Exhibit No. _____ (LPS-1T)
Docket No. TO-011472
Witness: Leon P. Smith

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY OF
LEON P. SMITH

OLYMPIC PIPE LINE COMPANY

June 11, 2002

Exhibit No. _____ (LPS-1T)

OLYMPIC PIPE LINE COMPANY

REBUTTAL TESTIMONY OF LEON P. SMITH

I. Name and Address

Q. Please state your name and address.

A. My name is Leon P. Smith. My address is 187 High Street, Strasburg, VA 22657.

II. Professional Experience and Qualifications

Q. Please stately briefly your professional experience and qualifications.

A. I was employed at the Federal Energy Regulatory Commission (FERC) and one of its predecessor agencies, the Interstate Commerce Commission (ICC), for over twenty-four years. My employment at these agencies began in August 1976 and continued until my retirement in September 2000. During that period, I held positions of increasing responsibility. At the ICC, I was responsible for work on oil pipeline valuations. In 1977, with the implementation of the Department of Energy Organization Act, I was transferred to the newly-formed FERC. I progressed through numerous positions--always dealing with oil pipeline matters--until I was in charge of the branch responsible for oil pipelines at the FERC. These positions included: (i) General Engineer; (ii) Assistant to the Director; Division of Rate Filings; (iii) Branch Chief, Oil and Gas Filings Branch; (iv) Branch Chief, Rate Review Branch; and (v) Group Leader, Group 2, Division of Corporate Applications in the Office of Markets Tariffs and Rates.

During my employment at the FERC, I was responsible for all facets of oil pipeline regulation. As stated, I began working in the valuation area (a regulatory methodology formerly used at the ICC and the FERC). Upon becoming Assistant to the Director, I became fully involved in all facets of the FERC's regulation over oil pipelines. I have provided advice to the FERC Commissioners concerning all oil pipeline matters. I was one of the primary individuals working on oil pipeline related rulemakings (i.e., the rulemakings in RM93-11-000, RM94-2-000, and RM94-1-000 (resulting in FERC Order Nos. 561, 571, and 572, respectively) that implemented major modifications to the FERC's regulatory rate determination methodologies). Representing the FERC, I addressed or lectured at numerous conferences related to oil pipeline regulation including Association of Oil Pipeline meetings and the Northwestern University Transportation Center. I represented the United States Government in oil pipeline dealings with foreign governments; I also represented the FERC in oil pipeline matters with other federal agencies, Congress, state agencies, the oil pipeline industry, and the public in general.

Since my retirement in September 2000, I have acted as an independent consultant providing advice and assistance to companies regarding the FERC's regulatory methods and approaches. I have provided assistance and advice to a wide variety of clients in dealing with activities at the FERC, state level involvement, and one foreign government.

II. General Purpose and Summary of Testimony

Q. What is the general purpose of your testimony?

A. I have been asked to review and comment on the direct testimony of Mr. John F.

Brown, witness for Tesoro Refining and Marketing Company ("Tesoro"), regarding certain matters relating to the regulatory policy and principles of the FERC as they relate to the economic regulation of oil pipelines. I have also been asked to review the direct testimony of Robert C. Means, witness for the Tosco Corporation ("Tosco"), relating to his recommendations for determination of the test period rates for Olympic Pipe Line Company ("Olympic"). Finally, I have reviewed the direct testimonies of Mr. Maurice L. Twitchell and Mr. Robert Colbo, witnesses for Washington Utilities and Transportation Commission Staff ("Staff").

Q. Could you please provide a summary of your testimony?

A. Certainly. In broad terms, my testimony will discuss the history of oil pipeline regulation at the FERC, my observations regarding Olympic's ratemaking practices, and issues that the Washington Utilities and Transportation Commission ("Commission") should consider in determining the proper ratemaking methodology in this case. My testimony will largely concentrate on precedent and history at the FERC. My reason for this is not that I believe FERC precedent should override Commission precedent. Rather, the Commission has had little opportunity to consider the issues associated with oil pipeline ratemaking, which, for reasons I will discuss below, involves significantly different considerations from those associated with other public utilities. By contrast, the FERC has spent considerable time analyzing oil pipelines and developing a ratemaking methodology that most accurately reflects the unique circumstances of oil pipelines. In addition, it is my understanding that, in many respects, the Commission has adopted elements of FERC's regulation with regard to oil pipelines, including requiring accounts to be kept according to the

Uniform System of Accounts and requiring pipelines to provide a copy of the FERC Form 6 to the Commission. I believe that by providing a discussion of this analysis, and providing a context for the FERC methodology based on my twenty-four years participating in the regulation of oil pipelines at the federal level, my testimony will allow the Commission to make a better-informed decision with regard to this case. In addition, I believe that in certain places, Mr. Brown, Dr. Means, Mr. Twitchell, and Mr. Colbo have misapplied or mischaracterized the FERC's methodology with regard to oil pipelines.

III. Regulation of Oil Pipelines at the Federal Level

Q. Does the FERC regulate oil pipelines in the same manner as other public utilities?

A. No, its does not. The FERC considered whether it was appropriate to adopt the public utility model for oil pipelines and ultimately determined that it was not. Instead, oil pipelines are regulated as common carriers--not as public utilities. It is my understanding that the statute in the state of Washington (RCW 81.88.030) makes clear that oil pipelines should be regarded as common carriers. For reasons I discuss below, I believe that common carriers in general, and oil pipelines in particular, face a very difference set of circumstances from typical public utility companies.

