Are Canadians Subsidizing Trans Mountain?

Yes, By About $8 billion
A Primer for Thoughtful Canadians

Ever since Finance Minister Bill Morneau announced the Liberal Cabinet decision to buy Trans Mountain from Kinder Morgan on May 29, 2018, Canadians have been asking “How much will Trans Mountain’s purchase end up costing us?”

Mr. Morneau promised then that “this $4.5 billion investment represents a fair price for Canadians…the core assets required to build the Trans Mountain Expansion Project have significant commercial value, and this transaction represents a sound investment opportunity.” He provided no analysis to back up those claims.

In the post-purchase announcement briefing with reporters, Mr. Morneau’s officials promised that, if he knew Ottawa would buy Trans Mountain by July 22, 2018, Canadians would be given an estimate of the cost to construct the expansion.¹ That date came and went. When the project was reapproved last June, we were promised a revised capital cost, but no revised budget has been provided.

For more than a year and a half, Ottawa has aggressively deflected requests for an updated capital cost on the project. Without a reliable capital cost, the full quantum of the taxpayer funded subsidy is not easily determined.

Information that has been provided is related to Trans Mountain’s operational performance on the existing pipeline. This has been released in a piecemeal fashion and is tucked away in Canada Development Investment Corporation (CDEV) financial statements and Canada Energy Regulator (CER, formerly the National Energy Board—NEB) filings. For most Canadians, the information is difficult to access and often impossible to understand.

Under scrutiny, the piecemeal information that is available does allow for an estimate of the cost to Canadians for the existing pipeline. The cost of the 66-year old pipeline system not being borne by commercial interests is $2 billion over three years, or $3.4 billion over five. As for the existing system, the price Ottawa paid was not fair, and the investment is not sound.

What’s missing from the information Ottawa has meted out is a complete and reliable estimate of the cost to construct Trans Mountain’s expansion. The most recent estimate Ottawa will confirm is a stale dated $7.4 billion budget prepared in late 2016 which was agreed to by long-term committed shippers in February 2017. There are a number of things that have changed since then.

¹ A post-purchase briefing transcript was provided to the author under the understanding that the official would not be named, the transcript would not be shared, and statements drawn from the transcript would be paraphrased.
• Trans Mountain expects the expansion will now take longer to build. Rather than the 30 months assumed in the $7.4 billion budget construction schedule, it is 36 months—that’s a 20% increase.

• The project is delayed by three years—the in-service date has moved to December 2022—which represents significant cost increases beyond a longer construction time frame. That date is probably overly optimistic given the slow start to construction since the project was approved in June.

• A new budget will need to accommodate the cost to Trans Mountain of responding to the August 30, 2018 court order to shut the project down.

• The $7.4 billion budget was based on contractor arrangements that were not yet firm, as Trans Mountain had identified builders for particular segments, but agreements with all of them were not finalized.

• Increased accommodation costs have resulted from negotiations over the past three years with First Nations and municipalities.

• A big unknown is the land acquisition costs, with agreements for some important parcels still not finalized.

• Trans Mountain capitalizes the carrying costs for the project in an Allowance For Funds Used During Construction (AFUDC). That amount has increased significantly over the approximate $600 million included in the $7.4 billion budget, not only because the cost to construct has increased, but also because of the delay in starting construction and the increased time horizon required to build it.

Recognizing all these factors puts Trans Mountain’s cost for the expansion at about $12 billion—about 60% more than the budget Ottawa says it relied upon to make the purchase.

An increase in the cost to construct of this magnitude might not be a problem if Trans Mountain could pass all these costs onto the shippers who use the pipeline through higher toll rates. The problem is that Ottawa cannot do so, and this is where the huge taxpayer funded subsidy on the expansion project comes in. At a capital cost of $12 billion, and with the information available, Canadians are on the hook for an additional $3.5 billion from Trans Mountain’s expansion.

Finally, there is the pro-rata share of the cost of the Oceans Protection Plan which Ottawa regularly promotes as part of the project that must be included in any estimate of the subsidy.

Available information puts the cost of Trans Mountain to Canadians at about $8 billion

1. $3.4 billion over five years for the existing pipeline;
2. $3.5 billion for the expansion; and
3. $1 billion for Trans Mountain’s pro-rata share of the Oceans Protection Plan.
Outline

The purpose of this brief is to provide Canadians with background information they can understand, so they can evaluate for themselves the cost of Trans Mountain’s purchase.

This brief begins by identifying two major initiatives that make up Trans Mountain:

1. The operation of a 66-year old pipeline system; and
2. The plan to expand it.

This distinction is important, particularly since Ottawa seeks to hide financial realities by conflating the two.

The brief then examines the financial viability of the 66-year old pipeline, the financial viability of the expansion, and the financial viability of both.

