National Energy Board
Office national de l'énergie

Reasons for Decision

TransCanada PipeLines Limited

RH-2-2004

Phase I

September 2004

Tolls and Tariff

Canada

National Energy Board

Reasons for Decision

In the Matter of

TransCanada PipeLines Limited

2004 Mainline Tolls & Tariff Application

RH-2-2004

Phase I

September 2004

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Abbreviations

$10^3m^3/d$	Thousand cubic metres per day
1996-1999 Incentive Settlement	TransCanada's 1996-1999 Incentive Cost Recovery and Revenue Sharing Settlement
2001-2002 S&P Settlement	TransCanada's 2001-2002 Mainline Service and Pricing Settlement
2004 Tolls Application	TransCanada's 2004 Tolls and Tariff Application
ATWACC	After Tax Weighted Average Cost of Capital
Bcf/d	Billion cubic feet per day
Board or NEB	National Energy Board
Coral/CA	Coral Energy Canada Inc. and the Cogenerators Alliance
CAPP	Canadian Association of Petroleum Producers
COA	Compressor Operating Agreement
Combination Plan	Combination Pension Plan
DB Plan	Defined Benefit Pension Plan
DC Plan	Defined Contribution Pension Plan
EDA	Eastern Delivery Area
EUB	The Alberta Energy and Utilities Board
FCA	Federal Court of Appeal
FGIP	Fuel Gas Incentive Program
FT	Firm Transportation
FT-NR	Non-Renewable Firm Transportation
Gaz Métro	Société en commandite Gaz Métro
GJ	Gigajoule
GLGT	Great Lakes Gas Transmission System
IGUA	Industrial Gas Users Association
IT	Interruptible Transportation
LTIC	Long Term Incentive Compensation

Mainline	TransCanada's Mainline Natural Gas Transmission System
NEB Act	*National Energy Board Act*
OEB	Ontario Energy Board
OM&A	Operations, Maintenance & Administration
Ontario	Minister of Energy for the Province of Ontario
Potter	Potter Station Power Co. Ltd.
Quebec	Procureur général du Québec
R&O	Repairs and Overhauls
Review Application	TransCanada's Application for Review and Variance of the RH-4-2001 Decision and related Orders
ROE	Return on equity
STFT	Short-Term Firm Transportation Service
TBO	Transportation by Others
TCP LP	TransCanada Power LP
TDC	Total Direct Compensation
TransCanada	TransCanada PipeLines Limited
TSR	Total Shareholder Return
TTF	TransCanada’s Tolls Task Force
Union	Union Gas Limited
U.S.	United States of America

Recital and Appearances

IN THE MATTER OF the *National Energy Board Act* (NEB Act) and the Regulations made thereunder; and

IN THE MATTER OF an application filed by TransCanada PipeLines Limited (TransCanada) pursuant to Part IV of the NEB Act, for approval of tolls that TransCanada shall charge for transportation services provided on its Mainline between 1 January 2004 and 31 December 2004; and

IN THE MATTER OF Hearing Order RH-2-2004;

Heard in Ottawa, Ontario on 14, 15, 16, 17, 21, 22, 24 and 25 June 2004;

BEFORE:

J-P. Théorêt	Presiding Member
D.W. Emes	Member
G. Caron	Member

Appearances	**Company**	**Witnesses**
C.K. Yates, Q.C.	TransCanada PipeLines Limited	G. Aker R. Barham R. Boulter D. Ferguson C. Frew L. Hobbs A. Leong P. MacGregor J. Murta S. Ricketts D. Rouillard D. Russell R. Tarvydas C. Tosi R. Whitmore
N.J. Schultz	Canadian Association of Petroleum Producers	B. Troicuk C. Worthy
V.J. DeRose	Industrial Gas Users Association	
C. Worthy	BP Canada Energy Company	

Appearances	Company	Witnesses
T. Lang	Cargill Power & Gas Markets	
R.J. King	Cogenerators Alliance	M. Stauft U. Valiante
R.J King	Coral Energy Canada Inc.	J. Cifaratto M. Stauft
T. Persad	Enbridge Gas Distribution Inc.	
B. Fraser	EnCana Corporation	
M. Perlman	New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation	
L.-C. Ratelle	Société en commandite Gaz Métro	
G. Cameron	Union Gas Limited	
J.C. Turchin	Minister of Energy for the Province of Ontario	
M. Bouchard R. Richard	Procureur général du Québec	
A. Ross D. Saumure	National Energy Board	

Glossary of Terms

Actual Year	A historical period (usually 12 consecutive months) between the Base Year and the Test Year. The 2003 Actual Year is the period from 1 January 2003 to 31 December 2003.
Base Year	A historical period (usually 12 consecutive months), for which actual data is available, used as the starting point in determining tolls for a future Test Year. The 2002 Base Year is the period from 1 January 2002 to 31 December 2002.
Dawn	A North American gas marketing centre located in Southern Ontario (i.e., Dawn Hub).
Deferral Account	For regulatory purposes, generally, a type of account used to record revenues and expenses held in abeyance for future disposition by a regulator.
Delivery Area	A geographic area within a toll zone that is comprised of multiple delivery points where shippers receive delivery of their natural gas.
Target Fuel Curves	A graphical depiction of the variation of average daily fuel requirements with average daily deliveries.
GH-2-93	NEB Proceeding in respect of TransCanada’s application for 1994 and 1995 expansion facilities.
Load Factor	The ratio of the average requirement to the maximum requirement for the same period, usually expressed over a year and as a percentage.
Rate Base	The amount of investment on which a return is authorized to be earned. It usually consists of net plant in service, plus an allowance for working capital.
Return on Equity	The return which a regulated company earns on its common equity.
Return on Rate Base (Return)	The return which a regulated company earns on its approved Rate Base.
Revenue Requirement	The amount sought to be recovered in the tolls which will reimburse the company for its cost of service.
RH-1-2002	NEB Proceeding on TransCanada's 2003 Tolls and Tariff Application.

RH-R-1-2002	NEB Decision on TransCanada's application for review and variance of the Board's RH-4-2001 Decision and related Orders.
RH-4-2001	NEB Proceeding on TransCanada's 2001-2002 Fair Return Application concerning cost of capital for the Mainline.
RH-1-2001	NEB Proceeding on TransCanada's 2001-2002 Tolls and Tariff Application.
RH-2-95	NEB Proceeding on TransCanada's 1996 Tolls Application.
RH-2-94	NEB Multi-Pipeline Cost of Capital Proceeding.
RH-4-93	NEB Proceeding on TransCanada's 1994 Tolls Application.
RH-4-81	NEB Proceeding for TransCanada tolls effective 1 July 1981.
Station 75	A compressor station on TransCanada's Mainline located near Nipigon, Ontario.
Tariff	The terms and conditions under which the services of a pipeline are offered or provided, including the tolls, the rules and regulations, and the practices relating to specific services.
Test Year	A period (usually 12 consecutive months) used for ratemaking purposes. The 2004 Test Year is the period from 1 January 2004 to 31 December 2004.
Toll	The price charged by a pipeline company for the use of its facilities.
Tolls Task Force	A joint industry task force initiated by TransCanada. Its membership is comprised of a wide cross-section of the natural gas industry, including representatives of the producing, marketing, brokering and pipeline segments of the industry, provincial governments and local distribution and industrial end-use customers.

Chapter 1

Introduction

1.1 Background

TransCanada PipeLines Limited (TransCanada) owns and operates the TransCanada Mainline Natural Gas Transmission System (Mainline), which is a high pressure natural gas transmission system that extends from the Alberta border across Saskatchewan, Manitoba, Ontario, through a portion of Quebec and connects to various downstream Canadian and international pipelines. In addition, the Mainline integrated system includes contractual entitlements to transport natural gas on the Great Lakes Gas Transmission Company (GLGT) system from Emerson, Manitoba to St. Clair, Michigan; on the Union Gas Limited's (Union) system from Dawn, Ontario to Parkway, Ontario and to Kirkwall, Ontario; and on the Trans Quebec & Maritimes Pipeline. Figure 1-1 shows a map of the Mainline's integrated system.

During the 1972 to 1995 period, the tolls for the Mainline were generally established through annual tolls hearings.

For the four-year period from 1996 to 1999, the Mainline operated under the terms and conditions of the Incentive Cost Recovery and Revenue Sharing Settlement (1996-1999 Incentive Settlement), which was approved by the Board in the RH-2-95 Decision.

For the year 2000, parties attempted to negotiate an extension of the term of the 1996-1999 Incentive Settlement for one year but were unsuccessful. However, TransCanada and its stakeholders were able to negotiate a separate one-year cost of service settlement for 2000.

For the years 2001 and 2002, the Board approved the terms of the 2001-2002 Mainline Service and Pricing Settlement (2001-2002 S&P Settlement) in its RH-1-2001 Decision. The 2001-2002 S&P Settlement prescribed the toll methodology to be utilized, applicable tariff provisions and the components of the Mainline's Revenue Requirement, with the exception of amounts relating to cost of capital. The Mainline's cost of capital for these years was addressed in the RH-4-2001 proceeding, which considered TransCanada's 2001 and 2002 Fair Return Application.

On 21 June 2002, the Board released its RH-4-2001 Decision in which it declined to adopt TransCanada's proposed After Tax Weighted Average Cost of Capital (ATWACC) methodology for establishing cost of capital, and held that the return on equity (ROE) generated by its RH-2-94 ROE Formula continued to be appropriate for the Mainline. The Board also approved an increase in the Mainline's deemed common equity from 30 percent to 33 percent effective 1 January 2001.

On 16 September 2002, TransCanada applied, pursuant to subsection 21(1) of the NEB Act and section 44 of the *National Energy Board Rules of Practice and Procedure, 1995*, for review and variance of the RH-4-2001 Decision and Orders TG-3-2002, AO-1-TG-3-2002 and TG-4-2002 by which that Decision was implemented (Review Application).

Also on 16 September 2002, TransCanada filed its 2003 Tolls Application including information pertaining to the proposed Rate Base, Revenue Requirement, toll design and pricing changes. Information concerning return was presented by TransCanada on an illustrative basis only. The 2003 Tolls Application specifically requested that the 2003 return for the Mainline be determined by the Board in accordance with its disposition of the Review Application. This application was disposed of in the Board's RH-1-2002 Decision, dated July 2003.

On 20 February 2003, the Board released its RH-R-1-2002 Decision, which addressed TransCanada's Review Application. The Board was of the view that the Review Application had not raised a doubt as to the correctness of the Board's RH-4-2001 Decision.

On 21 March 2003, TransCanada PipeLines applied to the Federal Court of Appeal (FCA) for leave to appeal the Board's RH-R-1-2002 Decision. TransCanada's leave application was granted and an appeal of the matter was subsequently heard by the FCA in early 2004.

On 26 January 2004, TransCanada filed its 2004 Tolls Application with the Board, seeking approval of tolls on its Mainline system for the period 1 January 2004 to 31 December 2004.

On 23 March 2004, the Board issued Hearing Order RH-2-2004 establishing a two-phase oral public hearing to consider TransCanada's 2004 Tolls Application. The order stated that Phase I would commence in Ottawa, Ontario on 14 June 2004 to consider all issues raised by the 2004 Tolls Application, with the exception of cost of capital. Phase II of the Hearing would consider cost of capital issues. However, the Board indicated that it would be inappropriate to initiate further procedural steps in respect of Phase II until after the release of the FCA Decision regarding TransCanada's appeal of the Board's RH-R-1-2002 Decision.

