

1 BEFORE THE WASHINGTON UTILITIES AND
2 TRANSPORTATION COMMISSION

3 WASHINGTON UTILITIES AND) Docket No. TO-011472
4 TRANSPORTATION COMMISSION,) Volume XXXIII
) Pages 4193 to 4353
5 Complainant,)
)
6 vs.)
)
7 OLYMPIC PIPELINE COMPANY,)
8 INC.,)
)
)
9 Respondent.)
)

10 A hearing in the above matter was held on
11 July 2, 2002, at 3:30 p.m., at 1300 South Evergreen Park
12 Drive Southwest, Room 206, Olympia, Washington, before
13 Administrative Law Judge ROBERT WALLIS and Chairwoman
14 MARILYN SHOWALTER and Commissioner RICHARD HEMSTAD and
15 Commissioner PATRICK J. OSHIE.

16 The parties were present as follows:

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5

6 LEON PAUL SMITH

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4 EXHIBIT: MARKED: ADMITTED:

5 LEON PAUL SMITH

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7 1202 4199

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10 Bench Request Number 1 4351

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1 P R O C E E D I N G S

2 JUDGE WALLIS: Let's return to the record,
3 please, following an afternoon recess.

4 Mr. Marshall.

5 MR. MARSHALL: Yes, we're ready to proceed
6 with Mr. Smith.

7 JUDGE WALLIS: Please do.

8 MR. MARSHALL: Was he sworn in, I forgot?

9 JUDGE WALLIS: The witness has been sworn.

10 MR. MARSHALL: Thank you.

11

12 D I R E C T E X A M I N A T I O N

13 BY MR. MARSHALL:

14 Q. Please state your full name for the record,
15 Mr. Smith.

16 A. Leon Paul Smith.

17 Q. I think your mike button has to be on the up.

18 A. Leon Paul Smith.

19 Q. And what is your address?

20 A. 187 High Street in Strasburg, Virginia 22657.

21 Q. And on whose behalf do you appear today?

22 A. On behalf of Olympic Pipeline.

23 Q. Did you prepare Exhibits 1201-T and 1202?

24 A. Yes, sir.

25 Q. Do you have any corrections or modifications

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1 to make to those exhibits?

2 A. Yes, I do.

3 Q. Mr. Smith just has a few, so we're not going
4 to submit an errata sheet.

5 A. On 1201-T, if you turn to page 4, line 19,
6 the third to last word, difference should change to
7 different.

8 The next page, page 5, lines 12 and 13, the
9 cite is incorrect. It should read 61583 instead of 563.
10 And on line 13, it should be Opinion 154, strike the -A.

11 The next change is on page 13, line 2, next
12 to the last word instead of being sue, S-U-E, it should
13 be use, U-S-E.

14 CHAIRWOMAN SHOWALTER: I got a kick out of
15 that one.

16 A. Yeah, I did too, it took me a while to find
17 it.

18 Page 14, line 6, the cite is incorrect, it
19 should read 61836.

20 Page 17, line 3, again the cite it's missing
21 a dash, the last jumble of numbers should read 62307-08.

22 Page 20, line 5, the next to the last word
23 rate making at the end of the sentence should be changed
24 to reporting.

25 Then on line, excuse me, page 27, line 15, it

4199

1 should read, economic need for industry to attract
2 investor capital. There's an extra to in there.

3 And that's all I have.

4 Q. As so corrected and modified, do you adopt
5 that testimony as your own here today?

6 A. Yes, I do.

7 MR. MARSHALL: We offer those exhibits into
8 evidence.

9 JUDGE WALLIS: Is there objection?

10 Let the record show that there's no response,
11 and the exhibits are received.

12 MR. MARSHALL: With that, the witness is
13 available for cross-examination.

14

15 C R O S S - E X A M I N A T I O N

16 BY MR. TROTTER:

17 Q. Good afternoon, Mr. Smith.

18 A. Good afternoon.

19 Q. Mr. Smith, you were employed at the ICC and
20 then FERC from 1976 to 2000; is that correct?

21 A. Yes, sir, that's correct.

22 Q. During that period, did you ever provide
23 testimony on rate making methodology or any other issue?

24 A. I provided testimony on one case that was
25 settled before it was actually got to hearing. But yes,

4200

1 I did provide testimony on one case.

2 Q. And did that have to do with rate making
3 methodology?

4 A. Yes, sir, it did.

5 Q. Do you know what year that was approximately
6 or what methodology you testified to?

7 A. It was the, let's see, I'm really not sure,
8 it -- I believe it was the 154-B methodology though, but
9 I only had a small part. And the testimony, I don't
10 want to mislead you, the testimony was only dealing with
11 rate allocation and rate design issues.

12 Q. By rate allocation, do you mean cost
13 allocation between jurisdictions?

14 A. I'm sorry, between segments of lines.

15 Q. And when you were at the ICC, you were
16 working on oil pipeline valuations; is that right?

17 A. Yes, sir, that's correct.

18 Q. In your resume', Exhibit 1202, page 1, the
19 bottom line, you state you participated in the creation
20 and implementation of several pipeline rate making
21 methodologies. Do you see that?

22 A. Yes, sir.

23 Q. I want to focus on the creation part of that.
24 How many pipeline rate making methodologies did you help
25 create?

4201

1 A. I had a part to deal with in varying degrees
2 for the different methodologies. The 154-B methodology,
3 I was involved in the creation of that in a minor way.
4 The indexing methodology that the commission uses I was
5 involved in a very major way. Market based rate filing
6 methodology I was also involved in a very major way.
7 The commission also, the FERC, I will try to keep that
8 straight, the FERC also has a settlement methodology
9 which wasn't really a creation. It kind of existed
10 before, but it was codified in the regulations, and I
11 had a large hand in that also.

12 Q. So indexing, market based rates, settlement
13 rates you had large responsibilities for, and 154-B a
14 relatively minor responsibility for?

15 A. The creation of, yes, sir.

16 Q. Okay. Are you familiar with the
17 methodologies ICC and FERC has used to regulate oil
18 pipelines?

19 A. Yes, sir.

20 Q. Was the first methodology the ICC consent
21 decree methodology?

22 A. It was the ICC valuation methodology, which
23 was used in conjunction with the consent decree, yes,
24 sir.

25 Q. And for what period of time was that

4202

1 methodology in effect approximately?

2 A. Approximately I believe the early 1940's is
3 when it began, and the valuation methodology ended with
4 the issuance of Opinion 154-B, so that was 1985.

5 Q. Now wasn't the ICC consent decree
6 methodology, that did include a fair value or
7 reproduction cost new rate base, correct?

8 A. That's correct, yes, sir.

9 Q. Did it also include an allowance of a 6%
10 return on rate base plus all interest expenses incurred?

11 A. There was an add on of 6% for going concern,
12 a going concern value, that was included as part of it.
13 And there was an allowance for interest during
14 construction. Yes, I think the answer to your question
15 is yes.

16 Q. And did that give the oil pipelines an
17 incentive to be 100% debt financed or close to it?

18 A. The valuation methodology in conjunction with
19 the consent decree tended to skew the debt-equity ratios
20 of the pipeline companies into almost 100% debt.

21 Q. Now we talked about two elements of the
22 consent decree methodology, the reproduction costs new
23 plus this return, 6% return plus interest expense in
24 addition to that. Was that methodology in effect until
25 Order 154-B?

4203

1 A. Okay, you mentioned a 6% return, it was a 6%
2 going -- an allowance for going concern of 6%. The
3 returns on the valuation were either 8% or 10% typically
4 for either crude or products. That was in effect until
5 -- the valuation methodology was in effect until Opinion
6 154-B, yes, sir.

7 Q. And just so we're clear, you include in your
8 valuation methodology this percentage return plus actual
9 interest expense?

10 A. Again, it's a percentage for -- it's an
11 allowance for going -- what was called going concern.
12 It was just a 6% add on to represent that a company in
13 business has by being already in business, it has a
14 value. That's what that represented.

15 Q. And you obviously didn't create that
16 methodology, but did you help implement it?

17 A. Yes, sir, I did.

18 Q. And did you agree that it was an appropriate
19 methodology for oil pipelines at that time you were
20 implementing it?

21 A. I was never really asked whether I agreed
22 with it or not. What my position was that I developed
23 the valuations doing the calculations and the
24 reproduction work, and so I was never really in a
25 position to judge whether the methodology itself was

4204

1 just and reasonable at that time at the ICC.

2 Q. Did you have any opinion at that time?

3 A. At that time no.

4 Q. Now FERC Order 154 was issued November 30,
5 1982; is that correct?

6 A. I believe so, yes, sir.

7 Q. You refer to this on page 10 of your
8 rebuttal, and I think you call that the Williams I
9 decision; is that right?

10 A. That's correct.

11 Q. Did that continue the valuation methodology
12 in all of the respects that we have discussed?

13 A. I believe it did yes, sir.

14 Q. And just to back up one step, at the time
15 FERC was created, and you indicate this at the top of
16 page 10, there was an appeal pending of an ICC decision
17 on valuation methodology that the FERC asked the court
18 to remand so it could look at it with a clean slate and
19 the court did remand, correct?

20 A. Yes, sir, that's correct.

21 Q. And then Order 154 was issued?

22 A. That's correct, yes, sir.

23 Q. And in Order 154, FERC reviewed its
24 regulatory history and its statutory mandate, did it
25 not?

4205

1 A. Yes, sir, it did.

2 Q. And is that the extensive -- of the
3 discussion of an extensive history of oil pipeline
4 regulation that you're referring to on page 10, lines 8
5 to 9?

6 A. Yes, sir, it is.

7 Q. And FERC's view of its regulatory scheme at
8 that time in that order was "to restrain gross
9 overreaching and unconscionable gauging"; do you recall
10 that?

11 A. I recall that definitely.

12 Q. At that time in 1982 when that order was
13 issued, did you agree that that was the appropriate view
14 of FERC's of the history of oil pipeline regulation?

15 A. The history part of the order was relatively
16 accurate as far as I understood. As far as what was in
17 the order and how it was constructed, I didn't agree
18 with that, no.

19 Q. Now FERC also supported its decision in Order
20 154 by eluding to the fact that the impact of oil
21 pipeline rates was minimal on the ultimate consumer,
22 correct?

23 A. That's correct, yes.

24 Q. And did you agree at the time that that was
25 an appropriate factor for FERC to consider when

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1 selecting an appropriate rate making methodology for oil
2 pipelines?

3 A. I believe it is a factor. It's not, of
4 course, not the only factor, but that would be one
5 factor to use.

6 Q. On page 10 you indicate that the U.S. Court
7 of Appeals for the D.C. Circuit reversed Order 154,
8 correct?

9 A. That's correct, yes, sir.

10 Q. And as you understand that decision, the
11 court ruled in part that FERC erred in considering the
12 impact of pipeline rates on the ultimate consumer,
13 correct?

14 A. I would have to refresh my memory on that;
15 I'm not sure.

16 Q. Let me read you from the court case, and I'm
17 reading from page 225 of the decision 734 F.2nd 1486:

18 Accordingly, the fact that the price of
19 oil to the ultimate consumer dwarfs the
20 price of oil pipeline transportation
21 "does not excuse deviation from a just
22 and reasonable standard for not even 'a
23 little unlawfulness is permitted'".

24 Would you accept that subject to your check?

25 A. Yes, sir, I will. I assume you can read

4207

1 correctly, so.

2 Q. Turn to page 26 of your testimony. Beginning
3 on line 6 you address several factors that you believe
4 this Commission should consider, and one of them
5 beginning on line 13 through 20 or actually 23, you
6 refer to the small portion, the pipeline tariff
7 representing a small portion of the overall retail pump
8 price. Do you see that?

9 A. Yes, sir, I do.

10 Q. Isn't that the same rationale that was
11 rejected by the Court of Appeals that you cite in your
12 decision and you cite in your testimony?

13 A. This is one of the factors, and I think I
14 said this earlier in answer to your questions, I think
15 it's one of the factors that needs to be understood and
16 looked at in developing appropriate methodology for a
17 pipeline, an oil pipeline company. It's not the only
18 factor, and it's not the primary factor I don't think.

19 Q. My question was, isn't this the factor that
20 the court rejected in the case that you cite in your
21 testimony?

22 A. I'm not sure the court actually said that the
23 Commission should not consider that the pipeline rates
24 have nothing to do with consumer interest.

25 Q. And when you do use the term consumer

4208

1 interest on line 14, by that do you mean retail
2 purchasers of petroleum products as opposed to shippers?

3 A. Yes, sir, I do. I believe I make that
4 distinction by identifying that the shippers, above that
5 on line 11, that the Olympic shippers are large
6 sophisticated companies.

7 Q. And is one point you're making here with your
8 computations and testimony that pipeline transportation
9 costs are such a small percentage of the ultimate cost
10 of retail gasoline that they have little or no impact on
11 retail gasoline prices?

12 A. I think what I'm trying to say there is that
13 given my view of the federal regulation that the FERC in
14 trying to lower gasoline prices at the pump for the
15 general public consumer wouldn't be successful because
16 the commission, excuse me, again the FERC, does not have
17 the ability to control all of the other factors that go
18 into making the pump price of gasoline. I think that's
19 the concept I'm trying to get to here.

20 Q. Would the same be true about an increase,
21 that you couldn't be assured that an increase would be
22 passed through to the ultimate consumer just as you
23 couldn't be assured a decrease would be passed through
24 to the ultimate consumer?

25 A. An increase in the oil pipeline tariff?

4209

1 Q. Yes.

2 A. That's correct, yes.

3 Q. Are you in your testimony here advocating
4 that this Commission adopt in any form the FERC 154
5 methodology and rationale that was rejected by the court
6 in the Farmers Union case you cite on page 10?

7 A. If you're referring to the valuation
8 methodology, and I'm assuming you are, no, I'm not
9 suggesting -- I'm actually not espousing any theory to
10 this Commission as to what they really should or
11 shouldn't use. You know, I'm trying to give them some
12 historical background of what the FERC went through when
13 it tried to change methodologies. And I think that's
14 what we have here is that the, you know, you have a
15 perception of the oil company, at least on behalf of the
16 oil company, that the 154-B methodology was in use
17 prior, and now it appears that this is not necessarily
18 going to go into the future.

19 Q. Turn to page 6 of your testimony, and here
20 you articulate what you believe are some differences
21 between what you call I guess traditional public
22 utilities and oil pipelines; is that right?

23 A. Yes, sir, again from my view on the federal
24 level.

25 Q. And by traditional, I'm focusing on line 9,

4210

1 the traditional public utility model, do you understand
2 that that's consistent with what this Commission uses to
3 regulate utilities, the depreciated original cost rate
4 base methodology?

5 A. Yes, sir.

6 Q. And you go on to say that:
7 Unless the ICC or FERC prohibited
8 trucks, barges, and railroads from
9 competing with pipelines, it would
10 simply not be possible to guarantee oil
11 pipelines the type of franchise that
12 regulatory commissions have historically
13 been able to guarantee to public
14 utilities.

15 Do you see that?

16 A. Yes, sir.

17 Q. And is this one of the factors that you want
18 this Commission to consider in this case?

19 A. Again, what I'm trying to give here is a
20 background of where the -- how the FERC decision --
21 where it came from, what it was based on.

22 Q. Is this a factor that you want this
23 Commission to consider or not consider, or is it not
24 even a factor in your --

25 A. As part of the history of how the FERC got to

4211

1 its regulatory scheme, it's a factor, yes.

2 Q. You did no independent study of competition
3 for petroleum products transportation in Western
4 Washington, did you?

5 A. No, sir.

6 Q. When you refer to franchise that regulatory
7 commissions have been able to guarantee to public
8 utilities, are you referring to exclusive franchises?

9 A. Yes, sir.

10 Q. Are you referring to anything else like a
11 grant of a service territory?

12 A. That's what I'm referring to, yes.

13 Q. And a grant of an exclusive service
14 territory?

15 A. That's correct.

16 Q. Okay. Now FERC does not grant exclusive
17 territories or franchises to electric or gas utilities
18 or oil pipelines, does it?

19 A. In that the FERC does control the siting and
20 the certificates of public convenience for, and I will
21 speak to natural gas pipelines, in effect yes, they do
22 control what could be considered franchise areas for
23 those industries in that there's, there's a lot of other
24 factors involved in this, in that, for example, there
25 are no reasonable or logical alternatives to natural gas

4212

1 pipeline transportation like you would have with
2 petroleum products. Again, and I state this a little
3 further down, in that -- I'm sorry, I lost that thought.

4 Q. Well, let me follow up.

5 A. Okay.

6 Q. The certificates that FERC grants are not
7 exclusive certificates, are they? There are, in fact,
8 gas pipelines that compete with one another?

9 A. There are now, yes. But again, the way the
10 structure originated, no, there weren't.

11 Q. Okay. Well, under the structure that FERC
12 uses today, it uses the traditional rate public utility
13 model to set rates for electric and natural gas
14 utilities, does it not?

15 A. That's correct, it has not changed its
16 methodology for them.

17 Q. Okay. Are you aware that Arco, BP Arco, owns
18 a natural gas pipeline in this state that competes with
19 Northwest Pipeline in this state?

20 A. No, sir.

21 Q. Is it your understanding that this Commission
22 grants to electric utilities exclusive franchises or
23 exclusive service areas?

24 A. I'm not really sure on electric utilities,
25 I'm sorry.

4213

1 Q. What about water or local exchange telephone
2 utilities, does this Commission grant exclusive
3 franchises or service territories to any of those --

4 A. That I don't know. What I did understand is
5 that for natural gas pipelines they do not.

6 Q. They do not what?

7 A. They do not grant franchise areas.

8 Q. Are you aware whether or not local franchises
9 for utilities in the state of Washington and oil
10 pipeline companies are exclusive or not exclusive?

11 A. Could you repeat the question?

12 Q. Do you know whether local franchises in this
13 state for utilities or oil companies are exclusive or
14 not exclusive?

15 A. I don't know. I didn't -- I didn't
16 understand that oil pipelines had franchises, so I'm not
17 sure I can answer that, for example.

18 Q. So it's your understanding in this state that
19 oil pipelines don't have exclusive franchises?

20 A. That's correct, yes, sir.

21 Q. And do you have any understanding whether
22 utility companies have exclusive franchises in this
23 state in any form?

24 A. Again, as I stated, my understanding is that
25 only as far as natural gas pipelines that they do not

4214

1 have exclusive franchises. I'm not -- I don't -- I'm
2 not sure of the other utilities.

3 Q. On page 6 of your testimony, line 17, you
4 talk about:

5 The two most important requirements of
6 the Interstate Commerce Act relating to
7 oil pipelines are the just and
8 reasonable tariff requirement and the
9 avoidance of unreasonable preferences or
10 discrimination.

11 Do you see that?

12 A. Yes, sir.

13 Q. Would you agree that public utilities have
14 the same requirements in the state of Washington?

15 A. I'm not sure of the legislative background
16 for that. I'm not -- I don't know it well enough to
17 understand it.

18 Q. Do they have a similar requirement at the
19 federal level for electric and gas utilities?

20 A. For gas pipelines they have the just and
21 reasonable standard, and I'm not sure about -- I'm not
22 sure of the duty to avoid unreasonable preference or
23 discrimination is there. Because natural gas pipelines
24 being contract carriers, they can in effect discriminate
25 and develop contracts with one shipper and not another.

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1 Long-term contracts I'm speaking of.

2 Q. Okay. Well, are you saying that contract
3 carriers can not exist in a statutory scheme that has
4 prohibitions against discrimination?

5 A. No, that's not what I said.

6 Q. So you can have a statutory scheme that calls
7 for common carriers and contract carriers and have a
8 prohibition against preference and discrimination such
9 as the Washington statutes, for example?

10 A. I wouldn't doubt it.

11 Q. Okay. On page 7, lines 10 through 17, you
12 discuss competition, and you indicate that FERC has
13 adopted a regulatory structure that fosters competition.
14 Do you see that?

