

Report of the Committee on International Energy Transactions

I. FEDERAL ENERGY REGULATORY COMMISSION: FLOW THROUGH OF IMPORTED GAS COSTS ON AN "AS-BILLED" BASIS.

The past year the Federal Energy Regulatory Commission (FERC or Commission) reaffirmed and further explained its mandate in Opinion No. 256¹ that domestic pipelines not be allowed to pass through on an as-billed basis² their Canadian suppliers' demand and commodity charges. The Commission also ruled on several as-billed proposals, denying as-billed flow through in all but a few cases.

A. *Opinion No. 256*

In Opinion No. 256, the Commission addressed the reasonableness of as-billed flow through of Canadian gas demand and commodity charges. Natural Gas Pipeline Company of America (Natural) is a domestic importer of natural gas which purchases Canadian gas for resale in the United States. Historically, Natural's Canadian suppliers charged Natural a volumetric rate, which Natural assigned to the commodity component of its rates. Subsequent to the Canadian government's initiation of its New Natural Gas Export Policy To Allow Negotiated Price,³ Natural and its Canadian suppliers renegotiated their rates and replaced the one-part rate with a two-part rate consisting of a negotiated demand charge and a commodity charge.

At issue in Opinion No. 256 was whether the Commission's as-billed purchase gas adjustment (PGA) rule allowing as-billed flow through of demand and commodity costs for domestic pipelines⁴ applied to the flow through of Canadian demand and commodity charges. The issue was a difficult one because Natural's Canadian suppliers had flowed through to their demand charges to Natural all of their fixed costs including non-transmission fixed costs, an approach that was inconsistent with the Commission's modified fixed variable (MFV) cost allocation method.⁵ In the initial decision in the proceeding,⁶ the administrative law judge (ALJ) ruled that the benefits of the renegotiated rates outweighed the possible detriments that could result from

1. Natural Gas Pipeline Co. of Am., 37 F.E.R.C. ¶ 61,215 (1986) [hereinafter Opinion No. 256]. Opinion No. 256 was discussed thoroughly in this Committee's last annual report, see *Report of the Committee on International Energy Transactions*, 8 ENERGY L.J. 147, 153-58 (1987).

2. "As-billed" flow through refers to a procedure whereby an upstream pipeline's demand charges are included in the downstream pipeline's demand charges and the upstream pipeline's commodity charges are included in the downstream pipeline's commodity charges as billed.

3. See *Report of the Committee on Natural Gas Imports and Exports*, 6 ENERGY L.J. 149 (1985).

4. 18 C.F.R. § 159.38(d)(4)(ii)(1987).

5. Under the MFV method, fixed production costs, an allowance for return on equity and associated income taxes and all variable costs are classified to the commodity component of a pipeline's two-part rates. Remaining costs are classified to the demand component. See Natural Gas Pipeline Co. of Am., 25 F.E.R.C. ¶ 61,176 (1983).

6. Natural Gas Pipeline Co. of Am., 35 F.E.R.C. ¶ 63,054 (1986).

as-billed flow through, and allowed Natural to flow through its Canadian demand and commodity charges as-billed.

In Opinion No. 256, the Commission reversed the ALJ's opinion and directed that Natural only flow through in its demand charge those charges that could be properly flowed through under the MFV rate design. The Commission justified its refusal to apply the as-billed principle to the Canadian charges on the basis that the as-billed principle is "premised on [the] Commission's having examined the costs in the upstream supplier's rates."⁷

Because the Commission was unable to examine and rule on the propriety of Canadian pipelines' demand and commodity charges, the Commission chose to examine those charges at the first opportunity it had after the natural gas crosses the border. The Commission concluded that this examination and recomputation of charges was necessary to place Canadian and domestic suppliers on a "level playing field," and to prevent the possibility of cost-shifting between high- and low-load factor customers.

