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June 13, 2002

VIA HAND DELIVERY

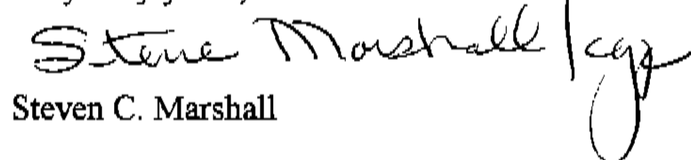
Carole J. Washburn
Office of the Secretary
Washington Utilities and Transportation Commission
1300 S. Evergreen Park Drive SW
Olympia, WA 98504-7250

Re: Application of Olympic Pipe Line Company
TO-011472

Dear Ms. Washburn:

Enclosed please find the original and nineteen (19) copies of Olympic Pipe Line Company's Motion For An Extension Of Time to Respond to Commission Staff's Answer In Partial Support to Tesoro's Motion For Summary Determination.

Very truly yours,



Steven C. Marshall

SCM:cgp
Enclosures

[33202-0006/BA021650.057]

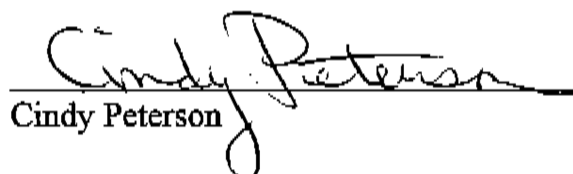
CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this date I caused to be served copies of Olympic Pipe Line Company's Motion For An Extension Of Time to Respond to Commission Staff's Answer In Partial Support to Tesoro's Motion For Summary Determination and this Certificate of Service via email, facsimile and overnight mail, to the following:

Mr. Donald T. Trotter/Lisa Watson Washington Utilities and Transportation Commission 1400 S. Evergreen Park Drive S.W. P. O. Box 40128 Olympia, WA 98504-0128 360-586-5522 (Fax) dtrotter@wutc.wa.gov	Mr. Edward A. Finklea/Chad Stokes Attorney at Law Energy Advocates LLP Attorneys at Law 526 N.W. 18th Avenue Portland, OR 97209-2220 503-721-9121 (Fax) efinklea@energyadvocates.com
Robin O. Brena, Esq. Brena Bell & Clarkson, P.C. 310 K Street, Suite 601 Anchorage, AK 99501 907-258-2001 (Fax) rbrena@brenalaw.com	C. Robert Wallis Administrative Law Judge 1300 S. Evergreen Park Drive S.W. Olympia, WA 98504-7250 bwallis@wutc.wa.gov

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Dated this 14th day of June, 2002 in Bellevue, Washington.



Cindy Peterson

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. OLYMPIC PIPE LINE COMPANY, INC., Respondent.	DOCKET NO. TO-011472 **EXPEDITED TREATMENT REQUIRED** OLYMPIC PIPE LINE COMPANY'S MOTION FOR AN EXTENSION OF TIME TO RESPOND TO COMMISSION STAFF'S ANSWER IN PARTIAL SUPPORT TO TESORO'S MOTION FOR SUMMARY DETERMINATION

Introduction

Yesterday, June 13, 2002, Commission Staff filed an "Answer on Behalf of Commission Staff in partial support of Tesoro's Motion for Summary of Determination." In its answer Commission Staff raises new arguments and uses materials and exhibits not in Tesoro's Motion for Summary Determination. Staff's answer to Tesoro's motion is in essence Staff's own Motion for a Summary Determination.

Staff's motion comes after all applicable deadlines, and Olympic needs to have an extension of time to respond in full to the issues raised by Commission Staff, including the procedural issue of whether Commission Staff's pleading is timely.

The following are examples of the responses Olympic would make in more detail if permitted more time:

1. Staff Incorrectly Imposed a Burden of Proof Not Applicable to the Policy and Rulemaking Process.

Staff incorrectly argues that because Olympic has the burden of proof on facts, it must therefore have the burden of proof on the appropriate rate methodology for the Commission to adopt as a matter of policy for oil pipeline companies. As described in Olympic's answer to Tesoro's motion, this is wrong as a matter of law. But, if permitted an extension of time, Olympic would show that setting a new policy for an oil pipeline methodology is in the nature of rulemaking under the Administrative Procedures Act. The choice of whether to use the federal methodology for oil pipelines or to formally adopt a different methodology for oil pipelines is a matter that will necessarily apply to other pipelines in Washington state.

If permitted the opportunity, Olympic would show in detail that in 1983, Commission Staff investigated the federal methodology for oil pipeline companies and concluded that there is a different end result when that approach was used compared to WUTC methodologies for utilities. That Staff's analysis for oil pipeline companies was repeated several times between 1983 and the present, and has been the basis of Olympic's last several rate changes.

In this case, rather than providing the Commission with a balanced evaluation of the two methodologies, Staff has taken the position that it is Olympic's burden of proof to show that one methodology applicable to oil pipelines is superior to another methodology that could be applicable to pipelines.

If permitted an extension of time, Olympic would show in more detail that the federal approach to oil pipeline rate regulation, including its approach to capital structure and rate of return, is appropriate to adopt for oil pipeline companies here based on the end result test..

If granted an extension of time, Olympic would show that Commission Staff in 1983 evaluated the unique circumstances applicable to oil pipeline companies, but did not make a

recommendation as to which methodology would be appropriate for the state regulations of oil pipelines. Staff's position essentially is that the question of what methodology is appropriate has been an open issue since at least 1983, and is a policy determination for the Commission:

> 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 guidelines, or reply 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.

In 1983, Staff recommended that from a cost of service standpoint, Olympic's WUTC Tariff No. 16 should be allowed to become effective July 1, 1983, as filed if the Commission accepted the FERC guidelines and methodology used for interstate oil pipeline rates. But if the Commission used "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." The Commission allowed WUTC Tariff No. 16 to become effective on July 1, 1983, **with the revenue requirement supported by the FERC methodology**.

