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## Negotiated Settlements and Just and Reasonable Rates

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**Case Commented On:** [National Energy Board, TransCanada Pipelines Limited \(TransCanada\) Application for Approval of 2018 to 2020 Mainline Tolls RH-001-2018, Reasons for Decision, December 13, 2018](#)

This is the most recent decision in a string of decisions from the National Energy Board (NEB) over the last five years dealing with TransCanada PipeLines (TCPL) as TCPL and the NEB seek to grapple with the dramatic changes that have occurred in North American natural gas markets over this period, and more specifically how these changes pose the risk of stranded assets and as such threaten to affect the viability of one of the NEB's most important regulated pipelines: TCPL and TCPL's mainline (or at least elements of that mainline). Perhaps the most dramatic of these changes is the increased availability of shale gas supplies, and specifically shale gas supplies from basins much closer to TCPL's traditional markets than the Western Canadian Sedimentary Basin (WCSB), TCPL's main source of gas.

What is interesting about these decisions, including this most recent decision, is the interplay or tension between the NEB's statutory authority to establish just and reasonable rates and the market-based approaches as reflected in negotiated settlements. While the NEB and other regulators seek to encourage negotiated settlements between the regulated entity and its customers, it is plain from this decision that the regulator retains a power of review. While a regulator may be reluctant to exercise that power given that settlements typically involve some give and take, this decision demonstrates that the regulator will not always defer to the paradigm of settlement and contract if it perceives that the *results* of the settlement depart significantly from fundamental rate-making principles. While this decision happens to deal with TCPL and the NEB, the same interplay is apparent in any jurisdiction that allows for the possibility that a regulated utility may reach a negotiated settlement with some or all customers rather than going through an adversarial rate hearing.

### The Background

The NEB handed down a major decision known as the TCPL [Restructuring Decision](#) for TCPL's mainline system in March 2013 (RH-003-2011). Since nobody was entirely happy with that decision, the main parties were incented to negotiate a more optimal solution. The main players (TCPL and the three largest mainline customers Enbridge, Union and Gaz Métro) reached a settlement agreement and applied to have the NEB approve the settlement. The NEB established a process for considering the settlement but ultimately concluded (in light of significant

opposition) that it could not do so. It gave the following reasons (letter of 31 March 2014) for reaching that conclusion:

#### Process used to arrive at the Settlement

A number of submissions commented that the process used to arrive at this Settlement was not inclusive of all parties having an interest in TransCanada's traffic, tolls and tariffs. Further, several submissions raised the concern that the Settlement proposes fundamental changes to the tolling framework through 2030, including Mainline segmentation and cost allocation post-2020, without providing adequate detail or analysis of how they would work or what the impacts would be. These changes will change the gas transportation network in Canada but the Settlement was negotiated without the inclusion of parties like Northland Power Inc. and Centra Gas Manitoba Inc. who would be directly and substantially impacted by these changes.

The Board's Settlement Guidelines set out several criteria that should be satisfied in order for a settlement to be acceptable. The Board relies on an open and fair settlement process where a full range of interested parties are involved to result in a settlement that reflects the public interest. The Board uses the open settlement process to help in its assessment that the resulting agreement tolls are just and reasonable and not unjustly discriminatory. Negotiated settlements are a give and take process where one party will give up something to gain something else. In assessing whether an applicant has justified the approval of a contested settlement, the Board will consider among other things, whether there is sufficient support for the settlement, based on the comments submitted by interested parties.

The settlement process must produce adequate information on the public record for the Board to understand the basis for the agreement, assess its reasonableness, and to be able to determine that the resulting tolls are just and reasonable and not unjustly discriminatory.

...

