

UNITED STATES OF AMERICA 134 FERC ¶ 63,020  
FEDERAL ENERGY REGULATORY COMMISSION

BP Pipelines (Alaska) Inc.	Docket No. IS09-348-000
BP Pipelines (Alaska) Inc.	Docket No. IS09-395-000
BP Pipelines (Alaska) Inc.	Docket No. IS10-204-000
ConocoPhillips Transportation Alaska, Inc.	Docket No. IS09-384-000
ConocoPhillips Transportation Alaska, Inc.	Docket No. IS10-205-000
ConocoPhillips Transportation Alaska, Inc.	Docket No. IS10-205-001
ExxonMobil Pipeline Company	Docket No. IS09-391-000
ExxonMobil Pipeline Company	Docket No. IS09-177-000
ExxonMobil Pipeline Company	Docket No. IS10-200-000
Unocal Pipeline Company	Docket No. IS09-176-000
Unocal Pipeline Company	Docket No. IS10-52-000
Unocal Pipeline Company	Docket No. OR10-3-000
Koch Alaska Pipeline Company, L.L.C. (consolidated cases)	Docket No. IS10-54-000

**INITIAL DECISION**

(Issued on March 10, 2011)

*APPEARANCES*

*Robin O. Brena, Esq., Sherri B. Manuel, Esq., Anthony S. Guerriero, Esq., Joseph S. Koury, Esq., Jeffrey G. DiSciullo, Esq., Andrew T. Swers, Esq., and David W. Wensel, Esq.* on behalf of Anadarko Petroleum Corporation.

*John E. Kennedy, Esq., Dean H. Lefler, Esq., Charles F. Caldwell, Esq., Amy Hoff, Esq., Michelle T. Boudreaux, Esq., Elizabeth B. Kohlhausen, Esq., and Albert S. Tabor, Jr., Esq.* on behalf of BP Pipelines (Alaska), Inc.

*Steven H. Brose, Esq., Steven Reed, Esq., William F. Flynn, Esq., and Daniel J. Poyner, Esq.* on behalf of ConocoPhillips Transportation Alaska, Inc.

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*Dennis H. Melvin, Esq., Patricia E. Hurt, Esq., Derek Anderson, Esq., and Kenneth Ende, Esq.,* on behalf of FERC Trial Staff.

*David D'Alessandro, Esq., and M. Denyse Zosa, Esq.,* on behalf of Flint Hills Resources Alaska LLC.

*Edward D. Greenberg, Esq., and David K. Monroe, Esq.,* on behalf of Koch Alaska Pipeline Company.

*Bruce J. Barnard, Esq., Richard H. Loeffler, Esq., Philip A. Reeves, Esq., The Honorable Daniel S. Sullivan, Esq., The Honorable Richard A. Svobodn, Esq., The Honorable John J. Burns, Esq., and Bradley S. Lui, Esq.,* on behalf of State of Alaska.

*J. Patrick Nevins, Esq., and Rob McMillin, Esq.,* on behalf of Unocal Pipeline Company

*Jonathan D. Simon, Esq.,* on behalf of Petro Star Inc.

## **MICHAEL J. CIANCI, JR., Presiding Administrative Law Judge**

### **I. BACKGROUND**

1. On May 29, 2009, BP Pipelines (Alaska) Inc. (BP, BPP, BP Alaska or BPPA) filed FERC Tariff No. 38 proposing to change the interstate rate for transportation of crude oil on BP's share of the capacity of the Trans Alaska Pipeline System (TAPS). As discussed below, the Commission in its June 30, 2009 order accepted and suspended BP's tariff, subject to refund, to become effective July 1, 2009, as proposed, established hearing and settlement judge procedures, and consolidated this proceeding with the proceedings in Docket Nos. IS09-177-000 and IS09-176-000. The settlement judge procedures were subsequently not successful.

2. On June 3, 2009, ConocoPhillips Transportation Alaska, Inc. (ConocoPhillips or CPTAI) filed FERC Tariff No. 17 proposing to change the interstate rate for transportation of crude oil on ConocoPhillips' share of TAPS capacity. The Commission accepted and suspended ConocoPhillips' tariff, subject to refund, to become effective July 4, 2009, as proposed, established hearing and settlement judge procedures, and consolidate these proceedings with the proceedings in Docket Nos. IS09-177-000 and IS09-176-000. The settlement judge procedures were not successful.

3. On June 8, 2009, ExxonMobil Pipeline Company (ExxonMobil or EMPCo) filed FERC Tariff No. 351 proposing to change the interstate rate for transportation of crude oil on ExxonMobil's share of TAPS capacity. The Commission accepted and suspended ExxonMobil's tariff, subject to refund, to become effective July 9, 2009, as proposed, and

consolidated these proceedings with the proceedings in Docket Nos. IS09-177-000 and IS09-176-000. The settlement judge procedures were not successful.

4. On June 11, 2009, BP filed FERC Tariff No. 39 proposing to change the interstate rate for transportation of crude oil on BP's share of TAPS capacity, and canceled BP's FERC Tariff No. 38. The Commission accepted and suspended BP's tariff, subject to refund, to become effective August 1, 2009, as proposed, established hearing and settlement judge procedures, and consolidated this proceeding with the proceedings in Docket Nos. IS09-177-000 and IS09-176-000. The settlement judge procedures were not successful.

5. Crude oil streams produced from different fields on the Alaska North Slope (ANS) are commingled into a common stream and shipped to market on TAPS. The Carriers<sup>1</sup> own TAPS, with each possessing an undivided joint interest and entitlement to its percentage ownership share of the pipeline's capacity. The Alyeska Pipeline Service Company (Alyeska), the Carriers' agent, operates TAPS.

6. In 1985, the owners of TAPS entered into a settlement agreement (the TAPS Settlement or TSA) establishing the TAPS Settlement Methodology (TSM), which was used to calculate the maximum interstate and intrastate rates for TAPS each year beginning January 1, 1986.<sup>2</sup> The Commission severed parties challenging the settlement and accepted the TAPS Settlement as an uncontested settlement subject to the fair and reasonable standard.<sup>3</sup>

#### **A. 2005 and 2006 TAPS Rates**

7. Pursuant to the TAPS Settlement, the Carriers filed their individual interstate rates with the Commission annually. No party protested any of these annual rate filings until the Carriers filed their 2005 and 2006 rates. Prior to 2005, the Regulatory Commission

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<sup>1</sup> The Carriers consist of BP, ConocoPhillips, ExxonMobil, Koch Alaska Pipeline Company, LLC (Koch or KAPCO), and Unocal Pipeline Company (Unocal or UPC). Due to the length of this decision, the undersigned will often repeat full citations for the convenience of the reader.

<sup>2</sup> The terms of the TAPS Settlement provided it would run until the end of 2011, but also permitted early termination as of 2008 if a party requested renegotiation of its terms and no new agreement was reached. The State of Alaska (Alaska or SOA) invoked this early termination provision resulting in the expiration of the TAPS Settlement on December 31, 2008.

<sup>3</sup> *Trans Alaska Pipeline Sys.*, 33 FERC ¶ 61,064, at 61,140, *reh'g denied*, 33 FERC ¶ 61,392 (1985). The Commission subsequently found no party aggrieved by its approval of the settlement and terminated the proceeding. The Court of Appeals affirmed the Commission's ruling in *Arctic Slope Reg'l Corp. v. FERC*, 832 F.2d 158 (D.C. Cir. 1987).

of Alaska (RCA) determined that the TSM no longer resulted in just and reasonable intrastate rates and ordered the Carriers to follow a different rate-making methodology which would substantially lower the intrastate rates. As a result, several parties filed protests and complaints alleging the Carriers' interstate rates for 2005 and 2006 calculated pursuant to the TSM were also unjust and unreasonable. The Commission accepted and suspended the 2005 and 2006 rates, subject to refund, and consolidated the proceedings, and set them for hearing.

8. On May 17, 2007, the Administrative Law Judge (ALJ) hearing that case issued an Initial Decision finding that the TSM no longer resulted in just and reasonable interstate rates and rejecting the Carriers' 2005 and 2006 filed rates.<sup>4</sup> In place of the TSM, the ALJ held that the Carriers should calculate the rates for 2005 and 2006 in accordance with the rate-making methodology in Opinion No. 154-B.<sup>5</sup> Prior to Opinion No. 502 (Opinion 502), discussed below, each of the Carriers charged individual rates for interstate transportation service on TAPS and these rates varied significantly between them. The ALJ found that the variations in the individual rates were not caused by differences in cost of service because all of the TAPS Carriers basically have the same cost of service.<sup>6</sup> The ALJ found that instead of each Carrier charging individual rates for transportation service, the Carriers should charge a uniform rate, effective January 1, 2005. The ALJ reasoned that because the Carriers provide the same transportation service on TAPS and their cost of service is virtually identical, it is unjust and unreasonable for the Carriers to charge individual rates and a uniform rate is necessary.

9. On June 20, 2008, the Commission issued Opinion No. 502 affirming the ALJ on all issues.<sup>7</sup> While the Commission affirmed that the Carriers should charge a uniform rate, the Commission recognized parties' concerns that some Carriers may under-recover their costs under a uniform rate because the Carriers' costs are allocated according to ownership percentage, while their revenues are allocated on the basis of throughput or usage. Thus, if a Carrier's throughput is not equal to its ownership percentage, that Carrier may over- or under-recover its costs. The Commission stated that a pooling mechanism, such as the one found in Section II-2(f)(ii) of the TAPS Settlement Agreement, could address this problem.

10. The Carriers sought rehearing of Opinion No. 502, and BP individually, requested rehearing on the pooling issue. By an order issued on November 20, 2008, the

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<sup>4</sup> *BP Pipelines (Alaska) Inc.*, 119 FERC ¶ 63,007, at P1 (2007) (Initial Decision).

<sup>5</sup> Initial Decision at P 47 (citing *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985)) (setting forth the generic principles for determining just and reasonable rates on oil pipelines and adopting a cost-based methodology for establishing those rates) (Opinion No. 154-B).

<sup>6</sup> *Supra* n.4, at P 251.

<sup>7</sup> *BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287 (2008) (Opinion No. 502).

Commission denied the Carriers' request for rehearing, affirmed that there must be a uniform rate on TAPS, and clarified that a pooling mechanism is necessary to ensure certain Carriers do not over- or under-recover their costs under a uniform rate.<sup>8</sup> The Commission found with expiration of the TAPS Settlement and its pooling mechanism,<sup>9</sup> the Carriers must implement a new pooling mechanism and include it in their Operating Agreement. The Commission determined that pooling was necessary and incident to establishing the just and reasonable rate. The Commission also accepted the Carriers' compliance filing for the 2005 and 2006 rates which were lower than the filed rates and below the refund floor (i.e., the last clean rates, which were the 2004 TAPS rates). Accordingly, the Commission ordered the Carriers to issue refunds limited to the amount above the refund floor.

11. Three of the Carriers (Indicated TAPS Carriers<sup>10</sup>) requested rehearing of the Commission's decision in the November 20 Order. In the Pooling Rehearing Order, issued contemporaneously with the Commission's June 30, 2009 Order, the Commission affirmed its decision to require the Carriers to implement a new pooling mechanism.<sup>11</sup> The Commission explained that it did not order the Carriers to implement a pooling mechanism under Section 5(1) of the Interstate Commerce Act<sup>12</sup> (ICA), but did so pursuant to its ancillary authority in establishing just and reasonable rates on TAPS. The Commission also directed the Carriers to include the pooling mechanism in their tariff, rather than in their Operating Agreement.

## **B. 2007 and 2008 TAPS Rates**

12. Prior to the issuance of Opinion No. 502, each of the Carriers submitted their individual annual interstate rate filings for 2007 and 2008 pursuant to the TAPS Settlement. Parties filed protests to these rates raising issues similar to the issues raised in the TAPS 2005 and 2006 rate proceeding. The Commission accepted and suspended the Carriers' 2007 and 2008 rate filings, but held the proceedings on those rates in abeyance subject to the outcome of the 2005 and 2006 rate proceeding.<sup>13</sup>

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<sup>8</sup> *BP Pipelines (Alaska) Inc.*, 125 FERC ¶ 61,215, at PP 33, 55-57 (2008) (November 20 Order).

<sup>9</sup> The pooling mechanism in the TAPS Settlement expired on December 31, 2008, as a result of Alaska's exercise of its right to renegotiate.

<sup>10</sup> The described Indicated TAPS Carriers are ConocoPhillips, ExxonMobil, and Unocal.

<sup>11</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,317 (2009) (Pooling Rehearing Order).

<sup>12</sup> 49 U.S.C. app. § 5(1) (1988).

<sup>13</sup> See *BP Pipelines (Alaska) Inc.*, 117 FERC ¶ 61,352, at P1 (2006); *Unocal Pipeline Co.*, 121 FERC ¶ 61,300, at P 3 (2007).

13. On December 29, 2008, after the issuance of Opinion No. 502, the Commission summarily disposed of the Carriers' 2007 and 2008 interstate rate filings.<sup>14</sup> Because the Carriers had calculated these filings pursuant to the TSM, the Commission directed the Carriers to make a compliance filing recalculating the rates in accordance with the methodology set forth in Opinion No. 502.

14. On January 28, 2009, the Carriers submitted a compliance filing establishing uniform rates for 2007 and 2008 in accordance with Opinion No. 502. A number of parties filed protests and comments on the compliance filing. On April 16, 2009, the Commission issued an order accepting the 2007 uniform rate.<sup>15</sup> The Commission stated that because the 2007 uniform rate fell below the refund floor (i.e., the last clean rates, which were the 2004 TAPS rates), no further proceedings regarding the 2007 rates were necessary and ordered refunds limited to the difference between the 2007 TSM rate and the 2004 rate. However, the proposed 2008 uniform rate was higher than the refund floor that had been protested. As a result, the Commission accepted, on an interim basis, the tariff containing the 2008 rate, subject to refund, ordered preliminary refunds for 2008 for the difference between the 2008 TSM rate and the 2008 compliance filing rate, and established hearing and settlement judge procedures.

15. Settlement judge procedures were ultimately successful.<sup>16</sup> In the interim, the Commission ordered the Carriers to charge, as an interim rate, the 2008 compliance filing rate of \$3.45 per barrel.<sup>17</sup> The Commission approved the settlement on April 1, 2010, and terminated the dockets involving the 2008 rates.

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<sup>14</sup> *BP Pipelines (Alaska) Inc.*, 125 FERC ¶ 61,367, at P 1 (2008).

<sup>15</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,047 (2009) (April 16 Order).

<sup>16</sup> *See BP Pipelines (Alaska) Inc.*, Docket No. IS07-75-000, *et al.* (May 22, 2009) (unpublished order of Chief Judge); *BP Pipelines (Alaska) Inc.*, 131 FERC ¶ 61,003 (2010).

<sup>17</sup> BP, Koch, ConocoPhillips, and Unocal all made filings to implement the interim rate established in the April 16 Order. ExxonMobil did not make such a filing because, on March 31, 2009, prior to the issuance of the April 16 Order, ExxonMobil filed to increase its TAPS interstate rates in Docket No. IS09-177-000.

## C. The Initial TAPS Rates<sup>18</sup>

### 1. ExxonMobil's Rate Filing in Docket No. IS09-177-000

16. On March 31, 2009, ExxonMobil filed a new interstate transportation rate for its share of TAPS capacity in Docket No. IS09-177-000. ExxonMobil stated that it calculated its rate of \$4.01 per barrel pursuant to the rate-making methodology established in Opinion No. 502. The other Carriers did not protest ExxonMobil's rate, though it was protested by the State of Alaska and Anadarko Petroleum Corporation (Anadarko or APC). On April 29, 2009, the Commission accepted and suspended ExxonMobil's filing, effective May 1, 2009, subject to refund, and established hearing

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<sup>18</sup> As the Commission noted in its July 29, 2010 order pertaining to ConocoPhillips Tariff No. 18, certain TAPS carriers made additional rate filings after the Commission's June 30, 2010 Order, which were additionally consolidated with this proceeding in Docket IS09-348-000. The aforementioned orders generally held the Non-SR issues pending before the undersigned to be held in abeyance pending the resolution of this case, but that resolution of this litigation would have applicability to the later filed tariffs. *See ConocoPhillips Transp. Alaska, Inc., et al.*, 132 FERC ¶ 61,084 (2010) (holding in abeyance ConocoPhillips FERC Tariff No. 18); *BP Pipelines (Alaska) Inc.*, 132 FERC ¶ 61,130 (2010) (holding in abeyance BP FERC Tariff No. 41). *See also Unocal Pipeline Co., et al.*, 129 FERC ¶ 61,275 (2009) (holding in abeyance Unocal FERC Tariff No. 14, and KAPCO FERC Tariff No. 306); *ExxonMobile Pipeline Co., et al.*, 131 FERC ¶ 61,133 (2010) (holding in abeyance ExxonMobile FERC Tariff No. 361, BP FERC Tariff No. 40, and ConocoPhillips FERC Tariff No. 17, plus Supplements); *Koch Alaska Pipeline Co., LLC*, 132 FERC ¶ 61,144 (2010) (accepting and suspending KAPCO FERC Tariff No. 15; *ExxonMobile Pipeline Co.*, 132 FERC ¶ 61,193(2010) (accepting and suspending ExxonMobile FERC Tariff No. 380); and *Unocal Pipeline Co.*, 133 FERC ¶ 61,091 (2010) (accepting and suspending Unocal FERC Tariff No. 318.1.0). By order of the Chief Judge dated May 26, 2010, noting the Commission's consolidation order of May 12, 2010, the undersigned has the following dockets consolidated in this proceeding: IS09-348-000; IS09-395-000; IS09-384-000; IS09-391-000; IS09-177-000; IS09-176-000; IS10-52-000; OR10-3-000; IS10-54-000; IS10-200-000; IS10-204-000; IS10-205-000; and IS10-205-001. However, the parties submitted a clarification letter to the Chief Judge dated July 12, 2010, requesting that the issues before the undersigned should (as discussed before both assigned ALJs) pertain to cost of capital, adoption of the pooling mechanism and the adoption of the implementation process for the uniform rate. The parties needed to firm up for long term discovery proceedings the issues pertinent to both proceedings and believed the SR issues would be closely interrelated to the remaining tariff issues. By email, the Chief Judge accepted this clarification and the undersigned confirmed this with the parties at the first day of hearing in this matter (Exhibit No. ALJ-7; Tr. Vol. 3, at 213-216). Therefore, the SR phase of this proceeding will decide the prudence issues and the remaining tariff related issues for the above referenced filings.

procedures.<sup>19</sup> As discussed, each of the TAPS carriers eventually filed new cost of service rates in 2009, which are now the subject of this proceeding. The various TAPS rate filings have been consolidated in Docket Nos. IS09-348-000, *et al.*<sup>20</sup> A previous ALJ initially held the hearing in abeyance pending the outcome of the hearing on the 2008 TAPS rates in Docket No. IS07-75-001, *et al.*<sup>21</sup>

## 2. Unocal's Volume Incentive Rate Filing in Docket IS09-176-000

17. On the same day ExxonMobil made its rate filing, Unocal proposed to establish a volume incentive rate for oil transportation on its share of TAPS capacity in Docket No. IS09-176-000. Unocal filed the volume incentive rate to compete with the other Carriers and encourage greater use of Unocal's share of the TAPS capacity. Unocal proposed a reduced rate of \$3.25 per barrel to any interstate shippers who transport volumes averaging 5,000 barrels per day or more in a calendar month. Unocal stated it was not proposing to change its existing maximum rate (i.e., the interim rate of \$3.45 established in the April 16 Order), which would remain applicable to shippers that do not satisfy the minimum volume threshold for the incentive rate. On April 28, 2009, the Commission accepted Unocal's filing, effective May 1, 2009, subject to refund and conditions.<sup>22</sup> Specifically, the Commission conditioned its acceptance of Unocal's volume incentive rate on the outcome of the TAPS 2008 compliance rate proceeding in Docket No. IS07-75-000 and explained that if the final maximum rate determined there is less than Unocal's volume incentive rate, the refund condition will apply.

## 3. BP's Rate Filing in Docket No. IS09-348-000

18. On May 29, 2009, BP filed FERC Tariff No. 38, proposing to increase its interstate transportation rate to \$4.01 per barrel, effective July 1, 2009. BP stated that it calculated this rate in compliance with the ratemaking methodology prescribed by the Commission in Opinion No. 502. BP further asserted its filing is consistent with the Commission's ruling that the Carriers should charge a uniform rate for service on TAPS.

<sup>19</sup> See *ExxonMobil Pipeline Co.*, 127 FERC ¶ 61,089 (2009) (*reh'g pending*).

<sup>20</sup> See *Unocal Pipeline Co.*, 129 FERC ¶ 61,275 (2009) (consolidating additional Unocal and KAPCO 2009 rate filings with lead docket); *ExxonMobile Pipeline Co.*, 131 FERC ¶ 61,133, at P 1 (2010) (consolidating revisions to 2009 BP, CPTAI and EMPCo rate filings with lead docket). The Commission also made clear that the consolidated proceeding would determine a new pooling mechanism. A number of parties had filed petitions for review with the United States Court of Appeals for the D.C. Circuit related to the 2007 rates. On May 6, 2009, the D.C. Circuit Court of Appeals ordered that those cases be held in abeyance pending further order of the Court. See *Williams Alaska Petroleum, Inc. v. FERC*, No. 09-1078 (D.C. Cir. 2009).

<sup>21</sup> See *ExxonMobil Pipeline Co.*, Docket No. IS09-177-000 (May 14, 2009) (unpublished order of Chief Judge).

<sup>22</sup> See *Unocal Pipeline Co.*, 127 FERC ¶ 61,088 (2009).

BP explained that it used the same base period (calendar year 2008) and test period (January 1, 2009 through September 30, 2009) that ExxonMobil used in its filing. BP stated that given the Commission's ruling requiring a uniform rate on TAPS, and ExxonMobil's rate filing, then "less than two months ago," BP adopted ExxonMobil's test period adjustments rather than making independent adjustments as of the time it filed, as contemplated by the Commission's regulations.<sup>23</sup> BP explained further that in connection with this filing, BP filed a petition requesting waiver of the requirement that BP adjust base period costs for changes that "are known and measurable with reasonable accuracy at the time of filing."<sup>24</sup>

#### **4. ConocoPhillips' Rate Filing in Docket No. IS09-384-000**

19. On June 3, 2009, ConocoPhillips filed FERC Tariff No. 17, proposing to increase ConocoPhillips interstate transportation rate to \$4.10, effective July 4, 2009. ConocoPhillips stated that it calculated this rate in accordance with the ratemaking methodology prescribed by the Commission in Opinion No. 502. ConocoPhillips further asserted the rate reflects the May 29, 2009 ruling by the Alaska State Assessment Review Board increasing the state property tax assessment on TAPS.

#### **5. ExxonMobil's Rate Filing in Docket No. IS09-391-000**

20. On June 8, 2009, ExxonMobil filed FERC Tariff No. 351, proposing to increase its interstate transportation rate to \$4.10 per barrel, effective July 9, 2009. ExxonMobil stated that it calculated this rate in accordance with the ratemaking methodology prescribed by the Commission in Opinion No. 502. ExxonMobil explained it submitted this filing to account for the May 29, 2009 ruling by the Alaska State Assessment Review Board increasing the state property tax assessment on TAPS.

#### **6. BP's Rate Filing in Docket No. IS09-395-000**

21. On June 11, 2009, BP filed FERC Tariff No. 39, proposing to increase its interstate transportation rate to \$4.10 per barrel, effective August 1, 2009. BP stated that it calculated this rate in accordance with the ratemaking methodology prescribed by the Commission in Opinion No. 502. BP explained it also tendered this filing to account for the May 29, 2009 ruling by the Alaska State Assessment Review Board increasing the state property tax assessment on TAPS. In connection with its filing, BP filed a petition requesting waiver of Section 346.2(a)(1)(ii) of the Commission's regulations to permit adoption of the \$4.10 rate filed by ConocoPhillips and ExxonMobil.<sup>25</sup>

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<sup>23</sup> 18 C.F.R. § 346.2(a)(1)(ii) (2010).

<sup>24</sup> *Id.*

<sup>25</sup> In each rate filing, the Carriers noted that petitions for review of Opinion 502 and the series of orders following it are pending before the U.S. Court of Appeals for the D.C.

**D. Protests**

22. The State of Alaska filed protests to BP's rate filing in both Docket Nos. IS09-348-000, and IS09-395-000, ConocoPhillips' rate filing in Docket No. IS09-384-000, and ExxonMobil's rate filing in Docket No. IS09-391-000. Anadarko filed protests to BP's rate filings in both Docket Nos. IS09-348-000 and IS09-395-000, ConocoPhillips' rate filing in Docket No. IS09-384-000, and ExxonMobil's rate filing in Docket No. IS09-391-000. These parties argued that BP, ConocoPhillips, and ExxonMobil's rates have not been shown to be just and reasonable and urge the Commission to suspend the rates, subject to refund, and set them for hearing.

23. In addition, the parties contended that because of the commonality of the issues presented in BP's rate filings in Docket Nos. IS09-348-000 and IS09-395-000, ConocoPhillips' rate filing in Docket No. IS09-384-000 and ExxonMobil's rate filings in Docket Nos. IS09-177-000 and IS09-391-000, the Commission should consolidate these proceedings. The parties further request the Commission to hold these proceedings in abeyance pending the outcome of the 2008 TAPS compliance filing rate proceeding in Docket No. IS07-75-000, *et al.*, which was then set for hearing and settlement procedures.

24. BP and ConocoPhillips filed answers to the protests filed by Alaska and Anadarko in Docket Nos. IS09-348-000 and IS09-384-000, respectively. BP and ConocoPhillips agreed with the State of Alaska and Anadarko that their rate filings should be consolidated with the other dockets relating to the TAPS uniform rate for 2009. BP also agreed with Alaska and Anadarko that the Commission should hold any further proceedings in this docket in abeyance pending the outcome of the proceeding on the TAPS 2008 compliance filing rate in Docket No. IS07-75-000, *et al.*

25. ConocoPhillips did not object to holding the proceedings in abeyance pending the outcome of the settlement procedures in the TAPS 2008 compliance filing proceeding. However, ConocoPhillips stated that depending on the outcome of the settlement discussions, it may be appropriate at some point to consolidate the 2008 compliance filing proceeding with any proceedings involving TAPS rates filed in 2009, since they will likely involve many of the same issues.

26. Alaska filed a protest to Unocal's volume incentive rate filing on June 15, 2009, more than a month after the Commission issued an order accepting the filing.<sup>26</sup> The Commission rejected Alaska's protest because it was not filed in a timely manner.

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Circuit.

<sup>26</sup> Alaska submitted the same protest in Docket Nos. IS07-41-005 and IS08-53-005. The protest was in response to Unocal's submission of FERC Tariff No. 304 on May 29, 2009, which reflects Unocal's existing rates. Multiple other motions to intervene and

### **E. The Commission's Order Setting this Case for Hearing**

27. The Commission in its June 30, 2009 Order accepted and suspended tariffs submitted by BP, ConocoPhillips, and Exxon Mobil, subject to refund, to become effective on the dates requested, established the aforementioned hearing and settlement judge procedures, and consolidated these proceedings with the ongoing proceedings in Docket Nos. IS09-177-000 and IS09-176-000. The Commission further held the hearing and settlement judge procedures in abeyance pending the outcome of the proceeding in Docket No. IS07-75-000, *et al.*, discussed above.

28. The Commission found that BP, ConocoPhillips, and ExxonMobil have made adequate initial showings that their filings meet the requirements of a cost of service filing under Section 346.1 of the Commission's regulations.<sup>27</sup> However, the Commission stated that these tariff filings raised a number of issues of material fact that could not be resolved on the record before it. Therefore, the Commission established hearing procedures to examine the varying data submitted by the Carriers and to determine, based on the ratemaking methodology set forth in Opinion No. 502, one rate for transportation service on TAPS.

29. The Commission ordered that the hearing will address the issues raised by the protestors, with the exception of the issue of the useful life of the line. Opinion No. 502 extended the useful life of the line from 2011 to 2034 and the Commission in the April 16 Order adhered to that finding,<sup>28</sup> and initially adopted that determination in this proceeding. However, in its subsequent rehearing order issued on December 10, 2009, the Commission ordered that the State of Alaska's and Anadarko's requests for rehearing were granted and held that the TAPS end-life issue may be an issue in this proceeding.<sup>29</sup>

30. The Commission further stated that in Opinion No. 502, it determined that the Carriers must charge a uniform rate for transportation service on TAPS. The

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protests were filed by numerous carriers to the multiple filings. Koch filed such motions on January 12, 2010 and November 12, 2009, and Flint Hills Resources Alaska LLC (Flint Hills) filed on June 16, 2009. From a review of the record it appears as though either the Commission or the preceding assigned ALJ acted upon all outstanding requests to intervene. In any event, the undersigned finds all of the participating parties in this case have an interest in the issues presented and finds no prejudice, and therefore, deems all and any outstanding motions to intervene and/or protests are granted pursuant to the authority provided to the undersigned in 18 C.F.R. § 385.214 (2010) (Rule 214, Rules of Practice and Procedure).

<sup>27</sup> 18 C.F.R. § 346.1 (2010).

<sup>28</sup> *Supra* n.14, April 16 Order at P 37.

<sup>29</sup> *BP Pipelines (Alaska) Inc., et al.*, 129 FERC ¶ 61,211, at P 1 (2009) (also holding and accepting Unocal's Volume Rate Incentive, FERC No. 304, subject to refund and to the outcome of the TAPS 2008 compliance rate proceeding).

Commission explained that it is just and reasonable for the Carriers to charge one rate because they all provide identical interstate transportation service to shippers, regardless of whose capacity is used, and they all have basically the same cost of service.<sup>30</sup>

31. The Commission also stated that while it established a clear policy in Opinion No. 502 that a uniform rate should apply for transportation service on TAPS, as explained above, several of the Carriers have individually filed their own rates. In these filings, each of the Carriers stated that they calculated their rate in accordance with the ratemaking methodology in Opinion No. 502. However, the Commission noted that the individual rates filed by the Carriers vary greatly and cover different periods of time.

32. Accordingly, the Commission found that to implement the directive in Opinion No. 502 the Carriers must charge a uniform rate. The Commission stated that it will consolidate these rate filings with the proceedings in Docket Nos. IS09-177-000 and IS09-176-000; finding that these proceedings involve the same issues and consolidating them ensures that there will be one proceeding to determine a just and reasonable uniform rate for TAPS.<sup>31</sup> In addition, the Commission granted the petitions filed by BP requesting waiver of Section 346.2(a)(1)(ii) of the Commission's regulations<sup>32</sup> "because doing so furthers achieving a uniform rate."<sup>33</sup>

33. The Commission also held that it expects a pooling mechanism to be included in the determination of this consolidated proceeding. In the November 20 Order, the Commission stated that it found that because of the December 31, 2008 expiration of the pooling arrangement in the TAPS Settlement, the Carriers must implement a new pooling arrangement.<sup>34</sup> The Commission explained that ordering pooling was necessary and incident to its decision to establish a uniform rate.<sup>35</sup> In the Pooling Rehearing Order, the Commission clarified that the TAPS pooling mechanism should reallocate the Carriers' costs based on throughput, so that the allocation of costs matches the allocation of revenues on TAPS.<sup>36</sup> The Commission also clarified that the Carriers must include the pooling mechanism in their tariff.<sup>37</sup> In accordance with these orders, the Commission held that the hearing on the consolidated proceedings at issue here should establish both a uniform rate and a pooling mechanism for transportation service on TAPS.

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<sup>30</sup> *Supra* n.7, Opinion No. 502 at P 242.

<sup>31</sup> The Commission is consolidating Unocal's volume incentive filing with the other rate filings to examine how it should treat discount rates under a uniform transportation rate.

<sup>32</sup> 18 C.F.R. § 346.2(a)(1)(ii) (2010).

<sup>33</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,316, at P 28 (2009).

<sup>34</sup> *Supra* n.8, November 20 Order at P 64.

<sup>35</sup> *See Id.*

<sup>36</sup> *Supra* n.11, Pooling Rehearing Order at P 39.

<sup>37</sup> *Id.*

34. The Commission further stated that it has consistently encouraged parties to resolve disputes of this nature through settlement, and indicated it was of the view that formal settlement procedures may lead to a resolution of this case.<sup>38</sup> The Commission stated that settlement procedures were particularly important in this proceeding because most oil pipelines increase their rates pursuant to the indexing methodology in the Commission's regulations; TAPS is exempt from these regulations under the Energy Policy Act of 1992.<sup>39</sup> However, it stated that since the TAPS Settlement is no longer in effect, the Carriers have no method for increasing their rates from year-to-year, except by making a rate filing with the Commission.

