National Energy Board
Office national de l'énergie

Traffic, Tolls and Tariffs

June 1997

Canada

Synopsis
This bulletin describes the Board's responsibilities and processes with respect to the regulation of traffic, tolls and tariffs.

THE BOARD

The National Energy Board is an independent regulatory tribunal that was created by the Parliament of Canada in 1959. Its powers and jurisdiction are based on the *National Energy Board Act*, the *Canada Oil and Gas Operations Act* and certain provisions of the *Canada Petroleum Resources Act*. The purpose of the Board is to make decisions that are fair, objective, and respected. The Board achieves this purpose by regulating in the Canadian public interest certain areas of the oil, gas, and electric utility industries. Copies of the Acts are available from the Board and from the Canada Communications Group, Public Works and Government Services Canada, 45 Sacré-Coeur Blvd., Hull, Quebec, K1A 0S7.

PUBLICATIONS

This information bulletin is one of a series that the Board publishes on its activities and procedures. Comments on this bulletin or suggestions for future topics are welcome. These bulletins provide general information only. For details of particular items, reference must be made to the relevant legislation. The *National Energy Board Act* and the regulations will prevail in the case of a conflict with information contained in this bulletin.

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Introduction

The National Energy Board (the Board) is an independent federal regulatory agency. It was established by the *National Energy Board Act* (the Act) of 1959. The Board has authority over companies operating pipelines which transport oil, natural gas, natural gas liquids, petroleum products and other commodities across provincial or international boundaries, and in certain Frontier areas. Part IV of the Act outlines the Board's mandate and responsibilities concerning the regulation of pipeline traffic, tolls and tariffs.

The transportation of hydrocarbons by pipeline is an essential public service. Since pipelines may exhibit the characteristics of a monopoly, pipeline owners may not typically be exposed to the discipline of the marketplace. Regulation seeks to protect the public interest by ensuring that tolls charged for transportation services are just and reasonable, there is fair access to pipeline services, and that there is no unjust discrimination in either the charges or the provision of pipeline transportation services.

This information bulletin provides an overview of the Board's role in regulating pipeline traffic, tolls and tariffs. For more detailed information, contact the Board or refer to Part IV of the Act.

Regulatory Processes

The Board is a court of record. Its decisions and reasons for decision are public documents. Applications and complaints concerning traffic, tolls and tariffs may be filed with the Board at any time. For purposes of examining tolls, the Board has the discretion to determine whether an oral or written public hearing is warranted in particular cases. In either case, the Board's practice is to seek input from interested parties before rendering a decision on an application or complaint. Information Bulletins II, III and IV provide information on the public hearing process, non-hearing procedures and how to participate in a public hearing.

Tariffs

Pipeline tolls are included in a tariff filed with the Board. This tariff may also include terms and conditions which describe how a prospective shipper may have access to the pipeline and the rights and responsibilities of both the pipeline and shipper once service commences.

Traffic

Under the Act an oil pipeline (i.e. a pipeline which carries oil, natural gas liquids and petroleum products) is a common carrier while a natural gas pipeline is a contract carrier.

As a common carrier, an oil pipeline must accept all oil offered to it for transportation on an equal basis to all shippers. When there is insufficient capacity for the volumes tendered, the pipeline company apportions its available capacity to accommodate all shippers requesting capacity. The Board ensures that access and apportionment occur on an equitable basis.

A gas pipeline is a contract carrier. This means that it is not obligated by statute to accept all gas offered to it for transportation. However, the Board has the authority under the Act to direct it to provide service for a shipper. In practice, gas pipelines operate on an open-access basis. A gas pipeline's tariff may contain provisions for the queuing and access procedures, the minimum duration of contracts, renewal requirements and the bidding mechanism used to secure interruptible service. In this way, gas pipelines provide equal and nondiscriminatory access for all shippers.

Recently the Board has obtained jurisdiction over pipelines which carry commodities other than oil or natural gas. This type of pipeline may carry commodities such as steam, brine, chemicals, pulp or coal slurry, alone or in combination with hydrocarbons. Commodity pipelines are not common carriers by statute. The obligations of these pipelines, in respect of service, are similar to those of gas pipelines.

Overview of Toll Regulation

Toll regulation aims to strike a balance between the interests of pipeline users and investors. Until 1995, cost of service regulation applied to all major pipelines. Under this approach, companies litigated before the Board, often annually, to determine the amount of revenue the pipeline was allowed to recover through tolls. Proceedings to determine the cost of service and tolls are generally adversarial and time-consuming, requiring legal counsel and expert witnesses.

