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EXPANSIONS ON AN ALASKA GAS PIPELINE

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I. INTRODUCTION

In my June 2004 testimony here, I discussed the general methodology and standards that the FERC utilizes to set gas pipeline rates. Dan Ives of the Lukens Group discussed access issues associated with initial pipeline capacity, in particular FERC's open season process. Today, I want to address another pipeline issue that looms potentially large and important, namely, the law that governs expansions of an Alaska Gas Pipeline after it is initially sized and built. I will first address the law on expansion as it stands today and then turn to the provisions of the Energy Act of 2003 that for the first time give the FERC the power to order expansion.

II. EXPANSION LIMITATIONS UNDER THE PRESENT LAW

Based on information provided in the various Stranded Gas Act applications, the Alaska Gas Pipeline is expected to be sized to carry initially anywhere from 2.6 to 5 billion cubic feet per day, with expansion capability up to 6.0 billion. Any expansion would be accomplished not by replacing the original pipe with larger diameter pipe, but rather by adding additional compression (additional compressors at existing stations or building new compressor stations) and/or "looping," that is, adding smaller diameter pipe parallel to the main pipe. A

question arises as to whether the Alaska Gas Pipeline owners can be forced to expand the pipeline in the event they do not voluntarily agree to do so. Under current law, the short answer is no. Let me explain.

The Natural Gas Act ("NGA") does not speak to expansions as such. Instead, it prohibits "enlargements" but gives the FERC authority to order "extensions." The pertinent language of Section 7(a) of the NGA is underscored:

> "Whenever the Commission, after notice and opportunity for hearings, finds such action necessary or desirable in the public interest, <u>it may by order direct a natural-gas company to extend or improve its transportation facilities</u>, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: <u>*Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes</u>, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers."

Stated simply, while FERC has the power to order "extensions and/or improvements," it does not have the power to order "enlargements" of pipeline facilities. What is the distinction? It turns out that there is no bright line, but courts and the FERC have interpreted this language in a manner that treats expansions as proscribed enlargements.

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It was not until 1949 -- eleven years after the NGA took effect -- that the courts first had the opportunity to interpret the expansion provision in Section 7. Back then, the Circuit Court of Appeals was troubled by the lack of clarity in Section 7(a), as can be seen from the following discussion:

> "The first question we have to deal with is whether what Consolidated wants done at the Edgerton Station under command of court decree, constitutes on the one hand a mere extension or improvement, concededly within the power of the Commission to direct, or an enlargement which the Commission may not order. The Act nowhere defines these terms and it is somewhat baffling to determine when and under what circumstances an extension or improvement of facilities ceases to be such and becomes enlargement." (Emphasis added.)[1]

A few years later, the then Federal Power Commission was faced with a tougher question as to whether the Sections 4 and 5 discrimination provisions of the NGA overrode the Section 7 prohibition against requiring enlargements. There, the FPC found that in order to avoid discrimination among shippers, it had the power to order improvement of transportation facilities by requiring their enlargement. The Circuit Court of Appeals disagreed:

> "While the Commission does not say so its position necessarily implies a duty on the part of Panhandle to enlarge its pipeline facilities, if it is necessary to do so to carry out its duty [to rectify discrimination] in this regard….The Commission concedes, of course, that the proviso of section 7(a) of the Act expressly deprives it of authority to compel the enlargement by a Natural Gas Company of its transportation facilities in connection with the extension or

[1] *Michigan Consolidated Gas Company v. Panhandle Eastern Pipe Line Company*, 173 F.2d 784, 788 (6th Cir., 1949) (emphasis added).