In this instance, the Board finds that the process used is insufficient to allow the Board to approve the Settlement as a contested settlement. The agreement negotiations included only TransCanada and its three biggest shippers, with other shippers being minimally involved after the agreement was nearly final. There are too many parties, including but not limited to Western Mainline receipt and delivery point shippers and those with differing Mainline utilization profiles, such as short haul shippers in the Eastern Ontario Triangle, who were not represented within the negotiation process of the agreement. The Board also finds that there are gaps in the adequacy of the record, such as information on the future treatment of the Western Mainline under the proposed segmentation, that arise at least in part from the under-inclusive process. For these reasons, the Board cannot determine that the resulting tolls are just and reasonable and not unjustly discriminatory.

Reproduced as Appendix IV of [NEB Reasons for Decision, TCPL, RH-001-2014, December 2014](#)

[The Board's Settlement Guidelines are available [here](#)]

Instead of approving the settlement, the NEB agreed to treat the settlement as the basis for a contested tolling application under Part IV of the *National Energy Board Act*, [RSC 1985, c N-7](#). The application was set down in the ordinary course and resulted in a new decision from the Board in December 2014: [NEB Reasons for Decision, TCPL, RH-001-204, December 2014](#). The NEB largely approved TCPL’s application.

The NEB decision examined here (RH-001-2018) deals with matters arising from that December 2014 decision relating to proposed tolls for 2018 – 2020 for the mainline. This happened because while the December 2014 decision approved the *toll design* for the mainline for 2015 – 2020, it directed TCPL to file an application for the approval of the *actual tolls* for 2018 – 2020 by 31 December 2017.

TCPL reached an agreement with the same three main players (with Énergir now replacing Gaz Métro) in early December 2017, shared that with interested parties in one-on-one meetings, and presented it to the Mainline Tolls Task Force (TTF). The majority of the TTF supported the agreement and on that basis TCPL filed for approval indicating that some parties would contest the application. The NEB established a written process to consider the application and objections, and issued its decision on 13 December 2018.

Intervenors raised issues principally with respect to two aspects of TCPL’s toll proposal (and especially the first element):

- The disposition and allocation of the Long-Term Adjustment Account (LTAA) in the 2018 to 2020 period; and
- The appropriateness of continued pricing discretion for Interruptible Transportation (IT) service and Short Term Firm Transportation (STFT) service.

### **The Disposition and Allocation of the Long-Term Adjustment Account in the 2018 to 2020 Period**

The LTAA was approved as an adjustment account in the RH-001-2014 proceedings where the account was described (at 46) as “an adjustment account to capture all variances between the actual and forecast costs and revenues during the period 2015 to 2020, net of incentive mechanism adjustments.” It is in the nature of adjustment (or deferral) accounts that at some point there has to be a decision about the disposition of the positive or negative balance in the account: see *Bell Canada v Bell Aliant Regional Communications*, [2009 SCC 40 \(CanLII\)](#).

By the time of TCPL’s application the LTAA balance had grown to approximately \$1.1 billion – much larger than had been anticipated. The NEB described TransCanada’s approach to the disposition of the LTAA in its decision as follows (at 4):

TransCanada stated that the Settlement and its approval created an expectation that the LTAA would be amortized based on composite depreciation rates, resulting in toll certainty and stability for all shippers during the 2015 to 2020 period and afterward. TransCanada stated that it is expected to take 46 years for the LTAA to be fully amortized at the proposed total system composite depreciation rate of approximately 3.9 per cent for the years 2018

to 2020 and the Eastern Triangle segment composite depreciation rate of approximately 2.1 per cent for the remaining years.

TCPL noted that the LTAA was established as part of the give and take of the settlement and thus that any decision (at 4) “accelerating the disposition of a positive balance, while maintaining or postponing the recovery of a negative balance would impose asymmetric risks that were not contemplated in the Settlement and are not reflected in the risk-return framework defined in the Settlement.”

