National Energy Board

Office national de l'énergie

Reasons for Decision

TransCanada PipeLines Limited

RH-1-99

April 2000

Tariff

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Reasons for Decision

In the Matter of

TransCanada PipeLines Limited

Interruptible Transportation and Short Term Firm Transportation Tariff Amendments

RH-1-99

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Chapter 3

Economic Issues

3.1 Appropriateness of a Bidding Mechanism to Allocate Short-Term Capacity

Neither TransCanada nor the intervenors questioned the appropriateness of a bidding mechanism to allocate marginal capacity. However, several parties questioned the appropriateness of the level of the existing floor price in a situation of excess capacity.

Views of TransCanada

TransCanada did not propose any changes to the underlying bidding or auction mechanism for pricing and allocating IT and STFT. TransCanada argued that, if demand for capacity were sufficiently strong, the bidding process could result in the price of IT and STFT being bid up above the Reserve Price set by TransCanada. TransCanada submitted that this approach would be consistent with the existing pricing methodology and would retain the allocative efficiency associated with a bidding or auction process, should demand for capacity exceed supply.

TransCanada submitted, however, that the current methodology (i.e., an IT floor price of 50% of the FT toll) contains a flaw that, in an excess-capacity situation, leads to the price for IT being forced to the floor and thus to inappropriate and unnecessary cost shifting from IT to FT customers. TransCanada suggested that, in the longer run, the current methodology provides a strong disincentive for shippers to purchase available capacity on a firm basis.

Views of Parties

CAPP submitted that, for a biddable service, there should be a floor price that reflects a minimum cost, above which bidding should set the price. CAPP suggested that bidding sets the competitive price for a service in a very efficient way. CAPP added that it was not surprised that, given the recent decrease in demand for transportation service on TransCanada's system, the bids for IT and STFT service have been at generally low levels both in quantity and price.

IGUA disagreed with TransCanada's assertion that, under a situation of excess capacity, the current bidding process for IT would always result in bid prices equal to the floor price. IGUA submitted that the market value is simply the price that the market commands for any given good or service and that there is no need for intervention (by TransCanada) in order to achieve this outcome.

The LDCs submitted that, because IT is a marginal service whose revenues are credited to the pipeline's revenue requirement, the price for the service should be allowed to fluctuate between incremental variable cost and market value.

TCGS was generally supportive of TransCanada's views and argued that a properly functioning market would not consistently return prices for interruptible transportation at or close to the floor.

Renaissance submitted that, if supply is greater than demand, customers at an auction are not going to bid above the Reserve Price because they know that the commodity will be available at the Reserve Price. Accordingly, Renaissance suggested that, in an excess supply situation, the bidding mechanism does not necessarily establish the market value for the commodity.

Views of the Board

The Board considers that a bidding mechanism is an inherently fair and efficient way of allocating available capacity for short-term services. The Board notes that the resulting prices will be market responsive.

In periods when capacity is tight, an auction ensures that available capacity will be used by the shippers that place the highest value on it. A shipper that wishes to acquire capacity may be willing to bid up to the maximum value that it assigns to the capacity in order to increase the odds of obtaining the capacity. In this situation, shippers may obtain capacity at different prices, but the price paid by each shipper would not exceed the value that this shipper assigns to the capacity.

In periods of excess capacity, there are no concerns with allocative efficiency. While some shippers may place a higher value on the capacity, they will generally bid at or close to the floor price. This outcome parallels the outcome that would be achieved in a competitive market. In this excess-capacity environment, the market-clearing price equals the floor price, and capacity may be allocated to any shipper that assigns a value to the capacity that is equal to or greater than the floor price.

The Board concludes that a bidding mechanism is appropriate for IT and STFT in this case.

3.2 Pricing Discretion to TransCanada

Views of TransCanada

The minimum Reserve Price of 65% of the FT toll (later adjusted by TransCanada to 55% during the course of the proceeding) is intended to be a reasonable proxy for the incremental variable cost of providing IT service. TransCanada indicated that it would be prepared to adjust the minimum Reserve Price periodically to reflect changing market conditions, but did not propose a specific adjustment mechanism.

