National Energy Board

Reasons For Decision

Foothills Pipe Lines Ltd.

RH-1-95

October 1995

Tolls

National Energy Board

Reasons for Decision

In the Matter of

Foothills Pipe Lines Ltd.

Application dated 30 September 1994, on the feasibility and financial impact of drawing down, all or a portion of, its deferred income tax balance, and an examination of the cost efficiencies of Foothills' operating arrangements for Zones 6, 7, 8 and 9.

RH-1-95

October 1995

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Abbreviations

APMC	Alberta Petroleum Marketing Commission
Applicant/Company/ Foothills	Foothills Pipe Lines Ltd.
Board/NEB	National Energy Board
CAPP	Canadian Association of Petroleum Producers
CCA	Capital Cost Allowance
ITA	Income Tax Act
NEB Act	The *National Energy Board* Act
Nova	NOVA Corporation of Alberta
NPV	Net Present Value
O & M	operating and maintenance
Pan-Alberta/PAG	Pan-Alberta Gas Ltd.
TCPL	TransCanada PipeLines Limited

Definitions

We provide here definitions for some terms used in these Reasons and which appear infrequently in the Board's Reports. Terms which are in common use in the area of NEB toll regulation are not defined.

Eastern Leg	The portion of the Foothills pipeline from Caroline, Alberta to Monchy, Saskatchewan consisting of Zone 6 in Alberta and Zone 9 in Saskatchewan.
Flow-through Income Taxes	The practice, for regulatory purposes, of accounting for income taxes on the basis of income calculated for income tax purposes rather than on the basis of income as calculated in accordance with generally accepted accounting practices.
Normalized Income Taxes	A provision for income taxes based on generally accepted accounting practices. To the extent that income for accounting purposes differs from income for the purpose of calculating income taxes, a deferred or prepaid income tax balance may be recorded.
Phase I/Prebuild	The portions of the Alaska Natural Gas Transportation System ("ANGTS") which have been prebuilt to transmit natural gas of Canadian origin before the pipeline is placed in service for the transmission of natural gas of Alaskan origin, being all or part of facilities in Zones 6 to 9.
Western Leg	The portion of the Foothills pipeline from Caroline, Alberta to Kingsgate, B.C., consisting of Zone 7 in Alberta and Zone 8 in B.C.

Recital and Appearances

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

IN THE MATTER OF an application by Foothills Pipe Lines Ltd. dated 30 September 1994, on the feasibility and financial impact of drawing down all or a portion of its deferred income tax balance, and an examination of the cost efficiencies of Foothills' operating arrangements for Zones 6, 7, 8 and 9; and

IN THE MATTER OF National Energy Board Hearing Order RH-1-95;

HEARD at Calgary, Alberta on 11 and 12 September 1995.

BEFORE:

R. L. Andrew	Presiding Member
K. W. Vollman	Member
R. Illing	Member

APPEARANCES:

J. Lutes B. Pierce	Foothills Pipe Lines Ltd.
N. J. Schultz	Canadian Association of Petroleum Producers
D. G. Davies	Alberta Natural Gas Company Ltd.
T. M. Hughes L. K. Meyer	Pan-Alberta Gas Ltd.
P. R. Jeffrey	TransCanada PipeLines Limited
J. T. Horte	Wascana Energy Inc.
A. Reid	Alberta Department of Energy

Overview

(NOTE: This summary is provided for the convenience of the reader and does not constitute part of this Decision or the Reasons, to which the readers are referred for detailed text and tables.)

An oral hearing was held in Calgary on 11 and 12 September 1995 to consider the issue of drawing down Foothills' balance of deferred income taxes. The issue arose out of a Board decision in 1992 authorizing Foothills to switch its methodology used in providing for income taxes in tolls from the normalized method to the flow-through method. At that time, Foothills' balance of deferred income taxes was $135.8 million. At the direction of the Board in its RH-1-93 Decision, Foothills prepared a study on this issue, dated 30 September 1994, which was deemed to be the application in this hearing. The Board decided to authorize a drawdown over ten years on a straight line basis commencing 1 January 1996. Including the impact on Foothills flow-through income taxes, the amortization of deferred taxes should reduce Foothills' total cost of service by approximately $24 million per year for each of the ten years of the drawdown. While this cost reduction represents almost 14% of Foothills' combined annual cost of service, the cost savings in tolls will be largely offset by a previously decided increase in Foothills' depreciation rate from 2% to 3% scheduled to commence 1 January 1996.

