THE TRANSCANADA MAINLINE DECISION: TOWARD HYBRID REGULATION

By Gordon E. Kaiser, FCIArb

Introduction

The theme for this issue of Energy Regulation Quarterly is the impact of new technology on the regulatory process. If ever there was a case that featured this issue, it's the March decision of the National Energy Board[1] on TransCanada's application to revise the toll structure of its mainline pipeline. The technology at issue is the horizontal drilling and hydraulic fracturing that released huge quantities of natural gas from shale deposits throughout North America. In recent years, the terms Bakken, Eagle Ford and Marcellus have grown to the same stature as Turner Valley in the old days.

Historically, the TransCanada Mainline system once carried 6 billion ft.^{3} of natural gas per day. However, increased gas production in the United States from fields such as Marcellus in New York and Utica in Pennsylvania has resulted in decreased throughput on the Mainline, resulting in increased tolls for shippers – something various participants in the NEB proceeding described as a death spiral. These new gas fields after all are next door to the major US markets, not thousands of miles away in Alberta.

In response, TransCanada filed a path breaking application to restructure tolls. The application proposed to shift $400 billion per year of costs to users of the Alberta system by extending the Alberta system to Saskatchewan and Manitoba. The application also proposed reallocating $1.2 billion of accumulated depreciation from the prairies and Eastern triangle segments to a northern Ontario segment that was underutilized and had a large undepreciated balance. This would reduce the book value of the northern Ontario line and shift costs to Western producers and Eastern consumers by increasing depreciation payments in the Prairie and Eastern segments of the Mainline.

The result was a 72 day hearing, 60 lawyers, 80 witnesses and a 257 page decision by the NEB. Most of the intervenors advocated a write-down of the mainline rate base by removing approximately $3 billion from the requested $5.8 billion rate base.

The Problem in a Nutshell

Before analyzing the decision, it may be helpful to better understand the circumstances that resulted in the application. The Mainline is one of largest natural gas systems in the North American continent. Conceived in 1950, it began its first full year of operation in 1959 and from that year until 1998 it served central Canadian and US markets largely without any competition, operating at high load factors underpinned by long-term long-haul contracts.

However, the competitive landscape began to change in 2000 when the Alliance and Vector pipelines began moving gas from Western Canada to eastern markets in the United States. The development of West Coast liquid natural gas projects where WCSB gas was converted into liquids to be transported to Asian markets was also a factor- although much later. (For example, the proposed Kitimat LNG and Sasol projects were, respectively, 1.4 bcf/d and 1 bcf/d each.)

The dominant factor, however, was the growing supply of shale gas. In 2006, shale gas production was 3bcf/day. By 2013, it had reached 29 bcf/day and is forecast to be at least 49 bcf/day by 2020.

The TransCanada Mainline was designed to transport 7 bcf/d of gas. By the time the NEB hearing was held, the volume had declined to 1.5 bcf /d. The fixed costs on this pipeline were high and they now had to be charged to lower firm transportation volumes. As a result, tolls rose. Transportation from Empress to Dawn in 2006 was $.80/gj in 2006. TransCanada estimated in its

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application that tolls would be $2.74 for 2013.

The Decision

Most intervenors favored a write-down of the rate base. TransCanada rejected this on the ground that the Board had no statutory authority. The Board accepted TransCanada's position on this point and moved to a new model. This was a long term fixed competitive price which the Board believed would allow TransCanada to recover. Effective July 1, 2013, the Empress to Dawn toll would be $1.42/gj for 4 ½ years.

The Board recognized the possibility that these tolls might be insufficient to recover costs and directed TransCanada to forecast the revenue deficiency. TransCanada did the analysis and determined that a $95 million annual deferral of costs would keep TransCanada whole over the period. A deferral account was established to record any positive or negative balance. At the end of the toll period, disposition would be considered by the Board.

The Board also recognized the increased risk the company faced and increased the return on equity (ROE) to 11.5% The Board also established an incentive earnings mechanism in which shareholders had significant upside with no downside. More importantly, the Board allowed TransCanada to set minimum bid levels for its Interruptible Transportation (IT) service at any level it chose and minimum bid levels for the Short Term Firm Transportation (STFT) service at any level equal to or greater than the Firm Transportation (FT) toll for the relevant path.

An interesting hybrid regulatory model was born - fixed tolls for almost five years at rates that would not likely recover costs to be subsidised by deregulated rates in "competitive" markets. At least that is what some argued.

TransCanada appealed the decision not to the courts but back to the Board for a review and variance. The application asked the Board to increase the five-year Empress to Dawn toll from $1.42 to $1.52, which TransCanada believed would take care of the $95 million annual loss. The company also asked for a new methodology to recover future costs that could not be anticipated by the company. The company also wanted to change the implementation date of the decision from July 1, 2013 to November 20, 2013 because they had missed the important winter season.