If granted the time, Olympic would show that a policy determination by the Commission is not in the nature of proof of fact, but is in the nature of the Commission's rule making authority, which is not limited to Olympic's direct testimony, or the rebuttal testimony, but should be more appropriately a matter of general rulemaking principles that allow broad policies for oil pipeline companies to comment on the advantages and disadvantages of a particular methodology.

In October, Olympic suggested seven factors that should be among those considered by the Commission in its rulemaking and policy setting rule:

1) The history, scope and purpose of oil pipeline regulation in the United States differs markedly from other common carrier industries and from public service utilities such as electric and gas retail utilities.

2) In general terms, Washington State's legislative history appears to favor consistency with federal Interstate Commerce Act principles.

3) The rate regulation of the oil pipeline at issue is divided between federal and state rate regulation. Use of a uniform methodology and common set of supporting data to set pipeline rates would be fair, economic and efficient. It would avoid duplication of effort and expense, for the Commission as well as the parties. It would avoid potentially contradictory rate outcomes for the same pipeline system.

4) Although it has not formally adopted the federal oil pipeline rate methodology, Staff and the Commission have accepted it for use in Washington State to set rates for Olympic (and other oil pipeline companies such as Chevron) since 1983.

5) There is no compelling Washington State public interest in adopting a separate state oil pipeline rate methodology. Unlike retail public service utilities, the Commission does not regulate the retail price of gasoline or other petroleum products. The proposed tariffs here would result in an increase to shippers (who are unregulated) of less than $0.0025 a gallon. Even if shippers were able to pass this entire cost onto Washington State drivers, the average driver would pay less than $3.00 a year in increased costs.

6) A change in methodology and procedures for filing supporting data would create needlessly complex transition issues and added costs. It could create

uncertainty and potentially discourage pipeline investments in Washington State.

7) Washington State has a compelling interest in pipeline safety, which is best met by encouraging responsible oil pipeline management and owners to remain in Washington State and by allowing recovery of oil pipeline safety investments without delay. Washington State also has a compelling interest in the expansion of oil pipelines in order to alleviate tanker truck traffic on highways in the Puget Sound region and to reduce barge traffic on water of Puget Sound and the Columbia River.

The rebuttal testimony of Leon Smith (attached) describes additional policy factors.

2. Staff Provides No Guidance for the Commission's Policy Determination on Methodology for Oil Pipelines

Staff has provided no guidance to the Commission comparing the federal methodology to the state methodology --- as it had done in 1983. Staff witnesses, for example, do not address the following policy questions to aid the Commission in its choice of methodology:

- Whether the use of different ratemaking methodologies or policies for the interstate versus the intrastate shipment of products on the same pipeline system creates potential conflicts and problems.

- Whether the history in Washington state of the use of the federal methodology as the basis for Olympic's tariff filings (and of Chevron's tariffs) and the acceptance of those tariffs by the Commission suggests a policy need for consistency and continuity.

- Whether the known difference in the end result produced by the federal approach compared to the approach used by Staff would create transition problem for Olympic or other pipeline companies.

- Whether the unique circumstances and regulatory history of oil pipeline companies suggest a need to adopt a variation on a different methodology if the Commission formally adopts one.

- Whether a change in methodology should be deferred until further review, including public comment

  Whether the Commission's new pipeline safety obligations require consideration

The Commission Staff has characterized the Commission's choice of methodology as one mostly of fact, not one of broader policy. But, as Commission Staff itself has recognized since 1983, when it specifically examined the unique nature of oil pipeline regulation, this choice is a policy choice. It is a rule-making choice, and although there are facts that will aid in the determination of a correct policy decision on methodology for oil pipeline companies in Washington state, the policy will have general applicability to all oil pipeline companies and is thus not in the nature the fact to be established, but of a policy to be adopted. Under the Washington State Administrative Procedures Act, See D/O Center v. Department of WDOE, 119 Wn.2d 761, 837 P[.]2d 1007(1992), a standard of general applicability that adopts substantive provisions of law pursuant to delegated legislative authority is to be adopted through-rule making. E.g., Simpson Tacoma Kraft Co. v. WDOE, 119 Wn.2d 640, 647[,] 835 P.2d 1030 (1992). The choice of the appropriate methodology for oil pipeline ratemaking if it is to be changed by the Commission should be made in full compliance with Ch. 34.05 RCW. Staff is inviting the Commission to err fundamentally on this issue. Any such choice should be made in compliance with the procedures for adoption of significant legislative rules.

3. The Commission Needs A Full Record On Methodology to Make an Informal Policy Choice

Because Staff incorrectly views choice of methodology as one of fact only and places the burden on Olympic to produce all facts related to the choice of methodology, Staff has not presented the Commission with a balanced evaluation of the pros and cons of choosing another methodology at this time for oil pipeline companies over the one that the Commission has accepted for oil pipeline companies in Washington state since at least 1983.

Olympic filed a separate motion at the outset of this case to request that the Commission formally adopt the federal methodology as a policy matter for oil pipeline companies from Washington state and for Olympic as an oil pipeline company of the state. A copy of that petition, dated October 31, is attached to Staff's motion.

The Commission should make a policy determination based on a full factual record and a full exploration of all the policy reasons both for and against use of a particular methodology for oil pipelines in Washington state. But Staff seeks to prevent the Commission from using any of Olympic's rebuttal testimony that addresses the unique circumstances of the oil pipeline industry, the application of prior federal methodologies and current federal methodologies to the oil pipeline industry.