Q. What are the reasons for different methodologies for public utilities and oil pipelines at the FERC?

A. Part of the reason is that, historically, the ICC regulated oil pipelines, whereas the Federal Power Commission (FPC) regulated gas pipelines and electric utilities. Additionally, the statutory authority that gave these two agencies their

respective regulatory authority were the Interstate Commerce Act, which provided the ICC with regulatory authority, and the Federal Power Act and Natural Gas Act, which provided regulatory authority to the FPC. As a result of the Department of Energy Organization Act of 1977, one agency (FERC) was formed with jurisdiction over both oil and natural gas pipelines, in addition to electric utilities and hydroelectric projects. This reorganization, however, did not alter the underlying legislative authority under which the FERC regulates oil pipelines. When it assumed authority over oil pipelines, the FERC recognized that oil pipelines had historically been subject to a different regulatory regime than the public utilities under its jurisdiction. See generally Williams Pipe Line Company, 21 FERC ¶61,260 at 61,563 (Nov. 30, 1982) ("Opinion 154-A" or "Williams I").

Q. What were the reasons that oil pipelines became subject to economic regulation at the federal level?

A. To understand the reasons that oil pipelines became subject to common carrier regulation, it is necessary to understand the history of the oil pipeline industry. The oil pipeline industry at the beginning of the 20th century was marked with bitter complaints concerning alleged abuses of small oil producers by the Standard Oil monopoly through its pipelines. These small oil producers charged Standard Oil Trust and other large oil firms with charging exorbitant rates to use their pipelines to squeeze out smaller producers and control the market.[1] These complaints led to the adoption of the Hepburn Amendment of 1906. 34 Stat. 584 (1906), as amended, 49 U.S.C. § 1. Under this amendment, interstate oil

[1] See, e.g., *Arthur M. Johnson, Petroleum Pipelines and Public Policy:1906-1959*, at page 20.

pipelines were declared common carriers subject to the jurisdiction of the ICC under the Interstate Commerce Act. It is my understanding that in Washington, intrastate oil pipelines are subject to a similar statute (RCW 81.88.030) that requires them to operate as common carriers.

Q. What is the significance of oil pipelines facing competition from other modes of transportation?

A. In the first place, it is one of the primary reasons that the traditional public utility model is not applicable to oil pipelines. Unless the ICC or the FERC prohibited trucks, barges, and railroads from competing with pipelines, it would simply not be possible to guarantee oil pipelines the type of franchise that regulatory commissions have historically been able to guarantee to public utilities.

Q. What are the regulatory requirements for oil pipelines regulated under the Interstate Commerce Act?

A. The two most important requirements of the Interstate Commerce Act relating to oil pipelines were (i) the requirement of oil pipelines to post "just and reasonable" tariffs and (ii) the duty to avoid unreasonable preferences or discrimination between similarly situated shippers. 49 U.S.C. § 1(4), (5), and (8).[2] Additionally, oil pipelines are not subject to the "commodities clause," which prohibits carriers from transporting articles produced or owned by them, thereby allowing shippers to own oil pipelines. 49 U.S.C. § 1(8). Moreover, oil

[2] More broadly, the Interstate Commerce Act also requires pipeline carriers to establish reasonable joint rates with connecting pipelines (49 U.S.C. § 1(4)); prohibits any greater charge for a shorter than for a longer distance (49 U.S.C. § 4); prohibits pooling agreements with other carriers except with Commission approval (49 U.S.C. § 5); requires rates to be published thirty days before the effective date (49 U.S.C. § 6(3)); requires annual and special reports (49 U.S.C. § 20); and requires books and records to be kept as prescribed by the Commission (49 U.S.C. § 20(3)).

pipelines are not required to obtain a certificate of convenience and necessity before constructing or extending a line or to obtain the permission of the FERC before abandoning a line. 49 U.S.C. § 1(18). In short, the FERC has no authority to regulate the entry or exit of oil pipelines from given markets.

Q. What is the significance of the FERC not having authority to regulate the entry or exit of oil pipeline companies from a given market?

A. In the first place, it provides yet another impediment to the FERC granting a franchise to a given oil pipeline. Since a competitor could enter this market at any time, such a franchise would be meaningless. Accordingly, the FERC has adopted a regulatory structure that fosters such competition. As discussed below, one of the driving forces behind the FERC's decision in Williams Pipe Line Company, 31 F.E.R.C. ¶61,377 (June 28, 1985) ("Opinion No. 154-B" or "Williams II") was the development of a methodology that would foster competition.

Q. What is the significance of the distinction between oil pipelines being regulated as common carriers and gas pipelines being regulated as contract carriers?

A. Common carriers are required to hold themselves open to all qualified shippers. When shippers' requests for pipeline capacity exceed the capacity available, the common carrier is required to treat each shipper equally. Usually this requires that each shipper's requested capacity be reduced in some equitable manner to bring throughput and capacity into balance. For example, a hypothetical pipeline might have capacity to transport 100 units of refined products per day and receive requests from shippers to transport 200 units. In this simple example, the oil pipeline might prorate or reduce each shippers request by 50 percent

(100/200). The exact formula for prorationing capacity would depend on the prorationing rules governing product movements on the carrier's pipeline system.

