Exhibit No. ____ (CAO-6)
Docket No. TO-011472
Witness: Christy Omohundro

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission,	)	DOCKET NO. TO-011472
Complainant,	)	
v.	)	
Olympic Pipe Line Company, Inc.	)	
Respondent.	)	

EXHIBIT TO
REBUTTAL TESTIMONY OF
CHRISTY A. OMOHUNDRO

OLYMPIC PIPE LINE COMPANY

June 11, 2002

M E M O R A N D U M

June 23, 1983

TO: Jim Ainey, Accounting Division Chief
A. G. Duclos, Administrator of Transportation
Tony Cook, Utilities & Accounting Administrator

FROM: Bob Colbo, Accounting Analyst
Edward J. Nikula, Supervisor - Revenue Requirements EJN

SUBJECT: Olympic Pipe Line Company, Inc. - Rate Increase

General

On Tuesday, May 17, 1983, the above-named oil pipeline company filed WUTC Tariff No. 16 to become effective July 1, 1983. This new tariff establishes higher rates generally averaging 15-20% to all Washington destinations except Sea-Tac Airport where the proposed rates are 30% higher than at present. Olympic's pipeline runs from the refineries at Cherry Point, Ferndale and Anacortes, Washington southward along the eastern side of Puget Sound and continues on to its final destination in Portland. Present rates have been in effect since 1978, and current activity is split approximately 50/50 between Washington intrastate and interstate deliveries. Total daily volume is averaging 195,000 bbls/day.

Olympic Pipe Line Company is a joint venture of Shell Pipe Line Corp. (43.5%), Texaco, Inc. (27.0%) and Mobil Pipe Line Company (29.5%). Mobil acts as general partner by assuming day to day operational control and overall management responsibility.

This proposal seeks to eliminate the current price differential existing between intrastate and interstate moves (on a per mile basis) and, if effective, will bring Washington rates equal to present interstate levels as approved by the Federal Energy Regulatory Commission (FERC).

The evidentiary material supplied by Olympic in support of their proposal, and the underlying books and records from which they were drawn, have been reviewed by the staff. Such material was in the form of, and seeks similar revenue need determinations consistent with, current FERC methodologies. These guidelines were enunciated in the 1982 "Williams" Pipe Line Co. decision, the first oil pipeline rate case decided by FERC since it assumed regulatory control over oil pipelines from the Interstate Commerce Commission (ICC) in 1977.

Williams Methodology

Using FERC techniques, the following tabulation determines allowable returns on Valuation Rate Base and Equity. The reasons and theory behind such an approach are explained at some length in the attachments that follow, particularly Foster Oil Pipeline Report No. 59 "Summary of FERC Decision in Williams Proceedings." See Attachment A.

TABLE 1
Olympic Pipe Line Company
Allowable Earnings With
Williams Decision Methodology
(000 Omitted)

A.	Twenty-Five Leading U.S. Oil Companies Nominal Return on Average Shareholders' Equity for the Five Years Ended December 31, 1982 (1)	18.1%
	Average Inflation included in Valuation for Five Years Ended December 31, 1982	(4.3%)
	Subtotal	13.8%
	Debt Guarantee Premium (2)	2.5%
	Total Return	16.3%
B.	Estimated FERC Valuation (Year End 1982)	72,044
	Deferred Tax Credits (Year End 1982)	(6,387)
	Long Term Debt Outstanding (Year End 1982)	(32,463)
	Rate Base for Return (Equity)	33,194

(1) As published by API - Average Return on Equity of 25 Leading U.S. Oil Companies.

(2) Approximation based on informal conversations with lending institutions as well as on preliminary research performed by other pipeline companies.

Using the above ratios, historic 1982 actual and projected future earnings levels are portrayed below:

TABLE 2
Williams Methodology
Olympic Pipe Line Company
Actual & Projected Earnings
(000 Omitted)

Line No.		Actual 1982 (a)	1982 w/ 7/1/83 Increase (b)	1983 w/ Full Yr. Impact Proposed Rates (c)	1983 w/ 1984 Expense Levels (d)
1.	Revenue	$ 20,218	$ 20,908	$ 21,563	$ 21,563
2.	Operating Expense	8,407	8,407	8,761	8,995
3.	Interest Expense	2,552	2,552	2,470	2,320
4.	Total Expense	10,959	10,959	11,231	11,315
5.	N.O.I. (BFIT)	9,259	9,949	10,332	10,248
6.	Federal Income Taxes	4,547	4,557	4,680	4,642
7.	Net Income (AFIT)	4,712	5,392	5,652	5,606
8.	Debt Guanantee Premium	811	811	924	924
9.	Carrier Return	$ 3,901	$ 4,581	$ 4,728	$ 4,682

TABLE 2 (cont.)

Line No.		Actual 1982	1982 w/ 7/1/83 Increase	1983 w/ Full Yr. Impact Proposed Rates	1983 w/ 1984 Expense Levels
10.	Estimated FERC Valuation	$ 72,044	$ 72,044	$ 74,652	$ 74,652
11.	Deferred Tax Credits	(6,387)	(6,387)	(6,690)	(6,690)
12.	Long Term Debt	(32,463)	(32,463)	(30,987)	(30,987)
13.	Rate Base for Return	$ 33,194	$ 33,194	$ 36,975	$ 36,975
14.	Return on Valuation (L. 7 ÷ L. 10)	6.5%	7.5%	7.6%	7.5%
15.	Return on Equity (L. 9 ÷ L. 13)	11.8%	13.8%	12.8%	12.7%
16.	Debt Premium (L. 8 ÷ L. 13)	2.4%	2.4%	2.5%	2.5%

Column (a) is actual 1982 as contained in Olympic's annual report. Column (b) is 1982 data restated as if the instant proposal became effective July 1, 1982, and is the basis used to determine the size of the current proposal. Specifically, the Williams' 13.8% return on valuation (less long term debt and deferred tax credits) is achieved. Columns (c) and (d) give full year impact to the current proposal and predicts earnings based on 1983 and 1984 budgeted expenses. Additional detail on the determination of Valuation Rate Base is included as Attachment B.