35. This means, the Commission noted, that when a Carrier seeks to increase the uniform rate on TAPS, it must file its proposal with the Commission and, as demonstrated here, all of the Carriers will be obligated to participate in the proceeding to protect their interests. The Commission noted that given the time and resources these rate proceedings usually require it would be much more efficient for the Carriers to enter into a settlement agreement establishing not only the uniform rate for this year, but also how the uniform rate on TAPS will increase from year-to-year. To encourage parties to enter into such an agreement, the Commission held that it would establish formal settlement judge procedures in this matter.<sup>40</sup>

36. The Commission initially, as previously mentioned, held the hearing and settlement judge procedures in this consolidated proceeding in abeyance pending the outcome of the 2008 TAPS compliance filing rate proceeding in Docket No. IS07-75-000, *et al.*,<sup>41</sup> which it viewed as being consistent with the decision of the Chief Judge in Docket No. IS09-177-000.<sup>42</sup> As also indicated above, the Commission approved the settlement involving the 2008 TAPS rates on April 1, 2010.

37. The Commission held that based upon its review of the filing, it found that the tariff filings by BP, ConocoPhillips, and ExxonMobil have not been shown to be just and reasonable and may be unjust, unreasonable, unduly discriminatory, or otherwise

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<sup>38</sup> See 18 C.F.R. § 343.5 (2010).

<sup>39</sup> See 18 C.F.R. § 342.0 (b) (2010). Section 1084(2)(B) of the Energy Policy Act of 1992 provides: (B) EXCEPTION.—The term “oil pipeline” does not include the Trans-Alaska Pipeline authorized by the Trans-Alaska Pipeline Authorization Act (43 U.S.C. 1651 *et seq.*) or any pipeline delivering oil directly or indirectly to the Trans-Alaska Pipeline.

<sup>40</sup> See 18 C.F.R. § 385.603 (2010).

<sup>41</sup> See *BP Pipelines (Alaska) Inc.*, Docket No. IS07-75-000, *et al.*, (May 22, 2009) (unpublished order of Chief Judge continuing settlement judge procedures).

<sup>42</sup> See *ExxonMobil Pipeline Co.*, Docket No. IS09-177-000 (May 14, 2009) (unpublished order of Chief Judge holding proceeding in abeyance and canceling prehearing conference).

unlawful, stating that BP, ConocoPhillips, and ExxonMobil “seek to implement different rates for different periods of time, which is inconsistent with the Commission’s ruling in Opinion No. 502 that there should be one rate for transportation service on TAPS.” The Commission further held that because it accepted and suspended each of the Carriers’ individual rate filings, subject to refund, each Carrier could continue to charge the rate it filed until the just and reasonable uniform rate for TAPS is determined through settlement or hearing procedures.

#### **F. The Hearing (Non-SR Phase)**

38. Unfortunately, as indicated above, settlement procedures were not successful. By order dated December 22, 2009, the Chief Judge terminated settlement judge procedures and appointed the undersigned as Presiding Judge.<sup>43</sup> On January 13, 2010, the Chief Judge bifurcated the hearing and severed the issues raised in the various filings into two distinct phases: the non-strategic reconfiguration (Non-SR) issues (the subject of this Initial Decision) and the strategic reconfiguration (SR) issues. Judge Silverstein was initially appointed to hear the SR issues phase by the Chief Judge on January 25, 2009.<sup>44</sup>

39. The undersigned held a pre-hearing conference in this matter with the parties on January 20, 2010. A procedural scheduling order was adopted on January 21, 2010, with some subsequent modification to accommodate the schedule and activities of the parties and the undersigned. The majority of documents were admitted into evidence at the first day of hearing. All documents were pre-marked before the hearing or marked at the hearing by number and party designation-abbreviation, identified by the undersigned on the record, and admitted into evidence by the undersigned.

40. The undersigned admitted into evidence as “ALJ” exhibits, the pre-filed exhibit lists of the parties, which contain detail descriptions of each document. Therefore, a complete list and description of all exhibits is available in the hearing transcript for October 28, 2010, and the admitted ALJ exhibits. The parties offered a joint stipulation to resolve the cost of capital issues, which the undersigned also admitted into evidence on October 28, 2010. Furthermore, several motions were heard and decided by the undersigned on October 28, 2010.

41. The undersigned granted all motions to maintain confidential and highly confidential designations filed by the parties in response to Anadarko’s October 19, 2010

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<sup>43</sup> The undersigned replaced Judge John P. Dring who had been previously appointed as Presiding Judge. Subsequently Judge Silverstein was replaced by Judge Cintron pertaining to the SR phase of this litigation.

<sup>44</sup> The Chief Judge also reiterated that the SR phase of the proceeding was authorized to hold out of town hearings and concurrent proceedings with the State of Alaska Commission.

notice to remove such protection, pursuant to the terms of the protected order issued by the undersigned. Additionally, the undersigned denied BP's motion to strike testimony of Anadarko witness Grasso and the TAPS Carriers' motion for partial summary disposition pertaining to the uniform rate issue. The hearing started on October 28, 2010 and was completed on November 5, 2010, after seven full days of hearing. Eleven witnesses testified at the hearing and initially 268 exhibits were admitted into evidence.<sup>45</sup>

## II. ISSUES

42. The parties stipulated verbatim to the following issues to be heard at hearing, and set the following numerical sequences. These issues are all addressed in the undersigned's findings, although in some circumstances in narrative format instead of by designated numerical order.

### A. Cost of Capital

43. The parties submitted the following issues regarding cost of capital. All agreed the undersigned had these issues before him in this proceeding:

1. From what period(s) should data be used to address cost of capital issues?
2. What are the appropriate proxy companies to use in determining cost of capital?
3. What is the appropriate capital structure?

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<sup>45</sup> Nineteen exhibits were designated as ALJ exhibits, which included copies of the parties exhibit lists that set forth specific descriptions of each exhibit and excerpts for documents which memorialize instances whereupon the undersigned took administrative notice either at the request of the parties or *sua sponte*. ALJ Exhibits Nos. 17 and 18 are demonstrative exhibits, as are BPP-104 and BPP-105. APC Exhibit 106 was not admitted into evidence but was ordered to be attached to the record under seal as an offer of proof by Anadarko. Additionally, the undersigned initially ordered attached to the record under seal, forty-three exhibits which were withdrawn by the parties, plus the pre-filed FERC Staff exhibits, which had not been offered. These exhibits pertain to the cost of capital issues. By order dated December 2, 2010, the undersigned re-opened the record to admit the previously withdrawn exhibits into evidence as well as ALJ Exhibit No. 20, which describes the FERC Staff's three exhibits; and ALJ Exhibit No. 21, which contains joint comments by the parties in support of the cost of capital stipulation. The undersigned denied BP Alaska's motion to also admit upon re-opening, additional exhibits pertaining to its cost of capital expert's reply testimony. The undersigned denied this request but ordered these exhibits attached to the record under seal, as an offer of proof (Exhibits Nos. BPP-108-BPP-122).

4. What is the appropriate cost of debt?
5. What is the appropriate cost of equity?
6. What is the appropriate overall cost of capital?

## **B. Pooling Issues<sup>46</sup>**

44. The parties agreed to the following issues involving pooling:
  1. All participants that have taken a position on the pooling arrangement to be established in this proceeding agree that the interstate portion of (i) operating expenses incurred by Alyeska on behalf of the TAPS Carriers and (ii) depreciation should be pooled. What other items should be included in that pooling?
    - a. Should return-related elements (including the cost of debt, return on equity, and allowance for income taxes) be pooled?
    - b. Should costs related to intrastate transportation be pooled?
    - c. Should Carrier-direct costs be pooled?
  2. When should that pooling begin?
    - a. On January 1, 2005?
    - b. On January 1, 2008?
    - c. On January 1, 2009?
    - d. Prospective from the effective date of the Commission order that approves a cost pooling mechanism?
    - e. Prospective from the effective date of the uniform rate to be established in this proceeding?
  3. How should the mechanics of the pooling be applied?

## **C. Uniform Rate**

45. Anadarko did not believe the uniform rate issue should be addressed, although in general, all parties provided some position on this issue. The parties generally agreed that the implementation process for coming up with a uniform rate should be determined

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<sup>46</sup> As indicated above, not all of the parties agreed that the Commission had jurisdiction to order pooling under the circumstances of this case. That issue was on appeal. The parties stipulated that assuming the Commission has jurisdiction to order a pooling in this case, the parties agreed that the submitted above referenced issues are relevant to the establishment of such a pooling arrangement. The appeal was recently denied on December 3, 2010, as discussed more fully below.

in this proceeding. At the hearing, the parties reached a consensus as to how the uniform rate process should work. The following list of issues was stipulated to by the parties as relevant. Due to the parties' consensus, which the undersigned generally adopts, with some modification, some of these issues are no longer material:

1. Whether implementation of a uniform rate has been set for hearing in this proceeding?
2. How should the Commission's order that the TAPS Carriers file a uniform rate be implemented?
  - a. Does the Commission's uniform rate requirement permit each Carrier to file rates individually and on its own initiative provided its rates do not exceed the uniform rate ceiling based on total TAPS costs and throughput?
  - b. Alternatively, must all of the TAPS Carriers agree upon a single maximum rate?
    - i. If so, must all of the TAPS Carriers file that rate on the same day?
3. If all of the TAPS Carriers are required to agree upon a single maximum rate, what process must the TAPS Carriers follow to establish and change that maximum rate?
4. If all of the TAPS Carriers are required to agree upon a single maximum rate, will the Commission immunize the Carriers from antitrust liability, and if so, under what authority?

### **III. SUMMARY OF PRE-FILED TESTIMONY ADMITTED INTO EVIDENCE**

#### **A. ExxonMobil – Direct Testimony**

##### **1. Jeffrey M. Ray**

46. Jeffrey M. Ray is employed by ExxonMobil Pipeline Company as TAPS Coordinator in the Business Development and Joint Interest Department. Mr. Ray received a B.S. degree in Civil Engineering from New Mexico State University in 1977 and has worked continuously for Exxon and ExxonMobil since graduation. Mr. Ray's work includes assignments in reservoir engineering, business planning and development, gas supply, sales and transportation, and sales and acquisitions of oil and gas producing properties. Mr. Ray assumed his present position as TAPS coordinator in July 1998. EMPCo indicated that the purpose of Mr. Ray's testimony is to provide an overview of TAPS and EMPCo's tariff filings, explain the relationship between the Commission's uniform rate requirement and the pooling mechanism that the Commission has ordered

the parties to develop, and to describe the collaboration necessary to develop a uniform rate (Exhibit No. EM-1, at 1).

47. Mr. Ray summarizes EMPCo's tariff filings in this proceeding. In 2009, EMPCo submitted two FERC tariff filings that proposed a change in the interstate rates for transportation on EMPCo's share of TAPS capacity. The first filing was on March 31, 2009, in Docket No. IS09-177-000, EMPCo proposed to change its' TAPS interstate rate to \$4.01 per barrel, effective May, 1, 2009. This change represented a decrease from the then-effective rate of \$4.87 per barrel. The second filing on June, 8, 2009, in Docket No. IS09-391-000, EMPCo proposed to change its' TAPS interstate rate to \$4.10 per barrel, effective July 9, 2009. In that same docket, on April 12, 2010, EMPCo filed a two-cent rate reduction to \$4.08 per barrel to implement the settlement of the TAPS Carriers' 2008 rate filings. The Commission issued orders accepting and suspending EMPCo's rate filing subject to refund and the outcome of hearing procedures in Docket No. IS07-177-000 and Docket No. IS09-391-000 on April 29, 2009, and June 30, 2009, respectively (Exhibit No. EM-1, at 3-5).

48. According to Mr. Ray, EMPCo calculated its rates in accordance with TAPS ratemaking principles established by the Commission in Opinion No. 502 and related rehearing orders that addressed TAPS Carriers' 2005 and 2006 rate filings. TAPS Opinion 502 ordered TAPS Carriers to file a uniform rate and established a new rate making methodology. Prior to Opinion No. 502, TAPS Carriers charged individual rates for transportation service. Beginning in 1985, eight years after TAPS was placed in service, rates were developed in accordance with the TSA. The Commission approved TSA established the TSM. Under TSM, each TAPS Carrier calculated and filed individual ceiling rates on an annual basis. The TSA remained in effect until December 31, 2008 (Exhibit No. EM-1, at 5-7).

49. EMPCo and several other Carriers challenged the uniform rate ruling in Opinion No. 502 proceedings. EMPCo believed a uniform rate could cause certain TAPS Carriers to over- or under-recover their costs. In addition, EMPCo was concerned with practical problems associated with developing a uniform rate, such as how the rate would be developed if a Carrier did not share necessary cost and throughput information with other Carriers (Exhibit No. EM-1, at 7).

50. Mr. Ray explains how the uniform rate could result in over- or under-recovery by certain Carriers. Carriers fund Alyeska's costs—the most significant portion of total system costs—on an ownership share basis (e.g., a Carrier with 20% share ownership pays 20% of Alyeska's costs). However, each TAPS Carrier receives revenue from shippers in proportion to the level of throughput it transports (e.g., a Carrier that transports 30% of total throughput receives 30% of total revenues). Because Carriers do not transport throughput volumes equal to their ownership shares of TAPS capacity, the uniform rate may lead to over- or under-recovery of costs. For example, a Carrier that has a throughput percentage less than its ownership percentage may not be able to recover its

costs, while a Carrier with throughput greater than its ownership percentage may over-recover its costs. The Commission believes the above concern is addressed through a cost pooling mechanism (Exhibit No. EM-1, at 7).

51. Mr. Ray further details the development of a uniform rate, which EMPCo proposed in its 2009 TAPS tariff filings. For 2009, EMPCo's rate filings include system-wide rates. Specifically, EMPCo calculated the total TAPS interstate cost of service and divided that figure by total TAPS interstate deliveries in arriving at its proposed tariff rates. The other Carriers 2009 rate filings contained system-wide rates, however, the Commission observed that the individual Carrier rates varied, and covered different periods of time. The Commission consolidated TAPS Carriers' 2009 tariff filings and directed that the hearing establish a uniform rate. According to the Commission, the uniform rate established the maximum rate Carriers may charge (Exhibit No. EM-1, at 7-10).

52. Mr. Ray states that in order to develop a uniform rate that did not vary among Carriers, the Commission envisioned it would be necessary for Carriers to share information and collaborate. The Carriers would need to share base period data (including non-recurring items, and the basis for normalizing adjustments) and test period adjustment data regarding: (1) throughput; (2) individual Carrier-direct cost; and (3) Alyeska costs. This is necessary in order to implement the Commission's uniform rate. With respect to throughput data, because each Carrier operates its own share of TAPS capacity, to develop a uniform rate for all Carriers, each Carrier would need to share the base period throughput on its share of capacity by destination. Furthermore, each Carrier may need to share its test period adjustments to those volumes to reflect known and measurable changes (Exhibit No. EM-1, at 9-10).

53. This involves information sharing related to how each Carrier expects volumes to change during the prospective test period. With respect to Carrier-direct cost information, EMPCo's direct costs include items such as fuel gas to operate pump stations, payments to third-party service providers (law firms and consultants), pipeline taxes, etc. To develop a uniform rate this information would need to be shared. With respect to the Alyeska cost information that would need to be shared to develop a uniform rate, the TAPS Carriers would need to collaborate to determine what base period costs are non-recurring, the basis for potential normalizing adjustments, and what test period adjustments should be made (Exhibit No. EM-1, at 10-11).

54. Mr. Ray states that Carriers have not historically shared information relating to prospective Carrier-direct costs and throughput. And although, Alyeska routinely shares its prospective cost information with TAPS Carriers, Carriers have not shared how they use this cost information in developing individual rates. EMPCo has not previously shared information with other Carriers because Carriers filed individual tariffs. Furthermore, EMPCo views this information as proprietary and believes it is not appropriate to share with Carriers that compete to transport on TAPS. EMPCo also is

concerned that providing this information may lead to potential antitrust claims. (Exhibit No. EM-1, at 12).

## **B. BPPA – Direct Testimony**

### **1. Charles J. Coulson**

55. Mr. Coulson is president of BPPA and has held this position since 2007. Mr. Coulson is also the current chairman of the TAPS Owners Committee and the Vice President of BP Oil Shipping Company, USA. Mr. Coulson's responsibilities as president of BPPA include overseeing all aspects of BPPA's interest in TAPS; this involves the financial performance of BPPA and the governing responsibilities of TAPS operations. BP asserts that the purpose of Mr. Coulson's testimony is to present the factual background for its Cost Allocation Mechanism, which is its approach to cost pooling (Exhibit No. BPP-1, at 1).

56. In so doing, Mr. Coulson provides an overview of the oilfields that produce oil for TAPS, the alternatives available to producers to market TAPS oil, and how owners of TAPS bear the costs to operate TAPS in the absence of cost pooling. Mr. Coulson also compares the ownership percentages to the respective shares of the Carriers' annual throughput and explains the reasons for the disparities between the percentages. Next, Mr. Coulson discusses the effects of charging a uniform rate in the absence of cost pooling, including the impact on the ability of TAPS carriers to manage TAPS effectively. Last, Mr. Coulson identifies the period that BPPA believes cost pooling should be required (Exhibit No. BPP-1, at 2).

57. According to Mr. Coulson, more than 90% of TAPS throughput is moved the full length of the pipeline to Valdez where the Arctic North Slope (ANS) oil is loaded onto tankers for delivery, principally to refineries located on the West Coast. A small amount (less than 5%) is delivered by tanker to a refinery at Nikiski, Alaska, owned by Tesoro Alaska Petroleum Company. The balance is delivered to two refineries at a location known as the Golden Valley Electric Association connection of TAPS, located about 60% of the way down the pipeline, and to a third refinery located north of the TAPS Valdez Marine Terminal (VMT) at the terminus of TAPS (Exhibit No. BPP-1, at 3).

58. Mr. Coulson provides delivery volumes to the respective locations but states that these numbers are likely to change in the future mainly due to oilfield depletion. Mr. Coulson predicts that intra-state oil consumption will stay steady or increase in the future due to in-state refinery demand, while interstate delivery of ANS will decrease on account of oilfield depletion. Three of the four in-state refineries depend entirely on ANS production shipped on TAPS. Therefore, TAPS deliveries to these refineries will equal demand (Exhibit No. BPP-1, at 4-5).

59. Mr. Coulson explains how the State of Alaska earns a typical 12.5% royalty for oil produced on State lands. The royalty is either taken as Royalty in Kind (RIK) or Royalty in Value (RIV). Under a RIK, the State takes possession of the physical barrels at the outlet to the oilfield where it sells to a third party, which ships on TAPS. When the State elects to receive its royalty as RIV, the producers have more barrels (an extra 12.5%) to nominate into TAPS (in their name) for transportation (Exhibit No. BPP-1, at 8-9).

60. Once oil reaches the VMT, a marine tanker transportation system is necessary to deliver oil to end consumers. A number of state and federal laws regulate marine transportation including: (1) the Jones Act; (2) the Oil Pollution Act of 1990 (OPA 90); (3) certain state laws that impose liability for pollution on cargo owners as well as vessel operators; and (4) state laws that require tanker operators to hold oil discharge prevention and spill contingency response plans (C-Plans). Among the requirements of the Jones Act, is the requirement that all goods transported by water between coastwise points of the United States be carried in vessels constructed in the United States. OPA 90, enacted in response to the Exxon Valdez spill, requires new tankers entering U.S. ports to have double-hulls. In addition, OPA 90 makes a tanker operator strictly liable for the clean-up, response and damages from an oil spill (Exhibit No. BPP-1, at 9-10).

61. Mr. Coulson states that Alaska and every other state on the West Coast have enacted state laws that assign spill liability to the cargo owner as well as the vessel operator. Tanker operators must hold valid C-Plans before they can enter the port of Valdez. In Alaska, C-Plans must undergo a public review and approval process and demonstrate spill response contracts with providers are in place. The above requirements have limited the number of tankers available for charter by ANS producers to transport oil out of Valdez (Exhibit No. BPP-1, at 10-11).

62. Alyeska Pipeline Service Company (Alyeska) was incorporated by TAPS Carriers to serve as their agent in operating and maintaining TAPS. Alyeska is owned by Carriers in the same proportion that they own TAPS. In addition to operating and maintaining the pipeline, Alyeska's responsibilities include response services to crude oil tankers. Alyeska's activities are overseen by Carriers through the TAPS Owners Committee. Voting rights are allocated based on ownership structure, in which the affirmative votes of three or more owners representing a collective 66% interest in TAPS is required for approval (Exhibit No. BPP-1, at 13-14).

63. Mr. Coulson explains further that the composite ownership for 2009 is as follows: BPPA – 46.843%; CPTAI – 28.189%; EMPCo. – 20.497%; KAPCO – 3.085%; and Unocal – 1.387%. Composite percentages are based on the dollar-weighted ownership percentages of two parts, (1) Terminal Tankage (crude oil storage tanks and ancillary equipment located at VMT), and (2) Pipeline (everything not included in Terminal Tankage) (Exhibit No. BPP-1, at 14-15).

64. Alyeska's costs are paid entirely by Carriers via daily cash calls. Services Alyeska provides to Carriers are provided at cost; therefore, Alyeska does not generate excess revenue. The cash call process is determined each week, as set forth in Section 11.6(b) of the TAPS Operating Agreement. Alyeska forecasts gross spending and prepares daily cash calls for each owner using composite ownership percentages. An accounting is made of the gross operating costs, capital expenditures, ad valorem tax payments and asset retirement costs (Exhibit No. BPP-1, at 15-16).

65. Mr. Coulson states that each item is separately tracked and assigned to either the Pipeline or Terminal Tankage asset category. Under this system, by the end of the year, each owner will have incurred its share of Alyeska's costs with respect to its ownership percentages in Pipeline and Terminal Tankage assets. Adjustments are made to Variable Costs annually. Variable costs, as opposed to Fixed Costs, make up less than 6% (2009 figures) of total operating costs. Variable Costs include liquid fuel costs, electrical power costs and costs for the chemical drag reducing agent injected into the pipeline for flow improvement. Variable Costs are allocated among Terminal Tankage and Pipeline asset groups. Pipeline ownership percentage is then compared to its 100 barrel-mile usage percentage for that year. The TAPS Operating Agreement defines the 100 barrel-mile usage percentage as the number of barrels delivered out of the system multiplied by the number of miles each barrel was transported, divided by 100. If an owner's 100 barrel-mile usage percentage exceeds its ownership percentage, its usage for the year is deemed to have exceeded its ownership share and that owner pays an adjustment amount to the other owners whose usage percentage is less than their ownership percentage (Exhibit No. BPP-1, at 16-18).

66. The sum of payments made and received offset to zero. The same concept applies to Terminal Tankage. The measure for this adjustment is based on the percentage of Valdez deliveries a Carrier makes for the year. A comparison is made between each owner's percentage of Valdez barrel deliveries and its Terminal Tankage ownership percent. The last cost allocation involves in-kind fuel gas by the owners to Alyeska to operate certain pump stations. The amount of fuel an owner is required to provide is based on 100 barrel-mile percentage throughput for each month (Exhibit No. BPP-1, at 18-19).

67. Mr. Coulson also discusses owners' capacity versus throughput shares. For tariff regulation purposes there are conceptually five different pipelines within the single physical TAPS pipeline because each owner transports barrels within its allotted pipeline space. In 2009, when TAPS transported 680,000 barrels per day, shippers nominated their respective portions of these barrels separately into the pipeline space of the five Carriers. Carriers are entitled to a portion of pipeline capacity or space under the Amended Capacity Settlement Agreement (ACSA), which has been in effect since November 1, 1996 (Exhibit No. BPP-1, at 19).

68. Relevant portions of ACSA have been incorporated into the TAPS Operating Agreement. Specifically, Section 1.2 of TAPS Operating Agreement provides that each Owner's share of pipeline space is equal to their pipeline ownership percentage multiplied by TAPS capacity, which for 2004 forward is 1,100,000 BPD. Because throughput is much lower than this figure, an owner may transport an amount of throughput that exceeds its ownership percentage. When owners transport amounts that are lower or higher than their ownership percentages, the requirement that Carriers charge a uniform rate creates a difference for each Carrier between its costs and revenues. Mr. Coulson provides a table for 2009 showing BPPA had the greatest difference (negative 12,032%) among Carriers between its ownership and throughput percentages (Exhibit No. BPP-1, at 20).

69. Mr. Coulson testifies that the barrels nominated into TAPS by shippers are unevenly distributed because of affiliate tendering. The vast majority of ANS production for the foreseeable future will be owned by the three major producers BPPA, CPTAI, and EMPCo, which are affiliated with the three largest TAPS Carriers. One of the other two Carriers, Unocal, has an affiliate (Chevron) with substantial ANS production, while the other Carrier, KAPCO, has an affiliate whose contract with the State provides it with State RIK oil for delivery to the largest refinery connected to TAPS (Flint Hills Resources at the GVEA connection). Each of the five Carriers has an affiliate with oil to be transported on TAPS. There has been a strong pattern of shippers on TAPS nominating their barrels to their affiliated pipeline companies. There are a variety of reasons for this activity, but mostly it can be understood by thinking about integrated corporate economics. When an upstream affiliate ships barrels in its pipeline affiliate's space, it pays the published tariff rate to the pipeline affiliate, and no money leaves the affiliated group. The payment is essentially a transfer within the corporate family (Exhibit No. BPP-1, at 20-21).

70. Therefore, there is no credit risk. In addition, there are other practical aspects that a shipper might consider when choosing to tender to a pipeline affiliate, such as familiarity with the pipeline affiliate's processes for receiving nominations, and ease in scheduling tanker loadings and managing inventory and line fill requirements. A company has a strong incentive to affiliate tender under the present circumstances since the Commission has found that the Owners should charge uniform rates, but cost pooling has not yet been implemented. With uniform rates but without cost pooling, a pipeline company whose usage exceeds its cost burden will collect tariff revenues that exceed its cost-of-service. This would also be true to a lesser extent if there were uniform rates and cost-pooling, but the pooling was incomplete (Exhibit No. BPP-1, at 21).

71. TAPS has been in operation for 33 years. Significant capital investments will be required over its remaining life if the Carriers are to maintain, replace and/or modernize aging equipment. Alyeska has identified additional future investments required to continue operations in an environment of decreasing throughput volumes. In the absence

of cost pooling, the TAPS Owners are economically misaligned in terms of their ability to recover their costs under a uniform rate regime. That misalignment could cause the Owners to come to different conclusions regarding whether certain future investments in TAPS are economically justified (Exhibit No. BPP-1, at 22).

72. Cost pooling would have the effect of aligning the interests of Carriers regarding future investment decisions on TAPS. These future investments will be substantial. Mr. Coulson examined the list of projects contained within the LRP and concluded that there are material portions of this \$1.2 billion of projected capital investment that pertain to system efficiency and reliability that will require evaluation by the Owners as to their economic merits. For example, if there is a piece of equipment, say a pump or power turbine, that has poor operating efficiency, requires an inordinate amount of manpower to operate due to outdated automation/control systems, or requires frequent maintenance due to its age, the Owners will need to evaluate the economic merits of overhauling or replacing that equipment before approving such an investment (Exhibit No. BPP-1, at 22).

73. Obviously, certain types of investment will need to occur to comply with (1) Department of Transportation requirements; (2) Right-of-Way stipulations issued by the State Department of Natural Resources and the Bureau of Land Management; and (3) BPPA's internal standards for safe operation of pipelines. Nevertheless, Mr. Coulson identified roughly \$500 million of these types of discretionary, economically-based capital projects in the LRP. Among these investments are some that, if not undertaken, will likely result in a sub-optimal system (for example, one having higher operating costs and more frequent down-time). Likewise, there may be some projects within this group that are sub-optimal but that an Owner that is over-earning would, nonetheless, support (Exhibit No. BPP-1, at 23).

74. Mr. Coulson concludes pointing out that cost pooling would have the effect of aligning the interests of Carriers, which is necessary because of the 66% voting requirement by the TAPS Ownership Committee to come to agreement on future investment decisions in the pipeline. BPPA calculated the cost pooling adjustments that would apply for 2005-2008 in accordance with the Cost Allocation Mechanism. If the Commission agrees with BPPA that the effective date should be January 1, 2005, a one-time readjustment will be required to conform allocations in years 2005-2008 to the approach used in the Cost Allocation Mechanism. An adjustment for 2009 is also required if the Commission orders the Cost Allocation Mechanism to have an effective date in any year from 2009 or earlier (Exhibit No. BPP-1, at 24).

## **2. Robert G. Van Hoecke**

75. Mr. Van Hoecke is a principle with Regulatory Economics Group, LLC, a firm specializing in economic, financial and regulatory consulting for the pipeline industry. Mr. Van Hoecke has more than 25 years of experience working in the oil pipeline

industry directly or as a consultant. The purpose of his testimony is to support the Cost Allocation Mechanism proposed by BPPA and explain why it is consistent with the methodology prescribed by FERC in Opinion 502 (Exhibit No. BPP-14, at 1-2).

76. Mr. Van Hoecke provides a 2008 table to illustrate how Carriers over- and under-recover costs. The table indicates that BPPA accounted for 34.71% of throughput but paid 41.92% of the Alyeska incurred costs. Mr. Van Hoecke states that this disparity is resolved under the Cost Allocation Mechanism, which pools both interstate and interstate cost of service elements. The Cost Allocation Mechanism also allocates return elements among Carriers based on their usage of TAPS so that if one Carrier has contributed 40% of the capital cost on TAPS but transports 55% of the traffic it must pay a pooling adjustment to make up for the under contribution (Exhibit No. BPP-14, at 4-6).

77. The Cost of service Mechanism is comparable in complexity to the cost of service calculations required for rate filing under Opinion 502. The calculation for the appropriate cost of service is determined and relies on aggregate cost data for the entire system captured in the Alyeska Incurred Costs. Under the mechanism each Carrier's inter and intra state usage of TAPS is determined based on actual deliveries reported for the year. The data is used to assign distance related costs on a barrel-mile basis and non-distance related costs on a volumetric basis for each Carrier and for TAPS as a whole. Cost of service derived for each jurisdiction is separately allocated to each TAPS Carrier based on usage. The Cost Allocation Mechanism determines the portion of TAPS costs associated with each Carrier's use of TAPS. The difference between a Carrier's initial funding and its TAPS usage cost is the amount of its payment or receipt under the Cost Allocation Mechanism. Without a pooling mechanism, any difference between allocated cost and usage may result in over recovery by some TAPS Carriers at the expense of others (Exhibit No. BPP-14).

78. Mr. Van Hoecke provides a table as example. The table illustrates CPTAI's earnings varying from 13.73 to 32.65% while BPPA under-earning 8.44 to losing 1.42%. Mr. Van Hoecke believes that this variance deviates from the just and reasonable return the Commission envisioned when it prescribed a uniform rate methodology in Opinion 502 (Exhibit No. BPP-14, at 7-8). Mr. Van Hoecke further believes the Cost Allocation mechanism solves this disparity and references Exhibit No. BPP-19, which demonstrates every TAPS Carrier achieving the same level of overall return on its investment under the BP mechanism. Mr. Van Hoecke states that the Modified II-2(f) approach proposed by CPTAI would not be consistent with the Commission's cost pooling instructions because it does not include enough return elements into the formula. Mr. Van Hoecke concludes by stating that the Cost Allocation Mechanism will not increase or affect the tariff rates that TAPS Carriers are allowed to charge shippers (Exhibit No. BPP-14, at 13).

### 3. James H. Vander Weide

79. Dr. Vander Weide is a research professor of finance and economics at Duke University, The Fuqua School of Business. He is also president of Financial Strategies Associates, specializing in strategic and financial consulting to business clients. Dr. Vander Weide has a B.A. degree from Cornell University and a Ph.D. in Finance from Northwestern University. Dr. Vander Weide also taught at Duke University for 35 years in finance and economics (Exhibit No. BPP-20, at 1).

80. The purpose of his testimony is to: (1) provide an independent assessment of BPPA's cost of capital, including its cost of equity, cost of debt, and capital structure, on December 2007, December 2008 and September 30, 2009; (2) recommend specific cost of capital input values for these periods; and (3) recommend reasonable cost of capital input values for 2005 and 2006. Dr. Vander Weide calculates BPPA's cost of equity using the Commission's discounted cash flow (DCF) methodology, modifying the long-term growth forecast used in that methodology as required by the Commission in its adopted *Proxy Group Policy Statement* (Exhibit No. BPP-20, at 3-4).

81. In Opinion 502, the Commission required Carriers to set their rates using hypothetical capital structure ratios and costs of long-term debt calculated using the proxy companies' average capital structure ratios and average embedded costs of long-term debt. Accordingly, Dr. Vander Weide calculates his recommended capital structure and cost of long-term debt input values for December 2007, December 2008, and September 30, 2009 in compliance with the requirements of Opinion 502 (Exhibit No. BPP-20, at 4-5).

