

COMM-OPINION-ORDER, 22 FERC ¶61,175, **Alaskan Northwest Natural Gas Transportation Company, Docket No. CP80-435-000, Northwest Alaskan Pipeline Company et al., Docket No. CP78-123-000**, (Feb. 18, 1983)

Alaskan Northwest Natural Gas Transportation Company, Docket No. CP80-435-000, Northwest Alaskan Pipeline Company et al., Docket No. CP78-123-000

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**Alaskan Northwest Natural Gas Transportation Company, Docket No. CP80-435-000
Northwest Alaskan Pipeline Company et al., Docket No. CP78-123-000**

Order on Rehearing

(Issued February 18, 1983)

Before Commissioners: C. M. Butler III, Chairman; J. David Hughes, A. G. Sousa and Oliver G. Richard III.

On September 21, 1982 ([20 FERC ¶61,321](#)), the Commission issued in the above captioned dockets an order establishing Certification Cost Estimate (CCE) and Center Point values for the Incentive Rate of Return (IROR) for the Alaska pipeline segment of the Alaska Natural Gas Transportation System (ANGTS), and resolving certain other related matters. On October 21, 1982, Alaskan Northwest Natural Gas Transportation Company (Alaskan Northwest), the project sponsor of the Alaska pipeline segment, filed an application for rehearing of the order. On November 16, 1982, the Commission issued an order granting rehearing for purposes of further consideration, to afford the Commission additional time in which to consider the application. Our order on rehearing herein resolves the substantive issues raised. No other applications for rehearing were filed.¹

At the outset, we note the application for rehearing's challenge by insinuation of the integrity of the Commission's decisional processes. As discussed at length in the September 21 order (at pages 1-5), that order culminated an exhaustive two year series of fact finding proceedings involving hundreds of technical expert participants and thousands of pages of data. Assisted by its decisional staff, who had first hand knowledge of those proceedings, the Commission carefully considered the factual record before it in reaching the decisions set forth in the September 21 order. With minor exceptions discussed below, the application for rehearing does not raise any new matters not previously considered.

One argument raised by Alaskan Northwest merits response. Alaskan Northwest, at page 6 of its application, cites recent orders of the Commission approving rates of return on equity for other regulated companies in the range of 17 percent. Those orders reflect recent trends and developments in prevailing interest rate levels. In contrast, at the time [Order No. 31](#) was issued, establishing the Center Rate of Return for the Alaska pipeline segment of the ANGTS, the then prevailing levels of interest rates were generally lower.² At first glance, the apparent implication is that Alaskan Northwest now has

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less margin for error in achieving a rate of return sufficiently competitive to attract equity financing, and therefore that the CCE looms more ominously now than it did in 1979.

[Order No. 31](#), however, foresaw the possibility of changing economic circumstances and also provided a remedy. First of all, [Order No. 31](#) (at pages 222-225), citing, *inter alia*, "overall changes in required rates of return in the nation's economy due to changes in inflationary expectations or changes in risk factors," provides for periodic review of the rate of return. Secondly, to preclude any potential undermining or

unravelling of the fruits of Alaskan Northwest's successful efforts to hold down costs, [Order No. 31](#) (at pages 102-110) provides for a "One-time Adjustment to Rate Base." Pursuant to that final step in the IROR formula, the rate that Alaskan Northwest achieves through holding down its costs will be converted into a commensurate one-time permanent adjustment to its rate base; thereafter, that benefit will be locked in and cannot be altered in the periodic rate of return review process.

In short, the Commission in [Order No. 31](#) foresaw the possibility that changed economic circumstances might require adjustment of the Operation Phase Rate of Return, and provided a mechanism for such adjustment on a periodic basis while immunizing the results of the incentive scheme from that periodic review process. Thus, if Alaskan Northwest perceives changes in the economic context of its project which, in Alaskan Northwest's view, justify an increase in its Operation Phase Rate of Return, [Order No. 31](#) provides a mechanism by which Alaskan Northwest can seek such review.³ The CCE, on the other hand, is not an appropriate vehicle for such purposes; the CCE is intended to be a factually determined estimate of anticipated costs. Recognizing that determinations by regulatory agencies inherently involve factors of judgment, the Commission believes that its determinations in its September 21 order (as modified in minor part below) constitute the most accurate estimates that can be made for IROR purposes on the basis of the exhaustive record compiled for that purpose.

Upon review of the September 21 order in light of the application for rehearing, we have decided to revise three aspects of our CCE and IROR determinations in that order: (1) the tax determination; (2) the Alyeska data determination; and (3) the labor cost adjustment determination. These three elements are discussed below. In each instance, our revision is intended to reduce the potential range of uncertainty, and thereby to facilitate financing.