On 16 April 2004, the FCA released its Reasons for Judgment dismissing the appeal by TransCanada of the RH-R-1-2002 Decision.[1]

On 12 May 2004, TransCanada advised the Board that, in light of the FCA Decision, it would not seek variance from the RH-2-94 ROE Formula for 2004. TransCanada also indicated that it would maintain its request for a capital structure containing a 40 percent deemed common equity ratio for 2004. On 28 May 2004, TransCanada filed related amendments to its 2004 Tolls Application.

On 7 June 2004, the Board issued Amending Order AO-1-RH-2-2004 setting out the procedure to be followed in Phase II which was scheduled to commence on 25 October 2004 in Calgary, Alberta. On 23 July 2004, Phase II was rescheduled to commence on 22 November 2004.

Phase I commenced on 14 June 2004, required eight hearing days, and was completed on 25 June 2004.

These Reasons for Decision reflect the Board's decisions with respect to Phase I matters only.

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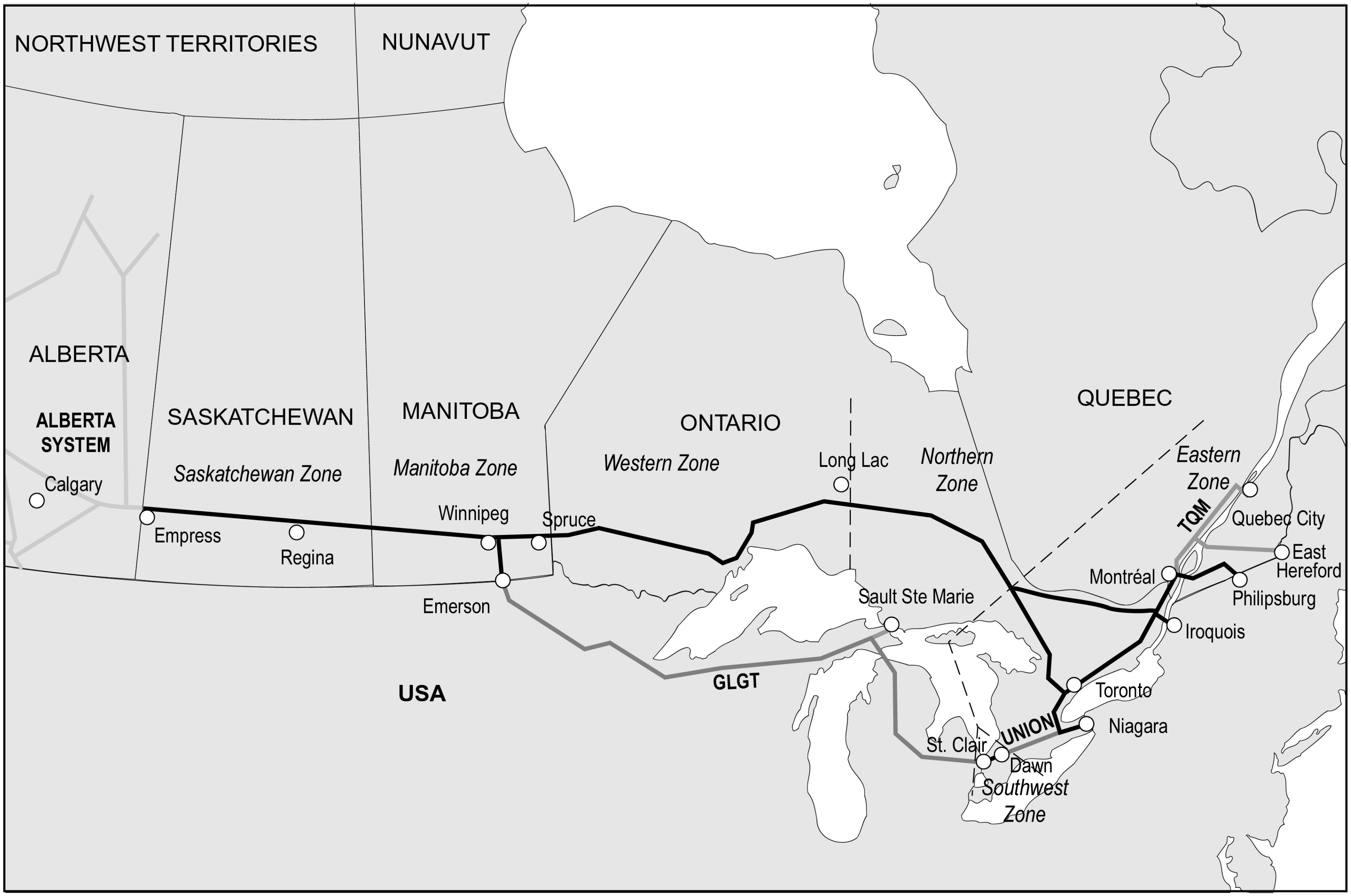
1 *TransCanada PipeLines Ltd. v. Canada (National Energy Board)*, [2004] F.C.J. No. 654 (FCA).

Figure 1-1
TransCanada Mainline



1.2 Overview of the Application

TransCanada's 2004 Tolls Application sought approval of tolls for the Mainline for the period 1 January 2004 to 31 December 2004. The Application, as revised, included requests for continuation of the 2003 Fuel Gas Incentive Program (FGIP) with modifications, the establishment of a new non-renewable firm transportation service (FT-NR), modifications to TransCanada's existing Short Term Firm Transportation service (STFT), and a change to the Mainline's capital structure from the previously approved 33 percent common equity level to a proposed 40 percent level. The Application also requested approval of the 2004 proposed Rate Base, return on Rate Base and other Revenue Requirement items.

The information contained in these Reasons for Decision reflects TransCanada's revisions dated 28 May 2004.

TransCanada requested an average Rate Base for the 2004 Test Year of $8,202.7 million and a Net Revenue Requirement of $1,719.4 million. Components of the proposed Net Revenue Requirement and Rate Base are presented in Tables 2-1 and 3-1.

TransCanada's originally applied-for Firm Transportation (FT) 100 percent Load Factor toll to the Eastern Zone was $1.222/GJ for 2004. On 28 May 2004, TransCanada revised its applied-for Eastern Zone FT toll to $1.169/GJ. TransCanada's Eastern Zone FT toll for 2003 was $1.195/GJ.

From 1 January 2004 to 31 July 2004, TransCanada's interim Eastern Zone toll was $1.222/GJ. The level of this interim toll was revised, effective 1 August 2004, to $1.189/GJ.

1.3 List of Issues

In Hearing Order RH-2-2004, as amended, the Board identified the following List of Issues for Phase I:

1. The appropriateness of the proposed 2004 Rate Base, Revenue Requirement and components thereof (with the exception of the return component);
2. The appropriateness of the proposed FGIP;
3. The appropriateness of the proposed FT-NR service;
4. The appropriateness of the proposed modifications to STFT;
5. The appropriateness of establishing the proposed deferral accounts; and
6. The appropriateness of any proposed enhancements to FT Service.

The sixth issue was added at the request of an intervenor. However, as no proposals were made in this respect, no consideration of this issue was required.

Chapter 2

Revenue Requirement

TransCanada proposed to recover, in its 2004 Tolls, a Net Revenue Requirement of $1,719.4 million, which is $154.2 million lower than TransCanada's 2003 actual expenditures of $1,873.6 million. The components of the applied-for 2004 Revenue Requirement, along with a comparison with 2003 Actuals, are presented in Table 2-1.

Table 2-1
Comparison of Proposed 2004 Revenue Requirement with 2003 Actuals* ($ 000)

	2003 Actuals	Change	2004 Test Year
Transmission By Others	360,015	(4,618)	355,397
Storage Operating Costs	11,371	805	12,176
Pipeline Integrity and Insurance Deductible Costs	45,200	(13,490)	31,710
NEB Cost Recovery	10,732	2,053	12,785
Return	789,692	(57,192)	732,500
Income Taxes	184,030	7,976	192,006
Depreciation	419,834	(4,674)	415,160
Inventory Management Program	12,000	(4,000)	8,000
Gas Related and Electric Costs	72,847	(5,570)	67,277
Municipal & Provincial Capital Taxes	115,741	3,031	118,772
Regulatory Amortizations	(69,141)	615	(68,526)
Gain on Sale of Storage Gas	(953)	953	-
Operations, Maintenance & Administration	228,107	(12,709)	215,398
Debt Redemption Costs/(Gains)	5,788	(47,389)	(41,601)
Regulatory Proceeding Costs	2,490	610	3,100
Pressure Charges	3,772	506	4,278
Gross Revenue Requirement	2,191,525	(133,093)	2,058,432
Miscellaneous Revenue			
Non-Discretionary Miscellaneous Revenue	(66,117)	(2,188)	(68,305)
Discretionary Miscellaneous Revenue	(251,794)	(18,962)	(270,756)
Total Miscellaneous Revenue	(317,911)	(21,150)	(339,061)
Net Revenue Requirement	**1,873,614**	**(154,243)**	**1,719,371**

* Information reflects TransCanada's revised evidence dated 28 May 2004, and the applied-for cost of capital, which will be the subject of Phase II.

Municipal Taxes

In response to an information request dated 3 May 2004, TransCanada noted that revised reassessments in Ontario had resulted in a reduction of $696,000 to the estimated Ontario Municipal tax cost for 2004.

Decision

Subject to any impact resulting from the Board's decisions elsewhere in these Reasons, as well as decisions resulting from Phase II of this proceeding, the Board approves TransCanada's applied-for Revenue Requirement of $1,719,371,000 for the 2004 Test Year, less an amount of $696,000 for the reduction in the estimated Ontario Municipal tax cost for 2004.

Chapter 3

Rate Base

TransCanada requested approval of an average Rate Base amount of $8,202.7 million for the 2004 Test Year. No party raised concerns with respect to the applied-for Rate Base or its components. A summary of TransCanada's applied-for Rate Base is provided in Table 3-1.

Table 3-1
Comparison of the Proposed 2004 Average Rate Base with the 2003 Actual Year Average Rate Base* ($ 000)

	2003 Actual Year	Change	2004 Test Year
Utility Investment			
Gross Plant	12,378,751	10,582	12,389,333
Accumulated Depreciation	(3,952,065)	(356,557)	(4,308,622)
Net Plant	8,426,686	(345,975)	8,080,711
Contributions in Aid of Construction	(23,220)	(68)	(23,288)
Total Plant	8,403,466	(346,043)	8,057,423
Working Capital			
Cash	23,215	(2,245)	20,970
Goods & Services Tax, Net	(5,585)	1,054	(4,531)
Materials and Supplies	30,133	(1,201)	28,932
Transmission Linepack	42,834	0	42,834
Storage Gas	16,194	(577)	15,617
Prepayments and Deposits	1,976	100	2,076
Total Working Capital	108,767	(2,869)	105,898
Deferred Costs			
Miscellaneous Deferred Items	45,385	(16,910)	28,475
Operating and Debt Service Deferrals	(29,136)	(1,303)	(30,439)
Surplus Pension/Post Employment	27,231	14,094	41,325
Total Deferred Costs	43,480	(4,119)	39,361
Total Rate Base	8,555,713	(353,031)	8,202,682

* Information reflects TransCanada's revised evidence dated 28 May 2004, and the applied-for cost of capital, which will be the subject of Phase II.

