From the desk of

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Senator Charlie Huggins, Chair
Senate Special Committee on Energy
Senate Finance 532
Juneau, Alaska 99811

Re: Fundamental Questions About Gas Pipeline Tariffs (Follow-Up to My Testimony July 25, 2007)

Dear Senator Huggins:

My plan of testimony yesterday was to raise fundamental questions about natural gas tariff processes at FERC after we discussed the overview points in the one-page testimony outline I submitted prior to the hearing. Unfortunately, we ran out of time before we got to these questions. Therefore, at the close of the hearing you instructed me to submit those questions in writing for you and your fellow committee members. Per your request, these questions follow. In reviewing these questions, I believe I have identified what may be the principal reason my emphasis on the importance of information in the tariff process may differ from the conclusions of many of the experts and informed reviewers working on the AGIA process. To explain this difference, I have also added additional materials that follow up on points we discussed during yesterday's wide-ranging hearing.

A. Fundamental Questions About Gas Pipeline Tariffs

1. The average litigated natural gas rate case at FERC is reported to be roughly 50 months and the average for a contested settlement is about 36 months. I have not been able to find a breakdown relating length of time to the size of the case. In view of the fact that the TAPS case was still moving slowly eight years after production began (this was a significant factor that induced the state to accept a settlement instead of continuing to litigate), I would like to know:

- 1a. What is the average length of time for resolution at FERC of a natural gas pipeline rate case affecting a rate base greater than $20 billion?
- 1b. What is the average length of time for resolution at FERC of a natural gas pipeline rate case affecting a rate base greater than $10 billion?
- 1c. What is the average length of time for resolution at FERC of a natural gas pipeline rate case affecting a rate base greater than $5 billion?
- 1d. What is the average length of time for resolution at FERC of a rate case affecting a rate base greater than $1 billion?

2. What is the likelihood that the FERC natural gas pipeline recourse/negotiated rate system can assure just and reasonable rates when there is no competition from other pipelines to test both the rates and the rate structure?

3. Natural gas pipeline tariffs may include price differentials for different shippers that are not based on tangible costs, depending on factors such as (a) volumes, (b) services and delivery requirements and (c) other services. How does FERC assure that price arrangements based on intangible factors do not grant undue preference to large volume shippers, reducing the ability of shippers with smaller volumes to get their gas to market?

4. It is my understanding that once FERC has accepted a negotiated gas pipeline rate, FERC does not, as a general rule, allow refunds on that tariff. (In the case of oil pipelines, where refunds are allowed, refund provisions do not fully compensate the overcharged shipper, or the state.)

- 4a. Does the practice of not allowing refunds on negotiated settlements on the natural gas side strengthen a pipeline company's natural tendency to seek a high tariff?
- 4b. On what elements of the opaque cost and service agreements spelled out in natural gas pipeline tariffs are refunds allowed?

Following yesterday's discussion, I would like to add the following two questions to my original list:

5. Do FERC ratemaking procedures contain provisions that proscribe, limit or otherwise inhibit potential tariff inflators such as collection of charges for tariff elements that do not require cash outlays until a future date, such as dismantling or negative salvage charges?

6. Do the FERC natural gas ratemaking process or the TransCanada AGIA proposal to the state contain substantive language to ensure that the veil of confidentiality imposed at the nuts-and-bolts level of this arcane process will not prevent parties with an interest in inflating their tariff numbers from disclosing the information that would enable those harmed by the particular transaction from obtaining, in a timely manner, the information they would need to identify the problem, assess its significance, understand its mechanics and respond to protect their interests?

I believe that broad tariff process questions such as these have fiscal and policy implications that may far outweigh the benefits of the mechanical tariff-lowering provisions TransCanada has offered. Answers to these questions strike me as particularly important when we know that: (a) FERC procedures impel pipeline companies toward a high ceiling tariff; (b) in the case of producer-owned pipelines the assumption of producer incentives to reduce tariffs during rate negotiations is highly questionable; and (c) refund provisions on negotiated natural gas pipeline rates are severely constrained. Therefore, as I testified,

without answers to these questions, I am unable to make a policy recommendation in favor of AGIA.

B. Independent v. Producer-Affiliated Pipeline Tariffs (Sen. Wielechowski)

When Senator Wielechowski asked whether I had researched whether independent pipeline builders tariffs are higher, lower or similar to those of producer-owned pipelines, he mentioned the view that independent pipelines are said to have higher motivation to incur cost overruns than producers. I want to take this opportunity to make sure my response was clear, and to call additional relevant information to your attention.

- The United States Attorney General banned producer-owned natural gas pipelines in 1977 due to antitrust concerns. While that ban is no longer in force, there are few examples of producer-owned natural gas pipelines.
- In Barry Pulliam's chart showing the relationship between recourse and negotiated tariffs (p. 30 of his June 4 presentation, which I referenced in my testimony and you later distributed), three independent pipelines show significant reductions to negotiated tariffs. I distinguished those results from the fourth pipeline on his chart, the Alliance Pipeline. The recourse tariff for Alliance was shown as $0.53, while its negotiated tariff was shown increasing to $0.54. I commented that I found this anomaly disconcerting.
- As we discussed yesterday, the Alliance Pipeline was underwritten by producers, then sold to an independent operator after operations began. Aside from being a large, trans-border project, Alliance is particularly interesting to us because a knowledgeable industry observer reports that former ExxonMobil CEO Lee Raymond once said the Alaska line would be built on the Alliance model. Moreover (I did not mention this yesterday), Alliance had a cost overrun provision reducing return on equity similar to that proposed by TransCanada, as well as a 70/30 debt equity structure.[1]

In my effort to stay out of the weeds, I did not add the following information from other consultants' reports, which was summarized in my July 22 report:

- The Brown, Williams, Moorhead and Quinn May 2008 report on regulatory issues observes that "[t]he [Alliance] pipeline's negotiated contract rate as posted in its tariff now slightly exceeds the recourse rate. The negotiated rate for the Project increased from 37.4 cents as reported in the certificate order to its present level of 53.9 cents.[2]

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[1] See: Fort Chicago Energy Partners, "Management Discussion Analysis," p. 13 (accessed July 2008 at *http://www.fortchicago.com/media/pdfs/annuals/fce99mda.pdf*).