WUTC Methodology

Using more traditional Washington Utilities & Transportation Commission procedures, the above results from Table 2 could be recast as follows:

TABLE 3
Olympic Pipe Line Company
WUTC Basis
Rates of Return

	(a)	(b)	(c)	(d)
Net Income (AFIT) L. 7	$ 4,712	$ 5,392	$ 5,652	$ 5,606
Add back:				
Interest Expense	2,552	2,552	2,470	2,320
Net Operating Income (AFIT) L. 7	$ 7,264	$ 7,944	$ 8,122	$ 7,926
Year End Rate Base: (Orig. Cost Less Accum. Depr. & Def. Tax Credits)	$31,522	$31,522	$31,522	$31,522
Rate of Return - %	23.0	25.2	25.8	25.1

Olympic Pipe Line Company's target rate of return can be determined from its Capital Structure at December 31, 1982 (000's ommitted):

TABLE 4
Olympic Pipe Line Company
Capital Structure &
Target Rate of Return

Source of Funding	Year End Balance	% Distribution		Cost Rate		Embedded Cost
Long Term Debt:	$ 8,526	(20.59)	x	4.70%	=	.00968
	23,800	(57.48)	x	8.85%	=	.05087
	138	(0.33)	x	11.45%	=	.00038
	32,464	(78.40)				
Accum. Defd. FIT Credits from Accel. Depr.:	6,386	(15.42	x	Ø%	=	Ø
Equity (18% cost rate is an assumption for illustration purposes only)	2,561	(6.18)	x	18.00%	=	.01112
Total Capitalization	$41,411	100.00		-		.07205
Target Rate of Return						7.21%

Discussion

As can be readily observed, the revenue need determination in this case depends on whether or not the commission is willing to adopt current FERC quidelines, or rely on the more traditional pro forma restated year with original cost, depreciated rate base. The staff feels this matter should be a policy determination of the commission itself, and Attachment A, earlier mentioned, will provide FERC's reasons (essentially Olympic's arguments) in support of the new process.

Recommendation

From a cost of service standpoint, therefore, it is recommended that should the commission accept FERC's methodology, WUTC Tariff No. 16 be allowed to become effective July 1, 1983, as filed. However, under the more traditional pro forma, depreciated rate base format, it is recommended that the filing be suspended and set down for hearing unless voluntarily withdrawn.

cc: B. Mar
E. Otis
R. Wells
R. Jacobson

BC:df

Commission accepted the filing + allowed to become effective 7/1/83 as filed.

SUMMARY OF FERC DECISION IN WILLIAMS PROCEEDING

On 11/30/82 the FERC issued Opinion No. 154 in the Williams Pipe Line Co. rate proceeding (OR79-1-000) ruling on questions of ratemaking methodology to be applied to oil pipelines. The major conclusions of the decision are to retain the ICC valuation rate base approach but to discard the ICC industry rate of return standards (8% on valuation for crude pipelines and 10% on valuation for product pipelines) in favor of case-by-case return determinations, including a "real, entrepreneurial" rate of return on equity. Commissioner Hughes dissented to much of the decision; Commissioners Sheldon and Richard issued separate concurring statements.

The Commission's decision was appealed the same day it was issued -- to the Tenth Circuit by oil pipeline interests (Association of Oil Pipe Lines and Williams Pipe Line Co. v. FERC, No. 82-2459) and to the D.C. Circuit by the complainant shippers (Farmers Union Central Exchange et al. v. FERC, No. 82-2412).

Termed a "treatise" by Commissioner Hughes, the FERC Majority decision is 391 pages in length 1/ (excluding dissenting and concurring statements), about half of which is devoted to a discussion of the genesis and history of oil pipeline regulation and its current insignificance to ultimate consumers of oil products. Much of the historical discussion reviews at length the writings in the early 1900's of Miss Ida M. Tarbell, an ardent and apparently prolific crusader against John D. Rockefeller and the efforts of Standard Oil Co. to squeeze out independent producers and refiners. According to the Commission, this sentiment was a major force prompting the passage in 1906 of the Hepburn Act provisions which brought oil pipeline rates under ICC jurisdiction. Unlike the Federal Power Act and Natural Gas Act, the Commission stressed, the Hepburn Act was a "producer protection measure," not a consumer protection measure. In view of this historical background, coupled with the minimal impact of oil pipeline rates on consumers and significant differences in the function and impact of rate regulation on oil pipelines compared to public utilities and natural gas pipelines, the Commission found no justification for vigorous cost-based regulation.

The summary below covers the Commission's holdings in regard to (1) the need for a "lighthanded" or "liberal" regulatory approach for oil pipelines; (2) adherence to the ICC's rate base formula (with only minor exceptions); (3) transfer of assets; (4) discarding of the ICC's 8% and 10% rate of return tests and adoption instead of a new company-by-company approach to rate of return determination; (5) certain questions relating to the computation of federal income taxes for ratemaking purposes; and (6) certain other matters. Concurring and dissenting statements are also reviewed.

1/ The decision -- drafted by Bernard Wexler, Director of the FERC's Office of Opinions and Review -- contains 581 footnotes, many of which exceed one page in length and several two pages. Aside from their number and length, the footnotes are notable for their copious references to contemporary and not so contemporary writings on oil pipeline regulation and, with the exception of some citations of certain briefs, for their virtual lack of reference to the record in this proceeding.

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Reasons for "Lighthanded" Regulation

As noted, over half of the FERC's 391-page opinion was devoted to describing the history of oil pipeline rate regulation, including the circumstances leading to passage in 1906 of the Hepburn Act (which gave the ICC jurisdiction over oil pipeline rates) and what that Act meant for oil pipelines, as well as the "utter insignificance" of the oil pipeline rate controversy to contemporary American consumers. The purpose was to support the Commission's view that aggressive federal intervention is unwarranted for the oil pipeline industry and that a "lighthanded" method of regulation should be followed.