Olympic, for example, has filed rebuttal testimony of Leon Smith, the former Chief of Oil Pipeline Regulations at the ICC and later the FERC. Staff's answer (which is in effect its own motion) would prevent the Commission from considering Leon Smith's testimony and the testimony of others on the important policy considerations regarding what methodology to adopt for oil pipeline companies in Washington state. This is not what the Commission mean by indicating that it wanted to have a policy determination on methodology in the context of the adjudication. Staff mischaracterizes the Commission' denial of Olympic's

request for a policy statement on appropriate ratemaking methodology for oil pipelines in this state. In its suspension order, the Commission said:

> Because the Commission has determined to address the question of applicable ratemaking methodology in the context of the adjudication. (Suspension Order at page 3, ordering ¶ 6).

There is nothing in that order that should be read to mean that the Commission would not look at the policy implications based on the entire case as presented, including rebuttal, cross-examination -- and questions by the Commission.

Olympic believes that the Commission, in exercising its policy making and rulemaking responsibilities, needs to have all relevant considerations of a policy nature before it when it makes a determination on methodology. Commission Staff's arguments that the Commission's determination should be limited to Olympic's direct evidence only and to ignore all other policy factors where this policy decision is untimely, incorrect and would be in violation of the Administrative Procedures Act.

Olympic does not have the time to respond in detail to Commission Staff's answer on this important issue and other issues, because Commission Staff just filed its position on this legal policy matter yesterday.

Conclusion

Olympic respectfully requests that the Commission extend the time for Olympic to respond to Staff in full. The Commission should have an opportunity to ask its own policy questions on methodology of all of the witnesses at the hearings. Olympic has further requested hearings be continued to August 5th.

DATED this 14th day of June, 2002.

Respectfully submitted,

PERKINS COIE LLP

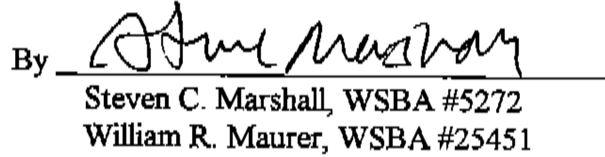
By 
Steven C. Marshall, WSBA #5272
William R. Maurer, WSBA #25451

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

1 **Exhibit No. _____ (LPS-1T)**

2 **OLYMPIC PIPE LINE COMPANY**
3
4 **REBUTTAL TESTIMONY OF LEON P. SMITH**
5

6 **I. Name and Address**

7 **Q. Please state your name and address.**

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

9 **II. Professional Experience and Qualifications**

10 **Q. Please stately briefly your professional experience and qualifications.**

11 A. I was employed at the Federal Energy Regulatory Commission (FERC) and
12 one of its predecessor agencies, the Interstate Commerce Commission (ICC),
13 for over twenty-four years. My employment at these agencies began in August
14 1976 and continued until my retirement in September 2000. During that
15 period, I held positions of increasing responsibility. At the ICC, I was
16 responsible for work on oil pipeline valuations. In 1977, with the
17 implementation of the Department of Energy Organization Act, I was
18 transferred to the newly-formed FERC. I progressed through numerous
19 positions--always dealing with oil pipeline matters--until I was in charge of the
20 branch responsible for oil pipelines at the FERC. These positions included:
21 (i) General Engineer; (ii) Assistant to the Director; Division of Rate Filings;
22 (iii) Branch Chief, Oil and Gas Filings Branch; (iv) Branch Chief, Rate Review
23 Branch; and (v) Group Leader, Group 2, Division of Corporate Applications in
24 the Office of Markets Tariffs and Rates.

1 During my employment at the FERC, I was responsible for all facets of oil
2 pipeline regulation. As stated, I began working in the valuation area (a
3 regulatory methodology formerly used at the ICC and the FERC). Upon
4 becoming Assistant to the Director, I became fully involved in all facets of the
5 FERC's regulation over oil pipelines. I have provided advice to the FERC
6 Commissioners concerning all oil pipeline matters. I was one of the primary
7 individuals working on oil pipeline related rulemakings (i.e., the rulemakings in
8 RM93-11-000, RM94-2-000, and RM94-1-000 (resulting in FERC Order Nos.
9 561, 571, and 572, respectively) that implemented major modifications to the
10 FERC's regulatory rate determination methodologies). Representing the
11 FERC, I addressed or lectured at numerous conferences related to oil pipeline
12 regulation including Association of Oil Pipeline meetings and the Northwestern
13 University Transportation Center. I represented the United States Government
14 in oil pipeline dealings with foreign governments; I also represented the FERC
15 in oil pipeline matters with other federal agencies, Congress, state agencies, the
16 oil pipeline industry, and the public in general.

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

22 **II. General Purpose and Summary of Testimony**

23 **Q. What is the general purpose of your testimony?**

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

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

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

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

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

10 **III. Regulation of Oil Pipelines at the Federal Level**

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

13 A. No, its does not. The FERC considered whether it was appropriate to adopt the
14 public utility model for oil pipelines and ultimately determined that it was not.
15 Instead, oil pipelines are regulated as common carriers--not as public utilities.
16 It is my understanding that the statute in the state of Washington (RCW
17 81.88.030) makes clear that oil pipelines should be regarded as common
18 carriers. For reasons I discuss below, I believe that common carriers in
19 general, and oil pipelines in particular, face a very difference set of
20 circumstances from typical public utility companies.

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

23 A. Part of the reason is that, historically, the ICC regulated oil pipelines, whereas
24 the Federal Power Commission (FPC) regulated gas pipelines and electric

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

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

16 A. To understand the reasons that oil pipelines became subject to common carrier
17 regulation, it is necessary to understand the history of the oil pipeline industry.
18 The oil pipeline industry at the beginning of the 20th century was marked with
19 bitter complaints concerning alleged abuses of small oil producers by the
20 Standard Oil monopoly through its pipelines. These small oil producers
21 charged Standard Oil Trust and other large oil firms with charging exorbitant
22 rates to use their pipelines to squeeze out smaller producers and control the
23 market.[1] These complaints led to the adoption of the Hepburn Amendment of

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

1 1906. 34 Stat. 584 (1906), as amended, 49 U.S.C. § 1. Under this amendment,
2 interstate oil pipelines were declared common carriers subject to the
3 jurisdiction of the ICC under the Interstate Commerce Act. It is my
4 understanding that in Washington, intrastate oil pipelines are subject to a
5 similar statute (RCW 81.88.030) that requires them to operate as common
6 carriers.