82. Cost of capital is the return investors expect to receive on alternative investments of comparable risk, which effects a firm's investment decisions because the central goal of a firm is to maximize the value of the firm. This goal can be accomplished by accepting all investments in plant and equipment with an expected rate of return equal to or greater than the cost of capital. From an economic perspective, a firm should continue to invest in plant and equipment only so long as the return on its investment is greater than or equal to its cost of capital. Cost of capital also measures the investors' required rate of return on investment because rational investors will not invest in a particular investment opportunity if the expected return on that opportunity is less than the cost of capital (Exhibit No. BPP-20, at 5-6).

83. Dr. Vander Weide explains further that cost of capital is a hurdle rate for both investors and the firm. Bond investors take a different position. Bond investors have a fixed claim on a firm's assets and income which must be paid prior to any payment to the firm's equity investors. Since the firm's equity investors have a residual claim on the firm's assets and income, equity investments are riskier than bond investments. Cost of equity exceeds the cost of debt. The overall or average cost of capital is a weighted average of the cost of debt and cost of equity, where the weights are the percentages of

debt and equity in a firm's capital structure. Cost of equity is the return investors expect to receive on alternative equity investments of comparable risk. Since the return on an equity investment of comparable risk is not a contractual return, the cost of equity is more difficult to measure than the cost of debt. Cost of equity, like cost of debt, is both forward-looking and market-based (Exhibit No. BPP-20, at 6-7).

84. Dr. Vander Weide states that the percentages of debt and equity in a firm's capital structure are measured by calculating the market value of the firm's debt and the market value of its equity. The percentage of debt is then calculated by the ratio of the market value of debt to the combined market value of debt and equity, and the percentage of equity by the ratio of the market value of equity to the combined market values of debt and equity. For example, if a firm's debt has a market value of \$25 million and its equity has a market value of \$75 million, then its total market capitalization is \$100 million, and its capital structure contains 25% debt and 75% equity (Exhibit No. BPP-20, at 7-8).

85. Investors measure the return and risk on their investment portfolios using market value weights. From the point of view of investors, the historical cost or book value of their investment is entirely irrelevant to the current risk and return on their portfolios because if they were to sell their investments, they would receive market value, not historical cost. The economic definition of the weighted average cost of capital is based on the market costs of debt and equity, the market value percentages of debt and equity in a company's capital structure, and the future expected risk of investing in the company (Exhibit No. BPP-20, at 8).

86. Dr. Vander Weide estimates the nominal cost of equity by applying the DCF model to a proxy group of oil pipeline companies. For companies that are publicly traded, the cost of equity can be estimated using company-specific market data such as unit or stock prices, distributions or dividends, and investor growth expectations. For companies that are not publicly traded, and specifically for TAPS Carriers, it is necessary to estimate the cost of equity using a hypothetical proxy group of publicly-traded companies that mirror a typical oil pipeline, as required by Opinion 502 (Exhibit No. BPP-20, at 11).

87. Dr. Vander Weide selects proxy companies based on the criteria that they: (1) are publicly traded; (2) have a significant percentage of income from oil pipeline operations; (3) have been in operation for at least five years; (4) have been followed by Value Line for at least six months; (5) have Institutional Brokers' Estimate System (I/B/E/S) growth estimates; and (6) are not the subject of a merger that is not yet completed. Economists agree that proxy companies must be similar in risk to the company whose rates are being evaluated and well established to reliably estimate the target company's cost of equity (Exhibit No. BPP-20, at 11).

88. Dr. Vander Weide requires that a proxy company have publicly-traded stock or units and I/B/E/S long-term growth estimates because stock and/or unit prices are key

inputs in the Commission-approved DCF model. For the years 2007 and 2008, he includes Buckeye Partners L.P., Enbridge Energy Partners, L.P. (Enbridge), Enterprise Products Partners, L.P., Kinder Morgan Energy Partners, L.P., Magellan Midstream Partners, L.P., NuStar Energy L.P., Plains All American Pipeline, L.P., and TEPPCO Partners, L.P. He notes that the Commission has previously approved the use of MLPs in oil pipeline proxy groups (Exhibit No. BPP-20, at 13).

89. The DCF model is based on the assumption that investors value an asset on the basis of the future cash flows they expect to receive from owning the asset. A second fundamental principle of the DCF method is that a future dollar is valued less than a current dollar because investors could invest a current dollar in an interest earning account and increase their wealth. This principle is called the time value of money (Exhibit No. BPP-20, at 13).

90. The DCF model assumes that a company's stock price is equal to the present discounted value of all expected future distributions. The annual DCF model is only a correct expression for the present discounted value of future cash distributions or dividends if distributions are paid annually at the end of each year. Since the companies in Dr. Vander Weide's proxy group all pay distributions quarterly, the current market price that investors are willing to pay reflects the expected quarterly receipt of distributions. Therefore, a quarterly DCF model should be used to estimate the cost of equity for these firms. However, Dr. Vander Weide uses the annual DCF model approved by the Commission's decision (Exhibit No. BPP-20, at 17).

91. Dr. Vander Weide estimates the distribution yield component of the Commission's DCF model by: (1) dividing each proxy company's current annualized distribution by the average of its high and low stock prices in the last six months; and, (2) multiplying the result by the factor  $(1 + 0.5g)$ . This estimate is not consistent with the underlying assumptions of the annual DCF model. The annual DCF model is based on the assumptions that: (1) distributions are received annually; (2) the first distribution will be received one year from now; and (3) distributions grow at a constant annual rate. Thus, to be consistent with the basic assumptions of the annual DCF model, the first distribution must be obtained by multiplying the current indicated annual distribution by one plus the growth rate;  $g$ . In contrast, the Commission-approved DCF model only multiplies the first distribution by the factor  $(1 + .5g)$  (Exhibit No. BPP-20, at 18).

92. Increasing the distribution for  $\frac{1}{2}$  year of growth only allows the analyst to approximate the average annual distribution that will be paid over the next year. Increasing the distribution in the context of an annual model does not account for the timing of the quarterly distribution payments or the time value of money associated with the quarterly payment of distributions. Therefore, the present value of the future quarterly distributions does not equal the company's current stock price, as the DCF method requires (Exhibit No. BPP-20, at 19).

93. Dr. Vander Weide prefers to use the analysts' estimates of future earnings per share (EPS) growth reported by I/B/E/S Thomson Reuters. He indicates that since forecasting earnings growth is inherently uncertain, it is unlikely that future earnings growth will mirror analysts' forecasts. However, although growth forecasts may not perfectly predict future earnings growth, they are better than historically-oriented growth measures in predicting stock prices because analysts are able to consider both historical and current information (Exhibit No. BPP-20, at 19).

94. The important consideration is what growth rates investors use to value a stock. For instance, I/B/E/S growth rates: (1) are widely circulated in the financial community; (2) include the projections of multiple reputable financial analysts who develop estimates of future EPS growth; (3) are reported on a timely basis to investors; and (4) are widely used by institutional and other investors. Dr. Vander Weide does not agree with the Commission's use of GDP growth forecasts in the DCF model and the requirement that GDP growth forecasts be reduced by fifty percent for MLP proxy companies. Dr. Vander Weide states that the DCF model requires the growth forecasts of investors, and his studies indicate that the I/B/E/S growth forecasts reflect the long-run growth expectations of investors (Exhibit No. BPP-20, at 20-21).

95. Dr. Vander Weide estimates the growth component of the DCF model in accordance with the Commission's decision in its Proxy Group Policy Statement. Specifically, he estimates the growth component by: (1) obtaining data on the I/B/E/S long-term growth estimate for each proxy company; (2) obtaining data on long-term GDP growth forecasts from the Energy Information Administration, the Social Security Administration, and Global Insight; (3) multiplying the average long-term GDP growth forecast from these sources by one-half; and (4) calculating a weighted average of the I/B/E/S and GDP growth forecasts, with the I/B/E/S growth forecast having a weight of two-thirds and the long-term GDP growth forecast a weight of one-third. The relevant I/B/E/S growth estimates and long-term GDP growth forecast calculations are set forth in his work-papers (Exhibit No. BPP-20, at 22-23).

96. Dr. Vander Weide states that it is appropriate to include flotation costs in estimating cost of equity because all firms that have sold securities in the capital markets have incurred some level of flotation costs, including underwriters' commissions, legal fees, printing expense, etc. However, to be conservative, Dr. Vander Weide does not include a flotation cost allowance in his DCF calculations. Dr. Vander Weide estimates the real costs of equity on December 2007, December 2008, and September 30, 2009 by subtracting the percentage change in the Consumer Price Index (CPI) over the previous 12 months from his nominal cost of equity estimate in each period. Dr. Vander Weide states that because the inflation factor is negative on September 30, 2009, he conservatively set the real cost of equity equal to its nominal cost of equity for this period—12.35% (Exhibit No. BPP-20, at 23).

97. Dr. Vander Weide sets the real cost of equity equal to the nominal cost of equity for the period ending September 30, 2009, but not in previous periods. He states that although the real cost of equity is necessarily greater than the nominal cost of equity when inflation is negative, the use of a greater than nominal real cost of equity tends to increase current rates. To reduce this impact on current rates, the Company asked that he conservatively set the real cost of equity equal to the nominal cost of equity at September 30, 2009. Based on his assessment of BPPA's nominal costs of equity, the rates of inflation in the CPI, and the Company's request, he recommends real median costs of equity for December 2007, December 2008, and September 30, 2009 equal to 7.19%, 14.14%, and 12.35%, respectively (Exhibit No. BPP-20, at 24).

98. Dr. Vander Wiede recommends for 2005 and 2006, the cost of equity input values set forth in the compliance filing made on July 21, 2008 by the TAPS Carriers in response to Opinion 502. Since the Commission has accepted these input values for 2005 and 2006 as reasonable estimates of TAPS Carrier's costs of equity, he believes it is also reasonable to use them for those years in this proceeding. Dr. Vander Weide assesses the capital structure ratios for these periods by calculating the average percentages of long-term debt and common equity in the capital structures of his proxy companies as reported on their consolidated balance sheets in their Form 10-K annual report and Form 10-Q quarterly report filings with the United States Securities and Exchange Commission (Exhibit No. BPP-20, at 26).

99. Dr. Vander Wiede reviewed the capital structure input values filed by the TAPS Carriers for 2005 and 2006 in the Carriers' July 2008 Compliance Filing. Dr. Vander Wide assesses the costs of long-term debt for these periods by estimating the average embedded costs of long-term debt of his proxy companies for these periods. Dr. Vander Weide states that his use of the average embedded costs of long-term debt of his proxy group of MLPs is required by Opinion 502. Dr. Vander Weide includes Enbridge's commercial paper outstanding as of December 31, 2007 in his cost of long-term debt calculations for Enbridge because Enbridge classified its commercial paper as long-term debt on its consolidated balance sheet in its 2007 Form 10-K (Exhibit No. BPP-20, at 28-29).

100. Dr. Vander Weide states that it is appropriate to impute a long-term debt interest rate to Enbridge's commercial paper that was classified as long-term debt because the interest rate on commercial paper is not indicative of the interest rate Enbridge will likely pay on the long-term debt that replaces its short-term debt. He imputes the average interest on Moody's rated utility bonds as of the balance sheet date to the commercial paper that Enbridge classified as long-term debt. Dr. Vander Weide believes this estimate is a reasonable estimate of the interest rate Enbridge would likely pay on the long-term debt issued to replace such commercial paper (Exhibit No. BPP-20, at 29-30).

#### 4. John R. Haines

101. Mr. Haines is a petroleum engineer employed as a Senior Commercial Analyst for BPPA. He has worked for BP or its predecessors for 28 years, all relating to BP's Alaska business. Mr. Haines provides tariff analysis and business evaluation in support of the management of BPPA's undivided joint interest in TAPS. The purpose of his testimony is to explain the Cost Allocation Mechanism BPPA proposes the Commission adopt for TAPS Carriers. The mechanism is designed to allocate two types of costs by Alyeska: (1) operating expenses incurred in a given year that are intended to be recovered through the tariff in that same year; and (2) long-term capital investments intended to be recovered through the tariff in the form of depreciation (return of investment) and return (return on investment) over multiple years (Exhibit No. BPP-10, at 1-3).

102. The Cost Allocation Mechanism realigns the first item, operating expenses, through a series of quarterly adjustments to keep with the real-time nature of these costs. The mechanism realigns the second item, capital investments, on an annual basis by adjusting costs for depreciation and return according to usage to keep with the multi-year manner in which these costs are recovered through rates (Exhibit No. BPP-10, at 3-4).

103. Under the Cost Allocation Mechanism the allocation of day-to-day operating expenses is straightforward. Day-to-day operating expenses refers to the distance and non-distance related operating costs incurred by Alyeska on an ongoing basis, along with ad valorem taxes paid to state and local governments by Alyeska. These operating costs are incurred each day over the course of a year, and they are recovered through the tariffs (on a usage basis) over the course of the year. He notes that because operating costs are relatively easy to determine on an on-going basis, those costs can be pooled during a year as they are incurred. Mr. Haines further states that it would be preferable to minimize the number of true-ups so as to avoid disrupting systems that Alyeska already has in place and to add these adjustment activities in a manner that does not create an undue administrative burden for Alyeska (Exhibit No. BPP-10, at 4).

104. Mr. Haines states that BPPA's Cost Allocation Mechanism accomplishes this objective. Under the mechanism, Alyeska will continue to bill out daily cash calls on an ownership basis as it does now. However, on a quarterly basis the gross actual expenditures pertaining to operating expenses and ad valorem taxes (as recorded by Alyeska and incurred by the Owners on an ownership basis) would be allocated to each Owner on a usage basis to be consistent with the cost of service tariff methodologies used to calculate rates (Exhibit No. BPP-10, at 4-5).

105. He further testified that Alyeska will true up the actual operating costs and ad valorem taxes on a cumulative basis every quarter to reflect actual deliveries to date for the year in which costs are allocated. The quarterly true-ups will distinguish between distance related and non-distance related costs. Distance related costs will be allocated

on running cumulative 100 barrel-mile percentages, while non-distance related costs will be allocated on the running cumulative barrel percentages (Exhibit No. BPP-10, at 5).

106. The Cost Allocation Mechanism identifies costs as either distance or non-distance related because TAPS rates are designed by assigning distance related costs to each destination on a 100 barrel-mile basis and non-distance related costs to each destination on a per barrel basis. Because the Commission has directed Carriers to pool and allocate costs so that costs are allocated in the same manner as revenues are collected through rates, the Cost Allocation Mechanism must track costs on a basis that is consistent with the distance and non-distance distinctions used in the tariff methodology. Alyeska will use the same method it currently uses for that purpose, which is necessary in order for Carriers to identify distance and non-distance related costs for purposes of calculating their rates (Exhibit No. BPP-10, at 5-6).

107. Through the daily cash call system, Alyeska will continue to bill the Owners for all costs on an ownership basis. At the end of each quarter, the Alyeska accounting system will have records of the total dollars of actual operating expenses and ad valorem tax payments that were incurred by the Owners broken out on a Pipeline and Terminal Tankage basis. Alyeska will also have records identifying the number of barrels each Owner has delivered to each destination during the quarter and the known mileage to each destination. At the end of each quarter, Alyeska will compare the dollars actually funded in the previous quarter on a Pipeline and Terminal Tankage ownership basis to the dollars that would have been funded on a usage basis to determine the adjustment amounts (Exhibit No. BPP-10, at 6).

108. To determine the individual amounts already incurred (on an ownership basis), Alyeska will identify the total dollars of operating expenses and ad valorem taxes incurred for the quarter on a Pipeline and Terminal Tankage basis and multiply these total dollar amounts by the respective Pipeline and Terminal Tankage ownership percentages of each Owner. To determine the amounts that would have been incurred on a usage basis, Alyeska will start with the total dollars of operating expenses and ad valorem taxes incurred in the quarter and subtract from this amount the non-distance related costs resulting in the distance related cost total (Exhibit No. BPP-10, at 7).

109. Mr. Haines further observes that it will then multiply the distance related cost total by each Owner's 100 barrel-mile usage percentage for the quarter and then multiply the non-distance related cost total by each Owner's barrel usage percentage for the quarter. Last, it will add each Owner's distance related cost amount with each Owner's non-distance related cost amount to determine the dollars that each would have incurred on a usage basis. Alyeska will then compare the dollar amounts each owner actually incurred for the quarter on an ownership basis to the dollar amount that each would have incurred for the quarter on a usage basis to determine the adjustment amounts pertaining to operating expenses and ad valorem taxes (Exhibit No. BPP-10, at 7-8).

110. Mr. Haines states that Part (B)(1) of Exhibit No. BPP-13, requires Alyeska to bill the Owners within 20 days after the end of each quarter for the amounts due, with payments to be made not later than 30 days after the end of the quarter. At the end of the next quarter, Alyeska will repeat these steps to determine the adjustment amounts for that quarter. The cumulative costs actually incurred on an ownership basis from the beginning of the year to the end of that quarter will be compared to the dollar amounts that would have been incurred on a usage basis from the beginning of the year through the end of the quarter, less the amount of adjustments that have been cumulatively administered in all previous quarters for the year (Exhibit No. BPP-10, at 8).

111. This will determine the incremental adjustments that need to take place in the current quarter. These steps are then repeated in each successive quarter, such that by the time the 4Q adjustment has been made, all Alyeska-incurred operating costs and ad valorem tax costs will have been paid for by each Owner on a usage basis for the calendar year just ended. Alyeska will conduct an annual reconciliation to reflect actual deliveries as reported in the Carriers' FERC Form 6 Annual Reports and actual costs that Alyeska reports to Carriers annually in the FERC Form 6 Data Report (Exhibit No. BPP-10, at 9).

112. Mr. Haines notes that capital costs are incurred in a given year, but the one-time incurrence of that investment cost spawns a multi-year stream of depreciation and return elements in the tariff. Costs for return on investment are recovered through the following subcomponents of the cost of service: (1) interest expense; (2) return on equity; (3) amortization of AFUDC; (4) amortization of deferred return; and (5) income tax allowance.

113. These five return elements, along with depreciation, comprise all of the costs contained within the cost of service that arises from capital investments made by the Carriers. Capital investment costs incurred by Alyeska are components of the cash calls Alyeska bills to the Owners on an ownership basis. The Cost Allocation Mechanism will not change this procedure. Each Owner will continue to fund capital investments at its ownership percentage. However, at the end of each calendar year, the Cost Allocation Mechanism will compare each Owner's usage percentage to its ownership percentage to determine depreciation and return adjustment. If, for a year, an Owner's usage percentage exceeds its ownership percentage, then that Owner will have under-funded its share of costs relative to usage for that year and will be required to pay an amount equal to its underfunded costs (Exhibit No. BPP-10, at 9-10).

114. Likewise, an Owner whose usage percentage is less than its ownership percentage during a year will have over-funded costs relative to usage and will be entitled to receive payback of this over-funding. Since TAPS is a single system, the dollar amounts paid out collectively by Owners with usage in excess of their ownership will be equal to the dollar amounts received collectively by Owners with usage less than their ownership. Finally, for tariff rate design purposes, since the depreciation and return which arise from capital

expenditures are considered distance related costs, the Cost Allocation Mechanism allocates these costs on the basis of each Owner's respective 100 barrel-mile percentage (Exhibit No. BPP-10, at 10-11).

115. There are additional distinctions for interstate vs. intrastate usage. In practice TAPS traffic is a mix of interstate and intrastate service with the much larger portion being interstate. The Cost Allocation Mechanism solves this problem by applying Opinion 502 and Order 151 methodologies proportional to the interstate and intrastate throughput levels that occur in each year across TAPS. The mechanism starts by using a stand-alone calculation to determine the cost of service on a total TAPS basis (in each year) under Opinion 502 based on the total capital investment incurred by the Owners through Alyeska. It does the same thing on a total TAPS basis under Order 151 (Exhibit No. BPP-10, at 11).

116. On the interstate side, the Model calculates for each year what is referred to in the Model as the Depreciation and Return Portion of FERC TRR, consistent with the assumption in Opinion 502 that this methodology is applied to 100% of the barrels. These dollar amounts include the interstate depreciation determined by the Model plus the five return elements mentioned above (i.e., interest expense, return on equity, amortization of AFUDC, amortization of deferred return, and income tax allowance). With respect to the interstate portion of traffic on TAPS, if at the end of the year, it is determined that the percentage of interstate traffic was 90% on a 100 barrel-mile usage basis, then the Depreciation and Return Portion of FERC TRR is multiplied by 90% to determine an amount called the Interstate Depreciation and Return Portion of FERC TRR (Exhibit No. BPP-10, at 12).

117. Mr. Haines further describes that on the intrastate side, in a similar fashion, an amount is calculated in each year for the Depreciation and Return Portion of RCA TRR consistent with the assumption under RCA's Order 151 that this methodology is applied to 100% of the barrels. This amount is multiplied by 10% (representing the 10% of intrastate traffic for the year on a 100 barrel-mile usage basis) to arrive at the Intrastate Depreciation and Return Portion of RCA TRR. The sum of the Interstate Depreciation and Return Portion of FERC TRR plus the Intrastate Depreciation and Return Portion of RCA TRR represents the dollars of depreciation and return that TAPS would have incurred as a cost of service in each year. (Exhibit No. BPP-10, at 12).

118. By multiplying the Interstate Depreciation and Return Portion of FERC TRR by each Owner's composite ownership percentage, we can then determine the contribution to depreciation and return that each Owner has already provided (through its ownership-based capital funding) to the interstate side of TAPS. To simplify, composite ownership percentages are used rather than individual Pipeline and Terminal Tankage ownership percentages. In this step, the Interstate Depreciation and Return Portion of FERC TRR is multiplied by the composite ownership percentage of each Owner to determine the

individual amounts called Interstate Depreciation and Return Portion of FERC TRR by Carrier Based on Ownership-Funded Costs (Exhibit No. BPP-10, at 13).

119. This process is then repeated for the intrastate side. The Intrastate Depreciation and Return Portion of RCA TRR is multiplied by the composite ownership percentage of each Owner to determine the individual amounts called Intrastate Depreciation and Return Portion of RCA TRR by Carrier Based on Ownership-Funded Costs. This is then all compared to actual usage (on the 100-barrel-mile usage parameter) for the year to determine over-contributions to the cost of service and under-contributions to the cost of service (Exhibit No. BPP-10, at 13-14).

120. The Interstate Depreciation and Return Portion of FERC TRR is multiplied by a percentage representing an individual Owner's 100 barrel-miles of interstate traffic divided by TAPS' 100 barrel-miles of interstate traffic. This yields an owner-by-owner calculation of the interstate cost of service amount for depreciation and return that each Owner should have paid based on usage. It is labeled, Interstate Depreciation and Return Portion of FERC TRR by Carrier Based on Usage (Exhibit No. BPP-10, at 14).

121. The difference between each Owner's Interstate Depreciation and Return Portion of FERC TRR by Carrier Based on Ownership-Funded Costs and each Owner's Interstate Depreciation and Return Portion of FERC TRR by Carrier Based on Usage represents the cost of service amount that has either been over-paid or under-paid for the year relative to usage. It is called the Interstate Depreciation and Return Allocation Adjustment. In these calculations, positive numbers mean an Owner has over-paid costs relative to usage, while negative numbers mean an Owner has under-paid costs. The sum of all positive numbers and all negative numbers is zero (Exhibit No. BPP-10, at 14).

122. Mr. Haines testifies that the same process is repeated for the intrastate side, resulting in a similar series of dollar amounts labeled, Intrastate Depreciation and Return Allocation Adjustment. On an owner-by-owner basis, the sum of the Interstate Depreciation and Return Allocation Adjustment and the Intrastate Depreciation and Return Allocation Adjustment is called the Total Depreciation and Return Allocation Adjustment Before Interest. In order to understand the concept, assume there are two owners of TAPS – Carrier A and Carrier B. Carrier A owns 60% of TAPS (and pays 60% of the capital costs through Alyeska cash calls), yet Carrier A only transports 45% of the traffic on a barrel-mile basis. Carrier B owns 40% of TAPS (and pays 40% of the capital costs through Alyeska cash calls) and transports the other 55% of traffic (Exhibit No. BPP-10, at 15).

123. The depreciation and return streams that arise from Carrier A's investments are 60% of the system-wide depreciation and return amounts. Likewise, Carrier B has funded 40% of the system-wide depreciation and return. Because Carrier B has 15% more usage than cost contribution (= 55%-40%), and Carrier A has 15% less usage than

cost contribution (= 45%-60%), the cost allocation adjustment is 15% of the system-wide depreciation and return; a cost pooling adjustment that Carrier B would be required to pay to Carrier A (Exhibit No. BPP-10, at 15).

124. After the cost pooling payment, Carrier B will have contributed 55% of the total cost: 40% through direct capital investment (creating 40% of the system-wide depreciation and return stream) plus another 15% in the form of a cost pooling payment. Carrier B's total funding contributions are thus aligned with its 55% of usage. Similarly, Carrier A will have contributed 45% of the total cost: 60% through direct capital investment (creating 60% of the system-wide depreciation and return stream) minus 15% in the form of an allocation adjustment. Its funding contribution is thus aligned with its 45% of usage (Exhibit No. BPP-10, at 15-16).

125. The primary inputs to the Cost Allocation Mechanism are the annual cost and volume data that is routinely maintained by Alyeska. However, the calculation of Depreciation and the Return Portion of TRR requires additional inputs, including the cost of debt, nominal rate of return, inflation rate, capital structure and amortization or depreciation rate. Going forward, Alyeska will use as a reference for such inputs the most recent rate filing made by a Carrier that calculates cost of service rates on a uniform basis and that is (or was) in effect for at least 90 days prior to the end of the subject year. If those inputs are later revised by the Commission, the calculation of Depreciation and the Return Portion of TRR will be revised to reflect the changed inputs, and the allocation of costs among Carriers will be adjusted (Exhibit No. BPP-10, at 17-18).

126. Mr. Haines further states that the volume data that Alyeska will utilize when performing the annual depreciation and return adjustments will be the actual deliveries as reported in Carriers' FERC Form 6 Annual Reports. The cost data that Alyeska will utilize will be the actual carrier property amounts that Alyeska reports to Carriers annually in a FERC Form 6 Data Report. He notes that BPPA has created this Cost Allocation Model, which automates these calculations so that Alyeska, as administrator of the Model, can populate it with a limited number of inputs, and the results will automatically flow into the output section. The Cost Allocation Mechanism allocates among Carriers virtually all of TAPS costs on the basis of usage of TAPS. The mechanism allocates all of the actual costs incurred by Alyeska that are billed to TAPS Owners, except for costs associated with asset retirement obligations (which are not part of the cost of service under Opinion 502 or Order 151). The Cost Allocation Mechanism does not include, however, overhead costs that each Carrier incurs directly (Carrier direct Costs) (Exhibit No. BPP-10, at 18).

127. He notes that Carriers' direct costs constitute a very small part of the total TAPS cost of service. The exclusion of these costs from the Cost Allocation Mechanism will allow each Carrier to recover in tariffs the TAPS average (per-barrel) cost for total Owner-direct Costs proportional to its usage. Under this approach, each Carrier or Owner, will have an incentive to keep its costs low. Ratepayers would benefit to the

extent this approach induced a Carrier to reduce its direct Costs below TAPS average levels. He notes further that the Cost Allocation Mechanism also allocates among Carriers ad valorem property taxes, which are considered direct costs, but billed to Alyeska. Ad valorem tax costs are substantial. In 2009, the gross ad valorem tax bill was in excess of \$180 million (Exhibit No. BPP-10, at 19-20).

128. The obligation for a Carrier to provide in-kind fuel gas for the operation of TAPS is also excluded from the Cost Allocation Mechanism, as this obligation is already allocated among Carriers based on each Carrier's respective usage of TAPS. He observes that the Model is intended to be used on an annual basis. Alyeska will perform the quarterly operating cost adjustments on a running basis such that by the end of the calendar year, all distance and non-distance related operating costs and ad valorem taxes will be allocated on a usage basis for the year just ended (Exhibit No. BPP-10, at 20).

129. Mr. Haines indicates further that this system of quarterly adjustments can be administered by Alyeska using information that is already contained in Alyeska's accounting records. The primary purpose of the Cost Allocation Model is to provide a mechanism to enable Alyeska to perform the annual depreciation and return allocations and a mechanism to ensure that all adjustments performed during the year are trued-up for the entire year (Exhibit No. BPP-10, at 21).

130. The Model displays the annualized results of the operating cost adjustments that should be applied over the course of the year using volumes from the Owners' FERC Form 6 Annual Reports and costs from Alyeska's FERC Form 6 Data Report (Exhibit No. BPP-10, at 21). The results of the annual Model run, which includes the annual depreciation and return adjustments plus any conforming adjustments pertaining to operating costs and ad valorem taxes, represents all amounts that will need to be paid on May 10 (following the calendar year) (Exhibit No. BPP-10, at 21).

131. Mr. Haines indicates that in his view, the 2009 Rehearing Order requires that Carriers include a pooling arrangement in their tariff and to submit it to the Commission for review. In response, BPPA developed the tariff language attached as Exhibit No. BPP-13, which the Commission can use as a prototype. The tariff provision that sets forth the Cost Allocation Mechanism is divided into five parts: Part (A) sets forth definitions used in the mechanism; Part (B) sets forth the mechanism for allocating operating expenses and ad valorem taxes on a quarterly and annual basis; Part (C) sets forth the mechanism for allocating annual depreciation and return-related costs among Carriers; Part (D) reallocates costs for 2009 as a distinct year; and, Part (E) reallocates costs for 2005-2008 on the basis of Carriers' respective usage of TAPS (Exhibit No. BPP-10, at 21-22).

132. The BPPA Model has been designed to make retroactive calculations on an annual basis in any year back to 2005, if the Commission determines that the Cost Allocation Mechanism has an effective date prior to 2009. For purposes of making adjustments for

2005-2008, the Model identifies dollar amounts that should have been paid on a usage basis during retroactive periods, plus adjustment dollars already paid between the Owners during prior time periods that will need to be netted-out from the above calculations (Exhibit No. BPP-10, at 23).

133. TSA Section II-2(f) cost pooling adjustments were made among the Owners during years 2005-2008, along with Variable Cost Adjustments made each year by Alyeska under TAPS Operating Agreement (i.e., fuel, power and drag reducing agent). Allocations previously performed under TSA Section II-2(f) and the Variable Cost Adjustments previously performed by Alyeska have been netted-out from the above results to determine the incremental 2005-2008 adjustments required to align with the uniform tariff methodology. No interest has been applied to these amounts. Because calendar year 2009 is now completed, if the Commission orders the Cost Allocation Mechanism to have an effective date in any year within the range of 2005-2009, then a cost pooling calculation must be made for 2009 (Exhibit No. BPP-10, at 23-24).

134. Mr. Haines indicates that the Cost Allocation Model is on Excel. The Model has been laid out so that Alyeska, as administrator of the Model, can go to the input section and enter the requisite annual data, and the results will automatically flow to the output section. The individual worksheets are intended to perform each of the steps involved in the process to make the overall structure straightforward. There are four key areas in the Model: (1) Schedules 1-3, where the allocations are made; (2) Schedule 4, where Alyeska will enter the annualized data inputs (costs, volumes, and certain tariff-based parameters); (3) a section where Opinion 502-based depreciation and return streams are calculated on a TAPS-wide basis; and, (4) a similar section where Order 151-based depreciation and return streams are calculated on a TAPS-wide basis (Exhibit No. BPP-10, at 25-26).

## **5. Dr. Lisa J. Cameron**

135. Dr. Cameron has a B.S. degree in Applied Economics from Cornell University and Ph.D. in Economics from Stanford University. She is a Senior Consultant at the Brattle Group, a firm that provides consulting services in economics, finance, business transactions and regulations. Dr. Cameron's testimony provides economic analysis of three issues: (1) how the current uniform rate regime impacts the ability of individual Carriers to recover their costs in the absence of a cost pooling mechanism such as BPPA's Cost Allocation Mechanism; (2) how application of BPPA's Cost Allocation Mechanism would impact the ability of individual Carriers to recover their costs under the uniform rate regime; and (3) whether application of BPPA's Cost Allocation Method will be in the interest of better service to the public or of economy of operation and will not unduly restrain competition (Exhibit No. BPP-5, at 1-3).

136. Dr. Cameron agrees with the Commission that the current regime in which costs are allocated among Carriers based on ownership shares is incompatible with uniform, cost-based rates and the allocation of revenues among Carriers based on throughput shares. Because TAPS ownership shares do not coincide with TAPS throughput shares, under the current regime some Carriers can be expected to over-recover their costs while other Carriers can be expected to under-recover their costs on a persistent basis. Persistent under-recovery and persistent over-recovery are inconsistent with the principles of cost-based regulation. Moreover, Carriers that are under-recovering have less incentive to support discretionary investments in TAPS investments that could make the pipeline run at lower cost in the long run (Exhibit No. BPP-5, at 5).