A number of parties including the Canadian Association of Petroleum Producers (CAPP) objected to the proposed treatment of the LTAA balance on the basis that it failed to adhere to key ratemaking principles long endorsed by the Board including the principles of cost causation, economic efficiency, and intergenerational equity. More specifically, CAPP was of the view that TCPL’s proposed treatment ignored the fact that most of the incremental revenues (i.e. revenues beyond forecast) had come from the Prairies segment of the mainline and yet the proposed disposition of proceeds would disproportionately benefit future shippers on the Eastern Triangle. Furthermore, “[t]he continued long term deferral of over a billion dollars of over collected revenues for the 2018 to 2020 period decreases the competitiveness of the WCSB” in TCPL’s traditional markets (at 5). CAPP proposed instead (at 7):

... that the entire LTAA be returned to shippers in the 2018 to 2020 period. Additionally, given that it is possible to track over-collection on the Mainline by segment in the 2015 to 2017 period, CAPP’s position is that the LTAA should be allocated to each segment using the same ratio that each segment paid above its forecasted targets. That is, if 57 per cent of the over-collection came from the Prairies, the same 57 per cent of the LTAA should be used to reduce the Prairies tolls over the 2018 to 2020 period.

This would have the added policy benefit of reducing tolls, thus rendering WCSB gas more competitive in traditional markets and lead to greater economic efficiency for the mainline.

In response to TCPL’s arguments to the effect that the NEB should not interfere with the balance achieved in a settlement agreement, especially where the agreement itself did not expressly provide for “off-ramps” (i.e. triggers that would allow the balance of the settlement to be revisited), CAPP noted that the NEB’s RH-001-2014 Decision itself did have some “change of circumstances language” that opened the door to revisiting the balance as follows (at 47):

Concerning TransCanada’s proposal to allocate the LTAA balance to the Eastern Triangle rate base in 2021, the Board has determined that this proposal is appropriate in the context of the package of gives-and-takes between TransCanada and the settling parties. However, should there be a *material change in circumstances* when 2021 tolls are determined, the Board may determine that a different allocation of the LTAA is more appropriate. (Emphasis added by CAPP)

I note that the italicized language on its face applies to the determination of tolls for 2021 rather than any prior period.

## The NEB Decision on the LTAA Issues

The NEB essentially adopted CAPP's entire position with the exception that it declined to return any of the amount collected to shippers between 2015 and 2017 on the basis that those tolls were final tolls and there could be no retroactive adjustment of those tolls.

Rather than paraphrasing it seems appropriate to let the NEB speak in its own words, especially since I anticipate that this decision will be widely quoted and relied upon in subsequent proceedings (references omitted) (at 16 – 19):

The Board finds that, based on the facts and circumstances presented in this case, TransCanada's proposed treatment of the LTAA would not adhere to the cost-based/user pay tolling principle, causes unreasonable intergenerational inequity, and therefore does not produce just and reasonable tolls. In order to better align with established tolling principles, the Board has decided that 100 per cent of the LTAA be returned to shippers in the 2018 to 2020 period using the over-collection allocation method as proposed by CAPP ...

### *Requirements of the NEB Act and Tolling Principles*

Under Section 62 of the NEB Act, all tolls must be just and reasonable. In determining whether tolls are just and reasonable, the Board has historically relied on fundamental tolling principles, including the principle of cost-based/user-pay tolls. The Board has stated that tolls should be, to the greatest extent possible, cost based and that users of a pipeline system should bear the financial responsibility for the costs caused by the transportation of their product through the pipeline. Similarly, the Board has stated that all reasonable efforts should be made to minimize cross-subsidization.

The cost-based/user-pay principle can be applied in consideration of costs over time, which can be referred to as intergenerational equity. In other words, one generation of shippers subsidizing the costs of another generation of shippers should be avoided.

### *Amount to Dispose*

The Board finds that the Application's approach to return only approximately 3.9 per cent of the \$1.1 billion LTAA balance each year to shippers in the 2018 to 2020 period represents an unreasonably large intergenerational cross-subsidy. From 2015 to 2017, shippers paid tolls that generated revenues significantly above the Mainline's costs. TransCanada's approach results in the majority of that significant overpayment being returned to shippers in 2021 and thereafter, and would not be fully returned to shippers until after 46 years.