A. Tax Determination.

Acting under the basic principal that, for IROR purposes, estimates should not be altered, after the fact, to reflect actual expenditures, the Adger/Berman and Smoler/Berman reports recommended rejection of all proposals advanced by Alaskan Northwest and/or the Trial Staff to substitute actual expenses for estimates in certain limited areas of the CCE, and the Commission's September 21 order adopted those recommendations. Consistent with that approach, the order (at page 55) rejected Alaskan Northwest's proposals to in effect eliminate the impact of tax law changes in determining the rate of return. In so doing, we acknowledged that Alaskan Northwest has no control over future tax legislation, but reasoned that taxes could either rise or fall and that Alaskan Northwest stood an equal chance of benefitting from changes in tax legislation.

In its application for rehearing, Alaskan Northwest stresses that the possibility of future adverse tax legislation poses the possibility of an erosion of its rate of return over which it would have no control, and that this possibility has an inhibiting effect on financing. While we would prefer to avoid creating exceptions to the fundamental IROR principle that estimates should not be altered, after the fact, to reflect actual expenditures, in this instance we are persuaded that that principle is outweighed by the benefit to be gained by eliminating an element of uncertainty in an area over which everyone agrees that Alaskan Northwest has little or no control. Accordingly, we will authorize the Federal Inspector to substitute taxes actually paid for the tax estimate component in the CCE. Thus, taxes will be eliminated as a factor in determining the rate of return.⁴

In accordance with our September 21 order (at page 62), wherein we determined that

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"contingency should not be applied to any portion of the base estimate that is derived from actual expenditures," we will adjust the CCE cost component for "Normal Contingency" by deleting \$27 million (12 percent of \$228,229,000, the CCE cost component for taxes approved in the September 21 order, at page 54).

B. Alyeska Data Determination.

In our September 21 order (at page 68), we expressed grave concern over the "unlimited scope over time of the deferred payment factor" in the Alyeska data contract, suggesting that it "could have the potential for radically inflating the rate base far beyond any level contemplated by the parties at the time they entered into their contract." We went on to suggest that "[s]uch an open-ended result would not be in the public interest, would be unlikely to foster just and reasonable rates for transporting the Alaskan gas, and might even serve to frustrate the project sponsors' own objectives of financing the project at a reasonable cost." We concluded by noting that "deferring this item at this time would afford the parties an opportunity to reconsider their data licensing agreements in the full context of their broader financial negotiations."

In its application for rehearing, Alaskan Northwest has reiterated its request that we decide the issue now rather than deferring it pending potential renegotiation of the contract. In so doing, Alaskan Northwest contends that the uncertainty inherent in deferring the issue creates another possibility for erosion of its rate of return. Accordingly, in the interest of narrowing the range of uncertainties that might inhibit financing, we will resolve that cost estimate issue now.

The Smoler/Berman Report concluded (at pages 36-53) that the Alyeska data contract was an arms-length agreement, and that Alaskan Northwest had very persuasive reasons for acquiring the data from Alyeska rather than developing it themselves. Alaskan Northwest needed the data (and, in fact, has since made good use of it); Alyeska had the data and was in the position of being able to deliver it quickly, to enable Alaskan Northwest to meet its then projected schedule. No one has questioned the \$55 million base cost of the data, nor the inflation adjustment factor. The sole element of controversy is the deferred payment factor, whose operation is described as follows in the Smoler/Berman Report (at pages 43-46, footnotes omitted):

. . . The payments are to be multiplied by a deferred payment factor "equal to $(1.0002739)^n$ " where n is the number of days between the effective date of agreement on the [base price] and the date such payment is paid or becomes due," whichever is first. As explained at the technical conference, the number "1.0002739 to the n th power" was selected by Alyeska; Alaskan Northwest agreed to it because it seemed reasonable; and it reasonably approximates ten and one half percent per year assuming that the " n " in the formula is 365 days.

It is important to note further that the deferred payment factor is not a substitute for an inflation adjustment factor. On the contrary, Article 3.2 also provides for an inflation adjustment formula, which is applied to the base price payments after they have been adjusted to reflect the deferred payment factor. The inflation adjustment formula is based on a Department of Labor consumer price index.

* * *

In its November 23, 1981 Amendment, Alaskan Northwest describes the deferred payment price as "interest payments . . . calculated per terms of the agreement at an annualized rate of 10.5 percent per year, compounding daily from the effective date of the price agreement."