The gas pipeline industry, however, is regulated under the contract carrier framework. Contract carriers are allowed to enter into long-term contracts committing capacity to shippers who enter into long-term agreements. While there are mechanisms to facilitate the transfer of surplus contracted capacity that may not be used at various times to shippers requiring capacity, a shipper with a firm contract for capacity cannot be curtailed. Accordingly, the shipper is normally assured that the capacity for which they have contracted will be available to them. Likewise, the pipeline is assured that they will be paid (barring financial default by the shipper). The real markets for gas pipeline capacity are more complex, and the high cost of holding capacity not being fully utilized has led to capacity release programs which create a secondary market for "firm capacity" that is not required at a point in time. At some level, however, the "structural" differences between the common carrier and a contract carrier are significant from a regulatory perspective since common carriers cannot discriminate among shippers when allocating capacity and cannot collect for shippers who do not use the capacity for which they have nominated.

Q. Please explain the significance of this constraint.

A. As I have noted elsewhere, the history of common carrier oil pipelines has been dominated by the companies requiring pipeline capacity to transport their refined products, as is the case for Olympic. Due to the common carrier requirements, Olympic cannot reserve capacity for the use of their affiliates. Likewise, they

cannot contractually bind non-affiliated shippers, such as Tosco and Tesoro, to commit to the use of capacity in the long-term. For ratemaking purposes, this implies that contract carriers will have more certainty with regard to future throughput than common carriers, who may experience sharp fluctuations in their throughput. The FERC has recognized that this fact, in addition to others such as the lack of monopoly protection, engenders higher risk for oil pipelines. In ARCO Pipe Line Company, 52 FERC ¶61,055 (July 18, 1990), the FERC explicitly noted that oil pipelines face higher risks than gas pipelines and as a result require a higher return on equity. Id. at 61,242-43.

Q. What methodologies have been used to regulate oil pipeline rates at the federal level since the passage of the Hepburn Act in 1906?

A. As discussed above, the federal regulatory regime governing oil pipeline rates historically has differed in a number of respects from the regulatory regime governing electric utilities and gas pipelines. For example, while utilities were obliged to justify their rates using a depreciated original cost methodology, oil pipelines were obliged to justify their rates using an approach known as "valuation." The basic premise of the "valuation" approach was that it allowed the pipelines to earn a "fair market" return on their assets. Williams Pipe Line Company, 21 FERC at ¶61,614.

At the time of FERC's creation, Williams Pipeline Company, a rate case decided by the ICC was pending before the U.S. Court of Appeals for the D.C. Circuit. The FERC requested the court to remand the case so that it could begin its regulatory duties with a "clean slate." The FERC also stated that it wished to use this proceeding as a vehicle to construct a generally applicable ratemaking methodology for oil pipelines. The court granted this request and remanded the

case to the FERC. On November 30, 1982, the FERC issued its decision in Williams I. While this voluminous decision discusses many items, including an extensive history of oil pipeline regulation, the key point from a ratemaking perspective was that it largely preserved the valuation methodology as the ratemaking regime. In the U.S. Court of Appeals for the D.C. Circuit, in Farmers Union Central Exchange, Inc. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), determined that the FERC's decision was not based on reasoned decision-making and, as a result, remanded the decision back to the FERC. On June 28, 1985, the FERC issued a new decision to provide a general methodology with which oil pipeline companies could set rates in Williams II. This decision provided a framework for oil pipelines to set their rates into the future. In terms of rate base, this decision contained two major features. First, it set aside the valuation methodology in favor of a trended original cost ("TOC") methodology. Second, it allowed for a transition rate base mechanism to facilitate the transition between the old methodology of valuation to the new methodology of trended original cost. On other matters, it discussed the appropriate capital structure, the appropriate cost of debt, and the appropriate treatment of income tax allowances.

Q. How does the TOC methodology differ from the DOC methodology that the FERC has used as the ratemaking methodology for gas pipelines?

A. As Mr. Collins discusses in his direct testimony at Exhibit No. ___(BAC-2) at 3-6, the basic difference is that the TOC methodology allows pipelines to earn a lower return on equity but compensates the pipelines by allowing them to add the deferred portion of their equity return into their rate base. Specifically, while the DOC methodology allows oil pipelines to earn a nominal return (which is composed of a "real" component and an inflation component), the TOC

methodology only allows the pipeline to earn a real return on the equity portion of its rate base in the present period and obliges the pipeline to defer the inflation portion to future periods.

Q. This methodology seems rather complicated. Why did the FERC choose this methodology rather than the DOC methodology?

A. As the FERC discussed at length in Opinion No. 154-B, the nature of the oil pipeline industry and the desire to foster new entrants to the market led to a concern that a DOC approach would front-end load the costs of the oil pipeline. 31 FERC at ¶61,834. For example, if in the first year of a pipeline a DOC approach would allow a pipeline to earn a 15% nominal return on its equity whereas a TOC approach would allow a pipeline to earn a 12% return on its equity, the rate set on the basis of DOC would result in higher rates then the rate set under TOC. Differences in return can become quite large in periods of high inflation. The FERC was concerned that oil pipelines might face market situations where they could not earn their full DOC return. This problem would become particularly acute in the case where a new un-depreciated pipeline was competing with an older, largely depreciated pipeline. Id. The FERC was concerned that, in the early operating years, this newer pipeline might not be able to recover all of the costs to which it was entitled under the DOC approach and this would provide a disincentive for new entrants into the pipeline market. To mitigate this problem, the FERC adopted the TOC methodology, which results in lower returns in the early years and higher returns in the later years.