[2] Brown, Williams, Moorhead and Quinn, *Regulatory Issues Report for State of Alaska (Findings*, Appendix J), May 2008, p. 9.

A table in an appendix to the BWMQ report shows that the Alliance recourse tariff was $0.420, with a negotiated rate of $0.374.[3]

- Alliance reports its 2008 filed Alliance U.S. tariff at $0.60, up from $0.56 in 2007.[4]

The pipeline that is sometimes said to be the financing model for the Alaska-Alberta pipeline clearly breaks the pattern that shippers negotiate the recourse tariff downward. Although there are some apparent inconsistencies in the recourse tariff data, it appears that the Alliance tariff is significantly higher than its original recourse rate, apparently due to cost overruns. In the limited time available, I have not explored possible links to the producers that initially financed that line and the relationship between the estimated recourse tariff and the outcome of the negotiated tariff process on the Alliance line. Nor have I encountered information to lead me to believe that others have done so in the necessary depth. In light of the TAPS history and in the interest of preventing a TAPS redux, I would like to know much more about these data.

C. Senator Wagoner's Question

Late in the hearing yesterday, Sen. Wagoner asked whether a producer would still have incentive to increase tariffs if it owned less than 50 percent of its production capacity on the pipeline. I believe that a portion of my response was incorrect. We know that every additional $1.00 spent on the pipeline reduces state production taxes and royalties by (say) $0.30. Therefore, all else equal, the producer spending an additional $1.00 on transportation would still lose $0.70. If this were the whole story, a producer would be less resistant to transportation overcharges than an independent shipper. But this would not constitute incentive to spend that dollar.

Since we know that on TAPS the producer-owners have consistently overcharged by significant amounts, we must look for another explanation for what happens on tariff filings. I think the cutting question here is whether the producer actually spends more on transportation, or merely reports spending more on transportation (as in shifting costs from the production operations to transportation). Clearly, this is not the time or place to go into the many ways to highball a tariff. I will let this simplified correction to my answer to Senator Wagoner stand and apologize for any confusion that may have resulted from my initial response

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[3] "Study of Major Gas Pipeline Certificate Projects – Summary of Recourse and Negotiated Rates,"*Regulatory Issues Report for State of Alaska,* unnumbered attachment.

[4] Alliance Pipeline, *Alliance Shipper Task Force Meeting*, October 10, 2007, slide 4.

D. The Need for an Information Guarantee Provision

I believe many of the questions I posed today point back to the sixth fundamental process question in the first section of this letter. To defeat the information barrier imposed by litigation and commercial confidentiality constraints, I want to reaffirm – in the strongest manner possible – the concern I stated in (Remedy #1 on my single sheet testimony outline). I believe that the state, in going into any agreement on a natural gas pipeline, needs to guarantee that it will have timely access to all information necessary to protect its interests. To ensure that my concern that AGIA lacks this key safeguard was not diluted during yesterday's exchanges, I would like to add the following supporting observations for the committee's consideration:

- While the AGIA contract specifies that the state is free to challenge pipeline company rate filings, Revenue Commissioner Galvin has testified that if push came to shove, the state would have to carefully consider the interests of its partner before making such a challenge. As discussion yesterday suggested, the information necessary to make such a challenge would be voluminous, arcane, dense and very technical. It has been my experience in oil and gas dealings that a company can inhibit the state's ability to mount a credible technical challenge by using confidentiality to withhold critical information.
- During yesterday's hearing, it was suggested that an ownership interest would provide the necessary seat at the table. During the 2006 PPT deliberations, I believe legislators received credible testimony that minority interest participants in a development are often inhibited by lack of complete information about the project in which they are participating.

At the end of the day, I believe it is the recognition of the importance of withheld confidential information – to which I have had access in various cases over the past three decades while working with various state and federal agencies on tax, royalty and ratemaking issues – that may explain why I have parted company from others engaged in this process whom I greatly respect. In my estimation, there is a vital need for provisions guaranteeing the state full and timely access to the information it needs to protect its interests, and those of independent developers, despite the constraints of commercial and litigation confidentiality.

In my experience, pipelines (due to geographic realities) and bureaucracies (due to the multiple responsibilities of the players) are both inherently vulnerable to information short circuits. For this reason, I am particularly worried about information constraints when the largest pipeline project ever undertaken on this continent will span 1,715 miles much of which is in another country with different tax, regulatory and oversight frameworks. Without affirmative, advanced resolution of this issue, the state will remain vulnerable to the consequences of tariff gaming. In sum, it remains my conviction that specific attention to the

provision and disclosure of full information is a prerequisite to the pro-active, “belt and suspenders” approach to tariff issues that many persons are recommending. Despite the complexities of critical issues, when stripped to its essence the fundamental, unaddressed problem is simple; it revolves around the old sports adage, “You can’t hit what you can’t see.”

Again, I am grateful for the opportunity to share these concerns and I wish you success in your continued deliberations. If I can provide additional information, please do not hesitate to let me know.

Sincerely,

Richard A. Fineberg