Decision

Subject to any impact resulting from the Board's decisions elsewhere in these Reasons, as well as decisions resulting from Phase II of this proceeding, the Board approves TransCanada's applied-for Rate Base of $8,202,682,000 for the 2004 Test Year.

Chapter 4

Operations, Maintenance and Administration Costs

This chapter addresses issues within TransCanada's Operation, Maintenance and Administration (OM&A) costs for its Mainline, including financial cost information, employee compensation, and pension conversion costs.

4.1 OM&A Costs - General

Position of TransCanada

TransCanada applied for a total OM&A budget for the Mainline for 2004 of $215.4 million, which the company submitted is $12.7 million less than the actual amount of $228.1 million for 2003. If the financial impact of the severance program that was part of the 2001-2002 S&P Settlement is removed, the net OM&A budget for 2004 is $212.3 million, or $1.2 million less than the net corresponding actual amount of $213.5 million for 2003.

TransCanada indicated that it was prepared to provide thorough explanations of individual budget line items, and stated it did so when requested. In TransCanada's view, the evidence provided during the hearing, combined with the presumption of management good faith, should lead the Board to approve the Revenue Requirement for TransCanada's Mainline as filed.

TransCanada submitted that following a detailed budget determination for any test year, it strives to reduce and control costs for sustained cost reductions, and that this is the fundamental incentive of fixed toll forward test year regulation. TransCanada stated that under this method of regulation, the utility applies to the Board using its best estimate of costs for the test year. The forecasted costs are then subjected to the scrutiny of both the intervenors and the Board and they are either approved or not approved. The pipeline is then at risk for variances. The incentive, which TransCanada contends intervenors have consistently wanted the pipeline to have, is the opportunity to increase the return to its shareholders by enhancing efficiency. For shippers, costs are reduced in the long run. The result, in TransCanada's view, is beneficial for both sides.

Position and Proposal of Coral/CA

Coral Energy Canada Inc. and the Cogenerators Alliance (Coral/CA) contended that it only appears that the Mainline's OM&A costs are forecast to decrease slightly in 2004. Focusing on costs associated with normal day-to-day activities that are driven by inflation and the overall level of business activity of the Mainline, and ignoring unusual or non-recurring costs such as Repair and Overhaul (R&O) expenses, and severance program benefits, the budgeted amounts for 2004 are 8.3 percent higher than 2003 actual expenses. Coral/CA suggested that this increase is excessive, given that TransCanada has not identified any changes in its business that would systematically increase its OM&A costs. Moreover, an examination of recent year-over-year variances indicates that TransCanada has over-estimated the Mainline's OM&A expenses by approximately $10 million in each of the last three years. In Coral/CA's view, this suggests that the current fixed toll forward test year method of regulation for OM&A costs is not working effectively.

Coral/CA expressed concern over the difficulty faced by intervenors in being able to evaluate the reasonableness of TransCanada's OM&A forecasts. Coral/CA suggested that it is not appropriate to presume that a utility's forecast is reasonable. In Coral/CA's view, there is a conflict of interest in that a utility always has an incentive to be conservative in its forecast.

Coral/CA submitted that, in principle, the existing fixed toll forward test year method of regulation is a logical way to approach the problem but that certain conditions have to exist for it to work properly, and that these conditions do not exist in TransCanada's case. In Coral/CA's view the major issue is the reliability of the forecast methodology for OM&A expenses. Coral/CA indicated that relying on TransCanada's budgeted amount for the test year is not the best predictor of actual costs.

While recognizing that no approach is ideal, Coral/CA expressed the view that there are a number of ways to approve an appropriate amount for OM&A costs, whether forward looking or backward looking. Coral/CA recommended a two step approach to determining the correct amount of OM&A expenses. First, remove costs that cannot be expected to be driven by inflation or the overall size of the business. Second, cap the remainder of the Mainline's 2004 OM&A expenses at the 2003 actual amount, inflated by two percent, less an assumed productivity gain of one percent. Coral/CA calculated that this would result in a disallowance of approximately $20 million. Coral/CA submitted that this approach is not a true performance based regulatory (PBR) scheme as it is only for one year and the Mainline's cost base would be adjusted each year to reflect the actual costs of the previous year. Coral/CA recognized that the Board rejected a similar type of approval method in its RH-1-2002 Decision, but stated that there is no other apparent way of dealing with the OM&A issue, as TransCanada continues to over-estimate the Mainline's OM&A costs.

TransCanada's Position on Coral/CA Proposal

TransCanada submitted that the clear implication of Coral/CA's evidence is that TransCanada intentionally inflates its cost estimates. TransCanada stated that this is effectively a "presumption of management dishonesty." TransCanada stated Coral/CA's "cap" approach is simplistic, arbitrary, misguided and without merit. TransCanada advised that it had provided evidence that showed a simplistic tie to inflation would be inappropriate. TransCanada argued that its 2004 OM&A budget is based on thorough and defensible estimates of costs to be incurred in 2004. TransCanada provided examples, such as significant changes in work programs and specific increases in compensation and benefits, to argue against the "cap" approach.

Finally, TransCanada submitted that, as a general rule, a regulator should not substitute its judgement on managerial and business issues for that of the utility's management, unless there is an abuse of discretion by management.

Position of Other Parties

The Canadian Association of Petroleum Producers (CAPP) submitted that TransCanada's revised reporting format, which stems from the Board's direction in last year's RH-1-2002 proceeding, results in a very much improved and very useful basis upon which to examine TransCanada's OM&A costs.

Views of the Board

In its RH-1-2002 Decision, the Board stated that there was "a need for TransCanada to provide more detailed Mainline cost information, as well as employee information, as part of future tolls applications in order to provide clarity, avoid numerous rounds of information requests, and reduce hearing time." Discussions were subsequently held between TransCanada, Board staff and CAPP that resulted in TransCanada filing its OM&A expense information in this proceeding in a revised format. The Board notes CAPP's statement that the revised format has resulted in a format and level of line-by-line expense information that is very much improved and very useful. The Board also found the revised format to be an improvement over the prior year's filing.

With respect to Coral/CA's suggestion that a "cap" approach be applied to the establishment of certain OM&A costs, the Board is concerned that such an approach can be unnecessarily arbitrary and inhibit TransCanada from responding appropriately to changing circumstances. In addition, the Board is of the view that the efficiency incentives contained in such an approach have not been demonstrated to be greater than those contained in the existing fixed toll forward test year approach.

4.2 Total Direct Compensation

Total Direct Compensation (TDC) for TransCanada's employees consists of base salary plus short-term and long-term incentive compensation programs. TransCanada submitted that short-term and long-term incentives have become standard components of competitive compensation for all levels of employees in the energy industry. For example, within the energy industry, 99 percent of employees have short-term incentives and 86 percent have long-term incentives. TransCanada indicated that it responds to market trends to remain competitive with companies in the energy industry. Consequently, TransCanada has introduced both short-term and long-term incentive programs. Without these programs, TransCanada contended that it would be offering employees a TDC package that is less competitive than those offered by other energy industry-based companies.

TransCanada submitted that its objective in establishing its TDC target is to be competitive with the median of its comparator group, which consists of approximately 25 companies in similar industries of comparable size and scope. TransCanada noted that its salary surveys show that the company's TDC for the majority of these job families was within plus or minus 10 percent of the market median in 2003, a level that TransCanada considers competitive. While these surveys are developed, maintained and administered by external compensation consultants, TransCanada selects the final comparator group.

In response to an information request dated 3 May 2004, TransCanada noted that the implementation of the 2004 market adjustment program for fixed rate and salaried employees resulted in a reduction of $360,000 to its forecast 2004 cost of service.

No party took issue with the overall level of TDC although some parties objected to the Long-Term Incentive Compensation (LTIC) component.

4.2.1 Long-Term Incentive Compensation

In RH-1-2002, an issue was whether Mainline tollpayers should pay 100 percent of LTIC costs allocated to the Mainline. In its Decision, the Board found that a variable compensation program which is paid out on the basis of measuring the increase in shareholder value could drive a different behaviour than one which focuses on areas of benefit to customers. The Board accepted that, in order to be competitive in the marketplace for employees, TransCanada must offer a suite of compensation components similar to its comparator group and that the focus on shareholder value is not necessarily detrimental to shipper interests. Nonetheless, the Board stated that in the case of LTIC, which clearly rewards employees for aligning their interests with shareholders, shareholders should bear a significant portion of the cost of LTIC. Therefore the Board determined that it would be appropriate for tollpayers to pay for only 50 percent of the cost of LTIC.

TransCanada has applied for the full inclusion of LTIC costs in its cost of service for the 2004 Test Year.

Position of TransCanada

LTIC costs are forecast to increase by $2.0 million to $15.1 million in 2004 primarily as a result of the continued implementation of the share unit program for management and executives. TransCanada indicated that incentive payments to employees at TransCanada are determined on the basis of performance measured against multiple benchmarks at the individual and company level. TransCanada employs skilled workers for the benefit of shippers and shareholders and it is not reasonably possible to separate the benefit of the work performed by employees between the two. TransCanada submitted that a market competitive TDC must be paid to adequately compensate employees for performing their jobs. TransCanada pointed out that in RH-1-2002 the Board disallowed 50 percent of LTIC costs because in its view, LTIC clearly rewards employees for aligning their interests with shareholders. TransCanada contended that the Total Shareholder Return (TSR) benchmark was singled out as the Board's reason for the disallowance. TransCanada stated there is a contradiction between the finding of reasonableness of its total compensation per employee and the related disallowance of costs based on one specific benchmark. In TransCanada's view, the benchmark is not the relevant issue; what is relevant is whether the total compensation per employee is appropriate.

TransCanada also stated that there has been a change in circumstances. A recent ruling by the Ontario Energy Board (OEB) in respect of Union Gas Limited accepts the importance of allowing utilities to effectively compete for skilled employees in the market place by offering competitive compensation. The OEB stated that:

> Incentive programs are a common element of business management in all sectors of the economy, and have come to be regarded by employees, and prospective employees, as an essential element of compensation. Unless the incentive programs can be shown to be extravagant or otherwise objectionable, they should be supported as part of the revenue requirement. It would be perilous to create a situation in which the gas distribution utility, alone among business categories, could not effectively attract and keep quality employees through the offering of reasonable incentive programs.[2]

TransCanada stated that long-term incentives allow it to remain competitive with the market in order to effectively attract and retain the skilled employees that are required to sustain safe, reliable, and efficient operations of its business. Further, TransCanada submitted that it focuses on providing the lowest cost of transportation, excellent customer service, and top environmental performance, and that these objectives are totally aligned with shippers' objectives. As a result, TransCanada saw no difference in creating long-term value for the company and shipper requirements.

TransCanada stated that strong share price performance is the key element of TSR growth and is an aggregate performance measure of doing the "right things" over a long period of time. These things include maintaining a strong safety record, customer service and relations, efficient and effective operations, a motivated workforce, community relations, and other factors. TransCanada suggested that on a day-to-day basis, employees do not focus on increasing the share price or dividend, but focus on matters within their control like safety, customer service and cost effectiveness. In TransCanada's view, TSR is just the measure that shows whether all the "right things" are being done consistently and on a sustained basis.