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

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

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

17 A. The two most important requirements of the Interstate Commerce Act relating
18 to oil pipelines were (i) the requirement of oil pipelines to post "just and
19 reasonable" tariffs and (ii) the duty to avoid unreasonable preferences or
20 discrimination between similarly situated shippers. 49 U.S.C. § 1(4), (5), and
21 (8).[2] Additionally, oil pipelines are not subject to the "commodities clause,"

[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));

1 which prohibits carriers from transporting articles produced or owned by them,
2 thereby allowing shippers to own oil pipelines. 49 U.S.C. § 1(8). Moreover,
3 oil pipelines are not required to obtain a certificate of convenience and
4 necessity before constructing or extending a line or to obtain the permission of
5 the FERC before abandoning a line. 49 U.S.C. § 1(18). In short, the FERC
6 has no authority to regulate the entry or exit of oil pipelines from given
7 markets.

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

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

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

20 A. Common carriers are required to hold themselves open to all qualified shippers.
21 When shippers' requests for pipeline capacity exceed the capacity available,
22 the common carrier is required to treat each shipper equally. Usually this

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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)).

1 requires that each shipper's requested capacity be reduced in some equitable
2 manner to bring throughput and capacity into balance. For example, a
3 hypothetical pipeline might have capacity to transport 100 units of refined
4 products per day and receive requests from shippers to transport 200 units. In
5 this simple example, the oil pipeline might prorate or reduce each shippers
6 request by 50 percent (100/200). The exact formula for prorationing capacity
7 would depend on the prorationing rules governing product movements on the
8 carrier's pipeline system.

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

1 **Q. Please explain the significance of this constraint.**

2 A. As I have noted elsewhere, the history of common carrier oil pipelines has been
3 dominated by the companies requiring pipeline capacity to transport their
4 refined products, as is the case for Olympic. Due to the common carrier
5 requirements, Olympic cannot reserve capacity for the use of their affiliates.
6 Likewise, they cannot contractually bind non-affiliated shippers, such as Tosco
7 and Tesoro, to commit to the use of capacity in the long-term. For ratemaking
8 purposes, this implies that contract carriers will have more certainty with
9 regard to future throughput than common carriers, who may experience sharp
10 fluctuations in their throughput. The FERC has recognized that this fact, in
11 addition to others such as the lack of monopoly protection, engenders higher
12 risk for oil pipelines. In ARCO Pipe Line Company, 52 FERC ¶61,055 (July
13 18, 1990), the FERC explicitly noted that oil pipelines face higher risks than
14 gas pipelines and as a result require a higher return on equity. Id. at 61,242-43.

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

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

1 At the time of FERC's creation, Williams Pipeline Company, a rate case
2 decided by the ICC was pending before the U.S. Court of Appeals for the D.C.
3 Circuit. The FERC requested the court to remand the case so that it could
4 begin its regulatory duties with a "clean slate." The FERC also stated that it
5 wished to use this proceeding as a vehicle to construct a generally applicable
6 ratemaking methodology for oil pipelines. The court granted this request and
7 remanded the case to the FERC. On November 30, 1982, the FERC issued its
8 decision in Williams I. While this voluminous decision discusses many items,
9 including an extensive history of oil pipeline regulation, the key point from a
10 ratemaking perspective was that it largely preserved the valuation methodology
11 as the ratemaking regime. In the U.S. Court of Appeals for the D.C. Circuit, in
12 Farmers Union Central Exchange, Inc. v. FERC, 734 F.2d 1486 (D.C. Cir.
13 1984), determined that the FERC's decision was not based on reasoned
14 decision-making and, as a result, remanded the decision back to the FERC. On
15 June 28, 1985, the FERC issued a new decision to provide a general
16 methodology with which oil pipeline companies could set rates in Williams II.
17 This decision provided a framework for oil pipelines to set their rates into the
18 future. In terms of rate base, this decision contained two major features. First,
19 it set aside the valuation methodology in favor of a trended original cost
20 ("TOC") methodology. Second, it allowed for a transition rate base
21 mechanism to facilitate the transition between the old methodology of
22 valuation to the new methodology of trended original cost. On other matters, it
23 discussed the appropriate capital structure, the appropriate cost of debt, and the
24 appropriate treatment of income tax allowances.

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

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

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

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

1 under the DOC approach and this would provide a disincentive for new
2 entrants into the pipeline market. To mitigate this problem, the FERC adopted
3 the TOC methodology, which results in lower returns in the early years and
4 higher returns in the later years.

5 **Q. Why did the FERC include a transition rate base as part of the Opinion No.**
6 **154-B methodology?**

7 A. As the FERC stated in Opinion No. 154-B, the pipeline industry's long reliance
8 on the valuation methodology it was concerned that switching methodologies
9 would provide a disincentive to future investment in pipeline assets. See 31
10 FERC at ¶ 61,835-36. Specifically, the FERC was concerned that if investors
11 at some point prior to 1983 had based their investment on the expectation of
12 being able to charge rates set under valuation, which they now could not do,
13 future investors might be loath to make pipeline investments for fear that they
14 would suffer an uncompensated shift in the regulatory regime. To ensure that
15 this did not occur, the FERC allowed pipelines that existed in 1983 to include a
16 component in their starting rate base that represented what the equity investors
17 could have expected to earn under the valuation methodology.

