATOR SEEKINS asked if he could guess for this pipeline.

MR. FROST replied that it would be within a range of about 12 to 14.5 percent.

CO-CHAIR OGAN observed that one penny's difference cost in the tariff, if it's higher, lowers the value of the project \$155 million over its life.

If that's an accurate figure, based on throughput and a 30-year life of the project, it equates to – our tax a royalty on that is roughly 20 percent. Some quick figuring - that equals a little bit more than \$30 million the state will not get for every penny of cost the tariff goes up.... We obviously have an intense interest in what those costs are going to be and what the alignments are going to be, who owns what and who is shipping what....

MR. FROST replied, "Pipeline rates and associated costs are always the subject of great debate and scrutiny at FERC. It's what they do."