At the same time, the FERC urged that Congress take a "fresh and hard look" at oil pipeline rate regulation. The present statute -- enacted 76 years ago in a "great hurry" without any semblance of supporting economic analysis -- is today "an artifact of the age of the horse, the buggy and the kerosene stove." Until that legislation is reexamined, "oil pipeline rate law will remain a quagmire for this agency and for reviewing courts. Judges and administrators will have to guess about what the Congress of 1906 thought or would have thought about an economic and a technological environment that it could not possibly have foreseen." The Commission noted a number of possible legislative options, any one of which -- if adopted after informed debate -- would provide some guidance. In this regard, the Commission acknowledged that it has quasi-legislative powers and presumably could take the actions sought by the critics of the pipeline status quo. However, the Commission declared, "the task of articulating what public policy should be toward this important industry is for the legislative branch." The question here is not one of legal power, but one of "policy, political science and prudence." Absent "a clear and a contemporary legislative mandate," it is not the Commission's role to "reshape the oil pipeline industry or any other industry." The situation would be different, the Commission added, if the status quo had been shown to cause "gross injustice" or "palpably deleterious" effects on the general welfare.

In the way of historical background, the Commission reviewed at length the writings of Miss Ida M. Tarbell and others in the very early 1900's attacking Standard Oil Co.'s monopolistic practices and attempts to squeeze out small independent producers and refineries. Partly as a result of this crusading, Congress by 1906 was "itching" to do something about Standard Oil, and that "something" took the form of a legislative attack on the oil pipeline problem. In fact, in proposing the amendment to the bill that later became the Hepburn Act, the amendment's sponsor made clear that its only purpose was to restrain Standard Oil. Thus, the Commission declared, the historical genesis of oil pipeline regulation is quite different from the genesis of electric power and natural gas pipeline regulation. Specifically, whereas the Federal Power Act and Natural Gas Act were based on exhaustive utility studies made by the Federal Trade Commission between 1928 and 1935, the oil pipeline provisions of the Hepburn Act appear to have been based solely on "visceral reaction." The Hepburn Act was a producer-protection measure, not a consumer-protection measure as the Federal Power and Natural Gas Acts. The apparent intent of Congress was to redress "an imbalance of economic power among entrepreneurs." Viewed in this light, the Commission observed, the ICC's "permissive stance" on oil pipeline rates was not quite so "outlandish" as it first seemed.

Furthermore, the Commission noted, it seems clear that the Hepburn Act was aimed at forbidding "prohibitive" pricing by Standard Oil. Hence, the phrase "just and reasonable" appearing in that Act was not used in the public utility sense but in the sense of ordinary commercial "reasonableness." In other words, rather than seeking to limit carriers' rates to "barebones cost," the Hepburn Act was intended "to restrain gross overreaching and unconscionable gouging."

Based on the above historical background, the Commission found no mandate for rigorous, cost-based regulation. To the contrary, the historical record indicates "substantial question" regarding the Commission's power to regulate the oil pipeline industry along classical public utility lines. Furthermore, Congress never expanded the ICC's powers over oil pipelines after 1906. "What we have here is pure rate control unaccompanied by other restraints on entrepreneurial freedom. Legislators intent on rigor would, we think, have fashioned something more rigorous." The D.C. Circuit -- in inferring "'a Congressional intent to allow a freer play of competitive forces among oil pipeline companies . . .'" -- appears to have reached a similar conclusion, the Commission said.

The Commission also discussed the minimal impact of oil pipeline rates on ultimate consumers. In 1981, the average pipeline charge was 61¢/bbl., excluding TAPS, or approximately 1.5¢ per gallon. Again excluding TAPS, aggregate carrier oil pipeline revenues in 1981 totalled $3.2 billion, or only about 1.34% of the $240 billion spent by the American public for petroleum products in that year. Moreover, the Commission noted, because of both market forces and the lack of any legal mechanism for flowing through pipeline rate reductions to the ultimate consumer, there is no assurance that any lower transportation costs to the refiner would necessarily mean lower prices for the motorist and the homeowner. Rather, in the short run at least, "it is just as likely to mean better margins for refiners who are not shipper-owners." While some consumers might in some circumstances reap some slight benefit from lower oil pipeline charges, the Commission added, such benefit would be of "microscopic dimensions," if present at all. From the consumer's perspective, oil pipeline rate regulation "is akin to efforts to do something about the high price of shoes by controlling the price of shoe laces."

In addition, the Commission observed, it has been many years since any charges have been heard about "prohibitive pricing" by oil pipelines. In 1931, pipeline charges averaged 44¢/bbl., or about 68% of the 65¢/bbl. sales price of crude oil. Subsequently, average pipeline revenue fell to 21% of the cost of crude in 1941, 10% in 1951, 8% in 1961, 6% in 1971, and 2% in 1981 (61¢/bbl. compared with a $31.77/bbl. cost of crude). These statistics suggest that the oil pipeline rate reform crusade is "anachronistic." Also, the fact that average oil pipeline revenue in 1979 was still below the 1931 average revenue in nominal terms (41¢/bbl. versus 44¢/bbl.) indicates that marketplace forces have held prices down.

The Commission added that there are probably many instances where shippers "deem it politic to pay more (perhaps on occasion a good deal more) than they would like to pay for the sake of peace and quiet. But obviously this patience has its limits. It follows that few, if any, pipeline owners are able to gouge their most important customers with impunity. And since the statute bars rate discrimination, small shippers are the unintended incidental beneficiaries of the potential competition among the giants."

Given the fact that pipeline transportation charges today constitute "an almost infinitesimal component" of the price of oil to ultimate consumers, the Commission termed the case for aggressive federal intervention in oil pipeline ratemaking "flimsy." The substantial costs of rigorous oil pipeline regulation "do not justify an incremental consumer benefit of a fraction of 2%."

Further, the Commission added, "the dangers of giving too little vastly outweigh those of giving too much." The major danger is underinvestment. Hence, it seems best "to err on the side of liberality."

Rate Base

With certain minor exceptions, the FERC adhered to the so-called "Oak" rate base formula inherited from the ICC. If "writing on an absolutely clean slate" and "beginning afresh in a brave new world," the Commission said it would fashion a simpler and more logical "inflation-sensitive" rate base policy. The simplest and perhaps best approach, the Commission observed, would be to link the rate base to the consumer price index or the gross national product deflator, and allow a real, inflation-free rate of return on the equity portion of that inflation-sensitive rate base. However, because it is not clear that such change would represent enough of an improvement "to warrant the social costs entailed," the Commission on balance found "no cogent reason to depart from the status quo."