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

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

23 > The actual capital structure could be the actual capital structure
24 > of either the pipeline or is parent. The Commission concludes
25 > that a pipeline which has issued no long-term debt or which

1 issues long-term debt to its parent or which issues long-term debt
2 guaranteed by its parent to outside investors should sue its
3 parent's actual capital structure. However, a pipeline which
4 issues long-term debt to outside investors without any parent
5 guarantee should use it's (the pipeline's) own capital structure.
6 (31 FERC ¶ 61,377 at 61,836)

7 The basic reason the FERC expressed a preference for actual capital structures
8 is that it realized these structures would more accurately reflect the risks of the
9 specific company for which the capital structure was being employed. If
10 parent companies guaranteed the debt of their subsidiaries, these parent
11 companies were, in essence, assuming the risk of their affiliates, and the FERC
12 determined it was more appropriate to use the parent company capital
13 structures.

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

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

19 Second, the historical capital structure of 1983 is used to determine the portion
20 of the starting rate base write-up associated with equity. Since the purpose of
21 the write-up, or transition rate base, was to mitigate the impacts of the
22 regulatory change on equity investors, the FERC determined that a pipeline
23 was only entitled to this transition mechanism to the extent that its assets in
24 1983 were financed with equity. 31 FERC at ¶ 61,836.

25 **Q. How did the FERC instruct the pipeline companies to calculate their rates of**

1 **return?**

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

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

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

17 **Q. Please explain.**

18 A. As part of the Energy Policy Act of 1992 ("EP Act"),[1] Congress mandated that
19 the FERC develop a "simplified and generally applicable" methodology for
20 establishing "just and reasonable" rates. 42 U.S.C. § 7172. The FERC has
21 established Indexation as the generally applicable ratemaking methodology for

1 adjusting existing tariff rates. Under Indexation, rates are capped by ceilings,
2 which are adjusted annually by a prescribed pipeline index, currently the
3 Producer Price Index for Finished Goods less one percent ("(PPI-FG)-1").
4 Pipelines can apply for temporary relief from Indexation by using two
5 alternative ratemaking methodologies, Cost-of-Service and Settlement. The
6 Cost-of-Service methodology for existing rates is similar to that employed for
7 setting initial rates (i.e., rate of return regulation under the FERC's prescribed
8 regulatory cost model, TOC). In order to qualify for an index waiver, a carrier
9 must demonstrate a substantial divergence between its regulatory Cost-of-
10 Service and the maximum revenue it could earn at its index ceiling rates.
11 Existing rates changed under the Settlement approach require unanimous
12 consent of all shippers currently utilizing the service. The COS and Settlement
13 approaches, however, only provide temporary relief from the FERC's
14 Indexation methodology. Rates filed under these alternative approaches
15 establish the new index ceiling, which is subsequently adjusted by the FERC's
16 annual index.

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

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

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

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

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

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

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

9 A. Yes.

10 **I. Observations Regarding Olympic's Ratemaking**

11 **Q. Mr. Brown suggests that the FERC "has acknowledged the advantages of the**
12 **DOC methodology even when considering regulation of .... Crude oil and**
13 **petroleum products pipelines." Is that statement accurate in regards to the**
14 **FERC's regulation of oil pipelines?**

15 A. No. As I have stated above, the Opinion 154-B Trended Original Cost
16 ("TOC") methodology is required by 18 C.F.R. 346. While it is also true that
17 FERC Administrative Law Judge Zimmet, in Endicott Pipeline Company, (55
18 FERC ¶ 63,028 at 65,144-46) did recommend the use of Depreciated Original
19 Cost ("DOC"), this decision was never affirmed by FERC. Moreover, this case
20 involved assets in Alaska, which the FERC has acknowledged have marked
21 differences from pipelines in the continental U.S. Of course, the FERC does
22 rely on DOC for cost of service regulation of utilities such as electric
23 transmission facilities. However, for the reasons I have explained, the FERC
24 has adopted the TOC methodology with a starting rate base adjustment in

1 Opinion 154-B ("154-B Methodology") for oil pipelines. It specifically
2 addressed the applicability of DOC methodology to oil pipelines in Lakehead
3 Pipe Line Company, 71 FERC ¶ 61,338 at 62,30708, and *again affirmed the*
4 *use of the 154-B TOC Methodology for oil* pipelines.

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

8 A. No. As should be clear from my discussion of the process by which 154-B
9 methodology was developed, this was not a casual exercise done in haste. The
10 FERC considered carefully how to ensure that: (1) rates produced by the 154-B
11 Methodology produce "just and reasonable" rates; (31 FERC ¶ at 61,832) and
12 (2) was fair to the industry by providing the Starting Rate Base adjustment to
13 avoid penalties relating to changes in cost of service methodology from the
14 valuation methodology that was relied on for rate regulation previously. (31
15 FERC ¶ at 61,835-36) Accordingly, it is fair to say that the FERC believes
16 the154-B Methodology fulfills the legal requirement for "just and reasonable"
17 rates.

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

23 A. No, it is not. The mechanics of the trended original cost methodology
24 ("TOC") applies a *real* rate of return to the equity portion of rate base. The
25 real rate of return on equity is determined by subtraction of inflation from the
26 nominal rate of return as is explained by Dr. Schink. The equity portion of rate

1 base is then "trended" by multiplying the net balance by the rate of inflation.
2 For example, if the equity portion of rate base were $100, and the rate of
3 inflation for the period were three percent, a trending adjustment of $3.00
4 would be made and the equity rate base would be $103.00 after trending. The
5 trending adjustment is stored in rate base and is amortized over the life of the
6 pipeline and recovered in cost of service in a manner much like depreciation
7 charges. The term "deferred return" refers to the fact that the inflation portion
8 of the nominal return on equity is not recovered in the current year, but is
9 stored in rate base and recovered over the life of the pipeline (i.e., the recovery
10 of a portion of return on equity is deferred, hence the term "deferred return").