15 A. Yes, sir, that's correct.

16 Q. And you said that -- and over on page 11, are
17 you saying the same thing when you talk about:

18 The desire to foster new entrants to the
19 market led to a concern that a
20 depreciated original cost approach would
21 front end load the costs of the oil
22 pipeline.

23 Is that the same concept?

24 A. In part, yes, it is.

25 Q. On line 11 on page 7 you say:

4216

1 Since a competitor could enter this
2 market at any time, such a franchise
3 would be meaningless.

4 And you're talking about FERC granting a
5 franchise to an oil pipeline. By competitor entering
6 the market, are you referring to another pipeline
7 entering the market?

8 A. That would be one of the entrants. It also
9 could be trucking, barges. Those are also other
10 competitors to oil pipelines.

11 Q. But just in the context here, are you just
12 speaking of oil pipelines, or are you speaking more
13 generally?

14 A. The answer is directly, you know, directed
15 toward oil pipelines in the competition there. I
16 wouldn't limit this answer though just to competition
17 with other oil pipelines.

18 Q. Now FERC uses a traditional utility model for
19 rate regulation of electric and gas utilities compared
20 to oil pipeline companies and still fosters competition
21 in those industries, electric and gas; is that correct?

22 A. They're making the effort to try to foster
23 competition in the gas and electric areas, yes.
24 However, it's -- there is a difference, because again
25 with the certificates of public convenience and

4217

1 necessity that the commission has control over, for
2 example with natural gas pipelines, the commission has
3 much more control over the marketplace than it does with
4 oil pipelines. In oil pipelines there is virtually no
5 control over the marketplace by the FERC.

6 Q. And by that, you mean there are -- they do
7 not control waterborne and trucking alternatives?

8 A. Or the entrance of another oil pipeline.

9 Q. Have you ever testified at any electric or
10 natural gas rate proceeding?

11 A. No, sir.

12 Q. In this state, isn't it true that an electric
13 company can enter the market at any time?

14 A. As I stated before, I'm not -- I'm not -- I
15 don't understand the rules here on electric.

16 Q. There never has been a pipeline competing in
17 this state with Olympic, has there?

18 A. Not that I'm aware of, no, sir.

19 Q. Did you hear Mr. Batch testify earlier in
20 this phase of our hearing that it has taken two years
21 for Olympic to just get a permit to bore under a single
22 river in this state?

23 A. No, I didn't hear that.

24 Q. Did you hear Mr. Peck testify that there was
25 "little chance" that there would be another competing

4218

1 pipeline to Olympic in this state?

2 A. No, I didn't hear that.

3 Q. Have you reviewed the siting requirements for
4 any new oil pipeline in Washington state?

5 A. No, sir.

6 Q. Do you know what the Energy Facility Site
7 Evaluation Counsel requirements are for major energy
8 utilities facilities such as a pipeline?

9 A. No, sir. I am aware of the difficult
10 procedures that are needed to go through for oil
11 pipelines in general across the United States, not just
12 on the West Coast. It's becoming much more difficult to
13 build pipelines anywhere.

14 Q. Turn to page 9 of your testimony, and the
15 question beginning on line 15 asks you to comment on the
16 methodologies for oil pipeline rates at the federal
17 level since the passage of the Hepburn Act in 1906, and
18 you state that utilities were obliged to just -- while
19 utilities were obliged to justify the rates under a DOC
20 methodology, "oil pipelines were obliged to justify
21 their rates using valuation". Do you see that?

22 A. Yes, sir.

23 Q. Isn't it true that electric and gas utilities
24 were also regulated based on fair valuation
25 methodologies until the mid 1940's?

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1 A. I don't know that. What I am aware of is
2 that under the Natural Gas Act that when jurisdiction
3 was trans -- was given to the Federal Power Commission,
4 which was one of the -- part of the predecessors to the
5 FERC, I believe that the whole time there that that was
6 using -- they were using net depreciated original cost.

7 Q. You have read the Hope Natural Gas U.S.
8 Supreme Court decision?

9 A. Yes, sir.

10 Q. Wasn't that a review of an order in which the
11 FPC rejected valuation and a form of trended original
12 cost methodology in favor of --

13 MR. MARSHALL: Objection --

14 Q. -- in favor of depreciated original cost?

15 MR. MARSHALL: Object to the form of the
16 question, mischaracterizes the holding of Hope. Hope
17 speaks for itself.

18 JUDGE WALLIS: I think the question was asked
19 to the witness's understanding, and the witness may
20 respond.

21 A. I obviously misspoke about whether the FPC
22 had used valuation before that if that's what the Hope
23 decision actually says.

24 BY MR. TROTTER:

25 Q. Beginning on page 7 and it's I think on line

4220

1 18, you begin discussing what you consider to be a
2 distinction between oil pipelines being regulated as
3 common carriers and gas pipelines being regulated as
4 contract carriers. Do see that?

5 A. Yes, sir.

6 Q. Is this an important distinction in your
7 mind?

8 A. Yes, it is.

9 Q. On page 8, lines 14 to 16, you I think
10 summarize your point here that for contract carriers the
11 shipper is normally assured that the capacity for which
12 they have contracted will be available, whereas under
13 common carriers that's not the case. Is that your
14 essential point?

15 A. I think you have actually stated the point
16 backwards. What I was trying to make here, the point I
17 was trying to get across here was that the pipeline
18 itself by having these long-term contracts for a
19 contract carrier has the assurance that they will have
20 the throughput. It also obviously works the other way
21 too, that the shipper, you know, but that's not the
22 point I was trying to make here.

23 Q. Okay. Now oil pipelines are not contract
24 carriers, right?

25 A. That's correct, they're common carriers.

4221

1 Q. But they do have throughput and deficiency
2 agreements don't they typically?

3 A. Yes, sir.

4 Q. And is that a form of guarantee that they
5 will take a specific volume and pay for it?

6 A. No, sir.

7 Q. What are they in your mind?

8 A. What are throughput and deficiency
9 agreements?

10 Q. Yes.

11 A. They are contracts between the shipper and
12 the pipeline assuring that the shipper will tender the
13 amount that they have contracted for. I'm not sure that
14 in the throughput and deficiency agreements I have seen
15 have a penalty where the shipper will pay regardless of
16 whether they ship or not.

17 Q. I hope my question didn't mean to say that.
18 Maybe it did.

19 A. I understood that.

20 Q. Okay.

21 A. That's okay.

22 Q. But they do contract for specific amounts of
23 product and say that they will pay for that product that
24 they receive?

25 A. There is a contract for that, but that

4222

1 doesn't necessarily mean that that's what will happen.

2 Q. Okay. Now let's talk about Olympic Pipeline
3 specifically. Are you aware of any time in its history
4 other than the time throughput was curtailed due to the
5 Whatcom Creek explosion and aftermath when its capacity
6 was not overnominated?

7 A. I don't know. I haven't researched the
8 nominations or the capacity or the -- the level of
9 nominations for the pipeline.

10 Q. That wasn't a factor you considered, correct?

11 A. In?

12 Q. In your testimony.

13 A. I didn't, like I said, I didn't address that
14 fact, that issue at all here I don't think.

15 Q. Are you aware of any shipper of petroleum
16 products on Olympic's pipeline that would not ship via
17 pipeline if pipeline capacity was available and they had
18 product to tender?

19 A. I don't have knowledge to that question.

20 Q. One way or the other?

21 A. Right.

22 Q. Okay. On page 11, lines 20 through 24,
23 you're talking about one of FERC's concerns that led it
24 to choose trended original cost, and you indicate that
25 FERC was concerned that oil pipelines might face market

4223

1 situations where they could not earn their full
2 depreciated original cost return. And then you say:

3 This problem would become particularly
4 acute in the case where a new
5 undepreciated pipeline was competing
6 with an older largely depreciated
7 pipeline.

8 Do you see that?

9 A. Yes, sir.

10 Q. Olympic was not a competing pipeline when it
11 began service in 1965, was it?

12 A. Not that I am aware of.

13 Q. Olympic was not a party to the FERC case that
14 gave rise to Order 154-B, was it?

15 A. I'm not sure. One of the parties to the case
16 was the Association of Oil Pipelines, and it's possible
17 that Olympic is part of the Association of Oil Pipelines
18 and therefore was represented. I'm not sure though.

19 Q. You don't know one way or the other for a
20 fact?

21 A. For a fact that's correct, yes, I don't know.

22 Q. At the bottom of page 15 of your testimony
23 beginning on line 17 and over to, excuse me, bottom --
24 start over.

25 On page 15 beginning on line 17 and then over

4224

1 to page 18, you discuss four types of rate methodologies
2 that FERC has, indexation, market based rates,
3 settlement rates, and cost of service filings. Do you
4 see that?

5 A. Yes, sir, I see that. Those are the four
6 methodologies that the commission has for changing
7 existing rates.

8 Q. Has Olympic ever used indexation, market
9 based rates, or settlement rates?

10 A. I would assume it has used indexation,
11 because that was -- that's the standard methodology for
12 all oil pipeline companies.

13 Q. Do you know that for a fact? Did you look at
14 the tariffs Olympic filed?

15 A. I probably did while I worked there, but I
16 don't remember. I mean I -- I looked at so many
17 tariffs, I can't swear that I did look at them in
18 particular, but I would almost -- I have great assurance
19 that they did file under indexing.

20 Q. Market based rates can be filed in markets
21 where a pipeline can establish it lacks market power.
22 Is that right?

23 A. That's correct.

24 Q. Has Olympic ever filed market based rates?

25 A. The market based rate option is a very time

4225

1 consuming and expensive option, and I don't believe
2 Olympic has chosen to do that.

3 Q. Turn to page 18 of your testimony, line 7,
4 where you describe the deferred return, and you say on
5 lines 8 to 9 that it is "stored in rate base". Do you
6 see that?

7 A. Yes, sir.

8 Q. Now rate base is purely a rate making
9 regulatory concept, isn't it?

10 A. That's correct.

11 Q. So deferred return is not stored anywhere, is
12 it?

13 A. It's stored in the rate base.

14 Q. Is that a physical location? I'll withdraw
15 the question.

16 That's not a physical location, is it?

17 A. The same as when you have depreciation stored
18 it's not a physical location, that's correct.

19 Q. And it's not in any account on the company's
20 books, is it?

21 A. If you're referring to the Uniform System of
22 Accounts, is that what you're referring to?

23 Q. I will start with that.

24 A. Not that I'm aware of.

25 Q. And does Olympic record it on its books of

4226

1 account?

2 A. I don't know. It is recorded on the FERC
3 Form 6 on the page 700.

4 Q. Page 700, but that's not reflective of an
5 account on the company's books, is it, it's simply
6 information that FERC orders pipelines to report on that
7 page?

8 A. Again, if you're asking me if it's a part --
9 if it's an account of the Uniform System of Accounts for
10 oil pipeline companies, it's not.

11 Q. Depreciation is an account on the company's
12 books, is it not, or a group of accounts?

13 A. Under the Uniform System of Accounts, yes.

14 Q. And is it your understanding that Olympic in
15 its books of account has depreciation accounts?

16 A. I would assume they do.

17 Q. When this Commission approves a cost or an
18 amount of revenue to be deferred, are you aware of how
19 that is accomplished?

20 A. I can't speak to how this Commission deals
21 with that, no.

22 Q. FERC has established its 154-B methodology by
23 rule, has it not?

24 A. It established the 154-B methodology by
25 issuing an opinion actually.

4227

1 Q. And then it adopted a rule that implemented,
2 essentially implemented that methodology; is that
3 correct?

4 A. If you're talking about Order 571, what that
5 did, that illuminated and codified the filing
6 requirements for the cost of service methodology in the
7 code of federal regulations.

8 Q. And in any event, it's codified in 18 CFR
9 Section 346; is that correct?

10 A. If you're talking about the cost of service
11 filing requirements.

12 Q. Yes.

13 A. Yes, sir.

14 Q. Okay. And do you consider that to be
15 reflective of the 154-B methodology or not?

16 A. I'm not sure what you mean by reflective.

17 Q. Do the requirements in that rule reflect
18 154-B methodology?

19 A. They were set up to provide the information
20 on a filing underneath the 154-B methodology.

21 Q. Okay. This Commission here has not
22 established any rate making methodology for oil
23 pipelines by rule, has it?

24 A. I don't know. I haven't seen any.

25 Q. Now I would like to ask you where we find the

4228

1 FERC methodology, and you talked about Order 154-B and
2 the rule, would you say those are two places that are --
3 that help us find where the methodology is?

4 A. If you're referring to a complete -- how to
5 get a complete understanding of how the 154-B
6 methodology works, is that sort of what you meant?

7 Q. I will go with that.

8 A. Okay. What you would have to look at is
9 first of all Opinion 154-B and then all of the
10 successive orders to that. There was a 154-C that made
11 some minor changes. There was an Order 351 which is an
12 Arco case that again made some additional changes to the
13 154, or clarifications I should say. They weren't
14 really changes, they were clarifications to the 154-B
15 methodology.

16 The way the FERC works is that unless it
17 undertakes a change by rule making, which it didn't with
18 the 154-B methodology, the way it develops its case law
19 is through proceedings. And when certain issues come up
20 that are unique to a pipeline or haven't been addressed
21 before, they are addressed in that order. And therefore
22 that's why you would have to -- and I assume this
23 Commission works the same way, building on precedent.
24 And then that's why you have to read a series of orders
25 to get a complete understanding of everything that the

4229

1 commission has said on the 154-B methodology.

2 Q. And it would be that set of documents, all of
3 the orders, and would you also include the rule that
4 would be the current FERC methodology that --

5 A. That would be the body of knowledge that
6 would lead you to the 154-B methodology as it exists
7 today and obviously will be interpreted into the future.

8 Q. Are you aware of any orders of this
9 Commission on oil pipeline methodology?

10 A. I haven't done any research to that.

11 Q. Turn to page 12.

12 A. (Complies.)

13 Q. Again on line 18, you address capital
14 structure, and you say that FERC's method of -- that
15 FERC uses the parent company's actual capital structure
16 for oil pipelines that have issued no long-term debt or
17 whose parent has guaranteed the debt; is that correct?

18 A. That's not exactly what I said here. I can
19 read that to you if you would like. The commission, the
20 FERC has chosen to use the actual capital structure of a
21 pipeline company or its parent company if the parent
22 company is a guarantor of the debt.

23 Q. Okay. Now if you have an oil pipeline
24 company where the parent or parents have guaranteed the
25 debt, then you use the parent capital structure; is that

4230

1 correct?

2 A. That's correct.

3 Q. Okay. And if the pipeline, oil pipeline
4 company, has issued no long-term debt, would it be
5 correct that FERC would use the parent's capital
6 structure?

7 A. Yeah, the statement I have right here, if you
8 just read the next sentence, it says:

9 The Commission concludes that a pipeline
10 which has issued no long-term debt or
11 which issues long-term debt to its
12 parent or which issues long-term debt
13 guaranteed by its parent to outside
14 investors should, and I'm going to
15 change the word here, use its parent's
16 actual capital structure.

17 Q. So your answer to my question is yes?

18 A. Yes.

19 Q. Okay. Would you accept subject to your check
20 that Olympic during the 1990's issued debt on its own
21 without any guarantee from its parents?

22 A. I don't know.

23 Q. Okay. Is that something you can check or
24 not?

25 A. That's probably a question better asked of

4231

1 another witness.

2 Q. Okay. Let me ask it --

3 A. I mean I can check that, but it's not within
4 my scope of testimony really.

5 Q. Let me ask it this way. I want you to assume
6 that Olympic during the 1990's issued debt on its own
7 without any guarantees from its parents, okay?

8 A. Okay.

9 Q. And I would also ask you to assume that
10 Olympic was highly leveraged, say had 90% debt in its
11 capital structure at that time. So we have a company
12 that's --

13 A. I think you have lost me in your assumption.
14 You're saying the company has issued no long-term debt
15 but yet --

16 Q. No, it issued long-term debt but on its own,
17 not through its parent.

18 A. Oh, I'm sorry, I misunderstood you.

19 Q. So we have a company with a 90% debt ratio,
20 and all the debt or at least some of it is not
21 guaranteed by the parent.

22 A. That's your hypothetical?

23 Q. That's the hypothetical.

24 A. Okay.

25 Q. Under that hypothetical, would the FERC

4232

1 methodology use a capital structure of 90% debt and 10%
2 equity, the oil pipeline's actual capital structure?

3 A. I'm not sure that's enough information to
4 make a decision on.

5 Q. What else do you need?

6 A. It would seem highly unlikely to me that a
7 pipeline company standing on its own with just its own
8 capital assets could leverage that much debt, so that's
9 -- that's why I say I'm not sure I understand -- the
10 hypothetical doesn't seem realistic to me.

11 Q. Well, I didn't ask you to assume that all of
12 the debt was issued on its own but only some of it.

13 A. Okay, I misunderstood the question. I
14 thought you said all of it.

15 Q. Well, I may have started there, but --

16 A. Okay.

17 Q. Okay, let's start over.

18 A. That's why it didn't make sense to me.

19 Q. We have an oil pipeline that has a 90% debt
20 ratio, 10% equity ratio. Some of the debt is guaranteed
21 by the parent, and some of it is not.

22 CHAIRWOMAN SHOWALTER: Did you mean that the
23 parent's debt-equity is 90 and 10 or the company?

24 MR. TROTTER: I will start over.

25 BY MR. TROTTER:

4233

1 Q. The oil pipeline company, that is what I
2 misstated, I apologize, the oil pipeline company's
3 actual capital structure is 90% debt, 10% equity. A
4 portion of that debt is not guaranteed by the parents.
5 Isn't it true that under the FERC methodology, FERC
6 would use 90% equity, start over, FERC would use 90%
7 debt, 10% equity, the actual capital structure of the
8 oil pipeline for setting rates?

9 A. I don't think that's correct, because again,
10 you have said only a portion of the debt that's been
11 incurred has been a stand alone debt for the oil
12 pipeline company. Again, if I'm hearing you right,
13 that's a very --

14 Q. That's fine, let's look at your testimony,
15 page 13, line 3:

16 However, a pipeline which issues
17 long-term debt to outside investors
18 without any parent guarantee should use
19 its, the pipeline's, own capital
20 structure.

21 Now isn't that the hypothetical I just gave
22 you?

23 A. No.

24 Q. So you're interpret --

25 A. Because you said that the pipeline company

4234

1 has received some of its debt guarantee from the
2 parents.

3 Q. Yes.

4 A. This -- the way I -- the way --

5 Q. Let me ask you, you interpret that last
6 sentence on lines 3 to 6 to mean a pipeline which issues
7 all its long-term debt to outside investors without
8 guarantee from the parents justifies using the
9 pipeline's own capital structure; is that what you're
10 saying?

11 A. This is a quote from the FERC, and I guess I
12 would like for it to stand on what it said alone. And
13 my interpretation would be to -- yeah. To use the term
14 all there may not be correct. Let me just say that.
15 You know, if you had \$1 Million in debt and \$1 came from
16 your parent, you know, at what level. There are so
17 many, you know --

18 Q. I'm saying it would be substantial, say 20%.

19 A. -- ins and outs.

20 Q. I'm not talking about trivialities here. Do
21 you know the answer based on the FERC methodology?

22 A. I don't know the answer based on your
23 hypothetical, I guess. I would have to have more
24 information.

25 Q. Okay, let's try another one. Assume that the

1 FERC methodology applies, and assume that in the year
2 2003 Olympic is taken over by a parent corporation that
3 has an actual capital structure of 80% debt, 20% equity,
4 and all the debt is guaranteed. Do you have that in
5 mind?

6 A. Yes.

7 Q. Under the FERC methodology, a rate case is
8 filed, under the FERC methodology, the FERC would use
9 the 80% debt, 20% equity ratio of the parent to set
10 rates in that case, correct?

11 A. In part. If you look at the starting rate
12 base component, that has to reach back to 1985 at the
13 owner at that time, the debt-equity ratio of the owner
14 and debtor.