An estimate is provided on the current cost of the purchase to Canadians. We find that both the existing pipeline and the expansion are already heavily subsidized and if the project continues the subsidies mount. There is nothing in the construction project agreement Trans Mountain has entered into with the committed shippers that will allow for a recovery of these costs, so Canadians will bear them.

What we do know is that if the expansion project continues the subsidy will grow. Until Ottawa provides an accurate and current capital budget, we won’t be able to estimate by how much the subsidies will mount, we just know they will increase.

What is Ottawa hiding and why?

Canadians deserve full and accurate information to make informed decisions. The point of no return on Trans Mountain’s expansion has not been reached. There is still time to stop the financial losses.

The brief then touches upon the cost of the Ocean’s Protection Plan. The plan is a subsidy because it was a cost that Trans Mountain’s shippers agreed to pay, but Prime Minister Trudeau turned it into a cost for Canadians to bear instead.
Trans Mountain—A Tale of Two Pipelines

Part I

The 66-year old Pipeline is Heavily Subsidized and Has Been Losing Money Since Ottawa Bought It

When Ottawa purchased Trans Mountain it bought shares rather than assets. This is a very important distinction. Buying shares rather than assets reduced the taxes Kinder Morgan was required to pay on the sale. It also guaranteed a huge subsidy to shippers through reduced toll rates because of how the CER administers toll rate approvals.

Ottawa’s decision to buy shares rather than assets was a gift to Kinder Morgan at the expense of the treasury. It was also a gift to Alberta’s oil patch, refiners in Washington State, Parkland Refinery in BC and refiners off Westridge dock (which means predominantly refineries in California).²

The proof for these subsidies is found in the Share and Unit Purchase Agreement, the toll application available on the CER website and Trans Mountain’s financial statements.³

Trans Mountain has a three-year contract with oil producers and refiners that ship product along the existing pipeline. It is called the 2019 - 2021 Incentive Toll Settlement (ITS). Trans Mountain must receive approval from the CER for any tolls it charges to shippers on its regulated facilities, and the most recent toll settlement agreement is no exception.

Had Ottawa bought the assets instead of shares, Trans Mountain would have been required to include the price it paid for those assets—the almost $2 billion more it paid for the assets than the value recorded on Trans Mountain’s books—in its recent application for toll rates charged to shippers. The ‘Net Rate Base’ (ITS Schedule 3 Line 20) upon which the tolls are calculated should be about $3 billion, instead it is about $1 billion ($967.8 million ITS-3, line 20).

This is significant. The CER allows for a recovery of the asset value in the toll rates, but because it is understated by about $2 billion, the tolls the CER approved pretend the fair market value of the regulated assets is $1 billion while Ottawa paid $3 billion.

What private company motivated by commercial returns would be interested in buying the existing pipeline for the $3 billion Ottawa paid when the tolls it would receive reflect a value for the facility of only $1 billion?

Mr. Morneau says that Ottawa paid ‘fair market value’ for the existing pipeline, but the valuation would have been done on the basis that the tolls could be raised to cover the cost reflected in that

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² Although very little crude is shipped off the Westridge dock, the majority of the barrels that are shipped are delivered to US destinations, primarily California.
³ This discussion does not deal with Kinder Morgan’s tax subsidy arising from a share purchase versus an asset purchase. That amount would be in addition to the $8 billion.
‘fair market value’. Simply put, Ottawa may have paid ‘fair market value’ but it was calculated on a market reality that didn’t exist—and that’s not fair.

What does the acquisition of regulated assets through a share purchase cost Canadians?

As long as Ottawa owns Trans Mountain, the acquisition will cost Canadians about $2 billion over the three-year agreement—yes, the toll subsidy to shippers is locked in now that the CER approved the application—and represents a $3.4 billion subsidy over five years.

The subsidy exists because the tolls charged to shippers on the existing pipeline under the 2019 – 2021 ITS cover only half the interest expense on the $3 billion loan Trans Mountain entered into to buy the operating facilities and the tolls do not recover any of the loan principal.

Trans Mountain Pipeline Finance (TMPF)—the parent company—is borrowing money and paying interest on that in order to cover the portion of the interest expense Trans Mountain cannot pay because it receives insufficient revenues from operating the pipeline. That’s right, TMPF is paying interest on interest.

Everyone involved in the ITS application filed with the CER knows it represents a significant subsidy to oil producers and refiners that rely on the pipeline. But all the parties involved—the government, the shippers and the CER—seek to subsidize the tar sands and thus the application for subsidized toll rates was approved by the CER.

The CER was advised of the subsidy on January 14, 2019, early in the toll application process. I alerted the regulator that if it approved the application it would violate Finance Minister Morneau’s promise to Canadians that ownership would be conducted on commercial terms.