Q. Why did the FERC include a transition rate base as part of the Opinion No. 154-B methodology?

A. As the FERC stated in Opinion No. 154-B, the pipeline industry's long reliance

on the valuation methodology it was concerned that switching methodologies would provide a disincentive to future investment in pipeline assets. See 31 FERC at ¶ 61,835-36. Specifically, the FERC was concerned that if investors at some point prior to 1983 had based their investment on the expectation of being able to charge rates set under valuation, which they now could not do, future investors might be loath to make pipeline investments for fear that they would suffer an uncompensated shift in the regulatory regime. To ensure that this did not occur, the FERC allowed pipelines that existed in 1983 to include a component in their starting rate base that represented what the equity investors could have expected to earn under the valuation methodology.

Q. What capital structure did the FERC indicate oil pipeline companies should employ?

A. In Opinion No. 154-B, the FERC stated that in recent gas pipeline cases it had expressed a preference for actual capital structures rather than hypothetical capital structures. Specifically the FERC stated:

> The actual capital structure could be the actual capital structure of either the pipeline or is parent. The Commission concludes that a pipeline which has issued no long-term debt or which issues long-term debt to its parent or which issues long-term debt guaranteed by its parent to outside investors should sue its parent's actual capital structure. However, a pipeline which issues long-term debt to outside investors without any parent guarantee should use it's (the pipeline's) own capital structure. (31 FERC ¶ 61,377 at 61,836)

The basic reason the FERC expressed a preference for actual capital structures is that it realized these structures would more accurately reflect the risks of the specific company for which the capital structure was being employed. If parent companies guaranteed the debt of their subsidiaries, these parent companies

were, in essence, assuming the risk of their affiliates, and the FERC determined it was more appropriate to use the parent company capital structures.

Q. How does capital structure influence the cost of service calculation?

A. The capital structure, or debt to equity ratio, influences the cost of service calculation in two ways. First, since investors in equity are normally thought to require a higher return than debt holders, the ratio of debt to equity will influence the overall return.

Second, the historical capital structure of 1983 is used to determine the portion of the starting rate base write-up associated with equity. Since the purpose of the write-up, or transition rate base, was to mitigate the impacts of the regulatory change on equity investors, the FERC determined that a pipeline was only entitled to this transition mechanism to the extent that its assets in 1983 were financed with equity. 31 FERC at ¶ 61,836.

Q. How did the FERC instruct the pipeline companies to calculate their rates of return?

A. With regard to debt, the pipeline companies are to use their actual cost of debt. In the case of return on equity, the FERC stated that the "equity rate of return should be determined on a case-specific basis with reference to the risks and corresponding cost of capital associated with the oil pipeline whose rates are in issue" 31 FERC at ¶ 61,386. In more recent decisions, the FERC has employed the five publicly traded oil pipeline companies as a proxy to determine the cost that equity investors expect of oil pipeline companies. The FERC considers the risks of the individual carrier at issue in determining the exact return on equity to allow the specific pipeline company to use in calculating its cost of service.

Q. Opinion 154-B established a cost-based methodology as the basis for determining "just and reasonable rates" rates.

A. Yes. However, subsequent to issuance of Opinion 154-B were other developments that have provided for more flexibility of how "just and reasonable rates" are determined.

Q. Please explain.

A. As part of the Energy Policy Act of 1992 ("EP Act"),[3] Congress mandated that the FERC develop a "simplified and generally applicable" methodology for establishing "just and reasonable" rates. 42 U.S.C. § 7172. The FERC has established Indexation as the generally applicable ratemaking methodology for adjusting existing tariff rates. Under Indexation, rates are capped by ceilings, which are adjusted annually by a prescribed pipeline index, currently the Producer Price Index for Finished Goods less one percent ("(PPI-FG)-1"). Pipelines can apply for temporary relief from Indexation by using two alternative ratemaking methodologies, Cost-of-Service and Settlement. The Cost-of-Service methodology for existing rates is similar to that employed for setting initial rates (i.e., rate of return regulation under the FERC's prescribed regulatory cost model, TOC). In order to qualify for an index waiver, a carrier must demonstrate a substantial divergence between its regulatory Cost-of-Service and the maximum revenue it could earn at its index ceiling rates. Existing rates changed under the Settlement approach require unanimous consent of all shippers currently utilizing the service. The COS and Settlement approaches, however, only provide temporary relief from the FERC's Indexation

methodology. Rates filed under these alternative approaches establish the new index ceiling, which is subsequently adjusted by the FERC's annual index.

Carriers who can successfully demonstrate a lack of significant market power in their origin and destination markets are permitted to establish market-based rates. Market-based rates are exempt from future Indexation or Cost-of-Service filing requirements.

In summary, rates for oil pipelines can be established under one of four alternative methods depending on their particular facts and circumstances.

(1) "Indexation" is the generally applicable simplified methodology which relies on a "price cap" to adjust rates up or down.

(2) "Market Based Rates" can be filed in markets where a pipeline can establish that it lacks market power.

(3) "Settlement Rates" can be filed if a pipeline can reach an agreement with its shippers.

(4) "Cost of Service Filings" can be relied on if a pipeline's costs have increased more then the level allowed by Indexation.

Q. So Opinion 154-B applies for any oil pipeline filing a rate under FERC's Cost of Service Filing " standard.

A. Yes.

I. Observations Regarding Olympic's Ratemaking

Q. Mr. Brown suggests that the FERC "has acknowledged the advantages of the DOC methodology even when considering regulation of …. Crude oil and

petroleum products pipelines." Is that statement accurate in regards to the FERC's regulation of oil pipelines?