B. Opinion No. 256-A

On May 27, 1987, the Commission issued Opinion No. 256-A,⁸ upholding the denial of as-billed flow through for Canadian gas costs. Opponents of Opinion No. 256 argued that the Opinion was contrary to Economic Regulatory Administration (ERA) policy, intruded on Canadian ratemaking methodology, interfered with freely negotiated international contracts and jeopardized trade between the U.S. and Canada.⁹ Canadian Prime Minister Brian Mulroney went so far as to write President Reagan to protest the Commission's decision.¹⁰

The Commission stated that its as-billed ruling "is not an attempt to extend our reach of our regulation of natural gas across the border."¹¹ The Commission noted that it had not modified the Canadian rate design because it had limited those Canadian demand charges the domestic pipeline could include in its demand charge but did not limit the demand charge actually paid to the Canadian exporter. Because the Canadian National Energy Board (NEB) had authorized straight fixed variable (SFV) rate design,¹² domestic pipelines would be at a disadvantage relative to the Canadian exporters if as-billed flow through was authorized.

The Commission rejected arguments that it had not properly deferred to Canadian regulators. The Commission noted that it had not questioned the prudence of the Canadian costs, which were approved by the Canadian regulators. Furthermore, the ERA had specifically recognized the Commission's authority "under [s]ections 4 and 5 of the NGA to examine Natural's demand

7. Opinion No. 256, 37 F.E.R.C. at 61,544.

8. Natural Gas Pipeline Co. of Am., 39 F.E.R.C. ¶ 61,218 (1987) [hereinafter Opinion No. 256-A].

9. See Foster Natural Gas Report (Foster Associates) No. 1621, at 6 (May 28, 1987).

10. *Id.*

11. Opinion No. 256-A, 39 F.E.R.C. at 61,764.

12. Under the SFV method, all fixed costs are assigned to the demand component of a pipeline's two-part rates. The SFV method thereby guarantees a pipeline recovery of a greater portion of its costs than the MFV method.

charge and to exclude components therefrom, if necessary, to achieve a just and reasonable result."¹³

The Commission responded to arguments that application of SFV rate methodology was proper in the case of Canadian imports. First, the Commission reiterated that Natural is free to pay all of its Canadian supplier's fixed costs through a demand charge, although it may not flow through those costs as-billed. Second, it affirmed its preference for MFV rate design for the reason that "there is no economic reason to assure pipeline profits when sales are not made."¹⁴ Third, the Commission noted that to approve SFV rate design for imported gas while requiring MFV rate design for domestically produced gas would disadvantage domestic producers.

The Commission conceded that SFV rate design may be appropriate in some very limited instances. "To be justified, current market conditions must be such that the object of marketability must outweigh the other important rate design objectives, such as minimizing cost shifting among Natural's various customers and apportioning risk to the Canadian transmission costs in domestic markets."¹⁵ The Commission confirmed that the goal of marketing Canadian gas in U.S. markets is strong, but no stronger than the goal of marketing domestic gas.¹⁶

C. *The "Administrative Conduit" Exception to Opinion Nos. 256 and 256-A*

Subsequent to issuing Opinion Nos. 256 and 256-A, the Commission has processed numerous applications for as-billed flow through of Canadian gas costs. In all but a handful of these cases, the Commission has refused to allow as-billed flow through, instead applying the mandate of Opinion Nos. 256 and 256-A.

The Commission, however, has developed a generic exception to Opinion Nos. 256 and 256-A. Known as the "administrative conduit" exception, the Commission allows a pipeline to flow through its Canadian demand charges on an as-billed basis if the pipeline can convince the Commission that it is nothing more than an "administrative conduit" by which demand charges that are negotiated directly between its upstream Canadian supplier and its downstream domestic customers are passed through. The exception does not appear to be applicable to the downstream customers of the conduit pipeline.

In *Boundary Gas, Inc.*,¹⁷ the Commission permitted Boundary Gas, Inc. (Boundary) to flow through its Canadian gas charges on an as-billed basis. As described by the Commission, Boundary serves as an administrative conduit for the importation of Canadian gas for the benefit of its pipeline shareholders. It purchases Canadian gas at the border and simultaneously resells it to its individual shareholder/repurchaser pipelines, never taking possession of the gas.

13. Opinion No. 256-A, 39 F.E.R.C. at 61,767.

14. *Id.* at 61,768 (quoting Opinion No. 256, 37 F.E.R.C. ¶ 61,215, at 61,545-46).

15. *Id.* at 61,768-69 (citations omitted).

16. *Id.* at 61,769.

17. *Boundary Gas, Inc.*, 40 F.E.R.C. ¶61,047 (1987).