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

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

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

1 A. No. Opinion 154-B defines the "cost of service" standard for determining
2 whether a rate falls within the limits of "just and reasonable" for the period
3 under examination. It incorporates a definition of rate base that includes a
4 number of considerations that are related to past events such as depreciation,
5 accumulated deferred income taxes, and the trending adjustments to the equity
6 component of rate base ("deferred earnings"). None of these items is
7 dependent on past earnings. For example, if a pipeline did not generate
8 sufficient revenue in a given year to recover its depreciation, it could not carry
9 this under-recovery into the present period. Likewise, there is no examination
10 of income taxes paid to determine the level sufficient to "fund" the amount of
11 deferred income taxes. Accordingly, there is no basis to argue that one element
12 of rate base (deferred return) should be subjected to tests relating to past
13 earnings.

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

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

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

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

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

16 A. As I have stated above, the FERC's regulations for oil pipelines require that the
17 test period be forward-looking. From reading the Commission regulations, it is
18 my understanding that the FERC's concept of a test period correlates to the
19 Commission's concept of pro forma adjustments. Accordingly, it has been my
20 experience that budget forecasts are frequently relied on for determining test
21 period amounts. Indeed, it is not possible to generate the type of forward-
22 looking numbers envisioned by the FERC's test period concept without relying
23 on the type of forecasts that budgets normally contain. While there may be
24 legitimate differences of opinion concerning the appropriate dollar amount for
25 a particular item, Mr. Brown's wholesale rejection of budget estimates and his
26 proposed adjustments to operating expenses are not consistent with the FERC's

1 standards for the test period. Pipeline companies develop budgets for
2 management's financial and operation purposes based on their best internal
3 projections. It is appropriate for the FERC and the Commission to rely on
4 projections contained in the managerial budget reports as the carrier's best
5 estimate of future operating costs for ratemaking purposes.

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

8 A. As I understand from Mr. Talley, the operator has formulated a plan to
9 eventually allow the system to be restored to full operating pressure and to be
10 operated in a manner that ensures the protection of public safety, preservation
11 of the environment, and addresses other concerns expressed by the community.
12 Although I have not performed any analysis of the costs involved, it is not
13 surprising to me that the safeguards would increase the costs of operation.
14 Also, unlike the FERC, I understand that the Commission has recently been
15 assigned certain statutory responsibilities relating to oil pipeline safety (See
16 WAC 480-75-005 et. seq.). Accordingly, it would not be appropriate, in my
17 view, for the Commission to deny Olympic the recovery of costs incurred in
18 complying with increased safety requirements in rates, simply on the basis that
19 they are higher than past spending levels.

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

22 A. I have not made a detailed review of Mr. Colbo's adjustments. I understand
23 that Mr. Ganz has some comments in that regard. As I have stated elsewhere,

1 there are several considerations I would consider relevant to determining
2 whether any adjustments are required or even appropriate.

3 **Q. Please explain.**

4 A. Mr. Colbo is concerned about the lack of audited financial records. (Ex. T-
5 ___(RGC-1T) at 7) However, as I have stated previously, it is common for oil
6 pipelines to prepare rate filings using data drawn from the FERC Form 6. I
7 understand that Mr. Collins has relied on the Form 6 for his presentation. I
8 also understand from Mr. Ganz that the Form 6 is the reporting standard relied
9 on by the Commission. Accordingly, it would seem appropriate for Mr. Colbo
10 to look to the Commission reporting standard as the source of information. An
11 officer of the corporation attesting to its accuracy signs the Form 6. Further,
12 the Form 6 is prepared in accordance with the Uniform System of Accounts
13 ("USoA") , a regulatory accounting standard adopted by the FERC and the
14 Commission for oil pipelines. I understand that Mr. Ganz discusses in his
15 testimony some of the differences between the accounting practices for oil
16 pipelines under the USoA and GAAP. Once again, the Form 6 approach would
17 seem to provide an appropriate starting point for Mr. Colbo's analysis for the
18 reasons stated above. Likewise, the reassignment of expenses to capital and
19 normalizing adjustments should consider the standards of the USoA and the
20 accounting practices of oil pipeline. The wholesale importation of utility
21 accounting practices is not appropriate.

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

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

6 **Q. Do the FERC's regulations for cost of service filings contained in 18 C.F.R.**
7 **346 contain any provision for providing incentives to compel pipelines to**
8 **behave in one way or another?**

9 A. No, they do not. The FERC's regulations lay out in explicit detail the type of
10 information that the FERC requires in a cost of service filing and the time
11 period that information should cover. Nowhere do the FERC's regulations
12 contemplate altering the cost of service requirements to provide incentives in
13 order to encourage pipelines to behave in a certain manner. As I discussed
14 above, while the Commission's regulations do not contain specific provisions
15 with regard to the time period of pro forma adjustments, making this time
16 frame too elastic could lead to mischief on the part of both (i) carriers seeking
17 to recover costs years before they occur, and (ii) shippers seeking to take
18 account of cost savings or increase in throughput years before they actually
19 occur.

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

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

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

6 (18 C.F.R.§ 346.2 (a)(ii)).

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

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

10 "will provide an apparently needed incentive for Olympic to
11 more expeditiously comply with OPS's safety requirements and
12 return its pipeline to normal operating pressure"(Ex. JFB-1T at
13 55).

14 Mr. Brown then goes on to make a number of largely unsubstantiated
15 assertions regarding the throughput that Olympic will likely experience in the
16 future. Mr. Brown's approach would effectively extend the test period to
17 include events that Mr. Brown himself recognizes may occur several years into
18 the future, it at all. I believe that this reveals two fundamental flaws about Mr.
19 Brown's ratemaking assumptions. First, the adjustments he proposes are not
20 known and measurable. It is not known, for example when or if Olympic will
21 be allowed to operate at full pressure. Second, as Mr. Brown admits, Olympic
22 has already stated it may not be possible to operate at full pressure until 2005.
23 I believe that adjustments based on events likely to occur that far in the future
24 are too speculative to be classified as known and measurable with reasonable
25 certainty.