A. No. As I have stated above, the Opinion 154-B Trended Original Cost ("TOC") methodology is required by 18 C.F.R. 346. While it is also true that FERC Administrative Law Judge Zimmet, in Endicott Pipeline Company, (55 FERC ¶ 63,028 at 65,144-46) did recommend the use of Depreciated Original Cost ("DOC"), this decision was never affirmed by FERC. Moreover, this case involved assets in Alaska, which the FERC has acknowledged have marked differences from pipelines in the continental U.S. Of course, the FERC does rely on DOC for cost of service regulation of utilities such as electric transmission facilities. However, for the reasons I have explained, the FERC has adopted the TOC methodology with a starting rate base adjustment in Opinion 154-B ("154-B Methodology") for oil pipelines. It specifically addressed the applicability of DOC methodology to oil pipelines in Lakehead Pipe Line Company, 71 FERC ¶ 61,338 at 62,30708, and *again affirmed the use of the 154-B TOC Methodology for oil* pipelines.

Q. Mr. Twitchell alleges that there is no basis for believing that Opinion 154-B "should be used for setting just and reasonable rates." Do you agree with that assessment?

A. No. As should be clear from my discussion of the process by which 154-B methodology was developed, this was not a casual exercise done in haste. The FERC considered carefully how to ensure that: (1) rates produced by the 154-B Methodology produce "just and reasonable" rates; (31 FERC ¶ at 61,832) and (2) was fair to the industry by providing the Starting Rate Base adjustment to avoid penalties relating to changes in cost of service methodology from the

valuation methodology that was relied on for rate regulation previously. (31 FERC ¶ at 61,835-36) Accordingly, it is fair to say that the FERC believes the154-B Methodology fulfills the legal requirement for "just and reasonable" rates.

Q. Both Mr. Twitchell and Mr. Brown assert that even if the 154-B Methodology were to be applied, Olympic should not be allowed to include "deferred return" since they contend that Olympic in fact has not "deferred" return in the past. (Ex. MLT-1T at 19 and Ex. JFB-1T at 25.) Is this an accurate interpretation of the FERC's application of 154-B methodology?

A. No, it is not. The mechanics of the trended original cost methodology ("TOC") applies a *real* rate of return to the equity portion of rate base. The real rate of return on equity is determined by subtraction of inflation from the nominal rate of return as is explained by Dr. Schink. The equity portion of rate base is then "trended" by multiplying the net balance by the rate of inflation. For example, if the equity portion of rate base were $100, and the rate of inflation for the period were three percent, a trending adjustment of $3.00 would be made and the equity rate base would be $103.00 after trending. The trending adjustment is stored in rate base and is amortized over the life of the pipeline and recovered in cost of service in a manner much like depreciation charges. The term "deferred return" refers to the fact that the inflation portion of the nominal return on equity is not recovered in the current year, but is stored in rate base and recovered over the life of the pipeline (i.e., the recovery of a portion of return on equity is deferred, hence the term "deferred return").

Q. Is Mr. Brown and Mr. Twitchell's contention that Olympic should only be allowed to include a deferred return in its rate base to the extent its revenues were below its cost of service appropriate?

A. No, neither Mr. Brown's contention nor Mr. Twitchell's contention is appropriate. The TOC methodology was not premised on past earnings. In its Lakehead decision, the FERC determined that the TOC methodology remained an appropriate methodology. 71 FERC ¶ at 62,307-08). Consequently, correct application of the 154-B methodology does not include an analysis of past earnings, nor is such an analysis appropriate. Oil pipelines, as common carriers are not required to make rate filings at regular periods. Rather, the oil pipeline decides when it will change rates. More importantly, the comparison of costs and revenues from past periods is a practice known as retroactive ratemaking. The basic idea of retroactive ratemaking is that earnings, or lack of earnings from past periods may be used to set rates in the present period.

Q. But doesn't Opinion No. 154-B carry earnings from one period to another?

A. No. Opinion 154-B defines the "cost of service" standard for determining whether a rate falls within the limits of "just and reasonable" for the period under examination. It incorporates a definition of rate base that includes a number of considerations that are related to past events such as depreciation, accumulated deferred income taxes, and the trending adjustments to the equity component of rate base ("deferred earnings"). None of these items is dependent on past earnings. For example, if a pipeline did not generate sufficient revenue in a given year to recover its depreciation, it could not carry this under-recovery into the present period. Likewise, there is no examination of income taxes paid to determine the level sufficient to "fund" the amount of deferred income taxes.

Accordingly, there is no basis to argue that one element of rate base (deferred return) should be subjected to tests relating to past earnings.

Q. Mr. Twitchell says that there is no "basis" established for the inclusion of AFUDC is correct for ratemaking purposes. Is he correct?

A. No, but I can understand his confusion on this matter. Mr. Collins' inclusion of AFUDC is consistent with the requirements of 18 C.F.R 346 of the FERC regulations regarding cost of service filings. See 18 C.F.R. 346.2 c (6). However, as explained by Mr. Ganz, the Uniform System of Accounts, the accounting standard under which the FERC Form 6 report is prepared, does not include a provision for recording AFUDC amounts. Accordingly, the FERC requires that a cost of service rate filing include Statement F, showing the calculation of AFUDC in support of any cost of service filing as Mr. Collins has done. The FERC clearly recognizes that the inclusion of AFUDC is required for a proper determination of cost of service.

Q. What are the problems with Mr. Brown's assertion that audited financial data must be used for the test period?

A. Many components of an oil pipeline's cost of service are drawn from the carrier's Form 6 Report (e.g., operating expenses). It is my understanding that the Commission also relies on the Form 6 for oil pipeline ratemaking. The Form 6 is not an audited financial statement. Likewise the projections used for the pro forma adjustments, by their very nature, cannot be based on audited financials, but they represent the best estimates of management. Mr. Brown's assertion that data for oil pipeline rate filings must be drawn from audited reports is not accurate. Based on my experience, rates for oil pipelines were rarely, if ever, based directly on audited financial statements.