Trans Mountain’s Board was advised of the subsidy before it was approved by the regulator. On February 15, 2019, I wrote to Trans Mountain Chair, William Downe.

I am writing to you as I have no reason to believe you did not mean what you said in (your press announcement). As you stated, “Our single-minded focus is on ensuring TMC continues to run efficiently and commercially…”

Should the NEB approve the application Trans Mountain has submitted to it, it not only subsidizes the tolls charged to shippers over the next three years to the amount of $2 billion and $3.4 billion over five years, it compromises potential resale and, more importantly, undermines the toll application approved by the NEB for the expansion.”

I was assured by staff that Mr. Downe had received my correspondence, but he refused to grant me the courtesy of acknowledging receipt personally as I requested in my letter. Having been on the board of a Crown Corporation myself, and recognizing the responsibility to the public such an office requires, I find the dismissiveness from Trans Mountain’s Board Chair totally unacceptable.
On February 22, 2019, Mr. Morneau was advised of the subsidy when there was still time to stop it. I forwarded to him the background research including my warning to the CER, and explained that “I doubt “commercially reasonable tolls” means billions in toll subsidies to shippers over the life of the agreement.” I asked why Mr. Morneau would negotiate a purchase of regulated assets at a ‘fair market price’ of about $3 billion when he knew the toll rates in future for the regulated assets would reflect a ‘fair market value’ of about $1 billion consistent with Kinder Morgan’s book value.

A senior official in Mr. Morneau’s office said in an email, “Can confirm receipt and I will get back to you promptly.”

Two weeks later the CER approved Trans Mountain’s sweet deal for its shippers and locked in a huge cost to Canadians.

After many months, and numerous follow up emails requesting the promised response from Mr. Morneau’s office, none has been forthcoming.

The Cost to Canadians of the Existing Pipeline: How the Subsidy Works

Here’s how the subsidy works:

1. The toll rates on Trans Mountain prior to Ottawa’s purchase are based on a depreciated value of the assets of approximately $1 billion. The ‘Net Rate Base’ figure is provided in ITS Schedule 3, Line 20.

2. Ottawa buys all the shares in Trans Mountain for $4.5 billion\(^4\) which gives it ownership of the assets for the existing pipeline. It pays approximately $3 billion for the existing facilities.\(^5\) TMPF borrows the money for the purchase from the Canada Account at an interest rate of 4.7%. The interest expense is $141 million a year with the $3 billion principal amount due in five years.

3. Trans Mountain submits an ITS application to the CER with the same value for the existing system as before the purchase, as if Ottawa paid $1 billion for it when it paid $3 billion.\(^6\)

4. The interest expense and return on equity allowed in the ITS—allowed to be charged in the tolls—is for $68 million per year\(^7\) while the interest charged on the loan to purchase the pipeline is $141 million a year. Slightly less than half the required interest expense is covered in the approved tolls. There is no accommodation in the tolls for the loan principal to be repaid.

\(^4\) CDEV, Third Quarter Report, September 30, 2019, page 19, $4,447 million.
\(^5\) Ibid., $2,910 million.
\(^6\) Not all of Trans Mountain’s operating assets are regulated under the ITS, but approximately 90% are.
\(^7\) ITS-3, Line 24.
5. The shortfall in revenue to cover the purchase is $2 billion over three years calculated as $70 million interest expense not recovered each year and $600 million a year principal not recovered (assuming a five-year amortization which is the term of the loan). If the principal recovery were spread over ten years, then the principal amount not recovered on an annual basis would be $300 million. A five-year payback is assumed since that is the term of the loan.

6. The subsidy will continue to mount as long as the asset value for regulated toll rates reflect the pre-purchase value of the existing pipeline and not the price Ottawa paid. Over five years the subsidy becomes $3.4 billion calculated as $70 million for five years of interest expense not recovered, and $3 billion in loan principal.

The above cost estimate assumes that Ottawa is unable to sell the aging pipeline to the private sector. In a scenario where Ottawa is a long-term owner the only way out of the inappropriate mounting of costs to Canadians, is to charge tolls on the existing line that reflect the commercial terms Ottawa said it relied on when it bought Trans Mountain. That is, charge the shippers who use the pipeline what it costs to own it.

**Ottawa has the authority to make sure Canadians stop subsidizing Trans Mountain’s current shippers and Mr. Morneau should be compelled to act.**

What about the resale value of Trans Mountain? The problem is, Trans Mountain was a profitable pipeline system when Ottawa bought it, but it is not generating earnings now—it is booking losses and has been since the government took over.

When a private sector buyer entertains a purchase, the price that buyer will be willing to pay will be driven by the expected revenues from the operating system. Due to the CER approval of the recent toll settlement, these revenues are constrained, and the tolls are subsidized.