Based on the Smoler/Berman Report and Alaskan Northwest's November 1981 Amendment, it is our understanding that Alaskan Northwest's \$93.23 million request was premised on the following payment schedule. The schedule is stated in 1980 dollars, and *includes* the deferred payment factor but *excludes* the inflation adjustment factor:

Amount Per	Event and	Base
17, 1979	Deferred Total	July
Agreement	Percentage Due	
	Payment Amount	

\$1000)	Factor	Under Agreement (in \$1000)	(in
	7/17/79--		Execution of Price Agreement
\$ 200	1.0000	\$ 200	
	5/1/82--		Assuming Alaskan Northwest Acceptance of Certificate (15% less \$200,000) ⁵
\$ 8,050	1.3329	\$10,730	
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	2/1/83--		Assuming start of Civil Construction (25%)
\$13,750	1.5753	\$21,660	
	8/1/84--		Assuming start of Pipeline Construction (35%)
\$19,250	1.6561	\$31,880	
	11/1/86--		Assuming Inservice (Balance) ⁶
\$13,750	2.0916	\$28,760	
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\$55,000		\$93,230	Total
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The Trial Staff argued in favor of approving \$55 million as the CCE cost component for Alyeska data, excluding all costs attributable to the deferred payment factor. Alaskan Northwest, supported by Alyeska, requested approval of \$93.23 million. That figure was based on the construction schedule slippage that had occurred as of the date of Alaskan Northwest's November 1981 Amendment to its CCE application but did not include the three additional years of slippage announced subsequent to that date. No party advocated deferral of the Alyeska data issue.

We noted in our September 21 order (at page 68, n. 227) that:

Our rough calculation indicates, for instance, that if Alaskan Northwest meets its currently anticipated completion date of November 1989, the cost for Alyeska data pursuant to the deferred payment factor in the contract--*unadjusted for inflation*--would increase from \$92.23 million to approximately \$122

million.

We also noted that, in the absence of a financing plan, the schedule could in theory extend well beyond 1989.

Our concerns about the contract, as expressed in the September 21 order, remain the same. The already announced slip and the strong possibility of additional delays in obtaining financing tend to push the price of the data beyond what could be considered reasonable. Thus, deciding the issue at this time requires us to make a judgment as to what is a reasonable price for the data.

The applicable standard is "prudence": is the Alyeska data contract, including its inflation and deferred payment factors, a prudently incurred financial commitment? If so, the cost of implementing it would be a prudently incurred cost of the project such that the estimate of that cost should be included in the CCE.

It is our understanding of the contract that it does not contain any limit or "cap" on the operation of the deferred payment clause.⁷ Thus, in the event of delay in the project, the deferred payment portion of the price can escalate indefinitely and without limit in terms of either the payment dates or a payment ceiling. We do not believe that a financial arrangement that includes a deferred payment element that can escalate indefinitely - ultimately dwarfing the base upon which it is calculated - is reasonable. Normally, either a date certain or an amount certain - beyond which the contract price would be fixed - would be included to protect the buyer. Absent such a "cap" on the operation of the deferred payment factor, we do not consider the contract to be a prudently incurred financial obligation. Thus, it would not be appropriate to include in the CCE a cost component premised on that contract without modification.

Unfortunately, analysis of the "market value" of the data at the time it was purchased is a frustrating exercise, because there was no meaningful competitive market. Alyeska was the only seller who had the data, and Alaskan Northwest was the only buyer who wanted it. Alaskan Northwest had the theoretical option of generating the data itself, but that option would have delayed the project from its then contemplated schedule. Moreover, the record is less than clear as to what it would have cost Alaskan Northwest to generate the data inhouse. The Smoler/ Berman Report (at page 49, n.65) concluded that that cost would have been more than \$55 million and less than \$145.9 million:

The difficulty with these comparisons is that Alaskan Northwest did not purchase all of the data that Alyeska incurred \$145.9 million to gather, and the record is not clear as to how much it cost Alyeska to gather the particular data it licensed to Alaskan Northwest. . . . what is clear in the record is that the \$55 million base price in 1979 was

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substantially cheaper than the alternative of generating the data in-house (to the extent, if any, that it was even feasible to generate such data in-house).

Two factors do shed some light on the value of the data as perceived by the parties at the time they negotiated the contract. First, the record indicates that the data was originally offered by Alyeska to Alaskan Northwest for \$72 million.⁸ Second, based on the major milestone schedule included in Alaskan Northwest's original CCE application as filed in July of 1980, Alaskan Northwest at that time apparently contemplated an in-service date of November 1985. Based on that schedule, the total payments under the contract (excluding the inflation adjustment factor) would have been approximately \$87.6 million.