Both economically, and as a matter of public policy, TransCanada stated that it did not believe that maximum Reserve Prices for IT and STFT were necessary, appropriate, or likely to lead to efficient results in the long run. TransCanada proposed a range for the Reserve Factor "... as a means of allaying any concerns that parties may have, until more experience is gained with the proposed market structure."

TransCanada suggested that the IT pricing regime should provide for an annual premium for IT prices relative to FT prices in order to provide economic parity between the two services. TransCanada argued that if all IT service were priced no higher than FT service on a daily basis, shippers would have an incentive to migrate from FT to IT service. TransCanada submitted that, on an annual average basis, the proposed maximum Reserve Prices for IT service would result in a price premium for IT service over FT service of approximately 10% for an IT shipper that purchased capacity every day of the year.

TransCanada also supported its proposed maximum seasonal Reserve Price on the premise that, in a situation of excess capacity, the system is likely to experience more seasonal flows, with shippers relying on IT as a reliable winter service when demand is high. TransCanada submitted that, as a matter of equitable cost recovery, it is reasonable to provide an opportunity to recover some of the seasonal value associated with IT service. In TransCanada's view, the maximum winter Reserve Price for short-term services of 125% of the FT toll might not be high enough to prevent system migration from FT service to IT/STFT service.

TransCanada indicated that it would be desirable, and in the interest of overall system efficiency, to have flexibility to define individual Reserve Prices for each individual path. However, TransCanada stated that it is prepared to continue with the existing approach of setting one floor price for the system (for each short-term service) at this time. TransCanada added that this approach would simplify consideration of this application, minimize any need for modifications to its information systems, and allow shippers to continue to operate in an environment with which they are generally familiar. TransCanada acknowledged that its proposal would be a "blunt instrument" if, as a result of gaming at one location, TransCanada decided to raise the floor price of IT on the entire system. This would result in an increased floor price for all shippers because of activity at one delivery point.

TransCanada argued that the main rationale for proposing pricing discretion is to provide greater benefits to firm shippers in the form of increased revenues. TransCanada submitted that there is a flaw in any mechanism that would establish a fixed floor for IT and STFT below the FT toll. TransCanada argued that, where the IT floor is consistently below the FT toll, shippers will seek to migrate from FT service to IT service even though the value of the capacity to the shipper may be above the IT toll.

The "fixed floor" alternatives to the current floor level, that were advanced by parties, would set the floor at 80% or 100% of the FT toll or some level above it. TransCanada submitted that, while these alternatives would all tend to discourage migration of FT shippers to IT service, they would render the pipeline unable to respond effectively to changing market conditions. TransCanada indicated that a failure to provide this opportunity to the pipeline and its shippers would result in unnecessary revenue losses.

TransCanada argued that two fundamental principles should govern short-term pricing on its system:

a) TransCanada's Tariff and toll-setting mechanism must not compel TransCanada to sell its short-term services at a price that is below the total cost of providing those services; and

b) Notwithstanding this first principle, TransCanada must be permitted to reduce the price of its short-term services below the total cost level in order to compete effectively, if market conditions require it to do so.

TransCanada supported the first principle by claiming that the true cost of providing IT service is the fully-allocated cost reflected by the FT rate and by the need to prevent migration from FT to IT service. TransCanada submitted that the second principle results from a desire to maximize short-term revenues in response to competition, for the benefit of firm shippers and itself.

TransCanada submitted that, if it is given the flexibility to manage the pricing of its services effectively, it would be in a better position to maximize revenues by having the ability to adjust the Reserve Price in order to optimize the price/quantity trade-off under prevailing market conditions.

TransCanada submitted that its proposed maximum Reserve Prices respond to concerns over potential abuse of market power because they would prevent TransCanada from unilaterally imposing prices for short-term services that are above the actual cost of providing those services.

TransCanada indicated that there is a distinction between deciding the appropriate pricing of services and determining the treatment of revenues received from the sale of those services. As a result, TransCanada did not agree with the suggestion that the issue of pricing discretion is linked to the issue of risk and cost consequences of non-renewed capacity.