Given these facts, the Commission found that as-billed flow through was warranted. The Commission reasoned that because Boundary is an administrative conduit, its shareholder/repurchaser pipelines should be treated as the direct purchasers from the Canadian supplier. The Commission found any cost-shifting from high- to low-load customers of Boundary, and guaranteed cost recovery, to be "of little moment" because any cost shifting and/or guaranteed cost recovery "is of Boundary's customers' own making just as if they individually negotiated the contract with [Boundary's Canadian supplier]."¹⁸ The Commission also stated that these issues and the issue of equal treatment for Canadian and domestic gas supplies are "best treated in cases involving the *de facto* purchasers of the Canadian gas."¹⁹

In an order issued the same day as the *Boundary* decision, addressing the propriety of as-billed treatment for one of Boundary's shareholder/repurchaser pipelines, the Commission applied the precept of Opinion Nos. 256 and 256-A and refused to allow as-billed flow through.²⁰ The Commission noted that Granite State Gas Transmission, Inc. (Granite State) is a jurisdictional natural gas pipeline that markets its gas using the MFV rate design method. Therefore, the Commission reasoned, Granite State is obligated to abide by the ratemaking mandate of Opinion Nos. 256 and 256-A.

The Commission has applied the conduit exception to at least one other Canadian gas importer. In *Great Lakes Gas Transmission Co.*,²¹ the Commission concluded that Great Lakes Gas Transmission Company (Great Lakes) was a conduit for purchases negotiated directly between its Canadian supplier and its resale customers and that the resale customers should be treated as direct purchasers. Great Lakes maintains separate PGA trackers for Canadian gas sold to six of its customers who negotiate the terms of their purchases directly with the Canadian supplier. Great Lakes has been in a "transitory" phase for some time—shifting from a merchant to a transporter. The Commission had previously applied Opinion Nos. 256 and 256-A to Great Lakes and expressed concern that Great Lakes may have improperly combined the roles of merchant and transporter.²² Great Lakes argued that Opinions No. 256 and 256-A should not be applied to it because, *inter alia*, its customers negotiate directly with its Canadian supplier.

In its latest Great Lakes' as-billed orders, the Commission concluded that Great Lakes had made satisfactory progress towards unbundling (i.e., towards making the change from a merchant to a transporter) to warrant authorization of as-billed flow through.²³ The Commission made this ruling despite protests from one of Great Lakes' affected customers, with whom Great Lakes had reached no unbundling agreement.

18. *Boundary*, 40 F.E.R.C. at 61,148.

19. *Id.*

20. Granite State Gas Transmission, Inc., 40 F.E.R.C. ¶61,043 (1987).

21. Great Lakes Gas Transmission Co., 41 F.E.R.C. ¶ 61,292 (1987).

22. See Great Lakes Gas Transmission Co., 40 F.E.R.C. ¶ 61,044, 61,115 (1987); Great Lakes Gas Transmission Co., 35 F.E.R.C. ¶ 61,442 (1986). See also Foster Natural Gas Report (Foster Associates) No. 1650, at 16-18 (Dec. 17, 1987).

23. Great Lakes Transmission Co., 41 F.E.R.C. ¶ 61,298 (1987).

At issue in the proceeding was who would be at risk for part of the Canadian demand charges. If Opinion Nos. 256 and 256-A had been applied to Great Lakes, Natural Gas Pipeline Company (Natural), a customer of Great Lakes, would have paid Great Lakes the same demand charge that Natural collects from its customers, which is a smaller demand charge than Great Lakes pays the Canadian supplier. If as-billed flow through were granted Great Lakes and Opinion Nos. 256 and 256-A were applied to Natural, Great Lakes would collect all of Natural's share of the Canadian demand charges from Natural, but Natural would not be able to pass through to its customers 100% of those charges in the demand component of its rates.

The Commission viewed the issue as "one of equity" and concluded that Great Lakes should be allowed to pass through its Canadian charges as-billed and that Opinion Nos. 256 and 256-A should be applied to Natural. The Commission reasoned that although Great Lakes is involved in the renegotiation process, its role is inferior to that of Natural, who negotiated the two-part demand/commodity rate.