We recognize, however, the substantial difficulties inherent in attempting to determine "market value" based on the presumed intent and assumptions of the parties at the time they negotiated their contract. For instance, Alaskan Northwest may have contemplated the possibility of a lengthier slippage in schedule, such as the three years of slippage that have occurred subsequent to the filing of the November 1981 Amendment. As noted above and in the September 21 order, assuming a 1989 completion date the base price and deferred payment factor calculated pursuant to the deferred payment schedule in the contract would total approximately \$122 million.

On the other hand, the most prudent course of action would be to pay off the contract obligation at the first practical opportunity when funds become available for that purpose rather than deferring portions of that obligation to various milestones during and after construction. At the date of acceptance of the certificate, the overall project financing arrangements would be in place and there would be no need to continue deferring the obligation to pay for the data. At the expected date of acceptance of the certificate (May 1985) assuming a completion date of November 1989 (which reflects the additional three-year slippage), the accumulated deferred payments plus the base price would total approximately \$98.8 million.⁹

Taking all of these factors into account (including the slippage to a 1989 completion date), basing our determination of market value on the presumed intent of the parties as best as we can ascertain it on the record before us, and giving a substantial benefit of the doubt to Alaskan Northwest, we will approve for inclusion in the CCE the full \$93.23 million requested by Alaskan Northwest. In doing so, however, we will make clear at this time our view that \$93.23 million represents the outer boundary of reasonableness, and is not subject to adjustment for schedule slippage either up to or beyond 1989. In light of the basis for our approval of the \$93.23 million, a factor for Normal Contingency would be inappropriate and will not be included.

The CCE approved in our order of September 21 was \$6.930 billion. As revised to reflect the addition of \$93.23 million for the Alyeska date (and as rounded off in the same manner as the \$6.930 figure was derived), and to reflect as well the deletion of \$27 million for "Normal Contingency" for taxes, the CCE will be \$6.996 billion. This figure, of course, does not include other CCE components that were deferred in the September 21 order and whose resolution awaits completion of the record on those select issues.

C. Labor Cost Adjustment Determination.

Finally, in its application for rehearing (at page 8), Alaskan Northwest stresses its concern that "[a]ny escalation in Alaskan labor costs above the rate of escalation prevailing in other U.S. labor markets will result in a lower equity rate of return."

The September 21 order (at pages 80-81), applying the standards established in Order Nos. 31 and 31-B, precluded use of any labor inflation index weighted towards Alaskan labor rates, and insisted on use of a purely national index of labor inflation. On further reflection, we have concluded that Alaskan Northwest's position is not unreasonable. In light of the concern expressed in the application for rehearing, and in order to further reduce the range of uncertainties inherent in the IROR, we will adopt the labor inflation index proposed by Alaskan Northwest - an index "based on the *Means* skilled average labor rates as adjusted by the *Means* weighted average labor index for Anchorage."¹⁰

The Commission orders:

(A) Ordering Paragraph (A)1. of the Commission's order issued on September 21, 1982 in the above-captioned dockets is amended to read as follows:

1. The Certificate Cost and Schedule Estimate (CCE) for the Alaska pipeline segment of the Alaska Natural Gas Transportation System (ANGTS), as defined in Condition No. 7 attached to Order No. 31, except for CCE components deferred in this order (as amended by the order on rehearing), shall be \$6.996 billion.

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(B) Ordering Paragraph (A)3. of the Commission's order issued on September 21, 1982 in the above-captioned dockets is amended to read as follows:

3. The labor cost adjustment index to be used in implementation of the inflation adjustment

mechanism set forth in Condition Nos. 5 and 18 attached to [Order No. 31](#), as amended by [Order No. 31-B](#), shall be an index based on the *Means* skilled average labor rates as adjusted by the *Means* weighted average labor index for Anchorage. The Federal Inspector, in his discretion, may consider and approve any alternative labor cost adjustment index proposed by Alaskan Northwest that meets the standards set forth in [Order Nos. 31](#) and [31-B](#), as amended and supplemented by the order on rehearing of this order.

(C) The application for rehearing filed by Alaskan Northwest Natural Gas Transportation Company is hereby denied except as hereinabove specifically provided.