TransCanada argued that its request for full inclusion of LTIC costs in the cost of service is based on the reasonableness of the aggregate level of TDC costs and the necessity to compete in the market for employees by offering compensation components that are similar to the comparator group. Further, TransCanada submitted that its LTIC plan does not vary significantly from that offered by comparator firms. TransCanada also stated that the disallowance of any portion of LTIC would reduce TransCanada's ability to attract and retain qualified employees, which would be a high price to pay for having an LTIC performance measure not seen as "ideal" by intervenors.

Position of Parties

In CAPP's view, a disallowance of the total amount of LTIC costs is appropriate; however, given that the facts and circumstances are the same this year as when the Board disallowed 50 percent of LTIC costs last year in RH-1-2002, CAPP stated the same decision should continue to apply this year.

CAPP stated that the issue with LTIC is not the total level of compensation, but rather, the form of this particular element of compensation. CAPP submitted that there is no contradiction in a decision that finds a company's proposed overall compensation level to be acceptable, but at the same time, finds that one component of the overall compensation is unacceptable. As LTIC is

2 OEB, RP-2003-0063 Decision (Union Decision), Page 90.

tied to the increase in shareholder value, the shareholder, as the beneficiary of the increased value, should also see cost.

Coral/CA proposed that only 50 percent of LTIC costs be included as the Board has previously found that a portion of these costs should not be borne by shippers.

The Minister of Energy for the Province of Ontario (Ontario) pointed out that the Board found in 2003 that the company's proposed program clearly rewarded employees for aligning their interests with shareholders and that it was the Board's view that shareholders should bear a significant portion of the LTIC costs. Ontario argued that nothing has changed, and for the same reasons set out in RH-1-2002, the Board should disallow 50 percent of the costs of LTIC for 2004.

Le Procureur général du Québec (Quebec) submitted that costs disallowed by the NEB at a hearing for a given year should not be reintroduced in a subsequent application unless the company can justify it on the basis of changed circumstances. Quebec expressed the view that no such evidence of changed circumstances was submitted by TransCanada.

Views of the Board

In its RH-1-2002 Decision, the Board expressed concern that a variable compensation program that is paid out on the basis of measuring the increase in shareholder value could drive a different behaviour than one which focuses on areas of benefit to customers. Accordingly, the Board was of the view that shareholders should bear a significant portion of the cost of LTIC. While the Board remains concerned that there can be potential conflicts between the interests of Mainline shippers and shareholders of TransCanada Corporation, the Board also accepts that there are many areas in which shareholders' and shippers' interests are aligned.

The Board is also of the view that long-term incentives can be an appropriate component of a total compensation package for employees. The Board recognizes that LTIC allows TransCanada to remain competitive with the market in order to attract and retain the skilled employees required for the efficient operation of the Mainline. In addition, the Board agrees with TransCanada that TSR growth can be an acceptable performance measure of doing the "right things."

With respect to the potential conflicts between shareholders' and shippers' interests, the Board is of the view that it is better to address these types of concerns directly through the establishment of an up-dated Code of Conduct (see Chapter 11) rather than considering the disallowance of a portion of employee compensation.

Accordingly, the Board is of the view that a disallowance of a portion of the applied-for LTIC costs for 2004 is not justified.

4.3 Pension Conversion Costs

In the RH-1-2002 proceeding TransCanada submitted that the Mainline's $9.3 million budgeted amount for pension and benefits adjustments for the 2003 Test Year was primarily related to an increase in the Defined Benefit plan (DB plan) expense as well as the consolidation of the former Defined Contribution plan (DC plan) and Combination Plan into the DB plan.

The Board expressed the view that both DC and DB plans were appropriate and a reasonable company should be expected to decide on one type of plan and stay with that plan. The Board further expressed the view that for shippers to cover the cost of moving back and forth between plans sets an inappropriate precedent in the event the trend reverses at some point in the future. Accordingly, while the Board determined that the reasons for converting from a DC plan back to a DB plan were understandable, it disallowed an amount of $3 million.

Position of TransCanada

The 2004 applied-for Revenue Requirement includes an amortization of $1.2 million of the total funding costs of $22 million. These funding costs were included in TransCanada's pension plan costs as a result of TransCanada converting its DC plan back to a DB plan. TransCanada pointed out that the interest or return in 2004 on the funding amount of $22 million associated with the conversion is $0.6 million. This amount should be netted against the $1.2 million for a net cost of $0.6 million for 2004.

TransCanada submitted that the determinative question in deciding if this cost should be recoverable is whether corporate management made a prudent decision in line with its business strategy when it converted its DC plan back to a DB plan.

Position of Parties

CAPP indicated that in RH-1-2002, the Board disallowed all of the pension conversion "keep whole" costs. In CAPP's view, there has been no change in the facts or circumstances on which the Board's decision was based. CAPP submitted that the rationale for the RH-1-2002 Decision still stands and should continue to apply this year.

In CAPP's view, there is no contradiction in saying that converting employees from one pension plan to another is acceptable, while also saying that some part of the cost should not be paid by toll payers. CAPP submitted that the full amount of $1.2 million should be disallowed, not netted against some "notional" calculation of interest earned on the full amount contributed and to be amortized over 13 years.

Ontario submitted that, for the same reasons set out in RH-1-2002, the Board should disallow all 2004 pension conversion costs. Ontario maintained that there are no new facts or circumstances to warrant a different decision than in RH-1-2002.

Views of the Board

The Board is of the view that the ongoing costs of maintaining the new DB regime are appropriate, and accordingly, does not believe that any further disallowance in addition to the $3 million disallowed in 2003 is warranted.

Decision

Subject to any impact resulting from the Board's decisions elsewhere in these Reasons, as well as decisions resulting from Phase II of this proceeding, the Board approves TransCanada's applied-for OM&A amount of $215,398,000 for the 2004 Test Year, less a reduction of $360,000 resulting from the implementation of the 2004 market adjustment program for fixed rate and salaried employees.

Chapter 5

Income Taxes

TransCanada calculated the 2004 Test Year income taxes based on the Revenue Requirement as submitted in the Application. No comments were received from parties on the method of calculation.

Decision

TransCanada is directed to re-calculate and file as part of its compliance filing, which will follow the issuance of the Board's Phase II Decision, the Mainline's Income Taxes for the 2004 Test Year in order to reflect the RH-2-2004 Decision.

Chapter 6

Incentives

6.1 Fuel Gas Incentive Program

The initial fuel gas incentive program (FGIP) was implemented as part of the 2001-2002 S&P Settlement and ran from 1 November 2001 to 31 December 2002. In RH-1-2002, the Board approved an extension of the same FGIP for 2003, and directed that a review of the program be conducted and reported to the Tolls Task Force (TTF), Mainline shippers, and to the Board so that future consideration of the FGIP could be undertaken with a better information base. In its 2004 application, TransCanada proposed that the FGIP be continued for 2004, but with two significant modifications. First, the target equations would be recalculated to reflect physical system changes made since the FGIP commenced in November 2001, and second, the incentive payment schedule would be revised.

Position of TransCanada

TransCanada stated that the results of the 2001-2002 FGIP showed that, for the 14-month period the FGIP was in place, TransCanada's fuel volume savings relative to the target averaged about 287 $10^3m^3/d$, with an estimated annual saving of $18.2 million. Of this amount, shippers realized a benefit of approximately $11.5 million while TransCanada's commission was $6.7 million. In 2003, TransCanada's incentive payment was $4.4 million for seasonal fuel savings of 351 $10^3m^3/d$ achieved during the April to October summer season. No fuel savings were realized during the 2003 January-March, November-December winter period. TransCanada submitted that the winter targets were not reached due to the large range of flows experienced over the split winter season. TransCanada also indicated these will be no fuel savings for the first three months of 2004 and that if November and December 2004 actuals were to duplicate November and December 2003 results, there will be no fuel savings for the 2004 winter season.

TransCanada reported that it was able to reduce fuel usage through improved linepack management; a compressor wheel change at Station 75; improved outage coordination combined with appropriate balancing of OM&A expenditures; and enhanced internal processes for developing operating strategies, responding to daily changes and monitoring system performance.

TransCanada stated that the merits of the program and the findings discussed by the Board in RH-1-2002 continue to be relevant and appropriate factors that support the continuation of the FGIP in 2004. TransCanada confirmed that it would be willing to enter into discussions with stakeholders with respect to a longer term fuel incentive.

TransCanada's proposed 2004 FGIP would feature revised target curves and a revised incentive payment schedule. According to TransCanada, the effect of these revisions is that it would not continue to benefit from prior changes resulting in sustainable fuel savings, but would be rewarded only for incremental effort that produces outcomes beneficial to shippers in 2004.

TransCanada stated that it had already established its 2004 budget objectives and that its employees are acting as if the FGIP was approved.

Under the 2004 FGIP, the proposed revised target curves would reflect the physical system changes and operating condition changes made since the commencement of the 2001-2002 FGIP. For example, the wheel change at Station 75, to which approximately 10 percent of total fuel savings was attributed, was incorporated into the revised targets. Additionally, the actual fuel volume would be adjusted by the level of fuel compensation provided to the Mainline shippers as a result of the arrangement between TransCanada and TransCanada Power LP (TCP LP) regarding cogeneration facilities in Northern Ontario. The revised targets would make it more difficult to achieve the fuel objective. Implementation of the rebased targets would mean that TransCanada must achieve and improve on its performance under the past fuel incentives to earn an incentive payment.

TransCanada suggested that about one third (100 $10^3m^3/d$) of the approximately 300 $10^3m^3/d$ fuel savings achieved in 2003 is considered sustainable with little additional cost to the company. To achieve the remaining benefits (200 $10^3m^3/d$) in 2004, TransCanada would be required to make operational decisions continuously to optimize fuel usage. Under the revised incentive payment schedule, relative to the 2003 incentive schedule, TransCanada would be required to achieve a minimum fuel saving of 200 $10^3m^3/d$ before it would receive the base commission of $3.5 million. Table 6-1 shows the 2004 proposed schedule relative to the 2003 approved schedule.

Table 6-1
2004 Proposed and 2003 Approved Fuel Gas Incentive Schedules

2004 Proposed Schedule		2003 Approved Schedule	
Fuel Volume Savings ($10^3m^3/d$)	**Annual Incentive Amount ($million)**	**Fuel Volume Savings ($10^3m^3/d$)**	**Annual Incentive Amount ($million)**
		0	0
		100	1.5
0	3.5	200	3.5
100	6.0	300	6.0
200	9.0	400	9.0
300	12.0	500	12.0
400	15.0	600	15.0

TransCanada stated that although it does not specifically track the costs of actions undertaken to improve fuel gas utilization, it could spend discretionary dollars from OM&A to increase fuel efficiency that it would not necessarily be able to recover.

TransCanada stated that symmetry is not the basis for the FGIP. If the incentive payment schedule were symmetric (that is, TransCanada would be penalized if it did not achieve the targets), shippers would benefit from the implementation of the incentive relative to the pre-implementation period, while TransCanada would be penalized. TransCanada also noted that for calculating fuel and flow, the linear averaging methodology in combination with seasonal averaging (rather than monthly averaging) could place TransCanada in a penalty position. In addition, TransCanada's view was that the introduction of a penalty would increase business risk to an inappropriate level under the Mainline's currently approved rate of return and deemed equity level.

