



National Energy  
Board

Office national  
de l'énergie

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# Reasons for Decision

**TransCanada PipeLines  
Limited**

**RH-4-2001**

June 2002

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**Cost of Capital**

### 3.1.5 Other Aspects of Business Risks

#### Depreciation

CAPP submitted that, if the matter of supply was really as uncertain as TransCanada maintained, then it raises the issue of the appropriate level of depreciation rates. CAPP suggested that TransCanada negotiated higher depreciation rates for 2001 and 2002, in part on the premise that changing supply and market conditions created uncertainty in terms of the recovery of capital. CAPP noted that TransCanada indicated that it might bring forward a depreciation study and request a further increase in depreciation rates post 2002. CAPP contended that TransCanada is seeking double recovery by requesting an increase in its return now and potentially in its depreciation rates later, to reflect the same uncertainty.

IGUA submitted that it is the depreciation rate which operates to mitigate TransCanada's short-term risk of failing to obtain a full return of capital, and that the Mainline's S&P Settlement, which increased the depreciation rates for the 2001 and 2002 Test Years, precludes TransCanada from seeking increases in its equity return component for those years.

TransCanada acknowledged that a higher depreciation rate could justify a lower return. TransCanada argued that if it was in a position where its depreciation rate allowed cost recovery over the terms of the outstanding contracts, then that would be something of relevance in determining return. TransCanada disagreed with the suggestion that its negotiated depreciation rate increases in 2001 and 2002 should preclude the Board from determining a fair return to the Mainline.

#### *Views of the Board*

Business risk represents the risk attributed to the nature of a particular business. It is made up of all the risks to which the income-earning capability of an asset is exposed. The assessment of business risk needs to extend over the economic life of an asset and should not be limited to risk factors that could arise within a given test year. With respect to the Mainline, potential sources of short, medium and long-term risk therefore need to be considered.

The Board last assessed the Mainline's business risk as part of the RH-2-94 proceeding. Since that time, the natural gas pipeline industry has continued to evolve. While many of the changes that have taken place since 1994 were contemplated at the time of the RH-2-94 hearing and reflected in the Board's previous assessment of the Mainline's business risk, the weight that specific risk factors should be given may have changed and may need to be re-examined in light of this evolution. For example, the Board is of the view that, while the prospect of increased pipe-on-pipe competition was recognized in RH-2-94, this source of risk should be given more weight in assessing the Mainline's prospective business risk in light of a change in the probability of expansions of existing pipelines.

The evidence indicates that the Mainline is exposed to five main sources of business risk, which are pipe-on-pipe competition risk, market risk, supply risk, regulatory risk, and operating risk. These five sources of business risk are discussed in turn.

### Pipe-on-Pipe Competition Risk

Pipe-on-pipe competition, which occurs both at the supply and market ends of pipeline systems, refers to direct competition for customers between pipelines. Directly, pipe-on-pipe competition impacts business risk by providing customers with alternative options to ship gas. Indirectly, it affects business risk by affecting market and supply risk.

One of the most significant changes to take place since 1994 has been an increase in competition for customers amongst pipelines, both out of the Mainline's supply basin and into its market areas. The entry of new pipelines, as well as capacity additions on previously existing pipelines, has resulted in a market structure that has been described as "competition amongst the few". The move towards a more competitive pipeline infrastructure implies an increase in business risk, although not all pipelines are necessarily affected to the same degree. At the time of the various decisions approving new pipelines, the Board recognized that these decisions would have the effect of increasing pipe-on-pipe competition and, in the near term, given the lumpiness of pipeline investment, could result in some temporary offloading from other pipelines' systems, necessitating a period of time for refill. These benefits of competition were judged to outweigh this concern and to enhance the overall public interest.

In the Board's view, there has been no "new paradigm of constructing pipeline capacity in advance of supply" as suggested by one of TransCanada's witnesses. Although some of the factors assessed by the Board have reflected the natural evolution of the pipeline industry and the integration of competitive forces into the Board's decision making, the Board continues to assess each application in accordance with well-established principles and on the basis of the evidence before it. Upon a careful reading of the decisions approving new pipeline additions since 1994, it is clear that the Board has not adopted, as a "paradigm" that new pipeline capacity should be constructed in advance of supply nor has it approved any application solely on the basis that it would provide a competitive alternative to TransCanada.