Q. What are the problems with Mr. Brown's assertion that "budget" estimates "do not provide a proper basis for development of test period (pro forma) costs because those costs are not based on actual costs incurred during the base period." (Ex. JFB-1T at 12)

A. As I have stated above, the FERC's regulations for oil pipelines require that the test period be forward-looking. From reading the Commission regulations, it is my understanding that the FERC's concept of a test period correlates to the Commission's concept of pro forma adjustments. Accordingly, it has been my experience that budget forecasts are frequently relied on for determining test period amounts. Indeed, it is not possible to generate the type of forward-looking numbers envisioned by the FERC's test period concept without relying on the type of forecasts that budgets normally contain. While there may be legitimate differences of opinion concerning the appropriate dollar amount for a particular item, Mr. Brown's wholesale rejection of budget estimates and his proposed adjustments to operating expenses are not consistent with the FERC's standards for the test period. Pipeline companies develop budgets for management's financial and operation purposes based on their best internal projections. It is appropriate for the FERC and the Commission to rely on projections contained in the managerial budget reports as the carrier's best estimate of future operating costs for ratemaking purposes.

Q. What should this Commission consider before rejecting increases in operating costs?

A. As I understand from Mr. Talley, the operator has formulated a plan to eventually allow the system to be restored to full operating pressure and to be operated in a manner that ensures the protection of public safety, preservation of the environment, and addresses other concerns expressed by the community.

Although I have not performed any analysis of the costs involved, it is not surprising to me that the safeguards would increase the costs of operation. Also, unlike the FERC, I understand that the Commission has recently been assigned certain statutory responsibilities relating to oil pipeline safety (See WAC 480-75-005 et. seq.). Accordingly, it would not be appropriate, in my view, for the Commission to deny Olympic the recovery of costs incurred in complying with increased safety requirements in rates, simply on the basis that they are higher than past spending levels.

Q. Mr. Colbo also made numerous adjustments to test period operating expenses. Are these appropriate?

A. I have not made a detailed review of Mr. Colbo's adjustments. I understand that Mr. Ganz has some comments in that regard. As I have stated elsewhere, there are several considerations I would consider relevant to determining whether any adjustments are required or even appropriate.

Q. Please explain.

A. Mr. Colbo is concerned about the lack of audited financial records. (Ex. T-___(RGC-1T) at 7) However, as I have stated previously, it is common for oil pipelines to prepare rate filings using data drawn from the FERC Form 6. I understand that Mr. Collins has relied on the Form 6 for his presentation. I also understand from Mr. Ganz that the Form 6 is the reporting standard relied on by the Commission. Accordingly, it would seem appropriate for Mr. Colbo to look to the Commission reporting standard as the source of information. An officer of the corporation attesting to its accuracy signs the Form 6. Further, the Form 6 is prepared in accordance with the Uniform System of Accounts ("USoA") , a

regulatory accounting standard adopted by the FERC and the Commission for oil pipelines. I understand that Mr. Ganz discusses in his testimony some of the differences between the accounting practices for oil pipelines under the USoA and GAAP. Once again, the Form 6 approach would seem to provide an appropriate starting point for Mr. Colbo's analysis for the reasons stated above. Likewise, the reassignment of expenses to capital and normalizing adjustments should consider the standards of the USoA and the accounting practices of oil pipeline. The wholesale importation of utility accounting practices is not appropriate.

Q. Do the Staff or Intervenors suggest that adjustments be made to Olympic's cost of service to provide certain incentives to Olympic?

A. Yes they do. Both Mr. Brown (Ex. JFB-1 at 55) and Dr. Means (Ex. RCM-1 at 3) suggest deviating from the Commission's regulations regarding test periods because they believe that certain types of "incentive ratemaking" are necessary.

Q. Do the FERC's regulations for cost of service filings contained in 18 C.F.R. 346 contain any provision for providing incentives to compel pipelines to behave in one way or another?

A. No, they do not. The FERC's regulations lay out in explicit detail the type of information that the FERC requires in a cost of service filing and the time period that information should cover. Nowhere do the FERC's regulations contemplate altering the cost of service requirements to provide incentives in order to encourage pipelines to behave in a certain manner. As I discussed above, while the Commission's regulations do not contain specific provisions with regard to the time period of pro forma adjustments, making this time frame too elastic could lead to mischief on the part of both (i) carriers seeking to recover costs

years before they occur, and (ii) shippers seeking to take account of cost savings or increase in throughput years before they actually occur.

Q. How do the Intervenors depart from the Commission's cost of service regulations to incorporate certain incentives into Olympic's cost of service filing?

A. By ignoring the FERC's test period requirements, which are analogous to pro forma adjustments at the Commission. As I will discuss in greater detail below, the FERC's regulations regarding a test period state as follows:

> "A test period must consist of a base period adjusted for changes in revenues and costs which are known and measurable with reasonable accuracy at the time of filing and which will become effective within nine months after the last month of available actual experience utilized in the filing."

(18 C.F.R.§ 346.2 (a)(ii)).

Q. How would the approach advocated by Mr. Brown contravene this prescription?

A. Mr. Brown suggests setting rates based on throughputs that

> "will provide an apparently needed incentive for Olympic to more expeditiously comply with OPS's safety requirements and return its pipeline to normal operating pressure"(Ex. JFB-1T at 55).