Position of Parties

CAPP opposed both the 2003 and the 2004 FGIP and listed a number of concerns regarding the 2004 FGIP. First, benefits would be measured against targets set by a process that could not be independently verified. Second, the decisions on targets would be made by the potential beneficiaries of the program and may be too easy to exceed. Third, benefits would be affected by matters beyond the control of TransCanada, such as flows and temperature. Fourth, TransCanada did not notice an error in the winter target curve until the information request process. Fifth, CAPP stated that TransCanada would have little or no chance of meeting its winter targets, while it is probable that the summer target would be met. This disparity and the undetected error combined to reduce CAPP's confidence in the incentive program. Sixth, TransCanada stated that it would continue to operate as if the incentive was in place regardless of its ability to actually reach the winter target. In CAPP's view, this suggested that all TransCanada would have to do to minimize fuel usage would be to direct its staff to do so. Seventh, TransCanada was unable to support its claims of hard work, ingenuity, and cost of saving fuel with quantifiable data. Eighth, line level employees make many of the actual decisions, for which, in many cases, there is no need for analysis or documentation. Ninth, costs of the previously approved programs, some of which may already be included in the OM&A budget, have not been tracked by TransCanada. Finally, TransCanada should have a goal of maximizing fuel efficiency to remain competitive without the need for an incentive program.

CAPP stated that incentives must be consistent with the cost-based model under which TransCanada is regulated and that value-based rewards are not cost-based. TransCanada recovers its costs for providing value to producers and consumers in connecting supply and markets, but does not share in the value its pipeline creates. CAPP requested that the FGIP be discontinued as an incentive program, but carried forward as a performance measure without extra payment. CAPP argued that any proposal to achieve additional fuel efficiency beyond the normal level, which TransCanada is expected to do on a regular basis, should be negotiated. In particular, the issue of symmetry should be addressed.

Coral/CA submitted that the FGIP can be supported on the basis that, without it, TransCanada's economic incentive would always be to minimize its OM&A expenditures, even if that resulted in higher than necessary fuel consumption. However, Coral/CA's view was that the incentive should be structured symmetrically so that, on average, the utility should not be able to earn more than its allowed return. To accomplish this, Coral/CA suggested a model for an FGIP that would involve TransCanada's utilization of the rebased target curves and the 2003 incentive payment schedule. To achieve symmetry, Coral/CA advocated applying a mirror image "negative incentive" payment schedule for the purpose of determining a penalty in the event that TransCanada is less efficient than the target level. Alternatively, Coral/CA suggested that the 2003 FGIP be maintained, including the 2003 target curves, but that the amount of the 2003 incentive payment should be credited to the OM&A component of the allowed Revenue Requirement.

Union stated that it recognizes that greater efficiencies can be discovered through an incentive mechanism, although it was also of the view that ideally, no incentives should be required. Union is supportive of negotiated incentive programs that appropriately balance risks, provide verifiable results and include appropriate payment schedules. The proposed 2004 FGIP, in Union's view, does not meet any criteria for a good incentive. Therefore, Union opposed the proposed 2004 FGIP, stating that it would prefer that the Board leave TransCanada and its shippers to negotiate an FGIP at the TTF.

Union expressed concern that, while benefits to shippers are easily observed, TransCanada is unable to provide information detailing the costs incurred to achieve fuel gas savings, making it impossible to conduct a cost-benefit analysis of the FGIP. Union also noted that to inspire shippers' confidence, the program should have a balance between upside and downside risk.

Ontario noted that the process to determine the target curves was neither transparent nor easily understood by parties and that it was prone to error. Ontario was also concerned that TransCanada has no control over flow patterns and temperature, which affect fuel usage. Ontario recommended that the Board accept TransCanada's revised fuel target curves but retain the 2003 Fuel Gas Incentive Schedule. Ontario also suggested that the Board direct TransCanada to file evidence indicating the actual amount of OM&A costs incurred in delivering the 2004 FGIP, so that an analysis of the net benefits of the program can be undertaken.

Quebec stated that incentive programs aligning the interests of TransCanada and its shippers have value. However, based on the evidence filed by TransCanada, Quebec indicated that it would prefer a more in-depth review of the various parameters of the proposed 2004 FGIP.

Views of the Board

The potential benefits of an FGIP were accepted by most parties. TransCanada's evidence suggested that the 2001-2002 FGIP produced a fuel savings amount to shippers of approximately $11.5 million relative to target, and TransCanada itself earned a $6.7 million commission. For the most part, parties diverged from TransCanada not on the principle of there being a program, but on the criteria upon which a program for 2004 should be based, and on the desirability of it being negotiated rather than imposed through a regulatory decision.

Of particular significance is the fact that several parties expressed the view that the FGIP proposed for 2004 was complex, difficult to fully understand and independently monitor, and therefore prone to errors that may be difficult to detect. For instance, it was indicated that the reasonableness of the revised fuel equations for 2004 is difficult to assess by parties other than TransCanada. The view was also expressed that the costs of the program were unknown, making it difficult to assess its overall benefit-cost ratio. The Board shares these concerns.

The Board continues to believe, as it stated in its RH-1-2002 Decision, that incentives can be appropriate mechanisms when they induce a company to behave in a way that improves the operation of the pipeline for its shippers, or when they provide mutual benefits to the shippers and the pipeline company. The Board also continues to hold the view that the desired outcomes of an incentive program, such as an FGIP, are unlikely to be achieved outside a negotiated settlement. Nevertheless, the Board may decide that an incentive should be approved when parties cannot agree, and when it is demonstrated that a particular incentive meets the criteria for a successful program.

The Board notes that intervenors who were active in the proceeding unanimously opposed implementation of the proposed 2004 FGIP as submitted, even though TransCanada's evidence suggested that shippers realized significant benefits from the 2003 version of the program. In the Board's view, this denotes that TransCanada and its customers may benefit from, jointly, re-thinking openly and explicitly the manner in which they negotiate and communicate on matters of potential mutual benefit.

In the RH-1-2002 Decision, the Board expressed concern that a review of the original FGIP expected to take place at the completion of the 2001-2002 S&P Settlement had not taken place. The Board notes that the review of the program that the Board had directed take place no later than 31 December 2003 was more limited than the substantive examinations and dialogue about potential improvements or modifications to the program that had been expected by the Board. While the Board remains fully prepared to adjudicate any matter in dispute, it wishes to re-iterate and emphasize that incentive programs inherently benefit from the iterative and potentially creative process of business negotiations.

In view of the foregoing, the Board has decided to suspend the FGIP for 2004. The Board expects to see an FGIP submitted for 2005 that reflects a genuine attempt on the part of all parties to negotiate a mutually satisfactory outcome. In designing a program for 2005, the Board expects its key components to be comprehensible without the need to have recourse to highly specialized expertise, and capable of independent third party verification if the results of the program were to give rise to a dispute. The Board also expects the benefit-cost ratio of a future program to be sufficiently understood in order that an assessment of net benefits can be made with more rigour than was possible in this proceeding.

Decision

The Board denies the applied-for FGIP.

Chapter 7

Great Lakes Transportation by Others Capacity

TransCanada's integrated system consists of facilities owned by TransCanada and contractual entitlements to transport natural gas on pipeline systems owned by others (referred to as Transportation by Others or TBO). One of the contractual entitlements is TransCanada's right to transport natural gas on GLGT from Emerson, Manitoba to St. Clair, Michigan. From St. Clair, the natural gas is transported across the international border into Southwestern Ontario for further transportation on Union and on the Mainline to Eastern domestic and export markets (Figure 1-1).

An issue was raised in this proceeding by Coral/CA as to whether TransCanada is doing everything it can to sell its excess GLGT TBO capacity during the winter months. Coral/CA suggested that TransCanada prefers to allow GLGT to market excess capacity since this has a greater impact on shareholder return.[3] Coral/CA contended that TransCanada, itself, should be participating in the daily marketing of its excess GLGT capacity during the winter months.

Position of TransCanada

TransCanada submitted that its decisions regarding the release of GLGT capacity are not driven by considerations related to GLGT revenue generation, but are driven by its expectation of demand for its services (Interruptible Transportation service (IT) and STFT), the expected trade-off between these potential revenues and the revenue expected from releases, and operational requirements to ensure that reliable, efficient service is provided. In addition to the GLGT capacity that it may post for release, TransCanada indicated that it also makes available all of its capacity on the integrated system as IT and STFT on a daily basis to the benefit of all shippers.

TransCanada submitted that it is difficult to determine how much spare capacity it has available on GLGT on any given day because of IT and STFT sales, and space on Union's system. For TransCanada to be participating in the current day release of GLGT capacity, TransCanada would have to auction its GLGT space at the same time as it is making its own short-term services available. This would result in TransCanada offering competing services with different service attributes and different processes, so its preference has been to make its own Tariff services available. To try and market its GLGT excess capacity on a daily basis at a price that is lower than its IT toll would be contrary to the concept of having an IT toll that has a floor of 110 percent of the FT toll. The IT floor price of 110 percent of the FT toll is intended to maximize the revenues of its firm services.

TransCanada also submitted that Coral both holds and requires additional GLGT capacity and desires this capacity at lower rates. In TransCanada's view, Coral would like TransCanada to aggressively discount GLGT capacity which would reduce the revenue benefit to all shippers but

3 TransCanada has a 50 percent ownership interest in GLGT.

increase the benefit to individual shippers like Coral. In addition, TransCanada maintained that it cannot determine if GLGT is selling TransCanada's capacity on GLGT.

TransCanada concluded by stating that it maximizes revenue to shippers by how it deals with its GLGT TBO capacity and that this matter should be left to TransCanada to manage under the presumption of management good faith.

Position of Parties

Coral/CA submitted that TransCanada does not require all of its GLGT capacity in the winter months and noted that to mitigate its TBO cost, TransCanada sells, from time to time, unneeded TBO capacity. Coral/CA argued that the $4.5 million TransCanada received in 2003 for selling this excess capacity is about $5.2 million less than it should have received if it had acted as any reasonable shipper would have done to mitigate its exposure and more actively sold unneeded GLGT TBO capacity. In Coral/CA's view, TransCanada has the incentive to do nothing, because if it sells its GLGT excess capacity itself, its shareholders get nothing, whereas if it lets GLGT sell the capacity, both GLGT and TransCanada shareholders profit.

Coral/CA contended that the capacity that GLGT used to provide short-term services was overwhelmingly TransCanada's own unutilized capacity. With respect to TransCanada's contention that it does not necessarily know how much spare capacity it has on GLGT on a day-to-day basis, Coral/CA maintained that if GLGT can successfully predict how much space TransCanada will leave empty, TransCanada should be able to do the same. Coral/CA submitted that the appropriate remedy is to subtract $5.2 million from TransCanada's TBO deferral account.

In Ontario's view, it is not appropriate for TransCanada to retain excess capacity on GLGT in the hope that shippers will contract for more expensive STFT. Ontario requested that the Board order TransCanada to undertake all reasonable commercial efforts to maximize the revenues of its unutilized GLGT capacity by bringing the capacity to market.

