



Case & Project Experience

NERA's Role in the National Energy Board's Rejection of "Rolled-In" Pricing for a Major Canadian Gas Pipeline Extension

Overview

In an unusual decision for Canada, the National Energy Board (NEB) last week declined to recommend to the Governor in Council that a Certificate of Public Convenience and Necessity be granted to NOVA Gas Transmission Ltd. (NGTL, a subsidiary of TransCanada Corp.) for a planned 97-km, 36-inch extension of the NGTL system into the shale gas fields in the Horn River Basin of northern British Columbia (the proposed "Komie North" section). Specifically relying on the testimony of Senior Vice President Jeff Makhholm, testifying for the local gas distributor in British Columbia (FortisBC Energy Inc. or "FEI"), the NEB held that NGTL's planned "rolled-in" pricing gave it an unfair commercial advantage over existing pipelines in the region and would not cover NGTL's costs with the incremental revenues of committed shippers.

On the question of NGTL's proposal rolled-in pricing treatment, the NEB agreed with Makhholm, quoting him as follows:

"Dr. Makhholm submitted that NGTL's proposed toll treatment is anti-competitive and would shift costs away from shippers most closely connected to new infrastructure and toward those who obtain no tangible or practical benefit from it. Dr. Makhholm recommended applying regulatory principles designed to present the pipeline company and the relevant shippers with the price signals that will promote competition and economic efficiency."

The Board's action marks a significant departure from past decisions on expansions in the area, as NGTL had traditionally rolled in all extensions on its transmission network. The final report of the NEB shows that when there are evident

competitive issues at stake, or when the cross-subsidy that can accompany rolled-in pricing obstructs the "user-pay" principles of reasonable pricing, the NEB will reject rolled-in pricing.

Background

Rolled-in pricing has historically been a somewhat contentious practice in both Canada and the United States. Under rolled-in pricing, assets for expansions are grouped with a transmission company's existing "rate base" and costs are flowed through equally to the tolls paid by a pipeline's shippers. This practice contrasts with a common alternative called "incremental" pricing, in which pipelines establish a *separate* rate base for expansion assets, thus recouping the expansion costs only from those shippers who use the expanded system.

In the US, the Federal Energy Regulatory Commission (FERC) for many years made decisions in a seemingly *ad hoc* manner, approving both rolled-in and incremental pricing for expansions. Only in 2000 did FERC finally adopt a rule establishing incremental pricing as the default method for allocating the costs of new additions.

Unlike the default incremental pricing treatment for new pipelines now used by FERC (which contributes to the competitiveness of new pipeline entry and speeds the granting of Certificates of Public Convenience and Necessity in the United States), the NEB has long used a case-by-case examination for new pipeline proposals with a seeming wide latitude for the use of rolled-in pricing. So, while NGTL's proposal in this case went against the established pricing policy in the US, it was unclear how the NEB would rule on NGTL's application.

NERA's Role

FortisBC Energy Inc. retained NERA to support its opposition to NGTL's proposal. FEI is the main gas distributor in British Columbia and would potentially suffer from anticompetitive pricing upstream of its distribution system. Dr. Makhholm, NERA's leading expert in pipeline regulation, acted as the testifying expert in the case. Vice President Kurt G. Strunk and Associate Analyst Stephen Collins served as consulting experts.

Dr. Makhholm submitted written evidence in the proceeding in which he established that NGTL's proposal would go against the public interest and result in inefficient and anticompetitive infrastructure development. NERA's evidence demonstrated how NGTL's proposal was contrary to policies in the US and, most importantly to the case, failed to adhere to the basic regulatory principles endorsed by the NEB.

The Result

Following a review of written and oral evidence from Dr. Makhholm and other parties to the proceeding, the NEB issued a report in January 2013 outlining its final conclusions in relation to NGTL's proposal.

In concordance with Dr. Makhholm's testimony, the NEB unequivocally concluded that the proposed toll treatment was inappropriate for the Komie North extension. In stating the reasons for its conclusion, the Board found that the proposal "would unreasonably subsidize the extension of the NGTL Alberta System into an area where it would compete with infrastructure already in place" (page 30) and would result in inefficient price signals and uncompetitive development.

Elaborating on its findings of "unreasonable subsidization", the Board stated on page 29 of its report that:

"NGTL's proposal to roll-in all costs of the Project to the rate base shifts the cost or risk of unused capacity to other NGTL shippers in the short and long term. ... Further, shifting the risk of underutilization of the selected pipe investment reduces NGTL's incentives for prudently sizing capacity of [Komie North]."

The toll treatment of new extensions will remain a pressing issue for the NEB, particularly as gas transmission companies continue expanding their networks into the promising new shale fields opening up across the continent. For its part, the NEB has now indicated that rolled-in pricing will no longer be the default method for pricing such expansions. In what could be a path-breaking statement, the NEB found in its report that rolled-in pricing is (at least in this case) antithetical to the efficient sourcing of new supply, stating that "[p]rices that are consistent with user-pay and appropriate risk allocation help economic efficiency in the development of supply" and, additionally, that there is "no reason to weaken such price signals in the current circumstances."

Experts Involved

Dr. Jeff D. Makhholm, Senior Vice President

Dr. Makhholm has extensive expertise in gas supply planning as well as unmatched experience in the organization, privatization, and regulation of the natural gas industry around the world. He has advised governments and international governing agencies, regulators, public-owned and investor-owned pipeline companies, and large groups of pipeline users around the world, and provided expert testimony, written numerous publications, made speeches, and published international reports on multiple issues in the field. These issues include determining reasonable interstate gas pipeline tariff levels, cost allocation issues for utility companies, forecasting the net market value for natural gas transportation and storage contracts, and reviewing nations' regulatory frameworks. Dr. Makhholm's book on the worldwide practices of pipeline regulation, *The Political Economy of Pipelines: A Century of Comparative Institutional Development* was published by the University of Chicago press in 2012.

Kurt G. Strunk, Vice President

Mr. Strunk has over 15 years of experience working on strategic, regulatory, and corporate financial issues in the energy industry. He has advised energy companies on rate cases, regulatory strategy, resource planning, contract and asset valuation, origination, hedging and risk management, prudence, cost of capital, affiliate transactions, and retail market issues. Mr. Strunk serves as a consulting and testifying expert in regulatory proceedings, commercial litigation, and arbitration proceedings. He has been retained as an expert to testify in US Tax Court, US Federal Court, and US Bankruptcy Court, as well as before public utilities boards in the US and Canada.

Stephen Collins, Analyst

Mr. Collins has consulted in energy economics since 2010 and has on numerous occasions supported expert reports regarding energy and regulatory issues in North America and elsewhere. In Canada, he has consulted on behalf of a variety of energy distributors and stakeholders, including Gaz Métro, Enbridge, Union Gas, FEI, ATCO Gas, the Alberta Utilities Commission, and the Ontario Energy Board. He has worked for clients outside of the North America in regions such as Oceania, Europe, and Latin America, and is a fluent speaker of Spanish.

About NERA

NERA Economic Consulting (www.nera.com) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

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