Views of Parties

TCGS supported TransCanada's proposal for pricing discretion to vary the floor price of IT. All other parties opposed TransCanada's application for such pricing discretion. All parties opposed any change to the existing floor price for STFT and therefore rejected TransCanada's proposal to have the ability to set the floor price of STFT below or above the 100% FT toll.

CAPP submitted that there is a strong presumption against giving TransCanada pricing discretion with an equally heavy burden on TransCanada to demonstrate that its market power would be satisfactorily controlled. In CAPP's view, there is no evidence that the proposed constraint of putting a lower and upper range to the pricing discretion would in fact constrain market power. In support of this argument, CAPP pointed to the Federal Energy Regulatory Commission's (FERC) *Notice of Proposed Rulemaking, Regulation of Short-term Natural Gas Transportation Services* where the FERC observed that even a price below the maximum (i.e., the 100% FT toll) may still be a monopoly price. CAPP filed empirical evidence to suggest that TransCanada has substantial market power vis-a-vis Canadian producers. In this analysis, market power is defined as the ability of an individual firm or a group of firms to maintain prices above the competitive level or successfully exclude potential competitors for a sustained period of time. CAPP also raised the concern that withholding capacity, whether by simply taking capacity off the market or by pricing it off the market, can itself be an anti-competitive act.

CAPP submitted that the concept of giving pricing discretion to a long-line transmission pipeline raises many issues that can only be evaluated in the context of the entire service structure and rate design. CAPP expressed its view that pricing discretion should be addressed in the Services and Pricing Negotiations or in TransCanada's 2001 Tolls application. Specifically, CAPP indicated that the issue of price discretion is linked to other aspects of rate design and cost allocation and suggested that TransCanada is using this proceeding to obtain an advantage with respect to future negotiations with its shippers.

CAPP submitted that TransCanada's proposal did not contain a detailed explanation of the criteria, standards, or other objective factors that are required to govern pricing discretion. CAPP further submitted that such absence leads to an inability to ascertain or monitor how pricing discretion would be exercised. CAPP argued that pricing discretion could interfere with the commodity market.

IGUA submitted that there is nothing in TransCanada's proposal preventing the potential abuse of market power. IGUA suggested that its concerns over the potential abuse of market power could have been alleviated had TransCanada proposed an objective formula or standards to provide a clear framework for the exercise of pricing discretion, or had TransCanada volunteered to be subject to some form of monitoring or control by the Board.

IGUA expressed concern that there could be potential losses for TransCanada's FT shippers if the floor price is set either too low or too high, particularly if the consequences of such mistakes were assumed by FT shippers. IGUA's concerns were amplified by the fact that market conditions are not the same on all segments of TransCanada's system. IGUA submitted that, if the Reserve Factor is not adequate for certain segments, then there could be discrimination against shippers on these segments.

IGUA argued that, if a pipeline company is allowed to unilaterally price transportation services, it would inevitably influence the price of delivered gas and therefore the price that the buyer and seller would negotiate for the commodity. IGUA contended that TransCanada's proposal would also inevitably interfere with the free operation of the Secondary Market for FT capacity, which in IGUA'a view would constitute a violation of the principles set forth in the Board's Decision of 2 February 1995 on *Possible Changes to the Secondary Market for Natural Gas Transportation Services*. IGUA submitted that allowing TransCanada to have pricing discretion would aid those firm shippers, such as TCGS, who seek to sell excess FT capacity in the Secondary Market by fostering higher IT prices and thus higher Secondary Market prices.

TCGS supported TransCanada's maximum Reserve Prices of 100% of the FT toll in the summer and 125% of the FT toll in the winter, stating that those rates are cost based and send appropriate pricing signals to potential shippers. TCGS also supported allowing TransCanada the discretion to discount below those rates in order to maximize revenue by selling capacity that would otherwise not have been sold during periods of low demand. TCGS argued that granting TransCanada pricing discretion would prevent potential shippers from assuming that discounts for IT would always be there.