Views of the Board

The Board expects TransCanada to manage its GLGT contracts in the best interests of all of its shippers. The evidence shows that TransCanada's decisions regarding the release of its GLGT capacity have been based on TransCanada's expectation of demand for its services (IT and STFT), the expected trade-off between these potential revenues and the revenue expected from releases, and operational requirements to ensure that reliable and efficient service is provided. The Board is of the view that this exercise of TransCanada's discretion is important and contributes to the effective operation of the integrated Mainline system. Further, no evidence demonstrated that TransCanada's decisions in this regard have been inappropriate. Accordingly, no further direction of the Board is necessary.

Chapter 8

Toll Design/Tariff Matters

This chapter deals with proposed changes to TransCanada's STFT service and TransCanada's application for a new non-renewable firm transporation service.

8.1 Short Term Firm Transportation Service

In its 2004 Tolls Application, TransCanada applied for approval of a modified STFT service. In its 14 April 2004 additional written evidence, TransCanada notified the Board that the TTF had approved, by unopposed resolution, the proposed modifications to existing STFT. By letter dated 23 June 2004, the Board approved the proposed modifications to STFT and the resulting revisions to the STFT Toll Schedule and List of STFT Tolls. As a result, no further consideration of STFT took place in the RH-2-2004 proceeding.

8.2 Non-Renewable Firm Transportation Service

In its 2004 Tolls Application, TransCanada applied for approval of a new Non-Renewable Firm Transportation service (FT-NR). TransCanada explained that the new FT-NR service, in combination with the modified STFT service, would provide shippers with access to term-limited blocks of capacity on a non-renewable basis.

Position of TransCanada

FT-NR would be for term-limited blocks of capacity made available when TransCanada awards firm service commencing more than one year in the future. FT-NR would be for finite terms of one year or more, would not be renewable, and would be a biddable service with a floor price equal to the 100 percent Load Factor Firm Transportation (FT) toll. In addition, diversions and assignments would be allowed for FT-NR contracts. TransCanada would not build new facilities for FT-NR. Terms for FT-NR would be limited by the commencement dates of future firm contracts.

TransCanada explained that its recent Firm Transportation Open Seasons demonstrated significant demand for Eastern short-haul service and that it was unable to accommodate all requests for service. TransCanada did award a request for service from Dawn to the Gaz Métro Eastern Delivery Area (EDA) beginning in November 2005 with the result that there was 40,000 GJ/d of capacity to the Gaz Métro EDA available on a non-renewable basis until 31 October 2005. During its 11 February 2004 Open Season, as an interim measure to deal with the block of capacity resulting from the Gaz Métro EDA contract, TransCanada offered the capacity under a modified FT contract, which included a step-down clause. The step-down clause stipulated that the daily contract quantity requested would be reduced to zero GJ/d on or before 31 October 2005, the last day prior to the commencement date of the future contract. The effect of the step-down clause is that the FT contract's renewal provision applies to zero volumes. The demand for the offering was high, as total bids were 2.3 times greater than the capacity available.

Although TransCanada has only once, to date, awarded a contract commencing more than one year in the future, TransCanada stated that it expects similar situations to arise in the future. In the absence of a service like FT-NR, shippers would have to bid for limited blocks of capacity through discretionary services with less flexibility and priority, while managing longer term requirements with multiple STFT contracts or daily IT bidding, which would provide less certainty. TransCanada submitted that it would prefer a unique service to manage the blocks of capacity created by future contracting to keep its records clean, as it is preferable not to have contracts with zero volumes, which would be the result of FT step-down contracts.

TransCanada acknowledged that virtually any type of firm contract with a future commencement date, including FT, Storage Transportation Service, and STFT, could be considered when designating FT-NR service capacity and that the term of an FT-NR contract could be considerable under certain circumstances. FT-NR availability would not necessarily correspond to particular service contracts as it would be determined based on the aggregate of contracts looking forward in time after considering the suite of services contracted, relevant time frames, and seasonal capacity variations. Although TransCanada stated that all available FT on any given segment of the system would be contracted before FT-NR was offered, it agreed that available capacity on the system is constantly changing with the result that it would be possible that capacity could be offered as FT-NR in one period, or could be available as FT in another period.

In TransCanada's view, the combination of STFT and FT-NR would provide shippers with more options to optimize their transportation portfolios and provide opportunity to increase revenues.

TransCanada provided two reasons for offering FT-NR as a biddable service. First, as the contracts would not be allocated based on term (by definition, FT-NR terms would be limited and specific), having shippers bid on price would be an efficient way to allocate capacity to those valuing it most. Second, to the extent that bidding exceeded the 100 percent load factor FT toll, incremental revenues would be generated to the benefit of all Mainline shippers. TransCanada expects that term-limited blocks of capacity available for FT-NR would be on high demand sections of the system. As a result FT-NR would provide high value to shippers. TransCanada's strong preference was that the service be biddable to ensure appropriate price signals for the service, although it conceded that the biddable aspect of the service was not entirely necessary.

Position of Parties

All active intervenors were opposed to the biddable feature of the proposed FT-NR service, although most indicated that they did not oppose a non-biddable form of the service.

CAPP stated that the proposed FT-NR service was designed for exceptional events that could be handled when they arise using existing services such as FT with a step-down clause, as TransCanada did with the Gaz Métro EDA capacity block. CAPP expressed the concern that by normalizing an exception with FT-NR, the incentive to make decisions that create non-renewable situations may be increased, and suggested caution before opening the door to more opportunities to offer FT without renewal rights. CAPP was also concerned that the proposed FT-NR service could lead to unanticipated outcomes.

CAPP was of the view that FT-NR would be substantially similar to FT and that changing a service feature (renewability) is not a sufficient justification for introducing price bidding for firm service. CAPP explained that firm service, with fully cost-based tolls that are just and reasonable, is the backbone of Mainline service. CAPP noted that the Board is required to ensure tolls are just and reasonable and charged equally under "substantially similar circumstances", and are not unjustly discriminatory. CAPP stated that it would be wrong to erode the cost basis for firm service tolls by introducing FT-NR service on a biddable basis. CAPP was opposed to FT-NR as a service, but suggested that if the Board decided that there should be an FT-NR service, it not be biddable.

The Industrial Gas Users Association (IGUA) did not oppose the FT-NR proposal with respect to most service parameters. However, it did oppose the biddable aspect of the service. IGUA suggested the FT-NR toll should be the same as the 100 percent load factor FT toll between the same receipt and delivery zone or points.

Coral/CA suggested that the need for FT-NR was unlikely to arise often, but if it did, temporarily stranded blocks of capacity could be sold as FT diversions, or IT or STFT service, until the long-term contract came into effect. Further, Coral/CA noted that TransCanada had already dealt with such a block of capacity by entering into FT contracts in which the shippers agreed to a step-down clause.

Coral/CA suggested that allocative efficiency is not a goal to be pursued at the expense of ensuring tolls are just and reasonable. They noted that cost-based tolls are established for regulated firms as they best mimic the long-run competitive outcome and that biddable pricing for the proposed FT-NR service would not be appropriate. Coral/CA suggested that there are other methods to allocate capacity, such as on a pro-rata basis. Regarding TransCanada's suggestion that FT-NR could help generate incremental revenues to the system, Coral/CA was of the view that this is not a legitimate objective.

Coral/CA submitted that the Board should deny the proposed FT-NR service, but that if it were approved, it should be priced at the fixed 100 percent load factor FT toll.

Union stated that there was no real pressing need for a discrete FT-NR service, but that it would prefer to see FT-NR regularized as a discrete service rather than achieved through adjustments to normal FT contract terms.

Union expressed concern regarding the term of FT-NR, noting that although TransCanada stated that it would be used mostly in situations where capacity is available for terms of about two years, no limit has been proposed for FT-NR service duration. Therefore, FT-NR could potentially be available for unlimited terms, depending on circumstances.

Union agreed with comments made by CAPP and other intervenors regarding biddability and strongly opposed FT-NR as a biddable service. Union suggested that if FT-NR were determined to be a substantially different service from FT, a different non-discriminatory cost-based price could be determined. In addition, Union stated that if TransCanada does not want to move to a relatively comprehensive risk-reward tolling structure for the recovery of its costs, including firm tolls, it should live within a cost-of-service regime for all but IT and short-term services, which are marginal services.

Ontario was of the view that FT-NR appears to be unnecessary, that it would add little value, and that it should not be approved. However, if approved, Ontario suggested that it not be biddable, citing the fact that TransCanada acknowledged that the service could be approved without the biddable feature.

Quebec acknowledged the usefulness of being able to offer FT-NR in exceptional cases. However, it was not convinced that the service is required given that TransCanada has been successful in awarding a block of firm capacity by using FT with a step-down clause. In Quebec's view, providing FT-NR as a biddable service could result in a market distortion since there would be more than one rate in use for firm service, as FT-NR, with the exception of renewal rights, would possess all the features of FT. Quebec indicated that it would not oppose approval of the service if it were approved without the biddable feature.

Views of the Board

TransCanada has proposed FT-NR as a new service that would allow it to market limited-term blocks of capacity in an orderly way. The Board is of the view that this service acts to round out the suite of services offered by TransCanada and, in particular, allows it to offer for use capacity that might otherwise be available only for short-term discretionary services. Although the evidence indicates that such capacity could be offered to the market through the use of FT contracts with a step-down provision, the Board is of the view that a specific discrete service, with clear terms and conditions, is preferable.

As all available FT would have been previously awarded, FT-NR would be the only firm service available for periods of one year or more on particular segments, and it would not be renewable. Therefore, FT-NR would be traffic that does not flow under substantially similar circumstances and conditions to FT.

As a unique service for a niche market, a unique pricing structure can be envisaged. The Board notes that there may be occasions when the demand for the capacity offered through FT-NR will exceed its availability. The use of bidding would ensure that the capacity would be awarded to those shippers who value it most and that the price would reflect the value of the service to those shippers who use it. This ensures allocative efficiency and contributes to overall economic efficiency. To the extent that the price paid for FT-NR exceeds the FT toll, the extra revenues would act to lower tolls for the benefit of all shippers. For these reasons, the Board is of the view that it would not be inappropriate for this service to be biddable and, in these circumstances, is satisfied that approving FT-NR on a biddable basis does not constitute an erosion of the cost-based approach to the determination of FT tolls.

In order to ensure that the introduction of FT-NR has had the desired benefits, the Board is of the view that TransCanada should file with the Board, and serve on its Mainline shippers and TTF members, a report on the use of FT-NR within two years of implementation of the new service. The report should present information on the use of FT-NR by customers, any issues that have arisen from its implementation, possible strategies for dealing with these issues, and an assessment of the continued desirability of FT-NR.

Decision

The proposed FT-NR service is approved as filed.

TransCanada is directed to file a report with the Board on the use of FT-NR on or before 1 November 2006.

Chapter 9

Deferral Accounts

TransCanada proposed the continued use of its flow-through deferral accounts for 2004 as well as an incentive-based deferral account for the FGIP. TransCanada also proposed the continuation of certain incentive-based deferral accounts related to the Severance Program contained in the 2001-2002 S&P Settlement and the Foreign Exchange Management and Interest Rate Management Programs.

This chapter also addresses intervenor proposals for a deferral account for Repair and Overhaul (R&O) costs, the proposed continuation of the Regulatory Costs deferral account, as well as certain disputed expenses included for disposition of the 2003 Regulatory Costs deferral account balance.