An offer price from private sector interests for the operating system today would be closer to $1 billion than the $3 billion Ottawa paid. So even in a sale scenario, the purchase of a 66-year old pipeline system would cost Canadians $2 billion plus the interest expense not covered to the date of sale. Simply put, Ottawa paid way too much for the existing pipeline.

But what about the vast earnings from the expansion that Mr. Morneau promises? Can’t those be used to compensate for the subsidy on the existing line, with enough left over to pay for a transition to a clean economy?

No. The reason? Ottawa has unnecessarily agreed to a huge toll subsidy on the expansion project too. Preliminary estimates put this cost to Canadians at an additional $3.5 billion. That is, the toll subsidies for the expansion will be piled on top of the toll subsidies for the existing pipeline because of how the toll methodology works. This is explained in detail in Part II.
Unless Ottawa acts and gets the toll rates on the existing system to a level that reflects the price Ottawa paid for it, the cost to Canadians on the existing system will continue to mount.

In summary, when it comes to the 66-year old pipeline system, unless decisive action is taken, Ottawa is effectively locked into selling the pipeline and related facilities for closer to $1 billion than the $3 billion it paid. A cost to Canadians of $2 billion plus however much of the interest expense is not recovered is a floor to the subsidy for the existing pipeline. The interest expense mounts every day Ottawa owns it.

The ceiling on the subsidy for the existing pipeline remains undefined. If Ottawa takes no action and continues to own Trans Mountain, the cost in five years is $3.4 billion. Presumably, the loan will roll over, but it’s still a cost to Canadians that will continue to rise by the amount of interest expense not recovered in toll rates for as long as Ottawa continues to own it.

**Promises of Earnings From Trans Mountain are Without Merit**

Not only have the medium-term subsidies inherent in the toll arrangements with shippers been hidden—by Ottawa, Trans Mountain, the CER and oil companies—Mr. Morneau deliberately recasts the crown’s operating performance to make the company appear profitable when it is not. Proper scrutiny of the financial statements reveals ongoing losses ever since Ottawa took over.

Trans Mountain reports its financial performance using US Generally Accepted Accounting Principles (GAAP), while its parent TMPF relies on Canadian standards—the International Financial Reporting Standards (IFRS). There are differences in the standards, and US GAAP makes Trans Mountain’s financial position appear stronger than it appears under IFRS.8

**How To Read Trans Mountain’s Financial Statements**

In order to determine how much Trans Mountain is losing every quarter, or on an annual basis, the most relevant information is provided in CDEV’s Financial Statement Notes. For the third quarter 2019, this is Note 20 on page 34. Table 1, below, provides a summary.

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8 For more about how a reliance on GAAP along with a Share Purchase rather than an Asset Purchase costs taxpayers, please see Appendix A.
Table 1

Trans Mountain’s $75.5 million Net Loss for the first 9 months in 2019
($ thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trans Mountain Corporation (IFRS) Net Income</td>
<td>$47,834</td>
</tr>
<tr>
<td>Deduct Tax Recovery 9</td>
<td>($52,862)</td>
</tr>
<tr>
<td>Deduct Other Expense</td>
<td>($20,424)</td>
</tr>
<tr>
<td>Deduct Other Interest Expense 10</td>
<td>($50,014)</td>
</tr>
<tr>
<td>Total Income (Loss)</td>
<td>($75,466)</td>
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</table>

When Trans Mountain’s purchase was announced on May 29, 2018, Mr. Morneau assured Canadians the old pipeline was profitable—and it was before Ottawa bought it. Afterwards, it began losing money because Mr. Morneau failed to ensure that the toll settlement agreement between Trans Mountain and its shippers resulted in toll rates high enough to cover the cost of buying it.

Part II

The Second Tale – The Trans Mountain Expansion Project

When Ottawa paid $4.5 billion for Trans Mountain it bought the existing pipeline for approximately $3 billion and the right to expand the system for approximately $1.5 billion. In Trans Mountain’s financial statements, the expansion project is identified as “Construction Work in Progress” with the additional amount Ottawa paid for the expansion tucked away in Goodwill.

The expansion project includes the construction of a 36” pipeline with an applied capacity for 540,000 barrels a day resulting in a system capacity of 890,000 barrels a day. An additional 50,000 barrels a day of capacity is expected on the existing pipeline after the expansion because it will not ship any heavy crude (diluted bitumen).

However, what Ottawa doesn’t tell the public is that the toll rates on Trans Mountain’s existing pipeline will need to more than double to help pay for the expansion. That’s right. The cost to deliver a barrel of refined product or light oil to the BC marketplace will more than double after the expansion, even though it will be transported along the old pipeline. This is because existing assets need to subsidize the cost of building the new ones.

Initially Kinder Morgan estimated the cost of the expansion at $5.4 billion. An increase in cost to $6.8 billion was announced in October 2015. A revised capital cost of $7.4 billion was announced in March 2017.