In another recent case, the Commission granted a waiver of the application of the rate design requirements of Opinion Nos. 256 and 256-A, even though the importer was not identified as an administrative conduit. In *Inter-City Minnesota Pipelines, Ltd.*,²⁴ without explanation, the Commission granted Inter-City Minnesota Pipelines Ltd. (Inter-City) permission to flow through its Canadian gas charges as-billed. In its application for as-billed flow through, Inter-City argued that its unique configuration warranted an exception to Opinion Nos. 256 and 256-A. Inter-City is a fifty-two-mile segment of an integrated Canadian-U.S. pipeline. No domestic supplies are available in Inter-City's service territory. Therefore, Inter-City argued, there was no danger of an otherwise "level playing field" being tilted in the direction of Canadian producers as the result of as-billed flow through.

Inter-City also argued that as-billed flow through would not burden its customers. Inter-City's supplier contracts differentiate price by delivery point and it flows its purchased gas costs through a "zoned" PGA that maintains the difference. Inter-City argued that because of these factors and because its customers do not have dissimilar load factors, there is no possibility of cost shifting on its system as a result of as-billed flow through.

Because there is little or no possibility of disadvantage to domestic producers or cost shifting on its system, Inter-City argued that the possible response of its dominant end-user should control the Commission's decision. Inter-City stated that application of the rate methodology of Opinion Nos. 256 and 256-A would "erode" its competitive situation and possibly lead to the loss of its dominant end-user to alternate fuels.

Although, the Commission offered no explanation for its decision to allow as-billed flow through for Inter-City, the Commission accepted that the dangers of disadvantage to domestic producers and cost shifting between high- and low-load customers (the primary reasons for the mandate of Opinion Nos. 256 and 256-A) were not present in Inter-City's system.

24. *Inter-City Minn. Pipelines, Ltd.*, No. TA88-1-45-000 (FERC filed Nov. 20, 1987).

II. UNITED STATES-CANADA FREE TRADE AGREEMENT

On January 2, 1988, President Reagan and Prime Minister Mulroney of Canada signed an agreement to establish a free trade area between the United States and Canada to supplement the General Agreement on Tariffs and Trade (GATT). If approved and implemented by the Canadian Parliament and the U.S. Congress, the Free Trade Agreement (FTA)²⁵ will take effect on January 1, 1989.

The comprehensive United States-Canada FTA will create the world's largest free trade area. The FTA provides for liberalization in numerous sectors of the economy, including areas not covered in previous FTAs such as trade in services, business travel, and investment. The FTA includes a chapter dedicated to bilateral trade in energy. The FTA is designed to:

1. Phase out all tariffs on bilateral trade in goods within 10 years;
2. Minimize nontariff trade barriers;
3. Establish rules for the conduct of bilateral trade in services and bilateral investment;
4. Resolve specific outstanding trade issues;
5. Enhance the energy and national security of the United States and Canada;
6. Facilitate business travel; and
7. Establish a dispute settlement mechanism.

A. *Bilateral Trade in Energy*

The United States and Canada are each other's largest trading partners. Bilateral trade in goods and services between the two countries exceeded \$150 billion in 1986. Trade in energy accounted for nearly ten percent of all U.S.-Canadian trade. Canada is the United States' most important foreign energy supplier. Canadian exports of oil, gas, electricity, and uranium, total over ten billion dollars. Canada is the leading source of U.S. imported oil, accounting for thirteen percent of U.S. net imports in 1986. Virtually all U.S. natural gas and electricity imports are from Canada. The U.S. Department of Energy (DOE) projects that by 1995, Canadian imports will account for ten percent of U.S. natural gas consumption and nearly two percent of U.S. electricity consumption.

The increasing importance of bilateral trade in energy between the United States and Canada is evidenced by Chapter 9 of the FTA which is dedicated to energy. As a result of recent efforts in both the United States and Canada to develop market-based energy policies, energy trade barriers between the countries are already relatively low. Thus, most of the FTA provisions on energy are general in nature. The principal effect of the new FTA energy provisions will be to eliminate most restrictions on U.S. purchases of Canadian energy and assure Canada's long-term ability to increase its exports of uranium, natural gas and electricity to the United States.

The FTA prohibits import and export restrictions, including quantitative restrictions, taxes, minimum price requirements or their equivalent. The two

25. Free Trade Agreement, Jan. 2, 1988, United States-Canada (as of Feb. 29, 1988, no ratification bills have been introduced to the Congress); See generally Radio Address to the Nation on the Canada-United States Free Trade Agreement, 24 WEEKLY COMP. PRES. DOC. 15 (Jan. 18, 1988).

limited exceptions from restriction are (1) for goods in short supply or conservation of natural resources threatened with exhaustion; and (2) for national security. The two countries also committed to consult on future energy regulatory actions which could result directly in discriminatory practices inconsistent with the agreement.

