BULLET POINTS from UNADDRESSED QUESTIONS

A Report to the Alaska Public Interest Research Group by Richard A. Fineberg
July 22, 2008 (Revised)

An independent evaluation of the administration's Alaska Gasline Inducement Act (AGIA) findings and determination.

Background: Differences between FERC oil and natural gas regulation

- FERC natural gas and oil pipeline tariff regimes differ in significant respects. In the case of oil pipelines, the TAPS tariff methodology that permitted excessive, non-cost-based charges was approved by the FERC in 1985, eight years after TAPS went into service. *(p. 3)*
- On the natural gas side, the estimated the recourse tariff effectively sets a ceiling for further tariff negotiations between the pipeline company and prospective shippers. A shipper agreement to pay for future pipeline space in the subsequent open season (a "take or pay" contract) enables the project to obtain the financing to go forward. Since the pipeline company is trying to entice investors, it is generally expected that negotiations prior to pipeline start-up will enable the shipper to seek and obtain better (lower) shipping rates. *(p. 4)*
- The FERC natural gas tariff system's reliance on estimated costs and negotiated rates are troubling to some observers who have watched the TAPS owners rely on estimates and hypothetical calculations to justify the excessive tariffs allowed under the 1985 settlement. But the voluminous AGIA proposal lacks systemic safeguards to protect against the possibility that unscrupulous parties might use various accounting devices to artificially elevate reported costs and filed tariffs. *(p. 5)*

The present situation: fraught with uncertainty (AGIA, Denali and LNG)

- The actions of the North Slope producers are critical to the outcome of current gas line negotiations. Careful consideration of the major producers' role in the proposed pipeline to Alberta raises a host of troubling questions about the project the AGIA contract would set in motion. *(p. 12)*
- A prospective gas line builder finances its project by obtaining commitments from shippers under "take or pay" terms, guaranteeing that the shipper will pay for the space on the proposed pipeline under any circumstance. If, for some reason, the shipper doesn't take the gas, the shipper will still pay. *(p. 11)*
- Assuming the proposed AGIA project goes forward, producer financing of the gas line is a likely outcome of current gas line negotiations. *(p. 12)*
- Other outcomes are possible, but a web of complicated financial arrangements could put the producers in control of the pipeline. For example, in 2005 outgoing ExxonMobil CEO Lee Raymond told associates that North Slope gas line financing arrangements would follow the Alliance Pipeline model. *(p. 13)*
- The administration has stated that nothing in the AGIA license would prevent the state from challenging the recourse tariff during the license application – or from opposing TransCanada's subsequent tariff defense. However, officials acknowledge that the state would carefully consider the interests of its partner before advocating a reduction in the pipeline company's tariff revenue. They say they can deal with the details of tariff implementation later. *(p. 5)*
- The major producers say they are reluctant to ship with an independent pipeline company because they want to be in a position to control cost overruns. But the major producers on the North Slope might want to own the pipeline to reap pipeline profits while reducing royalty and tax payments. *(p. 7)*

Cost overruns and over-reporting (different phenomena)

- When Shippers and Producers are subsidiaries of the same parent company (or otherwise affiliated), the TAPS record suggests that this unusual circumstance reverses the presumed Shipper incentive to seek lower gas line tariffs. *(pp. 3, 9)* The TAPS experience suggests that major producers on the North Slope might want to own the pipeline to reap pipeline profits while reducing royalty and tax payments. *(p. 7)*
- For ratemaking purposes, pipeline costs are reported and go into the rate base, which earns a specified rate of return. An actual cash outlay can be distinguished from an accounting entry (for, say, depreciation on previously incurred costs – or an erroneous duplicate invoice whose bottom line finds its way into the rate base without a second cash outlay). The shipper-owner is simply transferring the accounting entries from one pocket to another. For the producer-owner, accounting costs further enhance returns by reducing royalty and production tax payments to the state; the independent shipper who does not own an interest in the pipeline is handicapped competitively because it must pay the accounting cost out of pocket. *(pp. 18-19)*
- Due to the unique logistical and project management challenge of being spread out geographically (like a highway, as opposed to a house), pipelines are particularly vulnerable to imprudently incurred expenses and cost overruns. *(pp. 18-19)*
- (In addition to [1] ratemaking and [2] pipeline management and logistics problems, there are empirical reasons to think the limited data on producer-affiliated pipelines constitute a valid warning that the natural gas system is liable to fail because the producers, dressed up as shippers will not seek lower tariffs. A consultant presented four examples of negotiated tariff levels. In three cases, the negotiations lowered the recourse tariffs by an average of nearly 19%. But in the fourth instance, the negotiated tariff was much higher. The three instances in which the negotiated tariffs were reduced involved independent pipeline operators; the only tariff that went up was the above-mentioned Alliance, now independent but originally owned and financed by producers. *(p. 14)*

- Pipelines are inherently vulnerable to cost overruns and FERC does not grant refunds on negotiated tariffs. *(p. 26)*
- For many years, the federal government did not permit producers to own natural gas pipelines. . . . From the limited data available, it appears that the federal regulatory system is not used to dealing with producer-owned pipelines and in the case of producer-affiliated pipelines may be failing to function in the intended manner. *(pp. 14-15)*
- A cursory look at project cost estimates shows that the risk of cost overruns constitutes a significant factor in project economics. Basic project cost estimates for the TransCanada pipeline between the North Slope and Alberta range from TransCanada's base construction estimate of $26.5 billion to the state consultants' estimate that, all factors considered, the median construction cost estimate would be $46.0 billion. *(p. 20)*
- The problems associated with cross-country pipelines are compounded by the fact that 56% of the AGIA project will be in Canada, introducing additional problems that include First Nation problems, as well as different regulatory and oversight regimes and a different currency with changing valuation relative to the U.S. dollar. *(p. 20)*