The FERC noted a predecessor Commission's request several years ago for remand of the Williams record to begin its regulation of oil pipelines "with a clean slate" and the D.C. Circuit's grant of that request to allow the relevant administrative agency an opportunity "to build a viable modern precedent for use in future cases . . . free of the problems that appear to exist in the ICC's approach." But, the FERC declared, "we cannot escape history. Whatever this Commission's briefs may have said back in 1977 and 1978 and however jaundiced the court's view of the ICC's methodology, the fact is that that methodology has been in place for a long time and that drastic conceptual changes would be disruptive. And . . . such changes would frustrate entrepreneurial expectations that we deem rational, legitimate, and worthy of respect. Perhaps even more important is the total absence of any evidence to support a finding that the incremental benefits of the exercise would be worth its costs."

The Commission conceded that the ICC rate base formula is not characterized by "rigorous logic and Euclidean consistency" and that its "anomalies and inconsistencies would render the method unusable" if the Commission were dealing with "matters of vital import to the consumer." Moreover, "these ancient instruments are much too blunt and much too clumsy for close work." But, the Commission asserted, the objective here is to find a "pragmatic test." For that purpose, "a rate base that might flunk an examination in logic is usable provided that the combination of rate base and rate of return provides a socially acceptable end result." Also, the Commission added, while the ICC formula is "not good," it differs in several respects from the classical fair value approach which was so heavily criticized during the first part of the 20th century. Hence, the formula "is not so bad as it could be."

Further, the Commission continued, it began with a "strong predisposition" in favor of an original cost approach -- which is the "language of American finance" and the basis for FERC regulation of electric utilities and natural gas pipelines. Also, original cost is "easy" and "logical," a description that cannot be applied to the ICC methodology, the merits of which "are not obvious." However, "original cost is not a universal solvent," and this case is not "a public utility inquiry." Rather, "it is more akin to the sort of an inquiry that a court makes in fixing a 'reasonable' attorney's fee, 'reasonable' alimony after the breakdown of a marriage, or a 'reasonable' price for a good or a service when it holds for the plaintiff in an action sounding in quantum meruit."

Upon closer examination, the Commission concluded that implementation of an original cost methodology for oil pipelines would entail "lots of headaches." One major "headache," the FERC explained, relates more to rate of return than to an original cost rate base, but "these two subjects cannot be isolated from each other." In fact, "the

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1/ The Commission made clear it did not intend to depart from the original cost methodology in its electric and gas pipeline rate work.

real regulatory justification for an original cost rate base is that it facilitates rate of return analysis." Specifically, the Commission foresaw many difficulties in determining a cost of capital rate of return due to the widespread practice of financing oil pipelines on a virtually all-debt basis, parent company debt guarantees, and the near impossibility of determining a pipeline's stand-alone capital structure. For this industry, the Commission declared, construction of hypothetical capital structures would create "a perfect field day for regulatory economists. Professor A would testify that he thinks 70% debt and 30% equity right. Professor B would say 53% debt and 47% equity. Professor C would come on strong for 50-50. Miss D from an eminent Wall Street investment banking firm would testify that her computer tells her that 65% equity and 35% debt are the right mix. Mr. E from an even more eminent investment banking firm would have other numbers of his own." The Commission "would have to choose among these scenarios" and, since the industry is so "heterogeneous," would "probably have to do so over and over again." Such endeavor "would be a laboricus exercise in guesswork, a venture 'into the unknown and unknowable.'" For this reason, the Commission had little faith in its ability to estimate the oil pipeline industry's real cost of capital "with any semblance of precision."

Another difficulty, the Commission stated, relates to the assessment of risk. Whereas risk analysis for utilities "is at the heart of the process by which regulators balance the conflict between the investor's interest and that of the consumer," oil pipelines present a different situation in that investment decisions are made by oil company managers with no shortage of investment opportunities. Thus, whether or not oil pipelines are relatively risk-free will not induce integrated oil companies and profit-maximizing conglomerates to commit funds without "some assurance that they have a fair chance of earning as much on a pipeline as they would be likely to earn on something else in the unregulated sector." 1/ For this reason, even assuming most oil pipelines were low risk propositions, "it does not follow that the allowed rate of return should be as low as (or even in the general neighborhood of) those that regulators normally give to telephone companies and electric utilities."

The Commission discussed the subject of risk -- which, for the reasons noted above, it did not find particularly relevant -- in a footnote. The Commission concluded that independent oil pipelines, because of the lack of captive customers, face "appreciably greater" risks than natural gas pipelines. As to shipper-owned oil pipelines, the Commission noted vigorous competition from water carriers in many instances -- competition from which gas pipelines are immune -- and a greater number of instances where oil pipelines have had to be financially rescued relative to gas pipelines. Thus, on balance, the Commission viewed most oil pipelines as "probably at least somewhat riskier than most natural gas pipelines," but said that risk difference cannot be quantified. And even if it could be quantified, the number "would be of little aid in dealing with concrete cases involving particular pipelines."

Aside from the rationale described above, the Commission advanced three further considerations for not switching to an original cost rate base methodology.

1/ In this connection the Commission complained that most of the massive record in this case was devoted to financial analysis, which was not especially helpful. "Experts discoursed at length on risk, on competition, on the rates of return that investors in this, that, and the other thing have required, were then requiring, were likely to require in the future, and ought to require were they as rational as the witnesses and also as well-informed as they about the ups and downs in the stock market since 1926, about the history of interest rates, about how bondholders have fared over the long run, and kindred subjects. . . . In spite of the witnesses' eminence and academic attainments, their testimony seems beside the point."

The first relates to different industry "cultures." Specifically, "the pervasive controls, the ubiquitous regulation, and the franchised monopolies long characteristic of electricity, gas and telephones have formed a culture altogether different from the culture of oil and of the unregulated sector generally. Prospective returns that will induce investment by electric utilities and by natural gas transmission companies are not certain to have the same effect on oil companies. The culture of oil is not a public utility culture." In consequence, needed new oil pipelines will not be built unless they are expected by oil company managers to be an attractive capital budgeting option. Hence, "the original cost rate base, barebones cost of capital rate of return model cannot be expected to work here in the same way that it works in electricity, in gas, and in telephones. This is not to say that the model would not work for oil pipelines. But we think it clear that its oil pipeline fruits would cost more than its electric and telephone fruits."