Adherence to intergenerational equity and the cost-based/user-pay principle is often evaluated on a spectrum. Some levels of intergenerational cross-subsidization are inherent and acceptable in a fixed toll design such as on the Mainline. However, in this case, the imbalance in time from when the over-collection of revenues occurred to when it is largely returned, in conjunction with the magnitude of such a deferral resulting from the \$1.1 billion LTAA balance, conflicts with intergenerational equity and the costbased/user-pay

principle to a degree that, in the Board's view, necessitates a different approach. While there was no explicit off-ramp mechanism included in the RH-001-2014 Decision, clearly there must be, at some point, a level of deferral that does not produce just and reasonable tolls. The Board concludes that, in this case, that level has been reached.

The Board finds that CAPP's proposal to dispose 100 per cent of the LTAA in the 2018 to 2020 period better aligns with intergenerational equity and the cost-based/user-pay principle. CAPP's proposal provides a greater opportunity for the toll decrease benefits resulting from the amortization of the LTAA to accrue to those shippers that effectively overpaid Mainline costs in the 2015 to 2017 period. Since the Board cannot retroactively change final tolls that were in place between 2015 and 2017, the Board finds that disposing of the entire LTAA balance in the following period of 2018 to 2020 is a practical solution for returning prior shippers' over-funding of the Mainline's revenue requirement.

The Board heard arguments that CAPP's proposal would negatively impact toll stability and certainty. While toll stability is an important toll objective for the Mainline in its current environment, it would come at the expense of a significant departure from the principles of cost-causation and intergenerational equity. The Board finds that in these circumstances, addressing the magnitude of the LTAA balance and the significant proposed intergenerational inequity that would result from the Application takes precedence over toll stability and certainty.

#### *Allocation to Each Segment*

In this case, the Board finds that the Application's approach to allocate the LTAA Amount to each Mainline segment using the ratio of rate base methodology does not adequately adhere to the cost-based/user-pay principle. As stated previously, adherence to the cost-based/user-pay principle is often evaluated on a spectrum. Some levels of intersegment cross-subsidization are inherent and acceptable in an integrated toll design such as on the Mainline. However, given the magnitude of the inter-segment cross-subsidy that would result from the ratio of rate base method, and that no compelling evidence supporting the ratio of rate base method as being consistent with the Board's tolling principles was provided, the Board finds that an alternative allocation method is required.

The Board finds that CAPP's proposed over-collection allocation method better aligns with the cost-based/user-pay principle by allocating the LTAA Amount to each Mainline segment based on each segment's respective share of over-collected revenues from 2015 to 2017. CAPP's proposal will provide a greater opportunity for the toll decrease benefits to accrue to shippers that effectively overpaid Mainline costs in the 2015 to 2017 period. CAPP's over-collection allocation method is also consistent with TransCanada's three-step toll design, unlike the pro-rata approach proposed by Centra.

The Board heard arguments that CAPP's proposal ignores the fact that Eastern Triangle shippers paid higher tolls in 2015 to 2017 to cover the majority of revenue shortfall on the Western Mainline. The Board finds that CAPP's over-collection allocation method still adequately reflects the Eastern Triangle's previous contributions towards Western Mainline costs. As a function of TransCanada's three-step toll design, CAPP's proposal

for allocating the LTAA will still largely benefit the Eastern Triangle. The Eastern Triangle is provided with the largest toll decrease and a significant BAA balance at the end of 2020 to the credit of Eastern Triangle shippers.

#### *Consistency with the RH-001-2014 Reasons for Decision and Settlement Agreement*

The Board heard arguments that alternative LTAA proposals would be inconsistent with the RH-001-2014 Reasons for Decision and the Settlement Agreement between TransCanada and the settling parties. Parties argued whether the \$1.1 billion LTAA balance represented a material change in circumstances that warranted a different treatment. TransCanada argued that the Board did not contemplate any changes to the LTAA's treatment until 2021.