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9 Tax recovery due to Alberta’s Corporate Tax Cut is a one-off subsidy from Alberta taxpayers to the pipeline that should not be considered in an estimate of Trans Mountain’s operating profit.
10 TMP Finance is consolidated in CDEV’s financial statements under ‘Others’, however, the interest expense identified in ‘Others’ is incurred by TMP Finance.
All these construction budgets include an item that reflects a return on invested capital (debt and equity) during construction. The CER calls this account an Allowance For Funds Used During Construction (AFUDC). For example, the $7.4 billion budget includes construction costs of about $6.8 billion with an AFUDC of $600 million.

Table 2

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Cost Estimate ($billions)</th>
<th>In Service Date</th>
<th>Spend to Date at Year End (Cumulative) ($millions)</th>
<th>AFUDC* Cumulative Spend to Date ($millions)</th>
<th>Percent AFUDC of Capital Spend</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$5.4</td>
<td>December 2015</td>
<td>$97,051</td>
<td>$5,011</td>
<td>5.2%</td>
</tr>
<tr>
<td>2014</td>
<td>$5.4</td>
<td>October 2018</td>
<td>$200,860</td>
<td>$15,474</td>
<td>7.7%</td>
</tr>
<tr>
<td>2015</td>
<td>$6.8</td>
<td>October 2018</td>
<td>$335,062</td>
<td>$34,902</td>
<td>10.4%</td>
</tr>
<tr>
<td>2016</td>
<td>$6.8</td>
<td>December 2019</td>
<td>$480,243</td>
<td>$63,108</td>
<td>13.1%</td>
</tr>
<tr>
<td>2017</td>
<td>$7.4</td>
<td>December 2019</td>
<td>$927,368</td>
<td>$109,790</td>
<td>11.8%</td>
</tr>
<tr>
<td>2018</td>
<td>$9.3</td>
<td>December 2021</td>
<td>$1,551,177</td>
<td>$201,039</td>
<td>13.0%</td>
</tr>
<tr>
<td>2019e</td>
<td>$12.0</td>
<td>June 2023</td>
<td>$2,688,177</td>
<td>$301,039</td>
<td>11.2%</td>
</tr>
</tbody>
</table>

Source: ITS filings with CER 2013 - 2017, TD Fairness Opinion for 2018 and R. Allan for 2019 based on CDEV Q3 spending. *AFUDC included in Capital Spend to Date, not the AFUDC account in the total budget.

Ottawa has confirmed publicly the capital cost for the project of $7.4 billion based on an AACE International Level II/III budget prepared in late 2016 and agreed to by shippers in February 2017. Class II estimates are prepared as a detailed control baseline against which all actual costs are monitored for variations to the budget. It would be expected that any budgeting post March 2017 would include line item cost changes and reflect tightening of the detail.

This $7.4 billion budget was prepared as part of the contract terms with shippers that required a more detailed budget than the original $5.4 billion budget submitted to the Toll Hearing in 2013. The initial cost estimate for the $5.4 billion budget and the $6.8 billion budget announced in October 2015 was a Class IV with a deemed accuracy of +35% to -22.5% used at the study or feasibility stage of a project.

Trans Mountain refers to the $7.4 billion budget as the Certificate of Public Convenience and Necessity (CPCN) estimate because it was developed after the first CPCN. The CPCN is the permit authorizing federal approval to build the project and was issued by the CER in December 2016.

The capital cost of the project drives the toll rates shippers will pay once the expansion is complete. These toll rates are for both the existing pipeline and the new pipeline and the toll rates

11 TMC incurred costs of approximately $816 million on the TMEP including capitalized interest of $25 million. For the final three months of 2019, capital spend is estimated at $107 million a month to reach $2,688,177,000. See CDEV Q3, Page 3 and 5.
are the same for a given destination and product type, regardless of which pipeline is used to ship the product.

The contract terms with shippers required that a new CPCN budget be provided to them after the CER issued the second CPCN in June 2019. The second CPCN is the only valid CPCN. Had a revised budget been provided to the shippers with the increased capital cost known in June, it would have required that Trans Mountain pass on all capital cost increases over $7.4 billion to the shippers in their expanded system toll rates.

The increased cost for the project since February 2017—which is substantive because of project delays, longer construction time horizon, greater refinement in the estimates, finalization of contracts with contractors, new accommodations, and land acquisition costs, would likely have been so high that some of the shippers would have exercised the right afforded to them in the contract to abandon the project and walk away.

Instead of holding to the terms of the contract, however, and charging shippers the full cost of building the project, Trans Mountain agreed to another toll subsidy for the shippers. Trans Mountain is now unnecessarily on the hook for a large portion of the project’s cost above $7.4 billion when it could have relied on the issuance of the new (and only valid) CPCN to avoid subjecting Canadians to this cost.