Second, the Commission noted transitional questions which a radical switch in methodology would entail. While pipeline owners have no vested right to the perpetuation of a particular methodology, the Commission stated, it seems fairly clear that the industry has relied on continuation of the ICC valuation approach. That reliance is not binding, but neither should it be ignored. "The benefits that should be present before we decree a radical change in the oil pipelines' rate bases are not at all apparent . . . ."

Third, the Commission described the "front-end load" problem inherent in the original cost methodology. The problem stems from the bunching of income in the early years of a pipeline. However, because of actual or potential competition, a carrier may be unable to collect what regulation would allow in the first few years, but at the same time would be prevented by regulation from collecting what competition would permit in later years. This tends to have a "chilling effect on new pipeline investment." While the carriers' arguments along this line are "exaggerated," the Commission nonetheless found that the "front-end load" phenomenon is "not wholly imaginary" and that it also could have a far greater impact on oil pipelines than on electric utilities and natural gas pipelines, which are continually placing new plant in service as old plant is retired. Hence, an inflation-sensitive oil pipeline rate base mitigates the "income-bunching" effect of original cost regulation.

The Commission then called attention to a number of specific defects in the ICC formula. For example, the industry complained that land is included at only half its worth, that interest during construction is only 6%, that the cost of pipe coating has not been adjusted for inflation since 1960, and that reproduction cost is systematically understated by the use of a five-year "period index." However, the Commission noted, the sums involved here are either insubstantial or else are compensated by the 6% going value allowance which, absent undercounting elsewhere, would be "pure water." Other more disturbing features of the ICC formula, in the Commission's view, are the "mismatch" between the straight line depreciation used for cost of service purposes and the "condition percent" depreciation employed for rate base purposes, and the derivation of useful lives on the basis of ancient studies which disappeared many years ago. Nevertheless, these are "technical details" which are better treated through rulemaking, preceded by intensive staff studies.

Thus, for the present, the Commission decided to stick to the status quo until Congress considers the oil pipeline scene and provides a better guide for regulatory treatment. If there is no legislation and if the Commission is able to devote the necessary resources to oil pipeline rate base revision "without detriment to other programs of greater import, we or our successors may revisit this scene."

Also, as noted, the Commission adopted two exceptions to its adherence to the ICC formula. These exceptions -- termed "minor tinkering" by Commissioner Hughes in his dissent -- were (1) to eliminate "used but not owned" property from the rate base, since it is "egregious double counting" to give the carriers a return on property they never made; and (2) to leave the question of working capital open to challenge by shippers, carriers or other interested parties desiring to demonstrate a particular carrier's actual cash working capital needs. The Commission explained that the ICC's rule-of-thumb formula appeared "dubious," but that working capital accounted for only about $67 million or 0.75% of the industry's aggregate rate base at the end of 1979 (exclusive of TAPS). Moreover, much of the $67 million consisted of materials and supplies. In these circumstances, although the oil pipeline industry's cash working capital needs are minimal, the Commission decided to attach "a weak rebuttable presumption of correctness" to the ICC's traditional working capital formula. However, that formula will control only if no litigant chooses to question it.

In addition, the Commission noted the possibility of situations where the gap between cumulative cost of service depreciation and rate base depreciation may be so wide as to require some remedy. While that problem is not apparent for the industry as a whole -- which, the Commission said, is 42% depreciated under the straight line methodology used for cost of service purposes and 47% depreciated under the condition percent methodology -- it could arise in individual cases. In that event, fairness to shippers requires that the rate base be "pruned." The Commission added that it could not determine from the record whether such "pruning" should occur in the case of Williams and hence left the question for consideration in the second phase of this proceeding.

Transfer of Assets

The transfer of assets was a particular question in the instant proceeding since Williams purchased its pipeline system in 1966 at a price of $287.6 million, $120 million more than the then ICC valuation of $167.6 million. The ICC adopted a bifurcated approach under which the purchase price was not reflected in calculation of the rate base but was reflected in the calculation of depreciation for cost of service purposes.

The FERC agreed with the D.C. Circuit's view in Farmers Union that this "unexplained anomaly of a valuation rate base coexisting with a purchase price depreciation base" was totally irrational. Hence, the Commission ruled that Williams' purchase price is entitled to no recognition for any ratemaking purpose. Moreover, that rule shall apply to all future rate cases involving the purchase of oil pipeline property at prices either above or below depreciated original cost, except where the purchaser can affirmatively show by clear and convincing evidence that the acquisition conferred substantial benefits on the ratepayers.

Rate of Return

In contrast to its adherence to the ICC's rate base formula, the FERC concluded that the 8% and 10% rate of return standards adopted by the ICC in the 1940's (8% for oil pipelines and 10% for product pipelines) must be scrapped as both irrational and outdated. Not only has the process for deriving those standards never been adequately explained, the Commission noted, but they have been applied "mechanically and religiously decade after decade. That flies in the face of every regulatory principle known to us." In short, the Commission agreed with the D.C. Circuit's view in Farmers Union that the 8% and 10% tests are "'artifacts of a bygone era.'" 1/

1/ The D.C. Circuit also applied the same label to the ICC's rate base methodology. However, as noted, the Commission disagreed on this point, instead finding the rate base methodology to be "still serviceable."

Nor did the Commission consider the 1941 Consent Decree, which limited pipeline dividends to 7% of valuation, as any less irrational. In essence, the Commission stated, the Consent Decree "is an arbitrary test for distinguishing rates that are 'rebative' from those that are not. But rebativeness has no bearing on reasonableness. The idea that a rate is reasonable simply because it is not rebative makes no sense on its face." Furthermore, the Commission added, the Consent Decree is framed as a restraint on dividends, not earnings. "But restraints on earnings are what economic regulation is all about." Thus, the Commission agreed with the Antitrust Division that the Consent Decree "is an unfortunate historical accident that impedes effective regulation and spawns confusion."