The Board recognizes that, in the RH-001-2014 Reasons for Decision, it did not specifically contemplate changes to the LTAA's treatment for the 2018 to 2020 toll review. The Board also found in the RH-001-2014 Reasons for Decision that the LTAA's treatment was appropriate given the context of gives-and-takes between TransCanada and the settling parties.

However, regardless of previous Board direction and agreements that may be in place, tolls must be just and reasonable at all times. The circumstances have changed from the Board's previous consideration of the LTAA in the RH-001-2014 proceeding. The magnitude of the \$1.1 billion LTAA balance, which could not have been forecast in RH-001-2014, and the significant departure from intergenerational equity and the cost-based/user-pay principle that would result from the Application's treatment of that significant LTAA balance, result in tolls that are not just and reasonable, and therefore necessitate a different approach.

#### *Competitiveness*

The Board also considered the competitiveness (*sic*) of Mainline tolls in making its determination on the LTAA's treatment. The Board has stated previously that "long-haul Mainline tolls must be competitive to be just and reasonable". As TransCanada submitted, competitiveness is a spectrum. It varies among paths depending on many factors, and varies between different shippers. The Board finds that no evidence was provided to demonstrate that overall, TransCanada's proposed FT tolls were not competitive.

However, competition remains a threat to the Mainline, and the trend of declining long-haul contracting continues. This is evidenced by TransCanada's billing determinants and throughput forecasts provided as part of the Application. Additionally, TransCanada has applied recently for two LTFP services to specifically respond to competition. The Board finds that returning the entire LTAA balance to shippers in the 2018 to 2020 period will help towards the overall competitiveness of the Mainline's services in a competitive environment, and will promote increased utilization to the benefit of the Mainline and its shippers.

## The Pricing Discretion Issue

In its TCPL Restructuring Decision (RH-003-2011) and in its messaging since then, the NEB has emphasised that TCPL must actively manage the problem of fundamental risk (stranded assets) and use the tools that it has at its disposal rather than expecting the NEB to bail it out. One of these tools is the competitive pricing of Interruptible Transportation (IT) service and Short Term Firm Transportation (STFT) service. The argument here is that if TCPL prices these services competitively, not only will this bring in incremental revenues, but it might also increase the attractiveness of firm service options.

TCPL argued in this proceeding that the NEB should continue to allow it full pricing discretion for these services (at 20):

TransCanada submitted that it intends to continue using pricing discretion to increase revenues and associated throughput using available capacity. The use of pricing discretion to maximize overall Mainline revenue is an exercise of balance between providing an incentive for shippers who have firm requirements to contract for the firm service they require, and responding to market opportunities if and when they arise.

Most intervenors evidently supported TCPL's application with the principal opposition coming from Centra (Manitoba), which suggested upper limits for these services (1,500 per cent of the firm transportation (FT) toll). This time the NEB sided with TCPL reasoning as follows (at 24 – 25):

The Board is of the view that unlimited pricing discretion played an important role in increased FT contracting since RH-003-2011 and remains relevant in providing continued incentive for shippers to contract for firm services. With limitations on pricing discretion the Board is of the view that shippers would have a higher incentive to decrease FT contracting in favour of discretionary services, and therefore would not pay for the annual cost of operating the Mainline. As well, limits on pricing discretion would limit TransCanada's opportunity to derive higher discretionary revenues when market conditions could support higher IT bid floors.

The Board notes that the post-2020 Mainline toll design is unknown. The Mainline continues to evolve in response to changing market conditions with new facilities and services. The Board is of the view that the necessity of unlimited pricing discretion for IT and STFT services in a scenario of a segmented Mainline, higher contracting and lower uncontracted pipeline capacity will require a re-evaluation. ...

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