15 Q. I'm not talking about SRB, I'm just talking
16 about the rate of return applying to --

17 A. Oh, you're talking about -- you mentioned --
18 you said 154-B methodology, included in that is the SRB,
19 so I would, you know, you can't separate the two.

20 Q. Okay, but excluding that effect, the rate of
21 return applied to the rest of the rate base would be
22 based on the 80% debt, 20% equity ratio of the parent,
23 correct?

24 A. I believe so.

25 Q. Turn to page 21, lines 1 through 5, you

4236

1 indicate that pipeline companies develop budgets for
2 their financial and operation purposes, and then you
3 say:

4 It is appropriate for the FERC and the
5 Commission to rely on projections
6 contained in the managerial budget
7 reports as the carrier's best estimate
8 of future operating costs for rate
9 making purposes.

10 Do you see that?

11 A. Yes, sir.

12 Q. Do FERC rules refer to use of budget figures
13 as opposed to actual figures?

14 A. The FERC Code of Federal Regulations does not
15 actually mention budget figures. But it's my experience
16 with oil pipelines that given a review of the test
17 period costs, which are analogous to the pro forma costs
18 with this Commission I believe, budget estimates have
19 been used by the FERC and are typically used, because
20 they are a source of information as to the best
21 knowledge of the company at that time.

22 Q. Should budget amounts be used when they are
23 shown to be off by over 100% compared to actual for the
24 same period?

25 A. If you have actuals for the period, you're

4237

1 not going to use budget estimates, you're going to use
2 the actuals.

3 Q. Okay. But wouldn't showing that budgeted
4 amounts are off by substantial margins indicate that the
5 use of other budgeted amounts by the company may not be
6 appropriate?

7 MR. MARSHALL: Objection, speculative,
8 there's no foundation, kind of an unconnected question.

9 MR. TROTTER: There's an exhibit in the
10 record showing --

11 MR. MARSHALL: This witness is just being
12 asked to speculate on insufficient information.

13 JUDGE WALLIS: I think that the question is
14 sufficient, and the witness may respond.

15 THE WITNESS: Could you please repeat the
16 question?

17 MR. TROTTER: Could we have it read back,
18 please.

19 (Record read as requested.)

20 A. I guess I have insufficient information to be
21 able to answer that. If you have -- if you have a
22 budget that turned out to be wrong, that doesn't
23 necessarily make the next budget wrong.

24 BY MR. TROTTER:

25 Q. Does it make the next budget right?

4238

1 A. No, it didn't make the first one right
2 either. You know, you're using your best -- with
3 budgets typically what I have seen with the FERC, budget
4 estimates are used because they are a source from the
5 leadership of a pipeline company as to their best
6 information as to what's going to transpire in the near
7 future.

8 Q. Does FERC have any standards as to how to
9 test whether budgets are accurate or not or reliable or
10 not?

11 Let me ask it more specifically. Are you
12 aware of any FERC order or rule that sets forth
13 standards for determining the circumstances under which
14 budgeted amounts are deemed reliable or not reliable?

15 A. I'm not aware of any particular rule, no. As
16 I mentioned, the word budget I don't think is listed in
17 the Code of Federal Regulations as an item. It's known
18 and measurable changes is the way it's approached, and
19 part of that is that's what, you know, is known or
20 measurable or, you know, for the test period.

21 Q. Does the FERC methodology require budgeted
22 amounts be used, or is it permissive in your opinion?

23 A. Permissive.

24 Q. Is it acceptable under the FERC methodology
25 you advocate that Olympic earn a return on plant that is

4239

1 not used and useful for service?

2 A. The way you phrased the question, you sound
3 like I'm advocating using plant that's not used and
4 useful for service, and I don't think I have done that.
5 I would agree with the premise of your question that if
6 plant is not used and useful for service, then it
7 shouldn't be included.

8 Q. And that would be consistent with the FERC
9 methodology?

10 A. Yes, sir.

11 Q. And that was my question.

12 A. Okay.

13 Q. Turn to page 18 of your testimony, lines 21
14 through 24, where you talk about retroactive rate
15 making, and there's some discussion above that as well;
16 do you see that?

17 A. Yes, sir.

18 Q. And you agree that retroactive rate making is
19 not appropriate?

20 A. Yes, sir.

21 Q. An example of retroactive rate making would
22 be debt payments that are not paid when due but which
23 are accumulated and then recovery is sought in future
24 rates.

25 A. When you say debt payments --

4240

1 Q. You have a loan that calls for a debt payment
2 to be made on June 1st of 2001, for example. You don't
3 pay it, but you defer it, you're permitted to defer it,
4 and then a rate case the next year, and you seek to
5 recover the principal payment and interest payment that
6 was payable the prior year but was deferred instead of
7 paying.

8 A. I'm sorry, I have lost you on this, if you
9 could maybe rephrase it.

10 Q. Assume that you have a loan that calls for a
11 principal and interest payment due on the 1st of June.
12 Instead of paying that, the company defers it, so it
13 was --

14 A. And when you say defers it, did the person
15 giving the loan in effect waive the ability -- the
16 payment, or --

17 Q. Let's assume that the payment could be
18 deferred according to the loan contract, but it was due
19 and payable on June 1st.

20 A. Okay.

21 Q. If the company seeks to recover that loan
22 payment in future rates in a rate case the following
23 year, would that be retroactive rate making in your
24 opinion?

25 MR. MARSHALL: Object to the form of the

4241

1 question, insufficient information as to what the loan
2 was used for.

3 MR. TROTTER: I strenuously object to that
4 comment, he's suggesting an answer to the witness.

5 JUDGE WALLIS: I think the question is
6 permissible, Mr. Marshall. The witness may respond.

7 A. I'm still having great difficulty with the
8 premise of your question. It's, you know, there's so
9 many unknowns. Am I a pipeline company I assume, and
10 I've got a loan outstanding to build facilities that I
11 built, you know.

12 BY MR. TROTTER:

13 Q. Does retroactive rate making depend on what
14 the cost is used for? Doesn't it just depend on it's a
15 past cost and you're attempting to recover it through
16 future rates?

17 A. Retroactive rate making is reaching back into
18 a past time and either bringing forward costs that were
19 collected or weren't collected and trying to collect
20 them in a different period.

21 Q. And my question to you, for a payment on a
22 loan that was due in a prior period but was not paid
23 when due but was rather deferred, is it appropriate,
24 inappropriate retroactive rate making to recover that
25 through future rates?

1 A. I really don't have enough information to
2 answer. I'm sorry, but I don't have enough information
3 to answer your question. It would depend on things like
4 is the loan amortized over a longer period of time, is
5 this one loan payment, is it multiple payments. You
6 know, I'm sorry.

7 Q. Turn to page 21, lines 16 through 19. You
8 indicate that:

9 It would not be appropriate for the
10 Commission to deny Olympic the recovery
11 of costs incurred in complying with
12 increased safety requirements in rates
13 simply on the basis that they are higher
14 than past spending levels.

15 Do you see that?

16 A. Yes, sir.

17 Q. Are you aware of any adjustment Olympic has
18 proposed in this case where it is seeking to recover any
19 alleged increased costs of compliance?

20 A. My understanding is that Olympic has
21 increased costs as part of the compliance with safety
22 regulations, and that's part of what's built into the
23 rate case.

24 Q. Are you aware of a specific adjustment in
25 that regard, or are they just in the booked figures that

4243

1 Olympic has advocated?

2 A. I'm not sure.

3 Q. Are you aware of any adjustment that any
4 party other than Olympic has proposed in this case that
5 would deny Olympic recovery of cost of compliance on the
6 basis that they are higher than past spending levels?

7 A. No, sir.

8 MR. TROTTER: Those are all my -- one second.

9 That's all I have at this time, thank you.

10 JUDGE WALLIS: Mr. Finklea.

11

12 C R O S S - E X A M I N A T I O N

13 BY MR. FINKLEA:

14 Q. Good afternoon, Mr. Smith.

15 A. Good afternoon.

16 Q. I'm Ed Finklea representing Tosco. In light
17 of Staff's questions, I'm really down to just two.
18 Could I ask you to turn to page 27 of your testimony,
19 and I'm on lines 20 through 23. You observe there that:

20 The Commission fulfills an important
21 function as an arbiter in determining
22 the fair and equitable economic balance
23 between the carrier's and the shipper's
24 interests. That being said, the
25 Commission should attempt whenever

4244

1 possible to fulfill this role in a
2 manner that minimizes the burdon on all
3 parties.

4 And with that statement in mind, I would ask
5 you to turn to page 25 of your testimony, lines 14 to
6 21. All right, you're addressing at this portion of
7 page 25 Dr. Means' approach to throughput in this case,
8 and I ask you that, are you suggesting that if Olympic's
9 rates in this proceeding are set using actual volumes
10 and that the volumes then increase when Olympic returns
11 to full pressure as currently projected to occur in
12 April of 2004 that shippers should file a complaint and
13 initiate a new rate case; that's your suggestion on how
14 to deal with that scenario?

15 A. That would be the much more logical decision
16 than trying to imagine what those throughputs would be
17 now and setting them so far into the future at this
18 point in time. It would be much more logical to accept
19 what the actual throughputs are today, and then in the
20 future if the company wouldn't modify its rates if
21 throughput increases, then the shippers have the option
22 of filing a complaint in order to seek justice.

23 Q. And how does that solution minimize the
24 regulatory burdon on the pipeline and the shippers as
25 you have stated back on page 27 as a goal of regulation?

1 A. I think the burden would be very, very high
2 if this Commission would set Olympic's rates based on a
3 throughput that was unreachable and therefore deny
4 Olympic a just and reasonable return. So you have to
5 balance the efficiency of regulation with the prudence
6 of regulation. Just because it's more efficient or
7 easier to do doesn't make it right.

8 Q. And is Dr. Means recommending that Olympic's
9 throughput be set at the 130 million barrel level or
10 that an incentive mechanism be built around the 130
11 million?

12 A. My reading of Dr. Means, my understanding was
13 that he actually set the rates based on the higher
14 throughput level. But either way, I believe I go on to
15 mention that as far as the FERC would look at this,
16 setting a variable tariff methodology is not an answer.
17 As far as imposing -- something to be imposed by the
18 FERC, the FERC does not have the authority to say to the
19 pipeline companies, you must come in every six months
20 and file tariffs. That authority isn't given to them by
21 the Interstate Commerce Act, and therefore a variable
22 tariff methodology has been rejected by the FERC when
23 it's been suggested that the FERC impose it. It's been
24 used in settlements where the companies want to use it.

25 Q. Have you studied this Commission's use of

4246

1 incentive mechanisms or adjustment mechanisms in
2 regulating public utilities in this state?

3 A. No, sir, I haven't.

4 MR. FINKLEA: I have nothing further.

5 JUDGE WALLIS: Mr. Brena, do you have any
6 questions?

7 MR. BRENA: I do.

8

9 C R O S S - E X A M I N A T I O N

10 BY MR. BRENA:

11 Q. Good afternoon, Mr. Smith.

12 A. Good afternoon, Mr. Brena.

13 Q. We have to stop meeting like this.

14 A. I would prefer that.

15 Q. Your experience, I have some background
16 questions for you, your experience at the ICC all had to
17 do with working up valuations, correct?

18 A. That's correct, yes.

19 Q. Did you ever work up a valuation for a
20 pipeline company before the ICC where ultimately the ICC
21 ruled that the rate was too high?

22 A. Not to my knowledge, no.

23 Q. So far as you're aware, did the ICC ever rule
24 that a rate was too high?

25 A. I don't believe so, no, sir.

4247

1 Q. Are you aware with the congressional
2 legislation transferring the authority to the FERC that
3 one of the comments was in 42 years that there was never
4 a determination by the ICC that any rate was unjust and
5 unreasonable?

6 A. I'm not aware of that, but it wouldn't
7 surprise me.

8 Q. Now the valuation work that you did, that was
9 the valuation work that -- I mean the valuation
10 methodology, that was the valuation methodology which
11 was ultimately rejected as appropriate in Farmers Union
12 I, correct?

13 A. Yes.

14 Q. And it was referred to as an artifact of a
15 bygone age?

16 A. Yes, sir, along with me.

17 Q. I understand.

18 Have you ever represented a rate payer?

19 A. When you mention represent, I have assisted a
20 number of rate payers.

21 Q. Have you ever testified on behalf of a rate
22 payer for a lower rate?

23 A. Have I ever testified, no, sir.

24 Q. Do you consider yourself a 154-B cost of
25 service expert?

4248

1 A. I would say I'm a conceptual expert on it,
2 not a detail expert on it.

3 Q. And --

4 A. My position at the commission was such that I
5 had a staff that was working for me that in effect did
6 the work, but I had to review it.

7 Q. Now when I cross-examined you in the past
8 hearing I asked you if you were familiar with 154-B, and
9 if you take a look at 1212 at page 2335.

10 A. I'm sorry, I don't have any of those.

11 Q. Well, perhaps I can just read you the
12 question and answer. It's short, but you should have
13 them.

14 MR. TROTTER: Counsel, what page?

15 MR. BRENA: It's 2335.

16 MR. MARSHALL: Do you have an extra set?

17 MR. BRENA: Yeah, as a matter of fact I do,
18 right here.

19 MR. MARSHALL: I will hand them to the
20 witness.

21 JUDGE WALLIS: 1212 for identification, it
22 shows 20 of 61 at the top.

23 MR. BRENA: That's correct, lines 21 through
24 24.

25 THE WITNESS: I'm sorry, mine aren't marked,

4249

1 I apologize for the trouble.

2 MR. BRENA: Not a problem.

3 BY MR. BRENA:

4 Q. And I asked you:

5 Take FERC's approach, for example, at
6 154-B, you're familiar with the cost of
7 service methodology that FERC generally
8 applies?

9 And you responded:

10 Generally yes, I am generally.

11 That's the truth?

12 MR. MARSHALL: Well, if that was meant to
13 impeach, that's completely consistent with what this
14 witness said.

15 MR. BRENA: Was that an objection?

16 MR. MARSHALL: Yes, it was. I mean you used
17 deposition testimony for impeachment purposes, and I
18 don't believe that this contradicts what the witness
19 said.

20 MR. BRENA: I asked him if that was the
21 truth, and it's not a deposition, it was sworn
22 testimony.

23 MR. MARSHALL: Well, prior testimony, whether
24 it's by deposition or otherwise, is used for an
25 inconsistency, and I don't see the inconsistency here.

4250

1 I mean he's welcome to ask the question, but I think it
2 implies an inconsistency which doesn't exist.

3 JUDGE WALLIS: The question will be allowed.

4 BY MR. BRENA:

5 Q. My question was, just to rephrase it --

6 A. That's the truth, I remember, that's the
7 truth.

8 Q. Okay, that's the truth?

9 A. Yes, sir.

10 Q. All right. So I mean you don't consider your
11 -- have you ever done a 154-B cost of service study;
12 have you ever set up a model?

13 A. I have set up a model. I haven't actually
14 run the numbers all the way through one though, no.

15 Q. Have you ever presented a 154-B methodology
16 to any regulatory agency or court or --

17 A. Again, on the concept level, yes.

18 Q. Okay.

19 A. I have, you know, to --

20 Q. I'm talking about --

21 A. -- explain how the methodology works and --
22 but not again down to the detail level of the actual
23 intricate numbers.

24 Q. Okay. Have you given testimony with regard
25 to 154-B conceptually?

4251

1 A. No, sir, not testimony.

2 Q. Do you consider yourself a capital structure
3 rate of return expert?

4 A. No. My expertise lies with the concepts that
5 the FERC uses.

6 Q. Okay.

7 A. On most of these issues, but not the actual
8 mechanics of them.

9 Q. So you certainly wouldn't consider yourself
10 to be an expert on -- do you consider yourself to be an
11 expert on methodology or cap structure or return for the
12 purposes of the State of Washington?

13 A. No, and that's not what I have tried to
14 represent in my testimony.

15 Q. I'm just exploring that.

16 Are you familiar with the different
17 methodologies to approach rate of return, the cap and
18 the comparable earnings approach, the DCF one stage and
19 two stage methods?

20 A. Only again at the very general levels.

21 Q. Have you ever given testimony with regard to
22 any of them?

23 A. No, sir.

24 Q. Are you --

25 A. If I could add to that possibly.

4252

1 Q. Sure.

2 A. You're mentioning giving testimony. I
3 haven't actually testified in very many cases, and maybe
4 I can explain why that is. I was on the advisory side
5 of the FERC, which the FERC had two sets, and it may be
6 the same setup here, where you have a litigation side
7 and an advisory side. The litigation actually does the
8 testifying, the advisory side just advises the
9 commission. Since I was on the advisory side, my
10 testimony experience is extremely limited.

11 Q. How long has it been since you retired from
12 the FERC?

13 A. Since the early -- first part of September of
14 2000.

15 Q. Okay. And you have not been retained by
16 anyone as a 154-B cost of service expert during that
17 period?

18 A. During my retirement?

19 Q. Yes. Well, during your -- after leaving
20 government service.

21 A. Unless you qualify this testimony as being
22 that. I mean it's -- it verges on that in that I'm
23 explaining how the 154-B methodology functions.

24 Q. Okay. Are you familiar with the specific
25 statutes of the State of Washington that govern this

1 proceeding?

2 A. The procedural statutes?

3 Q. No, the substantive statutes.

4 A. The substantive, I have read through them.

5 I'm not an expert on them.

6 Q. What title did you read through; do you
7 recall without looking?

8 A. Without looking, no, I'm sorry, there are
9 numbers that I'm unfamiliar with.

10 Q. Okay, go ahead, look and tell me what you
11 have read through.

12 A. All right, and I may not have them all with
13 me today, RCW 81.88.030.

14 Q. Let me just -- perhaps I can short circuit
15 this a little bit, have you read all the way through
16 Title 81?

17 A. No, sir.

18 Q. Okay. You have read the Interstate Commerce
19 Act?

20 A. Yes, sir.

21 Q. Okay. Have you done any sort of study
22 comparing Title 81 with the Interstate Commerce Act?

23 A. No, sir.

24 Q. Are you aware FERC doesn't have the right to
25 force somebody to invest, do they?

1 A. As far as the Interstate Commerce Act giving
2 them the ability to do that?

3 Q. Correct.

4 A. As far as oil pipelines, because the
5 Interstate Commerce Act covered railroads also?

6 Q. Correct.

7 A. As far as oil pipelines, not that I'm aware
8 of.

9 Q. Do you know --

10 A. I'm not a lawyer though, so I shouldn't
11 probably interpret the Interstate Commerce Act.

12 Q. Okay. You agree, don't you, that a
13 regulatory methodology that a commission adopts should
14 be responsive to its unique statutory obligations?

15 A. It should fulfill its statutory obligations,
16 no doubt, yes.

17 Q. Now Mr. Trotter was asking you some
18 questions, and you responded to him. Now I'm going to
19 ask you if this is a fair statement. Is it fair to say
20 that the purpose and intention of your testimony is to
21 provide the Commission with the regulatory background
22 and history associated with the federal regulation of
23 product lines and not to recommend that any particular
24 methodology be adopted for rate making under the
25 Washington statutes?

4255

1 A. That sounds like you just about read my
2 testimony, part of it.

3 Q. You agree with that statement?

4 A. Yes, sir.

5 Q. You are not making a recommendation to this
6 Commission about any particular methodology under the
7 facts of this case, are you?

8 A. Not a direct recommendation. What I am doing
9 is explaining where the FERC has arrived at through its
10 tortured past, and maybe this Commission can use that to
11 its benefit.

12 Q. Okay. So to the degree that the Commission
13 views that the federal experience under FERC's tortured
14 past is helpful to it, then it's your intention to
15 provide that background and history, correct?