Mr. Brown then goes on to make a number of largely unsubstantiated assertions regarding the throughput that Olympic will likely experience in the future. Mr. Brown's approach would effectively extend the test period to include events that Mr. Brown himself recognizes may occur several years into the future, it at all. I believe that this reveals two fundamental flaws about Mr. Brown's ratemaking assumptions. First, the adjustments he proposes are not known and measurable.

It is not known, for example when or if Olympic will be allowed to operate at full pressure. Second, as Mr. Brown admits, Olympic has already stated it may not be possible to operate at full pressure until 2005. I believe that adjustments based on events likely to occur that far in the future are too speculative to be classified as known and measurable with reasonable certainty.

Q. Does Dr. Means' proposed approach use incentive ratemaking for Olympic?

A. Dr. Means is more explicit about the use of incentives in setting the rates for Olympic. He proposes a mechanism that assumes that Olympic's annual throughput reaches 130 million barrels per year on April 1, 2004, when he believes all of the pressure restrictions will be lifted on Olympic (Ex. RCM-1 at 37). In the first place, Dr. Means provides no evidence that the lifting of the pressure restrictions will instantly cause Olympic's throughput to rise to 130 million barrels per year. Therefore, there is no reason to believe that these changes are known and measurable, as the Commission's regulations require. Moreover, April 1, 2004, is more than two years after the initial rate filing in this case. Therefore, Dr. Means is suggesting pro forma adjustments based on changes that will take place far in the future, which is not appropriate for a cost of service filings.

Q. What if throughputs increase substantially at some point in the distant future as postulated by Dr. Means? Ex. RCM-1T at 30. Would this not result in a windfall to Olympic?

A. The FERC requires that each pipeline report throughput and revenues annually in the Form 6 report. Further, the Page 700 section of the Form 6 Report also states the Cost of Service as calculated under the FERC's 154-B methodology. Thus, shippers will have sufficient information in order to evaluate whether they

should to file a protest or complaint. If shippers do file a complaint, and they succeed in showing that Olympic's rates are no longer just and reasonable, then they will not only be entitled to lower rates going forward but for reparations for two years back, and thereby they have the means to prevent any "windfalls" to Olympic arising from either increases in throughput or reductions in costs. It is simply not appropriate or necessary to speculate here what may occur in the distant future regarding throughput. Moreover, I understand that Olympic is proposing an automatic throughput adjustment mechanism.

IV. Lessons of the FERC Experience

Q. What factors should the Commission consider when evaluating the proper methodology for establishing oil pipeline rates?

A. There are several factors that are relevant. First, unlike many of the large companies regulated by the Commission, pipelines are common carriers. Public utilities are generally regulated in order to protect the public interest of the consumer. Olympic's shippers are large sophisticated multi-million dollar corporations that are more than capable of defending their own economic interest. The Commission's objective in regulating common carrier oil pipelines has nothing to do with consumer interests. The pipeline tariff represents a small portion of the overall retail pump price (e.g., a 21 cent per barrel decrease in Olympic's tariff could, at most, result in a 0.5 cent per gallon decrease to the consumer). Even if the Commission desired to reduce the pump price paid by the consumer by reducing the pipeline tariff, it would have no assurance that the refiner, jobber, marketer, or consignee would pass a reduction in pipeline tariff through to the consumer. Accordingly, unlike regulated utilities that deliver directly to the consumer, it is not clear that actions taken by this Commission

relating to oil pipeline tariffs will have any effect on the prices paid by the consumer. The Commission's objective in regulating oil pipelines should be to establish just and reasonable rates that are equitable and strike a fair balance between the interest of the carrier and its shippers.

Second, it is important for the Commission to send a clear message that it intends to maintain rate stability and to minimize significant changes in its ratemaking methodology. The oil industry is, by its very nature, capital intensive. Refineries and pipelines are significant investments that often require complex financing from an array of investors. Investors need some assurance that the regulator is not going to change the requirements for operating and recovering the capital investments in a manner that jeopardizes their ability to recover their investment with a reasonable level of return. Absent this surety, investors will demand a higher risk premium in order to commit capital. This is true regardless of whether the investment is a pipeline or a refinery. Both groups of investors need some assurances on how the transportation rates will be established in the future. Moreover, besides the economic need to for industry to attract investor capital, the courts have historically taken a dim view of regulatory change not supported by reasonable and reasoned decision-making.

Third, all parties can benefit not only from regulatory methodologies and procedures that are clear and unambiguous but that are streamlined and simple to implement. The Commission fulfills an important function as arbitrator in determining the fair and equitable economic balance between the carrier's and shippers' interests. That being said, the Commission should attempt, whenever possible, to fulfill this role in a manner that minimizes the burden on all parties. As such, the Commission should avail itself at every opportunity to the existing

methodologies and procedures already established by the FERC with which Olympic is already required to comply.

Q Why should the Commission take notice of FERC's methods for regulation oil pipelines?

A. Although the FERC and the Commission may ultimately choose to regulate oil pipelines differently, I believe that understanding the unique economic position of oil pipelines and why this position led FERC to make certain regulatory choices may be helpful to the Commission. I have attempted to develop a general understanding of the Commission's statutes for the purpose of preparing my testimony; however, I am not a lawyer and do not wish to be interpreted as offering legal opinions.