TCGS submitted that parties' concerns over TransCanada's potential abuse of market power were overstated and suggested that CAPP's evidence appeared to be aimed at an application by TransCanada for complete discretion to set its rates. TCGS argued that there is no foundation for IGUA's suggestion that TransCanada's proposal had been developed mainly for the purpose of favouring TCGS as an affiliate.

The LDCs submitted that there is a fundamental link between IT revenues, the pricing of discretionary services, and risk and reward mechanisms. They were concerned that TransCanada's application would disconnect those issues. Specifically, the LDCs considered the pricing of short-term service to be only one method by which TransCanada and its stakeholders could address issues arising from the potential under-utilization of the TransCanada system. The LDCs were concerned that TransCanada's proposal would allow TransCanada unilateral discretion in the pricing of short-term services without any risk or even accountability on TransCanada's part. The LDCs submitted that imposing risk on TransCanada would give shippers some assurance that TransCanada would behave appropriately.

The LDCs indicated that the Services and Pricing Negotiations provide the ideal forum within which to address the pricing of short-term services in the context of the related service, pricing and risk-allocation issues. The LDCs noted that, if a resolution is not achieved in those negotiations, the Board would have the opportunity to review all of the issues when TransCanada files its 2001 Tolls application.

The LDCs submitted that there is considerable doubt regarding the ability of TransCanada to capture greater IT revenues under its proposal vis-a-vis the current methodology. The LDCs suggested that TransCanada's proposal could only be useful if the circumstances warranting an increase to the IT floor tended to occur at different times than the circumstances warranting a decrease to the floor. In the LDCs view, they are more likely to be occurring at the same time, given that excess capacity usually occurs as a result of competition.

The IPPs submitted that they are not ideologically opposed to the exercise of pricing discretion by pipelines, pointing out that discretion has existed for years on FERC-regulated pipelines. The IPPs suggested that the parameters of the discretion sought by TransCanada in this case are quite closely confined. They suggested that the Board could audit the process and step in if it saw abuse or market failure, or if there was a complaint.

However, the IPPs indicated that affected parties would need to be comfortable with the exercise of pricing discretion. In this instance, the IPPs argued that TransCanada had not provided participants with sufficient comfort to conclude that discretion would be exercised in a manner that would maximize revenues to FT shippers.

Centra Gas submitted that the pricing of IT and STFT are interrelated with other service and pricing issues and should not be considered in isolation.

Renaissance submitted that TransCanada's proposal for pricing IT has some potential merit, as there would at least be a possibility that IT would be sold at a price higher than incremental variable cost. However, Renaissance submitted that TransCanada should not have discretion to price IT because it would put TransCanada in a conflict of interest, in that TransCanada would have to choose between a floor price that maximizes the contribution towards fixed costs and one that maximizes revenues.

Alberta viewed TransCanada's application as an attempt to raise the bid price above the existing floor in order to ensure that the pipeline captures any differential that is available. Alberta submitted that granting discretion to TransCanada is tantamount to giving TransCanada the authority to interfere in or manipulate the markets. Alberta argued that giving pricing discretion to TransCanada should place a heavy onus on the pipeline to demonstrate thoroughly how its proposal would work and to give some comfort to those who will bear the brunt of its mistakes. Alberta did not believe that TransCanada had demonstrated how its proposal would work, pointing to, *inter alia,* the competing objectives of reducing migration and of attempting to compete by lowering prices. Alberta agreed with parties who suggested that the pricing of short-term services should be looked at as part of the Services and Pricing Negotiations.

Quebec submitted that TransCanada should not be granted discretionary pricing authority in the existing situation, particularly with no risk sharing. Quebec argued that such changes must be discussed as a whole, either during the ongoing Services and Pricing Negotiations or in an in-depth hearing on changes to TransCanada's services and pricing methodology.

Ontario expressed the view that the ongoing Services and Pricing Negotiations provide an appropriate framework to resolve the issues before the Board in this proceeding. Ontario argued that adjustments to IT and STFT services should be considered in the context of a broader analysis of TransCanada services and pricing methodology.