During this hearing the Board also examined the cost efficiency of Foothills' operating arrangements for Zones 6 to 9. It was the view of the Board that these arrangements continue to be cost efficient.

Chapter 1

Drawdown of Deferred Income Tax Balance

The primary focus of this hearing was the consideration of issues relating to the drawing down of Foothills' balance of deferred income taxes. The issue was worded as follows:

> In view of the Board's 1992 decision to approve the use of the flow-through method of providing for income taxes in calculating Foothills' tolls, is it now appropriate to draw down Foothills' balance of deferred income taxes, and if so to what extent and over what period?

1.1 Background

Since the start of operation of the Foothills' pipeline, income taxes have been provided for in the cost of service using the normalized methodology. In 1992, however, the Board approved a change to the flow-through methodology effective from 1 January 1992. At that time Foothills' balance of deferred income taxes was frozen at $135,792,000.

The Canadian Association of Petroleum Producers (CAPP) and the Alberta Petroleum Marketing Commission (APMC) raised the issue of drawing down Foothills' balance of deferred income taxes as an issue in the Board's 1993 Foothills tolls hearing held pursuant to RH-1-93. In that proceeding the Board decided that it required more information before making a decision in this matter, and directed the Company to conduct a study and to provide the Board and interested parties with the results by 30 September 1994.

Accordingly, on 30 September 1994, the Company filed with the Board a study titled "Report to the National Energy Board and Interested Parties on the Feasibility and Financial Impact of Drawing Down, all or a Portion of, Foothills' deferred income tax balance". At the time the study was filed the Board had initiated its RH-2-94 proceeding to consider the capital structure and rate of return on common equity for eight Group 1 pipelines regulated by the Board, including Foothills. As the Board was of the view that the issues of rate of return and capital structure could impact any decision on the drawdown of deferred taxes, consideration of the Foothills' study was deferred until after release of the Board's decisions in RH-2-94.

1.2 Flow-through Methodology

Under the normalized methodology, income tax recovered in tolls is provided for in the cost of service on the basis of accounting income. Under the Flow-through method, only the amount of income taxes payable are provided for in tolls. To the extent that a company's taxable income is less than its accounting income, the actual taxes paid may be less than the allowance provided for in tolls under the normalized tax accounting methodology. While Foothills was operating under the normalized method the difference between the income tax provided for in tolls and the actual taxes paid was accounted for as deferred income taxes payable.

Deferred income taxes occur primarily as a result of timing differences in the claiming of business expenses. The most significant timing difference results from the variance between the allowed rates of Capital Cost Allowance (CCA) under the Income Tax Act and a company's depreciation rates. The treatment of construction financing costs, which are considered to be current expenses for tax purposes but are capitalized for regulatory purposes, results in another common timing difference. Such timing differences have the effect of creating deferred tax balances when new pipelines are constructed or new assets are acquired.

The practice of providing for income taxes on a normalized basis enables companies to recognize the income tax liabilities associated with current operations, notwithstanding the fact that the actual taxes may not be payable until later. The point at which deferred taxes commence to be drawn down to pay the difference between the normalized tax provision in the cost of service and the actual taxes payable, is normally referred to as the crossover point.

1.3 Balance of Deferred Income Taxes

At the end of 1991, after having been in operation for approximately ten years, Foothills' balance of deferred income taxes had grown to $135,792,000. The balance was allocated among the four operating zones as follows:

Table 1-1
Foothills Pipe Lines
Accumulated Deferred Tax Balance
($000)

	Zone 6	Zone 7	Zone 8	Zone 9	Total
1981		1,166	1,110		2,276
1982	4,391	4,037	4,025	3,982	16,435
1983	12,311	1,836	2,403	13,007	29,557
1984	12,383	1,656	1,885	14,903	30,827
1985	9,886	768	764	15,748	27,166
1986	588	(140)	(71)	11,909	12,286
1987	420	(251)	(179)	807	797
1988	(489)	(351)	(262)	(144)	(1,246)
1989	5	(158)	(114)	133	(134)
1990	3,592	292	307	6,687	10,878
1991	3,307	242	321	3,080	6,950
Total	46,394	9,097	10,189	70,112	135,792