16 A. That's correct, yes, sir.

17 Q. Okay. Have you done any particular studies
18 with regard to the particular facts of Olympic?

19 Would you like for me to be more specific?

20 A. If you would like to be, sure.

21 Q. Well, I --

22 A. I haven't done any studies, no.

23 Q. So, for example, do you know whether or not
24 -- do you know how many shippers Olympic has?

25 A. No, sir.

4256

1 Q. Do you know whether they're large shippers or
2 small shippers?

3 A. My understanding is that they are relatively
4 well off shippers.

5 Q. Okay.

6 A. They're large shippers.

7 Q. Okay.

8 A. At least in general, at least there are a
9 number of large shippers, let me rephrase that.

10 Q. Now is that comment a reference to Tesoro and
11 Tosco?

12 A. Yes, sir.

13 Q. Who else?

14 A. Those are the two that I know about.

15 Q. Okay. Other than the affiliated shippers, of
16 course?

17 A. That's correct, of course.

18 Q. Okay. Would it surprise you to learn that
19 there's 70 total shippers on Olympic's line?

20 A. No, sir.

21 Q. And do you have any information at all with
22 regard to the other 66?

23 A. No, sir. As I said, I didn't do a study.

24 Q. Okay. Do you have any particular insight
25 into whether or not Olympic is in a natural monopoly

4257

1 position?

2 A. I haven't done any study to determine whether
3 they are or are not.

4 Q. Were you here when Olympic witness Cummings
5 testified?

6 A. No, sir.

7 Q. Are you aware, I mean is it fair to say that
8 the FERC was very concerned about a new pipeline's
9 ability to enter a marketplace by the application of the
10 depreciable original cost methodology because of its
11 concern that the front end loaded cost associated with
12 that may not be able to be recovered in a competitive
13 marketplace?

14 A. That was part of the problem that the
15 commission had with the DOC methodology, yes.

16 Q. Do you have any -- have you done any study to
17 determine whether or not that is also a problem for
18 Olympic Pipeline?

19 A. No, I have not.

20 Q. Do you know on what basis Olympic's investors
21 relied when they made their investment and constructed
22 Olympic?

23 A. I don't have any direct knowledge. However,
24 I think it's logical to assume that they would have had
25 an understanding of the regulations that they would be

4258

1 put under, placed under, and that they would have to
2 respond to.

3 Q. Well, my question is, do you have any
4 knowledge with particularity?

5 A. And I answered no, I don't.

6 Q. Okay. Do you know how long the current owner
7 has owned Olympic?

8 A. The current owner?

9 Q. Yeah.

10 A. I'm not sure exactly. I know it's not very
11 long.

12 Q. Do you know whether or not the current owner
13 when they purchased Olympic even did due diligence on
14 it?

15 A. I really know nothing about the transfer.
16 You know, I don't have any knowledge of what transpired
17 in the change of hands.

18 Q. So you don't have any sense for what the
19 purchase price was that may have been paid for minority
20 interest by GATX and whether or not that purchase price
21 reflected any particular investor expectations?

22 A. No, sir, I don't.

23 Q. Have you ever recommended to any state
24 regulatory agency that a rate be set that would allow
25 the collection of more revenue than is necessary to

4259

1 recover the actually and prudently incurred costs
2 related to providing service plus a reasonable rate of
3 return on remaining investment?

4 MR. MARSHALL: That question assumes that
5 he's given testimony in that area at all at any time.

6 MR. BRENA: I will rephrase.

7 BY MR. BRENA:

8 Q. Would you give testimony to a state
9 regulatory body in support of any rate that generated
10 more revenue than was necessary to recover the actually
11 and prudently incurred costs related to providing
12 service plus a reasonable rate of return on remaining
13 investment?

14 A. I can't imagine that I would support that,
15 no.

16 Q. If they get more than that, it's an unjust
17 and unreasonable rate in your opinion, isn't it?

18 A. Yes, sir.

19 Q. And I will just note for the record I was
20 reading from 1209.

21 In adopting the TOC at the federal level,
22 isn't it fair to say that their holding was that the TOC
23 was an acceptable cost based alternative to the DOC?

24 A. I would characterize it as being as the TOC
25 being a preferable methodology over the DOC.

4260

1 Q. Preferable, but both being considered cost
2 based methodologies?

3 A. Both TOC and DOC are cost based
4 methodologies, if that's your question.

5 MR. BRENA: I have no further questions at
6 this time.

7 JUDGE WALLIS: Commissioners.

8

9 E X A M I N A T I O N

10 BY COMMISSIONER HEMSTAD:

11 Q. First, do you know the environment within
12 which other state commissions regulate oil pipelines?

13 A. I don't know of any specific. I haven't
14 really dealt with a study that has outlined what each
15 state commission does. What I have done is provided
16 through the years a lot of advice to state commissions
17 on how the FERC operates.

18 Q. And do you know whether any states have
19 adopted the FERC methodology, and if so, which ones
20 have?

21 A. Again, I don't know what any individual state
22 does actually directly.

23 Q. But so you can't tell us whether any state
24 has adopted FERC methodology?

25 A. That's correct, I can't tell you that; I

4261

1 don't know.

2 Q. But do you know whether any states have not
3 adopted FERC methodology, or put it another way, have
4 applied traditional DOC methods?

5 A. Again, I don't know what each individual
6 state does, so I don't really have a feeling for that.
7 Sorry.

8 Q. You were asked about your quotation at the
9 top of page 13 and the language from one of the FERC
10 orders. Do you have an opinion, and it may be in your
11 testimony and I may not have picked it up, but do you
12 have an opinion as to what capital structure this
13 Commission should apply to Olympic Pipeline?

14 A. It's my, and I haven't done a complete review
15 so I wouldn't offer a strict opinion saying here's what
16 the FERC would do, but it's, you know, my understanding
17 from my limited knowledge of this case that what should
18 probably be used is the parent company's capital
19 structure, and I think that's what the FERC would use if
20 they were involved in this case.

21 Q. So that would be a very high equity to --

22 A. Apparently, yes.

23 Q. -- debt ratio?

24 A. Yes.

25 Q. And even though here the actual capital

4262

1 structure is more than 100% debt?

2 A. You know, again, you have asked my opinion,
3 and I think I have tried to give that to you as honestly
4 as I can.

5 Q. I asked this of another witness, but take the
6 hypothetical, what if in the general circumstances here
7 the shareholders conclude it's not worth a candle to
8 continue to own this pipeline and they sell it, and say
9 they sell it to Microsoft that has no debt, it's 100%
10 equity. Would it be your view in that environment that
11 we should look to Microsoft's capital structure as a
12 basis for setting rates for Olympic Pipeline then?

13 A. I believe it would be, yes, again because
14 what you look to is in Microsoft's purchase of Olympic,
15 if it would happen, it's their -- it's Microsoft's
16 investors that are -- it's their money that's involved
17 in this, and so it's their capital structure that you
18 would use.

19 Q. Even though that kind of a structure would
20 end up with a higher rate of return than say a more
21 balanced structure?

22 A. Yes, sir.

23 Q. This also may be either explicit or implicit
24 in your testimony and I may not have picked it up, here
25 the company is asking for a rate that it thinks is

4263

1 required in order to attract capital for future safety
2 investments. Is it your view that under FERC
3 methodology these future safety capital costs can be
4 ascertained now in such a way as to translate that into
5 future rates, or should they have to wait until those
6 costs have been incurred and then come back to this
7 Commission for consideration of their inclusion in
8 future rates?

9 A. The FERC looks to, for example, safety
10 regulations of the DOT, if they are instructing a
11 pipeline company to take certain actions into the
12 future, then as long as it -- those actions are within
13 the time frame of the known and measurable, the base
14 period, the test period, or can be quantified to a point
15 where they can be normalized out over a number of years,
16 if it's a one time cost and then you can normalize that
17 over a number of years, the commission would allow that.
18 If there, you know, there's a fine line you're going to
19 have to deal with as to sort of what is known, what
20 isn't. Again, if the FERC is dealing with an order by
21 the Department of Transportation that forces the oil
22 pipeline companies to take certain steps, then the FERC
23 is going to allow those costs, because they are real,
24 they are known.

25 Q. Well, in this instance, they're projected by

1 a company at some \$66 Million I guess over the next
2 three years. Two different circumstances, what if those
3 costs actually come in at \$30 Million, not 66, or, you
4 know, alternatively they come in at 100, not 66?

5 A. I think if they came in, if the costs came in
6 well under, it would be incumbent upon the Commission to
7 go and force Olympic to lower its rates. And similarly
8 if it came in over, Olympic would be back in here saying
9 we didn't get enough.

10 Q. And how would the Commission deal with the
11 issue, no matter what the amount of it, whether the
12 costs were prudently incurred?

13 A. If the costs are prudently incurred and
14 correctly represented in the rates, then you don't
15 really have a problem.

16 Q. But how would we know that if the rate is set
17 now for future expenditures?

18 A. You would have to deal with that through
19 either reporting requirements, maybe you can add a
20 little additional reporting requirements to the company
21 if you're going to allow this cost, or monitoring the
22 Form 6 I believe you use also, and you could monitor the
23 costs, some of the costs in there.

24 Q. Now at page 20, you discuss Form 6 and its
25 relationship to audited financial statements, and I take

4265

1 your testimony to say that audited statements aren't
2 necessary because you look to Form 6 as a basis for
3 determining costs. Is that a fair --

4 A. That's not quite what I said. It's always
5 preferable to have audited statements, but most of the
6 times in most of the companies that the commission deals
7 with, you don't actually have that. What you have is
8 the Form 6 information. And the Form 6 is attested to
9 by a company official. Given the events that have
10 transpired in the country over the last few months, I'm
11 not sure what that means anymore, but in general, you
12 know, that's accepted as a standard in an official
13 document.

14 Q. Well, at least at the present time here, we
15 don't have a set of audited books.

16 A. I understand.

17 Q. I assume there would have to be some
18 relationship between Form 6 utilization and an
19 underlying set of books. Wouldn't there have to be
20 that?

21 A. There should be a direct link between the
22 Form 6 and the underlying books. Now whether the books
23 have been audited or not, that's the problem you're
24 struggling with here.

25 Q. As a hypothetical, what if the books are

4266

1 wildly wrong?

2 A. Well, then again, depending on which way the
3 numbers swing, I think it's incumbent on the Commission
4 to either go out and lower the rates if the numbers have
5 skewed the rates the wrong way or for the company to
6 come in and say, you know.

7 Q. But how would we know that?

8 A. One way you could probably tell is if the
9 books are audited from this past year, then when the
10 Form 6 is filed next year, you know, you will have some
11 correlation between changes and costs, so that would be
12 one way to tell, either that or, you know, to ask for an
13 audit report yourselves.

14 COMMISSIONER HEMSTAD: Thank you, that's all
15 I have. And I apologize, I'm going to have to leave,
16 and I regret having to do so.

17 THE WITNESS: Thank you.

18

19 E X A M I N A T I O N

20 BY CHAIRWOMAN SHOWALTER:

21 Q. I have several questions, and probably most
22 of them have to do with asking you questions about the
23 rationale behind the FERC methodology.

24 A. Okay.

25 Q. I understand that you are not recommending a

4267

1 methodology to us and that you haven't made any detailed
2 study of Olympic's situation, but that you are prepared
3 to talk about the reasoning of FERC's methodology.

4 A. Yes, ma'am, that's correct.

5 Q. All right. On page 6, lines 7 to 14,
6 Mr. Trotter already asked you about this area, but you
7 are discussing what I think of as a two-sided equation,
8 competition on the one hand and franchise on the other,
9 and drawing the point that if there is effective
10 competition for a company and there is no franchise,
11 then the FERC methodology has some rationale behind it,
12 or that's one of the rationales, that's one rationale
13 behind FERC methodology; is that correct?

14 A. That's not quite correct. You know, what I
15 was trying to do here is draw the distinction between
16 depreciated original cost, DOC and TOC, and when they
17 would be or, well, actually just what is the difference
18 between the traditional public utility and the common
19 carrier.

20 Q. All right. And I realize I think I'm using
21 the term FERC methodology as a shorthand for TOC.

22 A. Okay.

23 Q. And it might be better to say TOC, but let me
24 ask you that to the degree that a company faces no
25 effective competition, would you agree that this

1 rationale is a weaker one, the justification for TOC is
2 weaker to the degree that there is less competition?

3 A. No, not -- no, I wouldn't.

4 Q. Why?

5 A. Because TOC and DOC are both cost based
6 methodologies, and they actually both return the same
7 amount of money to the investors. It's just a different
8 pattern of timing of that return. And I mean really
9 that's, you know, we're talking about a pattern of when
10 the dollars are returned to the company, and it's only
11 that. It's, again, if you drew a DOC curve showing the
12 life of the pipeline and then put a TOC curve on
13 underneath it, the area under the curves in theory
14 should be equal, because you're getting the same return
15 in present day in present value dollars.

16 Q. Well, all right, then what am I to make of
17 the sentences from lines 9 to 14 in which you say one of
18 the primary reasons for this is the significance of
19 competition is that the traditional public utility model
20 is not applicable to pipelines, and you go on to say,
21 unless you could keep these competitors out, it's not
22 possible to guarantee the franchise, which is why it
23 seems to me that the more competition on the one hand,
24 the stronger the rationale would be.

25 A. I would agree with you, yes.

4269

1 Q. So that my question was, the less
2 competition, if there is not -- to the degree there is
3 less competition, isn't this rationale weaker? I'm not
4 saying it's not valid, it's weaker.

5 A. That's correct, this one part of the
6 rationale is weaker.

7 Q. Right.

8 A. There's no doubt about it.

9 Q. All right.

10 A. Front end loading problem when you don't have
11 competition doesn't matter.

12 Q. All right. And then by the same token, to
13 the degree that a state does not have franchises or can
14 not guarantee them, again, all other things being equal,
15 isn't this rationale weaker than a state where there are
16 guaranteed franchises?

17 A. I'm not sure I would characterize it that one
18 methodology is weaker than the other. It's what I
19 pointed out here is when there -- when the strengths --
20 when a company -- when it wouldn't be logical to put a
21 company under a DOC methodology is when competition
22 exists. I'm not sure the inverse of that is true, that
23 if you don't have competition, that then the DOC is
24 better.

25 Q. Well, I didn't say that. Actually, my

4270

1 question is about the rationale for a TOC.

2 A. Mm-hm.

3 Q. Not that TOC itself is weak or strong.

4 A. Okay.

5 Q. But isn't the rationale for TOC let's say
6 stronger, isn't there a stronger rationale if there is
7 more competition?

8 A. Yes, I would agree with you there.

9 Q. All right.

10 A. Yes, that's correct.

11 Q. Doesn't that mean that there is a weaker
12 rationale if there is less competition?

13 A. I'm not sure I correlate that.

14 Q. Well, I want you to explain that. Because it
15 seems to me that if the justification for TOC, one
16 justification, not the only one, is that where there is
17 strong competition the DOC has some problems --

18 A. Right.

19 Q. -- that TOC was meant to address.

20 A. Right.

21 Q. Am I right so far?

22 A. That's correct, yes, ma'am.

23 Q. Well, then doesn't it follow that that
24 rationale is weaker for TOC in a case where there is no
25 competition?

4271

1 A. Okay.

2 Q. I'm not saying that TOC is wrong.

3 A. No, no, I didn't --

4 Q. I'm just saying that the compelling reason to
5 do it is less.

6 A. Maybe a compelling reason to change from, you
7 know, to -- if you look at the -- if you're looking for
8 a compelling reason to change from one methodology to
9 another, if you're currently in DOC and you've got
10 competitive markets, it would make sense to turn to TOC
11 and vice versa. If you're currently under a TOC
12 methodology and you have noncompetitive markets, it
13 could possibly make sense to change that way. However,
14 again, the underlying logic is that both are cost based
15 methodologies that are both right. I mean neither of
16 them is wrong. You know, they both result in a fair
17 return of the investment to the investors with profit.
18 It's the timing pattern. That's all we're dealing with.

19 Q. All right. Assume for my questions that this
20 Commission has no approved methodology, that this
21 Commission has never approved or affirmed any particular
22 methodology.

23 A. Mm-hm.

24 Q. And so here in this case we're going to
25 address that issue.

4272

1 A. Right.

2 Q. My question again is, in terms of the factors
3 that we need to consider, wouldn't it be more compelling
4 to use TOC in a case where there is robust competition
5 than in a case where there is weak competition, just on
6 that factor, all other things being equal?

7 A. Yes.

8 Q. All right. Then my next question --

9 A. And the inverse is true.

10 Q. All right.

11 A. I will give you a yes on that too.

12 Q. All right. And then but my next question is,
13 if we are a state that does not guarantee franchises,
14 isn't that another distinction of TOC that, and the
15 rationale for TOC, that doesn't exist here?

16 A. Yes.

17 Q. All right.

18 A. However, if I could, again, the perception at
19 least on behalf of the pipeline company is that you have
20 a methodology that you have been using, and I think it's
21 important to realize, and I have stated this further
22 back in my testimony, it's important to realize that the
23 investors relied heavily on at least their presumption
24 of what this Commission was doing.

25 Q. Well, that's a different issue, and we will

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1 address whether they were entitled to any presumption
2 whatsoever based on this Commission allowing a tariff to
3 take effect. But for my purposes, I'm asking you to
4 assume for the sake of this part of the discussion that
5 this Commission has never made any determination on the
6 appropriate methodology.

7 A. Okay.

8 Q. And it may very well be that the context that
9 you're alluding to is another factor that we should
10 consider when we decide what to do.

11 If you could turn to page 11, and I'm looking
12 at lines 21 through 24, where you say:

13 This problem would become particularly
14 acute in the case where a new
15 undepreciated pipeline was competing
16 with an older largely depreciated
17 pipeline.

18 And the problem related to the DOC
19 methodology.

20 A. Yes, ma'am.

21 Q. Do you agree that to the extent, to the
22 degree that we are not dealing with this situation of a
23 new underdepreciated pipeline competing against an older
24 depreciated pipeline, that the rationale for rejecting
25 DOC is weaker?

1 A. Right, I would agree with you that this one
2 point would probably not be applicable in this case.

3 Q. Right, and my interest here is not to be
4 absolute, it's to look at the different factors that
5 have been raised and that you raise as rationales for
6 using TOC versus DOC.

7 A. Okay.

8 Q. Could you turn to page 13, on lines 9 through
9 13, you say that:

10 If parent companies guarantee the debt
11 of their subsidiaries, these parent
12 companies were in essence assuming the
13 risk of their affiliates.

14 And I believe Mr. Trotter and Mr. Brena asked
15 you various questions about debt that is or is not
16 guaranteed. I would like to ask a little bit different
17 question. Is your assumption there that if the parents
18 do guarantee the debt of their subsidiaries, they are
19 assuming the risk of their affiliates?

20 A. Yes.

21 Q. Do you perceive any risks or liabilities
22 beyond the debt that a company owes?

23 A. There may be others, you know.

24 Q. Well, okay.

25 A. But here I was speaking really just to the

4275

1 guarantee of the debt.

2 Q. All right. Let's assume that all of the debt
3 is guaranteed by the parents in this hypothetical.

4 A. Okay.

5 Q. And that there is no equity in the company at
6 all.

7 A. In the parent company or in the --

8 Q. No.

9 A. -- subsidiary?

10 Q. In the regulated company.

11 A. Okay.

12 Q. If the company through negligence,
13 mismanagement, recklessness, some other thing, causes
14 injury, in that instance, is there a potential liability
15 to the company, of the company?

16 A. I'm not a lawyer, I would assume there would
17 be.

18 Q. All right.

19 A. But I really can't answer. That's a legal
20 question.

21 Q. In that instance, do you think that the
22 guarantee, the debt guarantee, in and of itself extends
23 to those liabilities?

24 A. I'm not sure, I'm sorry.

25 Q. All right. Well, then let me ask this

1 question. To the degree that the parent has not assumed
2 the risk of the affiliate, either because there's a
3 third party loan or because there are other liabilities
4 that the parent has not incurred or doesn't stand to
5 incur, to the degree that that's the case, isn't the
6 rationale for the capital structure in this case weaker
7 compared, well, weaker than if your sentence is all the
8 case? In other words, if there is not a perfect
9 identity between the parents and the company in terms of
10 the risks, isn't the case for using the parent's capital
11 structure weaker?