Pan-Alberta provided comments to the effect that pricing flexibility must be part of discussions that provide for a broader scope and a longer-term solution. In particular, Pan-Alberta argued that the discounting of STFT should not be approved without considering the sharing of the risk and reward.

In its comments, Direct Energy Marketing Limited (DEML) opposed the implementation of any controls on open-market forces for the benefit of any party. DEML submitted that, if the controls that TransCanada proposes were implemented, they would not solve TransCanada's excess capacity and FT decontracting difficulties.

Views of the Board

Historically, pipelines have been viewed as natural monopolies, requiring regulatory oversight in order to prevent the potential abuse of market power. Pipelines have not generally been granted any unilateral pricing discretion to set the prices for their services. However, pricing discretion has been determined to be appropriate in specific circumstances or for certain services. For example, pricing discretion has been granted to TransCanada for its Parking and Loan service and its Multiple Handshake/Pooling service.

Pricing discretion may become more widely accepted as the industry moves into a more competitive, market-based environment. The Board has both acknowledged and encouraged the trend towards a more flexible and market-responsive regulatory framework, as reflected in various decisions and evidenced by the Board's support for the incentive settlement process.

In this case, however, the Board is of the view that the evidence did not demonstrate that it would be appropriate to grant pricing discretion to TransCanada for the setting of the floor prices of IT and STFT services. In the Board's view, in order to fully assess the appropriateness of pricing discretion, it would be necessary to undertake a comprehensive review of TransCanada's services and pricing methodology.

The Board is concerned that the pricing discretion sought by TransCanada was not clearly structured and confined. The Board notes the absence of objective criteria and transparency in the setting of the floor prices. The Board also notes the competing nature of the underlying objectives supporting TransCanada's application. The Board believes that market conditions where TransCanada would want to raise prices to prevent migration and market conditions where it would want to lower prices to respond to competitive forces are likely to occur at the same time. It is unclear which objective would prevail in those circumstances. The Board agrees with intervenors who argued that the lack of clear and objective criteria for the exercise of the proposed discretion makes it inappropriate.

The Board notes that the exercise of pricing discretion necessarily entails the potential for error or for misjudgment of the market. In the Board's view, there should be accountability for any such error or misjudgement. TransCanada's proposal for pricing discretion was not accompanied with direct accountability for the consequences of the exercise of its discretion.

TransCanada sought to obtain pricing discretion across its entire system, while justifying the need for discretion by the presence of competitive forces. In the Board's view, competitive forces are only present on limited segments of the TransCanada system and the impact of those forces has not been assessed by the Applicant. The Board notes that TransCanada's witness acknowledged that TransCanada's proposal would be a blunt instrument if prices were raised on the entire system to address situations at specific delivery points.

It is apparent that TransCanada and its affiliates operate virtually all of the ex-Alberta gas pipelines and, as a result, TransCanada has significant market power vis-a-vis Canadian producers and consumers. Moreover, most Eastern Canadian customers have only limited transportation alternatives to the TransCanada system. The Board acknowledges that this situation may change with the commencement of service on Alliance and Vector. In the Board's view, however, TransCanada will continue to occupy a dominant position.

The evidence did not demonstrate that TransCanada would not be in a position to potentially abuse its market power under its proposal. The Board's concerns in this respect are exacerbated by the wide range within which TransCanada could exercise pricing discretion.

The Board rejects TransCanada's suggestion that it would merely have the discretion to reduce the prices of its short-term services below the full-cost level. The suggestion is based on the view that the cost of providing IT and STFT service is the fully-allocated cost or the 100% FT toll. As further discussed in Section 4.3.1, this position is not supported by TransCanada's present cost-allocation methodology and rate design, which allocates all of the fixed costs to firm shippers. Any change to the appropriate cost causation of short-term services on the TransCanada system could not be considered outside a comprehensive review of TransCanada's services and pricing methodology.

The Board notes that TransCanada's proposal was opposed by almost all other parties.

In summary, the Board finds that TransCanada's proposal has not adequately addressed the concerns expressed during the hearing.

Decision

The Board denies TransCanada's proposal for discretion to set the floor prices of IT and STFT services.