As Table 1-1 illustrates, the balances grew quickly from 1981 through 1985 and commenced to be drawn down for the Western Leg, Zones 7 and 8, in 1986 and for the Eastern Leg, Zones 6 and 9, in 1988. The trend was reversed in 1990 due to a decrease in Foothills' depreciation rates. Pursuant to Order AO-11-TG-4-82 the Board reduced Foothills' annual depreciation rate from 4% to 2% commencing in September 1989 until 1 January 1996 at which time the rate will become 3%. The temporary reduction to 2% was approved in order to adjust the accumulated depreciation balance to reflect a 3% rate since the start of Foothills' operations.

1.4 Drawdown Proposals

In its evidence Foothills provided data on the toll impacts of the following six drawdown scenarios:

1. Reverse Sum of the Years Digits, 23 Years (Foothills' proposal).
2. Lower of Flow-through or Normalized.
3. 3-year straight line (referred to as the TCPL method).
4. 10-year straight line (PAG Proposal).
5. Reduce Taxable Income to Zero (referred to as the Westcoast method) (CAPP proposal).
6. Flow-through taxes (provided for comparison).

1.4.1 Foothills' Proposal

Foothills stated that the primary principles that it had regard for in formulating its proposal were toll stability and the maintenance of financial integrity.

Based on its study Foothills concluded that a drawdown, commencing in 1996, based on a 23-year reverse sum of the years digits methodology would best meet these criteria. Under this proposal the amount amortized in each year would equal the number of years left in the 23-year amortization period divided by the sum of the numbers 1 to 23 (ie: 276). Under the Foothills proposal, the amortization would go from a high of 23/276 (8.3%) in the first year to a low of 1/276 (0.4%) in the final year. Foothills pointed out that under this proposal over half of the $135.8 million balance of deferred taxes would be refunded in the first seven years.

1.4.2 CAPP Proposal

CAPP proposed that the balance of deferred taxes should be drawn down, commencing in 1995, to eliminate taxable income each year until the balance is fully utilized. CAPP noted that this is the method approved by the Board for Westcoast. In CAPP's view, this method would result in the lowest transportation cost over time. Using a 12% discount rate, it calculated the net present value of the cost of service savings that would be generated by the CAPP proposal over the period 1995 to 2018 to be $68.6 million as compared to $43 million for the Foothills proposal over the same period.

1.4.3 Pan-Alberta Proposal

Pan Alberta proposed a ten-year straight line amortization commencing as soon as possible. Pan Alberta noted that this proposal approximates the period of time over which the deferred taxes were collected and provides a reasonable toll for the future which would be useful to them in negotiating contract renewals.

1.4.4 TransCanada and Westcoast Methods

In the past, the Board has approved the drawing down of deferred tax balances for TransCanada and Westcoast. In both cases the provision for income taxes had been calculated on a normalized basis for only four years, from 1979 to 1982, and each company had accumulated a balance of under $75 million. In those cases, the determinative factor in permitting a drawdown was the fact that crossover had occurred. The method approved for the Westcoast drawdown was the reduction of taxable income to zero until the balance was extinguished. This is the methodology now being proposed by CAPP for Foothills. In the TransCanada case, the Company was directed to amortize its balance in equal amounts over three years. Foothills point out in their evidence that in those two cases the balances had been accumulated over a much shorter time, and represented only 2% of TransCanada's rate base and only 6% of Westcoast's compared to nearly 20% for Foothills.

1.5 Issues

The discussion of these proposals centred around the issues of inter-generational equity, net present value of proposals, toll stability and Foothills' ability to finance the drawdown while maintaining financial integrity.

1.5.1 Inter-generational Equity

CAPP argued that a quick drawdown would be equitable as it would increase the likelihood that those tollpayers who paid the deferred taxes would benefit from the drawdown.