> <u>improvement of such facilities</u>....In the light of Section 7(a) we are compelled to conclude that Congress meant to leave the question whether to employ additional capital enlargement of its pipeline facilities to the unfettered judgment of the stockholders and directors of each natural gas company involved."[2]

The Court found it important that, since the passage of the NGA, the FPC had never until that case asserted power to direct a natural gas company to enlarge its transportation facilities. It quoted with approval a Supreme Court case that a "failure to use such an important power for so long a time indicates to us that the Commission did not believe the power existed."[3]

Four years later, the same controversy reappeared in another Circuit Court of Appeals. This time, the petitioner tried to argue that because Panhandle had sought a certificate of public convenience and necessity, that certificate could be conditioned under Section 7(e) of the NGA to require that Panhandle enlarge its pipeline system in order to avoid discrimination. But, the court found that

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[2] *Panhandle Eastern Pipe Line Company v. Federal Power Commission*, 204 F.2d 675, 678, 680 (3rd Cir., 1953) (emphasis added).

[3] *Id.* at 680. In dissent, one Judge argued that the case should have been remanded to the FPC for it to make a factual determination as to what constituted an improvement or extension on the one hand, or an enlargement on the other. *Id.* at 682. On rehearing, the Court reaffirmed its opinion with the following observation:

> "Whether a given improvement does or does not involve a prohibited enlargement may be a close technical question, however. We agree with the view expressed by our brethren of the 6th Circuit in *Michigan Consol. Gas Co. v. Panhandle Eastern Pipe L. Co.*, 6th Cir., 1949, 173 F.2d 784, 788, that it is a question which should be passed upon in the first instance by the Commission. *Id.* at 683."

imposing a condition under Section 7(e), rather than invoking Section 5 (the anti-discrimination section), did not change the fact that the company would still be compelled to enlarge its facilities:

> "However, despite the method employed, the effect remains the same -- the company would be compelled to enlarge its facilities, 'contrary to the express declaration of the court quoted above that to require such is beyond the power of the Commission.' To impose such a requirement would put us in a position of doing indirectly what we are forbidden to do directly."[4]

The FERC continues to follow these rulings and, accordingly, while the FERC currently takes the position that it has the authority to order a pipeline to construct new interconnects where certain conditions are met, it has been careful not to suggest that it can compel pipelines to expand capacity on their systems.[5] A recent case illustrates the FERC's sensitivity to the expansion issue:

> "The Commission emphasizes that this new policy, which relates only to the construction of new interconnections, does not require a pipeline to expand its facilities, to construct any facilities leading up to an interconnection, or even to construct the interconnection itself....
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> The Commission . . . is not requiring Panhandle or any other pipeline to construct or acquire any facilities. This modified interconnection

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[4] *Central West Utility Company v. Federal Power Commission* , 247 F.2d 306, 310 (3rd Cir., 1957).

[5] *See, e.g., ANR Pipeline Co. v. Transcontinental Gas Pipe Line Corp.*, 91 FERC ¶61,066 at 61,245 (2000) ("The instant case involves no enlargement of pipeline facilities, no assertion of authority to require a pipeline to provide service beyond capacity, and no expenditure of Transco's capital, since ANR will pay all involved costs."); *Arcadian Corp. v. Southern Natural Gas Co.*, 61 FERC ¶61,183 at 61,677 (1992) ("We assert here no authority to require a pipeline to provide service beyond capacity.").

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> policy seeks only to ensure that when pipelines respond to requests for interconnections, they do so in a manner that causes no undue discrimination and furthers the Commission's policies favoring competition across the national pipeline grid. Thus, the new policy does not run afoul of any statutory limitations or interfere with the legitimate and consistently applied business decisions of a pipeline's management.[6]"

In sum, whether an expansion of a pipeline would be considered an "extension or improvement" or, rather, an "enlargement" of transportation facilities is fact specific and not entirely clear. There are no instances where FERC has successfully ordered what would normally be understood to be an expansion. The type of expansions that may be needed for an Alaska Gas Pipeline probably would fall under the "enlargement" prohibition of the NGA. Thus, it is not in the State's interest to rely upon Section 7(a) of the NGA for meaningful expansion authority; case law casts too much doubt on FERC's power to order anything other than a minor extension or improvement. The preferable course of action would be federal legislation that clearly permits FERC to order an expansion of an Alaska Gas Pipeline.