12 A. No, I don't -- and maybe I'm misunderstanding
13 the point you're trying to make, but, you know, if the
14 parent is guaranteeing the debt for the subsidiary, then
15 that's what the parent should be looked at as to the
16 capital structure.

17 Q. Well, doesn't that assume that the capital
18 structure isn't about anything else than debt payment?

19 A. No. Well, it would be the responsibility,
20 the responsibility for debt, you know, who is backing
21 the loan up in effect, and that's where the
22 responsibility comes in.

23 Q. So as between a company, a regulated company
24 with an actual 50/50 debt-equity ratio versus a
25 regulated company with a 100% debt, 0% equity, and let's

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1 say in both cases the parents have backed the debt, do
2 you see any difference between those two companies as
3 companies?

4 A. If you're asking me, you know, would I still
5 look to the parent companies to adequately structure for
6 setting rates?

7 Q. No, I'm not asking that question.

8 A. Okay, I'm sorry.

9 Q. I'm asking you to assume two different
10 companies.

11 A. Right.

12 Q. One has 100% debt, the other has 50% debt.

13 A. Okay.

14 Q. In both cases, the companies happen to have
15 their debt completely backed by their parents. If you
16 looked at those two companies, would you say that one
17 was more vulnerable than the other?

18 A. Again, I think you would look to the parent
19 and determine the vulnerability there, because that's,
20 you know, that's where the real guarantee is.

21 Q. But isn't the guarantee --

22 A. The parent is a little more -- the parent of
23 the 50/50 company has a little more assurance, because
24 it has some equity there, so its investors are obviously
25 better off than the company with no equity.

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1 Q. Well, supposing you're a customer of both of
2 those companies and something goes wrong at the company,
3 doesn't the company with the 50/50 capital structure,
4 actual structure, have a better chance of withstanding
5 mishaps?

6 A. I'm not sure if the parent company is
7 guaranteeing --

8 Q. Well, the parent company in my example has
9 guaranteed all the loans. I didn't say that the parent
10 companies have promised that they will guarantee every
11 future loan or that they will promise to put a penny of
12 equity or debt into the company. All we know is what
13 has happened in the past. That's all we ever know
14 really.

15 A. I'm thinking that the FERC would look at this
16 and say that there is no difference between the two.

17 Q. And I --

18 A. And I understand what you're saying.

19 Q. I'm not so interested in what FERC would do,
20 I'm interested in the rationale, the justification for
21 the FERC methodology or the TOC methodology for the
22 using the capital structure of the parents. I'm looking
23 at the why of things, because we have to decide what we
24 want to do, and it simply isn't sufficient to say FERC
25 would do it this way. We have to -- we would have to

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1 adopt either their rationale or another rationale before
2 we approve this methodology.

3 A. Right.

4 Q. So I'm having a hard time seeing why it is
5 immaterial what a regulated company's actual capital
6 structure is.

7 A. I think what you need to do is actually, I
8 hate to pass the buck, but you're probably going to need
9 to talk to a capital structure expert on this who can
10 probably more fully explain to you the rationale behind
11 the investors than I can.

12 Q. Well, and I'm looking at your sentence that
13 said:

14 The basic reason FERC expressed a
15 preference for actual capital structures
16 is that it realized it would more
17 accurately reflect the risk. If parent
18 companies guaranteed the debt, these
19 parents were in essence assuming the
20 risk, and FERC determined it was more
21 appropriate to use the parent company in
22 that situation.

23 So it seems to me you have covered the FERC
24 rationale.

25 A. Right.

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1 Q. And I'm testing that rationale.

2 A. Okay. Maybe my knowledge base is not deep
3 enough for you to test.

4 Q. All right.

5 Then on that same page 13, lines 15 to 18,
6 you say:

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

14 And my question there is, well, which way
15 does this sentence cut? Because assume that the
16 regulated company is 100% debt but the parents are 80%
17 equity, so the cost --

18 A. Again --

19 Q. The cost of debt is less, but the parent's
20 equity ratio is very high.

21 A. You have to look at this in combination. You
22 know, again, if the parent company is guaranteeing 100%
23 debt of the pipeline company, and you look to then the
24 parent company, their capital structure, you use their
25 debt-equity ratio to give them a return on their

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1 investment into the pipeline company in effect, their
2 guarantee of that debt.

3 Q. All right. But supposing they haven't
4 invested, supposing they have not put in any equity into
5 the company.

6 A. Okay.

7 Q. Not any.

8 A. Then their return would be minimal, because
9 the return on debt is the return off debt.

10 Q. Well, if we were using actual capital
11 structure, then it would seem that the parents would get
12 a return on equity if they had put in any equity, but
13 they wouldn't get the equity rate of return if they
14 hadn't put in any equity; isn't that right?

15 A. I think we missed each other there.

16 Q. All right.

17 A. I'm sorry, maybe it was my fault. Again,
18 you're looking at the parent company's capital structure
19 in establishing the debt-equity ratio to be used in the
20 FERC method, and so kind of not -- depending on -- yeah,
21 you're looking at the pipeline, whether it's 100% debt
22 financed or 50/50, you would have to look at the parent
23 company and what their perception of that return is.
24 Because the FERC methodology would base the capital
25 structure on the participate company, so whether -- if

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1 they're getting a capital structure because they're --
2 if they're getting a return based on their capital
3 structure and say their capital structure is 100% of
4 equity, let's not go that extreme, 50/50, but the
5 pipeline company is financed with 100% debt that's
6 guaranteed by this 50% debt company, then the FERC
7 methodology would use the parent company's 50/50
8 structure to establish the return. Because again, in
9 finding -- in guaranteeing that debt, the parent company
10 is using its capital structure to be able to carry that
11 -- to be able to guarantee that debt. And again, I'm
12 probably not making myself completely clear, and I
13 apologize for that.

14 Q. Could you turn to page 22, lines 5 to 6. You
15 say:

16 It is common for oil pipelines to
17 prepare rate filings using data drawn
18 from the FERC Form 6.

19 At FERC, if there is a contested rate case,
20 is it the practice or common for the FERC to hear
21 testimony about what went into the Form 6, in other
22 words, to look behind the form, or in a contested case
23 does FERC simply take the Form 6 as is and not look
24 behind those numbers?

25 A. No, the FERC would either look behind the

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1 numbers and go actually out and do an audit of the
2 company, which they don't do very often. But, for
3 example, with the Trans Alaska Pipeline companies, they
4 did that, they spent the effort to go out and actually
5 audit the numbers in the Form 6. But typically you
6 wouldn't. The Form 6 is used to prepare rate filings;
7 however, when a company comes in to file its case, the
8 case itself doesn't necessarily reflect the exact
9 numbers in the Form 6, and a lot of times there's --
10 there's a lot of reasons for that. For example, you
11 could have timing differences, the Form 6 is from
12 calendar -- it's a calendar year document, it ends in
13 December of each year, whereas rate cases typically
14 don't, aren't that neat. They don't end at the end of
15 the year. They're filed for a time period that's, you
16 know, March to March or something like that. So, you
17 know, you wouldn't be using the numbers directly in a
18 rate case.

19 Q. All right. In a FERC contested case, is it
20 common to have someone testify before the FERC who can
21 vouch for the reasonableness and appropriateness and
22 accuracy of the numbers used to support the rate case?

23 A. Yes, ma'am, of course.

24 CHAIRWOMAN SHOWALTER: That's all the
25 questions I have, thank you.

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1 COMMISSIONER OSHIE: No questions.

2 JUDGE WALLIS: Should we break now?

3 MR. BRENA: It would be a good time for a
4 break. I have probably 15 minutes or a half an hour of
5 questions for this witness.

6 MR. MARSHALL: I probably -- I think, what, I
7 estimated an hour, I probably could do it in 45 minutes.
8 I would just mention that the witness has been up since
9 3:00 Eastern Standard Time today to get out here, so
10 that it may be that the quality of the responses will
11 diminish after dinner.

12 JUDGE WALLIS: Let's be off the record,
13 please.

14 (Discussion off the record.)

15 (Dinner recess taken at 5:50 p.m.)

16

17 E V E N I N G S E S S I O N

18 (6:35 p.m.)

19 JUDGE WALLIS: Chairwoman Showalter.

20 CHAIRWOMAN SHOWALTER: Yes.

21

22 E X A M I N A T I O N

23 BY CHAIRWOMAN SHOWALTER:

24 Q. Commissioner Hemstad questioned you about the
25 appropriateness of taking into account future or near

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1 future costs or projected costs. My question is, to the
2 extent that we accommodate future costs, shouldn't we
3 also take into account any increase in throughput that
4 expenditure of those costs would bring about, if any?

5 A. If both facts, either the throughput or the
6 other, the further investment are known and measurable
7 or in the foreseeable future, in the case of the FERC,
8 it's in the nine month test period, then yes.

9 CHAIRWOMAN SHOWALTER: Thank you.

10 JUDGE WALLIS: Do we want follow-up
11 questions?

12 MR. BRENA: Yeah, I have some.

13 JUDGE WALLIS: Mr. Brena.

14

15 C R O S S - E X A M I N A T I O N

16 BY MR. BRENA:

17 Q. You were asked a series of questions with
18 regard to capital structure, and I just -- are you
19 familiar with FERC's recent orders on capital structure
20 in the SFPP case, 435 and 435-A?

21 A. I have read them, it's been a long time since
22 I have read them.

23 Q. Is it --

24 MR. MARSHALL: I don't think this is a
25 follow-up to any commissioner question. This could have

1 been asked in Mr. Brena's cross-examination. I would
2 just ask him to confine himself to specific items that
3 he could not have brought up in his first cross.

4 MR. BRENA: I think that the standard is
5 whether it's within the scope of the commissioners'
6 questions. I think that's the appropriate standard, not
7 if on some ethereal level I could have brought it up on
8 my cross.

9 JUDGE WALLIS: Can you identify the area to
10 which you were responding?

11 MR. BRENA: Yeah, a couple of them.
12 Commissioner Hemstad asked a series of questions, as did
13 Chairwoman Showalter, with regard to different -- with
14 regard to the parent company use of capital structure by
15 the FERC, and what I'm exploring with the witness is
16 whether or not FERC does actually use the parent company
17 capital structures in the different situations that were
18 advanced by Chairwoman Showalter and Commissioner
19 Hemstad.

20 JUDGE WALLIS: Very well, the objection is
21 overruled.

22 BY MR. BRENA:

23 Q. Do you know that they rejected the use of the
24 parent company capital structure in the SFPP case?

25 MR. MARSHALL: Well, I just object to that.

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1 I don't think there's a link yet to what specific -- I
2 mean if there's a specific capital structure question,
3 then let's do -- this just sounds like it's reopening
4 the whole general topic.

5 JUDGE WALLIS: I think that this may be
6 preliminary.

7 Is that so, Mr. Brena?

8 MR. BRENA: Well, yeah, I'm probing his
9 understanding of FERC's application of the methodology
10 and their application of the parent company capital
11 structure. That particular question was an example of a
12 case in which the FERC rejected the parent company
13 capital structure, and I intend to explore with the
14 witness what the circumstances were for that rejection
15 and how they compare to the circumstances here and the
16 circumstances advanced by Chairwoman Showalter and
17 Commissioner Hemstad's questions.

18 JUDGE WALLIS: You may proceed.

19 BY MR. BRENA:

20 Q. Do you remember that?

21 A. Could you ask the question again, I'm sorry?

22 Q. Yeah, I will be happy to.

23 Are you aware that in the SFPP case that they
24 rejected the use of the parent company's capital
25 structure?

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1 A. I'm vaguely aware of it, however, if memory
2 serves me, and my memory is not that great, I think
3 there were some additional orders, follow-up orders to
4 this, to the SFPP case, so I don't know which order
5 you're referring to. I remember that the Commission did
6 in one of the orders not use the parent company's
7 capital structure for specific reasons.

8 Q. Okay. So I just want to be clear on what
9 your testimony is with regard to the parent company
10 capital structure. Is it that it's a presumption that
11 it will be used, or under every circumstance is it your
12 testimony that FERC uses parent company capital
13 structure if there's guarantees in place?

14 A. I would say it's a very strong presumption.

15 Q. Okay.

16 A. But just that.

17 Q. Were you aware that one reason, the reason
18 that they stated for not using the parent company's
19 capital structure in the SFPP case, was that the parent
20 company had a, and I quote, "had an unusually equity
21 oriented capital structure with equity comprising 78.29%
22 of the capital structure"; were you aware of that?

23 A. I didn't remember the reasons. I assume your
24 reading is correct, although again, you know, without
25 looking at the whole document, there may have been a

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1 number of other reasons there too. I don't remember.

2 Q. Okay. I mean isn't it, and if you don't know
3 say so, but isn't it fair to state that under those
4 circumstances, they will look to the parent company
5 capital structure so long as it's roughly representative
6 of the risks that the regulated company faces?

7 A. No, I'm not sure I would go that far to make
8 that exact statement.

9 Q. Okay. What is your understanding of the
10 circumstances under which FERC will not use the parent
11 company capital structure when the parent company does
12 guarantee the debt?

13 A. I'm not sure I know of any specific instances
14 to give you.

15 Q. I would like for you to -- I just want to
16 read you a part of this order and just ask if that's
17 consistent with your understanding of the FERC
18 methodology or not. It says, and I am reading, and I'm
19 happy to show it to you, 435-A, and it says:

20 On rehearing, the commission concludes
21 that the ALJ's analysis more accurately
22 reflects the risk of SFPP's underlying
23 operations. While the ALJ's decision
24 and the result here impute SFPP's
25 capital structure to its predecessor

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1 entity, this is appropriate in light of
2 the significant difference in the nature
3 of the pipeline operations and those of
4 its parent companies on June 28, 1985.

5 MR. MARSHALL: I would object that he's
6 reading a portion of a case. The case, the entire case
7 should speak for itself, and I'm not sure if this is a
8 memory test or what at this point. It could be argued
9 on legal briefing rather than --

10 JUDGE WALLIS: I think that -- excuse me,
11 Mr. Marshall, have you concluded?

12 MR. MARSHALL: Yes, thank you.

13 JUDGE WALLIS: I think that the question as
14 posed is clear and is permissible, and it asks for the
15 witness's view of the order and whether it's consistent
16 with the passage that was read.

17 Mr. Brena, is that a fair restatement of your
18 question?

19 MR. BRENA: Yes, it is.

20 JUDGE WALLIS: And as such, I believe it's
21 permissible.

22 Does the witness have the quotation in mind?

23 THE WITNESS: I do have it in mind.

24 MR. BRENA: Can I just show him the paragraph
25 and let him read it?

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1 JUDGE WALLIS: Please do.

2 A. Again, this is a series, you know, the second
3 order you're reading is the rehearing on this order if
4 I'm not mistaken.

5 BY MR. BRENA:

6 Q. Yep.

7 A. And I'm not sure whether there were any more
8 rehearings on the ultimate words.

9 Q. Well, I'm just looking for whether or not
10 this reading is consistent with your understanding. If
11 you would just read that paragraph, and then I will ask
12 you a question.

13 A. (Reading.)

14 MR. MARSHALL: The record should reflect that
15 the witness was just shown something different than what
16 he was just read a moment ago.

17 JUDGE WALLIS: Is that correct, Mr. Brena?

18 MR. BRENA: Yes, there's two orders, 435 and
19 435-A, and the paragraph that I just directed the
20 witness to review is page 49. It's the first full
21 paragraph on 435, which is the underlying order. The
22 order that I was reading from was the order on rehearing
23 confirming this.

24 BY MR. BRENA:

25 Q. But specifically, it says:

1 Based in part on this weighting, the ALJ
2 concluded that the risks facing SFPP's
3 parent company were different than those
4 of SFPP itself and that the use of the
5 parent's capital structure would be
6 inappropriate.

7 Did you see that language?

8 A. Yes, sir, I read that.

9 Q. Does that suggest to you in applying these
10 rules that one of the factors that the FERC considers in
11 whether or not the presumption of using the parent
12 company's capital structure should be overcome is
13 whether the risks facing the capital structure, the
14 risks facing the parent are similar or different from
15 the risks of the regulated entity?

16 A. I'm not sure I get that from the reading. If
17 it -- there's a whole lot more if I remember correctly
18 in that order that had pages and pages concerning the
19 capital structure and the positions on it. If not, it
20 was the ALJ's decision underlying that, and there were a
21 lot of different reasons. I don't remember what they
22 were, but I remember it was a very involved topic in
23 here. I remember the concept that the parent company at
24 one point was a railroad instead of a pipeline. I would
25 hate to make a characterization --

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1 Q. It's just too complicated for you to respond?

2 A. Without further information, further
3 readings, yes.

4 Q. Okay, I appreciate that.

5 When the capital structure of the parent
6 becomes very, very heavily weighted towards equity, is
7 that one of the circumstances that it's your
8 understanding that FERC will carefully review whether or
9 not the presumption of applying the parent company's
10 capital structure should be applied?

11 A. I would assume that, in my experience, let's
12 put it this way, any extreme abnormality of a capital
13 structure would be reviewed and then a determination
14 made as opposed to just a -- and again, that's a -- goes
15 to the presumption that the parent company capital
16 structure will be used.

17 Q. In your experience --

18 A. In the -- excuse me.

19 Q. I'm sorry, were you done?

20 A. Yes.

21 Q. I'm sorry to interrupt.

22 In your experience, what is the typical
23 percent equity that the FERC approves in the capital
24 structure for rate making purposes?

25 A. I'm not sure I could characterize anything as

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1 a typical debt-equity structure, if that's what you're
2 asking.

3 Q. That's used in -- what's the lowest percent
4 equity that you're familiar with having been approved?

5 MR. MARSHALL: In the parent's capital
6 structure? I guess I'm confused a little bit on the
7 question.

8 Q. The lowest equity capital structure used for
9 rate purposes that you're familiar with, parent or
10 otherwise, the lowest and highest for that matter in a
11 contested rate case, cost of service case, if you know.

12 A. I would like to answer that I don't really
13 know.

14 Q. Okay.

15 A. It's -- yeah, leave it at that.

16 Q. If the ALJ pointed out in that case that the
17 debt ratio that they applied is more consistent with
18 that of a generally adopted by the oil pipeline industry
19 of 45% to 55% debt, if the ALJ were to have said that in
20 that case, do you have any reason to dispute that?

21 A. I'm not sure why I would dispute what an ALJ
22 wrote.

23 Q. Is that consistent with your experience?

24 A. It would not be inconsistent, so yes, it is
25 consistent.

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1 Q. Okay. Now Commissioner Hemstad and in fact
2 Chairwoman Showalter just followed up on the known and
3 measurable standard and how it should be applied. For
4 something to satisfy the known and measurable standard
5 under FERC regulation, it has to be known at the time of
6 the filing, correct?

7 A. That's correct.

8 Q. So that's the point, and by the filing,
9 that's the date of the rate filing, correct?

10 A. Yes.

11 Q. So you have a base period of 12 months of
12 actual, and you know that when you make your rate
13 filing. And then from the date of that filing nine
14 months forward is how the known and measurable standard
15 is applied?

16 A. Yes, sir, that's correct.

17 Q. And it has to be known and measurable with
18 reasonable accuracy, correct?

19 A. Right.

20 Q. Okay. In this case, are you aware of any
21 proposed increase to the cost of service resulting from
22 future capital improvements? I mean is it your
23 understanding they quantified that and included that in
24 the rate request?

25 A. When you say future cost of service, capital

1 improvements, what time frame are we talking about
2 future, you know, within the known and measurable and
3 within the nine month test period or outside of that?