Traditional cost of service regulation focuses on cost control. For some time, the Board has been concerned with reducing the cost of regulation and in developing alternatives to the cost of service model. Since 1988, when the Board released its *Guidelines for Negotiated Settlements of Traffic, Tolls and Tariffs* (updated in 1994), it has been a leader in developing alternatives to the traditional cost of service approach. In the process, the Board has facilitated and supported consensus building between pipeline companies and their shippers.

Beginning in 1995, the Board approved a succession of multi-year negotiated settlements. These agreements generally include incentives to reduce costs, and provisions to share savings between the pipeline and its shippers. In the future, the Board anticipates that litigation to determine tolls will be used more selectively.

Negotiated Settlements

The *Guidelines for Negotiated Settlements of Traffic, Tolls and Tariffs* clarify the Board's role and establish acceptable criteria for the settlement process. Generally, the Board seeks to ensure that all interested parties have a fair opportunity to participate in the settlement process and that there is a general acceptance of the outcome. The guidelines have facilitated the resolution of specific toll matters and also the development of incentive regulation.

The Board does not participate in negotiations between parties since it must rule on the final proposal. However, the existence of an agreement does not limit the authority of the Board. In considering whether to approve an agreement, the Board takes into account the views of all interested parties as well as broader public interest concerns, including potential impacts upon public safety and protection of the environment. The Board either accepts or rejects a settlement package in its entirety. A settlement which is unopposed may allow the Board to determine that the resulting tolls will be just and reasonable.

Incentive Regulation

Incentive regulation has developed mainly through multi-year toll agreements negotiated between pipelines and interested parties. Such agreements provide for a sharing of the benefits that may result from improved performance by the pipeline. Typically, parties agree to a baseline level for costs which may be lower than what the pipeline applied for under cost of service regulation. Some protection is afforded to the pipeline for uncontrollable cost escalation along with a share of the rewards for keeping costs below the target level. Similar incentives can apply to efforts by the pipeline to increase throughput and revenue.

Once approved by the Board, multi-year agreements allow for a more relaxed form of regulation. Each year of the agreement, the pipeline makes a tariff filing containing new tolls based upon the agreement. After parties have had an opportunity to provide comments on the filing, new tolls come into effect, unless there is cause to examine them further.

Cost of Service Regulation

Until recently, the Board used the cost of service approach almost exclusively for setting tolls. A toll adjustment requires that a company file a toll application with the supporting documentation specified in Part X of the Board's *Guidelines for Filing Requirements*. The Board then establishes a proceeding to allow input from interested parties. Afterwards, the Board issues a decision approving final tolls.

Under this regime, a pipeline's tolls are set to provide users with the required service at a reasonable cost, and investors with the opportunity to recover costs and earn a reasonable return on their investment in the pipeline. To set tolls, the cost of service and throughput are forecast for a test year. The cost of service is made up of operating expenses, depreciation, taxes and return on capital. The Board allows, but does not guarantee, a pipeline the opportunity to earn an approved rate of return. This provides an incentive to keep costs within accepted limits.

A company may not recover costs from a previous year without prior approval. As a rule, the Board only allows a company to defer the recovery of costs to another year when they are beyond a company's ability to control or estimate accurately, such as an amount in dispute before the courts. Deferred costs are then subject to scrutiny before being included in another year's cost of service.

The return to be allowed on the rate base can be a contentious matter. Since the rate base is financed with both debt and equity, appropriate proportions for each, as well as their cost rates, must be determined. As interest is tax deductible, debt tends to be a lower cost source of financing than equity. On the other hand, equity investors must be fairly compensated for the risk they assume as owners of the pipeline. If a company's actual capital structure is found to be inappropriate, the Board may deem another one to derive the allowed return.

In 1995, the Board held a generic cost of capital hearing. The Board determined appropriate equity ratios for several companies based upon their business risks. The Board then approved a uniform rate of return on common equity, based upon the forecast interest rate for long-term Government of Canada bonds, plus a risk premium. Finally, the Board established a procedure for annual adjustment of the rate of return on equity. This initiative was in response to a desire to move away from adversarial proceedings and to avoid the repetition of cost of capital evidence.

Complaint-based Regulation

In 1985, the Board concluded that smaller pipelines under its jurisdiction should be subject to a lighter degree of regulation. The Board divided pipeline companies into two groups: ten companies with extensive systems are identified as Group 1, while the remaining companies are classified as Group 2. There are approximately 60 Group 2 companies which operate smaller pipelines.

The Board uses a complaint approach for the financial regulation of Group 2 companies. This method of regulation is described in each company's tariff. The pipeline company is responsible for providing shippers and other interested parties with sufficient information to enable them to ascertain whether the tolls are reasonable. Tariffs containing new tolls, once filed with the Board, automatically become effective.