-- Footnotes --

¹ Subsequent to the closing date for filing applications for rehearing, Atlantic Richfield Company filed (on November 1, 1982) a "motion for reconsideration"; Exxon Corporation filed (on November 2, 1982) a "statement in support of application for rehearing"; and Sohio Alaska Petroleum Company filed (on November 3, 1982) a "memorandum in support of application for rehearing." Putting aside the untimely and unauthorized nature of these filings, they do not raise any matters beyond those raised in Alaskan Northwest's application for rehearing.

² See generally [Order No. 31](#), "Order Setting Values for the Incentive Rate of Return, Establishing Inflation Adjustment and Change in Scope Procedures, and Determining Applicable Tariff Provisions," [Docket No. RM78-12](#) (June 8, 1979), [7 FERC ¶61,237](#); "Order No. 31-B on Rehearing," [Docket No. RM78-12](#) (September 6, 1979), [8 FERC ¶61,250](#).

³ We stress that we are *not*, in this order, making *any* determination as to the relevance of any economic developments that may have occurred subsequent to the issuance of [Order No. 31](#). We are merely pointing out that, if Alaskan Northwest perceives such relevance, [Order No. 31](#) provides a mechanism for bringing such matters to the Commission's attention for appropriate consideration.

⁴ In its application for rehearing, Alaskan Northwest has also raised a related issue with respect to the Commission's fees. Those fees, as a CCE cost component, are analogous to, and should be considered in conjunction with, the CCE cost component for government monitoring. As discussed in our September 21 order (at pages 64-65), government monitoring will be addressed in a supplementary report by the technical conference presiding officers, and all parties to the proceeding will have an opportunity to file comments on that report after it has been issued. Accordingly, at this juncture we will note Alaskan Northwest's point on the CCE cost component for the Commission's fees, but will defer consideration of it until the government monitoring cost component is ripe for decision.

⁵ The schedule included by Alaskan Northwest in its November 1981 Amendment (Vol. XXXIV at page II-2), as reproduced in the Smoler/ Berman Report (at page 45), shows this line of figures next to the date "3/3/81" (identified as "assuming certification") with a blank line of space next to the date "5/1/82" (identified as "(15% less \$0.02)"). The Smoler/Berman Report noted the obvious discrepancy but did not attempt to clarify it. Our calculation of the three figures in that line indicates that those figures would be accurate if associated with the 5/1/82 date, but would be too large if associated with the 3/3/81 date.

⁶ The schedule included in the November 1981 Amendment, as reproduced in the Smoler/Berman Report, showed this line of figures next to the date "12/1/86" (identified as "Assuming Inservice"), with a blank line of space next to the date "11/1/86" (identified as "(Balance)" and portrayed beneath the 12/1/86 line). It is our understanding that 11/1/86 is the correct date to be associated with these figures.

⁷ As discussed in the Smoler/Berman Report, the "contract" consists of a License Agreement (dated August 17, 1978) and several subsequent amendments and documents incorporated by reference. Paragraph 9.1 of Article 9 of the License Agreement provides that "[u]nless earlier terminated as hereinafter provided, this agreement will terminate on December 31, 1988." Subsequent paragraphs provide for the possibility of termination at an earlier date, at the option of one or more parties, pursuant to certain prescribed procedures and/or potential occurrences. Paragraph 9.6, however, provides (as we understand it) that, once the parties have agreed on a base price for the data (which they did - \$55 million), "termination shall not relieve

NORTHWEST of its duty to make the payments required in Article 3 [which includes the deferred payment factor] of its agreement, whether or not such payments are due and payable at the date of such termination." We also note the existence in the License Agreement (at Article 11) of a "Force Majeure" provision.

Recognizing the possibility that the contract, as a commercial agreement between the parties, might some day become the subject of negotiation, arbitration or litigation between the parties to it, we stress that the determinations in this order are solely for the purpose of resolving the CCE issues presently before us for decision, and are not intended as "findings" for any other purpose. In the event of commercial negotiation, arbitration or litigation in the future, the parties are free to advance any interpretation of their contract whether consistent or inconsistent with the assumptions we have made in resolving the CCE issues before us.

⁸ See February 16, 1982 technical conference, tr. 110. The \$72 million figure was stated by the Trial Staff, and was not challenged or corrected by any other party.

⁹ This analysis assumes that Alaskan Northwest has the option to pay off the full amount of its obligation at any time - i.e., that the contract *permits*

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deferral of payments but does not *require* it. (By way of contrast, at the expected date of acceptance of the certificate (May 1982) assuming an in-service date of November 1985, the accumulated deferred payments plus the base price would total approximately \$73.2 million.)

¹⁰ See Alaskan Northwest Initial Comments on the Adger/ Berman Report, at pages 49-50.