137. Dr. Cameron agrees with the Commission that it is necessary to implement a mechanism that will allocate responsibility for TAPS costs to Carriers based on usage. She analyzes the mechanism created by the BPPA Cost Allocation Model and finds that it would provide each Carrier with an opportunity to earn a fair rate of return on its investments in TAPS. She also opines that the mechanism created by the BPPA Model would be in the interest of better service to the public, as well as economy of TAPS operation, since it will remove under-recovering Carriers' disincentives to make discretionary efficiency-enhancing investments that could allow the pipeline to operate more efficiently and extend its economic life, and over-recovering Carriers' incentives to over invest in TAPS (Exhibit No. BPP-5, at 5-6).

138. Dr. Cameron believes that the Commission's implementation of the regime created by the Cost Allocation Mechanism would not unduly restrain competition for the following reasons. Almost all barrels subject to TAPS interstate tariffs are provided by shippers that are vertically integrated with a TAPS Carrier. Therefore, the regime created by the Cost Allocation Mechanism will not significantly alter incentives for taking advantage of discounts on TAPS interstate tariffs (Exhibit No. BPP-5, at 6).

139. In her view, the affiliated shippers have strong incentives to tender to their own Carrier affiliates, regardless of any interstate tariff discounts offered by other Carriers. Moreover, it is reasonable to expect that affiliated shippers will continue to account for the vast majority of interstate oil on TAPS. Dr. Cameron believes the Commission has ensured that no shipper will pay more than a just and reasonable rate for interstate transportation on TAPS. TAPS interstate shippers receive the same type of protection from unreasonable rates as shippers on other rate-regulated pipelines (Exhibit No. BPP-5, at 6).

140. Dr. Cameron testifies that Opinion 502 has the requirement that there should be a uniform rate and that no Carrier should be allowed to charge more than that rate. Opinion 502 also recognizes that as part of the process of establishing just and reasonable rates, the Commission has authority to order pooling adjustments based on actual usage in order to address the problem of under- or over-recovery of costs. The 2009 Rehearing Order recognizes the potential for under- or over-recovery as a result of TAPS' unique

cost allocation methodology. It proceeds to state that Carriers should develop a pooling mechanism that reallocates all of Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS (Exhibit No. BPP-5, at 7-8).

141. Currently, she notes that the vast majority of TAPS costs are shared among Carriers in proportion to their ownership shares in TAPS. Prior to 2009, TAPS costs were shared on a different basis under the operation of a mechanism specified in the TSA. Under this mechanism, operating costs, ad valorem taxes, depreciation costs and an allowance for future dismantlement were allocated among Carriers on the basis of throughput (Exhibit No. BPP-5, at 8-9).

142. Dr. Cameron states that in order to see how the current circumstances causes individual Carriers to under-recover or over-recover, it is necessary to consider how an individual Carrier earns its revenues and is charged for its share of costs. Currently, each Carrier earns revenues by charging a per-barrel transportation rate for each barrel of oil that it carries. Since rates are uniform, Carrier revenues are proportional to throughput. In contrast, each Carrier has paid for its past investments in TAPS in proportion to its share of ownership in TAPS (Exhibit No. BPP-5, at 9).

143. On-going costs, both operating expenses and incremental investment, are paid for on the same basis. Since revenues under Opinion 502 are designed to cover the expected cost of service for TAPS as a whole, she states that an individual Carrier's revenues would only be sufficient to cover its individual share of costs if its share of TAPS ownership were equal to its share of TAPS throughput. If a Carrier's share of TAPS ownership exceeds its share of TAPS throughput, its revenues will not cover its costs, and such a Carrier will earn less than a fair rate of return (Exhibit No. BPP-5, at 9).

144. On the other hand, Dr. Cameron believes that if a Carrier's share of TAPS ownership is below its share of TAPS throughput, it will earn more than a fair rate of return. She states that BPPA owns about 47% of TAPS (the basis on which investment has been made) but in 2009 carried only about 35% of TAPS throughput (the current basis for revenues). Hence, BPPA under-recovered its costs. In contrast, CPTAI, which owns about 28% of TAPS but in 2009 carried about 41% of TAPS throughput; over-recovered its costs. BPPA's under-recovery and CPTAI's over-recovery can be expected to persist for the foreseeable future in the absence of adopting BPPA's Cost Allocation Mechanism or another mechanism that achieves a similar result (Exhibit No. BPP-5, at 9-10).

145. Dr. Cameron further states that in her view, Carriers cannot discount their tariffs and attract additional barrels, thereby earning their required rates of return. She indicates that oil producers that are vertically integrated with a Carrier supply, almost all of the oil that is shipped on TAPS at interstate rates. Each of these vertically integrated shippers has strong economic incentives to affiliate tender. As a result, an under-recovering

Carrier cannot expect to gain enough additional barrels through discounting to cover its total costs. The expectation that BPPA and similarly situated Carriers will under-recover their costs on a persistent basis, while other Carriers will over-recover on a persistent basis, is inconsistent, in her opinion, with the principles of cost-based regulation (Exhibit No. BPP-5, at 10-11).

146. One of the fundamental precepts of regulatory policy in her opinion, is that all investors subject to cost-based regulation be provided with a reasonable opportunity to recover their costs, including a fair return on investment. The problem of some Carriers persistently under-recovering is explicitly recognized in both Opinion 502 and the 2009 Rehearing Order (Exhibit No. BPP-5, at 11).

147. Moreover, Dr. Cameron believes that the current situation has a negative impact on Carriers' incentives and ability to coordinate among themselves and carry out efficient investments in TAPS on a going forward basis. This is because BPPA and other Carriers that are assured of under-recovery on past investment are also assured of under-recovery on any incremental investment they make in the future. These Carriers have a reduced incentive to support future discretionary investment. At the same time, over-recovering Carriers have an incentive to over invest in TAPS (Exhibit No. BPP-5, at 11-12).

148. She states further that there are two features of TAPS that cause the current circumstances to produce these results. First, the vast majority of throughput that a Carrier can hope to attract will be the production of its own affiliate. Second, the distribution of ownership of production among Carriers' affiliates does not match the distribution of TAPS ownership among Carriers. The current regime—in which TAPS costs are allocated based on ownership, but revenues are proportional to throughput—produces the outcomes described above. Carriers that own a high proportion of TAPS but carry a low proportion of TAPS throughput can expect to recover less than their cost of service on a persistent basis (Exhibit No. BPP-5, at 12).

149. Dr. Cameron testifies further that the current situation impacts the incentives of both under- and over-recovering Carriers. A Carrier that is over-recovering has an incentive to over invest in TAPS because it reaps the benefit of higher rates on its throughput without bearing its share of the costs associated with the investment. In contrast, a Carrier that is under-recovering has the opposite incentive. Under the TAPS Operating Agreement, which governs the process through which Carriers make investments in TAPS, expenditure decisions require the agreement of BPPA (the largest Carrier), plus one of the next largest Carriers (either CPTAI or EMPCo) plus one other Carrier (Exhibit No. BPP-5, at 12-13).

150. Given this structure, the fact that some Carriers, such as CPTAI, are expected to over recover and others, such as BPPA, are expected to under-recover can lead to gridlock with respect to new investment. Alyeska's 2010 Long Range Plan includes a ten-year forecast of future capital investment, which sums to over \$1.2 billion. Of this

amount, investments totaling approximately \$500 million will require evaluation by Carriers as to their economic merits. The absence of such projects would result in a sub-optimal system with higher operating costs and more frequent down time. A regime that eliminated Carriers' expectations of persistent under-recovery and thus removed their disincentives to agree to make efficient investments in TAPS, while at the same time removing incentives of over-recovering Carriers to over invest, would be in the interest of better service to the public or efficiency of operation. As long as revenues are collected in proportion to throughput, TAPS costs should be allocated among Carriers on the same basis (Exhibit No. BPP-5, at 13).

151. Dr. Cameron opines that if the Commission implemented the BPPA Cost Allocation Mechanism, the interests of all Carriers would be better aligned, and all Carriers would have an equal opportunity to earn a fair return on invested capital, in accordance with the principles of cost-based regulation. In her view, all Carriers would be incentivized to undertake incremental investments that are cost-effective (Exhibit No. BPP-5, at 14).

152. Dr. Cameron further states that interstate shipments will continue to be dominated by affiliated shippers. The amount of in state demand significantly exceeds the amount of non-affiliated barrels expected to be produced each year during the period 2010-2013. Given the incentives of the refiners and the affiliated producers as well as the State's declared interest in helping non-affiliated producers, it is likely that the majority of these barrels will remain in State, as is the case today. Currently, as a result of various circumstances, a portion of in State demand is being filled with production from affiliates with tankers calling at Valdez (Exhibit No. BPP-5, at 17).

153. Moreover, Dr. Cameron indicates that Exhibit No. BPP-9HC is designed to consider the impact on interstate shipments of non-affiliated barrels if these conditions remain in place over the period 2010-2013. Exhibit No. BPP9HC takes the amount of in-State demand accounted for by affiliate production as given. It then computes the difference between the balance of in State demand and the supplies of all other producers (those without tankers calling at Valdez) (Exhibit No. BPP-5, at 18-19).

154. Dr. Cameron believes that this projected difference, which ranges from approximately 2% to 7% of total ANS production over the period 2010 through 2013, is an over estimate of the amount of non-affiliated barrels that may not be absorbed by in State refineries during this period. Under cost of service regulations, the unaffiliated barrels will never be charged more than a just and reasonable rate. TAPS interstate shippers receive the same type of protection from unreasonable rates as shippers on other rate regulated pipelines (Exhibit No. BPP-5, at 18-19).

155. Dr. Cameron opines that the regime created by the Cost Allocation Mechanism will be consistent with all of the Commission's requirements, while the current regime is not. The Cost Allocation Mechanism allows for uniform, cost-based rates, reallocating

TAPS costs among Carriers based on usage. It eliminates the problem of persistent over- and under-recovery among Carriers, and in so doing, eliminates disincentives for efficiency enhancing discretionary investments in TAPS (Exhibit No. BPP-5, at 19-20).

156. Dr. Cameron further states that production affiliates currently account for almost all of the barrels subject to interstate rates and can be expected to do so for the foreseeable future. Because these entities engage in affiliate tendering, they will not be harmed by any change in the availability of interstate tariff discounts associated with the regime created by the Cost Allocation Mechanism. Furthermore, under cost of service regulation, no shipper will be charged more than a just and reasonable rate (Exhibit No. BPP-5, at 20).

### **C. Indicated TAPS Carriers – Direct Testimony**

#### **1. Dr. Bruce H. Fairchild**

157. Dr. Fairchild is a principal in Financial Concepts and Applications, Inc., a firm engaged in financial, economic, and policy consulting to business and government. Dr. Fairchild holds a B.A. degree from Southern Methodist University and a MBA and PhD from the University of Texas at Austin. He is also a Certified Public Accountant. His previous employment includes working in the Comptroller's Department at Sears, Roebuck and Company and serving as Assistant Director of Economic Research at the Public Utility Commission of Texas. Dr. Fairchild has been on the business school faculties at the University of Colorado at Boulder and the University of Texas at Austin (Exhibit No. ITC-1, at 1-2).

158. The purpose of Dr. Fairchild's testimony is to recommend a reasonable rate of return by Carriers in connection with their respective TAPS rate filings. His analyses are based on capital market data and other financial information available in late April and early June of 2009. Dr. Fairchild states that the rate of return serves to compensate shareholders for the use of their capital to finance the plant and equipment necessary to provide service (Exhibit No. ITC-1, at 3).

159. Investors commit money in anticipation of earning a return on their investment commensurate with investment alternatives having comparable risks. Consistent with both sound regulatory economics and the standards specified in the U.S. Supreme Court cases of *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of the State of W. Va.*, 262 U.S. 679 (1923), and *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the return on equity allowed a pipeline must be sufficient to: (1) fairly compensate capital presently invested in the pipeline; (2) enable the pipeline to offer a return adequate to attract new capital on reasonable terms; and (3) maintain the pipeline's financial integrity. Dr. Fairchild recommends that Carriers be authorized to earn an overall rate of return of 9.78% on their investments in TAPS. As shown on Exhibit No. ITC-3, this rate of return is based on capital structure ratios of 53.98% debt and 46.02% equity, a cost of

debt of 6.19%, and a real rate of return on common equity of 14.01% (Exhibit No. ITC-1, at 4).

160. Details of Dr. Fairchild's recommended capital structure ratios, cost of debt, and rate of return on equity are contained in Exhibit Nos. ITC-4, ITC-5, and ITC-6, respectively. A firm's capital structure reflects the mix of capital sources (e.g., debt and equity) used to finance its permanent assets (Exhibit No. ITC-1, at 3).

161. Dr. Fairchild opines that in Opinion 502, the Commission directed that the rate of return for TAPS is to be based on capital structure ratios of a group of proxy firms, not those of its owners. A proxy group is designed to serve as a representative sample of firms having risks and other financial characteristics comparable to the activity at issue, and from which relevant data can be developed. The first step in developing capital structure ratios for present purposes was to identify a proxy group. The Commission requires that firms to be included in the proxy group for an oil pipeline such as TAPS are to be substantially engaged in the oil pipeline business for at least five years, have publicly traded equity and have a 5-year growth forecast published by I/B/E/S. He observes that, *In Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034 (2009) the Commission indicated that proxy companies may also need to have an investment grade bond rating.

162. Dr. Fairchild selected the following eight companies, which met the four criteria listed above, for inclusion in his proxy group: Buckeye Partners, LP; Enbridge Energy Partners, LP; Enterprise Products Partners, LP; Kinder Morgan Energy Partners, LP; Magellan Midstream Partners, LP; NuStar Energy, LP; Plains All American Pipeline, LP; and TEPPCO Partners, LP. In addition, all of these firms have investment grade bond ratings by Standard & Poor's and Moody's Investors Service. For the eight proxy firms, Dr. Fairchild's obtained their December 31, 2008 balance sheets published in their respective 2008 Form 10-Ks (Exhibit No. ITC-1, at 5-6).

163. He then determined the amounts of long-term debt and equity for each firm, shown on Exhibit No. ITC-4. Each firm's debt and equity ratios as of December 31, 2008 were calculated by dividing the respective amounts of long-term debt and equity by the sum of long-term debt and equity. Dr. Fairchild then took the simple average of the debt and equity ratios for the eight firms in the proxy group to arrive at his recommended capital structure ratios of 53.98% debt and 46.02% equity. These calculations are shown at the bottom of Exhibit No. ITC-4 (*See also* Exhibit No. ITC-1, at 6).

164. He states that as directed by Opinion 502, the cost of debt for TAPS is to be based on the cost of debt of the proxy group. Dr. Fairchild obtained data regarding the cost of debt for each proxy group company from the footnotes to the December 31, 2008 financial statements published in its 2008 Form 10-K. Using this information, Dr. Fairchild then calculated an average cost of debt for each proxy firm. For each issue or type of long-term debt, the embedded cost, or the cost at year end for variable rate debt,

was determined and applied to the amount of debt outstanding to derive a weighted average cost of debt for each proxy firm. The only debt excluded from this calculation was special purpose debt, because it is generally used for a specific project and is not available to finance general corporate assets (Exhibit No. ITC-1, at 7).

165. Dr. Fairchild's recommended average embedded cost of debt for each proxy company is displayed in Exhibit No. ITC-5. The average cost of debt for the proxy group is 6.19%. Dr. Fairchild states he followed the Commission's methodology to develop a nominal rate of return on equity, which uses a DCF model applied to a group of proxy companies. Dr. Fairchild states he used the same group of companies that he used to develop his recommended capital structure ratios and cost of debt (Exhibit No. ITC-1, at 7).

166. Furthermore, he states that the Commission's DCF model estimates investors' required rate of return, or the cost of equity, for each of the proxy firms by summing its expected dividend yield and a two stage growth rate. The details of Dr. Fairchild's application of the Commission's DCF model are shown in Exhibit No. ITC-6. The first step in calculating each firm's expected dividend yield is to obtain a representative stock price. Under the Commission's methodology, this is the average of the monthly high and low prices over the previous six months, which for present purposes was between November 2008 and April 2009 (Exhibit No. ITC-1, at 7-8).

167. Dr. Fairchild then divided each firm's current annualized cash dividend or distribution by its six-month average stock price to calculate a current, or unadjusted, yield. The high, low, and average stock prices for each firm in the proxy group and the annualized cash distributions and unadjusted yields, which range from a low of 8.84% to a high of 13.32%, are shown in Exhibit No. ITC-6. He states that these current yields will be converted to expected dividend yields once a growth rate has been determined.

168. According to Dr. Fairchild, under the Commission's methodology, a two-stage growth rate is calculated as the weighted average of each firm's 5-year projected earnings growth rate and a long-term, economy wide growth rate. The 5 year projected earnings growth rate is the security analysts' consensus growth rate published by Institutional Brokers' Estimate System (I/B/E/S), and is given a two-thirds weight. The long-term, economy-wide growth rate is the average growth in GDP beginning in 6 years projected by Global Insight, the Energy Information Administration, and the Social Security Administration. This growth rate is given a one-third weight. As shown in Exhibit No. ITC-6, the average projected GDP growth rate was 4.33% (Exhibit No. ITC-1, at 8-9).

169. For firms organized as master limited partnerships (MLPs), which all of the proxy firms are, he states the Commission's methodology requires this average long-term GDP growth rate be reduced by one-half to account for the higher payout ratios of MLPs. According to Dr. Fairchild, as shown in Exhibit No. ITC-6, giving two-thirds weight to each proxy firm's I/B/E/S growth rate, and one-third weight to the adjusted long-term

GDP growth rate of 2.21%, resulted in two-stage growth rates for the proxy firms ranging from 2.72% to 4.39%. Having determined a growth rate, each proxy firm's current yield was converted to an expected yield (Exhibit No. ITC-1, at 9).

170. This was done by increasing the current dividend yield by one-half of one year's growth (i.e., multiplying the current yield by one plus one-half the adjusted growth rate). For the proxy group, this produced the expected dividend yields shown in the column labeled Adjusted Yield on Exhibit No. ITC-6. These expected dividend yields were then combined with the respective two-stage growth rates to calculate a cost of equity estimate for each of the proxy companies, which ranged from 12.71% to 17.43%. From within this 12.71 % to 17.43% range, Dr. Fairchild selected his recommended nominal rate of return on equity of 14.01%. He opines that the Commission's policy is that the median of the range is to be used unless it is can be shown by strong evidence that a higher or lower number from within the range is more appropriate (Exhibit No. ITC-1, at 9-10).

171. Dr. Fairchild opines that the nominal rate of return on equity is not used to calculate the overall rate of return for oil pipelines. The ratemaking methodology for oil pipelines separates the cost of equity into a real component that is used to establish the cost of capital that becomes an element of the cost of service, and an inflation component that is treated as deferred earnings. For the twelve months prior to April 2009, inflation was negative, which conceptually would increase the real cost of equity to above the nominal cost of equity. For present purposes, Dr. Fairchild assumed zero inflation, resulting in a real cost of equity equal to the nominal cost of equity of 14.01% (Exhibit No. ITC-1, at 10).

172. Combining a capital structure of 53.98% debt and 46.02% equity with a cost of debt of 6.19% and a real rate of return on equity of 14.01%, results in Dr. Fairchild's recommended overall rate of return for Indicated TAPS Carriers of 9.78% (Exhibit No. ITC-1, at 11).

## **D. ConocoPhillips - Direct Testimony**

### **1. Joseph C. Falcone**

173. Mr. Falcone is a Commercial Supervisor for ConocoPhillips and is responsible for business and economic analysis. Mr. Falcone received a B.S. degree in Mathematics from the Massachusetts Institute of Technology and a MBA from the Wharton School of the University of Pennsylvania. He has worked in the petroleum industry for thirty years. The purpose of his testimony is to provide factual background regarding TAPS and its history, with particular reference to the facts relevant to the TAPS uniform rate and pooling orders (Exhibit No. CPT-1, at 1-2).

174. Mr. Falcone's states that an undivided joint interest structure differs from a corporate or partnership structure. Under a corporate or partnership structure, multiple

investors share ownership of a single entity that operates as a common carrier providing pipeline service to shippers. Under this kind of structure, there would be one set of tariffs issued by the single entity, which would incur all costs and earn and collect all revenues for its own account. The sharing of costs and revenues among the investors would be governed by the organizational documents (such as articles of incorporation, partnership agreement, etc.) of that particular entity. By comparison, under an undivided joint interest structure there is not a single carrier. Rather, two or more companies each hold a separate and distinct ownership interest in their defined shares of a single facility. In the case of TAPS, there are five owners holding varying percentage interests. Each Carrier manages its undivided joint interest share as a separate enterprise, dealing directly with shippers and regulators (Exhibit No. CPT-1, at 3-4).

175. He further states that each Carrier sets and files its own tariff rates, rules and regulations. Each Carrier solicits and accepts nominations for movements through its own share of the pipeline. The five Carriers are thus in competition for shipper nominations to transport petroleum through TAPS. The five Carriers and their respective TAPS ownership percentages of both the pipeline and terminal assets are: BPPA 46.93% Pipeline and 46.10% Terminal; CPTAI 28.30% Pipeline and 27.25% Terminal; EMPCo 20.34% Pipeline and 21.92% Terminal; Koch 3.08% Pipeline and 3.08% Terminal; Unocal 1.36% Pipeline and 1.66% Terminal (Exhibit No. CPT-1, at 4).

176. Mr. Falcone states that Alyeska is not a regulated common carrier. It does not post tariffs and does not solicit or accept nominations from shippers. Rather, Alyeska is simply the agent of the five Carriers that physically operates and maintains TAPS on their behalf. Costs incurred by Alyeska in performing its role as agent are passed through to Carriers in the form of periodic cash calls (Exhibit No. CPT-1, at 4-5).

177. Alyeska collects no revenue from shippers. The governing practices for Alyeska were agreed to by Carriers and specified in the TAPS Agreement and the TAPS Operating Agreement. Alyeska effectively has no assets, since the entire pipeline and terminal assets are owned directly by Carriers in the percentages shown above. The five Carriers also own shares in Alyeska equal to the pipeline ownership percentages shown above (Exhibit No. CPT-1, at 4-5).

178. The TAPS Agreement, often referred to as the System Agreement, is the foundation contract for the creation of TAPS. Eight pipeline companies entered into it in 1970 in order to design and build the undivided joint interest crude oil pipeline system, including pump stations, terminal, docks, tanks, and other assets. The System Agreement established the initial ownership and design capacity of the pipeline, described how capacity could be expanded and set out how construction was to be managed (Exhibit No. CPT-2, at 9-14).

179. The System Agreement also identifies Alyeska as operator, governs how the operatorship of TAPS can change; how costs (capital and operating) are allocated; how

ownership interest is transferred; how capacity could be expanded; sets the term and procedures for termination of the Agreement; and addresses various other issues (Exhibit No. CPT-2, at 14-37). Mr. Falcone opines that the System Agreement is important to this proceeding because it documents how Carriers agreed to fund all capital and operating costs on TAPS (Exhibit No. CPT-2, at 13, 18-23, 32). Having established the undivided joint interest structure, this Agreement also states that each owner shall utilize its interest solely as an individual common carrier facility, including separately publishing tariffs for its share of the total capacity (Exhibit No. CPT-2, at 14). The TAPS Operating Agreement defines how TAPS operations are managed. It addresses the rights of Carriers and basic operating procedures (Exhibit No. CPT-1, at 5-6).

180. The Operating Agreement was originally executed in 1977, and an amended operating agreement was executed in 1994. Mr. Falcone believes the Operating Agreement is important to this proceeding because it describes in greater detail how certain costs are allocated among Carriers. Specifically, Carriers agreed that fixed operating expenses and capital expenditures will be paid by ownership share and variable operating expenses by usage share (Exhibit No. CPT-3, at 23-24).

181. Mr. Falcone further states that at the time of start-up, the System Agreement established the mechanical design capacity of TAPS at 1,420 thousand barrels per day (MB/D). After the pipeline began operational, a new technology called drag reducing agent (DRA) was developed that allowed the existing facilities to transport more than 1,420 MB/D. An agreement was entered into by Carriers that, among other things, allocated the additional capacity on TAPS created by DRA to each owner in proportion to ownership interest. At its peak in 1988, TAPS carried more than 2.0 million barrels per day (Exhibit No. CPT-1, at 7).

182. Throughput declined on the North Slope by the mid-1990s. There were also disagreements among Carriers about how capacity would be allocated when throughput fell below 1,420 MB/D. Some Carriers took the position that their capacity would be their ownership share of the then-current throughput, while others took the position that their capacity equaled their ownership share of 1,420 MB/D. This dispute was resolved in 1996 with an agreement among Carriers in which they reached a compromise where they agreed to reduce the total capacity in stages over seven years; from 1,420 MB/D to 1,100 MB/D (Exhibit No. CPT-1, at 7-8).

183. Mr. Falcone states that each owner has the right to use its ownership share of this total defined capacity amount. Since the 1,100 MB/D level was reached on January 1, 2004, each Carrier's commercial capacity (i.e., the portion of TAPS on which a Carrier can offer transportation to shippers) remains fixed at its ownership share of 1,100 MB/D (Exhibit No. CPT-1, at 8).

184. Furthermore, Mr. Falcone notes that Alyeska reported that in 2009, TAPS transported an average of approximately 672 MB/D. Because current throughput is less

than total capacity, some Carriers now transport less than their ownership share of capacity. Each Carrier's usage percentage generally varies from its ownership percentage. Mr. Falcone states that if one would assume a pipeline that has two undivided joint interest owners, each holding a 50% interest, and that the pipeline has a total capacity of 100 MB/D. If each Carrier transports 50 MB/D through its respective share of the pipeline, ownership and usage percentages would be equal. However, if Carrier A transports 50 MB/D and Carrier B transports 40 MB/D, Carrier A's usage percentage will exceed its ownership percentage and Carrier B's usage percentage will be less than its ownership percentage (Exhibit No. CPT-1, at 8-9).

185. Mr. Falcone indicates further that a Carrier cannot transport more barrels than its percentage ownership share of the defined capacity as provided in the amended agreement because it cannot transport oil using space that belongs to another Carrier. In fact, CPTAI has frequently had to pro-rate volumes when nominations to its space exceeded CPTAI's ownership share of the defined capacity. Any excess barrels would then be transported by a competing Carrier that has available capacity, with that Carrier collecting the revenue for moving those barrels. CPTAI has taken steps to try to assure itself of having adequate capacity to transport volumes nominated to its space. Over time, CPTAI and its predecessors have purchased additional ownership shares from other Carriers, so that its ownership share has grown from 23.711% of the pipeline at the beginning of 2001, to 28.295% of the pipeline, which is CPTAI's current ownership share. Other Carriers have maintained or reduced their ownership shares (Exhibit No. CPT-1, at 9).

186. Mr. Falcone states further that the amended agreement, which is still in effect, was entered into by Carriers voluntarily, supported by the State, and approved by the FERC as a lawful pooling. It resolved the outstanding questions over what portion of TAPS each Carrier had the right to use based on its ownership interest (Exhibit No. CPT-1, at 9-10).

187. Mr. Falcone also provides a short history of the TSA and its Section II-2(f). Shortly before start-up in 1977, Carriers all filed individual tariffs at the Interstate Commerce Commission. Those rates were protested by the State and others, and extensive litigation ensued. From 1977 to 1985, TAPS operated with no cost pooling. As was stated earlier, under the Operating Agreement, costs were paid by Carriers based on ownership percentage, except those operating expenses that vary directly with throughput (e.g., fuel and power costs), which Carriers were responsible for on a usage basis. In 1984, the State approached then Carrier, ARCO, with a compromise settlement proposal that ultimately became the TSA. In its eventual form, the TSA resolved the existing litigation through 1985 and established a forward-looking methodology for setting rate ceilings on TAPS rates from that point forward. The original ARCO/State settlement had no pooling provision in it and did not affect cost or revenue allocation among Carriers. One at a time, Carriers signed onto the TSA. BPPA was the first to join

after ARCO and, like ARCO, it agreed to the TSA without any pooling provision (Exhibit No. CPT-1, at 10-11).

188. However, Mr. Falcone states that subsequent Carriers negotiated for a pooling provision (Section II-2(f) of the TSA) as a condition of entering into the agreement. Under Section II-2(f), Alyeska's fixed operating expenses that were paid during the calendar year on an ownership basis were annually pooled and then reallocated based on usage. Other pooled components were Alaska ad valorem property taxes, depreciation expense under TSM (TAPS Settlement Methodology), and dismantlement, removal and restoration (DR&R) amounts under TSM. These other pooled components were either initially paid for on an ownership basis, or in the case of DR&R, the ultimate DR&R obligation for each Carrier is on an ownership basis. Section II-2(f) of the TSA was approved as a pooling mechanism by FERC after making the necessary regulatory findings, and Carriers complied with that voluntary pooling agreement from 1985 until the TSA was terminated by the State at the end of 2008 (Exhibit No. CPT-1, at 11-12).

189. Mr. Falcone further opines that currently, in the absence of an approved pooling mechanism, Alyeska fixed operating expenses and capital expenditures are paid on the basis of ownership under the System Agreement and Operating Agreement, just as they were prior to the TSA. State ad valorem property taxes and depreciation expense are not currently pooled, and DR&R is not allocated among Carriers because there are no ongoing DR&R collections in the TAPS rates (Exhibit No. CPT-1, at 11-12).

190. Mr. Falcone states that expert witness Mr. Wetmore's testimony presents and defends a pooling model that closely resembles Section II-2(f), which was referenced in the Commission's orders as the model for the new pooling ordered by the FERC. The model Mr. Wetmore presents requires Carriers whose barrel-mile usage exceeds their ownership share during a given year to pay those Carriers whose ownership share exceeds their barrel-mile usage, and it does so in a manner highly similar to Section II-2(f). He indicates that his client, CPTAI, asserts that the TSA pooling worked successfully for the signatories for over twenty years. The Section II-2(f) provision became well understood by all affected by it (Exhibit No. CPT-1, at 12).

191. In Mr. Falcone's view, the Carriers and Alyeska understood exactly what costs were included and excluded, how to collect the necessary data to make the calculation, and the other nuances required to fully implement pooling on this large system. The Section II-2(f) provision seems to have satisfied all the Carriers and provided incentives to carry incremental barrels. Section II-2(f), was agreed to by all Carriers. He further indicates that CPTAI has taken the position that a new pooling may not be imposed on Carriers without their consent. Without waiving its appeal on this issue, CPTAI submits that a mechanism similar to Section II-2(f), such as presented in Mr. Wetmore's testimony, complies with the Commission's orders and has the advantages of being similar to the pooling mechanism that was contained in the TSA (Exhibit No. CPT-1, at 12-13).

192. Mr. Falcone states that CPTAI does not object to the Commission's uniform rate orders to the extent: (1) they simply impose a uniform rate ceiling based on total TAPS costs and continue to permit each Carrier, individually and on its own initiative, to file rates below the ceiling; and, (2) they permit each Carrier, individually and on its own initiative, to justify an increase in the existing ceiling if that Carrier believes the ceiling needs to be adjusted. CPTAI is concerned, that the Commission may intend to require future changes to the uniform rate ceiling to be filed jointly by all Carriers. To the extent that is the case, he believes believes that certain procedural matters must be resolved prior to imposing such a system in order to permit the rate filing process to work while protecting Carriers from potential antitrust liability (Exhibit No. CPT-1, at 13).

193. Most of Mr. Falcone's concerns revolve around the communication problems inherent in jointly implementing a uniform tariff under the undivided joint interest structure for TAPS. The uncertainties include: To what extent are the Carriers permitted to meet and collaborate with respect to changes to the uniform rate? Are they required to collaborate? Must 100% of the Carriers agree before the uniform rate is changed, or may a majority override the wishes of the minority? Is the majority determined on the basis of ownership percentage, usage percentage (barrels or barrel-miles) TAPS Operating Agreement voting requirements, or are any three of five Carriers sufficient? (*See* Exhibit No. CPT-1, at 14).

194. Mr. Falcone has many other concerns. For instance, what happens if the Carriers disagree on how the new uniform rate should be calculated? How are such disagreements to be resolved? If an individual Carrier believes a higher uniform rate is appropriate, can it individually file for such a rate even if other Carriers file for a lower uniform rate? Conversely, if an individual Carrier believes that a lower uniform rate is appropriate can it individually file for such a rate even if other Carriers have filed for a higher uniform rate? (*See* Exhibit No. CPT-1, at 14).