For various reasons (e.g., lower producer netbacks relative to those achieved on competing pipelines, timing of FT contract expiry), the current situation of excess capacity from the WCSB has had a particularly notable impact on contracted firm capacity and throughput of the Mainline. Excess capacity has also acted as an incentive for some shippers to rely on short-term service, such as IT, instead of FT. Since 1994, the average outstanding FT contract term on the Mainline has been reduced from 8 years to 5 years in 2001.

The risk arising from the Mainline's increased exposure to competition is, however, mitigated by a number of factors. The Mainline is the largest pipeline leaving the WCSB and a substantial portion of its customers (both end-users and producers) are captive and are expected to remain captive to the Mainline for the foreseeable future. TransCanada has increased its ownership interest in pipelines leaving the WCSB, which would tend to reinforce its market power. In this respect, the Board notes that a substantial share of capacity addition leaving the WCSB was constructed by pipelines in which TransCanada has an ownership interest. As the Mainline is depreciated, a lower absolute return on rate base will provide further flexibility in meeting the challenges of competition. As

well, having some excess capacity may provide the Mainline with a competitive advantage for capturing incremental supply and may allow it to achieve throughput levels in excess of contracted capacity through the provision of short-term discretionary services. Overall, the Board is of the view that the Mainline is well-positioned to compete effectively and considers that long-term supply and demand fundamentals provide a reasonable opportunity for increased throughput on the Mainline.

To date, TransCanada's earnings have not been affected by the excess capacity or increased pipe-on-pipe competition since the Mainline has been allowed to increase its tolls with the result that it has earned its full Revenue Requirement. Nonetheless, there is some uncertainty over the Mainline's future ability to attract sufficient gas volumes, which could have an impact on its earnings. Specifically, the Mainline's ability to recover its full cost of service would be put in jeopardy if its throughput declined to a point where the resulting tolls exceeded what the market could bear. While there is no indication that such an outcome is to be expected, the possibility that it may happen appears to have increased since 1994. Accordingly, the Board is of the view that there has been an increase in pipe-on-pipe competition since 1994, which acts to increase the Mainline's prospective business risk.

#### Market Risk

Market risk may be defined as the risk that the Mainline's income-earning capability could be affected by the market demand for natural gas. It is affected both by the overall size of the gas market and by the market share achieved by the Mainline.

The level of competition in downstream markets for gas has increased, suggesting that there has been an increase in the Mainline's risk related to competition for market share. The change in market risk associated with competition for market share is already reflected in the Board's assessment of pipe-on-pipe competition risk.

North American demand for natural gas has increased and growth is forecast to be strong, particularly with respect to gas demand for electricity generation. Although other pipelines, existing or potential, may bring gas into areas served by the Mainline, the Board notes that TransCanada accepts that the downstream market can generally absorb all the gas that the Mainline can deliver. While there is uncertainty with respect to future demand growth, the market for natural gas in markets served by the Mainline is, in the Board's view, significantly more robust than was forecast in 1994, suggesting a reduction in the Mainline's risk related to the overall market for gas.

#### Supply Risk

Supply risk may be defined as the risk that availability of supply could impact on the Mainline's income-earning capability. Supply risk relates to the physical availability of natural gas.

In the Board's view, the overall supply of conventional gas from the WCSB will be a key determinant of the Mainline's future utilization rate. Since 1994, growing North American market demand has supported the growth in the supply of conventional natural gas from the WCSB and has led to supply capacity additions. Recently, however, the

pace of supply growth has been more modest and has been accompanied by higher decline rates, lower initial production, and a reduction in reserve-to-production ratios. While many expect ongoing supply growth from the WCSB, some consider the recent drilling results to be an indication that the WCSB is maturing and that further growth may be more difficult to achieve. The Board also notes that the growth in intra-Alberta demand is forecast to remain quite robust, which will generally reduce the amount of supply available to all pipelines leaving the WCSB.