Pan Alberta's witness, Mr. Olson, gave evidence to the effect that there has been a variety of regulatory, contractual and market changes over the past ten years, and that to assign or match the benefits resulting from a drawdown to those who paid the deferred tax would be extremely complex, if not impossible. He indicated that the benefit of decreased tolls might not all go to producers, anticipating that the market might take some of the benefits at the consumer end. He also noted that, under the terms of Pan-Alberta's contracts, some of the benefits of the lower tolls would flow to local distributors in the Midwest. On the other hand, Mr. Olson indicated that he expects subsequent increases in tolls would be fully borne by producers.

Noting the effect of roll-ins in Zones 6, 7 and 8. Foothills argued that it is difficult, if not impossible, to trace who contributed the deferred tax balance and who should get the benefits. Foothills suggested that its proposal, which included an accelerated payback schedule, would achieve the desired level of inter-generational equity. In response to an information request from CAPP, Foothills noted that the traditional declining rate base toll model generally leads to a front end loading of tolls and does not totally satisfy the requirements for inter-generational equity. Foothills expressed the view that the extent of inter-temporal bias depends on a variety of factors, including depreciation rates and rate base additions. Foothills argued that, to the extent tolls can be levelized over an extended period of time, inter-temporal bias can be mitigated.

1.5.2 Net Present Value

It was CAPP's evidence that a faster drawdown would have a higher NPV and that its proposal would result in the lowest transportation cost over time. Using a 12% discount rate CAPP calculated that its approach would save $25 million compared to the Foothills proposal. It was Foothills’ evidence that if its rate of return on rate base was used as the discount factor, then all of the drawdown proposals would have the same net present value on a before tax basis. While acknowledging that including the impact of income taxes in the calculation would result in the faster drawdown proposals having a higher NPV, it maintained that such a conclusion would only be correct under the assumption that shippers pay no income taxes to governments. CAPP noted that Foothills had provided no analysis with respect to the tax position of shippers and argued that what the shippers do with the money is their business.

1.5.3 Toll Stability

Foothills indicated that maintaining toll stability is necessary to place it in a position where it can achieve the renewal of the approximately 85% of Foothills’ transportation contracts which must be renewed by 2004. The Company referred to the evidence of its witness, Dr. Carpenter, to the effect that stable tolls through time better match long run marginal cost and send better market signals. Dr. Carpenter testified that capacity in the United States secondary market is sensitive to a toll increase of 1 or 2 cents and Mr. Olson, witness for Pan Alberta, indicated that a toll increase of 3.5 cents could influence a decision to renew capacity.

CAPP made the point that the impact of a sharp toll increase after the drawdown would be mitigated because Foothills’ tolls are effectively rolled in with NOVA’s in Zones 6 and 7 and with ANG’s tolls in Zone 8. With respect to Zone 9 tolls, CAPP point out that Foothills is a small part of a long chain to market and suggested that the impact should not be assessed in isolation. While acknowledging the mitigating influence of the roll-ins on Zones 6, 7 and 8, Foothills pointed to the fact that significant capacity on Zone 6 could revert to Pan Alberta on one year’s notice and that Nova can cancel the balance of its Zone 6 capacity on four years’ notice. The Company also noted that over one-half of the total deferred tax balance is attributable to Zone 9.

1.5.4 Financial Integrity

A primary concern for Foothills was the maintenance of financial integrity. Foothills argued that the key indicator of its financial integrity would be its ability to attract and maintain a Single-A bond rating. The Company referred to the evidence of its financial witness, Mrs. McLeod, to the effect that Foothills’ drawdown proposal should enable the company to achieve an "A" rating without any increase in the equity component of its capital structure. Foothills referred to the fact that during the period of the drawdown it will need to negotiate an extension to its depreciation basket clause, an extension of the special charge in the year 2000 and the renewal of existing transportation contracts.

A key factor in the determination of a company’s credit is the interest coverage ratios achieved. CAPP recognized that its drawdown proposal would depress Foothills’ interest coverage ratios in the short term. However, CAPP argued that the financial community takes a long view and has the capacity to identify and understand temporary adjustments. CAPP noted that under their proposal, interest coverage ratios are higher than those forecast to be achieved under the Foothills proposal by the sixth year.