The problem is that the shippers benefit from Trans Mountain’s willingness to absorb project costs directly, so why would they try to hold Trans Mountain to the terms of the agreement? Trans Mountain for its part, serves the needs of oil producers and refiners, not the Canadian public, so it became an ally in designing the subsidy when it should have been protecting the public purse.

The CER won’t intervene and protect the public if neither party to the toll agreement protests. I know this because I filed a complaint with the CER.

A similar complaint to mine was filed by Living Oceans and Raincoast Conservation who were also intervenors at the CER hearing and plaintiffs in the Supreme Court case that resulted in the first CPCN being invalidated.

The CER ruled in Trans Mountain’s and the shippers’ favour. This ruling represents a significant and ongoing cost to Canadians, that, given a likely $12 billion current capital cost for the project, would be an estimated additional $3.5 billion subsidy.

The cost to Canadians of the Expansion: How the Subsidy Works

1. There is a feature in the arrangements between Trans Mountain and its shippers whereby cost overruns for approximately 75% of the budget items are charged to Trans Mountain once the CPCN budget is finalized. This is partly because the shippers give up their rights to terminate the contract. The portion of the cost overruns charged to Trans Mountain are called ‘capped costs’ (because they cannot be passed on in toll rates) and the portion
charged to the shippers are called ‘uncapped’ (because they can be passed on in toll rates).

2. If Trans Mountain had adhered to the letter of its contract with shippers and presented a CPCN budget based on current costs after the CER issued the CPCN in June, that entire budget would have been reflected in the toll rates shippers pay, and none of the current capital cost would be borne by Trans Mountain.

For example, if the current budget is $12 billion (including AFUDC), shipper tolls would have increased from an average of $5.17 per barrel as reflected in the $7.4 billion budget (the most recent one presented to the shippers based on the original CPCN) to about $8.39 per barrel. An increase of $3.22 per barrel in today’s economic environment would likely have triggered termination of long-term agreements to ship for at least some shippers.

3. Instead, Trans Mountain agreed to be tied to the original CPCN budget (which is a contravention of the contract, but shippers are not going to refuse a subsidy). This means that Trans Mountain is at risk for any budget items above the value of the estimate for these items in the $7.4 billion budget.

For example, if the current budget is $12 billion and Trans Mountain’s capped costs represent 75%, Trans Mountain is on the hook for $3.45 billion of that amount—a toll subsidy of about $2.42 a barrel. Where is Trans Mountain going to get the revenue to cover its share of the cost? It is going to get it from Canadians.

4. Trans Mountain knows that any increase in the amount borne by Trans Mountain reduces the project’s financial viability because Kinder Morgan was concerned about this risk when it explained its serious exposure to cost overruns to the CER during the Toll Hearing. Despite all the spin that political interference caused Kinder Morgan to sell Trans Mountain, the company was motivated by the financial reality that after March 2017, it was on the hook for an increasing share of the cost, and its rate of return was quickly being eroded.

Regrettably, Ottawa has not provided an updated Class I project budget as it promised it would more than a year and a half ago. Nor has Ottawa informed Canadians about the risk of capped costs versus uncapped costs to the project’s financial viability and to the federal treasury.

This is how Kinder Morgan explained the risk to its shareholders more than a year and a half ago. Remember, the capped, 76% portion, is the risk of cost overruns to Trans Mountain.

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For each $100 million in capital cost increase the shippers pay an average of $0.07 per barrel. $12 - $7.4 = $4.6 billion. 46 x $0.07 = $3.22 per barrel. $5.17 + $3.22 = $8.39 per barrel.
Capped costs are structured as follows:
- Costs above the capped cost amount are the responsibility of KML.
- Costs below the capped cost amount will be reflected in lower tolls for shippers by ~$0.07/bbl per $100mm of capital cost for the benchmark toll.

Ununcapped costs:
- Price of steel for pipe
- 2 of 7 of the more difficult pipeline construction spreads totaling ~10% of the project
- 1 mountain spread in the Coquihalla Summit, British Columbia (spread 5b)
- 1 urban spread between Langley and Burnaby, British Columbia (spread 7)
- Land acquisition costs between Langley and Burnaby
- All consultation and accommodation costs including indigenous and non-indigenous communities
- Burnaby Tunnel

Ottawa must provide to Canadians an updated capital cost with sufficient detail to enable an assessment of the capped cost exposure facing Trans Mountain.

A capital cost budget provided in Trans Mountain’s Toll Hearing in 2013 gives a clearer indication of the breakdown between capped and uncapped costs once the CPCN Cost Estimate is locked in. That schedule is reproduced below.

Table 3
Cost Estimate Filed FSA and TSA Schedules January 10, 2013. All figures in millions.