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

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

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

17 A. The FERC requires that each pipeline report throughput and revenues annually
18 in the Form 6 report. Further, the Page 700 section of the Form 6 Report also
19 states the Cost of Service as calculated under the FERC's 154-B methodology.
20 Thus, shippers will have sufficient information in order to evaluate whether
21 they should to file a protest or complaint. If shippers do file a complaint, and
22 they succeed in showing that Olympic's rates are no longer just and reasonable,
23 then they will not only be entitled to lower rates going forward but for
24 reparations for two years back, and thereby they have the means to prevent any
25 "windfalls" to Olympic arising from either increases in throughput or

1 reductions in costs. It is simply not appropriate or necessary to speculate here
2 what may occur in the distant future regarding throughput. Moreover, I
3 understand that Olympic is proposing an automatic throughput adjustment
4 mechanism.

5 **IV. Lessons of the FERC Experience**

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

8 A. There are several factors that are relevant. First, unlike many of the large
9 companies regulated by the Commission, pipelines are common carriers.
10 Public utilities are generally regulated in order to protect the public interest of
11 the consumer. Olympic's shippers are large sophisticated multi-million dollar
12 corporations that are more than capable of defending their own economic
13 interest. The Commission's objective in regulating common carrier oil
14 pipelines has nothing to do with consumer interests. The pipeline tariff
15 represents a small portion of the overall retail pump price (e.g., a 21 cent per
16 barrel decrease in Olympic's tariff could, at most, result in a 0.5 cent per gallon
17 decrease to the consumer). Even if the Commission desired to reduce the
18 pump price paid by the consumer by reducing the pipeline tariff, it would have
19 no assurance that the refiner, jobber, marketer, or consignee would pass a
20 reduction in pipeline tariff through to the consumer. Accordingly, unlike
21 regulated utilities that deliver directly to the consumer, it is not clear that
22 actions taken by this Commission relating to oil pipeline tariffs will have any
23 effect on the prices paid by the consumer. The Commission's objective in
24 regulating oil pipelines should be to establish just and reasonable rates that are

1 equitable and strike a fair balance between the interest of the carrier and its
2 shippers.

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

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

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

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

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

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

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

1 on a combined intrastate and interstate basis. Given the large and sophisticated
2 parties on both sides of this important economic issue, these disputes can lead
3 to an additional regulatory burden for the Commission. FERC has already
4 considered most of the issues currently confronting the Commission regarding
5 oil pipeline regulation. It has conducted fully-litigated proceedings and has
6 scrutinized the reasoning behind and application of its cost-based methodology
7 several times. Moreover, all parties to this proceeding are fully aware of how
8 the FERC methodology functions. There is ample justification for the
9 Commission to rely on the FERC's methodology when establishing rates for
10 Olympic.

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

13 A. No. Obviously, if the Commission believes that the existing methodology does
14 not result in rates that fall within the zone of justness and reasonableness, then
15 it is obligated make modifications. The Commission should, however, be wary
16 of making substantial changes to its methodology needlessly. Careful
17 consideration should be given to the impact on the investors that have
18 committed capital to the markets before any changes are made. As I mentioned
19 above, the Commission should strive for stability by maintaining unambiguous
20 regulations that treat all parties fairly and equitably. There are times when the
21 Commission may determine that a change in policy is necessary. In 1985,
22 FERC changed its prior ratemaking methodology for oil pipelines. It did so
23 with serious consideration to issues such as investor reliance, capital recovery
24 patterns, and the desire to foster greater competition. Opinion No. 154-B was
25 the outcome of these deliberations. In that opinion, the FERC dealt with the

1 concern regarding investor reliance on equity returns, achieved under
2 Valuation, by establishing a transitional starting rate base that carriers were
3 allowed to earn a return on until it is amortized. The FERC also addressed the
4 issues of capital recovery and competition by creating a trended equity rate
5 base. This reduced the concerns recognized with the front-end load problems
6 associated with DOC, while, at the same time, potentially fostering competition
7 by enabling newer pipelines to enter the market and compete with older
8 pipelines because a portion of their current return has been deferred into later
9 periods when they will be more likely to be able to recover it. These issues
10 provide examples of the concerns that a regulatory agency should consider
11 when contemplating a change in methodology. If the Commission decides to
12 begin imposing a DOC methodology at this point in time, it should consider the
13 issues of fairness in light of the Commission's role in setting investor
14 expectations and the potential complications of different rate methodologies for
15 intrastate and interstate traffic.

16 Q. **Please explain your concerns regarding "fairness?"**

17 A. The Commission cannot remove itself entirely from the current situation where
18 there are widely divergent understandings of how the Commission evaluates
19 rates for oil pipelines. This is not the first rate filing based on the Opinion No.
20 154-B methodology submitted to this Commission by Olympic; and Mr.
21 Collins states that the three prior Olympic filings were allowed to go into effect
22 without any changes. If the Commission had concerns with the methodology
23 used in the prior filings, it could have acted on them. To change "horses" at
24 this juncture, after Olympic has committed to a significant capital-spending
25 program to bring the system up to highest standards for a safety and reliability,

1 strikes me as unfair. Certainly, the Commission is not "locked in" by the past,
2 but I believe it needs to consider what a fair "transition" to a new regime
3 requires—if the Commission concludes that a change is required.

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

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

14 Second, it is important to understand that oil pipelines are common carriers and
15 cannot provide long-term reservations of capacity for the use of specific
16 shippers. Therefore, all parties, present and future, benefit when a pipeline
17 makes a long-term investments in order to minimize pro-rationing adjustments
18 that force shippers to seek other transportation alternatives. More importantly
19 however, these facilities are built specifically to meet peak demand
20 requirements and will not necessarily be used to their maximum capacity
21 throughout the year. For these reasons, the FERC does not require the
22 recognition of the effect these facilities may have on peak period capacity
23 when determining test (pro forma) period throughput. Throughput reflects
24 what the system carrier actually transported, or is projected to transport in the
25 near term, not the peak system capacity. To put it simply, the FERC's

1 regulation of oil pipelines assumes that management is making economically-
2 rational decisions. I would expect that BP does not desire to invest in
3 unnecessary facilities. Oil pipelines are designed to handle peak requirements
4 to avoid the disruption of pro-rationing shippers on the system due to capacity
5 constraints. Therefore, to remove facilities from rate base in the current
6 transitional stage, when Olympic is striving to restore the system to normal
7 operations, is not appropriate.