The main argument for the review was that the decision model developed by the Board had not been proposed by TransCanada or any other party. As a result, TransCanada claimed that they had not been given an opportunity to present evidence to counter this unique and what they believed was unprecedented regulatory model. TransCanada argued that under the rules of natural justice they were entitled to a reasonable opportunity to call this evidence.

TransCanada also objected to many of the legal rulings the Board made with respect to recovery of prudent investments and the right to a fair return. However, it elected not to proceed to the courts because it viewed those comments as obiter dicta, as the Board had not disallowed any costs. On June 12 the Board rejected the TransCanada review application in its entirety.

The Legal Principles

Two important but distinctive legal issues run throughout this decision. The first is the rulings that question traditional public utility law. The second concerns the scope of the Boards jurisdiction to deregulate services.

The NEB decision questions two established principles of public utility law. The first was the prudence doctrine. TransCanada argued that, having made prudent investments the utility was entitled to recover the investment. That principle was affirmed as recently as two months ago by the Ontario Court of Appeal[2] when it repeated that prudence must be determined without the benefit of hindsight. The issue is - was investment prudent at the time it was made. No one in the TransCanada case argued that was not the situation.

Nonetheless some parties argued, and the Board agreed, that there was a conflict between the traditional prudence test and the concept of "used and useful". The Board questioned-how could an investment be prudent if it was no longer used and useful?

In the end, the Board concluded that this inherent conflict made the prudence rule virtually useless and it should fall back on the general authority under its statute, to set rates which are just and reasonable.

The Board also appeared to question the long-established Canadian rule that utilities have a right to earn a fair rate of return.

In 1960, the Supreme Court of Canada clearly stated that the obligation to approve rates that will produce a fair return to a utility is absolute.[3] In Union Gas v. Ontario Energy Board, the Ontario Divisional Court stated that the provision of a fair return is essential to the preservation of the financial integrity of the applicant, which is of mutual concern both to the company and its customers.[4] The NEB in the Mainline decision not only accepted these decisions[5] but noted that past Board decisions had endorsed them.[6]

Instead of applying the established rule, the Board relied on a 1944 U.S. Supreme Court decision in the

Market Railway case[7], which held that a utility was not entitled to a guaranteed profit if the profit had declined as result of market forces. However, that case was based on a provision in the U.S. Constitution guaranteeing that the government cannott confiscate private property. Understandably the US Supreme Court said the Constitution, which was relied upon by Market Street Railway, did not protect the company from market forces; it protected the utility from government action. What relevance the case had in the case before the NEB is questionable.

However, the real rationale also emerged in the decision. The reference to Market Street Railway only confused it. First, the Board found that, unlike a gas utility such as Enbridge or Union, there was no guaranteed monopoly for TransCanada. In short, there was no franchise agreement.

But there was also a different and more substantial ground. The Board accepted the argument by a number of intervenors that over the years TransCanada had received from its regulator a ROE that rewarded it for bearing risk. In short, TransCanada was never a riskless enterprise. And while that risk had never materialized before, it had now.

There was also some discussion as to whether TransCanada had managed that risk properly. For example, should the company have increased its depreciation rates earlier? Whether that is true is difficult to say on the facts. But the general principle is set out - a utility has the obligation and the ability to manage its risk. Moreover, it has been compensated for that risk.

In the end, nothing in the decision turned on the Market Railway case. The Board had applied the fair rate of return in the past and would in the future. In fact, the decision recognized that competition had increased, as had the related risk. The Board therefore increased the ROE substantially.

The same can be said of the prudence test. Most would say that the Board got the prudence test wrong by introducing hindsight. It is likely that the only reason the Board developed this

unique conflict between prudence and used and useful was because TransCanada was using the prudence principle to argue against a write-down of its rate base. In the end the Board avoided that problem by simply declaring that it lacked authority to engage in a write-down. No particular authority was referred to.

The Board clearly believed that it had considerable scope in setting just and reasonable rates. And not setting rates apparently can result in just and reasonable rates.

Did the Board have the legal authority to deregulate? We have seen this picture before. When the Canadian Radio-Television and Telecommunications Commission (CRTC) decided to deregulate long-distance service, the Federal Court of Appeal ruled that the Commission did not have the authority.[8] Parliament then amended the statute giving the Commission clear authority. The Ontario legislature added that exact wording into the Ontario Energy Board Act and that provision was used by the Ontario Board when it deregulated natural gas storage.[9]

However it is not clear that that the Federal Court ruling would be the same today. We live in a different world. Courts across the country from the Supreme Court of Canada down now grant regulatory agencies a much greater degree of deference- not just on the facts but also on the interpretation of their home statute.[10]

What's Down the Road?

The more important question that results from this decision is - what will happen in this new regulatory world?