Under the complaint approach, the Board does not normally examine a tariff filing. If a complaint is filed, the Board may establish a procedure to examine tolls. In the absence of a complaint, the Board may presume that the filed tolls are just and reasonable. Overall, this approach has resulted in few complaints.

In addition, the Board now uses a complaint approach for tariff filings by certain Group 1 companies with the general support of their stakeholders.

Toll Design

Toll design is the process of deriving tolls from the cost of service or revenue requirement and throughput. Tolls should generate sufficient revenue to recover approved costs, and at the same time fairly allocate charges to users in relation to the costs and benefits of different services.

The basic principle is user pay. Toll design divides costs between the various functions performed by the pipeline system, such as transmission and metering, and then determines costs and usage of those functions. Some costs are common to every unit of throughput. Other costs may depend upon variables such as the distance shipped, and still other costs may be unique to a particular type or class of shipper. Finally, some costs may be more appropriately allocated within a geographic zone. Generally, the Board has allocated costs on a straight fixed variable basis; none of the pipeline's fixed costs are allocated to the variable portion of the toll.

For a new pipeline, the method of tolling can be crucial to its economic viability. The large costs and high risks associated with the construction of a new pipeline have resulted in novel approaches to the setting of tolls. Such approaches seek to keep tolls as low as possible in a pipeline's early years to attract throughput. More recently, the Board has approved the construction of new pipelines which will compete with established pipelines. This has occured when the project sponsors have indicated they are willing to bear the risk of underutilization and offer available capacity at market-based tolls. In some cases, shippers have negotiated discounts which increase according to the duration of their shipping commitments and this then assists the sponsors of the pipeline in underpinning their financing. Generally, the Board has approved innovative approaches where these are supported by arm's-length agreements negotiated between the pipeline's sponsors and shippers following an open season. In the Board's view, non-discriminatory access requires that service be offered on the same basis, at the same time, to all potential shippers.

With additions to an existing pipeline, there may be toll issues concerning whether costs should be pooled and charged to all users or kept separate and charged only to particular users. Does the project increase capacity or extend pipeline service? In deciding such matters, the Board considers whether this is a new distinct service or an expansion of an existing service and what the relative costs and benefits are to the parties. Rolling-in all costs has the advantage of lower tolls through the spreading of costs among many users; however, this may result in inequitable cost-sharing.

Tolls on an Interim Basis

The Board can only consider toll adjustments on a forward or prospective basis. A company may apply to have its tolls adjusted during a year as long as it uses estimates for an entire calendar year to calculate new tolls. This restricts its ability to recover extra costs incurred earlier in the year.

In situations where the desired effective date for new tolls will have passed before a decision on final tolls can be made, the Board may issue an order allowing the company to charge tolls on an interim basis until the final toll order is issued. The tolls contained in the final order can then be made effective from the date of the interim order. Refunds or charges which result from the final toll order usually include interest charges.

Surveillance Reporting

Unless specifically exempted, a Group 1 pipeline company is required to file a surveillance report at the end of each quarter pursuant to the *Toll Information Regulations*. Part XI of the *Guidelines for Filing Requirements* outlines the information and the format of surveillance reports. These reports provide details of financial performance and explain any significant variations from approved amounts. Through these reports the Board is able to determine whether changes in tolls are likely to be needed and to test the reliability of estimates used to establish tolls.

The Board recognizes that an incentive agreement reduces the need for ongoing surveillance. Accordingly, some Group 1 companies operating under approved incentive agreements have been exempted from the requirement to file quarterly surveillance reports.

For some time, the Board has required all Group 2 companies to file audited financial statements each year. In recent years, many Group 2 companies, primarily those operating pipelines serving only their owners, have been exempted from this filing requirement.

Accounting

The Board's *Gas Pipeline Uniform Accounting Regulations* and *Oil Pipeline Uniform Accounting Regulations* establish a uniform system of accounts for Group 1 companies. This provides for the recording of costs in a consistent manner. Group 2 companies are required to keep their accounts in accordance with generally-accepted accounting principles. The Board can audit a pipeline company's records to ensure the accuracy of filed documents and compliance with the Board's decisions, regulations and other directives.

Conclusion

Since 1985, deregulation of the energy commodities market has encouraged the development of a continental market for energy. At the same time, the construction of new pipelines and the expansion of existing ones have greatly increased alternatives and competition in pipeline transportation. These factors have brought about a dramatic change in the way the Board regulates the traffic, tolls and tariffs of pipelines. The Board will continue to facilitate the development of streamlined and easily-understood regulatory processes and innovative and effective methods of regulation.