B. Energy Provisions of the FTA

The specific energy provisions of Chapter 9 of the FTA are detailed below.

1. Article 901: Scope

The FTA provisions apply to energy goods originating in either the United States or Canada. Energy goods are those goods classified in the Harmonized System under: (a) Chapter 27 (except headings 2707 and 2712); (b) subheading 2612.10; (c) subheadings 2844.10 through 2844.50 (only with respect to uranium compounds classified under those subheadings); and (d) subheading 2845.10.

2. Article 902: Import and Export Restrictions

This section reaffirms the respective rights and obligations of the United States and Canada under the GATT subject to the further rights and obligations of the FTA. The GATT rights and obligations prohibit, in any circumstances in which any other form of quantitative restriction is prohibited, minimum export price requirements and minimum import price requirements except as permitted in enforcement of countervailing and antidumping orders. Article 902 also provides that in any situation where either the United States or Canada applies an import or export restriction on trade in energy goods with other countries, it may limit or prohibit the pass through of imports from those countries into its own territory. The country applying such restrictions may also require that its exports to the other be consumed within the other's territory.

Annex 902.5 commits the United States specifically to eliminate all U.S. restrictions on enrichment of Canadian uranium in return for which Canada will eliminate the requirement that uranium be processed into uranium hexafluoride before it is exported to the United States. Section 161(v) of the U.S. Atomic Energy Act allows the U.S. Department of Energy to restrict uranium imports if the U.S. industry is found to be non-viable. Although the Department of Energy (DOE) found the U.S. industry non-viable in 1984, 1985, and 1986, no import restrictions have yet been imposed. The most controversial energy provision of the FTA effectively nullifies section 161(v). If approved, the Agreement would supercede a final decision by the U.S. Supreme Court on a case brought by U.S. uranium producers to force the DOE to restrict imports.²⁶ The FTA would similarly override proposed Senate legislation to

26. *Western Nuclear, Inc. v. Huffman*, 825 F.2d 1430 (10th Cir. 1987), *cert. granted*, 108 S. Ct. 692 (1988).

restrict uranium imports temporarily to give the U.S. industry time to regain viability.

The annex to Article 902 also commits the United States to end its embargo on exports of Alaskan North Slope (ANS) crude oil to Canada. Canadians will be allowed to import up to 50,000 barrels per day on an annual average basis. The Canadian importation of Alaskan oil is subject to the condition that such oil be transported to Canada from a suitable location within the lower forty-eight states. The import of ANS crude by British Columbia is expected to be accompanied by comparable imports of Canadian oil by the midwestern U.S. region.

The FTA does not limit any sovereign's authority to determine whether or not to export its products. Each nation also retains the ability to license and monitor exports.

3. Article 903: Export Taxes

Neither party to the FTA may impose taxes or charges on exports unless the same tax or charge is applied to the domestic consumption of the energy within its own country.

4. Article 904: Other Export Measures

Under Article 904, if either country institutes an otherwise justified restriction on export of energy goods (e.g., for short supply, conservation, or national security), the restriction may not reduce the proportion of the good exported to the other country relative to the total supply of the good compared to the proportion exported prior to imposition of the restriction. Licenses, fees, taxes, and minimum price requirements are also prohibited as means of charging higher prices for exports where justifiable restrictions are implemented. Furthermore, export restrictions may not be crafted so as to disrupt normal trade patterns or normal proportions among specific energy goods exported to the other country; for example, between crude oil and refined products, and among different categories of crude oil and refined products. Thus, if Canada were to decide to restrict consumption of oil, Canadian exports of oil to the United States could be reduced only in proportion to the total supply of oil available in Canada.

Under the FTA, neither country may introduce new fees; however, existing U.S. Customs user fees will be phased out through twenty percent annual reductions from 1990 through 1994.