195. Mr. Falcone further testifies that CPTAI, acting alone and without prior consultation with other Carriers about the specifics of its filings, made an independent calculation of the uniform rate ceiling and submitted a tariff based on that calculated ceiling. The other Carriers appear to have taken the same approach. To the extent that satisfies the Commission's uniform rate requirement, CPTAI does not object to the implementation of a uniform rate. However, he opines that if the Commission intends a greater degree of collaboration among the TAPS Carriers going forward, it is essential that the terms of such collaboration be defined and some mechanism be put in place to shield Carriers from potential antitrust risk for following the prescribed process (Exhibit No. CPT-1, at 14-15).

## **2. Erik G. Wetmore**

196. Mr. Wetmore is a Principal in the consulting firm Turner Wetmore Collins LLC., a firm that provides consulting services to the regulated sector of the energy transportation

industry. Mr. Wetmore has more than 20 years of professional experience, primarily in advising regulated energy transportation companies on ratemaking, accounting, and business strategy issues. He has a MBA with concentrations in Finance and Economics, from the University of Chicago Booth School of Business, and a B.A. degree in Mathematics and Economics from the University of California at Santa Barbara. Mr. Wetmore is also a C.P.A. The purpose of his testimony is to present a cost pooling model for TAPS that complies with the Commission's orders regarding pooling (Exhibit No. CPT-6, at 1).

197. Mr. Wetmore prepared a cost pooling model admitted in the record at Exhibit No. CPT-8. He believes this model is in compliance with the Commission's orders in this case. Mr. Wetmore states that, while the Commission stated that it will not dictate the particulars of the pooling mechanism, the Commission appears to contemplate a pooling mechanism similar to the pooling arrangement in Section II-2(f) of the TSA. Accordingly, Exhibit No. CPT-8 begins with Section II-2(f) of the TSA, and then makes certain adjustments to comply with the Commission's orders that the revenue requirement is based on usage.

198. Mr. Wetmore's understanding is that CPTAI is challenging on appeal the Commission's authority to impose pooling on Carriers without their consent. CPTAI has not consented to any form of pooling, including the proposal in Exhibit No. CPT-8. However, CPTAI agrees that the proposal in Exhibit No. CPT-8 complies with the Commission's orders to the extent they are upheld on appeal. Mr. Wetmore states that under Section II-2(f) of the TSA, certain costs were pooled and then reallocated among Carriers so that the costs were ultimately borne based on each Carrier's usage of TAPS (rather than based on the Carrier's ownership interest) (Exhibit No. CPT-6, at 4).

199. Specifically, Alyeska's fixed operating expenses, state ad valorem property taxes, TAPS TSM Depreciation, and the TSM allowance for dismantlement, removal and restoration of TAPS (DR&R) were pooled and reallocated based on usage. Alyeska's fixed operating expenses and state ad valorem property taxes were paid for by each Carrier based on its respective ownership interest. Similarly, invested capital was paid for by each Carrier based on its respective ownership interest, and depreciation is simply the recovery of invested capital through periodic charges. The TSM DR&R obligation for each Carrier was based upon the proportion of each Carrier's interest in the right-of-way at the time of dismantling the pipeline (Exhibit No. CPT-6, at 5).

200. Mr. Wetmore states that the cost allocation provisions set forth in Section II-2(f) of the TSA were not extended to Alyeska variable operating costs because those costs are already shared in proportion to actual use. He notes that the Commission approved Section II-2(f) and found that it was in the interests of better service to the public and economy of operation, and would not unduly restrain competition (Exhibit No. CPT-6, at 5-6).

201. Mr. Wetmore's model makes three adjustments to the cost pooling approach set forth in Section II-2(f) of the TSA. First, it reallocates all other Carrier-direct operating expenses (in addition to just ad valorem property taxes) in response to the Commission's requirement that the pooling arrangement be more inclusive than the TSA pooling. Carrier-direct operating expenses are comprised of costs incurred directly by individual TAPS, as opposed to costs incurred directly by Alyeska. He notes that other Carrier-direct operating expenses are incurred disproportionately by smaller Carriers. Second, Mr. Wetmore's model eliminates the reallocation of TSM Depreciation and TSM DR&R, which no longer apply. Instead, his model reallocates the depreciation expense used by FERC for ratemaking purposes. Third, intrastate costs are not pooled because the Regional Commission of Alaska has not required either a uniform rate or pooling, and because FERC did not order the pooling of intrastate costs, nor did it intend to, in his view (Exhibit No. CPT-6, at 5-6).

202. Mr. Wetmore's understanding is that for the Commission to approve a pooling arrangement, the pooling must be agreed to by all Carriers involved and the Commission must find that the proposed pooling is in the interest of better service to the public or of economy in operation, and will not unduly restrain competition. CPTAI has not consented to any form of pooling, including the approach set out in Exhibit CPT-8. If Carriers were to assent to the pooling approach in Exhibit CPT-8, Mr. Wetmore knows of no reason why the adjustments to Section II-2(f) would cause the Commission to be unable to make the required regulatory findings with respect to Exhibit No. CPT-8 (Exhibit No. CPT-6, at 5-6).

203. Mr. Wetmore further indicates that when the Commission approved Section II-2(f), it found that it would not unduly restrain competition, because it does not pool revenue requirement components related to return. The Commission explained that the exclusion of the return components from the pooling arrangement will provide the owners with an incentive to compete to earn their return. More specifically, the Commission explained that under Section II-2(f), each owner retains its own return revenues and is at risk as to whether it will earn those revenues. This is necessary in his view so that there remains an incentive to compete. He further states that Exhibit No. CPT-8, like Section II-2(f), does not pool return on investment and would not unduly restrain competition (Exhibit No. CPT-6, at 6-7).

204. Mr. Wetmore opines that none of the other changes to Section II-2(f) described previously change the fundamental approach in the TSA pooling. There does not appear to be any reason why the Commission could not make the required regulatory findings with respect to Exhibit CPT-8, assuming all Carriers assented to that form of pooling (Exhibit No. CPT-6, at 7). Mr. Wetmore states that a revenue requirement, commonly referred to as cost of service, is used to develop just and reasonable tariff rates so that a Carrier has the opportunity to recover its operating costs, including depreciation, and earn a reasonable return on its investment. A Carrier is not guaranteed that it will actually

collect its revenue requirement. The Carrier generally has no recourse to the extent it does not collect its full revenue requirement in a given period.

205. Conceptually, according to Mr. Wetmore, a revenue requirement includes three components: (1) operating expenses; (2) a return of investment; and (3) a return on investment. Mr. Wetmore describes each of the three revenue requirement components, and explains how each component is treated under the cost pooling approach in Exhibit CPT-8. First, Operating expenses: under cost of service ratemaking, a Carrier is given the opportunity to recover its operations, maintenance, and general expenses (operating expenses) incurred in providing regulated services. Operating expenses relating to the operation and maintenance of TAPS are composed of two categories. The first category includes those operating expenses incurred directly by Alyeska. Alyeska incurs both fixed and variable operating expenses (Exhibit No. CPT-6, at 7-8).

206. The second category of operating expenses includes those costs incurred directly by the individual Carriers in operating their TAPS capacity, including state ad valorem property taxes. Mr. Wetmore indicates that his model reallocates Alyeska's fixed operating expenses and state ad valorem property taxes based on usage because those expenses are initially paid on an ownership basis, but a Carrier that uses a greater proportion of TAPS arguably incurs a greater percentage of the costs of operating the pipeline. Mr. Wetmore states that his model also pools all other Carrier-direct operating expenses, ensuring that they are also put on a usage basis. Alyeska's variable operating expenses are not reallocated because those costs are already shared in proportion to actual use. Mr. Wetmore notes that in his cost pooling model, all operating expenses will ultimately be borne based on each Carrier's usage of TAPS (Exhibit No. CPT-6, at 7-8).

207. Under cost of service ratemaking, a Carrier is given the opportunity to recover the cost of its investment (i.e., capital expenditures) in regulated assets, over the estimated useful life of the facilities. Mr. Wetmore states that his model reallocates FERC ratemaking depreciation based on usage because that is consistent with the approach taken in Section II-2(f), which is the model for the pooling ordered by the Commission. He indicates that in his model, the cost of investment in TAPS will ultimately be borne based on each Carrier's usage of TAPS. Under cost of service ratemaking, a Carrier is given the opportunity to earn a reasonable return on its investment in regulated assets. Return on investment does not represent the recovery of the cost of investment, as that is accomplished through depreciation. Rather, return on investment is compensation that a Carrier has an opportunity to earn (in addition to having the opportunity to recover the cost of its investment through depreciation) (Exhibit No. CPT-6, at 9).

208. More specifically, a return on investment component is included in a revenue requirement so that a Carrier is given the opportunity to earn compensation for the use of its capital to finance the investment necessary to provide regulated service. This compensation is earned by a Carrier by transporting volumes. Correspondingly, Mr. Wetmore argues that his model does not reallocate return on investment, as the return

on investment is already both earned and collected based on each Carrier's usage of TAPS, so long as the Carrier retains its own return revenues. Section II-2(f), on which Mr. Wetmore claims that his pooling model is based, did not pool return on investment, and he indicates that the Commission relied on that fact in finding that Section II-2(f) did not unduly restrain competition (Exhibit No. CPT-6, at 9-10).

209. Mr. Wetmore opines that in accordance with the Operating Agreement, no Carrier can accept nominations that exceed its ownership share of the total defined capacity of TAPS. Correspondingly, a Carrier cannot use another Carrier's capacity to transport barrels. CPTAI has at times faced pro-rationing and has been unable to accept all of its nominations. The pooling approach in Exhibit CPT-8 does not require redistributions of ownership among Carriers. The proposal contained in Exhibit CPT-8 preserves the existing provisions of TAPS System Agreement and TAPS Operating Agreement with respect to ownership of TAPS. Each Carrier's ongoing capital investment obligations would be unaffected by this pooling approach. In accordance with the Commission's orders, pooling under Mr. Wetmore's model would begin when the uniform rate resulting from the 2009 proceedings is established (Exhibit No. CPT-6, at 10-11).

210. In its response to BPPA's compliance filing and interim pooling proposal, CPTAI stated that BPPA has created an elaborate and highly complex mechanism that not only pools joint operating expenses, but also attempts to reallocate capital and other return elements by tracking each Carrier's capital contributions and returns by year from the beginning of TAPS (Exhibit No. CPT-6, at 12).

211. Mr. Wetmore sums up his dissatisfaction with the BP model by arguing that the complexity of the BP mechanism results in over ten pages of new tariff rules and an electronic spreadsheet model that is several hundred pages long. In addition to creating unnecessary complexity, the BPPA proposal would, among other things: guarantee certain Carriers their full allowed return regardless of whether that particular Carrier transports even one barrel of throughput; eliminate all incentives for competition among Carriers, contrary to multiple Commission orders and the agency's obligation to protect the public interest; require Carriers to contribute capital to the system in proportions different from their agreed-upon ownership shares (contrary to the existing agreements governing Carriers' joint undivided interests in TAPS), effectively changing system ownership; unlawfully impinge on the jurisdiction of RCA by pooling elements of the intrastate revenue requirement in the absence of a mandatory uniform rate at the intrastate level; and fail to protect the smaller Carriers from disproportionate cost obligations relating to their Carrier-direct costs (Exhibit No. CPT-6, at 12).

212. Mr. Wetmore states that EMPCo, KAPCO, Anadarko and Unocal filed protests or comments in response to BPPA's compliance filing and interim pooling proposal. Mr. Wetmore observes that EMPCo noted several flaws in BPPA's proposed Model. Moreover, he opines that the RCA, which regulates Carriers' intrastate rates, has not

ordered pooling, and that in his view, BPPA is effectively ordering a federal mandate for intrastate pooling (Exhibit No. CPT-6, at 13-14).

213. In addition, he notes that Unocal stated that it disagrees with one aspect of the proposed BPPA Cost Allocation Mechanism: the exclusion of the costs that each Carrier incurs directly, rather than through the operator of TAPS Alyeska Pipeline Service Company (referred to as Owner-direct Costs). In its response, BPPA generally did not address the specific issues raised by other parties to its compliance filing and interim pooling proposal (Exhibit No. CPT-6, at 13-14).

214. Mr. Wetmore also summarizes the specific data needed to complete the annual calculations included in the Exhibit No. CPT-8 pooling model and the sources for that annual data are: barrel-mile share, by Carrier; composite ownership share, by Carrier; Alyeska's fixed operating expenses; State ad valorem property taxes; other Carrier-direct operating expenses; Alyeska's annual carrier property activity; Alyeska's non distance related operating expenses; Alyeska's operating expenses; and, Volumes by destination and by Carrier. Except for two data items – (1) other Carrier-direct operating expenses and (2) the interstate/intrastate breakdown of Valdez deliveries, all of the data is already compiled by Alyeska (Exhibit No. CPT-6, at 15-16).

215. He further states that to ensure that Alyeska would have the data needed to complete the proposed pooling calculation in a timely manner, if this proposal is adopted, each Carrier should be required annually to report its other Carrier-direct expenses and volumes by destination to Alyeska by April 18<sup>th</sup> of the subsequent year, the same date that each Carrier is required to file its FERC Form No. 6 with the Commission. Alyeska would then bill each Carrier within 120 days of the end of each calendar year, and Carriers would be required to pay amounts billed within 135 days of the end of the calendar year. Alyeska would then immediately disburse amounts received pro rata to the Carriers entitled to receive such payments (Exhibit No. CPT-6, at 16).

216. Mr. Wetmore describes that Lines 1 through 6 of the Exhibit CPT-8 pooling model calculate the amount each Carrier pays or receives under this proposed pooling approach. Lines 7 through 14 calculate the amount of costs to be pooled. As presented on Lines 1 through 6, the amount each Carrier pays or receives is calculated by multiplying the difference between each Carrier's Barrel-Mile Share (column (a) and the Composite Ownership Share (column (b)) by the total costs to be pooled presented on line 14. As presented on lines 7 through 14 of Exhibit CPT-8, the total costs to be pooled are the sum of the following costs for the applicable year: (1) Alyeska's fixed operating expenses; (2) state ad valorem property taxes; (3) other Carrier-direct operating expenses; and, (4) FERC ratemaking depreciation expense; minus the portion of the amounts in subparagraphs (1) through (4) derived by multiplying those amounts by the Intrastate Percentage (Exhibit No. CPT-6, at 17).

217. He notes that the calculation of depreciation expense is set forth on Exhibit CPT-9. Depreciation expense is based upon the net depreciable carrier property in service balance (Initial Net DPIS) determined by the Commission in its then-most-recent final order establishing or accepting a tariff rate for TAPS interstate service and the method for calculating an annual depreciation factor as determined by the Commission in its then-most-recent final order. As presented on Lines 1 to 17, the Initial Net DPIS balance is adjusted annually for changes in DPIS (depreciable property placed in service and retirements) and net charges from retirement of DPIS (collectively referred to as Net DPIS Additions and Retirements), as reported by Alyeska in its annual Final FERC Form 6 Data Report, as well as accrued depreciation expense. On Line 14, annual depreciation expense is calculated as follows: (1) the prior year's net DPIS balance is adjusted for fifty percent of the following year's Net DPIS Additions and Retirements; and (2) the result is multiplied by the applicable depreciation factor (Exhibit No. CPT-6, at 17-18).

218. The Exhibit No. CPT-8 pooling model excludes intrastate costs because the Commission's pooling requirement is based on a uniform rate requirement. At present, there is no mandatory uniform rate requirement at the RCA, and the intrastate rates vary substantially. Moreover, the Commission orders did not intend to pool intrastate costs. The calculation of the Intrastate Percentage is presented on Exhibit No. CPT-10. The Intrastate Percentage calculated on Line 10 is the sum of (1) the non-distance related operating expense incurred by Alyeska divided by all operating expense incurred by Alyeska for the calendar year, multiplied by the percentage of total barrels transported through TAPS in intrastate commerce for that calendar year; plus (2) the distance-related operating expense incurred by Alyeska divided by all operating expense incurred by Alyeska for the calendar year, multiplied by the percentage of total barrel-miles transported by TAPS in intrastate commerce for that calendar year (Exhibit No. CPT-6, at 19).

219. Mr. Wetmore further shows in Exhibit CPT-8 estimates that the respective Carriers would pay or receive if the Exhibit CPT-8 pooling approach were applied in 2010. He emphasizes that these are hypothetical amounts, which are shown solely for the purpose of illustrating how the Exhibit CPT-8 pooling model works. The actual 2010 amounts would differ, potentially significantly, depending upon the actual data for 2010 (Exhibit No. CPT-6, at 20).

## **E. ExxonMobil – Answering Testimony**

### **1. Jeffrey M. Ray**

220. Mr. Ray's answering testimony responds to the two pooling proposals that were advanced in the prepared direct testimony submitted on behalf of BPPA by Mr. John Haines and CPTAI by Mr. Erik Wetmore. In 1985 and 1986, Carriers entered into the TSA with the State. The TSA established the TSM, which was used to set annual ceiling

rates for each Carrier. Among the elements of the TSA was a provision for the pooling of certain costs, set forth in TSA Section II-2(f). This section was designed to address the mismatch described above between the amount of funding a Carrier provides Alyeska and the revenues the Carrier receives from shippers under its tariff. Costs that Carriers pooled and reallocated on the basis of pipeline usage under Section II-2(f) included: (1) Alyeska's fixed operating expenses; (2) Alaska ad valorem (property) taxes; (3) depreciation expense under TSM; and, (4) DR&R amounts under TSM. Exhibit No. CPT-5, at 16. Mr. Ray opines that the substantial majority of the costs incurred in operating TAPS were pooled and reallocated among Carriers under Section II-2(f) (Exhibit No. EM-3, at 1-2).

221. Mr. Ray states that three categories of costs were not pooled and reallocated, including: Carrier-direct expenses, such as litigation costs and overhead expenses; Alyeska's variable operating expenses (which had already been reallocated on a usage basis under the TAPS Operating Agreement); and fuel costs. Return on investment was not among the elements that were included within the scope of Section II-2(f). The pooling mechanisms proposed by Mr. Haines and Mr. Wetmore contain similarities to Section II-2(f) and two each other. Under both proposals, the following expense categories would be pooled and reallocated: (1) Alyeska's fixed operating expenses; (2) Alaska ad valorem (property) taxes; and (3) depreciation expense. These are the same expense categories that were pooled and reallocated under Section II-2(f), with the exception of DR&R amounts under TSM (Exhibit No. EM-3, at 3-4).

222. The proposals of Mr. Haines and Mr. Wetmore differ with respect to whether three items should be included in the pooling mechanism, namely: (1) Carrier-direct expenses; (2) return on investment; and (3) costs associated with intrastate transportation. The proposals also differ with respect to the proposed effective date for the new pooling mechanism. Mr. Wetmore includes Carrier-direct expenses within the scope of his pooling mechanism, Mr. Haines does not. Mr. Haines includes return on investment and costs associated with intrastate transportation on TAPS within the scope of his proposal, Mr. Wetmore does not. BPPA proposes an effective date of January 1, 2005, CPTAI proposes that its pooling mechanism become effective prospectively from the date of a Commission order in this proceeding (Exhibit No. EM-3, at 5-6).

223. Mr. Ray states that EMPCo's position on the two pooling proposals in this proceeding is based on its experience with the pooling mechanism incorporated in TSA Section II-2(f). That mechanism worked well for over 20 years. Therefore, the pooling mechanism adopted in this proceeding should include the pooling and reallocation of the expense categories that were included in Section II-2(f) and that are not in dispute here, including: (1) Alyeska's fixed operating expenses; (2) Alaska ad valorem taxes; and (3) depreciation expense (Exhibit No. EM-3, at 6-7).

224. With respect to the differences between the two pooling proposals, Mr. Ray states that EMPCo supports adoption of a pooling mechanism that maximizes Carrier efficiency

and competitive incentives and is relatively simple to apply. To that end: (1) EMPCo supports BPPA's position that Carrier-direct expenses should not be pooled and reallocated; (2) EMPCo supports CPTAI's position that return on investment should not be pooled and reallocated; (3) EMPCo supports BPPA's position that intrastate costs should be pooled and reallocated; and, (4) EMPCo believes that the appropriate effective date for the pooling mechanism adopted in this proceeding is January 1, 2009 (Exhibit No. EM-3, at 7).

225. Mr. Ray states that the exclusion of Carrier-direct expenses from the pooling mechanism will provide each Carrier with an incentive to keep its Carrier-direct expenses as low as possible (Exhibit No. BPP-10, at 19). Under TAPS ratemaking methodology prescribed in Opinion 502, each Carrier's rates recover the average per barrel cost for Carrier-direct expenses incurred by all Carriers. A Carrier with above average Carrier-direct expenses would recover only the average amount of Carrier-direct expense per barrel, whereas a Carrier with below average Carrier-direct expenses would recover the average amount of Carrier-direct expense per barrel.

226. Mr. Ray opines that return on investment should not be pooled and reallocated for several reasons. First, Section II-2(f) did not pool and reallocate the return element of cost of service. Section II-2(f) worked well during the 20-plus years of its existence. Additionally, the purpose of pooling is to address the mismatch that arises with regard to how certain TAPS costs are initially funded by Carriers (on an ownership share basis) and how those costs are then collected by Carriers from ratepayers (on a usage basis) (Exhibit No. EM-3, at 7-8).

227. However, this cost-incurrence/cost-recovery mismatch does not arise with respect to return on investment because TAPS Carriers do not make return on investment payments prior to providing transportation service, as they do with other elements of cost of service. Stated differently, Mr. Ray argues that while return on investment may constitute an economic cost, Carriers do not fund cash calls from Alyeska for the return on investment component of their rates. Return on investment is a revenue component of the cost of service and is already collected in rates on a usage basis. Finally, excluding return on investment from the rate elements that are pooled and reallocated will promote competition on TAPS (Exhibit No. EM-3, at 9).

228. Mr. Ray further opines that if return on investment were pooled and reallocated on an ownership share basis, a Carrier would have less incentive to seek to attract additional barrels to its share of TAPS capacity because it would earn its ownership share of the total return on TAPS investment regardless of how many barrels it transports. Furthermore, Mr. Ray argues that costs associated with intrastate services are significant, and are increasing as a percentage of the total TAPS cost of service. Therefore, those costs should be included in the pooling mechanism that the Commission ultimately adopts. Moreover, including intrastate costs will promote efficiency and ease of

administration in that Carriers will have only one pooling mechanism to implement (Exhibit No. EM-3, at 9).

229. Mr. Ray indicates further that intrastate costs were included in Section II-2(f) and worked well for Carriers while it was in effect. Carriers ceased pooling costs under Section II-2(f) at the end of 2008. In their request for rehearing and related pleadings in response to the Commission order that imposed a uniform rate, certain Carriers (including EMPCo) argued that a uniform rate would necessarily produce over- and under-recoveries, and that the pooling mechanism incorporated in Section II-2(f) would not solve this problem because Section II-2(f) would soon expire. In response to that argument, and BPPA's arguments in support of pooling, the Commission directed Carriers to agree on a new pooling mechanism. Accordingly, Mr. Ray states that if mandatory pooling and a uniform rate are imposed on Carriers, a new pooling mechanism should simply replace the now-expired Section II-2(f). If the effective date is set at January 1, 2009, there will be no time period in which pooling was not in effect (Exhibit No. EM-3, at 9-10).

230. Mr. Ray further discusses Mr. Falcone's testimony. Mr. Falcone described how CPTAI interpreted the uniform rate requirement when it filed its 2009 rates in this proceeding. According to Mr. Falcone, CPTAI, acting alone and without consultation with any other Carrier, made an independent calculation of the uniform rate ceiling based on system-wide costs and throughput and submitted a tariff based on that calculation. Mr. Ray observes that EMPCo followed this same approach in preparing and submitting its rate filings in this proceeding (Exhibit No. EM-3, at 10-11).

231. Mr. Ray also states that Mr. Falcone expressed concern that preparation and submission of a joint uniform rate, which would necessarily involve information sharing and collaboration among Carriers, would expose Carriers to antitrust risk if the Commission does not shield Carriers from that risk. Mr. Ray agrees with Mr. Falcone's statements concerning the potential for antitrust liability risk (Exhibit No. EM-3, at 11).

232. In addition, as Mr. Falcone described, there are a variety of problems or uncertainties associated with the requirement that Carriers file a single uniform rate, including: (1) the extent to which Carriers may meet and collaborate with respect to changes to the uniform rate; (2) the level of support among Carriers that would be required to initiate rate changes; (3) disagreements among Carriers; (4) a Carrier's view as to the appropriateness of a uniform rate; and (5) the level of information Carriers are permitted or required to exchange in preparing a uniform rate (Exhibit No. CPT-1 at 14). According to Mr. Ray, the greatest practical difficulty is that there is no mechanism for resolving disagreements among Carriers as to rate submissions. Indeed, Carriers' own conduct since 2008 illustrates the kinds of disagreements that can arise (Exhibit No. EM-3, at 11-12).

233. For example, while the other four Carriers filed intrastate rate increases at the Regulatory Commission of Alaska in 2008 and 2009, BPPA chose not to make such a filing. Mr. Ray believes that no Carrier should be forced to make a rate filing, or to incur the costs of doing so, if it chooses not to do so. Yet, according to Mr. Ray, as the Commission envisions its uniform rate requirement in this proceeding, all Carriers will be required to participate in the development of a uniform rate even if some Carriers choose not to file that rate. Another example is each Carrier's rate of return in this proceeding. BPPA has sponsored one rate of return witness in support of its rate of return, while the other four Carriers have sponsored a different witness in support of a different rate of return.

234. Mr. Ray asserts further that if Carriers were forced to collaborate on the submission of a joint uniform rate, it would be very difficult for the Carriers to move forward in the face of different Carrier positions on whether a rate change should be filed, or different views on how a uniform rate should be calculated. Given this and the other problems, Mr. Ray asserts that Carriers should be permitted to continue filing individual uniform rates, as they did in 2009, based on their own computations of system-wide costs and throughput (Exhibit No. EM-3, at 12-13).

## **F. BPPA – Answering Testimony**

### **1. Charles J. Coulson**

235. The purpose of Mr. Coulson's answering testimony is to respond to CPTAI witness Mr. Falcone's statements that the TSA pooling worked successfully for the signatories for over twenty years and that the Section II-2(f) provision seems to have satisfied all the Carriers. Mr. Falcone relies on these statements to support his recommendation that a mechanism similar to Section II-2(f) of the TSA be adopted in this proceeding (Exhibit No. BPP-32, at 1).

236. Mr. Coulson disagrees with Mr. Falcone for two reasons. First, Mr. Falcone's statements suggest that he does not recognize that circumstances today are not the same as when the TSA was executed. Second, Mr. Falcone's statement that the Section II-2(f) provision seems to have satisfied all Carriers implies that all Carriers, including BPPA, would be satisfied now and in the future with a Section II-2(f) provision, which is incorrect. Circumstances are different today than when the TSA was executed (Exhibit No. BPP-32, at 1-2).

237. For example, as the Commission recognized in its 2009 Rehearing Order in Docket No. IS05-82, throughput on TAPS has fallen below capacity and the pipeline is undersubscribed. However, the most important difference is that the Commission has ordered Carriers to calculate rates on a uniform basis. Mr. Van Hoecke explains in his direct testimony and answering testimony that under uniform rates, if return is not included among the costs that are pooled, some Carriers will over-recover their cost of

service while others will not have an opportunity to recover their cost of service. All Carriers, including CPTAI, acknowledged this reality in their request for rehearing they filed with the Commission in Docket No. IS05-230. Mr. Coulson attached the relevant portion of this request for rehearing as Exhibit No. BPP-33 (Exhibit No. BPP-32, at 2).

238. Mr. Coulson states that the Commission discussed the relationship between uniform rates on TAPS and the need for cost pooling in decisions it issued in Docket No. IS05-230. First, the Commission explained the connection between uniform rates and pooling. The Commission said, only when the Commission determined that a uniform rate was required to achieve a just and reasonable rate did the Commission impose a pooling mechanism. The Commission said that the purpose of the pooling mechanism is to ensure that carriers do not over- or under-recover their costs. Second, the Commission recognized that the TSA pooling provision was not extensive enough. The Commission ordered Carriers adopt a pooling mechanism that is all inclusive rather than including only certain costs, as was the case under the TSA's Section II-2(f) (Exhibit No. BPP-32, at 2-3).

239. Mr. Coulson does not agree with Mr. Falcone to the extent he suggests that, under a uniform tariff, all Carriers would be satisfied with a pooling provision similar to the Section II-2(f) provision. As the Commission recognized in the 2009 Rehearing Order, Section II-2(f) was an incomplete remedy to under-recovery. BPPA would not have an opportunity to recover its cost of service under uniform rates. BPPA does not support adoption of a provision that, when combined with charging uniform rates, will essentially guarantee that BPPA will not have an opportunity to recover its cost of service (Exhibit No. BPP-32, at 2-3).

## **2. Robert Van Hoecke**

240. The purpose of Mr. Van Hoecke's answering testimony is to respond to the Prepared Direct Testimony of Joseph C. Falcone and Erik G. Wetmore, on behalf of CPTAI, and by Jeffrey M. Ray, on behalf of EMPCo. Mr. Van Hoecke attempts to demonstrate the impact of Mr. Wetmore's cost pooling model presented in Exhibit No. CPT-8 (CPT-8 Model), which is a modification of Section II-2(f) of the TSA (Exhibit No. BPP-41, at 1).

241. Mr. Van Hoecke states the Commission expressed concerns that a uniform rate could lead to certain Carriers over-recovering their costs. The purpose of BPPA's Cost Allocation Mechanism is to ensure that no Carrier over-recovers its costs and that no Carrier is deprived of the opportunity to recover its costs. To demonstrate whether a particular cost pooling approach effectively addresses the issue of over-recovery, Mr. Van Hoecke utilizes an analysis that calculates achieved return with respect to each Carrier to test whether that approach provides an opportunity for each Carrier to achieve a reasonable return. Mr. Van Hoecke states that in his direct testimony he presented such an achieved return analysis of BPPA's Cost Allocation Mechanism and demonstrated that

it meets this objective. In this testimony Mr. Van Hoecke sets forth a series of achieved return analyses to demonstrate the impact of Mr. Wetmore's cost pooling approach shown in the CPT-8 Model to eliminate certain errors identified by Mr. Haines (Exhibit No. BPP-41, at 2).

242. In Exhibit No. BPP-42, Mr. Van Hoecke computes the achieved returns for individual Carriers based on Mr. Wetmore's CPT-8 Model as he presented it, without any changes to correct what Mr. Van Hoecke considers to be computational or methodological errors. Mr. Van Hoecke believes Mr. Wetmore's approach is inconsistent with the instructions provided by the Commission in Opinion 502 and subsequent orders. Unlike the BPPA Cost Allocation Mechanism, in which all Carriers have an opportunity to earn an equal return on their investment in TAPS, the CPT-8 Model results in certain Carriers, most notably CPTAI, over-recovering their costs and earning elevated returns at the expense of other Carriers (Exhibit No. BPP-41, at 3-4).

243. Mr. Van Hoecke states that in a uniform rate environment, Carriers are engaged in a zero-sum game. If a pooling mechanism allows one Carrier to over-earn, that means that one or more other Carriers will be deprived of the opportunity to earn a reasonable return on investment. One of the Commission's goals in ordering a cost pool on TAPS was to eliminate this over/under recovery scenario (Exhibit No. BPP-41, at 4-5).

244. Mr. Van Hoecke believes the CPT-8 Model is riddled with internal inconsistencies and computational errors. First, Mr. Wetmore allocates interstate costs on the basis of total barrels (interstate plus intrastate barrels) rather than only interstate barrels. Second, he errors in calculating the division between the interstate and intrastate portions of the TAPS cost of service. Third, he fails to properly reflect how costs are initially incurred by Carriers on the basis of Pipeline and Terminal ownership percentages. Fourth, he fails to honor the distance and non-distance distinctions within the tariff ratemaking methodology. Mr. Van Hoecke concludes that from a regulatory perspective Mr. Wetmore's errors result in a mismatch between costs and volumes and an improper assignment of costs among individual Carriers and between different classes of service (i.e., intrastate and interstate traffic) (Exhibit No. BPP-41, at 5).

245. These errors must be corrected in any cost pooling mechanism if costs are going to be properly assigned based on usage. Consequently, Mr. Van Hoecke prepared an achieved return analysis which modifies the CPT-8 Model to correct these four errors. In performing this analysis, Mr. Van Hoecke adjusts the analysis contained in Exhibit No. BPP-42 to reflect the adjustment in transfer payments into and out of the cost pool associated with the four errors determined by Mr. Haines. This analysis can be found in Exhibit No. BPP-42, Case 2A (Exhibit No. BPP-41, at 6).