Already two LDC shippers have complained that TransCanada has rescinded prior agreements for incremental service requests for service that was initially to commence November 2014 from Dawn to Eastern Ontario and Québec markets and to build out the pipeline bottlenecks which were needed to accommodate that service. In addition, TransCanada has conditioned the market, through open seasons and regulatory filings, to expect a withdrawal of existing capacity on the already constrained Eastern Triangle to accommodate TransCanada's Energy East oil conversion project from Alberta to Saint John New Brunswick. Capacity could start to be removed from gas service in the 2015 to 2017 time frame.

None of this should be surprising. The NEB ruled that TransCanada was not a garden-variety monopoly utility. It had no franchise agreement and therefore no legal monopoly. And therefore no duty to serve. The Board also suggested that the company never had a monopoly in the first place. And even if it did it, the ROE granted by the regulator compensated the company for risk. Now that the risk had arrived, TransCanada could not complain and argue that the company should be free from any risk.

And even if it had a monopoly in the beginning times have changed. Competition has arrived. Not just from new pipelines. The market power of the Mainline was always linked to Alberta gas being the dominant supply source in North America. That has been replaced by shale gas now located next door to the key American customers.

This decision creates a unique regulatory model. Deregulation has taken place in the past both in telecommunications and energy. That has been accompanied by a careful analysis of the state of competition in the proposed market. Even if we leave that issue aside and assume that the Board had jurisdiction and that the facts established growing competition, which does seem to be the case, deregulation usually brings with it structural rules to deal with cross subsidization between monopoly markets and competitive markets. Whether the NEB likes it or not, it's now in the business of regulating competition. That, most would agree, is a tricky business.

At some point, the NEB will have to determine the degree to which the Board should be involved in enforcement proceedings related to competition issues in the new regulatory framework. They will occur. And they can escalate in complexity. Often they have short timelines. That may require a Board proceeding designed to analyze the range of competitive issues as well as potential remedies and procedures.

It may be that the Board is not the only game in town. Where the degree of regulatory oversight is diminished, the exemption from the Competition Act[11] may also disappear. That presents parties with a much wider range of civil and criminal remedies and even the prospect of parallel proceedings. The Competition Bureau has the authority to intervene in regulatory proceedings where competition issues are at play, but it also has the option of proceeding through its own process where the relief is more extensive.

And of course private parties may elect to proceed with civil actions in the courts relating to a breach of the Competition Act seeking both damages and injunctive relief, possibly including class actions. And do not be surprised if well-schooled lawyers argue that the duty to serve does not require a franchise agreement and that a common law obligation exists where the utility enjoys monopoly power. It promises to be a colourful regulatory landscape.

Conclusion

It is easy to be critical of some aspects of the Mainline decision. To be fair, this was a difficult fact situation. There were serious economic consequences. This was a major piece of national infrastructure that when it was first built almost brought down the government of the day. This pipeline has been a major economic instrument in Canada for decades.

The solution advanced by many interveners - simply write down the rate base - had a host of consequences, none of which were pretty. A decade of litigation would have resulted. And shifting the costs to other customers in other areas, which TransCanada proposed, was even less attractive. It was also apparent that TransCanada customers had substituted short-term services for long-haul services for price reasons.

The reason those services were more attractive in financial terms had something to do with the level of competition in that marketplace. As a result the Board said let's give TransCanada the tools to meet that competition and recover some of the revenue shortfall that exists in the long-haul services. There may be nothing wrong with that analysis. And, it may have been the only practical option.

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1 National Energy Board, Re TransCanada Pipelines Limited RH-003-2011 (March2013), (Reasons for Decision).

2 Power Workers' Union (Canadian Union of Public Employees, Local 1000) v. Ontario (Energy Board) 2013 ONCA 359.

3 British Columbia Electric Railway Co. v. Public Utilities Commission, [1960] SCR 837 at 848.

4 Union Gas Ltd v. Ontario Energy Board 43 OR (2d) 489, 1 DLR (4th) 698.

5 Supra note 1 at 147, (Reasons for Decision).

6 National Energy Board, Trans Québec and Maritimes Pipelines Inc. RH-1-2008 (March 2009) (Reasons for Decision).

7 Market Street R. Co. v. Railroad Commission, 324 US 548 (1945).

8 Telecommunication Workers' Union v. Canada (Canadian Radio-television and Telecommunication Commission), (1989) 2 FC 280, (FCA).

9 National Energy Board, Natural Gas Electricity Interface Review EB-2005-0551 (7 November 2006), (Decision with Reasons).

10 Newfoundland and Labrador Nurses' Union v. Newfoundland and Labrador (Treasury Board), 2011 SCC 62, [2011] 3 SCR 708; Alberta (Information and Privacy Commissioner) v. Alberta Teachers' Association, 2011 SCC 61, [2011] 3 SCR 654 at para 22.

11 Competition Act, RSC 1985, c C-34.