Because the applicable historical tradition is "so palpably deficient" and because the parties' arguments -- especially the industry's arguments for an "inflation-sensitive" return on an "inflation-sensitive" rate base -- have been "so unhelpful," the Commission found it necessary to devise its own oil pipeline rate of return methodology. In so doing, the Commission decided that rate of return should be determined on a case-by-case basis and should include three elements: (1) debt service costs; (2) a "suretyship" premium to compensate parent oil companies for any debt guarantees shown to have been "material" to the lenders -- with procedures for deriving these premiums to unfold through case-by-case adjudication; and (3) a "real entrepreneurial rate of return" on the equity component of the valuation rate base.

The "real entrepreneurial" rate of return on oil pipeline equity, the Commission stated, should be "appreciably" higher than allowances granted to natural gas pipelines and electric utilities. This is because "oil companies have lots of places to put their money" and because "the social need in this field is for returns high enough to induce the construction of new pipelines and to avert the premature abandonment of old ones." Toward this end, the Commission identified eight possible comparable earnings standards for determining an equity rate of return -- realized nominal rates of return on book equity for the oil industry during the past five years or during the past year, realized nominal rates of return on book equity for U.S. industry generally over the past five years or in the most recent year, the nominal rate of return realized by the particular parent (or parents) on total nonpipeline book equity over the past five years or in the most recent fiscal year, and total returns (dividends plus capital gains) on a diversified common stock portfolio over the past five years or over the long run (25 years, 50 years, or longer) -- and recommended selection of the measure most favorable to the particular carrier or carriers involved. The Commission said use of a "liberal" yardstick is consistent with the concept that what is needed for the oil pipeline industry is a "cap on gross abuse." If returns do not exceed those being realized "somewhere or other in a roughly comparable segment of the economy's unregulated sector, it is hard to see how they can be branded extortionate or abusive."

This approach of "relative permissiveness," the Commission added, greatly simplifies the risk problem. With respect to business risk, a pipeline can hardly claim "it is so hazardous that it is entitled to more than anybody makes anyplace else." As to financial risk posed by the thinness of equity investment, the Commission said the parent companies "arranged the game" and "set the odds." Hence, "to the extent that the parents' equity investments in [pipelines] are a gamble, it was the parents themselves who elected to gamble." Further, the Commission observed, the rate of return on equity standards proposed here are "far more generous" than those afforded by other regulation -- not only will the levels of return be high, but they will also be applied to a fair value rate base for an industry with mostly debt capital. Thus, "to superimpose generous premiums for self-created financial risks on top of very generous compensation for business risks would be far too open-handed."

To eliminate the "double-counting" problem which could result from applying a nominal rate of return reflecting inflation to an inflation-sensitive rate base, the Commission proposed a procedure which would reduce the nominal rate of return derived from comparable earnings analysis by the percentage increase in the rate base due to inflation during the "relevant period" (defined as the time period considered in deriving the appropriate nominal rate of return).

The Commission conceded that, even after the above procedure to remove the effect of inflation, the resultant returns on book equity may appear to some "outlandishly high." For example, the Commission hypothesized a case where a 14% "real" equity rate of return -- when applied to an aggregate valuation rate base less funded debt -- would yield a dollar return equating to 61% on the book value of equity. However, the Commission declared, the objective here is not to find the lowest rate of return on equity capital that will render the enterprise viable under private ownership. Rather, the question involves the treatment of leverage, including the disposition of gains due to inflation on the value of assets acquired with borrowed money. Under the public utility concept, such gains are deemed to belong to the ratepayer. However, for the purpose of oil pipeline rate of return methodology, the Commission preferred to follow the unregulated competitive market model where the gain goes to the equity investor. In support of this preference, the Commission said competition, both actual and potential, is a "far more potent price-constraining force" for oil pipelines than for other companies it regulates. Also, unlike utilities for which regulation is central to the pricing process, regulation of oil pipelines "has been, is, and . . . should continue to be peripheral to the pricing process. . . . That peripheral function relates to situations in which monopolistic pockets, short-run disequilibria, or other factors produce market prices that are grossly abusive and socially unacceptable." In short, "the mere fact that a carrier's earnings exceed some bureaucratic appraisal of its true cost of capital is not enough to warrant regulatory intervention. Such intervention should be resorted to only in cases of egregious exploitation and gross abuse. Hence, we need a rate of return methodology that will identify such exploitation and such abuse and that will not meddle unduly with the market process."

Further, the Commission reiterated that the primary end of oil pipeline rate regulation is not consumer protection. "It is equity among entrepreneurs." And when entrepreneurs borrow money to acquire productive assets and when inflation leads to an increase in the value of those assets, "they reap the full gain." While a "more austere" standard is applied in the utility field, the Commission added, utility regulation also includes stringent controls on abandonment. For an industry free to abandon without regulatory restraints, however, "application of an austere rate base, rate of return methodology . . . can engender perverse incentives for the socially premature but entrepreneurially advantageous abandonment of useful but fully or almost fully depreciated facilities. This is an important consideration for a society that wants to inhibit waste and to conserve resources. It militates strongly against the slavish imitation of the utility model."

In addition, the Commission observed, the "seemingly outlandish" returns potentially resulting from its methodology "are a by-product of many years of serious inflation. During those years under our methodology, the equity investor gets no compensation at all for inflation in the rate of return. The rate of return on equity is a real rate absolutely devoid of any inflation premium of any sort. Nor has the equity investor been recompensed for inflation in the depreciation component of the cost of service. That is computed on a fixed-dollar basis. These factors must be kept in mind when one gauges the propriety of the handsome rate base writeups and the creamy returns on book equity enjoyed by the owners of our hypothetical . . . pipeline company and by the actual owners of real pipelines of a certain age."

Federal Income Tax Questions

With respect to the treatment of federal income taxes, the Commission ruled that (1) the computation for regulatory purposes should be made on a stand-alone basis (especially since no party in this case had urged flowthrough of the resultant savings to ratepayers) -- subject to a "fresh look" after the validity of that approach has been considered on a generic basis; (2) pipelines may elect to normalize deferred tax benefits resulting from use of accelerated depreciation, although need not do so; and (3) carriers should be allowed the full benefit of the investment tax credit, with no deduction from the rate base.