246. Mr. Van Hoecke states that even after correcting all the CPT-8 Model's computational errors, Mr. Wetmore's approach still results in some Carriers, most notably CPTAI, over-recovering their costs and earning elevated returns at the expense of

other Carriers, most notably BPPA, KAPCO and Unocal, which the CPT-8 Model would effectively preclude from recovering their cost of service. Mr. Van Hoecke states that in a uniform rate environment, the application of the original II-2(f) cost pool (which included both interstate plus intrastate costs) in the years 2005-2008 resulted in certain TAPS Carriers over-earning at the expense of other Carriers (Exhibit No. BPP-41, at 7-6).

247. Mr. Van Hoecke argues that the CPT-8 Model does not even address, much less correct, the fundamental shortcoming of the II-2(f) approach which excludes significant amounts that are properly includable in the costs to be pooled. The CPT-8 Model fails to comply with the Commission's instructions that the pooling mechanism should be all inclusive, so that the revenue requirement is based on usage, not the ownership share. The CPT-8 Model excludes return on rate base, amortization of AFUDC, amortization of deferred return and income tax allowance from the costs eligible to be recovered. Yet all of these are costs used to compute the uniform rate. Moreover, it excludes all intrastate related costs while including intrastate volumes. As a result, the CPT-8 Model is not all inclusive and does not allocate costs (revenue requirement) on the basis of usage. The result is that a Carrier in the position of CPTAI is over-earning, while a Carrier in the position of BPPA is effectively guaranteed that it cannot recover its cost of service (Exhibit No. BPP-41, at 7-8).

248. Mr. Van Hoecke modified the analysis in Exhibit No. BPP-42, Case 2A, to include return on rate base, amortization of AFUDC, amortization of deferred return and income tax allowance, without including intrastate costs. This demonstrates the impact of simply adding return to Mr. Wetmore's method, as previously corrected in Case 2A above. This analysis is presented in Exhibit No. BPP-42, Case 2B. This does not resolve all concerns regarding the CPT-8 Model. Because the CPT-8 Model now excludes both intrastate costs and intrastate usage, it does not address the broader requirement that it be all inclusive. Excluding intrastate costs and usage leads to erroneous results for Carriers who transport significant portions of their volumes intrastate, primarily KAPCO. In order to resolve these problems it is necessary to include the intrastate costs and usage in the cost pooling mechanism. Exhibit No. BPP-42, Case 3A, incorporates the intrastate costs to the corrected CPT-8 Model shown in Case 2A (Exhibit No. BPP-41, at 8).

249. Mr. Van Hoecke states that the deviations in the individual Carriers' achieved returns still exist because return on rate base, amortization of AFUDC, amortization of deferred return and income tax allowance are still missing from the costs to be pooled. Exhibit No. BPP-42, Case 3B, demonstrates the effect of including return on rate base, amortization of AFUDC, amortization of deferred return, income tax allowance, and the intrastate costs to the corrected CPT-8 Model (i.e., Case 2A) (Exhibit No. BPP-41, at 9).

250. Mr. Van Hoecke further states that it is only after all these corrections to the CPT-8 Model are made that there is a pooling mechanism that is all-inclusive and eliminates the over-recovery problem in accordance with the Commission's orders. In

Mr. Wetmore's testimony, Exhibit No. CPT-6, he states that his CPT-8 Model makes certain adjustments to the Section II-2(f) approach contained in the now expired TSA to comply with the Commission's orders that the revenue requirement be based on usage. Mr. Wetmore also states that the adjustments are three in number and describes them.

251. However, Mr. Van Hoecke asserts that only the first of Mr. Wetmore's three adjustments, inclusion of Carrier-direct costs, goes in the direction of a more inclusive cost pooling arrangement. First, as the Commission itself has recognized, Carrier-direct costs are de minimis in relation to the overall costs incurred by Carriers. Second, if Carrier-direct costs are to be included in the pooling mechanism at all, it would make sense to do it in a manner that ensures no Carrier over-recovers or under-recovers its costs. In other words, if it is to be done at all, it ought to be done correctly (Exhibit No. BPP-34, at 21-25). Mr. Wetmore's second adjustment does not make the CPT-8 Model pooling arrangement more inclusive than Section II-2(f) pooling. It merely recognizes the reality that the TSM is dead and that Opinion 502 values for depreciation and DRR must replace TSM values. He further argues that Mr. Wetmore's third adjustment does not make the CPT-8 Model any more cost-inclusive (Exhibit No. BPP-41, at 10-11).

252. As Mr. Wetmore testifies, according to Mr. Van Hoecke, it excludes rather than includes. It excludes all intrastate costs from the pool. Moreover, it does so while continuing to include intrastate volumes in Mr. Wetmore's pooling calculation, thereby creating the most significant of the CPT-8 Model's internal inconsistencies and computational errors (Exhibit No. BPP-41, at 11).

253. Mr. Van Hoecke states that he will not address the uniform rate issues raised by Mr. Ray and Mr. Falcone in their direct testimony based on counsel's advice. However, Mr. Van Hoecke addresses one related subject to uniform rates. The subject is the procedural matters related to uniform rates that Mr. Falcone lists at pages 13-15 of Exhibit No. CPT-1. EMPCo witness, Mr. Ray, addresses the subject at pages 9-12 of Exhibit No. EM-1, as well. In his view, neither CPTAI nor EMPCo, raised the procedural issues listed by Mr. Falcone in a motion for rehearing or clarification in Docket No. IS05-82. Mr. Van Hoecke believes that these matters could have been filed in that docket and that in his experience that is the way that such issues are generally addressed (Exhibit No. BPP-41, at 12).

254. Mr. Van Hoecke further states that the data that he presented in his testimony bears out Mr. Ray's concern about the interrelationship between the Commission's uniform rate requirement and the pooling mechanism (Exhibit No. EM-1, at 3, 6-7). This data shows that, absent a properly constructed cost pooling mechanism, a Carrier that has a throughput percentage that is less than its ownership percentage may not be able to recover its costs, while a Carrier with throughput that is greater than its ownership percentage may over-recover its costs (Exhibit No. EM-1, at 7). Mr. Van Hoecke states that the purpose of BPPA's Cost Allocation Mechanism is to ensure that no Carrier over

recovers its costs and that no Carrier is deprived of the opportunity to recover its costs. (Exhibit No. BPP-41, at 13).

255. Mr. Van Hoecke states that the advent of uniform rates has exacerbated the problems that already existed for Carriers in BPPA's position irrespective of the existence of Section II-2(f). Mr. Falcone's observation that the Section II-2(f) provision became well understood by all affected by it, Exhibit No. CPT-1, at 12, does not distinguish a Section II-2(f) type cost pool from BPPA's Cost Allocation Mechanism or some other pooling mechanism that the Commission approves. Once the pooling provisions are known, Carriers and Alyeska will understand exactly what costs are included and excluded, how to collect the necessary data to make the calculation, and the other nuances required to fully implement pooling on this large system (Exhibit No., CPT-1 at 12). The data needed to complete the calculations in BPPA's Cost Allocation Mechanism would be much the same data Mr. Wetmore lists in Exhibit No. CPT-6, at 15-16 as needed to complete the calculations in the CPT-8 Model (Exhibit No. BPP-41, at 13-14).

256. He continues that in his view, the Cost Allocation Mechanism requires some additional data to address the CPT-8 Model's failure to include return on rate base, amortization of AFUDC, amortization of deferred return and income tax allowance. There is also a reduction of data required. Because BPPA's Cost Allocation Mechanism excludes Carrier-direct costs, Carriers would not need to submit the breakdowns of their Carrier-direct costs (Exhibit No. BPP-41, at 14).

257. According to Mr. Van Hoecke, the purpose of the Cost Allocation Mechanism proposed by BPPA is to ensure that no Carrier over-recovers its costs and that no Carrier is deprived of the opportunity to recover its costs. To be consistent with the Commission's orders the Cost Allocation Mechanism ensures that the common economic costs of operating TAPS are allocated based on throughput. This requires that return on rate base, amortization of AFUDC, amortization of deferred return and income tax allowance are included in the Cost Allocation Mechanism. These ratemaking elements are contained within the TAPS wide costs that are used to derive the uniform rate for all Carriers (Exhibit No. BPP-41, at 14-15).

258. Mr. Van Hoecke states that given Mr. Falcone's emphasis on the maintenance by CPTAI of its rights under the Amended Capacity Settlement Agreement (Amended CSA) and its use of only its allotted space on TAPS, he wishes to be clear that BPPA is not suggesting that CPTAI is transporting more oil than its allotted space on TAPS allows. What Mr. Van Hoecke disputes on behalf of BPPA is how the costs of operating TAPS are allocated among various Carriers. The Commission has stated the overall costs should be allocated based on usage. It is the assignment of the overall costs to each Carrier through a cost allocation mechanism which is the heart of the dispute between Carriers in this proceeding, not a Carrier's right to use its allotted capacity on TAPS in accordance with the Amended CSA (Exhibit No. BPP-41, at 15).

### 3. John. R. Haines

259. The purpose of Mr. Haines's testimony is to address certain aspects of the testimony and exhibits of Mr. Erik Wetmore, Exhibit Nos. CPT-6 through CPT-11, which he filed on behalf of CPTAI. Mr. Haines identifies and quantifies errors in the cost pooling model that Mr. Wetmore presented. For ease of reference, he refers to the model in Exhibit No. CPT-8 as the CPT-8 Model. Mr. Haines states that Mr. Wetmore has not performed his calculations in a manner that is logically and mathematically consistent with his stated objectives (Exhibit No. BPP-34, at 1-2).

260. Mr. Wetmore's CPT-8 Model differs from BPPA's Cost Allocation Mechanism because Mr. Wetmore: (1) intends for his approach to apply to just the interstate portion of TAPS costs; (2) excludes return on investment and an allowance for income taxes from the costs to be pooled; (3) includes Carrier-direct operating expenses; and (4) performs adjustments on an annual basis without taking the time value of money into account (between the time costs are recovered through tariffs and the time pooling payments are made)(Exhibit No. CPT-6). To be mathematically and logically correct, a cost pooling mechanism for TAPS must accurately reflect: (1) how TAPS costs are incurred by or allocated among Carriers before any pooling (Ownership Allocation); and, (2) each Carrier's usage of TAPS, recognizing that, since under a uniform tariff each Carrier recovers a portion of the aggregate TAPS system cost of service through its usage of TAPS. This part of the comparison should reflect how TAPS costs are treated for ratemaking purposes (Usage Allocation) (Exhibit No. BPP-34, at 2-3).

261. Accordingly, the cost categories Mr. Haines identifies consist of logical groupings of costs that have a common Ownership Allocation and a common Usage Allocation, such that a comparison can be made between the two (Exhibit No. BPP-34, at 3).

262. The cost categories are as follows: Depreciation; Fixed-distance related operating expenses and ad valorem taxes related to the Pipeline; Fixed-distance related operating expenses and ad valorem taxes related to the Terminal; Non-distance related operating expenses related to the Pipeline; Non-distance related operating expenses related to the Terminal; Carrier-direct operating expenses – distance related; Carrier-direct operating expenses – non-distance related. In Mr. Haines's view the errors in Mr. Wetmore's CPT-8 Model have a significant effect on the results of his calculations. He indicates that Exhibit No. BPP-35 to his testimony shows Mr. Haines's corrections to the CPT-8 Model (Exhibit No. BPP-34, at 4).

263. Mr. Haines notes that Mr. Wetmore's use of system-wide barrels (interstate and intrastate) to allocate the pooled interstate costs among Carriers has a much greater impact on the results in the CPT-8 Model than the other errors. Mr. Haines prepared Exhibit No. BPP-39, which shows the impact of this alleged single logic error. Mr. Haines states that Mr. Wetmore's use of system-wide barrel mile percentages (by Carrier) to allocate interstate only costs rather than what he should have done is utilize

interstate barrel-mile percentages when allocating interstate only costs (Exhibit No. BPP-34, at 6).

264. He states further that there are four fundamental logic and computational errors in the CPT-8 Model that affect the pooling and allocation of all categories of costs included in the CPT-8 Model: (1) Mr. Wetmore's use of system-wide barrels to allocate pooled interstate costs among Carriers; (2) Mr. Wetmore's use of an erroneous percentage to allocate TAPS costs between interstate and intrastate service; (3) failure of the CPT-8 Model to reflect the bases on which costs are allocated initially among Carriers; and, (4) failure of the CPT-8 Model to allocate costs among Carriers on a usage basis that is consistent with the distance and non-distance distinctions used in setting rates for Carriers.

265. Mr. Haines states that it is incorrect for Mr. Wetmore to use system-wide barrel mile percentages to allocate costs in the CPT-8 Model. While Mr. Wetmore has intended to include in the CPT-8 Model only interstate costs, he has incorrectly assumed that those interstate costs are recovered in the uniform interstate tariff on the basis of system-wide barrel-mile percentages. System-wide barrel-mile percentages reflect usage of the system for both interstate and intrastate deliveries. CPTAI's position is that the Commission cannot order pooling with respect to TAPS costs allocable to intrastate movements. It follows that in order to determine the correct allocation in an interstate only approach; the pooling calculations should be limited to interstate components only (Exhibit No. BPP-34, at 7-8).

266. This, according to Mr. Haines, requires Mr. Wetmore to rely on interstate usage parameters for the allocation of interstate costs. In other words, in order to determine the correct allocation in an interstate-only approach, the interstate components and the intrastate components must be segregated into separate parts both in terms of cost and usage such that only the interstate components are contained in an interstate-only allocation scheme. Otherwise the results will be mathematically incorrect. The impact of using each Carrier's system-wide barrel mile percentage (rather than its interstate barrel-mile percentage) in the pooling calculations has significant consequences (Exhibit No. BPP-34, at 9).

267. Mr. Haines states TAPS costs must be segregated into distinct interstate and intrastate portions in order to be mathematically correct, but Mr. Wetmore failed to properly isolate the interstate costs. First, and most significant, is that Mr. Wetmore has invented a single allocation factor for separating interstate costs from total system costs, an allocation factor itself that is founded on an improper ratio of underlying interstate versus intrastate costs. Second, he believes that Mr. Wetmore has formed his hypothetical example in an inconsistent manner. With respect to the allocation factor Mr. Wetmore invented, he has intended to isolate the interstate costs (from the system-wide costs in his hypothetical) through the use of a single allocation factor he calls the Intrastate Percentage in the CPT-8 Model (Exhibit No. BPP-34, at 9-10).

268. Mr. Haines believes that this single factor is multiplied by the total system-wide costs in order to isolate the intrastate costs, an amount which is then subtracted from the total system-wide costs to identify the remaining interstate portion of costs to be pooled. This, apparently, is intended to be a simplified approach to segregating the interstate costs to be pooled. Yet, even that simplified calculation is performed incorrectly, according to Mr. Haines. In the CPT-8 Model, Mr. Wetmore applies the Intrastate Percentage to the total \$734 million of system-wide costs in order to identify the interstate portion of costs to be pooled. Yet, his development of the Intrastate Percentage (in Exhibit No. CPT-10) was derived from examining the respective interstate and intrastate portions of only \$490 million in underlying costs, rather than from an examination of the full \$734 million of underlying costs. Inclusion of the full \$734 million of underlying costs, properly categorized into their respective distance and non-distance components would have been the mathematically correct way to develop his simplified Intrastate Percentage, according to Mr. Haines (Exhibit No. BPP-34, at 10).

269. Mr. Haines further states that his analysis in Exhibit No. BPP-35, which corrects the CPT-8 Model, resolves this computational problem by starting with the specific categories of cost that need to be individually allocated in the first instance, rather than using a single blended allocation factor, as Mr. Wetmore does (Exhibit No. BPP-34, at 10).

270. According to Mr. Haines, Mr. Wetmore's second mistake is that he formed his hypothetical in terms of the relative usage between interstate and intrastate service, which affects the dollars of cost that are assigned to interstate usage. In Mr. Wetmore's hypothetical example, he assumed that 11% of TAPS traffic is in intrastate service on a barrel-mile basis, thereby leaving 89% in interstate service. However, for purposes of determining the system-wide barrel mile ratios (by Carrier), Mr. Wetmore used year 2009 actual deliveries. Using hypothetical usage for one purpose and actual usage for another within the same example is inconsistent. Mr. Haines states that he therefore assumed, for the sake of forming a consistent hypothetical, that the 2009 actual deliveries should also be used as the basis for determining the percentage of TAPS traffic in interstate service (Exhibit No. BPP-34, at 11).

271. Mr. Haines superseded Mr. Wetmore's assumption that 11% of TAPS traffic is in intrastate service on a barrel-mile basis with the actual 2009 amount of 8.83%, thereby leaving 91.17% as the barrel-mile percentage utilized in interstate service. Because the analysis Mr. Haines conducts extends to both the interstate portion (Exhibit No. BPP-35) and the intrastate portion (Exhibit No. BPP-36), and because Mr. Wetmore himself has utilized actual 2009 volumes as the basis for his hypothetical barrel-mile ratios in the first instance, Mr. Haines synchronized the interstate vs. intrastate volume ratios to the same underlying data. Otherwise, according to Mr. Haines, the system-wide allocation amounts (Exhibit No. BPP-37) in the overall system will not balance (Exhibit No. BPP-34, at 11).

272. Mr. Haines believes that using the actual barrel-mile percentages creates consistency within the overall hypothetical. Mr. Wetmore assumes that all costs are initially incurred by Carriers on the basis of their composite ownership percentage in TAPS. This is not necessarily the case, as costs are initially incurred on TAPS using several different bases. Failure to adhere to the fundamental principles in how costs are initially incurred is a fundamental error in logic, in his opinion (Exhibit No. BPP-34, at 12).

273. Moreover, Mr. Haines states that a proper cost allocation mechanism needs to compare how costs are initially incurred among Carriers with how these costs are recovered in the tariff. Mr. Haines identifies how Mr. Wetmore failed to recognize how costs are initially incurred. On the other side of the comparison, Mr. Wetmore incorrectly identified how costs are recovered in the tariffs. Failure to do so would comprise a fundamental error in logic. TAPS tariffs are calculated based on longstanding barrel/barrel mile rate design principles in which distance related costs are allocated to each destination (and therefore collected in tariffs) on the basis of barrel-miles ratios, while non-distance related costs are allocated to each destination (and collected in tariffs) on the basis of barrel ratios (Exhibit No. BPP-34, at 13).

274. Mr. Haines opines that Mr. Wetmore failed to make this distinction and instead made the simplifying assumption that all costs are recovered in the tariff on a distance basis. Mr. Wetmore incorrectly applied barrel-mile percentages to all cost categories. Non-distance related cost categories must be allocated on the basis of interstate barrel percentages (rather than interstate barrel- miles). Even after correcting for Mr. Wetmore's improper use of system-wide barrel-mile percentages (as described in Section III. A) by replacing it with interstate barrel-mile percentages, there remain three non-distance cost categories that require further correction. They are: (1) Pipeline Non-Distance Related Operating Expenses, (2) Terminal Tankage Non-Distance Related Expenses and (3) Other Carrier-Direct Non-Distance Related Expenses (Exhibit No. BPP-34, at 14).

275. Mr. Haines further describes his evaluation of the how depreciation was handled in the CPT-8 Model. The capital investments that give rise to depreciation (within tariff ratemaking) were made by each Carrier on the basis of their respective ownership percentages. Since the capital investments themselves were made on an ownership basis, depreciation costs are likewise incurred based on each Carrier's ownership interest in Pipeline and Terminal Tankage. Carriers' composite ownership percentages can be used as a simplified method to accurately allocate investment based costs (such as depreciation) because the percentage represents the weighted blend of dollars of carrier property in the Pipeline and Terminal Tankage asset groups (Exhibit No. BPP-34, at 14).

276. Mr. Haines asserts Mr. Wetmore incorrectly assumed that interstate depreciation costs are recovered in the uniform interstate tariff on the basis of system-wide barrel-mile percentages, not interstate barrel-miles. Mr. Haines states that he corrected this error by

first determining the interstate depreciation amount to be pooled by multiplying the system-wide depreciation dollars as assumed by Mr. Wetmore (\$49 million) by the interstate barrel-mile percentage for 2009 (91.17%) (Exhibit No. BPP-34, at 16).

277. Then, for purposes of calculating rates, depreciation is distributed to each location based on barrel-miles. Mr. Haines allocated these costs on the basis of each Carrier's interstate barrel-mile deliveries. In other words, the difference between each Carrier's composite funding percentage (used in the Ownership Allocation) and its interstate barrel-mile percentage (used for the Usage Allocation) becomes the allocation factor (a percentage), which is then applied to the interstate portion of depreciation costs to determine the dollar amounts to be distributed among Carriers for this cost category. Mr. Haines's results are shown in Table 1 of Exhibit No. BPP-35 (*See also*, Exhibit No. BPP-34, at 16).

278. Mr. Haines states that the next cost category is fixed-distance related operating expenses plus ad valorem taxes for Pipeline assets. His calculation is shown in Table 2 of Exhibit No. BPP-35. Mr. Haines testifies that Mr. Wetmore's hypothetical example incorrectly treats all fixed operating costs incurred by Alyeska and ad valorem taxes as a single category and ignores whether operating expenses were initially incurred among Carriers as related either to the Pipeline or to Terminal Tankage. Accordingly, Mr. Haines states that he broke down Mr. Wetmore's combined numbers into their respective Pipeline and Terminal Tankage dollar amounts, using as a proxy (since he has used hypothetical costs), the ratios presented in Alyeska's accounting records for year 2009. In 2009, Alyeska reported that 87.97% of the fixed operating expenses and ad valorem taxes were for Pipeline assets. Mr. Haines used this percentage to segregate Pipeline distance related operating costs (out of the total fixed operating costs and ad valorem taxes) in his reconstruction of Mr. Wetmore's hypothetical (Exhibit No. BPP-34, at 16).

279. Once Mr. Haines determined how much of the total distance related fixed operating costs and ad valorem taxes are assignable to Pipeline assets (on a system-wide basis), he multiplied this dollar amount by the same 91.17% distance based factor that he calculated above (for depreciation allocations), which is the fraction of barrel-miles used in interstate service out of the total barrel-miles. With this step, Mr. Haines identified the dollars of interstate Pipeline distance related fixed costs and ad valorem taxes to be allocated as part of the Ownership Allocation (Exhibit No. BPP-34, at 16).

280. The interstate Pipeline distance related operating costs and ad valorem taxes are recovered in the uniform interstate tariff on the basis of the respective percentages of interstate barrel-miles utilized by each Carrier. Mr. Haines replaced Mr. Wetmore's use of system-wide barrel-mile percentages in this circumstance with interstate barrel-mile percentages, in keeping with an interstate only approach. The difference between each Carrier's Pipeline funding percentage (used in the Ownership Allocation) and its interstate barrel-mile percentage (used for the Usage Allocation) becomes the allocation

factor (a percentage), which is then applied to the interstate portion of Pipeline distance related fixed costs and ad valorem taxes to determine the dollar amounts to be distributed among the Carriers for this cost category (Exhibit No. BPP-34, at 16-17).

281. Mr. Haines used the same analysis for interstate Pipeline distance related fixed operating expenses and ad valorem taxes except that he identified the portion of these costs related to Terminal Tankage. For the Ownership Allocation part of the comparison, he calculated the interstate portion of distance related fixed operating costs and ad valorem taxes for Terminal Tankage assets that are subject to the allocation using the percentage of fixed operating expenses and ad valorem taxes that Alyeska identified as Terminal Tankage assets for 2009. Mr. Haines then multiplied this dollar amount by the 91.17% distance based factor that he calculated above to identify the interstate portion of Terminal Tankage distance related costs and ad valorem taxes for purposes of the Ownership Allocation (Exhibit No. BPP-34, at 17-18).

282. Mr. Haines states that Interstate Terminal Tankage distance related fixed operating costs and ad valorem taxes are recovered in the uniform interstate tariff on the basis of the respective percentages of interstate barrel-miles by each Carrier. Mr. Haines replaced Mr. Wetmore's use of system-wide barrel-mile percentages in this circumstance with interstate barrel mile percentages, in keeping with an interstate only approach. The results of the calculation of these costs are shown in Table 3 of Exhibit No. BPP-35 (*See also*, Exhibit No. BPP-34, at 19).

283. Next Mr. Haines analyzed non-distance related interstate operating costs for Pipeline assets. Non-distance related operating expenses related to the Pipeline are allocated based on Carriers' ownership interest in Pipeline assets. Mr. Wetmore allocates virtually all operating expenses on the basis of composite ownership percentages, ignoring whether they were related to the Pipeline or Terminal Tankage. In Mr. Wetmore's hypothetical example, he assumed that 14% of TAPS' barrel volume was in intrastate service, leaving 86% to be in interstate service. Mr. Haines states that to form a consistent hypothetical, he superseded Mr. Wetmore's assumption with the actual 2009 barrel delivery ratios by using the actual intrastate barrel volume percentage of 11.32%, leaving 88.68% of the traffic in interstate service (on a barrel volume basis) (Exhibit No. BPP-34, at 19-20).

284. Mr. Haines's analysis of non-distance related Pipeline operating expenses starts with the same \$95 million of non-distance system-wide costs assumed by Mr. Wetmore. Mr. Haines apportioned this into the respective amounts pertaining to Pipeline and Terminal Tankage assets using Alyeska's 2009 accounting records (using the same approach used above for distance related operating costs above). Finally, Mr. Haines used the consistent hypothetical assumption that 88.68% of these Pipeline non-distance related costs are assignable to interstate service on a barrel basis (Exhibit No. BPP-34, at 20).

285. Non-distance related costs are recovered in the uniform tariff on the basis of the percentage of barrels at each destination (rather than barrel-miles) (Exhibit No. BPP-14, at 8). Accordingly, the appropriate allocation basis for the Usage Allocation part of the comparison is each Carrier's interstate barrel percentage. Mr. Haines opines Mr. Wetmore did not treat these costs correctly for purposes of the Usage Allocation part of this calculation. According to Mr. Haines, Mr. Wetmore incorrectly used a system-wide allocation factor rather than taking into account only the interstate portion and he treated these non-distance related costs as if they were distance related (i.e., he incorrectly used barrel-miles as the usage parameter, rather than barrels) (Exhibit No. BPP-34, at 21).

286. Mr. Haines states that his calculation, shown in Table 4 of Exhibit No. BPP-35, corrects both issues. Mr. Haines used the same basic approach to evaluating Mr. Wetmore's allocation of the interstate portion of Terminal Tankage non-distance related operating costs. The same steps to allocate the interstate portion of Pipeline non-distance related costs are repeated for Terminal Tankage assets. The allocation of Terminal Tankage non-distance related operating expenses is shown in Table 5 of Exhibit No. BPP-35 (Exhibit No. BPP-34, at 21).

287. Mr. Haines testifies further that Carrier-direct operating expenses are the costs that are individually incurred by each Carrier (outside of Alyeska), excluding ad valorem taxes (which are treated by Carriers for purposes of the Ownership Allocation as if incurred by Alyeska. Alyeska pays these costs to the taxing authorities and then allocates them among Carriers on the basis described above. Mr. Haines asserts that Mr. Wetmore's calculations do not accurately reflect how these costs are treated for purposes of the Ownership Allocation. The math behind the CPT-8 Model assumes these costs are incurred by each Carrier in proportion to its composite ownership percentage. In actual practice, these costs are incurred directly by each Carrier and are not proportional to each Carrier's ownership interest in TAPS. To ensure each Carrier recovers no more or no less than its actual Carrier-direct costs through the uniform tariff (if these costs are to be included in the pool at all), there would need to be a mechanism that tracks the actual funding percentages for Carrier-directs (by Carrier) and compares this to the actual usage percentage (by Carrier) (Exhibit No. BPP-34, at 22).

288. Mr. Haines states that Mr. Wetmore proposes each Carrier be required to annually report its other Carrier-direct operating expenses to Alyeska so that the total dollar amount of these costs can be determined (Exhibit No. CPT-6, at 16). Mr. Haines states that if this information is indeed provided (on a Carrier-by-Carrier basis), then it becomes a simple calculation to determine the actual percent contribution each Carrier has made to the total other Carrier-direct operating expenses (Exhibit No. BPP-34, at 23).

289. Because Mr. Wetmore has provided only hypothetical data and has not provided individual Carrier cost information, Mr. Haines states he uses as a proxy the actual 2008 Carrier-directs as reported in a compliance filing Carriers filed in Docket No. IS07-75-

000, *et al.*, which shows each Carrier's individual Carrier-direct costs for 2008. Mr. Haines states that this filing allows him to unwind the relative Carrier-by-Carrier contribution percentages. In actual practice, if Carriers were required to provide this data to Alyeska (as the pooling administrator) as suggested by Mr. Wetmore, Alyeska would have all of the information required to correctly perform the allocation (Exhibit No. BPP-34, at 23).

290. Mr. Haines also testifies that Mr. Wetmore fails to honor the distance and non-distance distinctions within the tariff ratemaking methodology for Carrier-direct cost tracking. Referring to Exhibit No. BPP-38, he notes that the actual percentage for distance and non-distance other Carrier-direct operating expenses (as reported by each Carrier) varies from the composite ownership percentage for each Carrier. This variance shows that it is erroneous to use composite ownership percentages as the basis under which Carrier-direct costs are incurred, as Mr. Wetmore has done (Exhibit No. BPP-34, at 24).

291. According to Mr. Haines, Mr. Wetmore's approach would cause some Carriers to over-recover their costs while others under-recover their costs. Mr. Haines states that he corrects this problem in Exhibit No. BPP-35 by comparing the percentage of actual costs contributed by each Carrier (on a distance and non-distance basis) from the 2008 Compliance Filing to the usage percentage of each Carrier, thereby ensuring each Carrier ultimately recovers the same level of costs that each Carrier provided. To begin Mr. Haines's analysis, he subdivided Mr. Wetmore's total dollar amount for other Carrier-direct operating expenses (\$40 million) into a distance piece and a non-distance piece consistent with the same ratios that were reported in the 2008 Compliance Filing (Exhibit No. BPP-34, at 24-25).

292. For distance-based other Carrier-direct operating expenses, Mr. Haines used as an allocation factor the difference between the actual distance related funding percentage (i.e., the percentage that should be used for the Ownership Allocation) and the interstate barrel-mile percentage (i.e., the percentage that should be used in the Usage Allocation part of the comparison). For non-distance related other Carrier-direct operating expenses, Mr. Haines used as an allocation factor the difference between the actual non-distance related funding percentage (i.e., the percentage that is consistent with the Ownership Allocation) and the interstate barrel percentage (i.e., the percentage that reflects how costs should be allocated for purposes of the Usage Allocation.) Tables 6 and 7 of Exhibit No. BPP-35, show the results of these calculations (Exhibit No. BPP-34, at 25).

293. Mr. Haines performed a similar intrastate analysis. He prepared a corrected version of Mr. Wetmore's CPT-8 Model, as applied to intrastate costs and intrastate usage, which is contained in Exhibit No. BPP-36. Mr. Haines further calculates that \$21.8 million in pooling payments are owed on the intrastate portion using Mr. Wetmore's hypothetical example costs. The results are shown in Table 8 of Exhibit No. BPP-36. In Exhibit BPP-37, Mr. Haines creates a separate version of a corrected

CPT-8 Model on a system-wide basis, using system-wide costs and system-wide usage parameters as the inputs (Exhibit No. BPP-34, at 25-27).

294. Mr. Haines states that he does this for the purpose of proving mathematically that when the separate interstate portion in Exhibit No. BPP-35 is added to the intrastate portion in Exhibit No. BPP-36, the sum of these two components yields the same result that would otherwise be obtained if the analysis had been conducted on a system-wide basis from the beginning. Mr. Haines does this as a math check (similar to a material balance test) to confirm that the sum of the parts do indeed add up to the whole. If the system were not to balance, that would indicate a math error or data input error. The interstate analysis in Exhibit No. BPP-35 resulted in \$119.6 million in total pooling payments (and an equal and opposite number of pooling receipts). The intrastate analysis in Exhibit No. BPP-36 resulted in an additional \$21.8 million in pooling payments (and an equal number of receipts). However, when the two are combined, the total pooling payment dollars are reduced to \$99.3 million. This is because some payers under the interstate only analysis receive offsetting pooling receipts when the intrastate portion is included (Exhibit No. BPP-34, at 27).

295. For example, a Carrier such as CPTAI goes from paying \$107.9 million in an interstate only cost pool to only paying \$97.7 million in a system-wide cost pool under this hypothetical example. On the other hand, limiting the pooling mechanism to just the interstate portion produces some peculiar imbalance effects, according to Mr. Haines. Carriers that tend to have near zero interstate traffic and relatively high levels of intrastate traffic (such as KAPCO in 2009) should be expected to receive substantial dollar amounts out of an interstate-only cost pool (since their interstate usage is low relative to their initial interstate cost contribution). However, in the absence of an intrastate cost pool, there is no corresponding offset to balance their interstate pooling receipts (Table 8 of Exhibit No. BPP-37) (Exhibit No. BPP-34, at 27-28).