III. EXPANSION AUTHORITY UNDER PROPOSED FEDERAL LEGISLATION

The good news is that Section 375 of the Alaska Natural Gas Pipeline Act, which is a subtitle of the Energy Policy Act of 2003, would grant FERC the

[6] *Panhandle Eastern Pipe Line Company*, 91 FERC ¶ 61,037 at 61,141 (2000).

authority to order expansions, subject to certain conditions. The bad news is that the legislation is languishing in Congress.

Section 375, if it becomes law, would be the first time the FERC has been given the power to order expansion for any pipeline. This represents a recognition by Congress of the unique circumstances of an Alaska Gas Pipeline, namely, that it is likely to be the only road to market for North Slope gas resources. This is a provision that was fashioned only after much discussion and compromise among present and future North Slope producers, pipeline owners in the lower 48, would-be pipeline owners in Alaska, and the State of Alaska. Some urged that the FERC be given greater powers for expansion; others urged that its existing powers not be changed at all. As you will note by reading the language carefully, FERC's new powers do not extend to interstate gas pipelines in the lower 48. This is a solution for an Alaska Gas Pipeline and only for that pipeline.

The expansion provision contains the following language:

"SEC. 375. PIPELINE EXPANSION.

(a) AUTHORITY.–With respect to any Alaska natural gas transportation project, on a request by 1 or more persons and after giving notice and an opportunity for a hearing, the Commission may order the expansion of the Alaska natural gas project if the Commission determines that such an expansion is required by the present and future public convenience and necessity.

(b) RESPONSIBILITIES OF COMMISSION.–Before ordering an expansion under subsection (a), the Commission shall–

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(1) approve or establish rates for the expansion service that are designed to ensure the recovery, on an incremental or rolled-in basis, of the cost associated with the expansion (including a reasonable rate of return on investment);

(2) ensure that the rates do not require existing shippers on the Alaska natural gas transportation project to subsidize expansion shippers;

(3) find that a proposed shipper will comply with, and the proposed expansion and the expansion of service will be undertaken and implemented based on, terms and conditions consistent with the tariff of the Alaska natural gas transportation project in effect as of the date of the expansion;

(4) find that the proposed facilities will not adversely affect the financial or economic viability of the Alaska natural gas transportation project;

(5) find that the proposed facilities will not adversely affect the overall operations of the Alaska natural gas transportation project;

(6) find that the proposed facilities will not diminish the contract rights of existing shippers to previously subscribed certificated capacity;

(7) ensure that all necessary environmental reviews have been completed; and

(8) find that adequate downstream facilities exist or are expected to exist to deliver incremental Alaska natural gas to market.

(c) REQUIREMENT FOR A FIRM TRANSPORTATION AGREEMENT.–Any order of the Commission issued in accordance with this section shall be void unless the person requesting the order executes a firm transportation agreement with the Alaska natural gas transportation project within such reasonable period of time as the order may specify.

(d) LIMITATION.–Nothing in this section expands or otherwise affects any authority of the Commission with respect to any natural gas pipeline located outside the State.

(e) REGULATIONS.–The Commission may issue such regulations as are necessary to carry out this section."

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Let me comment on some of the other compromises embodied in this language. First, the language does not mandate how expansion capacity will be priced by the FERC. It gives the FERC power to use either rolled-in price treatment or incremental price treatment. This determination will significantly affect the incentives that unaffiliated explorers will face in determining what their costs of transportation will be. A parallel provision, subsection (b)(2), requires that the rates for expansion capacity not require that existing shippers "subsidize" expansion shippers. What is a "subsidy" lies in the eye of the beholder -- in some circles what is called a subsidy is viewed as an entitlement or natural benefit by others.

Let me turn back, for a moment, to how the FERC prices expansion under current law. Although it has reinterpreted its policy several times in the last decade, in its most recent general policy statement, the FERC said that expansion capacity should be paid for by those demanding the expansion unless there is a systemwide benefit.[7] A systemwide benefit would mean that when the costs of the expansion are rolled into the existing costs of operation, the costs of transportation per unit for all is lowered. This is technically possible in some circumstances depending on engineering and throughput matters. If, however, the average system

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[7] *Certification of New Interstate Natural Gas Pipeline Facilities*, 92 FERC ¶ 61,094 (2000).