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost Estimate $5.4b</th>
<th>Capped Costs $5.4b</th>
<th>Uncapped Costs $5.4b</th>
<th>Uncapped Cost Items</th>
<th>Trans Mountain Costs Current Budget $??..?b</th>
<th>Shipper Costs Current Budget $??..?b</th>
<th>Total Cost Current Budget $??..?b</th>
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<tbody>
<tr>
<td>Project Management (incl. Regulatory)</td>
<td>209.9</td>
<td>209.9</td>
<td>0.0</td>
<td>None</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engineering (including Survey &amp; Environment)</td>
<td>275.7</td>
<td>275.7</td>
<td>0.0</td>
<td>None</td>
<td></td>
<td></td>
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<tr>
<td>Pipeline Materials</td>
<td>720.5</td>
<td>191.8</td>
<td>528.7</td>
<td>100% of bare pipe at mill</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land (ROW)</td>
<td>403.8</td>
<td>222.0</td>
<td>181.8</td>
<td>100% ROW Fort Langley Westridge (34 km)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pipeline Construction and Inspection</td>
<td>2333.3</td>
<td>2018.5</td>
<td>314.8</td>
<td>100% Coquihalla Summit Wahleach (74km) 100% Fort Langley Westridge (34km)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Facilities (incl. Terminals and Stations)</td>
<td>1391.6</td>
<td>1391.6</td>
<td>0.0</td>
<td>None</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commissioning (incl. Loop Reactivation)</td>
<td>68.3</td>
<td>68.3</td>
<td>0.0</td>
<td>None</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>103.2</td>
<td>4.1</td>
<td>99.1</td>
<td>100% of Consultation &amp; accommodation costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td>5506.3</td>
<td>4381.9</td>
<td>1124.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm Service Fee Credit</td>
<td>(136.3)</td>
<td>(136.3)</td>
<td>0.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Cost Estimate</td>
<td>5370.0</td>
<td>4245.6</td>
<td>1124.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Kinder Morgan did not update the capped versus uncapped summary for the $6.8 billion or the $7.4 billion budget which is why the table above relies on figures from the $5.4 billion budget. It is important to recognize that when this budget was prepared, the full effect of the $5.4 billion cost was incorporated into the toll rates shippers would pay, but the line items were separated into capped and uncapped. For example, if the $5.4 billion budget had been locked in, and then Project Management costs (the first item) rose above $209 million, the amount above $209 million would be borne by Trans Mountain and not flowed-through to shippers in their toll rates.

It would be responsible for Mr. Morneau to ensure that the three columns at the end (which I have added to Kinder Morgan’s filing) be completed. This would facilitate an accurate and reliable representation of the construction cost risks to which Trans Mountain is exposed, and by extension the construction cost risks to which Canadians are exposed.

When Ottawa provides this information, it must include the AFUDC amount which, for comparative consistency, was imbedded in each of the line items in the table above. It would also be helpful for Ottawa to indicate the total quantum of AFUDC and an estimate of the contingency related to the budget since Trans Mountain’s $5.4 billion did not appear to identify contingency. The exclusion of a contingency fund is likely because it was a preliminary Class IV budget.

Mr. Morneau may assert that Trans Mountain’s expansion represents a sound investment for Canadians, and yet he provides no evidence that this is the case. All available information points to just the opposite.

Canadians deserve to know how the arrangements in the capital cost sharing agreement translate to toll rates, along with the degree to which the revenue stream is compromised when Trans Mountain directly bears the majority of cost overruns beyond $7.4 billion. This information would assist in preparing a realistic and reliable net present value calculation.

Ottawa must provide a discounted cash flow assessment based on the price it paid to purchase the existing pipeline and the expansion project, the toll rates it receives for the existing pipeline, the toll rates expected on the system once the expansion is complete, operating costs, commercial terms for interest expense and a current capital cost and construction schedule for the expansion that reflects Trans Mountain’s obligation to pay capped costs.

Much has been discussed about the discounted cash flow analysis provided in Kinder Morgan’s Fairness Opinion, particularly since the Parliamentary Budget Office relied upon it to evaluate whether Ottawa overpaid for the 66-year old pipeline and the right to expand the system.

It should be noted that the Fairness Opinion was undertaken from the perspective of Kinder Morgan retaining Trans Mountain, not from the perspective of Ottawa overpaying for it. As a result, there are a number of misrepresentations in the analysis when applied to Ottawa’s purchase.
The cash flow analysis provided in the Fairness Opinion should not be used to evaluate Ottawa’s purchase because it egregiously overstates the likely cash flow and returns.

The first issue is that the cashflow statement in the Opinion assumes all project costs to date were sunk costs, whereas Ottawa picked up those costs and debt financed them.