5. Article 905: Regulatory and Other Measures

This article incorporates the parties' agreement to initiate non-binding consultations regarding any energy regulatory action which by either country could directly result in discriminatory practices inconsistent with the principles of the Agreement. "Energy regulatory action" includes any action by the National Energy Board of Canada and either the Federal Energy Regulatory Commission or the Economic Regulatory Administration of the United States, or their successors. Consultations with respect to the above agencies

would include the Canadian Department of Energy, Mines, and Resources, as well as the U.S. Department of Energy. The parties can determine whether other agencies implicated in a given regulatory action should participate in consultations. The consultation provision is prospective only, and will not affect the "as-billed" controversy. Canada proposed the consultation provision as a means of preventing similar controversies in the future.

In Annex 905.2, Canada committed to apply its "surplus test" only as a monitoring device. The surplus test applies primarily to electricity exports. Presently, Canadian hydropower may be exported only after it is determined to be surplus to domestic energy needs. Future exports will be subject to the proportionality and nondiscriminatory pricing provisions of Chapter 9. Canada is also required to eliminate its discriminatory electricity pricing test for exports which allowed Canadian utilities to base their export price on a U.S. utility's least cost domestic power alternative. Also pursuant to this annex, the United States has committed to support ongoing negotiations between the Bonneville Power Administration (BPA) and British Columbia Hydro (B.C. Hydro), requiring BPA to treat B.C. Hydro no less favorably regarding access to its power transmission interties than other U.S. utilities located outside the Pacific Northwest.

6. Article 906: Government Incentives for Energy Resource Development

The two countries agreed to allow existing or future incentives for oil and gas exploration and development in order to maintain the reserve base for these energy resources. Some U.S. natural gas producers protest that Canadian incentives offer significant advantages to Canadian producers and that this provision will encourage the United States to become dependent on imported gas supplies.

7. Article 907: National Security Measures

Article 907 tightens the GATT national security exception. Energy import and export restrictions are permitted only if necessary for a country to supply its military establishment or enable it to fulfill a critical defense contract; respond to an armed conflict involving the country instituting the restriction; implement national or international agreements relating to non-proliferation of nuclear weapons or nuclear devices; or respond to direct threats of disruption in supply of nuclear materials for defense purposes.

8. Article 908: International Obligations

In the event that any inconsistency exists between the provisions of Chapter 9 and the Agreement on an International Energy Program (IEP), the provisions of the IEP shall prevail over the FTA. The IEP governs trade in oil during tight supply conditions.

C. *Approval Procedures*

Negotiations on the FTA began on June 17, 1986. On October 3, 1987,

President Reagan notified Congress of his intent to enter into a free trade agreement with Canada. U.S. and Canadian negotiators initialed a final text of the agreement on December 9, 1987, and on January 2, 1988, President Reagan and Prime Minister Mulroney signed the final text of the agreement, exactly ninety days after President Reagan notified Congress of his intent to do so.

Now that the agreement is signed, the President must submit it along with draft implementing legislation to the Congress. The implementing legislation must be introduced and referred to the appropriate committees. House committees will have forty-five legislative days in which to report the bill. The full House must then vote on the bill within fifteen days. The appropriate Senate committees then have fifteen legislative days in which to report the bill and the full Senate has fifteen days in which to vote on the measure. Amendments to the bill are not permitted. A simply majority of each House is required for approval.

D. Prospects for Approval

Approval of the U.S.-Canada FTA by Congress is not certain. Although most of the energy provisions are non-controversial, several Senators from western states are concerned that the uranium provisions in the FTA will further weaken the U.S. uranium industry. Therefore, Senator Pete Domenici (R-NM) recently introduced into the Senate a resolution that would allow the Senate to modify the uranium provisions of the FTA. Congressional ability to amend the agreement on this or other issues would likely jeopardize Canadian approval of the agreement. Parliament's approval is already uncertain due to some significant public opposition by Canadians who fear that the FTA would allow the United States to dominate their economy.

E. Conclusion

The principal effect of the FTA energy provisions is expected to be an expansion of trade in the long-term. No significant immediate effect on oil and natural gas trade between the United States and Canada is likely. The Agreement will not affect the FERC's controversial 1986 "as-billed" decision, which increased commodity charges for buyers of Canadian gas and thereby diminished its competitiveness against some U.S. gas. An import fee on Canadian crude oil would violate the FTA; therefore, Canada would have to be exempted from any future import fee legislation.