4 Q. I think Chairwoman Showalter directed you to
5 the \$66 Million estimate over the three years, as did
6 Commissioner Hemstad. By somebody stating that they may
7 have \$66 Million of capital improvements over the next
8 three years, does that meet the known and measurable
9 standard as it's applied by the FERC?

10 A. It would depend on the information backing
11 that up.

12 Q. Are you aware whether or not Olympic has
13 quantified that information and included it in its rate
14 request?

15 MR. MARSHALL: This is beyond the scope of
16 the direct and of what the Commission questions are.
17 This witness isn't being offered in this specific area.
18 Mr. Talley is, Mr. Batch, Mr. Fox might be, but not this
19 witness.

20 JUDGE WALLIS: Mr. Brena.

21 MR. BRENA: Well, Commissioner Hemstad asked
22 a series of questions with regard to the known and
23 measurable standard and how it could be applied relative
24 to future capital improvements, and Chairwoman Showalter
25 followed up on that.

1 JUDGE WALLIS: Is it your view that the
2 question falls within the scope of the topic for which
3 the witness is offered, that is his expertise in FERC
4 matters?

5 MR. BRENA: Yes, my question was, under the
6 FERC application of the known and measurable standard,
7 would that apply.

8 JUDGE WALLIS: I believe that the question is
9 within the scope of the Commissioner questions, and it
10 is within the topic for which the witness is offered.

11 BY MR. BRENA:

12 Q. Well, I think in my last question, I was just
13 intending to explore whether or not it's your
14 understanding that there's been any attempt in this rate
15 case by Olympic to include any portion of that \$66
16 Million within its rate case under the known and
17 measurable standard?

18 A. I don't know, sorry.

19 Q. Okay. Chairwoman Showalter asked you some
20 questions about whether or not the FERC 6 information on
21 a stand alone basis was sufficient information for a
22 contested cost of service filing. Do you recall that
23 line of questioning?

24 A. Yes.

25 Q. Okay. Is it fair to say that the FERC 6 is a

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1 regulatory reporting instrument?

2 A. Yes, that's a fair characterization.

3 Q. And to add to that characterization, that it
4 is not intended to be a cost of service demonstration
5 under cost of service rate making?

6 A. It's not intended to be the prima facie case
7 of a pipeline company filing for a rate increase, but it
8 is to be used by, and the Commission stated this in its
9 work in reviewing the Form 6, that it is to be used for
10 -- as a tool for shippers to determine when or when not
11 to file protests or complaints.

12 Q. And that would be consistent with its
13 regulatory reporting function, wouldn't it?

14 A. Yes, sir.

15 Q. Okay. And specifically you're referring to
16 page 700?

17 A. Yes.

18 Q. Now Chairwoman Showalter asked you some
19 rather broad methodology questions with regard to the
20 rationale behind the use of the TOC. Now just so that
21 you and I are clear, the TOC and 154-B are not
22 synonymous, correct?

23 A. I think that they were probably used
24 interchangeably in the conversation. The 154-B
25 methodology is a form of trended original cost, but it

4299

1 also has other features, for example, the starting rate
2 base, things like that, you know, so as opposed to a
3 pure just trended original cost rate base.

4 Q. And within the parameters of a TOC, there are
5 several deferral mechanisms that could be used that
6 still would fall within the parameters of the TOC and be
7 different from simply the deferral of the nominal
8 portion of the return as is contained within 154-B,
9 correct?

10 A. If you're asking, could you formulate a
11 different methodology that's still trended original cost
12 using different deferral items, different parts, I'm
13 sure you could.

14 Q. Okay.

15 A. But, you know, the ultimate goal would be to
16 get a just and reasonable result.

17 Q. Now 1215 of the handouts, do you have my
18 handouts still with you?

19 A. No, I'm sorry, I handed them back to you.

20 Q. I will give them back to you.

21 JUDGE WALLIS: By handout, you meant the
22 compilation of Exhibits 1208 through 1215 as identified?

23 MR. BRENA: Yes.

24 JUDGE WALLIS: Is that correct?

25 MR. BRENA: 1215.

4300

1 THE WITNESS: It's the Farmers Union II
2 decision; is that what you're referring to?

3 MR. BRENA: No, it's 154-B.

4 THE WITNESS: Oh.

5 MR. BRENA: Do you have it?

6 THE WITNESS: I don't see it here. I may
7 have another copy of it.

8 MR. BRENA: There you go.

9 THE WITNESS: Sorry.

10 MR. BRENA: That's okay.

11 BY MR. BRENA:

12 Q. Now I would like to direct your attention to
13 page 61834, which is in the upper left-hand corner of
14 the page or upper right-hand corner as you turn the
15 pages, the third and fourth full paragraphs, and those
16 are the paragraphs where the FERC explains why it adopts
17 a TOC, correct?

18 A. That's part of the explanation, yes.

19 Q. Okay. Now you made the point to Chairwoman
20 Showalter that a TOC and a DOC work out to the same net
21 present value, and that is one of the observations that
22 the FERC uses, correct?

23 A. Right, that's correct, that's what the
24 Department of Justice said.

25 Q. And just to illustrate this point, I have

4301

1 tried to draw the rate chart under a DOC and a TOC. And
2 is it fair to say that what you were trying to explain
3 to the Chairwoman is that if you look at the rate
4 profile of a DOC, it starts high and goes low, where a
5 TOC is more of a normalized rate?

6 A. That's correct, yes.

7 Q. And so if you take these two income streams
8 back under net present value terms, they should be
9 equal?

10 A. Right, that's the theory, yes.

11 Q. And that was the point that you were making
12 to her, correct?

13 A. Yes.

14 Q. Now this point assumes that the inflation
15 factor that's used in the TOC formula is correct, right?
16 I mean there is an inflation --

17 A. Right, the inflation --

18 Q. -- adjustment --

19 A. Right, the inflation adjustment --

20 Q. -- of the equity portion?

21 A. -- is in the TOC and the DOC, because the DOC
22 has the equity -- has the inflation, by using a nominal
23 return, has inflation built into it also.

24 Q. Right. But these could vary in net present
25 value. I mean if you plug in an inflation factor in TOC

4302

1 in determining what the deferral component is, correct?

2 A. That's a step, yes.

3 Q. Okay. If you plug in 10% but the real
4 inflation factor turns out to be 5%, then the net
5 present value of the income stream under a TOC will be
6 different than the net present value under a DOC,
7 correct?

8 A. That will be the same effect as if you use
9 the wrong inflation factor on the DOC, yes. It would
10 skew the lines either way if you use the wrong factor.

11 Q. You're suggesting that the return under a DOC
12 uses forward looking inflation adjustments?

13 A. No.

14 Q. Okay.

15 A. I was just saying if you use the wrong
16 factor, you're going to get the wrong answer.

17 Q. So if you use the wrong -- if you use the
18 wrong return, okay. But in terms of forward looking
19 inflation adjustments, the TOC does rely on the validity
20 of forward looking factors in order for the net present
21 value to equal itself?

22 A. You know, you have simplified it down to a
23 point where it's probably not an accurate statement,
24 because you could have a coincidence where they would
25 still be the same if you overestimate one year and

4303

1 underestimate another year, but yes.

2 Q. But they're not necessarily the same; I mean
3 they could be different based on --

4 A. If you made wrong assumptions consistently
5 the wrong way, yes.

6 Q. Now I want you to assume that where we are is
7 right here. That's the time line, okay?

8 JUDGE WALLIS: At this point, Mr. Brena, I
9 think it becomes necessary either to explain where
10 you're drawing or to make that drawing an exhibit. I
11 think up to now it's been pretty clear from the language
12 that you have used the meaning of what you're saying,
13 and someone reading the transcript can follow. But at
14 this point, could you give us a little help.

15 MR. BRENA: I would like to just make it an
16 exhibit, and if I could just -- I will have it reduced
17 down and introduced; would that be appropriate?

18 JUDGE WALLIS: Yes, it would, and I would ask
19 you to describe for the record what you are doing on the
20 chart as you are doing it so again we can look at the
21 exhibit when it is reduced and duplicated and follow the
22 words in the transcript.

23 MR. BRENA: Okay. I have a graph -- is this
24 coming through all right?

25 CHAIRWOMAN SHOWALTER: I don't think it is.

4304

1 MR. BRENA: Not all right but coming through?

2 CHAIRWOMAN SHOWALTER: Well, no worse than
3 the way your voice always comes through.

4 MR. BRENA: All right.

5 JUDGE WALLIS: I think it is coming through.

6 MR. BRENA: Okay, I will try to speak up.

7 BY MR. BRENA:

8 Q. I have a graph. On one axis I have rate. On
9 the other axis I have time. And I have drawn two
10 initial lines, one a DOC line showing that the rate
11 structure under a DOC starts high and ends lower in
12 comparison with a TOC. The TOC line is flatter
13 representing the normalization of the rate as a result
14 of the deferral of a portion of the equity return.

15 Mr. Smith, is that about right so far?

16 A. That's what I see other than you now have a
17 vertical line at the year 2002 also.

18 Q. Yes.

19 A. And your vertical axis starts at 1983.

20 MR. TROTTER: Excuse me, Your Honor, if I
21 could offer, it doesn't appear that the word rate is
22 appropriate. Perhaps it should be revenue or return,
23 but I will just offer that to short circuit some
24 additional redirect later, recross later.

25 Q. I will make it return, the comments.

4305

1 And on the one axis, the time line starts in
2 1983 and then moves forward. Now, Mr. Smith, is it fair
3 to say that under a valuation methodology that the
4 result of a valuation methodology is higher rates than
5 under either of these cost based methodologies?

6 MR. MARSHALL: Objection, the hypothetical
7 doesn't give enough facts. I mean what kind of
8 valuation, what kind of value? I mean obviously if you
9 have a low value, it's different than if you have a high
10 value. I think it's an incomplete hypothetical, and I
11 don't know how that ties to any of the Commissioner
12 questions frankly.

13 JUDGE WALLIS: The witness may respond if he
14 understands the question.

15 MR. BRENA: Let me rephrase it.

16 BY MR. BRENA:

17 Q. The reason that they rejected the valuation
18 methodology under the ICC as was memorialized in 154 was
19 because of the extremely high rates that it produced
20 relative to a cost based methodology?

21 A. No, the reason they rejected the 154 order
22 which espoused the valuation was that the decision
23 making wasn't reasoned.

24 Q. Okay.

25 A. It was sent back by the court.

4306

1 Q. Do you agree or not generally that the
2 return, well, not the return, but that the rates under a
3 154 methodology will generally be higher than under a
4 154-B methodology or a DOC methodology?

5 A. No, I wouldn't agree to that.

6 Q. That's not a general proposition?

7 A. No, it's not.

8 Q. Okay.

9 MR. MARSHALL: This also appears to be beyond
10 the commissioner questions and could have been asked on
11 Mr. Brena's cross.

12 JUDGE WALLIS: I continue to believe, as
13 noted earlier, that this is within the topic raised by
14 the commissioner questions and within the scope of the
15 topic that the witness is offered for, and consequently
16 I think it's appropriate.

17 BY MR. BRENA:

18 Q. Now instead of either return, I want you to
19 make an assumption then if we can't agree that the 154
20 rates are generally higher. I want you to assume that
21 in this case that Olympic has collected a return that is
22 above both the DOC or the TOC. Do you have that
23 assumption in mind?

24 A. Yes.

25 Q. Okay. Now on a theoretical basis, if this is

4307

1 2002 in the middle, the theoretical justification for
2 collecting deferred return in this period is because and
3 only because it was forgone in this period; is that
4 correct?

5 JUDGE WALLIS: Could you number those 1 and 2
6 respectively, please.

7 MR. BRENA: 1 would be the deferred return
8 from prior periods, and 2 would be the collection of the
9 deferred return in future periods.

10 JUDGE WALLIS: In reverse order to your
11 earlier mention.

12 MR. BRENA: Correct.

13 BY MR. BRENA:

14 Q. Now I mean I'm just -- I'm at a conceptual
15 level here.

16 A. Okay.

17 Q. The reason you ought to get 2, and let's
18 forget about this line for now, whatever their rates
19 have been, the reason you're entitled to collect this
20 amount here is because you forwent the collection of
21 that amount plus the inflation component?

22 JUDGE WALLIS: Please use the numbers.

23 Q. The reason that you're entitled to collect
24 the amount indicated under number 2 is because you
25 forwent the amount in theory indicated by number 1,

4308

1 correct?

2 A. You're really comparing apples and oranges
3 with the talking about rate base and then talking about
4 the deferred return. The deferred return is just a
5 component of the calculation of how the TOC rate base
6 works. It's not an amount that's taken from here and
7 put to there. It is a different pattern of recovery and
8 which gives you the flat or the sloping line.

9 Q. Well, I appreciate it, but what you're doing
10 under a TOC is pushing return into the future. You're
11 deferring return, that's the whole concept of a TOC, is
12 it not? You're forgoing return today in order to
13 recover it tomorrow, and the reason that you're entitled
14 to recover it tomorrow is because you forwent it today,
15 correct?

16 A. You're deferring a component of the return to
17 a future period, yes.

18 Q. So if it's -- so the only theoretical basis
19 for recovering the deferred return in the future is the
20 fact that it has actually been deferred in the past?

21 A. Because that's the way the calculation
22 operates.

23 Q. Right.

24 A. Right.

25 Q. So we agree on that. Is there some other

4309

1 theoretical basis?

2 A. No, the calculation sets, you know, the whole
3 methodology is set up so that the calculation operates
4 that way.

5 Q. Now is there any theoretical justification at
6 all for the justification for the future collection of
7 deferred amounts if, in fact, there have been no
8 deferred amounts?

9 A. Are you saying you haven't been under a TOC
10 in the past?

11 Q. What I'm saying --

12 A. Because if you have been under TOC from 1983
13 to the year 2002, then you have deferred amounts. It's
14 a calculation.

15 Q. Correct. So if Olympic in this example had
16 been under the 154-B from 1983 to now --

17 A. Or from whatever starting period you're
18 starting both rate -- both pipelines at.

19 Q. Correct. So the only way that these income
20 streams work out to be correct is if the beginning point
21 in the calculation is prior to the deferral?

22 A. You have said that the only way they can work
23 out correct.

24 Q. Well --

25 A. I think what you meant to say was the only

4310

1 way they will work out to give you the same area under
2 the curve is if they both start at the same spot and end
3 at the same spot and continue through consistently.

4 Q. Correct, I accept that. Okay, now let me ask
5 my question again just -- if it's a fact that there was
6 nothing deferred under portion 1 in the prior period, if
7 that's a fact of this case, and this is where we're at
8 2002, then is there any theoretical support or
9 justification for Olympic being allowed to collect the
10 portion under 2 into the future?

11 A. You have confused me I guess when you say
12 there has been no deferred amount because it wasn't -- I
13 assume because you're thinking it was overcollected or
14 something.

15 Q. Correct.

16 A. But that's -- that is irrelevant. Because
17 what we're talking about is the return in dollars versus
18 a theoretical calculation of how the pattern of recovery
19 is to exist. And if, in your assumption, if Olympic's
20 return was up along the top line, then as a regulator I
21 would say, wow, that company overearned, I didn't do my
22 job. But you can't come in and penalize the company for
23 past sins, that's retroactive rate making, to go into
24 the future.

25 Q. Okay, let me pose it differently then. And

4311

1 the reason that you're not looking back is that
2 overcollections or undercollections don't matter to the
3 future prospective rate making, correct, under
4 retroactive rate making?

5 A. That's correct, yeah, both ways.

6 Q. Now so far our whole conversation has assumed
7 that there's been a deferral methodology in place from
8 1983 forward, correct?

9 A. That was your assumption, yes.

10 Q. All right. What if there was not a deferral
11 methodology in place prior to 2002?

12 A. What is it --

13 Q. Then --

14 A. Excuse me, go ahead.

15 Q. Then should the point, would the proper point
16 to begin the TOC be here instead of here?

17 A. I think you just asked the question --

18 JUDGE WALLIS: Excuse me, could we identify
19 those for the record, please.

20 CHAIRWOMAN SHOWALTER: Make it A and B.

21 MR. BRENA: Okay, now let me --

22 CHAIRWOMAN SHOWALTER: The first here was A,
23 and the second here was B.

24 MR. BRENA: I will just rephrase it all,
25 otherwise I will be lost, forget the record.

4312

1 BY MR. BRENA:

2 Q. If the methodology in place during this
3 period was not a deferral methodology, okay, the rates
4 were just and reasonable rates, then is there any
5 theoretical justification to reach into that prior
6 period under a theoretical calculation of deferred
7 earnings all the way back to 1983 and to pull those
8 forward into future collections?

9 MR. MARSHALL: I would object to this
10 hypothetical as assuming a lot of facts not in evidence,
11 and it's gotten very confusing too.

12 JUDGE WALLIS: I think the witness may
13 respond.

14 A. With the hypothetical, you said from the
15 period 1983 to the year 2002, for that block you have
16 said that there were no deferrals, but the rates were
17 just and reasonable. If you can show me what
18 methodology it was under, which line we were talking
19 about, whether you're talking TOC, DOC valuation,
20 whatever, then I can show you what should go forward.
21 Or in the case of the commission, the FERC, excuse me,
22 in changing over from valuation prior to 1983 and moving
23 forward, in excuse me 1985, reviewed the mechanics of
24 all of this type of approach and settled upon a
25 transition rate base to get from one place to another.

4313

1 So there are methods to do this. I'm not sure I have
2 answered your question, because I'm not sure what your
3 question really was.

4 BY MR. BRENA:

5 Q. Did your answer just shift from the deferral
6 concepts of the TOC into the starting rate base aspects?

7 Well, I will withdraw the question.

8 MR. MARSHALL: Your Honor, I am concerned
9 about time. I don't think it's -- I don't know how much
10 longer we have with this witness at the level of
11 alertness that he has.

12 CHAIRWOMAN SHOWALTER: You didn't mean that
13 literally, did you?

14 JUDGE WALLIS: He seems to be in pretty good
15 health.

16 MR. BRENA: I only have a couple more
17 questions, I believe.

18 BY MR. BRENA:

19 Q. You are aware that, and I'm just following up
20 on your last answer talking about the transition taking
21 us into the starting rate base issues in your answer,
22 you are aware, are you not, that when the D.C. Circuit
23 sent this issue back to FERC, it said that it should not
24 allow reparations based on the occurrence of the prior
25 methodology?

4314

1 MR. MARSHALL: I would object as selective
2 reading from a case. The case speaks for itself, and
3 it's available for legal briefing.

4 MR. BRENA: I'm exploring his comment about
5 what FERC did with what the D.C. Circuit said they
6 should have done.

7 JUDGE WALLIS: The witness may respond if he
8 knows the answer.

9 A. Could you ask the question again, please.

10 BY MR. BRENA:

11 Q. You're aware when FERC became involved and
12 asked for it to be remanded back that the D.C. Circuit
13 let go of it, and they said, you have an opportunity to
14 do this on a clean slate, and you should do it without
15 allowing reparations based on the occurrence of the
16 valuation methodology in the past. That was their
17 instructions to the FERC in remanding it back to them;
18 are you aware of that?

19 A. You're talking Farmers Union I now?

20 Q. Yes, I am.

21 A. Okay. I don't remember the reparations part
22 in Farmers Union I.

23 Q. Okay.

24 A. If you can refresh my memory or show me a
25 copy.

4315

1 Q. 1213, page 418, the last paragraph on the
2 page and continuing on to 419, and particularly the last
3 sentence, specifically the language:

4 The solution is not to perpetuate that
5 reliance but to end it prospectively
6 without allowing reparations based on
7 its occurrence in the past.

8 A. I see that.

9 Q. So that's your understanding of the
10 instructions that FERC was given with regard to
11 transitioning from the valuation rate base to a cost
12 based rate base?

13 A. That Williams wasn't entitled to reparation,
14 or excuse me, that the shippers on Williams weren't
15 entitled to reparations. That's what that refers to,
16 which was that one specific case, not the methodology in
17 general.