296. Mr. Haines prepared additional cost pooling results based on his review of the CPT-8 Model. Mr. Van Hoecke requested Mr. Haines prepare three cases in order for him to calculate the achieved return for each Carrier. They are contained in Exhibit No. BPP-40HC. In addition, Mr. Van Hoecke requested that Mr. Haines prepare two subsets for Cases 2 and 3. When preparing the cases for Mr. Van Hoecke, Mr. Haines revised his exhibit BPP-11HC to recreate the results presented in the CPT-8 Model for hypothetical year 2010, using the BPPA Model. For the purpose of calibration, he revised BPP-11HC to align its structure and assumptions with the CPT-8 Model. In addition, Mr. Haines added the option to Cases 2 and 3 for either excluding, or including, return elements in the cost pooling calculation. Mr. Haines relied on Mr. Wetmore's data and assumptions from the CPT-8 Model (Exhibit No. BPP-34, at 28-29).

297. Mr. Haines further states that he recreated Mr. Wetmore's results exactly (Case 1). Mr. Haines's calibrated model is presented in Exhibit No. BPP-40HC (Case 1). The results from his calibrated model are identical to those presented in the CPT-8 Model.

Mr. Haines revised Mr. Wetmore's data and assumptions within the BPPA Model to correct all the errors that he discussed previously to his interstate only approach. Mr. Haines explains the results of all the corrections of Mr. Wetmore's errors in the CPT-8 Model (Exhibit No. BPP-34, at 31).

298. To validate that Mr. Haines made all the appropriate corrections within the BPPA Model, he confirmed that the results of Case 2A match the results he obtains in Exhibit No. BPP-35 (his corrected interstate version of the CPT-8 Model). The corresponding case that includes return (Case 2B) is also presented in BPP-40HC. Mr. Haines expanded Exhibit No. BPP-40HC to include intrastate costs in a manner consistent with his exhibit BPP-11HC (including the proper use of RCA Order 151 ratemaking methodology to identify the applicable intrastate depreciation and return elements to be included in the cost pool, rather than use of interstate depreciation methodology as a proxy for intrastate depreciation as Mr. Haines did in Exhibit Nos. BPP-36 and BPP-37). These expanded exhibits are also included in BPP-40HC (Case 3A and Case 3B) (Exhibit No. BPP-34, at 31).

## **G. ConocoPhillips – Answering Testimony**

### **1. William H. Hieronymus**

299. Dr. William Hieronymus is an economist, with a doctorate from the University of Michigan. He has spent more than three decades specializing in the field of economics of regulated industries. The purpose of Dr. Hieronymus's testimony in this proceeding is to respond primarily to the testimony of BPPA witness Dr. Lisa Cameron. In this context, he also reviewed the testimony of BPPA witness Charles Coulson as well as the testimony of the CPTAI witnesses, Joseph Falcone and Erik Wetmore (Exhibit No. CPT-24, at 1).

300. Dr. Hieronymus concludes that, contrary to Dr. Cameron's suggestion, the Commission's uniform rate mandate does not necessitate the pooling mechanism proposed by BPPA. The imposition of a single maximum rate does not materially change how rate ceilings were historically set on TAPS or the level of rates that individual Carriers can charge. Over- and under-recovery by individual Carriers is not inconsistent with cost-based regulation and does not require the Commission to impose the pooling mechanism proposed by BPPA. Differences in cost recovery among Carriers do not affect whether the maximum TAPS rate is just and reasonable. Such differences are the result of Carriers' own business decisions affecting their capacity utilization and freely negotiated agreements (Exhibit No. CPT-24, at 2).

301. He testifies that a regulated entity is entitled to a reasonable opportunity to recover its costs, but this does not require the Commission to undo the consequences of Carriers' own actions and agreements. In addition, BPPA's proposal not only restrains competition, it completely eliminates any possibility of competition. The claim that the

potential for competition is small ignores intrastate competition and understates both actual and potential interstate competition. Dr. Cameron states she has assumed that BPPA's proposed pooling mechanism works properly and in fact allocates costs based on usage, so that the allocation of costs matches the allocation of revenues on TAPS (Exhibit No. CPT-24, at 2-3).

302. Dr. Hieronymus testifies that there are technical errors in Dr. Cameron's characterization; revenues are not allocated and costs in the BPPA methodology include profits and associated income taxes. In addition, CPTAI witness Mr. Wetmore explains how BPPA's pooling mechanism does not actually pool return on the basis of usage as BPPA claims. Nevertheless, for the purposes of his testimony, Dr. Hieronymus assumes that BPPA's proposed pooling mechanism works as BPPA claims (Exhibit No. CPT-24, at 3-4).

303. According to Dr. Hieronymus, the most important fact concerning TAPS ownership is that its owners each have an undivided joint interest in the pipeline. Although Alyeska operates the pipeline on the Carriers' behalf, each Carrier manages its share of TAPS capacity as an independent common carrier. That is different from an arrangement in which the entire pipeline is jointly owned as a partnership or company, with each owner receiving a share of the profits of the enterprise in proportion to its ownership. Instead, the undivided joint interest structure on TAPS is equivalent to each owner having its own individual pipeline (Exhibit No. CPT-24, at 4).

304. Dr. Hieronymus indicates this is important because the TAPS ownership structure is the arrangement the Owners agreed to when they invested in TAPS. A change in the ownership structure or a change in the basis for profitability of ownership away from what was agreed to raises equity and regulatory issues. It is the undivided joint interest structure that gives rise to the pooling issue. If TAPS were a partnership or similar arrangement, there would not be individual carriers with individual capacity. Instead, there would be a single entity that would incur all costs and collect all revenues. The undivided joint interest structure makes competition on TAPS possible because each Carrier owns a share of pipeline capacity and has an incentive to attract as many barrels as it can to fill its space. In a simple partnership or equivalent arrangement, there would be no opportunity or incentive to compete among ownership shares (Exhibit No. CPT-24, at 5).

305. Dr. Hieronymus states that this mode of ownership existed from the beginning of TAPS. When TAPS began service each Carrier filed individual rates with the Interstate Commerce Commission (ICC), which then regulated interstate oil pipelines. The ICC suspended the initial TAPS rates and began an investigation and was later transferred to its successor, FERC. Ultimately, the State and Carriers entered into the TSA, which was approved by the Commission with respect to six Carriers in 1985 and all Carriers in 1986. The TSA resolved the existing litigation over TAPS rates through 1985 and established a forward-looking mechanism for setting TAPS rate ceilings (TSM). TSM ceiling rates

were based on a total TAPS revenue requirement and total TAPS throughput (Exhibit No. CPT-24, at 5-6).

306. Because individual Carriers were required to estimate future costs and throughput in the first instance, there were variations in individual rates. However, as actual data became available, Carriers' rates were trued up, and over time all rates were capped by a rate ceiling based on a total TAPS revenue requirement and total TAPS throughput. Carriers were permitted to post rates below the TSM ceilings. The TSA expired on December 31, 2008. Since that time, individual Carriers have filed individual rates. Carriers' individual rate filings have all been based on total TAPS costs and throughput as required by the Commission's Opinion 502 methodology (Exhibit No. CPT-24, at 6).

307. He indicates that the Commission has also required that there be a uniform maximum rate for TAPS, the details of which are to be worked out in this proceeding. Shippers are allowed to switch their shipments among owners in response to price differences. However, a Carrier can only move volumes on its own capacity. If shippers nominate more barrels to an individual Carrier than can be moved on that Carrier's space, the shipper's nominations will be subject to pro-rationing, so shippers that prefer to ship on the capacity of the owner with the lowest tariff may not be able to do so (Exhibit No. CPT-24, at 7).

308. TAPS originally operated with no cost pooling. Instead, all fixed Alyeska costs were paid by Carriers based on their ownership percentage. The TSA included a pooling mechanism that was agreed upon by Carriers and specifically approved by the Commission. That pooling mechanism (known as Section II-2(f)) pooled all fixed Alyeska operating expenses, as well as State ad valorem taxes and two defined TSM elements (TSM Depreciation and TSM DR&R). BPPA's ownership share is nearly 47% but its usage share is only about 35% (Exhibit No. CPT-24, at 7-8).

309. Dr. Hieronymus shows that CPTAI owns a little over 28% of TAPS but its current usage share is approximately 41%. EMPCo and KAPCO have ownership shares that nearly match their current usage shares (about 20 and 3% respectively), while Unocal, had a larger ownership share than usage share (1.4 versus 0.2%). The total deemed capacity of TAPS is 1.1 million bpd. Total average TAPS throughput in 2009 was 672,000 bpd. Only CPTAI approaches full utilization of its share. CPTAI's share of capacity is approximately 311,000 bpd, and its throughput averaged approximately 279,000 bpd in 2009. BPPA, has an ownership share of approximately 516,000 bpd and throughput averaging approximately 234,000 bpd in 2009 (Exhibit No. CPT-24, at 8-9).

310. Dr. Hieronymus indicates that Dr. Cameron states that allocation of all TAPS costs on the basis of usage is necessary since allocation based on ownership is incompatible with uniform cost-based rates and the allocation of revenues among Carriers based on throughput shares (Exhibit No. BPP-5). In Dr. Hieronymus's opinion the Commission's uniform rate rulings do not require the pooling arrangement proposed by BPPA because

there is no direct nexus between the Commission's uniform rate mandate and the pooling of costs among Carriers. The uniform rate does not necessitate BPPA's proposal, which not only pools and reallocates operating costs, but also pools and reallocates return (Exhibit No. CPT-24, at 9).

311. In his view, the imposition of a uniform maximum rate ceiling is not fundamentally different from the TSA rate ceilings in effect during most of TAPS history. The TSA effective ceiling rates were based on a total TAPS revenue requirement and total TAPS throughput. Thus, the TSA included conceptually uniform rate ceilings. The TSA Section II-2(f) pooling mechanism pooled fixed Alyeska operating costs, ad valorem taxes and two defined TSM elements (TSM Depreciation and TSM DR&R) but did not pool return. The Section II-2(f) pooling arrangement was agreed to by all Carriers and approved by the Commission and appears to have operated effectively during most of the history of TAPS operations without litigation among Carriers over its implementation (Exhibit No. CPT-24, at 9-10).

312. Dr. Hieronymus opines that the pooling of all costs and return as BPPA proposes, is not required or necessary. The over- and under-recovery by individual Carriers that Dr. Cameron claims the BPPA pooling proposal is intended to address, did not suddenly arise with the Commission's uniform rate decision. Profitability variance is a function of each Carrier's utilization of its share of TAPS capacity. Differences in capacity utilization among Carriers have existed for years and are due to various business decisions made by Carriers and their affiliates over time. The impact of differences in utilization were mitigated but not eliminated historically by Carriers through Section II-2(f), which did not pool return. The mere fact of differences in profitability among Carriers does not necessitate the pooling of return proposed by BPPA (Exhibit No. CPT-24, at 10).

313. BPPA's under-recovery is due to its share of usage being less than its ownership share. That is not the result of a uniform rate, but rather of BPPA's inability to attract sufficient volumes to fill its space. When TAPS was full, all Carriers had utilization equal to their ownership shares. As production declined, BPPA was unable to fill its space and BPPA's TAPS operations became less profitable. The decline in utilization was not uniform among Carriers and the excess capacity on BPPA's share of TAPS is by far the largest of any Carriers. BPPA's disproportionate excess capacity is the result of various business decisions that it, its parent and its affiliates made. BPPA could discount its rate in order to attract more volume. In fact, BPPA has discounted its intrastate rates (Exhibit No. CPT-24, at 11).

314. Dr. Hieronymus points out that Dr. Cameron and Mr. Coulson jointly argue that discounting is likely to be ineffective for BPPA with respect to interstate movements, primarily because shippers affiliated with a Carrier will not ship on an unaffiliated Carrier's space so long as the affiliated Carrier has space, and interstate shippers that are not affiliated with a Carrier are generally small. Even so, it cannot explain why Carriers

with a mismatch between TAPS capacity and affiliated production are less profitable than those with higher levels of utilization. That condition has long existed and has nothing to do with the Commission's uniform rate order (Exhibit No. CPT-24, at 11-12).

315. If all Carriers were required to file rates based on their own individual costs and throughput, low utilization owners would be permitted to file significantly higher tariffs than in a regime where rates are set on the basis of total TAPS cost and throughput. By contrast, high utilization owners would be required to file significantly lower maximum tariff rates. Assuming BPPA's affiliated shipper continued to ship on BPPA and assuming BPPA were able to eliminate regulatory lag, BPPA might be able to charge individual rates that covered its full revenue requirement (Exhibit No. CPT-24, at 12).

316. In that case, Dr. Hieronymus states that BPPA would need to establish a rate that was so high that no non-affiliated shippers would ship on it. While BPPA would technically recover its full revenue requirement, it would merely be transferring money from one corporate pocket to another. BPPA would not be able to generate any revenue from non-affiliated shippers, and BPPA's owners would not be any better off if BPPA were permitted to file an individual rate. The uniform rate therefore is not the cause of BPPA's lack of profitability. Under an individual rate regime, CPTAI and EMPCo would have materially lower rates than BPPA, since CPTAI and EMPCo have higher levels of capacity utilization than BPPA. Non-affiliated shippers would prefer to ship on CPTAI and EMPCo rather than BPPA. BPPA could attract non-affiliated barrels only if CPTAI and EMPCo were fully subscribed (Exhibit No. CPT-24, at 13).

317. Dr. Hieronymus points out further that according to the data in Mr. Coulson's testimony (Exhibit No. BPP-1, at 20, Table 5), CPTAI and EMPCo collectively own 48.6% of TAPS. In 2009, CPTAI and EMPCo collectively moved approximately 61.7% of TAPS movements. There is approximately 120,000 bpd of available capacity on CPTAI's and EMPCo's collective share of capacity alone. Even assuming that CPTAI and EMPCo currently have no third party shipments (and not factoring in the continuing decline in TAPS throughput or the available capacity of the smaller Carriers, KAPCO and Unocal), BPPA could only hope to attract non-affiliated movements if non-affiliated volumes were greater than 120,000 bpd (Exhibit No. CPT-24, at 13).

318. Dr. Hieronymus points out that Dr. Cameron makes an estimate about the total production of producers not affiliated with BPPA, CPTAI or EMPCo in 2010. However, in his view, it is clear that BPPA could not induce non-affiliates to nominate barrels to it if BPPA were free to set its rates based on its own costs and throughput. Even if the amount of non-affiliated shipments increased significantly above Dr. Cameron's estimate and overall TAPS throughput did not continue to decline, all non-affiliated shippers would have lower cost alternatives than shipping on BPPA. Accordingly, even if BPPA were permitted to file individual rates, it would not be able to increase its profitability (Exhibit No. CPT-24, at 13-14).

319. Dr. Hieronymus further testifies that Dr. Cameron previously analyzed the effect of competition on TAPS rates in affidavits submitted to the RCA in connection with the transfer of certain TAPS interests. In RCA Docket No. P-02-10, Dr. Cameron submitted an affidavit in support of regulatory approval of the transfer of Amerada Hess Pipeline Corporation's remaining 1.5% share of TAPS to CPTAI's predecessor Phillips Transportation Alaska, Inc. (PTAI) (Exhibit No. CPT-26). The primary topic addressed by her affidavit was the effect of the transfer on incentives to discount pipeline rates to attract additional volumes (Exhibit No. CPT-24, at 14).

320. The basic framework of her analysis derived from an earlier analysis developed by Dr. Cameron and Professor Adam B. Jaffe in affidavits submitted in RCA Docket No. P-01-8, in support of approval of the transfer of an approximately 3% interest in TAPS from BPPA to PTAI (Exhibit No. CPT-27). In Docket No. P-01-8 affidavit, Dr. Cameron determined that the maximum number of barrels that a Carrier would compete for would be the lesser of the total amount of capacity that was competitively in play and the amount of that Carrier's excess capacity. In-play capacity, which she termed System Unmatched Barrels, was the sum of volumes owned by shippers not affiliated with a Carrier and any volumes of competing Carriers' affiliated shippers that exceeded the Carrier's share of its individual TAPS capacity (Exhibit No. CPT-24, at 14-15).

321. The reasoning was that there was no incentive to compete for barrels that would not change Carriers even if there was a rate incentive to do so, and there was no incentive to compete for barrels that the Carrier lacked the space to accommodate. Dr. Cameron made one adjustment to this framework. She stated that a Carrier also would not compete for shipments that had no choice but to ship on it. In her view, if the total amount of System Unmatched Barrels was greater than the excess capacity of all other Carriers, the portion of System Unmatched Barrels that exceeded the aggregate excess capacity of the other Carriers would have no choice but to ship on the Carrier with remaining excess capacity, so there would be no incentive for that Carrier to discount to obtain the excess portion of System Unmatched Barrels (Exhibit No. CPT-24, at 15).

322. Dr. Hieronymus indicates that Dr. Cameron concluded that in 2003 the amount of System Unmatched Barrels would exceed the amount of aggregate excess capacity of all Carriers except for BPPA, so that BPPA could count on carrying the excess portion of System Unmatched Barrels and would have no incentive to discount in order to carry those volumes (Exhibit No. CPT-24, at 15-16).

323. Dr. Hieronymus further notes that Dr. Cameron's prior affidavits demonstrate her recognition that the incentive to compete arises from the fact that shippers have alternatives. Since all shippers have alternatives today, there is a presumption that the decision concerning which Carrier to ship on will be influenced by price. Unlike the situation at the time Dr. Cameron submitted the above affidavits, the facts now are that the amount of aggregate excess capacity of Carriers other than BPPA substantially

exceeds Dr. Cameron's calculation of competitively accessible shipments (i.e., unaffiliated shipments) (Exhibit No. CPT-24, at 16).

324. Dr. Hieronymus states there are no price insensitive barrels from shippers not affiliated with BPPA that it could hope to carry (irrespective of whether other Carriers' affiliates' shipments are regarded as price sensitive). It follows, that BPPA could not hope to attract any third party shipments if the rate it was allowed to charge exceeded the rates being charged by other Carriers. Differences in profitability among Carriers are the result of conscious business decisions, including voluntary agreements entered into by the Carriers. Cost-based regulation does not guarantee a carrier a particular profit margin or level of return. A carrier is only permitted a fair opportunity to recover its revenue requirement. In providing such an opportunity, the Commission is not required to protect individual carriers from the results of their business decisions or to undo freely negotiated commercial arrangements (Exhibit No. CPT-24, at 16-17).

325. Dr. Hieronymus states that most Alyeska costs are paid for by Carriers on an ownership share basis, while revenues are earned by Carriers based on the number of barrels they move. Other things equal, this should translate into differing levels of profitability. The sharing of Alyeska fixed costs on an ownership basis is required by the TAPS Operating Agreement. Carriers voluntarily entered into the TAPS Operating Agreement prior to TAPS start-up and can amend the Operating Agreement if they had wished to (Exhibit No. CPT-24, at 17-18).

326. He further points out that various business decisions by Carriers and their affiliates have led to the differences in capacity utilization among Carriers. If a Carrier has a low level of capacity utilization, that is because the Carrier: (1) purchased more capacity than it is now able to fill; (2) failed to sell sufficient capacity to equalize its ownership and throughput shares; or (3) failed to discount its rates to attract more volumes. Because of affiliate tendering, decisions of a Carrier's production affiliate with respect to exploration, field share purchases and wellhead purchases also affect the level of throughput a Carrier can expect to move (Exhibit No. CPT-24, at 18).

327. Dr. Hieronymus describes that the TAPS System Agreement sets forth the ownership shares of the original eight TAPS owners (Exhibit No. CPT-2, at 12). As set forth in the System Agreement, each of the original owners had rights to purchase additional shares of TAPS during pipeline expansions. Carriers that elected not to purchase additional shares of capacity during expansions would see their overall share of capacity reduced. Carriers could also sell all or part of their shares to others (with other TAPS owners having a right of first refusal). By the same token, shares could be increased by acquiring other owners' expansion rights, purchasing shares from other owners, or acquiring a company that owned a share of TAPS. Over time, each of these different types of transactions has occurred on TAPS (Exhibit No. CPT-28). Focusing on BPPA, it first acquired approximately 16% of the pipeline in 1974 prior to TAPS start-up. In 1980, BPPA increased its relative share of TAPS by participating in two expansions

while some other Carriers chose not to expand their capacity (Exhibit No. CPT-24, at 18-19).

328. According to Dr. Hieronymus, in 1988 BPPA acquired an additional 33% of TAPS, which brought BPPA's total pipeline ownership percentage to slightly over 50%. In 2000, when BPPA's parent company acquired ARCO, it was required to divest ARCO's share of TAPS. Thereafter, in 2001, BPPA sold a 3% share in the pipeline to CPTAI, which brought BPPA's pipeline ownership to its current 46.926% share. The other TAPS owners have also changed their ownership percentage over the years (Exhibit No. CPT-24, at 19).

329. Dr. Hieronymus additionally states that a Carrier can try to attract more volumes. Assuming additional production does not become available to TAPS, the primary way a Carrier can do this is by discounting rates. BPPA has discounted its intrastate rates, which led to a significant increase in its share of the intrastate market. A Carrier can also seek to attract third party volumes in other ways. Carriers are not required to move more than their ownership share of intrastate movements (Exhibit No. CPT-24, at 20).

330. He states further that a Carrier which seeks to attract additional intrastate barrels may waive this rule. For example, on February 17, 2009, BPPA notified shippers that it was waiving its right to limit intrastate movements and would accept all volumes of intrastate barrels tendered for transportation through BPPA's capacity, up to the limits of BPPA's capacity. That notice was clearly intended to attract additional intrastate volumes (Exhibit No. CPT-24, at 20).

331. Dr. Hieronymus also believes that most of the oil moved on TAPS is owned by affiliates of Carriers, which currently ship their volumes primarily on their respective affiliated Carriers. In his view, the business decisions of a Carrier's production affiliate affect Carrier's throughput. For example, a production affiliate may be able to increase the oil it has available for shipment on TAPS through increased exploration, development of new and existing fields, acquiring production rights from other producers or purchasing barrels from other producers at the wellhead (Exhibit No. CPT-24, at 20-21).

332. The determination of how much ANS oil to control is largely the result of decisions about capital allocation made by the parent company of the Carrier and its production affiliate. In the case of BPPA, Dr. Hieronymus notes that its production affiliate was not a participant in the Alpine field, that some smaller fields opened in recent years, and that its share of production has been declining. Whatever may have been the bases for their strategies, it is clear that the decisions of various Carriers (and their parents and affiliates) have resulted in differing balances between pipeline ownership and usage (Exhibit No. CPT-24, at 21).

333. According to Dr. Hieronymus, Carriers and their parents are all large and sophisticated energy companies. Corporate business decisions were intended to be profit

maximizing, have resulted in differing TAPS revenue and profit levels. Those differences in profitability are not inconsistent with cost-based ratemaking and do not require the Commission to attempt to undo the consequences of the various business decisions that have led to differing levels of profitability among Carriers (Exhibit No. CPT-24, at 21).

334. Differences in profitability levels are not inconsistent with just and reasonable rates. Opinion 502 recognized that, as part of the process of establishing just and reasonable rates, the Commission has authority to order pooling adjustments based on actual usage in order to address the problem of under- or over-recovery of costs (Exhibit No. BPP-8). In Dr. Hieronymus's opinion, over- or under-recovery of costs by Carriers is not inconsistent with just and reasonable rates (Exhibit No. CPT-24, at 22).

335. He further states that no Carrier is alleging in the context of the pooling issue that it is actually failing to cover its operating costs. Rather, the issue is whether differences in profitability among owners are inconsistent with just and reasonable rates. In Dr. Hieronymus's view, differences in profitability among Carriers as well as related issues of cost allocation among Carriers have no effect on the justness and reasonableness of the rates to be established in this proceeding (Exhibit No. CPT-24, at 22).

336. He believes that in Opinion 502, the Commission found that a uniform rate based on total TAPS costs and throughput was just and reasonable. The Commission's primary concern in setting rates is that shippers not pay more than a just and reasonable amount. The maximum just and reasonable rate that Carriers are permitted to charge shippers is not affected one way or another by how costs are shared among Carriers (Exhibit No. CPT-24, at 22).

337. Alyeska costs are currently shared among Carriers based on a commercial contract voluntarily entered into. Dr. Hieronymus opines that to the extent the agreed upon method for sharing Alyeska costs causes some Carriers to bear a greater share of costs than their usage share, is not the result of any action of the Commission. Nor is there any compelling policy reason for the Commission to undo the effects of Carriers' voluntary cost allocation agreements in setting just and reasonable rates, in his view (Exhibit No. CPT-24, at 23).

338. Dr. Hieronymus also states that cost-based regulation does not guarantee full cost recovery, but only a reasonable opportunity to recover the carrier's revenue requirement. Under-recovery is not uncommon in the oil pipeline context. Dr. Hieronymus's understanding is that the Commission's regulation of oil pipelines includes various types of rates where the Commission makes no attempt to determine whether the pipeline is over- or under-recovering. He believes that the Commission, in regulating other industries such as wholesale electricity in which bilateral contracts are common, generally accepts that contract rates are just and reasonable (unless they result from fraud or coercion) and is loath to change them even when the passage of time and unforeseen

circumstances makes them reflective of neither cost nor market conditions. Contrary to Dr. Cameron's testimony, over- and under-recovery by individual pipeline carriers is not at odds with cost-based regulation by the Commission (Exhibit No. CPT-24, at 23).

339. Dr. Hieronymus notes further that Dr. Cameron asserts that differences in profitability among Carriers are inconsistent with the principles of cost-based regulation. In Dr. Hieronymus's view the principles of cost-based regulation do not require the Commission to review and amend privately negotiated agreements entered into among carriers. According to Dr. Hieronymus the Commission does not generally attempt to change privately negotiated agreements, even where the agreement turns out to be unprofitable for one party or the other (Exhibit No. CPT-24, at 24).

340. From an economic perspective, Dr. Hieronymus sees no reason why the Commission should substitute its judgment for those of the contracting parties or attempt to undo such agreements absent compelling public policy reasons. The level of the maximum TAPS rates will be unaffected by how costs are allocated among Carriers. Given the Commission's general reluctance to interpose itself to overturn private contractual arrangements, the absence of a nexus to rates should make the Commission still more reluctant to undo Carrier's cost sharing agreements in this case (Exhibit No. CPT-24, at 24-25).

341. Dr. Hieronymus states that Dr. Cameron believes it is necessary to implement a regime that will allocate responsibility for TAPS costs to Carriers based on usage. TAPS is an undivided joint interest pipeline. BPPA's would not change the formal ownership structure but would essentially convert the five current Carriers into a single pipeline in which each owner, from an economic perspective, would be a passive investor with a pro rata share of profits based on ownership share. The primary economic effect of BPPA's proposal is to transfer revenues from high utilization owners, primarily CPTAI, to low utilization owners, primarily BPPA (Exhibit No. CPT-24, at 25).

342. For example, according to Dr. Hieronymus, even though CPTAI cannot use BPPA's share of TAPS capacity to transport barrels, CPTAI would be required to compensate BPPA for a portion of BPPA's maximum allowable return on investment related to BPPA's capacity. In short, what BPPA seeks is nothing less than an uncompensated appropriation of CPTAI's property (Exhibit No. CPT-24, at 26).

343. He further believes that there is no merit to BPPA's claim that anything other than its proposed pooling mechanism will lead to inefficient investment decisions. Dr. Cameron testifies that BPPA's proposal will improve the economy of operations by removing under-recovering Carriers' disincentives to make discretionary efficiency enhancing investment that could allow the pipeline to operate more efficiently and extend its economic life, and over-recovering Carriers' incentives to over invest in TAPS (Exhibit No. CPT-24, at 27).

344. Beyond this assertion, Dr. Hieronymus asserts that her testimony does little more than summarize Mr. Coulson's testimony on this subject. Mr. Coulson explains that approval by the TAPS Owners Committee requires at least a two-thirds vote and the support of at least three owners. Given current ownership shares, all TAPS investments require the support of BPPA, either CPTAI or EMPCo and at least one of the remaining owners (Exhibit No. CPT-24, at 27).

345. Dr. Hieronymus agrees that absent BPPA's pooling proposal under-recovering carriers have a disincentive to make efficiency enhancing investments in TAPS. An entity that expects low profits on incremental investment will have less incentive to make the investment than if it expected to earn higher profits on the investment. It is not clear, that this has any practical impact on TAPS or that this requires the implementation of BPPA's proposal (Exhibit No. CPT-24, at 27-28).

346. As an initial matter, Carriers are regulated entities that are obligated to operate TAPS in a prudent and safe manner. Mr. Coulson attempts to distinguish between investments required for safe operations and so called discretionary investments related to system efficiency and reliability. Mr. Coulson fails to explain why Carriers as regulated entities would not also be obligated to operate the system efficiently and reliably. Even a Carrier expecting a lower level of return on investment will likely have an incentive to fund the so called discretionary projects that Mr. Coulson describes. Mr. Coulson defines discretionary projects as investments which, if not undertaken, will likely result in a sub-optimal system (Exhibit No. CPT-24, at 28).

347. Mr. Coulson states further that a Carrier such as BPPA, that is required by the TAPS Operating Agreement to pay approximately 47% of all TAPS costs, as is the case currently, will reap 47% of the benefit of the cost reductions arising from such investments. Its incentive mirrors its share of the costs. The differences in system utilization and recovery among Carriers have existed for many years. At no time during its history has TAPS operated under a pooling arrangement such as that proposed by BPPA in which all costs and revenues are pooled. Despite this, BPPA fails to point to a single project that it claims was efficiency enhancing that it voted against or otherwise failed to support (Exhibit No. CPT-24, at 28-29).

348. Dr. Hieronymus also notes that during the period the TSA was in effect, certain costs were pooled under Section II-2(f) but return was not pooled. However, BPPA does not point to any discretionary projects that BPPA opposed during this period even though failure to approve the project would likely result in a sub-optimal system. Mr. Coulson states that if BPPA's pooling proposal is not approved, gridlock could arise when it comes time for the Owners to vote on future investment decisions, since under-recovering Owners would have an incentive not to make additional investments in TAPS (Exhibit No. CPT-24, at 29).

349. However, Dr. Hieronymus asserts that BPPA makes no such claim in its pre-filed testimony, Mr. Coulson acknowledges that there was no gridlock during this period. Mr. Coulson claims that, because TAPS throughput rates were higher [during the period Section II-2(f) was in effect] than they are now and higher than they are forecasted to be in the future, the magnitude of the over and under recovery was not as significant as it is now and will be in the future. There were significant differences in utilization among Carriers for many years during the period Section II-2(f) was in effect. Since the TSA terminated on December 31, 2008, there has been no pooling mechanism in place on TAPS (Exhibit No. CPT-24, at 29-30).

350. Dr. Hieronymus indicates that Mr. Coulson provides no examples in his testimony, and in discovery he stated that he was not aware of any such projects. Mr. Coulson identifies roughly \$500 million in discretionary projects that Alyeska has proposed for the 10 year period from 2010-2019. Furthermore, he notes that Mr. Coulson does not identify any specific projects that BPPA opposes even though the project will be efficiency enhancing. Moreover, Mr. Coulson stated that BPPA is not aware of any discretionary, economically based capital projects that it does not intend to approve. Dr. Cameron also argues that the BPPA pooling proposal would eliminate the incentive for over-recovering owners to over invest in TAPS, which he rejects, and he also notes that BPPA has a veto with respect to all TAPS projects, so even if an over-recovering Carrier had an incentive to over invest, BPPA could veto any such proposal (Exhibit No. CPT-24, at 30-31).

351. Dr. Hieronymus states further that Dr. Cameron believes under the BPPA proposal the interests of all Carriers would be better aligned, and all Carriers would be incentivized to undertake incremental investments that are cost effective. However, even if BPPA's proposal operated to equalize the returns of all Carriers (which Mr. Wetmore shows it does not), it is not clear that would improve the cost effectiveness of TAPS investment decisions, according to Dr. Hieronymus. Merely aligning Carriers' interests might only result in Carriers collectively having an incentive to over- or under-invest depending upon whether earned rates of return were above or below the market cost of capital (Exhibit No. CPT-24, at 31-32).

352. By contrast, the current situation where Carriers have different levels of return, would appear to create dynamic tension among owners that helps to ensure that all projects are scrutinized and thoroughly reviewed before approval. In his view, BPPA's proposal entirely eliminates the incentives for competition among Carriers. There is no incentive under BPPA's proposal for individual Carriers to compete for additional volumes, since each Carrier would earn the same overall return regardless of the amount of volumes it moved. There would be no benefit to attracting additional volumes and no cost for losing volumes. Even if a Carrier moved no volumes at all, it would still earn the same overall profit margin (Exhibit No. CPT-24, at 32-33).