Q. Do you believe this creates an obligation that the WUTC must adopt every aspect of FERC's oil pipeline regulations?

A. No. I do think there are good reasons for the Commission to strongly consider the FERC's approach when setting cost-based rates. First, the continued use of FERC's cost of service methodology seems to be a logical extension of the Commission's current practices. The Commission already has decided to mirror FERC accounting and record keeping requirements. Second, as explained by Mr. Collins approximately 62 percent of the barrel-miles are transported under FERC rates and 38 percent moves under Commission rates. Having two different ratemaking regimes can result in future disputes between the carrier and shippers regarding the proper allocation of carrier property and other costs between interstate and intrastate classes of traffic. This will create a potential mismatch between Olympic's overall costs and its allowed recovery on a combined intrastate and interstate basis. Given the large and sophisticated parties on both

sides of this important economic issue, these disputes can lead to an additional regulatory burden for the Commission. FERC has already considered most of the issues currently confronting the Commission regarding oil pipeline regulation. It has conducted fully-litigated proceedings and has scrutinized the reasoning behind and application of its cost-based methodology several times. Moreover, all parties to this proceeding are fully aware of how the FERC methodology functions. There is ample justification for the Commission to rely on the FERC's methodology when establishing rates for Olympic.

Q. Are you saying that it is inappropriate for a Commission ever to change ratemaking methodologies?

A. No. Obviously, if the Commission believes that the existing methodology does not result in rates that fall within the zone of justness and reasonableness, then it is obligated make modifications. The Commission should, however, be wary of making substantial changes to its methodology needlessly. Careful consideration should be given to the impact on the investors that have committed capital to the markets before any changes are made. As I mentioned above, the Commission should strive for stability by maintaining unambiguous regulations that treat all parties fairly and equitably. There are times when the Commission may determine that a change in policy is necessary. In 1985, FERC changed its prior ratemaking methodology for oil pipelines. It did so with serious consideration to issues such as investor reliance, capital recovery patterns, and the desire to foster greater competition. Opinion No. 154-B was the outcome of these deliberations. In that opinion, the FERC dealt with the concern regarding investor reliance on equity returns, achieved under Valuation, by establishing a transitional starting rate base that carriers were allowed to earn a return on until

it is amortized. The FERC also addressed the issues of capital recovery and competition by creating a trended equity rate base. This reduced the concerns recognized with the front-end load problems associated with DOC, while, at the same time, potentially fostering competition by enabling newer pipelines to enter the market and compete with older pipelines because a portion of their current return has been deferred into later periods when they will be more likely to be able to recover it. These issues provide examples of the concerns that a regulatory agency should consider when contemplating a change in methodology. If the Commission decides to begin imposing a DOC methodology at this point in time, it should consider the issues of fairness in light of the Commission's role in setting investor expectations and the potential complications of different rate methodologies for intrastate and interstate traffic.

Q. Please explain your concerns regarding "fairness?"

A. The Commission cannot remove itself entirely from the current situation where there are widely divergent understandings of how the Commission evaluates rates for oil pipelines. This is not the first rate filing based on the Opinion No. 154-B methodology submitted to this Commission by Olympic; and Mr. Collins states that the three prior Olympic filings were allowed to go into effect without any changes. If the Commission had concerns with the methodology used in the prior filings, it could have acted on them. To change "horses" at this juncture, after Olympic has committed to a significant capital-spending program to bring the system up to highest standards for a safety and reliability, strikes me as unfair. Certainly, the Commission is not "locked in" by the past, but I believe it needs to consider what a fair "transition" to a new regime requires--if the Commission concludes that a change is required.

Q. Are there other considerations, not directly relating to the ratemaking methodology, that the Commission should consider?

A. There are some fundamental regulatory concepts I believe should be addressed. The first relates to accounting standards. The FERC requires that oil pipelines maintain their accounting data in accordance with the Uniform System of Accounts for regulatory purposes and report their accounting results in the Form 6 Annual Report. It appears that the Commission has adopted these standards; however, Staff does not appear to be consistently applying them. The Commission should consider clarifying its intention regarding the accounting standards, record keeping, and reporting.

Second, it is important to understand that oil pipelines are common carriers and cannot provide long-term reservations of capacity for the use of specific shippers. Therefore, all parties, present and future, benefit when a pipeline makes a long-term investments in order to minimize pro-rationing adjustments that force shippers to seek other transportation alternatives. More importantly however, these facilities are built specifically to meet peak demand requirements and will not necessarily be used to their maximum capacity throughout the year. For these reasons, the FERC does not require the recognition of the effect these facilities may have on peak period capacity when determining test (pro forma) period throughput. Throughput reflects what the system carrier actually transported, or is projected to transport in the near term, not the peak system capacity. To put it simply, the FERC's regulation of oil pipelines assumes that management is making economically-rational decisions. I would expect that BP does not desire to invest in unnecessary facilities. Oil pipelines are designed to handle peak requirements to avoid the disruption of pro-rationing shippers on the

system due to capacity constraints. Therefore, to remove facilities from rate base in the current transitional stage, when Olympic is striving to restore the system to normal operations, is not appropriate.

Q. Please explain your concerns regarding ratemaking stability.

A. There seems to be a great deal of confusion concerning this Commission's standards for oil pipelines. Clearly, Olympic thought that rate regulation was going to be based on the Opinion No. 154-B methodology as it had been in the past. Both the Intervenors and the Staff dismiss the notion that the Commission could even consider application of Opinion No. 154-B. Accordingly it would be "good" regulatory policy to remove the aura of mystery and uncertainty concerning how rates will be determined. This clarification will benefit both Olympic's owners and shippers. This will allow both parties to conduct their planning with a better understanding of the economics of their decisions regarding pipeline transportation.

Q. Does this conclude your present testimony?

A. Yes.

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