Views of the Board

The drawdown of Foothills' balance of deferred income taxes is a necessary part of a transition from the normalized to the flow-through method of providing for income taxes in the cost of service. In so far as possible, the Board believes that such transitions should be made quickly, and with a minimum of disruption to the ongoing business of the pipeline. In this respect the Board finds the timing of the Foothills proposal over 23 years to be an unnecessarily long transition period.

It is notable that crossover occurred on the western leg in the sixth year of operation and on the eastern leg in the eighth year. A subsequent reduction in Foothills' depreciation rate and capital additions reversed the crossover and pushed it into the future. The Board believes that deferred taxes should not be drawn down until the point of crossover has been reached. As that date is now forecast to occur in 1996, the Board accepts that a drawdown should commence at that time.

In this case the Board recognizes that the balance of deferred income taxes represents a large component of the current financing of Foothills' rate base. To finance the drawdown Foothills will need to raise $135.8 million, which equals a 19% increase in its capital structure. A rapid drawdown as proposed by CAPP could affect Foothills' ability to access financial markets on the most reasonable terms.

The primary arguments presented in support of a fast drawdown were minimization of inter-generational inequity and a higher NPV of the refund in the hands of shippers. The evidence on the issue of inter-generational equity led the Board to conclude that it was unlikely that the period over which the drawdown is made would have any significant impact on the likelihood that those who contributed to the deferred tax pool would share in the drawdown.

As to the question of whether or not a rapid drawdown would result in the benefit having a higher NPV in the hands of shippers, the Board accepts the proposition advanced by CAPP that, all things being equal, a faster drawdown would have a higher NPV. However, the Board was not persuaded by the evidence that was presented as to what the appropriate discount rate should be. The Board is satisfied that a fair return is provided to tollpayers by crediting the unamortized balance to rate base.

The CAPP proposal would result in a wide swing in tolls over a short period. While it is true that the effective roll-in of Zones 6 and 7 tolls with Nova's tolls and Zone 8 tolls with ANG's tolls, masks the effects of these toll swings, the impact would be felt in Zone 9. The Foothills proposal produces the most stable toll projections, however, the Board was not persuaded of the value of a forecast beyond ten years.

On balance, the Board finds that the Pan Alberta proposal for a straight line amortization over ten years provides for a smooth transition, while minimizing toll variations.

Decision

Foothills shall amortize to its cost of service for each operating zone commencing 1 January 1996, one-tenth of the balance of deferred income taxes for that zone as of 31 December 1995. To the extent that drawing down the full amount of the amortization authorized in any one year would reduce taxable income to zero, the excess amortization shall be carried forward and used to reduce taxable income in the first subsequent year in which such unused balance can be utilized.

Chapter 2

Cost Efficiency of Foothills' Operating Arrangements

At the time of filing its intervention in this proceeding, CAPP suggested the list of issues be amended to include an examination of the cost efficiencies of Foothills' operating arrangements for Zones 6, 7, 8 and 9. In requesting inclusion of this issue CAPP made reference to statements made by ANG in the recent CanWest proceeding to the effect that ANG and Foothills were continuing to explore the potential for cost rationalization in the southern B.C. corridor.

It was Foothills' evidence during the proceeding that it had been able to negotiate a reduction in its forecast 1995 ANG operating agreement charges from $1.63 million to $1.03 million. Foothills also stated that, as a result of a recent review of its business processes and practices, it had reduced its budgeted staff count for 1996 to 69 from a previously budgeted 79 positions.

CAPP questioned Foothills on the apparent increasing trend in its operating costs from 1993 to 1995. Foothills' witness, Mr. Anderson, explained that part of the increase resulted from work on maintenance projects that were postponed during a period when new capital projects were undertaken in 1991 and 1992. It was his evidence that the company had minimized its Operating and Maintenance (O&M) program in those years in order to have its engineering staff work on capital projects. Additionally, Mr. Anderson attributed further cost increases in 1994 to an increase in the System Integrity Program, the need for compressor overhauls and a program of renewing and renegotiating land agreements. Similar expenses, together with significant cost increases in the System Integrity Program to include work related to hydrogen induced cracking, were offered as the cause of budgeted 1995 increases. Foothills argued that it has demonstrated a continuing record of achieving cost reductions for the operation of its system.