18 Q. That's your reading of that language?

19 A. I believe so.

20 Q. Okay.

21 A. With the limited piece I have here, that's
22 what I read.

23 Q. Well, the D.C. Circuit addressed this issue
24 twice, didn't it, in Williams II it also addressed it?

25 A. I believe it spoke to a different issue

4316

1 there, but it talked about the need for a transition
2 rate base, I believe.

3 Q. Okay.

4 A. Or mentioned it, which the commission dealt
5 with by adopting a transition rate base, which hasn't
6 been overturned.

7 Q. Has the transition rate base had a judicial
8 review?

9 A. Not that I'm aware of, no.

10 Q. Okay. It can't be overturned until it does,
11 can it?

12 A. Well, the option is there.

13 Q. Okay. I would like to draw your attention to
14 1214, page 1517, under subsection D, the special costs
15 and benefits of transition to a new rate base formula,
16 and specifically the language after the quote.

17 MR. MARSHALL: These are all questions from
18 exhibits that were marked before the Commission asked
19 its questions and could have been asked in cross. It
20 doesn't relate to any Commission question about starting
21 rate base, because I don't think the Commissioners asked
22 any questions about starting rate base, so we're way
23 beyond what the Commissioner questions have been, and
24 we're kind of doing supplemental cross.

25 MR. BRENA: I only have a couple of questions

4317

1 left for this witness.

2 MR. MARSHALL: With that representation, I
3 will let it go then.

4 MR. BRENA: Okay.

5 BY MR. BRENA:

6 Q. I would like to draw your attention to 1518
7 right after the Farmers Union I quote that we just
8 discussed, and what was intended by the court in Farmers
9 Union I, here is the court in Farmers Union II saying
10 what they meant. It said:

11 We specifically advise that the
12 pipeline's reliance on an outdated rate
13 base formula should not justify a
14 continuation of the error. Rather the
15 solution is not to perpetuate the
16 reliance but to end it prospectively
17 without allowing reparations based on
18 its occurrence in the past. We adhere
19 to that principal today.

20 And that is the conclusion of their analysis
21 that there is any reason to construct a transition rate
22 base at all. And, well, on 1517, it says:

23 First FERC failed to give a reasoned
24 basis for its assumption that a
25 transition rate base would have to be

4318

1 constructed at all.

2 A. Is there a question, I'm sorry?

3 Q. Yeah, yeah, didn't the D.C. Circuit twice
4 tell FERC, the first time they told FERC there's no need
5 for a transition rate base, and the second time they
6 said, we said there was no reason for a transition rate
7 base and you haven't presented a reasoned basis to
8 support it?

9 A. Okay. The first if I remember was based on
10 reparations and not a transition rate base. And this --
11 and in dealing with the second Farmers Union, again the
12 commission determined what -- the FERC determined what
13 was the appropriate methodology to apply to oil
14 pipelines to result in just and reasonable rates, and
15 that methodology was Opinion 154-B, and so far it hasn't
16 been challenged.

17 Q. By challenged, you mean --

18 A. In court, I'm sorry.

19 Q. Okay.

20 A. I should have finished that statement.

21 MR. BRENA: I have no further questions.

22 Thank you, Mr. Smith.

23 THE WITNESS: Thank you, Mr. Brena.

24 JUDGE WALLIS: Now, Mr. Marshall.

25 MR. MARSHALL: Thank you.

4319

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R E D I R E C T E X A M I N A T I O N

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BY MR. MARSHALL:

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9

Q. This starting rate base, the transition rate base, we had discussion earlier from Dr. Means saying that the formula for setting that up used a figure from 1983 adjusted by a figure from 1984. My question to you is simply when was the starting rate base calculation set up under the FERC methodology 154-B?

10

11

12

A. 154-B was issued in 1985, and in that, that's where the construction of the entire rate base including the starting rate base was established.

13

14

15

16

17

Q. And since 1985, any shipper that wanted to challenge that starting rate base methodology could have challenged that starting rate base methodology if it wished, to take it into court if it wanted to challenge it?

18

19

20

21

22

A. Yes, sir.

Q. Tesoro could have done that?

A. Sure.

Q. Nobody ever did that?

22

A. No.

23

24

25

Q. Now is the transition rate base in FERC Form 6 on page 700, is there a line for discussing what the amortized portion of the starting rate base might be for

4320

1 any particular company?

2 A. They --

3 Q. Or what does it say about the amortized
4 starting rate base?

5 A. Okay. The page 700 contains a number of the
6 elements that go to make up the 154-B methodology, and
7 included in those is an element of deferred return.

8 Q. Now as you understand it and your testimony I
9 believe on page 28 states that 62% of the barrel miles
10 for Olympic are interstate rate, under interstate rates,
11 and the rest, 38%, are in intrastate rates, correct?

12 A. That's correct.

13 Q. So there's a -- there's always been an
14 incentive for shippers that were interstate shippers
15 here on Olympic to take a challenge to any of this
16 federal methodology if they wished?

17 A. Of course that would be the logical step
18 since that's where the larger amount of volumes are
19 from.

20 Q. Are you aware of any shipper that has
21 challenged any of this methodology since 1985?

22 A. Here for --

23 Q. With regard to Olympic.

24 A. No, sir.

25 Q. Now let's assume for the moment that in 1996

4321

1 Olympic comes in and has tariffs both at the federal
2 level and the state level, and it sets let's talk about
3 the trended original cost for a moment and kind of use
4 Mr. Brena's graph here, but use instead of 1983 as a
5 starting point, let's use 1996.

6 A. Okay.

7 Q. At that time, if Olympic went in at the
8 federal level, they would have been under the trended
9 original cost without any question; is that right?

10 A. That's correct, yes.

11 Q. Because nobody challenged it, that was the
12 accepted methodology at the federal level?

13 A. That's the standard, yes, sir.

14 Q. So regardless of the reasons for why it was
15 adopted, and I presume it was adopted on a national
16 basis without regard to specific local issues?

17 A. That's correct, it was -- it covered the
18 entire United States.

19 Q. So in 1996 assuming with this hypothetical
20 rates are set for interstate shipments using a trended
21 original cost, at least 62% of the rates would now be
22 covered under the trended original cost. Do you follow
23 me on that?

24 A. Yes, sir, using the same -- expanding those
25 percentages to the national level, that would work, and

4322

1 in my experience, that's probably about right.

2 Q. And let's assume that for the remainder, for
3 the 38%, Olympic files a tariff with the WTC, and it is
4 accepted, but it's accepted with the trended original
5 cost as the basis for the tariff. Do you follow that?

6 A. Okay.

7 CHAIRWOMAN SHOWALTER: Mr. Marshall, you will
8 have to use a different word than accepted if you mean a
9 hypothetical to apply to this Commission.

10 Q. Let's say it was allowed to go into effect or
11 whatever was stamped on the cover sheet, but all the
12 shippers know, everybody knows that this -- the same
13 methodology used at the federal level at the state
14 level.

15 A. Okay.

16 Q. So again, regardless of what the reasons were
17 for using TOC versus some other, that in 1996 is what we
18 have now for both the federal rate for the intrastate
19 portion and now the state rate for the state portion.
20 Now move ahead six years, you have had six years of
21 trended original cost, and now somebody suggests that
22 maybe now in 2002 at least for the state portion you
23 ought to move to a DOC methodology. Well, at that time
24 if there is a switch, does that work to the disadvantage
25 of the pipeline company?

4323

1 A. Most definitely.

2 MR. TROTTER: I will object to the question,
3 Your Honor. The phrase move to DOC in the context of
4 the question included the concept that the rates were
5 allowed to go into effect. That does not constitute the
6 adoption of a methodology. All it does is adopt the
7 rate or allow a rate to go into effect. That's all it
8 does. And so moving to a DOC methodology is irrelevant
9 in that context, because there was no methodology to
10 move from or to. It was a rate, period, so.

11 MR. BRENA: I will join the objection, and he
12 also used the word switch, and that assumes you start
13 somewhere, because you can't switch if you don't start
14 somewhere.

15 MR. FINKLEA: Tosco will join the objection
16 as well.

17 MR. BRENA: The fact is that under whatever
18 they filed, there was no deferral.

19 MR. TROTTER: One additional --

20 MR. BRENA: That was reviewed and approved by
21 this Commission.

22 MR. TROTTER: One additional point,
23 Mr. Marshall made a point about shippers being permitted
24 to appeal or challenge rates and so on, but the company
25 at any time also could have filed for declaratory

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1 ruling, could have filed for a policy statement, could
2 have petitioned for similar types of relief, and they
3 didn't either. So if the shippers were at fault, if
4 they are, then certainly the company is too.

5 MR. BRENA: And I have just one final point,
6 and it's a relevancy point.

7 MR. MARSHALL: This is tag team objection. I
8 have never experienced this before. It's sort of
9 exciting in a way. I'm kind of wondering what's next,
10 but.

11 MR. FINKLEA: Three.

12 MR. BRENA: Yeah, you have three.

13 But the entire line of questioning assumes --

14 MR. MARSHALL: I hope counsel behind me
15 doesn't chime in.

16 MR. BRENA: The entire line of questioning
17 assumes that if a shipper doesn't protest an earlier
18 rate that he doesn't have a right to protest a rate
19 today. That is legally irrelevant.

20 JUDGE WALLIS: The issue that Mr. Marshall is
21 attempting to explore is one that reflects Olympic's
22 theory of the case. We understand that the other
23 parties have a different theory of the case, but I think
24 we should allow Mr. Marshall to explore his theory and
25 to ask questions about it. But I would ask that the

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1 question be rephrased to speak not in terms of the
2 acceptance of a tariff or similar terms, but to refer to
3 the application of rates.

4 MR. MARSHALL: Certainly.

5 BY MR. MARSHALL:

6 Q. With that clarification, do you have the
7 question in mind? Probably not.

8 A. I think I have an idea of it. If the company
9 -- maybe you better restate the question, I'm sorry.

10 Q. If in 1996 rates were allowed to go into
11 effect and it can be shown that they were based on TOC
12 at the state level, and they were certainly based on TOC
13 at the federal level, but focusing on the state level,
14 and then you move ahead six years, and there is an
15 argument by shippers that DOC ought to be the way of
16 looking at that, is the pipeline company disadvantaged?

17 A. Okay, the answer is definitely yes. If you
18 look at the -- Mr. Brena's chart up here, if the
19 company --

20 JUDGE WALLIS: Just for convenience sake,
21 let's call that Exhibit 1218. Could 1218 be marked on
22 that, please.

23 MR. BRENA: (Complies.)

24 A. On Exhibit 1218, if you look at the portion
25 of the chart that's crosshatched with the number 1 in

1 it, that would be the difference between what the
2 company would have been allowed to collect under DOC had
3 it been under and then -- excuse me, let me back up.
4 What we're doing is moving the time frames. Instead of
5 having 1983 at the bottom left, that is now in your
6 example 1996 I believe, and then we're at the six years
7 later at 2002, so we're at the second vertical line for
8 your change. And what would happen is the company
9 instead of being under DOC the whole period of time and
10 being allowed to earn a higher return early on, which is
11 the function of a DOC rate base, would then be under the
12 TOC. It would have been under the TOC methodology from
13 1996 to the year 2002 at the lower rate. And then
14 moving into the future, if it's then switched to the DOC
15 there, it gets -- you have lost the benefit of the
16 shaded portion under number 1. You have deprived the
17 company of that earning.

18 BY MR. BRENA:

19 Q. DOC in other words gives you greater return
20 earlier on than TOC?

21 A. That's correct, that's the way it's set up.

22 Q. But if you started with DOC in 1996 instead
23 of TOC, you would have had more revenues?

24 A. Right, in theory you would have produced
25 higher rates for that period of time than TOC would

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1 have.

2 Q. Now --

3 JUDGE WALLIS: Excuse me, Mr. Marshall, I'm
4 having a little bit of trouble concentrating, hearing.

5 Please continue.

6 Q. The word reparations, is that a term of art
7 that applies to shippers?

8 A. Yes, the term reparations comes in the --
9 it's established or where I have read it is in the
10 Interstate Commerce Act under section, let's see if I
11 can remember. I don't remember the exact section, but
12 what it refers to is if a complaint is filed by shippers
13 against a pipeline company, they are entitled or they
14 can -- if they can prove their case, they are entitled
15 to go -- to reach back for a period of up to two years
16 and be paid reparations for any damages that they have
17 had inflicted on them. So that's where the reparations
18 is, that the -- as far as a term. It's a, in effect, a
19 penalty that's placed on the pipeline company in a --
20 normally monetarily.

21 Q. So when you hear the word reparations in a
22 case involving FERC and oil pipeline rate making, that
23 has a specific meaning to you related to what shippers
24 might be able to claim?

25 A. That's correct.

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1 Q. And so when a court says you can't get
2 reparations, to you, it's saying that shippers can't
3 reach back in time and make a claim for some damages for
4 a past period; is that right?

5 A. Yes, sir, that's correct.

6 Q. Now there were a number of questions asked
7 about capital structure, so I'm going to turn to that at
8 this time and go into that in a little bit of detail.
9 Maybe what we should do is start out with a hypothetical
10 here too. Assume a company that has \$100 Million in its
11 rate base, and it has two parents that are very strong
12 financially, large companies, very good credit ratings.
13 And let's assume that there are actually two of these
14 companies, one company with \$100 Million that has -- and
15 these two parents own this company. It's an oil
16 pipeline company with \$100 Million of rate base, and
17 that oil pipeline has 100% debt that it owes to those
18 two parents. We will just start with that for the
19 moment.

20 A. Okay.

21 Q. And that has occurred I take it in the past
22 where you have an oil pipeline owned by two very large
23 refinery parents or more; it's not uncommon in your
24 experience in the oil pipeline business to have that
25 kind of a situation?

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1 A. That's correct.

2 Q. Now let's assume that there's another
3 company, oil pipeline company, with \$100 Million of rate
4 base and also owned by two strong, financially strong
5 refinery parents, but this time it has 50% debt
6 guaranteed by the parents and 50% equity. Do you have
7 that in mind?

8 A. Yes, sir.

9 Q. And that also may happen from time to time in
10 the oil pipeline industry?

11 A. (Nodding head.)

12 Q. Now let's move it forward a little bit and
13 assume that there is a catastrophe, and that catastrophe
14 wipes out the entire \$100 Million worth of rate base in
15 this company. The \$100 Million is gone whether it's
16 entirely loaned by the parents and guaranteed or whether
17 it's half loaned and half equity; is that fair to say?

18 A. That's correct, yes. Yeah, the -- it doesn't
19 really, you know, what -- what you look at is the fact
20 that both companies, both pipeline companies that you
21 have referred to here regardless of what the level of
22 debt is in the pipeline company, the level of risk of
23 the parent companies is the same. It's the \$100 Million
24 whether it's invested in debt or in equity.

25 Q. Okay. Now so insofar as having capital at

4330

1 risk, is it the same under both hypotheticals, the
2 capital that has been entirely at risk now is lost
3 entirely?

4 A. That's correct.

5 Q. When you have a situation like that where you
6 have two financially strong parents owning an oil
7 pipeline and the pipeline has no independent capital
8 structure of its own, it could be 100% debt, 50/50, or
9 100% equity as the parents wish to have it, I take it in
10 that situation where the parents are supplying all of
11 the money, FERC will look to the capital structure of
12 the parent company to find what the appropriate capital
13 structure and therefore rate of return for the capital
14 would be for the parents?

15 A. Yes, sir, that's exactly what happens.

16 Q. Now a number of questions were asked about,
17 well, that is the way FERC does it, but then the
18 question I think the Chairwoman asked is why would that
19 be fair to use the capital structure of the parent to
20 set a rate of return on that capital structure. Do you
21 have that question in mind?

22 A. Yes, sir. If you look back at your example
23 that you gave of the two pipeline companies, both having
24 two strong, each pipeline company having two strong
25 parent companies, if the investment from the parents is

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1 either in debt or in equity, it's still an investment,
2 and that's what's at risk to the parent companies. So
3 that's why the commission looks to the parent companies
4 for the debt-equity structure, because that's -- those
5 are the investors who are in effect insuring the
6 pipeline company.

7 Q. And if you look at it from a prospective
8 investment standpoint, if a parent is going to put money
9 into a pipeline, it will look to its own capital
10 structure in order to find out what the appropriate
11 level of return is; is that fair to state?

12 A. That's correct.

13 MR. TROTTER: I'm going to object, Your
14 Honor. I have been very non-objecting for a long time
15 with all the leading questions to shorten it up, but at
16 this point, it's just Mr. Marshall testifying, and I
17 feel the obligation to object, leading.

18 MR. MARSHALL: I will rephrase the question.

19 JUDGE WALLIS: Please do.

20 BY MR. MARSHALL:

21 Q. Why is it fair for the FERC to look to the
22 rate of return on capital, both equity and debt, of the
23 parent while looking at attracting capital for the oil
24 pipeline company owned by the parents?

25 A. In order -- in order to continue to acquire

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1 new investment in oil pipeline companies, there needs to
2 be a sufficient incentive for investment, and that's why
3 the FERC looks to the parents, that's another reason why
4 the FERC looks to the parent company and their capital
5 structure is to main -- ensure that the parent companies
6 will continue making prudent investments in the
7 subsidiary. If the return is sufficient, the investment
8 is going to be there. If not, it's not. The parent
9 companies have enough other activities that they can
10 invest in, and I have heard this over and over from a
11 lot of the pipeline companies that I have met, that
12 they're fighting with their parent to get these funds to
13 make these investments, because the parents are
14 interested in return, and if they can get a higher
15 return somewhere else, they're not going to invest in
16 the pipeline company.

17 Q. Commissioner Hemstad asked the question
18 assuming that Microsoft bought Olympic; do you recall
19 that hypothetical?

20 A. Yes.

21 Q. Assuming Microsoft or Bill Gates bought
22 Olympic, which would be a kind of interesting thought,
23 and the question came as to what is the appropriate rate
24 of return to allow for that ownership, why would it be
25 fair to look to the capital structure of Microsoft or

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1 Bill Gates in that situation?

2 A. Again, the funds that are invested came from
3 Microsoft, and therefore you're competing at Microsoft
4 for other investments, and so the -- it is appropriate
5 to look at the capital structure of Microsoft in that
6 instance to set the return.

7 Q. Now, of course, we heard that if you have too
8 much equity, FERC will take a look at that and look at
9 other factors to find out, for example, whether it's a
10 railroad that owns the pipeline or whether it's a
11 refinery that owns the pipeline, it may look at some
12 other factors. But in essence, have you set forth your
13 understanding of why it's fair to look to the capital
14 structure of financially strong parents that own an oil
15 pipeline company?

16 A. Yes, I have. It's in my testimony, and I
17 think if you read through there, you will understand
18 hopefully better than what I was able to explain to you.

19 Q. In the past when these considerations were
20 being made as to how to establish an appropriate
21 methodology for oil pipelines, I understand that there
22 were a number of rules and a number of decisions that
23 occurred at the FERC.

24 A. That's correct, yes.

25 Q. You referred to some of those. How would you

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1 characterize the level of thought and consideration
2 given at the federal level in adopting this particular
3 approach to oil pipeline rate making?

4 A. I have described it in the past as being
5 tortuous, because it took so many years. For example,
6 the process that ended up with the 154-B decision
7 started back prior to the formation of the Federal
8 Regulatory Commission back with the Interstate Commerce
9 Commission. It started as the Williams case there, and
10 that was sort of a -- turned into from a rate case into
11 a generic review of the methodology itself, the
12 valuation methodology in that case. And like I say,
13 that -- I'm not sure of exactly the year it began, I
14 think it was maybe '74 or '75. In the interim period
15 between that period and 1985 when the commission issued
16 154-B, you know, you had a change of agency, and you had
17 a tremendous amount of thought put in and several fits
18 and starts and a lot of testimony from a lot of
19 different witnesses and a lot of different parties that
20 resulted in the 154-B methodology. It was an extremely
21 serious thought process that considered all different
22 kinds of methodologies and concepts.