In regard to the question of normalization versus flowthrough of deferred tax benefits, the Commission noted that the situation for oil pipelines is somewhat different than for utilities. There, the benefits will undoubtedly go to consumption if passed through to consumers, and to investment if retained by the utilities. In the case of oil pipelines, however, the tax savings are almost certain to be invested -- either by shipper-owners or by independent shippers. This raises the difficult issue of whether customers of shipper-owners should provide reimbursement for taxes which the shipper-owners are not now paying. On balance, the Commission opted for normalization for the principal reason that this approach "facilitates the comparable earnings analyses basic to the determination of appropriate rates of return on oil pipeline equity investments." Since rates of return on equity are reported on a normalized basis throughout the economy, the Commission explained, a flowthrough approach would require elaborate adjustments to compare oil pipeline returns with returns of other industries. "That would be administratively difficult. And . . . nothing of substance would be accomplished."

However, as noted, the Commission would not require compulsory normalization. "Competitive considerations may lead some pipelines to prefer lower rates that they can actually collect right now to higher rates that we would permit but which market forces preclude them from collecting. Lines in such circumstances will want to take less now in return for more later. We see no reason to preclude them from doing that."

In the event a carrier chooses normalization, no return will be permitted on deferred tax reserves. This is the general rule for regulated companies, the Commission said, and oil pipelines do not warrant an exception.

With respect to the investment tax credit, the Commission analyzed the history of Section 203(e) of the 1964 Revenue Act, including the replacement of Section 203(e)(1) applicable to public utility property by Section 46(f) of the 1971 Revenue Act and the effect of that change on Section 203(e)(2) of the 1964 Act applicable to non-public utility property. From this analysis, the Commission concluded that Section 203(e)(2) prohibited exclusion of investment tax credits from the rate base of oil pipeline carriers.

Other Matters

Regarding the question of systemwide versus segment-by-segment regulation, the FERC held that systemwide regulation would continue to be the general rule. This avoids the need for "refined inquiries" into the allocation of costs that would be required for segment-by-segment regulation. The Commission made clear, however, that the general rule applies to "systems," as opposed to "companies" with noncontiguous systems. Also, strict regulatory scrutiny will be given to any situations where shipper-owners might design low rates for segments which they use heavily and high rates for other segments patronized mostly by other shippers.

Respecting the matter of transactions with affiliates, the Commission said the burden of justification -- in the event of a complaint -- should be on the pipeline, not the complainant, because of the potential for abuse. The Commission rejected the contention that the Uniform System of Accounts provides sufficient "safeguards" in this area. Payments for such items as managerial services and office space are likely to be the main targets for attack, the Commission noted, and questions on these items cannot be answered from accounting records.

Finally, the Commission declined to prescribe any rules about test periods or throughput variations -- two of the many questions posed by Judge Benkin at the outset of Phase I of this proceeding. Unlike electric utility and natural gas pipeline rate regulation where there is much litigation and the need for guidance, the Commission stated, no detailed filing requirements apply to oil pipelines and "there is no need for Staff analysis." Moreover, oil pipeline rate cases are "rarities" thus far, and there is no reason to anticipate "torrents of litigation in this field." Accordingly, details as "who has to prove what and just when he has to prove it" should be left to the litigants, their lawyers and the Commission's hearing officers.

Concurring and Dissenting Statements

Commissioner Georgiana Sheldon, while concurring in the results reached by the majority opinion, expressed serious reservations regarding the rate of return formula, especially the "suretyship premium" and "real entrepreneurial rate of return on common equity" components. She feared these novel concepts might well become the source of "unproductive and socially undesirable litigation" as well as "handsome" fees for lawyers and expert witnesses. In addition, Ms. Sheldon was concerned that application of the prescribed rate of return methodology might enable the charging of unreasonable rates by those members of the pipeline industry less subject to competition. She urged that the administrative law judge in Phase II of this case should scrutinize the evidence carefully so as both to permit a final decision consistent with the "just and reasonable" standard and to assure a factual basis for the "insurance premium" component. She further requested that the record developed in Phase II be sufficiently broad to allow a generic determination on rate of return.

Although "skeptical" about the workability of the majority's rate of return approach, Commissioner Sheldon added that she had "nothing compellingly better to offer." Therefore, she concurred in the result "for this case and for this day only."

Commissioner Oliver G. Richard, III, also concurring, did not favor a drastic change in the method for regulating oil pipelines without a strong showing that they have earned "outrageous profits compared to similar industries." He noted that the Commission cannot guarantee an oil pipeline's market from competition and cannot correct a miscalculation of what it thought was a fair and adequate return. Mr. Richard further observed that the Commission has received no Congressional mandate to launch "a new era of stringent oil pipeline control," and that any such undertaking would entail "staggering" costs. He therefore concurred with the Majority, while stressing the need for Congress to provide "clear direction" in this field.

Commissioner J. David Hughes, dissenting in part and concurring in part, was sharply critical of the Majority's approach, especially its disposition of rate base and rate of return issues. 1/ Overall, "the product is an apologia for the ICC's

1/ Commissioner Hughes also expressed general opposition to the tone and content of portions of the opinion which he did not specifically address. While the Majority "treatise" on oil pipelines is "erudite, clever and ingenious, there is much irrelevancy, undue length (aside from the 391 pages, there are footnotes which outdistance the body of the text on numerous pages) and some sophistry that, for my literary and legal tastes, could have been omitted."

lethargy in this field" and, as such, does not appear to satisfy the D.C. Circuit's remand in Farmers Union to build a "modern, viable precedent for use in future cases" of the problems surrounding the ICC's approach. In its totality, Mr. Hughes stated, the Commission's opinion decides fewer issues than the ICC's last decision in the Williams case in 1976. In short, much of the Majority's opinion is merely a "smoke screen" for its failure to "adequately review and find a workable solution to an admittedly complex problem."

Commissioner Hughes viewed retention of the ICC's valuation rate base formula, already condemned by the D.C. Circuit, as completely invalid. He said this formula is fatally defective because of its "inflationary debility," its reliance on costs of reproducing existing lines anew (even though technology and other factors have changed), and the irrationality of many of its elements. For example, the ICC "period indices" used to determine reproduction costs have not been updated since 1947, land is included at only half its cost, and the 6% "going value" allowance is "unexplained largesse" (and not seriously supported by any party in the record). The Majority indicated the need for a "fresh look" at the mismatch between straight line methodology for cost of service and condition percent for rate base purposes -- through rulemaking after "intensive Staff studies" -- but then apparently consigned this matter to "an uncertain oblivion" by making the review contingent on both legislative inaction and on its ability to devote Commission resources "without detriment to other programs of greater import."

