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MEMORANDUM

VIA E-MAIL

To: Rep. Ralph Samuels
Ms. Cheryl Sutton

From: William A. Mogel
Shuchi Batra

Date: January 15, 2008

Subject: Payment Obligations of Alaskan Northwest Natural Gas Transportation Co. (ANNGT) to Withdrawn Partners

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I. SUMMARY

Despite representations made on behalf of TransCanada Alaska Co., LLC (TC Alaska), and Foothills Pipelines Ltd. (Foothills),[1] both subsidiaries of TransCanada Corporation, a question has been raised whether TC Alaska and/or Foothills[2] can recover those payments in the rates of their proposed "AGIA" pipeline.

[1] As to the obligation of withdrawn partners, it was reported that an attorney for Foothills stated on September 7, 2007 that the original investment of the partners was approximately $250 million and the "current [un-named] partners … are in negotiations with withdrawn partners over the sunk cost [which is not] a $4 billion issue." Kristen Nelson, *Former Alaska Highway Gasline Partners Could Be Owed $4 Billion*, Petroleum News, Vol. 6, No. 9. In a letter dated January 9, 2008 transmitting the ANNGT Partnership Agreement to the undersigned, TransCanada stated that TC Alaska does not "propose to rely upon any of the ANNGT assets."

[2] In an April 12, 2007 filing at FERC, ANNGT has asserted that it *inter alia* has an approximately $9 billion obligation to withdrawn partner.

The 37-page ANNGT Partnership Agreement ("Agreement") provides that withdrawn partners may be entitled to a return of their investment "after the line becomes operational and … when the payment may be made without undue hardship to the partnership" (Para. 4.4.4). Given the broad definition of "Line,"[3] withdrawn partners could make a claim for return of their capital once the Alaskan segment becomes "operational."[4]

Notwithstanding the *in futuro* the obligation to withdrawn partners created by the ANNGT Partnership Agreement, TransCanada would not be allowed to recover those payments because they occurred in connection with another entity more than 30 years prior to the AGIA pipeline's operation and would not be considered "used or useful" in providing service to ratepayers.

II. FACTS

President Carter chose ANNGT in 1979 and his decision was ratified by the Congress to construct and operate an Alaskan pipeline.[5] It has two general partners: 1) TransCanada

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[3]"Line" is defined in Para. 2.22 of the Agreement as:

> The gas pipeline and related facilities to be owned and operated by the Partnership, which shall initially extend from the Prudhoe Bay area to an interconnection with the Canada Pipeline on the Alaska-Canada border …

[4] TransCanada's License Application states:

> Initial rate base of the pipeline will include, among other things, Actual Capital Cost, allowance for funds used during construction ("AFUDC") , property tax paid during construction, and initial working capital but excluding the Alaska portion of the $500 million State reimbursement. (p. 2.2-65)

As to AFUDC, it has been observed:

> The AFUDC is not included in the rate base until the time the facility is completed and placed into service. This allowance, … is recovered through the useful life of the property in the form of depreciation and the rate of return on investment. Regulation of the Gas Industry § 29.04[3]

[5] ANNGT is the successor to the Alcan Pipeline Co. project (Alcan). Alcan changed its name to Northwest Alaskan Pipeline Co., which consisted of Northwest Energy and Foothill Pipeline, Ltd. *Midwestern Gas Transmission Co. v. F.E.R.C.*, 589 F.2d 603, 610 (D.C. Cir. 1978). The Canadian portion of the pipeline was approved in 1978 by the Northern Pipeline Act Bill C-25 passed April 4, 1978 3rd Session, 30 Parliament, S.C. 1977-1978, C-20.

Pipelines USA Ltd., a subsidiary of TransCanada, and 2) United Alaska Corp., a subsidiary of Foothills, also a subsidiary of TransCanada.

In *Alcan Pipeline Co*., 1 F.E.R.C. ¶ 61,248 (1977), FERC, pursuant to the Alaska Natural Pipeline Gas Transportation Act, 15 U.S.C. § 719 *et seq* (ANGTA), issued a "conditional" certificate of public convenience and necessity to Alcan Pipeline Co., Northern Border Pipeline Co. and Pacific Gas Transmission Co. ("Alcan Pipeline Project"). FERC stated:

> the Alcan Pipeline Project is at too incipient a stage to warrant Commission acceptance of applications for permanent certificates. 1 F.E.R.C. at 61,641.