The three criteria that the Board generally considers in establishing a deferral account were set out in its RH-4-93 Decision as follows: absence of control over the level of costs/revenues; the inability to reasonably forecast the level of costs/revenues; and the materiality of the potential cost/revenue deferral account balances.

9.1 Repair & Overhaul Costs

TransCanada estimated its 2004 Mainline R&O costs to be $23.9 million, which is $11.1 million less than the actual costs incurred in 2003.

Position of TransCanada

TransCanada noted that it did not apply for a deferral account for R&O costs because such costs do not meet the Board's three criteria for such an account. TransCanada acknowledged that it has only limited control over the timing of repairs and overhauls as they are driven mostly by the level of throughput on the system, which TransCanada does not control. However, TransCanada stated that the amount of R&O costs can be reasonably forecast. Although TransCanada accepted that variances between expenditures and forecasts may be material from year to year, it maintained that, when viewed over multiple years, the actual costs relative to budget are within one percent.

TransCanada also stated that being at risk for R&O costs provides it with the incentive to actively develop means to reduce costs over time, which is a benefit to both TransCanada and its shippers.

TransCanada pointed out that it is not regulated on a full cost of service basis. In TransCanada's view, shippers are paying for a compressor R&O program that takes place over a number of years where the pipeline company assumes the risk for expenditure variance.

TransCanada contended that repairs and overhauls were conducted on the basis of what was required by the safety, reliability and operation of the system, without regard to the economic consequences for shareholders. TransCanada explained that its evidence shows that the company's priority has been to manage the R&O program to minimize service disruptions and reduce overall costs on a long-term basis.

Position of Parties

CAPP noted that there are wide annual variances between budgeted amounts for R&O costs and actual amounts. In CAPP's view, TransCanada does not have the ability to accurately forecast R&O costs due to factors beyond TransCanada's control. For instance, flow level on the system, which is a significant factor, is not within TransCanada's control. Furthermore, a large proportion of scheduled R&O work does not proceed as planned. Given the materiality of the amounts involved, CAPP concluded that R&O costs plainly fit the criteria for a deferral account. CAPP questioned the validity of TransCanada's attempt to show that over a multi-year period the annual variances are not significant, as TransCanada is not regulated on a multi-year basis.

In CAPP's view, R&O costs relate to the integrity of the system, and the safety and reliability of the system should not be affected by cost risk borne by TransCanada. CAPP also stated that the value of having capacity available to the market is such that TransCanada should always have the budget available for R&O work and a deferral account would meet this goal.

In Coral/CA's view, R&O costs differ from normal OM&A expenditures and are influenced by factors that produce somewhat random results. Coral/CA submitted that it does not appear TransCanada is able to accurately forecast R&O costs, nor are such costs entirely within TransCanada's control. To the extent to which R&O activity is within TransCanada's control, in the sense that some activity can be moved into later years or brought forward from later years, Coral/CA suggested that this would appear to give TransCanada opportunities to benefit shareholders through "astute scheduling."

Coral/CA submitted that R&O costs, when viewed on an annual basis, meet the criteria for deferral account treatment. Coral/CA argued that the small cumulative variance experienced over the last five years or so is not relevant as costs should be matched against revenues on an annual basis for tolling purposes. Coral/CA also observed that the variances, as they occurred over each of the last five years, could have been coincidental. Finally, a deferral account would remove the risk of having to pay the R&O cost twice.

Ontario noted that TransCanada has some discretion in scheduling R&O work and recommended that a deferral account be established. Ontario also pointed to an example of an R&O project that was budgeted in 2003, but not performed, and would therefore have to be included in a future budget. Ontario submitted that having to pay twice for work done once demonstrates that the R&O program is flawed. Ontario also argued that safety and reliability cost risk should not be borne by TransCanada and that R&O costs are impacted by throughput, which is not controlled by TransCanada. Ontario was of the view that R&O costs meet the Board's three criteria for a deferral account.

Views of the Board

The Board continues to view the three criteria outlined in the RH-4-93 Decision to be appropriate in considering whether to approve a deferral account.

The Board accepts TransCanada's statements that it has only limited ability to control its R&O costs. Accordingly, the Board can find no evidence of "astute scheduling" on the part of TransCanada to suggest that the company has benefited inappropriately in years when its actual R&O costs have been less than budgeted.

However, this limited ability to control R&O costs is reflected in the variances between actual and budgeted costs. Although TransCanada has shown the ability in the past to reasonably forecast R&O costs over a multi-year period, on an annual basis, the variances between actual and budgeted R&O costs have been significant.

Given TransCanada's limited ability to control its R&O costs and the significant variances between actual and budgeted costs that can occur in any given year for these costs, the Board is of the view that a deferral account for R&O costs is appropriate.

Decision

The Board directs that TransCanada establish a deferral account for its Mainline's R&O costs effective 1 January 2004.

9.2 Regulatory Costs

In the RH-1-2002 Decision, the Board approved the establishment of a deferral account for regulatory proceeding costs for the 2003 Test Year. TransCanada proposed the continuation of this deferral account for 2004, to which no parties objected. This section deals with the concerns expressed by several parties over whether certain costs related to TransCanada's Review Application of the RH-4-2001 Decision and subsequent appeal of the RH-R-1-2002 Decision should be approved for recovery in Mainline tolls for 2004.

Position of TransCanada

In TransCanada's view, legal costs are a legitimate cost of doing business that should be recoverable whether a particular legal action is won or lost. If the costs are reasonable and prudently incurred, they should be recoverable through tolls.

In this case, TransCanada submitted that any question of prudence is resolved by the Federal Court of Appeal (FCA) decision that confirmed the legal principles that were the genesis and basis for the TransCanada appeal. In TransCanada's view, proper application of the fair return standard means that the Mainline cost of capital must be determined by the Board without regard to the impact on customers and consumers.

The appeal was dismissed because, in TransCanada's view, the FCA found that TransCanada had not demonstrated that the Board had actually taken consumer interests into account in making its decision. It does not follow from the FCA's conclusion that the expenses of the appeal should be disallowed as unreasonable or imprudent.

According to TransCanada, neither the review application nor the appeal were found to be "without merit." Further, the appeal to the FCA was subject to the granting of leave to appeal by the FCA. The preliminary question that was considered by the FCA is whether there is "an arguable question of law." The FCA granted leave over the opposition of CAPP and other intervenors.

TransCanada stated that it would be inappropriate and unreasonable to deny recovery of regulatory and legal costs where the legal action pursued an arguable question of law that resulted in confirmation of the legal principles that were the basis and genesis of the appeal.

TransCanada submitted that the Alberta Energy and Utilities Board (EUB) procedures as outlined in EUB Guide 31B provide no guidance on what should be done on this issue. The EUB has a very different cost regime than the NEB and the EUB's power to award costs is statutorily mandated.

Position of Parties

In CAPP's view, all costs relating to TransCanada's Review Application that led to the Board's RH-R-1-2002 Decision, the subsequent leave to appeal, the appeal that was dismissed with costs and the costs paid to the respondents to the appeal should not be recovered from tollpayers.

CAPP pointed out that the EUB would not allow the recovery of costs for reviews that fail to get over the first step in the review process or of subsequent unsuccessful appeals. CAPP noted that the Review Application failed to get over the Board's first step. The appeal of the Review Decision was dismissed with costs and the FCA did not even have to consider the standard of review.

In particular, CAPP submitted that tollpayers should not have to pay for TransCanada's decisions to pursue review applications, or appeals, that are found to be without merit as they do not constitute necessary, reasonable or prudent expenditures. Certainly the costs that the FCA required TransCanada to pay the respondents should not now be recovered in tolls. In CAPP's view, it is not acceptable for shippers to have to pay for TransCanada's refusal to accept a Board decision that is reasoned and considered.

Ontario argued that TransCanada should not recover in 2004 tolls the award of $162,500 in costs made against it by the FCA. Ontario noted that including the costs award in the 2004 costs of service would effectively immunize TransCanada from the financial consequences of the costs award. Ontario submitted that there is no principled basis why TransCanada, unlike other litigants, should be immunized from the effects of a cost award made against it by a court on a case that it brought.

Quebec submitted that it will rely on the Board to determine what regulatory costs should be recovered, but believes that a guideline similar to that adopted by the EUB should be considered.

Views of the Board

In the RH-1-2002 Decision, the Board approved the establishment of a deferral account for regulatory proceeding costs for the 2003 Test Year. The Board is now asked to determine whether the review and appeal costs incurred by TransCanada should be approved for recovery in Mainline tolls for 2004.

The Board recognizes that regulatory and legal expenditures are an integral and legitimate cost of doing business. Further, the Board is also of the view that when operating under a regulated environment, it should be possible for a company to recover those costs, as long as it can be demonstrated that they were incurred reasonably and prudently. Absent any applicable guidelines regarding the treatment of costs with respect to reviews or appeals, the Board is of the opinion that those two principles, reasonableness and prudence, should be used when determining if a company is entitled to recover regulatory and legal costs.

After reviewing all of the evidence, the Board is satisfied that the review and appeal costs were incurred in a reasonable and prudent manner. Therefore, TransCanada should be allowed to recover those costs, with the exception of the $162,500 that TransCanada paid to the respondents as part of the costs awarded by the FCA.

The Board recognizes that those costs were not intended to be punitive in nature but were awarded to compensate some of the costs incurred by the parties. TransCanada paid $32,500 to each of the five respondents. Allowing TransCanada to recover this amount from the respondents and other shippers through its tolls may in part frustrate the cost award determination made by the FCA. Therefore, the Board determines that TransCanada should be allowed to recover through its tolls, the regulatory costs claimed in this application with the exception of the $162,500.

Decisions

The Board approves TransCanada's applied-for regulatory costs, with the exception of the $162,500 that TransCanada paid to the respondents as part of the costs awarded by the FCA.

The Board also approves the continuation of all existing deferral accounts proposed by TransCanada.

Chapter 10

Compressor Operating Agreement

In 1990, TransCanada entered into a waste heat agreement with Potter Station Power Co. Ltd. (Potter) to allow Potter the exclusive right to use waste heat (also referred to as exhaust gas) produced by Mainline compressor unit 102 A1 in its cogeneration facility (Potter Agreement). Currently, TransCanada has similar waste heat agreements with its affiliate, TransCanada Power, L.P. (TCP LP), to allow TCP LP to use waste heat from five Mainline compressor stations at TCP LP cogeneration facilities.

The waste heat agreements provide that the waste heat must be available more than 80 percent of the contract year for full payment to be received by TransCanada. Due to lower forecast Mainline flows, it appeared that this might not always be the case. Accordingly, TransCanada signed a Compressor Operating Agreement (COA) with TCP LP (which had also taken over the Potter Agreement), effective 6 October 2003. In the COA, TransCanada agreed to make reasonable efforts to maximize operation of the compressors supplying the waste heat. In return, TCP LP agreed to pay incremental costs, including incremental fixed costs, if any could be identified.

The COA and waste heat agreements came under stakeholder scrutiny due to changes TransCanada proposed to the fuel volume saving calculation in the 2004 FGIP. Concerns centered on whether TransCanada had received fair market value for the waste heat and whether it had obtained the necessary regulatory approvals.