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transportation cost increases due to the expansion, then the expansion shippers, under current FERC policy, would pay a different and higher rate to ship on expansion space. The rationale, simply put, is that those who "cause the expansion" should pay for it. Informed observers have noted that there is a "heads I win, tails you lose" aspect to this policy. If expansion costs are lower per unit, then those causing expansion lose that benefit to the system as a whole. If, on the other hand, expansion costs are higher per unit than before, the expansion shippers are forced to bear the higher cost. Time will tell how this works out for an Alaska Gas Pipeline.

There are other limitations in Section 375. Several parties were concerned that expansion not affect the financial underpinnings of the project, hence Section 375(b)(4). Certainly, this language would give the financial institutions that will loan vast sums for this project a voice in any expansion proceedings at the FERC. Similarly, the rights of those who have already contracted to ship on the pipeline are not to be "diminished" by any mandated expansion. I suspect that this means, at least, that there cannot be any reduction in existing shippers' shares of initial capacity.

Two other aspect of Section 375 are worthy of comment. First, the FERC is required to examine whether there are adequate downstream facilities -- outside of Alaska -- for the new gas that would be shipped through the expanded facilities.

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This stands in marked contrast with the process spelled out for initial pipeline facilities authorized under the Alaska Natural Gas Pipeline Act. There Congress directs the FERC not to look at whether adequate downstream capacity exists but to presume it. Second, subsection 375(c) requires that the party who requests the expansion at the FERC execute a firm transportation within a reasonable time after an expansion order issues or lose the expansion rights. This is, in clear language, a put up or shut up clause. The expansion order becomes void unless the parties who sought the order sign up for the expansion capacity.

Finally, conditions (b)(4) and (5) in the proposed legislation require the Commission to make non-adverse findings on financial, economic, and operational factors. On their face, those provisions appear to provide fertile ground for an opponent of expansion. They certainly invite litigation.

In the end, the proposed legislation allows, but does not mandate, FERC to order an expansion. From the State's prospective that is a far better situation than the status quo.

I do not have to be a prophet to make the simple observation that in granting expansion rights to the FERC for, and only for, an Alaska Gas Pipeline, the legislation would lay a careful path with several potential hurdles to clear. How high those hurdles will be is left to the informed discretion of the FERC. Based on everything else connected with this project, I would not expect an expansion

proceeding at the FERC to be short, uncomplicated, and uncostly. Nonetheless, the power to order expansion would exist for the first time. That alone will also influence how parties approach expansion on a voluntary basis, because the prospect of involuntary expansion lurks in the background.

IV. CONTRACTS AMONG THE PIPELINE OWNERS

The absence of new federal legislation does not necessarily mean that there will be no expansion requirements for an Alaska Gas Pipeline. As I indicated a few moments ago, the expansion language in the pending federal legislation reflects a consensus that was reached among interested parties. Those parties felt that they could live with the expansion concept and specific conditions attached thereto. It would appear therefore that there is no insurmountable obstacle to interested parties contractually agreeing to the very same terms contained in the proposed legislation, or different ones. It is a fair bet to say that the existence of this compromise language, whether adopted or not, will also provide a framework for voluntary expansion negotiations.

The ongoing Stranded Gas Development Act contracting process could serve as one vehicle to ink an expansion agreement. Another contracting opportunity will arise in the negotiations attendant to the various ownership agreements. However, if the State is not a pipeline owner, its interests will not be directly represented in those ownership negotiations.

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Would FERC honor such contractual agreements? I see no reason why the FERC would reject any agreement that required the owners to seek expansion authorization from the FERC in the event that certain agreed upon conditions or events were to occur. So long as FERC remained free to make its normal certificate inquiry, it would likely applaud rather than disapprove a voluntarily reached expansion agreement.

That concludes my presentation. I will be happy to entertain any questions.