By subsequent Order issued in *Alaskan Northwest Natural Gas Transportation Co*., 3 F.E.R.C. ¶ 61,290 (1978), FERC authorized the transfer of the conditional certificate to ANNGT. In its Order, FERC observed regarding the Partnership Agreement:

> Subsection 4.1.4 recognizes the Commission's authority to rule on these Qualified Expenditures and to possibly disallow them from rate base of [ANNGT] … if found to be unreasonable, unnecessary, or imprudent. 3 F.E.R.C. at 61,754-55.

In 2004, ANGTA was amended by the Alaska Pipeline Act, 15 U.S.C. §§ 720 *et seq*. which sought to expedite the development of an Alaskan gas pipeline. 15 U.S.C. § 720b(d). The Alaska Pipeline Act authorizes *inter alia* that the Secretary of Energy to issue a federal loan guarantee of up to $18 billion to the developer of the pipeline. Significantly, the Alaska Pipeline Act did not affect any decision (i.e. the conditional FERC certificate held by ANNGT), authorization or Presidential action relating to ANGTA. It further stated that if no application for a certificate was filed by April 2006, the Secretary of Energy should study alternate approaches.

III. DISCUSSION

A. Partnership Agreement

ANNGT, a corporation, succeeded as of January 31, 1978[6] to the Agreement entered into between United Fuels Corporation and TransCanada Pipelines USA Ltd. In addition to the foregoing, eleven other companies, including TC Alaska, were partners to the Agreement.[7] It was contemplated by the Agreement that a natural gas pipeline would be designed and constructed "from the Prudhoe Bay area … to an interconnection with the Canadian Pipeline on the Alaska-Canada border." (Para. 2.31). The Agreement specifically stated:

> The Partnership is the successor to all of the rights, titles and interests of Alcan Pipeline Company … to construct and operate a natural gas pipeline system in Alaska pursuant to … the Alaska Natural Gas Transportation Act of 1976. The Partnership shall plan, design, obtain financing for and construct the Project, own and operate the Line and place the Line in service on January 1, 1983 or as soon thereafter as practicable. (Para. 3.3)

Each partner was required by the Agreement to fund "Qualified Expenditures" which were defined by Para. 2.32 as:

> Expenditures to acquire information, knowledge, studies, tests, computer programs or governmental authorizations by any Partner or corporate Affiliate of a Partner, in the course of activities reasonably related to the selection of a transportation system for the delivery of Alaskan natural gas, if such

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[6] The Agreement has been amended four times. Curiously, Amendment No. 4 is "dated January 1, 1995, proposed December 19, 2000."

[7] The partners are: Northern Arctic Co.; Northwest Alaskan Pipeline Co.; Pan Alaskan Gas Co.; Natural Gas Corporation of California; Pacific Interstate Transmission Co. (Arctic); United Alaska Fuels Corp.; American Natural Alaskan Co.; Columbia Alaskan Gas Transmission Co.; Tetco Four, Inc.; Texas Gas Alaska Corp.; and TC Alaska.

> expenditures were made by such Partner or corporate Affiliate prior the Formation Date [January 31, 1978].

The Agreement also required that each partner make a capital investment prior to July 31, 1978 of its *per capita* share of $24 million (Para. 4.2.2). [8]

As to whether a qualified expenditure could be included in the proposed Alaskan pipeline's rate base, Para. 4.1.4 provides:

> Qualified Expenditures, and the value of assets generated thereby, shall be subject to review and verification by the FERC, and only those expenditures, and the values ascribed to such assets, found by the FERC to reflect reasonable and necessary expenditures, prudently incurred, shall be retained in the Capital Accounts, and then only to the extent that FERC authorizes the inclusion thereof as a capital expenditure appropriately made on behalf of the Partnership for inclusion in rate base. Any disallowance by the FERC of an amount included in any Capital Account … shall be reflected forthwith in a retroactive adjustment of (i) the Capital Account from which such amount was so disallowed and (ii) all other Capital Accounts affected by such disallowance in accordance with this Agreement.

Significantly, Para 4.4.4 provides that no partner shall be "entitled to any return of their expenditures … except":

> after the line becomes operational and … when [the] payment may be made without undue hardship to the partnership.[9]

B. Ratemaking Principles

A natural gas pipeline, subject to FERC's jurisdiction, may recover in rates its costs and a return of items properly included in its rate base.

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[8] Para. 4.4.4 (ii) states that:

> No return shall be paid on any contribution to the capital of the Partnership to a withdrawing partner.