Position of TransCanada

TransCanada defined fair market value as the amount another party is willing to pay and, although disputing its obligation to obtain fair market value if above incremental cost, stated that the waste heat agreements and COA reflected fair market value. TransCanada noted that the Potter Agreement valued the use of exhaust gas at approximately $50,000 (indexed to the Consumer Price Index) and also provided for an additional annual payment related to fuel gas to compensate for the effects of connecting the Potter facility to the Mainline compressor. TransCanada submitted that, at the time, Potter was the only party interested in negotiating for waste heat, a substance which is valueless to the system.

In addition, TransCanada stated that shippers benefit as a result of the Waste Heat Agreements, as the revenue generated has been credited to the Mainline's Revenue Requirement for the last 12 years. Further, by providing for the recovery of incremental costs associated with the operation of the compressors, when they otherwise might not be in operation, the 2003 COA provides an incentive for TransCanada to operate the compressors and potentially increases revenue to the Mainline. Finally, TransCanada contended that it adhered to the existing 1997 Mainline Standards of Conduct for Relations Between Affiliates (Code of Conduct), which requires that it treat an affiliate like any other party.

With respect to arguments of IGUA and others, that TransCanada ought to have applied for regulatory approvals, TransCanada stated that, based on the Board's RH-4-81 Decision to exclude ducting to an experimental greenhouse from Rate Base, it did not require regulatory approval for the connection of the power generation facilities to the compressor stations, or for the exhaust gas agreements. Further, TransCanada maintained that the waste heat agreements were neither a sale nor a service.

Positions of Parties

CAPP submitted that the waste heat agreements and the COA involved an exchange of economic value between TransCanada and its affiliate, TCP LP, and that both should be based on fair market value. In addition, CAPP, supported by IGUA, Coral/CA and Ontario, stated that the agreements are examples of affiliate transactions and highlight the need to revise the Code of Conduct. CAPP suggested the Board direct TransCanada to bring this to the TTF, with a view to including a revised Code of Conduct in its 2005 Mainline Tolls Application.

IGUA submitted that TransCanada's conduct with respect to the compressor stations connected to the waste heat generators was not in accordance with the NEB Act. IGUA contended that the modifications made to the compressor stations should be considered "pipeline" as defined in Section 2 of the NEB Act, and that under Section 45, Board approval is required for deviations to regulated pipelines.

IGUA differentiated the exhaust ducting to a greenhouse discussed in the RH-4-81 Decision from the additions to the cogeneration compressor stations, by stating that the latter have a detrimental impact on the operation of the Mainline. As a result, TransCanada should have sought Board approval for modifications to the five compressor stations and allowed stakeholders to address concerns regarding the effect of changes, and appropriate cost recovery from TCP LP.

IGUA requested that the Board issue a directive requiring that TransCanada adhere to the NEB Act, file a Plan, Profile and Book of Reference for each of the five compressor stations, properly identify all incremental costs arising from the waste heat agreements, and ensure the Mainline is fully compensated by TCP LP for these costs.

With respect to compensation, IGUA expressed concern that TransCanada stated it had no duty to obtain fair market value for waste heat if that value is greater than incremental costs. IGUA suggested that waste heat has a value greater than incremental costs, and that TransCanada had calculated this value on the basis of discounted avoided costs. IGUA recommended that the Board rely on evidence provided by Coral/CA with respect to the costs TCP LP avoided through the waste heat agreements, factor in transportation costs, and adjust TransCanada's Revenue Requirement to reflect this estimate.

Coral/CA stated that shippers have a right to expect TransCanada to receive fair market value for its waste heat, and that a reasonable person would attempt to recover more than incremental costs. Coral/CA submitted that its avoided cost approach attempts to value the buyer's best alternative. In addition, Coral/CA asserted that the waste heat agreements should have been indexed to the price of natural gas, (as was effectively done with the fuel gas compensation component of the Potter Agreement) and that a prudent person would have renegotiated the waste heat agreements in 2003, and brought them in line with current conditions.

Based on its calculations, Coral/CA suggested that the Board establish a deferral account and credit TransCanada's Revenue Requirement with $21.2 million, its best estimate of TCP LP's avoided costs resulting from the original waste heat agreements and a further $5.3 million arising from the avoided costs resulting from the COA. In addition, Coral/CA requested the Board treat the valuation of waste heat as a technical issue requiring further study.

Ontario noted that the COA benefits TCP LP as it allows TCP LP to request that TransCanada operate the compressors when it might not otherwise do so. Ontario further noted that under the COA, the depreciation and capital costs of the five compressors have not been captured.

Quebec noted that given the circumstances at the time, the Potter Agreement seems reasonable. However, Quebec submitted that the context for this type of agreement has changed as Mainline throughput and gas and electricity prices have changed. Quebec stated that it is unacceptable for TransCanada to recover only incremental costs through the COA, and that TransCanada did not consult the Board or shippers before signing the COA. Quebec recognized the difficulty of establishing a reasonable value to assign to the waste heat, and therefore suggests the creation of a task force to study the issue.

Views of the Board

TransCanada has entered into physical and financial arrangements for access to the exhaust stream and associated heat from certain of its Mainline compressors in Northern Ontario. The use of such waste heat in value-added initiatives is appropriate and encouraged by the Board.

In respect of the physical arrangements for the provision of access to waste heat, IGUA raised concern regarding the absence of prior application by TransCanada for approval of facilities connected to or resulting in impacts on the efficiency of Mainline compressors. The Board is mindful, however, that this is a proceeding for the determination of tolls to be charged pursuant to Part IV of the NEB Act. In the context of the matters for determination in this proceeding, the Board does not consider it necessary or appropriate to consider matters related to Part III of the NEB Act.

Financial arrangements related to the provision of access to waste heat date back to 1990, when the first waste heat agreement was negotiated by TransCanada with Potter. While the Board heard divergent views of parties regarding the timing and adequacy of prior disclosure by TransCanada of the terms and conditions of the various waste heat agreements, revenues from the provision of access to waste heat have been included in the calculation of TransCanada's Revenue Requirement since 1992. The issue of the use of waste heat by Potter was also noted in the Board's GH-2-93 Decision.

The Board is of the view that TransCanada should seek the higher of incremental costs or fair market value in all non-tariff transactions from parties wishing to contract with it. Further, fair market value is whatever a competitive market is willing to pay. The Board sees no evidence that there were other parties interested in waste heat from Mainline compressors at the time the Potter Agreement was signed. The Board also finds no persuasive evidence that at least incremental costs incurred by TransCanada are not being recovered through the original waste heat agreements, or that at the time they were signed, the waste heat agreements were unreasonable.

Similarly, the Board finds that there is no persuasive evidence to suggest that the 6 October 2003 COA was imprudent and notes that TransCanada has committed to recover and credit to the Mainline Revenue Requirement all incremental costs related to the COA that can be identified and quantified.

Nonetheless, the Board recognizes that affiliate transactions give rise to prudence and conflict concerns. Accordingly, the Board expects TransCanada to consider this type of agreement in the process to update its Code of Conduct for transactions with its affiliates, as discussed in Chapter 11.

Chapter 11

Code of Conduct

Throughout the course of the hearing, certain intervenors expressed concern regarding the potential for conflicts of interest to arise between actions that would be in the best interest of shippers and actions that would be in the best interest of shareholders (See section 4.2.1 Long-Term Incentive Compensation and Chapter 10 Compressor Operating Agreement). As a result of these concerns, several intervenors suggested that the Board should direct TransCanada to revise the Mainline's Code of Conduct. In particular, Ontario suggested that TransCanada should be directed to conduct a review of its Code of Conduct; consult with the TTF on any proposed modifications; and file a revised Code of Conduct as part of its 2005 Tolls Application.

During the hearing, TransCanada indicated that it was prepared to undertake a review of its Code of Conduct with stakeholders.

Views of the Board

The Board notes that TransCanada has a number of affiliates with which it does business or shares corporate services. While the Board is of the view that these relationships can be beneficial for TransCanada's customers (e.g. overall cost savings due to efficiencies), or impose no harm, the potential for conflicts is real. As a result, clarity with respect to how TransCanada should operate to ensure fairness for both shippers and shareholders is required.

Accordingly, the Board is of the view that TransCanada should work with the TTF to develop a revised Code of Conduct and file it with the Board no later than 28 February 2005. Without restricting the subject areas that the Code may address, the Board expects that, at a minimum, the Code would address affiliate transactions and cost allocation policy. Should TransCanada and the Tolls Task Force be unable to come to a resolution on an appropriate Code of Conduct, TransCanada should file with the Board its revised Code of Conduct, along with supporting rationale by the same date.

Decision

The Board directs TransCanada to file, no later than 28 February 2005, a revised Code of Conduct for approval by the Board.

Chapter 12

Disposition

The foregoing chapters together with Order AO-2-TGI-07-2003 constitute our Reasons for Decision in respect of those aspects of the 2004 Tolls Application heard by the Board in Phase I of the RH-2-2004 proceeding.

J-P. Théorêt
Presiding Member

D.W. Emes
Member

G. Caron
Member

Calgary, Alberta
September 2004

Appendix I

Order AO-2-TGI-07-2003

ORDER AO-2-TGI-07-2003

IN THE MATTER OF the *National Energy Board Act* (Act) and the Regulations made thereunder; and

IN THE MATTER OF an application filed by TransCanada PipeLines Limited (TransCanada) pursuant to Part IV of the Act for orders fixing and approving tolls that TransCanada shall charge for transportation services provided on its Mainline Natural Gas Transmission System (Mainline) between 1 January 2004 and 31 December 2004; and

IN THE MATTER OF Hearing Order RH-2-2004.

BEFORE the Board on 25 August 2004.

WHEREAS TransCanada filed an application dated 12 November 2003 for interim tolls for the Mainline effective 1 January 2004;

AND WHEREAS on 18 December 2003, the Board approved TransCanada's 12 November 2003 application, as amended on 3 December 2003, and issued Order TGI-07-2003;

AND WHEREAS TransCanada filed an application dated 26 January 2004 for an order fixing just and reasonable tolls that it may charge for or in respect of transportation services provided on its Mainline between 1 January 2004 and 31 December 2004 (2004 Tolls Application);

AND WHEREAS on 23 March 2004, the Board issued Hearing Order RH-2-2004 Directions on Procedure establishing a two-phase procedure to consider TransCanada's 2004 Tolls Application;

AND WHEREAS an oral public hearing was held in Ottawa, Ontario between 14 June 2004 and 25 June 2004 during which time the Board heard the evidence and argument presented by TransCanada and all interested parties with respect to RH-2-2004 Phase I matters;

AND WHEREAS on 23 July 2004, the Board issued Amending Order AO-1-TGI-07-2003 approving revised interim tolls effective 1 August 2004;

AND WHEREAS the Board's Decisions arising out of the RH-2-2004 Phase I proceeding are set out in its Reasons for Decision dated September 2004, and in this Order;

THEREFORE, IT IS ORDERED, pursuant to Part IV of the Act, that:

1. TransCanada shall, for accounting, tollmaking and tariff purposes, implement the decisions outlined in the RH-2-2004 Phase I Decision dated September 2004 and in this Order; and

2. The Mainline's tolls shall remain interim at the level established by Order AO-1-TGI-07-2003 pending disposition of the RH-2-2004 Phase II proceeding.

NATIONAL ENERGY BOARD

Michel L. Mantha
Secretary