CAPP questioned the increase in Foothills' operating costs, in relation to the costs incurred by the operator companies, since 1992. In argument, CAPP suggested that rather than accepting a growing role for Foothills in the operations area, Foothills should be pressed to demonstrate why more duties should not be assigned to the operating companies under the operating agreements. CAPP further argued that Foothills should be required to provide periodic reports to the Board, quantifying the efficiency of its approach to operating arrangements.

Foothills explained that the increase in its costs, relative to charges from operator companies, was due to its policy of handling the compressor integrity program in-house, in order to maintain consistency between zones. Foothills maintained that there would be no additional savings if it did less in-house and assigned additional responsibilities to its operators.

Views of the Board

The Board believes that Foothills has provided satisfactory explanations for the increasing trend of its O&M costs from 1992 to 1995 and the increase in these costs relative to those of its operators. The Board is not persuaded that the reports requested by CAPP are required. Foothills' Quarterly Surveillance Reports provide information on actual and forecast operating expenses. As well, in accordance with Order TG-6-81, parties have the right to question, or make submissions in connection with, Foothills' O&M expense budgets and variance analysis filed with the Board.

Decision

The Board finds that Foothills' operating arrangements for Zones 6 to 9 continue to be cost efficient.

Chapter 3

Disposition

The foregoing chapters together with Order TG-1-95 constitute our Decisions and Reasons for Decision on this matter.

R.L. Andrew
Presiding Member

K.W. Vollman
Member

R. Illing
Member

Calgary, Alberta
October 1995

Appendix I

Order TG-1-95

TG-1-95

IN THE MATTER OF the *Northern Pipeline Act*, and the *National Energy Board Act* ("NEB Act") and the regulations made thereunder; and

IN THE MATTER OF the tariffs and the tolls to be charged by Foothills Pipe Lines Ltd. ("Foothills") and its subsidiaries, Foothills Pipe Lines (Alta.) Ltd., Foothills Pipe Lines (South B.C.) Ltd. and Foothills Pipe Lines (Sask.) Ltd. ("its subsidiaries") in the operation of the prebuilt facilities in Zones 6 to 9.

BEFORE THE BOARD on 12 September 1995.

WHEREAS the Board having by Order TG-4-82, as amended, and Order TG-6-81, as amended, prescribed the tolls Foothills and its subsidiaries may charge in respect of natural gas transmitted by them in each month through their prebuilt facilities in Zones 6 to 9;

AND WHEREAS the Board having by Order AO-11-TG-4-82, dated 26 November 1992, changed the methodology to be used by Foothills in calculating the provision for income taxes in its tolls from the normalized methodology to the flow-through methodology;

AND WHEREAS the Board in its decision in RH-1-93, dated November 1993, directed Foothills to conduct studies and enter into discussions with its shareholders and lenders on the feasibility and financial impact of drawing down all or a portion of, its deferred income tax balance and to provide the Board and interested parties with the results of this review by 30 September 1994;

AND WHEREAS Foothills filed with the Board a study titled "Report to the National Energy Board and Interested Parties on the Feasibility and Financial Impact of Drawing Down, All Or A Portion of, Foothills' Deferred Income Tax Balance";

AND WHEREAS the Board, following a public hearing held pursuant to Order RH-1-95, at which all interested parties were heard, having made certain determinations respecting the tolls and tariffs to be charged by Foothills;

AND WHEREAS the Board having considered the evidence and submissions, and having found that the tolls to be charged by Foothills in accordance with this order are just and reasonable;

IT IS ORDERED THAT:

1. Foothills shall amortize to its cost of service for each operating zone, commencing 1 January 1996, one-tenth of the balance of deferred income taxes for that zone as of 31 December 1995, except that to the extent that the drawing down of the full amount of the amortization authorized in any one year would reduce taxable income to zero, in which case the excess amortization shall be carried forward and used to reduce taxable income in the first subsequent year in which such unused balance can be utilized.

2. This Order comes into effect on 26 October 1995 and prevails, to the extent of any inconsistency, over the provisions of any previous order respecting the tariffs and tolls of Foothills and its subsidiaries.

NATIONAL ENERGY BOARD

J. S. Richardson
Secretary