These factors are partially mitigated by an increase in the probability of development of frontier resources, as shown by the renewed interest in Arctic gas supplies from the Mackenzie Delta and Alaska, and the recent development of unconventional resources (e.g., CBM) from the WCSB. In 1994, TransCanada considered that it had only one supply basin (i.e., the WCSB) to draw on, given that frontier basins were expected to remain beyond reach. In this proceeding, the Board notes that TransCanada forecast that both Arctic gas and CBM will come on stream within the next 10 years.

On balance, it is the Board's view that uncertainty over the future growth potential of the WCSB and the increased intra-Alberta demand for gas suggests that, since 1994, there has been a modest increase in the degree of gas supply risk to which the Mainline is exposed.

#### Regulatory Risk

Regulatory risk is the risk to the income-earning capability of the assets that arises due to the method of regulation of the company. While the regulatory model has evolved and will continue to evolve and adapt to the changing needs of the pipeline industry and of its stakeholders, there is nothing to suggest that the Board will alter its approach of considering significant changes to the regulatory framework only on the basis of a comprehensive, balanced and prospective examination of all relevant factors. Although the regulatory regime has permitted increased competition, there has been no indication that it has increased the possibility that prudently incurred costs will not be recovered. For example, there has been an annual true-up through deferral accounts to collect real costs as incurred and the cost of under-utilized capacity has been borne by shippers. As a result, the Board is of the view that the regulatory model continues to provide the Mainline with a reasonable opportunity to recover its prudently incurred costs. In the Board's view, there has not been any significant change in the Mainline's overall regulatory risk.

The Board does not expect that the way in which TransCanada conducts its Mainline business will remain unchanged. The world in which the Mainline operates continues to evolve and the Board expects that TransCanada's management will be proactive in recognizing new sources of risk arising from this evolution and in finding means to mitigate such risk. In this respect, the Board is aware that TransCanada and its stakeholders are currently discussing a new business and regulatory model for the Mainline. The Board considers that it may be appropriate to re-assess the Mainline's prospective business risk resulting from any new regulatory framework, jointly with the consideration of proposed Tariff amendments.

### Operating Risk

Operating risk is the risk to the income-earning capability that arises from technical and operational factors. The Board agrees with TransCanada that, while there may have been a slight reduction in operating risk due to the fact that Mainline is presently operating at a lower utilization rate, it would be offset by an increase in risk to the security of the Mainline.

### Depreciation

The Board views the issues of cost of capital and depreciation as being related, but as addressing different factors. The primary goal of a depreciation rate is to reflect the assessment of the economic life of an asset. Business risk, which is a key determinant of cost of capital, addresses the probability that the utility may not be able to recover its prudently incurred costs over the economic life of the asset, whatever that economic life may be.

In RH-1-2001, the Board approved a modest increase in the Mainline's composite depreciation rate. This increase, however, did not materially change the assessed economic life of the Mainline and, in the Board's view, its impact on business risk and cost of capital is negligible.

### Summary

Overall, the Board concludes that the level of business risk facing the Mainline has increased since 1994, although it remains low. The increased business risk primarily reflects an increase in the risk resulting from pipe-on-pipe competition and increased supply risk. Other sources of risk have not changed materially.

## **3.2 Investment Perspectives and Financial Risk**

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#### **TransCanada's Position**

From the perspective of TransCanada, a fair return is the competitive market return required to induce investment by TransCanada in its existing Mainline, in expansions of that system, in pipeline projects, and in TransCanada by both debt and equity investors. From the perspective of existing and potential investors, TransCanada stated that a fair return on the Mainline is required to encourage them to retain their existing investment in TransCanada and to provide new equity capital to TransCanada.

TransCanada stated that its ability to compete for capital and for expansion opportunities depends on a fair return to investors of the Company. If the return on an investment in TransCanada is less than the return on other investments of similar risk in the global marketplace, then TransCanada will be unable to attract capital on reasonable terms and conditions.

TransCanada argued that the combination of increased business risk, high leverage and low profitability leaves it with less capacity to make new commitments without overextending the Company.