- **Loan guarantees.** The proposal to apply loan guarantees to cost overruns . . . raises issues that warrant further consideration. For example: Since federal loan guarantees function to reduce the cost of project debt, why would the state defer use of these funds by targeting them to cost overruns? *(p. 21)*

- **Is there danger of a TAPS Redux on natural gas pipeline tariffs?** Yes. TAPS experience shows that there is a critical distinction between the rate structure and implementation. This is an important distinction when pipelines are demonstrably prone to manipulation. *(p. 26)*

- **Can the State Rely on FERC to Ensure Low Tariffs?** In my estimation, no. Review of FERC's recent history with natural gas regulation strongly suggests that the notion that that the state can rely on FERC to ensure low natural gas pipeline tariffs is unrealistic. System gaming and price manipulation by Enron in. 2000 (subsequent to creation of the natural gas pipeline negotiated tariff procedures in 1996) and by BP (subsequent to system modification in 2003) suggest that the FERC regulations is inefficient in preventing those practices. *(pp. 25-26)*

- **Bottom line:** Given the magnitude of the North Slope natural gas project, the revenues at stake and the importance of assuring competitiveness on the North Slope, tariff issues require further consideration. *(p. 6)*

***Recommendation:* The state should establish an ad hoc oversight group to ensure that the state maintains a pro-active posture in its efforts to assure low pipeline tariffs on the AGIA pipeline.** *(p. 26)*

Port Authority / LNG

- **The good news:** The potential for costly project delays and significant cost overruns on the TransCanada route discussed in preceding sections appears to support selection of the Alaska Gasline Port Authority (AGPA) all-Alaska route to Valdez. The AGPA pipeline route is more than 50% shorter and involves none of the transnational problems faced by the TransCanada route. An additional advantage of the all-Alaska route that is seldom discussed is that the shorter route through one country presents significantly less opportunity for tariff manipulation. *(p. 22)*

- **The bad news:** The shorter, one-country pipeline route is only part of the story. The trade-off is that the all-Alaska route requires construction of a liquefaction plant, tanker shipments and international marketing. Cost estimates for the liquefaction plant range from $7.9 billion to $21.1 billion. In addition to cost considerations, the liquefaction plant, unregulated by FERC, poses a potential bottleneck. The possibility of state regulation could ameliorate this problem. *(p. 22)*

- **The Asian price premium:** Many experts question whether the hefty Asian LNG price premium, which presently makes this commodity worth approximately twice as much in Asia as the same quantity of natural gas in the Lower-48, can be maintained. In light of the difficulties of forecasting LNG prices and the long-term growth of Asian demand, the weight that should be accorded this assumption can be questioned. In June 2008, the U.S. Energy Information Administration reported, "[h]igher crude [oil prices] will also spur greater GTL production, placing additional pressure on natural gas supplies. Collectively, these activities are expected to increase overseas wellhead natural gas prices and worldwide LNG prices. *(pp. 22-23)*

***Recommendation [Port Authority/LNG]:* In view of the benefits of the shorter pipeline route in one country, additional analysis of the uncertainties associated with the Asian marketing premium and liquefaction plant cost and bottleneck aspects is warranted.** *(p. 24)*

Models: transparency and public engagement

- The administration deserves credit for its efforts to inform and engage the public in review of the AGIA process. However, the failure to create and provide an interactive model that would enable members of the public to change key variables such as tariffs, gas prices and volumes and assess the results, constitutes a serious barrier to public participation.

> ***Recommendation:***
> ***To promote public participation in policy formulation, the administration should create and provide an interactive model that will enable interested citizens to put in variables such as tariffs, gas prices and volumes and assess the results.*** *(p.24)*

Models: importance of low and mean price forecasts

- In the data available for public review, it is often impossible to tell what price forecast scenario produced the results presented. Modeled data should specify the price scenario (for example: Were the data on display generated from a low, mean or high price scenario?)

> ***Recommendation:***
> ***To ensure that we who live in times of high oil prices won't force our descendants to pay for our good fortune, as a general rule use mean forecasts.***
> ***If the model is being used to understand how industry is likely to behave, to avoid over-estimating industry's capacity to risk shareholder capital on an uncertain future, consider a lower (say, 33 percentile) forecast.*** *(p. 27)*

Basin Opening v. Basin Control:

- TransCanada speaks of its experience opening basins. At the same time, an industry veteran says the industry strives for basin control. Major producers seek to control pipeline terms so that they can determine the course of North Slope development without the need to respond to competition from other companies; this theory is known as basin control. At that time, he recommended that the state must protect its interests by taking a "belt and suspenders" approach to its contractual negotiations.

> ***Recommendation:***
> ***The history of TAPS suggests that it would be a mistake to assume that the Basin Opening approach to development is operating but the Basin Control phenomenon is not.*** *(p. 26)*

What this report does: *This report identifies potential problems attendant to the TransCanada AGIA proposal that could seriously undermine state interests, examines the historical context that lends significance to these concerns and makes problem-specific recommendations based on these findings.*

What this report does not do: *This report does not recommend that legislators vote for or against granting TransCanada's AGIA license application. This report does not, in any way, endorse the proposed Conoco-Phillips/BP "Denali" project.*

– RAF 7/22/08 [Revised]