The second issue is that there is no accommodation for the $3 billion expenditure Ottawa made for the existing pipeline.

The third major misrepresentation is that the shippers would pay all construction costs, when we now know Trans Mountain will bear the brunt of costs beyond $7.4 billion. This does not appear to have been contemplated in the cash flow for the Opinion in either the $8.4 billion or $9.3 billion net present value calculation.

These are serious issues and when corrected would reveal that the expansion project is not financially viable.

One final word. It is important to recognize that the subsidy on the existing tolls for the operating pipeline will continue whether or not the expansion is built, because the expansion costs are placed on top of the existing tolls, and there is nothing in the toll agreement for the expansion that will change that. If a subsidy exists before the expansion it will continue after it because of how the toll methodology is designed.

This is why the cost to Canadians on the existing line and the cost to Canadians on the expansion are added together.

The Oceans Protection Plan

When it set out to expand Trans Mountain. Kinder Morgan knew it faced serious marine transport safety hurdles. In February 2013, Kinder Morgan Canada president, Ian Anderson told the CER that, “One of the greatest challenges I believe in providing British Columbians with the confidence and trust will be confidence and trust that the tanker traffic industry itself can be operated safely through that port.” (paragraph 1176)

Oil producers at that toll methodology hearing confirmed it would be a "great cost challenge" to ensure the safe transport of toxic diluted bitumen through marine waterways. They also confirmed they were willing to pay that cost.

Suncor said, “The other great cost challenge will be ensuring that the public, regulators, and governments are satisfied the tanker traffic through the Port of Vancouver and Canadian territorial waters and beyond can be undertaken as safely as practicable. This is entirely a shipper cost … Trans Mountain has agreed to essentially negotiate on behalf of shippers what these costs might be, but it takes no liability or responsibility for paying them. Regardless of what the costs
are determined to be, the shippers have to pay them…” (emphasis added, paragraphs 7699 – 7701)

Similar acknowledgement is peppered throughout Toll Hearing transcripts. Trans Mountain, the shippers and the CER all know this—they were in the room when the promises were made.

Yet, when Prime Minister Trudeau announced the Oceans Protection Plan—which he confirmed is needed because of the risk posed by the tanker traffic triggered by Trans Mountain’s expansion—he put this cost on the backs of taxpayers. Trudeau handed oil producers a huge subsidy the industry never expected to receive while unnecessarily burdening Canadian taxpayers in the process.

The Oceans Protection Plan isn’t all for Alberta’s tar sands, but the majority is. In fact, Mr. Trudeau stated publicly that without Trans Mountain, “We (Canadians) won’t get the Oceans Protection Plan” at all. For estimating the subsidy, the cautionary principle has been followed, and 2/3 is allocated to Trans Mountain.

Instead of advising cabinet that shippers would willingly bear the cost burden of protecting the marine environment, the CER knowingly withheld this information from decision makers. Nowhere in the May 2016 CER report, or its Reconsideration Report, did the Board alert cabinet to the offer dock shippers made to bear the cost so Canadians wouldn’t need to.

In summary:

Available information puts the cost of Trans Mountain to Canadians at $8 billion

1. $3.4 billion over five years for the existing pipeline;
2. $3.5 billion for the expansion; and
3. $1 billion for Trans Mountain’s pro-rata share of the Oceans Protection Plan.

Robyn Allan
December 4, 2019
Appendix A:

If Trans Mountain had been purchased by a US company listed on the stock exchange, under US GAAP, its share purchase would have been treated as an asset purchase and identified as such in the ITS application. Ottawa would have had to find a different way to hide the subsidy it is giving to oil producers.

Further, if it had been treated as an asset purchase, the CER would have been required to approve the sale before it took place. This means the shippers through their toll rates, and not Canadian taxpayers from their wages and salaries, would have been on the hook for the premium price Ottawa paid for the 66-year old pipeline.

You see, when it was the NEB the CER was required under Section 74 of the NEB Act to review a pipeline sale and pipeline purchase, but it shrugged off its duty when there was a share sale instead of an asset sale. There was no sound reason for the Board to make this distinction, but it helped pipeline owners make more money.

Other regulators are not so derelict in their duties. For example, the BC Utilities Commission considers a change of control to be the important trigger for a review (which is the prudent way to look at the issue), not how the change in control takes place. Since many companies engage in share deals to reduce their tax obligations, the CER is side-stepping its responsibilities in a clever two-step: one it does not review changes of control when controlling interest changes through a share purchase and two, it can claim plausible deniability about taxpayers being sold short when companies engage in purchase structures that reduce their tax liability.

When companies sell shares rather than assets, they treat the gain as a capital gain which means only half the gain is taxed leading to a lower effective tax rate than if the gain were taxed as profits. When assets are sold at a premium, the revenue is taken into income and taxed at the higher corporate tax rate.