III. EXPORTS OF NATURAL GAS: THE TRANS-ALASKA GAS SYSTEM

The Yukon Pacific Corporation moved forward during 1987 at both the Commission and the ERA with its proposal for a Trans-Alaska Gas System (TAGS). The TAGS will consist of a gas pipeline running across Alaska's North Slope from Prudhoe Bay to the tidewater coast at Valdez. TAGS' sponsor, Yukon Pacific, intends to liquefy the gas at Valdez and to ship the resultant LNG to markets in Asia.

A. *The Commission's Jurisdiction*

In response to a Yukon Pacific request, the Commission issued a declaratory order on May 27, 1987, concerning the extent of its NGA jurisdiction over the TAGS.²⁷

1. NGA Section 7

The Commission found that TAGS, if built, will not involve or facilitate the sale or transportation of gas in interstate commerce because the courts have consistently construed the definition of interstate commerce in NGA section 2(7) to exclude the sale or transportation of natural gas between one state and a foreign country.²⁸ Since gas in the TAGS will cross only one state, Alaska, before moving to foreign markets, the Commission disclaimed any certificate jurisdiction under NGA section 7.

2. NGA Section 3

As for the question of its NGA section 3 jurisdiction, the Commission looked to authority delegated to it by the Secretary of the DOE under DOE Delegation Order Nos. 0104-111 and 0204-112, both issued February 22, 1984. The Commission concluded that those orders provided it with NGA section 3 jurisdiction to approve or disapprove the place of export of the natural gas to be transported by the TAGS, subject however, to prior disapproval by the Administrator of the ERA.

Independent of the foregoing, the Commission also found that it had "plenary and elastic" jurisdiction under NGA section 3 over the siting, construction, and operation of the TAGS facilities. This independent section 3 authority, according to the Commission, is analogous to its NGA section 7 jurisdiction over interstate facilities. However, the Commission declined to exercise its broad section 3 jurisdiction on the ground that "[i]n the instance of an export of gas, unlike an import, there are no economic consequences to U.S. ratepayers."²⁹ The Commission observed that "[t]he cost of the project, and the risks inherent in it, will be borne (in whatever fashion) by the project sponsors, its lenders and investors, and its foreign purchasers of the gas."³⁰

While the Commission declined to exercise its section 3 authority over the TAGS' siting, construction, and operation, it reserved the authority to review the TAGS' physical i.e., environmental and safety, impact. The Commission noted that preparation of an environmental impact statement (EIS) had commenced at the Department of Interior (DOI). The Commission concluded that the EIS process would afford ample opportunity to consider environmental and safety issues and, if necessary, to attach appropriate conditions to any authorization of a place of export.

27. Yukon Pac. Corp., 39 F.E.R.C. ¶ 61,216 (1987).

28. *Id.* at 61,758 (citing *Border Pipe Line Co. v. FPC*, 171 F.2d 149 (D.C. Cir. 1948); *Distrigas Corp. v. FPC*, 495 F.2d 1057, 1065 (D.C. Cir.), *cert. denied*, 419 U.S. 834 (1974)).

29. *Yukon*, 39 F.E.R.C. at 61,759.

30. *Id.*

3. Executive Orders

Yukon Pacific's petition for a declaratory order contended that any Commission jurisdiction over exports is conditioned by Executive Order 10,485³¹ as amended by Executive Order 12,038.³² These executive orders provide for approval by the Secretary of the DOE of the construction and operation of gas pipeline facilities at the border of the U.S. and another country. The authority created by the executive orders, since delegated to the Commission, requires that the Commission obtain the views of the Secretaries of State and Defense regarding any such approval.

The Commission rejected Yukon Pacific's argument. First, the Commission found that the executive orders are inapplicable because the TAGS does not involve the construction of gas pipeline facilities at the border of the U.S. and another country, because the TAGS facilities will be located at the tidewater. Second, the Commission concluded as a matter of law that NGA section 3 is not conditioned or otherwise limited by the executive orders. The executive orders, according to the Commission, raise issues of national security that are supplemental to and independent of the public interest requirements that concern it under the NGA.

4. Order Denying Rehearing

On August 5, 1987, the Commission denied rehearing of its May 27, 1987 order.³³ Rehearing was sought by two intervenors, Foothills Pipe Line, Ltd. and Alaska Natural Gas Transportation Co. These intervenors challenged the Commission's finding that exports of gas result in no economic consequences to U.S. ratepayers. They pointed out that exports could have an economic consequence by reducing the total supply of gas available in the U.S. The intervenors also contested the Commission's finding regarding the EIS being prepared by the DOI. They alleged that the first draft of the EIS was flawed and that the Commission could not rely on it.