With respect to rate of return, Mr. Hughes accepted the Majority's decision to compensate equity investors for inflation through trending the debt portion of the rate base -- provided such equity holders receive only a "real" rate of return. However, to the extent the Majority's "real entrepreneurial" rate of return differs from "real" rate of return, Commissioner Hughes would oppose the trending of debt. Moreover, as to the mechanics of the Majority's approach, Mr. Hughes disputed the assumption that changes in a pipeline's valuation approximate the rate of inflation. To illustrate, he compared annual percentage changes in Williams' valuation over the 1971-1981 period with annual changes in the Consumer Price Index and GNP Deflator. Discrepancies in the range of 50% or higher were shown in several years. In 1976, for example, the GNP Deflator Index increased 5.2% and the CPI Index 5.8%, while Williams' valuation increased by 11.3%, more than twice as much. Due to these "gross disparities" between the inflation measures and the valuation changes, Commissioner Hughes said the Majority's approach "would lead to arbitrary and capricious adjustments" having little relation to actual inflation.

Additionally, with respect to the "double counting" question, Commissioner Hughes said the Majority opinion reflects a basic misunderstanding of the manner in which nominal rates of return account for inflation. Nominal returns on equity reflect prospective or future inflation which investors expect will occur. Thus, the "double count" adjustment should remove the perception of future inflation. The Majority's adjustment, however, would remove past increases in valuation, which seem unrelated to future inflation.

Commissioner Hughes also rejected the Majority's explanation for its "generosity" regarding rate of return, namely, the threat that oil pipelines might otherwise go out of business. Mr. Hughes said the Commission should not be hostage to such a "hollow" threat. "Integrated oil companies need their oil pipelines to move their crude to their refineries and to move their product from the refineries to their market."

As an alternative, Commissioner Hughes proposed a variant of the trended original cost methodology recommended by Dr. Stewart Myers, a witness for Marathon Pipeline. This proposal would treat each pipeline addition or expansion as a separate

project for purposes of calculating capital cost. An accounting life would also be determined for each project. Periodically, the Commission would determine an industry-wide real cost of equity capital. Then, using the actual project investment (adjusted for multi-year projects to year-in-service dollars) along with the generically determined real cost of equity capital for each project, a level amortization payment (in year-in-service dollars) would be computed at the time the investment enters service. This computation would yield equal annual or monthly payments which, over the life of the project, would repay the present value of the equity investment and a fair return (in constant dollars). The total revenues to investors in any year would be the sum of the levelized payments for all projects still within their accounting lives -- adjusted to reflect the appropriate degree of historic inflation or deflation. Rates would be determined from that sum plus annual operating and maintenance expenses, tax expenses, and debt service costs. In the case of plant additions beyond their accounting lives, recovery of return on investment could continue to be allowed "upon a showing that such plant additions operate in a competitive market," Commissioner Hughes added.

For transition purposes, Mr. Hughes suggested use of the existing ICC valuation less outstanding debt -- i.e., "the original equity, the trended equity and trended debt could be taken as the present equity investment for each company or system." Current debt outstanding would be transferred at its actual cost. While this transition rate base would "certainly transfer some outmoded or erroneous value," Mr. Hughes said it would be inequitable to impose a radically different rate level on investors who made decisions based on the long-standing regulatory regime imposed by the ICC over a period of some 40 years. Likewise, "it would be a financial and administrative debacle for this agency to attempt to reconstruct an original cost rate base."

Commissioner Hughes concluded that the above proposed variant of the trended original cost method -- intended to provide for a level revenue stream or levelized rates which are constant in real dollars -- comes closest to the "viable, modern precedent" the Commission is seeking. Moreover, in contrast to the Majority's approach, the proposed method would impose no additional administrative burdens on the Commission Staff. For each significant addition to pipeline plant, the Staff would need to calculate the levelized revenue increment -- but only once. Also, the Commission would periodically determine a real rate of return on pipeline equity -- but on a generic basis.

Further, Commissioner Hughes added, whatever the final approach, the determination of return should be made on an industrywide basis, subject to review as indicated by changing economic circumstances. "For an industry already familiar with an industrywide rate of return, it is astounding that the Majority would abandon the efficiency of that system and willingly enter the probable morass of case-specific adjudications."

by which we collectively arrive at a final value must be formulated before we can lawfully issue a report on final value, such a report can never be issued. It may well be that after many final values have been made a general descriptive rule may be formulated illustrating the manner in which typical final figures have been arrived at." (emphasis added) 75 ICC at 592

Today we have reached a point where we can provide a general descriptive rule to illustrate how a typical single-sum final value figure is found. Briefly stated one might say that in ascertaining a single-sum value, consideration is given first to two elements, cost of reproduction new and original cost to date. On the premise that the value of the property before depreciation should lie between these two elements of cost, the two are weighted together based on each one's percentage to the sum of the two in the ascertaining such value. This value is then reduced to reflect a value of the property in its present condition. The factor used to accomplish this is derived from a ratio of cost of reproduction new less depreciation value to the cost of reproduction new value. The resultant value is increased by six percent to reflect an amount for going concern. To this is added an amount for present value of lands, present value of rights of way and an amount for working capital. The resultant single-sum figure is an estimated value of the carriers property for ratemaking purpose.

If one wished to express this as a formula, he might do so in the following manner:

$$V = \left\{\left[\left(\frac{R_1}{R_1 + O_1}\right)\left(R_1\right) + \left(\frac{O_1}{R_1 + O_1}\right)\left(O_1\right)\right]\left(\frac{R_2}{R_1}\right)\right\}(1.06) + \left(L_1 + L_2 + W_1\right)$$

In this formula,

V = single-sum value

R_1 = cost of reproduction new

R_2 = cost of reproduction new less depreciation

O_1 = original cost to date

L_1 = present value of lands

L_2 = present value of right of way

W_1 = working capital