[9] Under certain circumstances, a partner was permitted to transfer its interest. (Para. 10)

For ratemaking purposes, the primary cost components are operation and maintenance (O+M) expenses, depreciation and amortization, taxes other than income taxes, return on rate base, federal and state income taxes, and revenue credits. Generally, O+M expenses are not allowed to be recovered if shown to be unrepresentative, non-recurring, non-qualifying or imprudent. Energy Law and Transactions Ch. 80.[10] To be included in a pipeline's rate base:

> [The] utility's plant and property … [must] provide service to the public …. [and] be "used and useful" to the consumer before the ratepayer will be required to pay a return on the capital invested by the utility's investors. Regulation of the Gas Industry §29.01 (citations omitted).[11]

As part of the ratemaking process, FERC, in determining the value of a rate base, utilizes a "test period" to define the time period in which data covering operations is compiled.

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[10] Rate base treatment of a prudent investment also has been denied if a project is later abandoned. *Natural Gas Pipeline Company of America v. F.E.R..C.*, 765 F.2d 1155, 1163 (1985), *cert denied* 474 U.S. 1056 (1986). *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) (Cost of cancelled plant denied inclusion in rate base because it was not used and useful in service to the public).

[11] *See, e.g.*, *Tarpon Transmission Co.*, 59 F.E.R.C. ¶ 61,241, at 61,820-21 (1992) which denied rate base treatment for carrying charges on extraordinary, non-recurring regulatory costs because "they are not an investment that is used and useful in providing utility services to the public and are no benefit to the pipeline's customers." FERC further stated:

> the regulatory cost component of a pipeline's operating and maintenance expenses ordinarily does not include any authorization of *past* regulatory costs. Rather, normal Commission practice is to recover only those prudent costs which the pipeline projects it will occur in the *future*.
> 59 F.E.R.C. at 61,820 (emphasis added).

In *The Detroit Edison Co.*, 54 F.P.C. 3012 (1975) (DTE) FERC's predecessor denied the inclusion of $8 million in rate base. That sum was a loan to a coal company intended to assure DTE a coal supply for 25 years. The Commission concluded that the loan "was made merely to assist the coal company with its initial investment … not to promulgate exploration efforts." 54 F.P.C. at 3016. FERC also denied rate base treatment for an "acquisition premium" expended in separate transactions for facilities acquired to form a new pipeline. *Enbridge Pipelines (KPC)*, 100 F.E.R.C. ¶ 61,260 (2002).

A test period either may be historical or based upon future projections.[12] FERC's Regulations at 18 C.F.R. § 154.303(a)(1) provide that if a pipeline company has been in operation for 12 months as of the filing date, the test period "consists of 12 consecutive months of the most recently available actual expenses." If the pipeline has not been in operation for 12 months as of the filing date, a future test period using projections of costs of property devoted to public service is to be used. Pursuant to 18 C.F.R. § 154.303(b), the test period "must consist of 12 consecutive months ending not more than one year after the filing date."

In *Federal Power Commission v. Natural Gas Pipeline Co. of America*, 315 U.S. 575 (1942), the Supreme Court held that FERC's predecessor was correct in disallowing $8.5 million from inclusion in a pipeline's rate base. The pipeline had argued:

> [T]here are items of cost or expense incurred in the establishment and *development of the business during the seven-year period prior to regulation* … [and] should be capitalized and added to the rate base to the extent of $8,500,000 for going concern value. They include … expenditures for securing new business; interest on money invested in non-productive plant capacity; taxes paid on non-productive capacity; fixed operating expenses attributable to non-productive capacity, and depreciation on non-productive capacity. 315 U.S. at 588 (footnote omitted; emphasis added).

This argument was rejected by the Supreme Court because it involved the pipeline company 's financial history *preceding regulation* and because "the elements relied upon for that purpose could rightly be rejected as capital investment in the case of a regulated company…" 315 U.S. at 591.

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[12] Advance payments made by a pipeline to participate in gas exploration and development projects have been included, as an exception, in rate base. In this regard, FERC explained:

> their departure from the usual rule that current rates should reflect only the costs of supplying service to current rate payers was justified by the public interest in enlarging the field supply of natural gas. Regulation of the Gas Industry § 29.06 [3]

IV. CONCLUSION

Based on the foregoing, including the language in the ANNGT Partnership Agreement recognizing FERC's jurisdiction to disallow expenditures, TransCanada would not be allowed to recover in its rates any payments to withdrawn partners. This expense would be for period significantly preceding operations of the Alaskan segment by a different entity and would be neither construed as used or useful to ratepayers.