8 **Q. Please explain your concerns regarding ratemaking stability.**

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

19 **Q. Does this conclude your present testimony?**

20 A. Yes.

21

22

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Exhibit No. ______ (LPS-2)
Docket No. TO-011472
Witness: Leon P. Smith

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

EXHIBIT TO
REBUTTAL TESTIMONY OF
LEON P. SMITH

OLYMPIC PIPE LINE COMPANY

June 11, 2002

Mr. Leon Paul Smith

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PERSONAL INFORMATION

EDUCATION: Graduated Washington-Lee HS, Arlington, VA June 1964
Graduated University of Virginia, Charlottesville, VA
June 1968 with a Bachelor of Science in Civil Engineering

MILITARY: US Army Oct. 1968 to Oct. 1970 with honorable discharge

AFFILIATIONS: Member of the American Society of Civil Engineers.

EMPLOYMENT HISTORY

Sept. 2000 – Present ***PIPELINE REGULATORY CONSULTANT***

Leads pipeline engagements providing consultation on matters dealing with economic regulation the oil pipelines. Expertise covers most all areas of oil pipeline regulation including, but not limited to, tariff transportation rate structuring, Federal Energy Regulatory Commission rules, regulations, and processes, common carrier requirements and regulations, historical perspectives of oil pipeline regulation in the United States, and permitted and prohibited practices and actions under the regulatory laws of the United States. Consulting projects are listed below.

Oct. 1977 – Sept. 2000 ***CHIEF, OIL PIPELINE REGULATION*** [1]

Federal Energy Regulatory Commission, Washington, DC

Office of Markets, Tariffs and Rates, Division of Corporate Applications

Duties included the supervision of a staff of professionals (engineers, accountants, lawyers, energy industry specialists, public utilities specialists, etc.) and non-professionals engaged in all aspects of regulation of interstate transportation of crude oil and petroleum products by pipeline. Served as the Commission's primary expert on oil pipeline regulation, providing advice to the Commissioners, regulated industries, state and local governments, foreign governments and the public. Served as a member of the US-Russia Interministerial Experts Group of the Gore/Chernomyrdin Commission in assisting the Russians in establishing a workable regulatory regime for their oil pipeline industry. Provided advice and information to numerous foreign governments such as: China, South Africa, Kazakhstan, Brazil, Canada, and Mexico. Assisted in developing and writing the Commission's rules and regulations concerning oil pipeline regulation through rulemaking procedures. Developed an extensive experience in pipeline ratemaking methodologies. Participated in the creation and implementation of several pipeline ratemaking methodologies.

	complaint made by Chevron Products Company. Docket No. OR01-04-000
March 13, 2001	Provided Testimony to the Federal Energy Regulatory Commission in support of the response of Anschutz Ranch East Pipeline Company to answer to complaint made by Big West Oil Company Docket No. OR01-03-000.
March 5, 2001	Provided Testimony to the Federal Energy Regulatory Commission supporting the response of Frontier Pipeline Company to answer of complaint made by Big West Oil Company. Docket No. OR01-02-000.
Feb 26, 2001	Provided Rebuttal Testimony on behalf of TAPS CARRIERS regarding various regulatory concepts used in calculating 1997, 1998, 1999 and 2000 tariff rates for the Intrastate Transportation of Petroleum over the Trans Alaska Pipeline System before the State of Alaska, Regulatory Commission of Alaska, P-97-4.
Feb. 6, 2001	Provided Testimony the Federal Energy Regulatory Commission supporting the response of Anschutz Ranch East Pipeline Inc. to the complaint made by Big West Oil Company. Docket No. OR01-03-000.
Jan. 29, 2001	Filed Affidavit at the Federal Energy Regulatory Commission supporting the response of Frontier Pipeline Company to the complaint made by Big West Oil Company. Docket No. OR01-02-000.
Nov. 14, 2000	Testified in State Property Tax Commission on behalf of Kinder Morgan Energy Partners, LP, regarding the Federal Energy Regulatory Commission's Uniform System of Accounts for Oil Pipeline Companies.

CONSULTING PROJECTS

- Provided explanation of United States rules, regulations and general experiences dealing with common carrier pipelines to the Ecuadorian government on behalf of the client.
- Assisted a common carrier pipeline company client in preparing a filing at the FERC requesting approval for modifications to their FERC Form No. 6, page 700.

[1] The actual titles of the positions held during this period vary but the duties under each different title were ostensibly the same as listed. The actual titles were:

02/27/2000 – 09/08/2000	Group Leader, Group 2, Division of Corporate Applications, Office of Markets Tariffs and Rates, FERC.
08/21/1994 – 02/27/2000	Branch Chief, Rate Review Branch III, Division of Pipeline Rates – West, Office of Pipeline Regulation, FERC.
11/04/1990 – 08/21/1994	Branch Chief, Oil and Gas Filings Branch, Division of Rate Filings, Office of Pipeline and Producer Regulation, FERC.
01/03/1988 – 11/04/1990	Assistant to the Director, Division of Rate Filings, Office of Pipeline and Producer Regulation, FERC.
09/30/1977 – 01/03/1988	General Engineer, Valuation Branch, Division of Pipeline Rates and Tariffs, Office of Pipeline and Producer Regulation, FERC.
08/01/1976 - 09/30/1977	General Engineer, Valuation Branch, Section of Cost and Valuation, Bureau of Accounts, ICC.