The Commission rejected the intervenors' arguments as premature. The Commission noted that it has made no final determinations on the merits of the TAGS and that its May 27, 1987 order was conditioned on certain factual assumptions. If those assumptions do not prove accurate, the Commission's conclusions may change. More specifically, the Commission noted that its earlier finding of no economic consequence was limited to a concern over who paid for the cost of the facilities. Thus the Commission found the conclusion to be fundamentally correct. Finally, the Commission noted that the environmental considerations raised by the intervenors were not ripe inasmuch as Yukon Pacific has yet to file for actual approval of a place of export.

B. Yukon Pacific's Applications for Authority

On December 3, 1987, Yukon Pacific filed for authority to go forward

31. Exec. Order No. 10,485, 18 Fed. Reg. 5397 (1953).

32. Exec. Order No. 12,038, 43 Fed. Reg. 4957 (1978).

33. Yukon Pac. Corp., 40 F.E.R.C. ¶ 61,164 (1987).

with the TAGS project at the ERA and the Commission.³⁴ At the ERA, Yukon Pacific requested authority to export up to 14 million metric tons of LNG annually (equating roughly to 2.1 Bcf/d) to three Pacific Rim countries—Japan, Korea, and Taiwan. The authority, if granted, would permit such shipments for a twenty-five-year term. At the Commission, Yukon Pacific contemporaneously applied for authority to use Port Valdez, Anderson Bay, as the place of export.

Yukon Pacific's plans call for use of either an existing or a newly authorized gas conditioning facility and the purchase of approximately 36.6 Tcf of proven and producible reserves from the Prudhoe Bay oil field. The purchase price to be paid producers will be determined by a formula using a base price per MMBtu, adjusted for variations in the LNG sales price at the point of destination. However, the price may not exceed the NGPA section 109 ceiling price. Furthermore, natural gas takes will be based on Yukon Pacific's total market requirements and will be apportioned among the various producers on the basis of their proportionate share of the aggregate producer commitment to the TAGS project. It was noted in the application that Atlantic Richfield Co., Exxon Co. U.S.A., and Standard Alaska Production Co. (British Petroleum) together own over ninety percent of the North Slope gas reserves.

Natural gas from the TAGS project will be marketed in Japan, South Korea and Taiwan. According to Yukon Pacific, the size of the TAGS project requires long-term sales agreements with the Pacific Rim purchasers. The delivered sales price for the LNG in Japan will consist of a base price per MMBtu, indexed monthly for changes in the average price of selected crude oils imported into that country. For LNG deliveries to Korea and Taiwan, the crude oil prices to be used in the pricing formula will be determined through arm's length negotiation.

Both the ERA and the FERC were urged to expedite action on Yukon Pacific's applications to avoid possible forfeit of an eighty billion dollar LNG market to Indonesian and other competing foreign suppliers. Yukon Pacific indicated that ERA export approval is necessary before it can secure firm commitments from Pacific Rim markets.

C. Presidential Finding

The TAGS project received a further boost when, on January 12, 1988, President Reagan issued a finding³⁵ under section 12 of the Alaska Natural Gas Transportation Act³⁶ regarding Alaskan gas exports. Specifically, the President found that the exportation of Alaskan natural gas "will not diminish the total quantity or quality nor increase the total price of energy available to the United States." The President also found that the demand of American consumers can be satisfied by lower-forty-eight gas production and, if necessary, by coal, oil, imported LNG, natural gas from Mexico, and other energy

34. Yukon Pac. Corp., No. 87-68-NG (ERA filed Dec. 3, 1987); No. CP88-105-000 (FERC filed Dec. 3, 1987).

35. Presidential Finding Concerning Alaska Natural Gas, 24 WEEKLY COMP. PRES. DOC. 30 (Jan. 18, 1988).

36. 15 U.S.C. § 719j (1982).

resources. The President indicated that these alternate fuel resources offer lower delivered energy costs in the lower forty-eight states than the Alaskan gas and that increased world energy resources would likely offset any reduction of domestic supplies resulting from the Alaskan gas exports. However, the President added that his finding should not be read as an endorsement of any specific project "but rather lets the marketplace undertake a realistic consideration of various options concerning Alaskan natural gas."

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