23 Q. Through this process of trying to determine
24 how to set capital structures and rates of return and
25 transitions and all, was there a concern for

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1 underinvestment in oil pipeline infrastructure in the
2 United States?

3 A. Yes, there definitely was, and that was
4 another thought -- that was one of the other thoughts
5 behind the 154-B methodology, that they wanted to ensure
6 that given investor reliance on the old valuation
7 methodology, which the commission, the FERC itself said
8 was a pretty, well, I will use their words, it provided
9 creamy returns, the investors were in a situation where
10 they were getting these creamy returns, and the FERC had
11 to make a decision to bring the rates back to just and
12 reasonable if you could assume that they weren't because
13 of what the Commission said, which I'm not sure I will
14 make that leap, but I will make that statement. But in
15 doing so, the FERC had to really look at the investors'
16 concerns and realize that if they went to a rate base
17 that didn't give the investors a proper return that
18 investment in oil pipelines would cease, and they were
19 very concerned about that. The 154-B methodology was
20 part of that thought process, the result of that thought
21 process, to take -- to partially take care of that
22 problem.

23 Q. Mr. Trotter asked a number of questions about
24 environmental and permitting and other difficulties. I
25 believe he quoted from Mr. Batch's testimony about the

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1 time that it takes to get permits and so on. Do you
2 remember that general line of questioning about
3 environmental hurdles?

4 A. Yes, I do, right.

5 Q. And there's been testimony here in this case
6 about how certain new regulations, including
7 environmental concerns, have increased costs for oil
8 pipelines. Given that kind of issue with the costs
9 going up for pipelines, the risks going up, in your
10 opinion, is there still a legitimate concern for
11 underinvestment in oil pipelines, focusing on this type
12 of activity?

13 A. Of course there is. There's a lot more
14 capital involved in pipeline projects nowadays, and, you
15 know, as Mr. Trotter pointed out, it's very difficult to
16 build a pipeline, and that's because it has become very
17 expensive. And if the incentives aren't there and the
18 returns aren't there to produce prudent investment, the
19 oil pipeline industry is going to just deteriorate.

20 Q. And as the costs of building and maintaining
21 oil pipelines on land goes up, it closes in on
22 alternatives that you mentioned, barges and --

23 A. Right.

24 MR. TROTTER: I will object, Your Honor, this
25 witness said he did no independent analysis of

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1 competitive alternatives on Olympic Pipeline, he
2 indicated he had no knowledge of the overnominations of
3 the historic unceasing, except for Whatcom Creek,
4 overnominations on the pipelines, so he's simply not
5 qualified to speak to the facts of this case on that
6 issue, I object.

7 MR. MARSHALL: I'm just cross-examining on an
8 area that Mr. Trotter himself opened up. He may not
9 have a quantitative view of what the difference is
10 between, but I'm asking about whether those differences
11 are now beginning to close up given these other factors
12 that Mr. Trotter himself brought up.

13 JUDGE WALLIS: I think that the area is
14 within the scope of Mr. Trotter's questions, but I do
15 think the witness clearly indicated that he had no
16 information about the relative costs or prices involved,
17 and consequently Mr. Trotter's objection should be
18 sustained.

19 MR. MARSHALL: I'm just looking for that area
20 of cross-examination so I can --

21 BY MR. MARSHALL:

22 Q. Without regard to any specific level of
23 price, if you assume that costs are going up for oil
24 pipelines and you assume that costs for barges, I will
25 just ask you to assume this.

4338

1 A. Okay.

2 Q. Are on a spot basis 70 cents per barrel or
3 less, at some point it's obvious, isn't it, that the oil
4 pipeline costs will arrive at or exceed that assumed
5 barge rate that I just mentioned?

6 MR. TROTTER: Objection, it's the same
7 objection, Your Honor.

8 JUDGE WALLIS: And I think it should be
9 sustained for the same reasons.

10 BY MR. MARSHALL:

11 Q. Are there other costs that are going up apart
12 from environmental regulations? Are you familiar with
13 the HCA and the integrity management programs and the
14 increased level of inspections that are required of oil
15 pipelines generally across the country?

16 MR. BRENA: Objection, this witness hasn't
17 been asked a single question in my memory, admittedly
18 it's getting a little fuzzy at this point, relating to
19 any of those things, and we just heard extensively from
20 Mr. Talley who did know something about those things.

21 MR. MARSHALL: I will withdraw that question.

22 Excuse the pause, I'm just trying to go
23 through this to shorten this up. I'm not trying to
24 create issues, I'm just trying to make sure that I focus
25 on the things that seem to be of any significance in the

4339

1 long run here.

2 BY MR. MARSHALL:

3 Q. There were some questions about whether there
4 have been any challenges to rates at the ICC for a
5 period of time, and I think Mr. Brena had asked the
6 question of whether there was anything that had
7 validated an ICC methodology in 42 years. Was there any
8 challenge brought -- let me back up.

9 How many pipeline cases, contested cases,
10 were in this period of time when the ICC valuation
11 method was going on?

12 A. Are you talking rate cases?

13 Q. Yes.

14 A. None that I know of.

15 Q. So when Mr. Brena asked whether there had
16 been any challenges and what the results of the
17 challenges were, there just hadn't been any challenges;
18 is that right?

19 A. That's correct.

20 Q. Now for Olympic, assume that Olympic went
21 into service in 1965, up until this case, have you heard
22 of any challenges to Olympic either at the federal or at
23 the state level for any of their rates?

24 A. No, sir, I haven't.

25 Q. Mr. Brena asked you about whether you had

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1 testified for rate payers in the past; do you remember
2 that question?

3 A. Yes, I do.

4 Q. Have you testified much at all for anybody?

5 A. No, I think I had mentioned that earlier,
6 that I, being on the advisory side of the commission, I
7 wasn't in a position to testify, and so really I have
8 only started that type of career since my retirement.

9 Q. Is it fair to say that rate making as you
10 view it is a series of choices made by the regulators,
11 whether it's capital structure, cost of capital,
12 methodology, and so on?

13 A. Right, it is, it's how you blend all of the
14 different parts into a methodology that results in just
15 and reasonable rates.

16 Q. And --

17 A. It's the whole thrust of what you're trying
18 to do.

19 Q. And there may be a series of choices that
20 either one of which may be fair, just, and reasonable,
21 for example TOC versus DOC, depending on when you make
22 that decision, a choice one way or the other could be
23 reasonable. Later on, there may be other factors just
24 because of the passage of time, but that's one example
25 of how you could make a choice, either one of which

4341

1 could be fair, just, and reasonable?

2 MR. BRENA: Objection, this choices isn't the
3 subject of the cross-examination.

4 MR. TROTTER: I will object on the basis that
5 it's contrary to law. The test is the end result test,
6 not -- you could have a series of choices, each
7 individually might be fair, just, and reasonable, but in
8 combination, they're not, so the question is
9 meaningless.

10 MR. BRENA: And I don't know if I can object
11 based on his representation that we're just focusing on
12 what's going to have an impact in the long run, but if I
13 could do that, I would do that.

14 JUDGE WALLIS: Mr. Marshall.

15 MR. MARSHALL: Again, I was actually going to
16 go to the very next question that Mr. Trotter has
17 suggested, which is, after the series of choices are
18 made, do you look to the end result of those choices.

19 A. Right, and the end result has to be a just
20 and reasonable rate. That's the statute that the FERC
21 lives under, and I assume that the WTC has a similar
22 task.

23 BY MR. MARSHALL:

24 Q. When Mr. Brena asked you about what
25 recommendations you had to make to this Commission, are

4342

1 those recommendations found beginning at pages 28, 29,
2 and 30 of your testimony?

3 A. Yes, sir, they are. I think I have laid it
4 out a lot more lucidly than I probably am right now.

5 JUDGE WALLIS: Then you need not repeat it.

6 THE WITNESS: Thank you, I appreciate that.

7 BY MR. MARSHALL:

8 Q. And one of the other final goals of rate
9 making, one of the end results is the ability to attract
10 sufficient capital on reasonable terms?

11 A. That's correct.

12 Q. And are there also other public interest
13 factors that this state might look to apart from what
14 the FERC might look to?

15 MR. FINKLEA: Objection.

16 MR. TROTTER: Objection, beyond the scope.

17 MR. BRENA: Objection, he's repeating the
18 direct testimony. Nobody asked him questions about
19 this.

20 MR. MARSHALL: Actually, Mr. Trotter did ask
21 about various statutes, and Mr. Brena asked about
22 various statutes, and there is a statute in this
23 jurisdiction, a specific public interest statute, that I
24 was going to ask my next question of this witness.

25 MR. FINKLEA: Well, Your Honor, the basis of

4343

1 my objection is in some of my questions and in some of
2 Mr. Trotter's, this witness made it very clear that he
3 was not familiar with the specific statutes of this
4 state.

5 MR. MARSHALL: Actually, this witness said
6 that he had reviewed various RCWs. He said 81.88.030,
7 and Mr. Brena then stopped him from going through all
8 the rest. This is during his cross-examination. He
9 said I don't want you to go all the way through Title
10 81.

11 JUDGE WALLIS: You may inquire.

12 BY MR. MARSHALL:

13 Q. Are you aware of a broad RCW on the public
14 interest in this state?

15 A. Yes, sir, I have read that.

16 Q. Okay, thank you. And is that also in the
17 Commission's 3rd Supplemental Order granting interim
18 rates in part?

19 A. I believe it is, yes, sir.

20 MR. MARSHALL: I think I may be finished with
21 my questions, but if you just give me a half a second, I
22 will take a look.

23 I would love to go on for longer, but
24 considering the hour and considering Mr. Smith's status,
25 I think that this is probably the most efficient point

4344

1 on which to conclude.

2 JUDGE WALLIS: Very well.

3 There is at least one further question from
4 the Bench.

5 CHAIRWOMAN SHOWALTER: I have one follow-up.

6

7 E X A M I N A T I O N

8 BY CHAIRWOMAN SHOWALTER:

9 Q. Mr. Marshall posed a hypothetical about two
10 companies and the parents, and at one point I believe
11 you said that there's no significant difference between
12 equity and debt because in both cases the parents are
13 investing money and putting that money at risk. Is that
14 generally -- that's a preliminary question, I'm just --

15 A. Okay, I think what I was referring to is in
16 the way that the risk involved by the two companies,
17 whether they're investing -- whether they lent the money
18 to the company or guaranteed the money to be lent by the
19 company, you know, whether you're dealing with debt or
20 equity at the pipeline company level is what I was kind
21 of referring to.

22 Q. All right. If there's no real difference,
23 why is it that the parent companies under this FERC
24 methodology seem to overwhelmingly lend the pipeline
25 companies money versus put in equity? From the parents'

4345

1 point of view, why are they choosing to loan money
2 versus invest equity directly?

3 A. You would probably have to talk with somebody
4 with more of a financial background than I have.

5 Q. All right. In your view, given the FERC
6 methodology, do you think a parent company has equal
7 motivation to invest equity versus lend?

8 A. It would seem like given the 154-B
9 methodology with its higher return on equity investment
10 that it would be more inclined to use equity, but
11 obviously with your statement, that's backwards.

12 Q. Well, but since the FERC methodology provides
13 an equity rate of return because of the parent structure
14 on debt issued from the parent to the company, so that's
15 not -- that can't be the reason. They're going to get
16 under the FERC methodology they'll --

17 A. You're right.

18 Q. -- the return structure. So the question is,
19 from the parents' point of view looking at the child and
20 saying what shall I do, shall I put in equity, put that
21 money at risk that way, or shall I loan the child the
22 money, do you first agree that predominantly what
23 actually occurs is the parents loan instead of put in
24 equity?

25 A. I think that's correct, yes.

4346

1 Q. All right. The question is, why? And if you
2 don't have any idea why, that's all right.

3 A. I really haven't given that a lot of thought,
4 I don't know why.

5 CHAIRWOMAN SHOWALTER: All right, thank you.

6 THE WITNESS: Yes, ma'am.

7 JUDGE WALLIS: Anything further?

8 MR. TROTTER: Just a couple, Your Honor.

9

10 R E C R O S S - E X A M I N A T I O N

11 BY MR. TROTTER:

12 Q. You talked about you were unaware of any
13 challenges to Olympic's rates up until now, did you
14 understand that this Commission suspended a prior rate
15 filing of Olympic last summer?

16 MR. MARSHALL: Well, I --

17 A. No, I didn't know that.

18 Q. Did you understand that FERC rejected
19 Olympic's first tariff filing in 2001?

20 A. That wouldn't be a challenge though.

21 Q. Pursuant to challenge by shippers?

22 A. I believe that rejection was for a technical
23 problem with the filing, that it didn't comply with the
24 regulation, so it didn't require the challenge to be
25 there to be rejected.

4347

1 Q. Fair enough. And you are aware that a FERC
2 administrative judge recently recommended FERC dismiss
3 Olympic's current filing based on technicalities?

4 A. I have heard that. I haven't understood the
5 reason why or the course of subsequent events to that.

6 Q. And you are aware of the various witnesses
7 testifying to methodology issues in this case, correct?

8 A. Yes, sir.

9 Q. And is it your opinion that there's full
10 awareness of how FERC methodology functions by the
11 parties in this case?

12 A. I think there are some misconceptions with
13 some of the -- or at least some, I'm trying to think of
14 the word, legal license with stretching, you know, what
15 fits and what doesn't within the FERC methodology, but I
16 think -- I think there is a general understanding of the
17 FERC methodology, yes.

18 Q. Are the technical requirements, the FERC
19 filing requirements, important to FERC?

20 A. Yes.

21 Q. And if they're not complied with, they reject
22 filings?

23 A. That's normal, yes.

24 Q. So if you don't understand the technical
25 requirements and you file improperly, they reject it,

4348

1 correct?

2 A. That's one of the possible outcomes, yes.

3 MR. TROTTER: Thank you.

4 MR. FINKLEA: I have a question based on the
5 Commissioner's question.

6 MR. MARSHALL: Uh-oh.

7 CHAIRWOMAN SHOWALTER: Sorry.

8

9 R E C R O S S - E X A M I N A T I O N

10 BY MR. FINKLEA:

11 Q. I want to follow up on Chair Showalter's
12 question about incentives. If we can assume that the
13 subsidiary has 100% debt capital structure, but for rate
14 making purposes the parent has 100% equity, so we're
15 just on the absolute extremes of 100% debt capital
16 structure and 100% equity assumed for rate making
17 purposes, if the cost of debt is 7% and for rate making
18 purposes the return on equity is 13%, doesn't the parent
19 company in essence have a 6% incentive to leave the
20 situation exactly where it is where the company
21 continues to be 100% debt financed but the parent
22 company realizes a 13% return on a 7% investment?

23 A. Right, and I think that's where I was going
24 with the Chairman's question, and I think there have got
25 to be other things involved, particularly the -- that

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1 might be an instance with, you know, we're looking at
2 hypotheticals that are so skewed out of the norm that
3 they're almost laughable, but that would probably be a
4 case where the FERC would tend to look at the what is
5 the appropriate capital structure to use here, you know,
6 what's going on.

7 Q. Well, in this case, isn't Olympic suggesting
8 an equity ratio of 86% even though the company has a
9 100% debt capital structure?

10 A. I'm not sure on that.

11 Q. Assuming that's correct, is that very far off
12 from the hypothetical I just gave you?

13 A. I don't know at what point it becomes widely
14 skewed. You know, the 100 one way and the 100 the other
15 way is obviously the most -- as far in the extreme as
16 you can get. But at what point then do we back down and
17 say, okay, now this is reasonable or it's not.

18 MR. FINKLEA: Nothing further.

19

20 R E D I R E C T E X A M I N A T I O N

21 BY MR. MARSHALL:

22 Q. I have to follow up on that, because I think
23 the premise in Mr. Finklea's question is exactly where
24 we may have gone astray. He suggests a parent with 100%
25 equity, and then he assumes that the capital structure

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1 of the subsidiary is 100% debt. The misstatement he
2 makes is that the cost of that debt is 7%. It's the
3 cost of that debt that we're trying to establish, and if
4 the parent is the source of funds, either directly or
5 guaranteeing it or supplying it totally, isn't the cost
6 of debt the cost to the parent?

7 A. That's correct, yes.

8 Q. And so you have to look to the cost of the
9 capital for the parent, whether it's 80% equity and 20%
10 debt, and you look at what those rates are, correct?

11 MR. BRENA: Objection, he had about a full
12 paragraph leading question on the question before, and
13 he's just asking the witness to confirm what he's
14 saying.

15 JUDGE WALLIS: The hour is late, and we are
16 allowing some license in order to allow this matter to
17 be wrapped up, so the question and answer will stand.

18 MR. MARSHALL: One more question, I'm
19 finished.

20 BY MR. MARSHALL:

21 Q. One issue about debt versus equity, is there
22 a tax advantage in having -- making a loan versus making
23 equity contribution if all other things being equal that
24 capital is at risk, or do you know?

25 A. I'm not sure.

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1 MR. MARSHALL: Mr. Maurer advised me that he
2 did not answer the previous question about the cost of
3 debt being that of the parent, the one that you --

4 JUDGE WALLIS: Does the witness have the
5 question in mind?

6 THE WITNESS: Yes, I do, I thought I had
7 answered it yes, but --

8 MR. MARSHALL: Okay, sorry, that's all.

9 JUDGE WALLIS: Very well, is there anything
10 further?

11 Just one administrative matter. We have
12 asked informally for some information to the record. I
13 think it would be appropriate to identify a request for
14 information from the company as general rate case Bench
15 Request Number 1, and that is in conjunction with the
16 earlier witness's testimony, Mr. Talley, he testified in
17 response to some questions from Mr. Trotter as to power
18 costs and KWH used in conjunction with the Bayview
19 facility. As general rate case Bench Request Number 1,
20 would the company provide us with a copy of the Schedule
21 13 which the company is now using and comparable figures
22 to the power costs on KWH costs that the witness
23 testified to in Mr. Trotter's examination that included
24 demand, lease, and energy charges or other comparable
25 charges. If you could provide that in writing, then

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1 other parties would have the opportunity to examine it,
2 and if they wish to object to its consideration, have
3 the opportunity to do so.

4 MR. BEAVER: Yes, Your Honor. In fact,
5 several times that I have been walking out of here it's
6 been to work on that very issue. We relayed the request
7 to Olympic, and I think we almost have the information
8 complete.

9 JUDGE WALLIS: Fine. If you would provide
10 that information to us, we would appreciate it. I will
11 do my best over the weekend to get to the parties a
12 discussion draft briefing outline. As we have
13 discussed, I will take the suggestions that the parties
14 have made and do my best to meld them into a single
15 document, and that would be available for further
16 discussions next week. My goal would be by the end of
17 the week to have the outline decided so that parties can
18 begin organizing their thoughts toward completing the
19 briefs. We do not have a firm schedule on briefs. That
20 is another matter that will be determined next week.

21 Is there anything further of an
22 administrative nature?

23 MR. BRENA: Your Honor, just an expression of
24 concern that we have seven and a half witnesses and two
25 and a half days. I don't know if there's any additional

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1 time in the system that's possible. I understand that
2 Commissioner Hemstad is gone on Friday. I don't know if
3 we can get a half a day somewhere else, but I would just
4 observe that's a very tight schedule.

5 JUDGE WALLIS: It is a very tight schedule,
6 however we did accomplish more this week than I thought
7 would be possible, and that's even balancing the time it
8 took to consider the two witnesses who didn't testify,
9 which may have taken as long administratively as it
10 would have if they had testified. So on balance, I
11 continue to be very optimistic that we will get our one
12 gallon hearing into the three quarts of time that
13 remain.

14 So with that, I certainly want to wish
15 everybody a safe journey home to wherever your home is
16 and a very patriotic and happy Fourth of July
17 celebration, and we look forward to seeing you promptly
18 at 9:30 in the morning on Tuesday next.

19 (Hearing adjourned at 8:20 p.m.)

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