353. Dr. Hieronymus additionally provides a hypothetical. Assuming two Carriers, A and B. A owns 60% of total pipeline capacity and B owns 40%. Total volumes on the pipeline are 200 barrels. The total system operating costs (excluding return) are \$600 and the total revenue requirement (including costs and return) is \$1000. The maximum tariff rate on the system is \$5.00 per barrel. Carriers A and B have agreed to share the \$600 in total system operating costs on an ownership basis. A pooling arrangement is in place, which requires the entire \$1000 revenue requirement to be reallocated between Carriers based on the difference between each Carrier's ownership share and usage share (the BPPA proposal). In the first case, each carries 100 barrels. In the second, Carrier A loses 20 barrels, and Carrier B acquires 20 barrels. Each Carrier earns the same overall margin regardless of its share of throughput. If BPPA's proposal were adopted a Carrier would not increase its profitability by discounting its rate to attract more volumes under BPPA's proposal if a Carrier discounts its rate, it will lower its overall revenue even if succeeds in attracting more volumes (Exhibit No. CPT-24, at 33-35).

354. The assumption is that by offering a 10 cent per-barrel discount, Carrier A attracts 10 barrels that otherwise would be carried by Carrier B. Consistent with anti-discrimination provisions of the ICA, it is assumed that the discount applies to all shipments, not just to the 10 barrels of incremental shipments. If Carrier A discounts its rate in order to attract more barrels, it will ultimately earn less overall revenue and profit after taking into account pooling payments. While its market revenues increase by \$39, its transfer receipts go down by \$50, making it \$11 worse off as a result of successfully competing for additional shipments. Therefore, there is a disincentive to discount under the BPPA proposal (Exhibit No. CPT-24, at 35-36).

355. Dr. Hieronymus further testifies that the results of the above hypothetical example apply to TAPS because the logic and qualitative results would be the same. Any discount will be unprofitable under BPPA's proposal, because the reduction in transfer receipts will be less than the additional revenues. Mr. Wetmore's testimony provides concrete examples of the effects on Carriers of discounting under BPPA's model. He indicates that because BPPA's model pools a hypothetical revenue requirement that tends to exceed the total amount of actual revenue collected, BPPA's proposal tends to allocate underutilized Carriers a return share even greater than their ownership share. That results in an even greater disincentive to compete for additional volumes (Exhibit No. CPT-24, at 36).

356. Dr. Hieronymus indicates that BPPA's model not only eliminates the incentive to compete for added share, it tends to encourage Carriers to reduce their throughput levels. Such incentives are entirely at variance with the operation of normal competitive behavior, in his opinion. Under Section II-2(f) Carriers had less incentive to compete than if there had been no pooling, but Section II-2(f) did not eliminate all competitive incentives as BPPA's proposal does. Because Section II-2(f) did not pool return elements, it preserved Carriers' incentives to compete for additional volumes in order to

earn additional return. A change in volumes affects Carriers' overall return, with the volume gaining Carrier becoming more profitable and the volume losing Carrier less so (Exhibit No. CPT-24, at 36-37).

357. In his opinion, this crucial difference between Section II-2(f) and BPPA's proposed form of pooling represents the difference between the possibility of competition and the complete elimination of all incentives for competition. There would not be any incentive to discount under BPPA's proposal but there may be incentives to discount under a Section II-2(f) type pooling mechanism. If a Carrier discounts, it may be able to attract more barrels and earn more revenue than had it not discounted. The Commission recognized the importance of preserving an incentive to compete by not pooling both operating costs and return. In approving the Section II-2(f) pooling agreement, the Commission found that it did not unduly restrain competition, because the incentive to compete was preserved since each owner retains its own return revenues and is at risk as to whether it will earn those revenues (Exhibit No. CPT-24, at 37-39).

358. Dr. Hieronymus notes Mr. Coulson and Dr. Cameron suggest that the amount of potential TAPS shipments subject to competition is small, and that even if the incentive to compete is eliminated entirely by BPPA's proposal, the impact on competition would not be significant. In his view, from an economic perspective, a pooling mechanism that wholly eliminates any incentive to compete would be significant unless it was determined that competition itself was a bad thing. Dr. Cameron does not assert that there is no competition only that it is limited. He believes that her testimony supports a belief that the potentially competitive segment of the market is growing rapidly (Exhibit No. CPT-24, at 40).

359. In addition, Dr. Hieronymus notes that Dr. Cameron's testimony understates the amount of potentially competitive shipments. Given the Commission's prior concern for preserving competition, the complete elimination of any incentive for competition is certainly not something that the Commission should approve absent reasons far more compelling than those provided by BPPA here. The Commission's approval of Section II-2(f) as a pooling arrangement was premised on the specific finding that Section II-2(f) preserved the possibility of competition. He also notes that the Federal Trade Commission has also twice required the divestiture of TAPS ownership interests as a condition of approving mergers between companies that both owned interests in TAPS. That suggests that preserving the potential for competition on TAPS is considered to be of public policy importance, even though most of the shipments on TAPS are made by affiliates of Carriers (Exhibit No. CPT-24, at 40-41).

360. Dr. Hieronymus states further that the amount of TAPS volumes potentially affected by competition is greater than Dr. Cameron suggests. Dr. Cameron completely ignores intrastate competition. Her analysis significantly understates the amount of volumes potentially subject to interstate competition. With the exception of Flint Hills and KAPCO, the potential intrastate shippers on TAPS generally are not affiliated with

any Carrier. In deciding which Carrier to ship on, these intrastate shippers are free to consider which Carrier's rate is the lowest without regard to considerations of integrated corporate economics. Dr. Cameron's testimony ignores intrastate competition. In discovery she stated that she was not asked to consider intrastate competition and has not done so. He opines that there is recent empirical evidence of intrastate competition by BPPA itself. In late 2008 and early 2009, each of the pipeline owners other than BPPA increased their intrastate tariffs significantly. BPPA has not filed for intrastate increases (Exhibit No. CPT-24, at 41-42).

361. Furthermore, Dr. Hieronymus indicates BPPA also waived the limitations on intrastate movements contained in RCA Order 26. In discovery, Mr. Coulson acknowledged that to the extent that one or more Carrier has waived the limitation of RCA Order 26, there is competition among Carriers for some intrastate barrels. By the end of the spring of 2009, BPPA had gained all of the intrastate volumes to the Tesoro refinery and BPPA's overall intrastate barrel-mile share increased from 29.6% in 2008 to 52.5% in 2009 (Exhibit No. CPT-24, at 42).

362. Dr. Hieronymus believes that intrastate competition is relevant. BPPA proposes to pool costs and return for both interstate and intrastate shipments on TAPS and the pooling mechanism it proposes would have the same adverse effect on intrastate competition as it does on interstate competition. He believes Dr. Cameron's analysis understates the amount of interstate volumes potentially affected by competition, because it: (1) ignores sales by non-affiliates at the wellhead; (2) ignores the potential for the State to take barrels as Royalty-in-Kind (RIK); (3) overestimates the amount of non-affiliated volumes moving in intrastate commerce; (4) ignores movements by producers affiliated with Carriers on other Carriers' capacity; and (5) ignores the potential for future growth in non-affiliated volumes (Exhibit No. CPT-24, at 42-43).

363. Dr. Hieronymus also believes that Dr. Cameron's treatment of wellhead sales by non-affiliates understates the amount of volumes affected by competition. One of the arguments that Dr. Cameron makes is that non-affiliated producers will often sell to an affiliated producer at the wellhead. She suggests that these volumes are not available for competition among pipelines. The fact that a non-affiliate may sell its production at the wellhead does not mean that these volumes are irrelevant from the point of view of TAPS competition, in his view. The non-affiliated producer still has a choice of whether to sell at the wellhead and which affiliated producer to sell its production to. Discounting of a TAPS tariff could induce such a producer to ship in its own name and nominate its volumes to the low priced Carrier (Exhibit No. CPT-24, at 43).

364. In Dr. Hieronymus' view, the State is entitled to a percentage of all oil produced on the North Slope, which it may take either as Royalty-in-Value (RIV) or RIK. While the share of RIV oil has been declining, it is still significant. He points out that Dr. Cameron ignores the RIV oil and treats the RIK oil as affiliated with KAPCO (Exhibit No. CPT-24, at 43-44).

365. While it is true that KAPCO, which has no production affiliate, has been the dominant carrier of RIK oil to date, there is no substantial reason why this should be regarded as a set aside from the competitive market since all of other Carriers now have space available. According to Dr. Hieronymus, the State's decision of whether or not to take oil as RIK is subject to modification depending on competitive alternatives. If a Carrier were to offer a significant discount, it would be in the State's interest to take more oil in kind and nominate that oil to ship on the lower priced Carrier (Exhibit No. CPT-24, at 43-44).

366. Moreover, he points out that in Dr. Cameron's prior affidavit in RCA Docket No. P-08-1, she acknowledged that from an economic perspective, the State RIK barrels could constitute an important component of unmatched barrels (i.e., unaffiliated barrels subject to competition) on the system. Dr. Cameron's analysis overestimates the amount of non-affiliated oil moving in intrastate commerce, unavailable for interstate shipment. Dr. Cameron assumes that all oil shipped intrastate to the Tesoro refinery at Nikiski comes from non-affiliates, leaving less non-affiliated oil available for interstate competition. Dr. Hieronymus believes that there is no basis to assume that all of the oil purchased by Tesoro will necessarily come from producers not affiliated with a Carrier (Exhibit No. CPT-24, at 44-45).

367. Dr. Hieronymus continues that Dr. Cameron's analysis does not account for shipments by producers affiliated with Carriers on non-affiliated Carriers. She assumes it would be economically irrational for affiliated producers to ship on non-affiliated Carriers even if the non-affiliated Carrier offered a discount. Dr. Cameron's testimony also supports the belief that there will be significant growth in non-affiliated barrels. She estimates that potentially competitive interstate shipments will grow rapidly from 2% of ANS oil in 2010 to 7% in 2013. The companies prospecting for ANS oil include a number of non-affiliates and that some recent fields have been opened by non-affiliates with no participation by TAPS owning companies (e.g., the Ooguruk field developed by Pioneer Natural Resources and the Nikaitchuq field developed by Eni Petroleum) (Exhibit No. CPT-24, at 45).

368. Moreover, Dr. Hieronymus states that Shell Oil is actively engaged in exploration and production of new fields that would be served by TAPS. Furthermore, in a prior affidavit, Dr. Cameron stated that increased exploration will lead to increased development, which will lead to increased system unmatched barrels, thereby increasing competition. In his view, price competition can be effective in redirecting shipments on TAPS, and recent experience of BPPA in 2009 shows that discounting can increase volumes and market share (Exhibit No. CPT-24, at 46).

369. Dr. Hieronymus further states that while this proceeding is intended to establish just and reasonable maximum TAPS rates, that does not make it appropriate to eliminate all incentives for competition on TAPS. In his view, even where the Commission

imposes just and reasonable maximum rates, there are significant benefits from competition (Exhibit No. CPT-24, at 46).

## **H. Anadarko – Answering Testimony**

### **1. Frank J. Hanley**

370. Mr. Hanley is a Director of AUS Consultants. He has a B.S. degree from Drexel University in Business Administration and is also certified as a rate return analyst by the Society of Utility and Regulatory Financial Analysts. The purpose of his testimony is to respond to the direct testimonies of ITC witness Mr. Fairchild and BPPA witness Dr. Vander Weide. Mr. Hanley states that the recommendations of witnesses Fairchild and Vander Weide grossly overstate the cost of capital applicable to Carriers because they are based upon the test period ending September 30, 2009 which is anomalous as it encompasses the worst months of the global financial crisis. (Exhibit No. APC-1, at 1).

371. He opines that the trend of every meaningful indicator confirms that the financial crisis impacted all of the oil pipelines utilized as proxies by Mr. Hanley and witnesses Fairchild and Vander Weide (Exhibit No. APC-1, at 1). In his view, regulators have tools to address the impacts of anomalous circumstances in ratemaking. A fundamental precept of ratemaking is to adjust or exclude unusual or extraordinary costs and rate elements. Similarly, the Commission has recognized that setting representative rates may warrant reliance on post test period information, particularly for financial data which can be volatile and unpredictable. The test year in the instant matter is anomalous and should not be relied upon to establish a representative forward looking cost of capital in this proceeding (Exhibit No. APC-1, at 4-6).

372. He further points out that distribution yields during the period are anomalous; Baa/BBB utility bond yields during the period were anomalous; and that inflation during the period was anomalous. Moreover, it is not reasonable for investors to expect on a going forward basis a zero level of inflation as is assumed by witnesses Fairchild and Vander Weide. The DCF model, especially the version utilized by the FERC, assumes a long-term future investment horizon. Accordingly, the most current period available as of the date of preparation of this answering testimony, which is generally through May of 2010, should be used as the test period (Exhibit No. APC-1, at 6).

373. This period is relatively normal in contrast to the anomalous period ending September 30, 2009. Given that the test period encompasses the worst financial crisis since the Great Depression, these circumstances fully warrant using more normal data that is currently available, according to Mr. Hanley (Exhibit No. APC-1, at 6).

374. Mr. Hanley testifies further that should the Commission choose not to go beyond the end of the test period, he presents an alternative case for the test period ending September 30, 2009, using a normalized inflation factor. In presenting this case,

Mr. Hanley shows two different approaches for normalizing inflation. He cautions that this alternate case is not his primary approach because it relies on data from the anomalous test period, with key elements such as distribution yields likely overstated (Exhibit No. APC-1, at 6-7).

375. While Mr. Hanley does not believe differences in the proxy groups utilized would make a significant difference, he explains why Mr. Fairchild's utilization of Enterprise Products Partners and TEPPCO Partners is incorrect and inconsistent with precedent of this Commission. The basis of selection for the proxy oil pipelines Mr. Hanley used is summarized on Exhibit No. APC-2. Those criteria are: (1) must be a limited partnership (LP); (2) must have long-term debt rated within the investment grade category by S&P and/or Moody's (that is at least BBB- and/or Baa3 or higher, respectively); (3) must be substantially involved in the oil pipeline business for at least 5 years; (4) must be included in Value Line; (5) must have I/B/E/S growth rates in earnings per share (EPS); (6) must have total permanent capital greater than \$1.0 billion; and (7) must not have been involved in merger and/or acquisition activities during the test period (Exhibit No. APC-1, at 7-8).

376. In his view, there were eight companies that met these criteria. However, because of merger activity, Enterprise Products Partners and TEPPCO Partners should not be included in the test period used by witnesses Vander Weide and Fairchild. During the test period, Enterprise Products Partners was in the process of acquiring TEPPCO Partners. Accordingly, during the test period there should be a proxy group of only seven LPs. However, because the TEPPCO Partners acquisition was consummated on October 30, 2009, more than six months before the May 2010 data Mr. Hanley uses for his primary update case, it is appropriate to use Enterprise Products Partners in the proxy group for the update case (Exhibit No. APC-1, at 8).

377. Utilizing the most current information, the proxy group for the update case should consist of all eight LPs as shown on Exhibit No. APC-2, which includes Sunoco Logistics Partners. Mr. Hanley's group includes Sunoco Logistics Partners, a company not included by witnesses Fairchild and Vander Weide. Responses to Anadarko's data requests related to their exclusion of Sunoco Logistics Partners and their responses are shown in Exhibit No. APC-3. He notes that Dr. Fairchild originally believed that Sunoco Logistics Partners had only been a publicly traded firm with published financial data for four years prior to the April-May 2009 time period (Exhibit No. APC-1, at 9).

378. However, Mr. Hanley subsequently learned that Sunoco Logistics has been in operation since 2002 and had more than five years of history. Dr. Vander Weide's reasoning was based on his own chosen criterion (Exhibit No. APC-3, at 2). Sunoco Logistics Partners meets all of the criteria specified *supra* and on Exhibit No. APC-2 and should be included in the proxy group (Exhibit No. APC-1, at 9).

379. Mr. Hanley testifies further that both witnesses Vander Weide and Fairchild use a base period consisting of calendar year 2008 and a test period ending on September 30, 2009. Dr. Vander Weide uses data through the end of this test period, while Mr. Fairchild uses data from late April and early June of 2009, well before the end of the test period. This test period encompasses the depths of the worst financial crisis in recent history. To deal with this financial calamity, the Federal Reserve had to make extraordinary moves including slashing interest rates to zero and buying Treasuries and mortgage debt to keep long-term interest rates low (Exhibit No. APC-1, at 10-11).

380. The data Mr. Hanley presents includes the performance of inflation, bond yields, and distribution yields, confirms that the financial crises was a singular moment in recent financial history, in which these indicators performed in atypical ways unlikely to be repeated as the economy recovers. The test period used by witnesses Vander Weide and Fairchild is an anomalous episode and is not indicative of the period when the rates at issue here will be in effect. Regulators have tools to address anomalies in financial data like those present in this case. Abnormal and non-recurring rate elements are excluded or adjusted (Exhibit No. APC-1, at 11).

381. Where appropriate, Mr. Hanley indicates further, regulators will look beyond the test period. In particular, the FERC has recognized post-test period updating may be required for financial data, given its volatility. Additionally, under its regulations, for good cause shown, the Commission may allow reasonable deviation from the prescribed test period (Exhibit No. APC-1, at 12).

382. Mr. Hanley describes the exhibits submitted with his testimony. For instance, Exhibit No. APC-6 is a graphical depiction of the annual rate of inflation since January of 1960. It is clear from this exhibit that the period encompassed by the test year is anomalous as no prior period during this time span had inflation that was at or below 0%. Exhibit No. APC-7 presents more focused look at the rate of inflation. It depicts graphically inflation by month from January 2007 through April 2010 (Exhibit No. APC-1, at 13).

383. It shows the rapid decline of inflation from about positive 5% at the beginning of the 12-month period ending September 2009 and reached the 0% level by sometime between February and March 2009, and remained below 0% until approximately October 2009, rising rapidly to in excess of 2% in November 2009. It has remained above 2% through April 2010. This information along with that shown on Exhibit No. APC-6, demonstrates to Mr. Hanley that inflation was anomalous during the 12-month period ending September 30, 2009. Exhibit No. APC-8 presents the monthly Consumer Price Index (CPI) for all urban consumers as released by the Bureau of Labor Statistics from January 2000 through April 2010. It shows that a decline in the rate of inflation, beginning between July and August of 2008 (Exhibit No. APC-1, at 13-14).

384. By September 2009, the index of 215.969 was below the index at September 2008 of 218.783. Since that time and through April 2010, the index has increased to the point where it is getting close to the September 2008 level. Exhibit No. APC-8 indicates that the rate of inflation has increased to an annual rate of 2.24% between April 2009 and April 2010. To the extent that the long-term future is likely to be similar to the long-term past, the expected rate of inflation may well be in excess of the current 12-month rate of 2.24% as can be gleaned from the data on Exhibit No. APC-6. It is readily determined from the data on Exhibit No. APC-8 that during the entire 21-month period, January 1, 2008 through September 30, 2009, inflation increased by 2.82%. Such rates of inflation are far better indications of investors' long-term expectations in contrast to the assumption of 0% inflation by Dr. Fairchild and Dr. Vander Weide (Exhibit No. APC-1, at 14).

385. Exhibit No. APC-9 shows a graphical depiction by month between January 2007 and April 2010 of the yields on Moody's Baa rated public utility bonds. All of the proxy oil pipelines have bonds which are rated in the Moody's Baa and/or S&P BBB category. This exhibit shows there was a large spike in the yields during the period ending September 2009, with resumption thereafter to a more normal level based upon the preceding period. That spike in yields was the result of investors' flight to quality during the financial crisis. Bottom of investment grade bond yields (e.g., those of the oil pipeline proxies) spiked much more than higher-rated utility bonds, while yields of government securities plummeted. That spike in bond yields was a temporary result of the financial crisis and is another indication of the anomalous 12-month period ending September 30, 2009 (Exhibit No. APC-1, at 15).

386. Exhibit No. APC-10 shows distribution yields by month for the proxy group of seven oil pipelines which are relevant to the test period ending September 30, 2009. The graphical depiction Mr. Hanley shows yields between January 2008 and May 2010. Distribution yields increased as a result of declining market prices, along with those of virtually every dividend paying stock, due to the massive market decline caused by the financial crisis. It is clear that the spike in distribution yields is consistent with the other trends in the anomalous period attributable to the financial crisis. Moreover, a review of Exhibit No. APC-10 shows that the spike is encompassed by the entire 12-month anomalous period ending September 30, 2009 (Exhibit No. APC-1, at 15-16).

387. Mr. Hanley indicates that there are other reasons to go outside the anomalous test period. Reviewing the timeline of Carriers' 2009 TAPS rate filings at issue in this proceeding, Carriers' rate filings were staggered between March 31, 2009 and November 25, 2009. However, all of those rate filings used the same base period and test period used in the earliest filing, i.e., EMPCo's filing on March 31, 2009. EMPCo used a base period of calendar year 2008 and a test period ending in September 2009 (Exhibit No. APC-1, at 16-17).

388. If the two Carriers that filed their rate cases on November 25, 2009 had used updated base periods and test periods, those test periods typically would have extended through the end of May 2010 (e.g., using the same time intervals for base period, test period and filing date used by EMPCo's March 31, 2009 filing). Carriers obtained a waiver to use the older test period reflected in EMPCo's March 31, 2009 filing (Exhibit No. APC-1, at 17).

389. Mr. Hanley's recommendations are from the standpoint of establishing just and reasonable rates that will be representative of the period when those going forward rates will be effective. From that standpoint, he believes the Commission should not rely on the anomalous and stale test period data utilized by Carriers. Instead the Commission should consider updated and normalized data for more recent and representative periods. The Commission's current policy for establishing common equity cost rate for gas and oil pipelines was established on April 17, 2008 in its Policy Statement (Exhibit No. APC-1, at 17-18).

390. The Commission clarified its DCF methodology regarding the inclusion of limited partnerships as proxies. The Commission stated that it would not cap the cash distributions used to calculate distribution yields, but would reduce instead the long-term growth component, Gross Domestic Product (GDP), by one-half. The other aspects of the Commission's DCF model remained unchanged (Exhibit No. APC-1, at 18).

391. Specifically, Mr. Hanley notes that the short-term growth component would be the I/B/E/S growth rates and the long-term growth in GDP would be based upon one-half of the average derived from the Social Security Administration (SSA), the Energy Information Administration (EIA), and Global Insight. The Commission maintained its weighting of two-thirds to the I/B/E/S short-term growth component and one-third weight to one-half of the average long-term growth in GDP (Exhibit No. APC-1, at 18-19).

392. Mr. Hanley uses eight companies in the proxy group. Because of the anomalies in the financial data for the test period, he uses the most updated information available. This information includes market data through May 2010 and the most recent capital structure and long-term debt rates for the proxy companies that are available. He included in the current analysis Enterprise Products Partners since utilizing data through May 2010 to establish equity cost rate is more than six months from the October 30, 2009 closing of Enterprise Products Partners' acquisition of TEPPCO Partners (Exhibit No. APC-1, at 19).

393. Moreover, Mr. Hanley points out that summarized on Exhibit No. APC-11 are the most recent capital structures available where enough detailed information is available to also calculate the long-term debt cost rate. Accordingly, as shown at the bottom of Exhibit No. APC-11, he relied upon SEC Form 10-Q as of March 2010 for six of the eight companies, while out of necessity, he relied upon the 2009 SEC Form 10-K for two companies (Exhibit No. APC-1, at 19).

394. On Exhibit No. APC-11, Mr. Hanley shows the capital structure ratios by company and average for the group of eight companies. The average capital structure consists of long-term debt capital of 53.89% and equity capital of 46.11%. For comparison, Dr. Vander Weide supports a capital structure of 52.85% debt and 47.15% equity (Exhibit No. BPP-20, at 28). Dr. Fairchild, in comparison, proposes a capital structure of 53.98% debt and 46.02% equity (Exhibit No. APC-1, at 19-20).

395. Mr. Hanley calculated long-term debt cost rates for each of those eight oil pipelines and average for the group based upon the most recent information available. The information is shown in Exhibit No. APC-12. Page 1 shows the composite long-term debt cost rate for each company and the average for the group of 5.97%. Pages 2 through 9 of Exhibit No. APC-12 contain the information detailed by company. For comparison, Dr. Vander Weide computes a 6.46% cost of debt and Dr. Fairchild supports a 6.19% cost of debt. Mr. Hanley also calculated a cost of equity capital utilizing this Commission's DCF methodology. The information is contained in Exhibit No. APC-13. Page 1 contains a summary of the results; page 2 contains the details of the distribution yields by month for the six months ending May 2010; page 3 contains the determination of the average growth rate by company and average for the group based upon the I/B/E/S five-year estimated growth rates in earning per share; and one-half of the GDP growth rate the details of which are shown on page 4 (Exhibit No. APC-1, at 20-21).

396. Mr. Hanley gives two-thirds weight to the I/B/E/S growth rate and one-third weight to one-half of the average growth rate in GDP of 4.54%, the latter being the average of the forecasts from the EIA, the SSA, and Global Insight, as shown on Page 3 of Exhibit No. APC-13. The range of nominal DCF cost rates is from 9.82% to 11.81%, with a median nominal cost rate of 10.72%. The actual rate of inflation during the 12 months ending April 2010 (the latest available at the time of the preparation of this testimony) was 2.24%, resulting in a real median equity cost rate of 8.48% (10.72% - 2.24%). This compares with the 12.35% return on equity calculated by Dr. Vander Weide and the 14.01% return on equity advanced by Dr. Fairchild (Exhibit No. APC-1, at 21).

397. Mr. Hanley states that in the event that the Presiding Judge and the Commission decline to adopt his primary approach of utilizing updated information beyond the anomalous test period, he developed an alternative proposal. Mr. Hanley developed a cost of capital for the test period ending September 30, 2009 using test period information with a normalized inflation rate. He emphasizes that this alternate case is not his primary approach. The test period includes some of the worst months of the most severe financial crisis since the Great Depression (Exhibit No. APC-1, at 21-22).

398. It is not appropriate, in Mr. Hanley's view, to rely on bond yields, distribution yields, inflation measures and other data reflecting those crisis conditions. Such test period data are not representative of going forward conditions and are not an appropriate basis for establishing a just and reasonable forward looking cost of capital. Nonetheless,

if the Presiding Judge and the Commission confine their analysis to the test period, at a minimum, the test period inflation rate should be normalized (Exhibit No. APC-1, at 22).

399. As shown on Exhibit No. APC-7, the inflation rate plunged during the test period, even turning negative. As shown in Exhibit No. APC-6, that period of negative inflation during the recent financial crisis is the only instance of negative inflation in the last 50 years. He states that even Dr. Vander Weide and Dr. Fairchild recognized the inappropriateness of using the negative inflation during the test period in calculating a real cost of capital in this proceeding. Both of those witnesses used an inflation factor of 0% in their test period real return calculations. However, Mr. Hanley believes the use of a 0% inflation rate is arbitrary and no more representative of investor expectations going forward than the negative inflation rate that both witnesses properly rejected. Accordingly, in presenting Mr. Hanley's alternate case below, he offers two approaches for developing a normalized inflation rate for the test period (Exhibit No. APC-1, at 22-23).

400. In Mr. Hanley's view, normalizing inflation is particularly important given the Commission's use of the Trended Original Cost (TOC) methodology for oil pipeline ratemaking. Under the TOC methodology, the inflation component of the return on equity is subtracted from the nominal return on equity and capitalized over the life of the line. Allowing the Carriers to use a 0% inflation factor, as Dr. Vander Weide and Dr. Fairchild advocate, means that no portion of the return on equity would be capitalized for the period the rates established in this proceeding are in effect. Accordingly, to the extent that inflation actually occurs during those periods, as Mr. Hanley expects and as the current data indicate, the use of a 0% inflation factor would understate the trended rate base and overstate the current real return (Exhibit No. APC-1, at 23).

401. Mr. Hanley further states that the major difference between the equity cost recommendations of Dr. Vander Weide (12.35%) and Mr. Fairchild (14.01%) is attributable to Dr. Fairchild's reliance upon market data in late April and early June of 2009 in contrast to Dr. Vander Weide who relied upon data through the end of the test period. He believes Dr. Fairchild's market data encompasses the period when capital costs, as measured by yields on Baa utility bonds and distribution yields of the proxy oil pipelines were at their highest levels during the anomalous period (Exhibit No. APC-1, at 23-24).

402. Conversely, Exhibit Nos. APC-6 and APC-7 show that Dr. Fairchild relied upon the period from late April to early June 2009, when inflation was near the lowest level in 50 years. Finally, it is seen by reference to Exhibit No. APC-10 that Mr. Fairchild's reliance upon data in late April and early June of 2009 was when distribution yields of the proxy pipelines were at their anomalous peak. Reference to the same exhibits shows that while the use by Dr. Vander Weide of months later in the period ending September 30, 2009 results in a lower equity cost rate, the rate of inflation was still abnormally low, Baa utility bond yields were still extraordinarily high, albeit on the

decline, and did not decline to pre-crisis levels until the end of the test year. Similarly, distribution yields, while on the decline from their peak, did not come close to reaching pre-financial crisis levels until after the end of the test period (Exhibit No. APC-1, at 24).

403. The data for Mr. Hanley's alternate case cost of capital calculation for the test period ending September 30, 2009 using normalized inflation data is shown in Exhibit Nos. APC-14 through APC-16. Exhibit No. APC-14 contains the capital structures and related ratios by company for the seven companies that are applicable for use during the test period. They exclude Enterprise Products Partners and TEPPCO Partners because these companies were engaged in acquisition discussions. They do include Sunoco Logistics Partners LP, which meets Mr. Hanley's selection criteria, as set forth on Exhibit No. APC-2. Accordingly, there are seven proxy oil pipeline companies whose average capital structure is shown to be 52.21% long-term debt and 47.79% common equity capital (Exhibit No. APC-1, at 24-25).

404. Mr. Hanley states he relied upon the latest information available from SEC Forms 10-Q or 10-K as indicated. In other words, he indicates that he utilized the most recent data available wherein there was sufficient information to calculate a composite long-term debt cost rate for each company that is consistent with the latest long-term debt capital available. The composite long-term debt cost rate for that proxy group of seven oil pipelines if reliance is placed upon the latest information available within the test year period is 6.14%, as shown in Exhibit No. APC-15 (Exhibit No. APC-1, at 25).

405. Information on each proxy company's composite long-term debt cost rate is shown on Exhibit No. APC-15. The nominal cost of common equity capital for the proxy group of seven oil pipeline companies during the test year ending September 30, 2009 is a median cost rate of 12.36% as shown on Exhibit No. APC-16. Notwithstanding Mr. Hanley's inclusion of Sunoco Logistics Partners in the proxy group, he indicates that this nominal cost rate is very close to the 12.35% determined by BPPA witness Dr. Vander Weide (Exhibit No. APC-1, at 25-26).

406. However, the distribution yields during the April through September 2009 period were still considerably above normal, and therefore, unrepresentative of the period when the rates will be in effect. He states that Exhibit No. APC-10 shows during the period April 2009 through September 2009, the distribution yields for the group were substantially above the pre-financial crisis level and gradually returned to near the pre-crisis level subsequent to September 2009. Mr. Hanley states he has not normalized the distribution yields, although it should be clear that the test period levels are overstated for use in establishing a going forward cost of equity (Exhibit No. APC-1, at 26).

407. Mr. Hanley's alternate case calculation of real equity cost rates is summarized on Exhibit No. APC-16. Page 1 of this exhibit shows the adjusted distribution yields and indicated nominal equity cost rates. A test period nominal median equity cost rate is 12.36%. In calculating the real equity cost rate, he indicates that it is inappropriate to use

either the negative inflation rate that occurred during the test period or a 0% inflation rate used by witnesses Fairchild and Vander Weide (Exhibit No. APC-1, at 26).

408. Accordingly, Mr. Hanley presents two approaches for normalizing the inflation rate during the test period. First, he calculated a reasonable normalized inflation rate of 2.24% based on the recent actual 12 months ending April 2010. Using a 2.24% normalized inflation rate produces a real median equity cost rate of 10.12% (12.36% - 2.24%). This recent inflation rate can be calculated from the information shown in Exhibit No. APC-8, and was used in Mr. Hanley's primary case cost of capital recommendation based on the most recently available data. This recent inflation rate has the advantage of being a rate likely to be expected by investors on a going-forward basis. In this regard, the cost of equity capital, especially as established under the FERC's DCF model, is based on forward-looking investor expectations (Exhibit No. APC-1, at 26-27).

409. Additionally, the 2.24% inflation rate is conservative given the long-term historical rates of inflation, as can be seen from the 50 years inflation data shown on Exhibit No. APC-6. A second approach to normalizing the test period inflation rate would be to use the inflation rate of 2.82% which occurred over the entire 21 months of the base and test periods, i.e., calendar year 2008 through September 2009. Using a 2.82% normalized inflation rate produces a real median equity cost rate of 9.54% (12.36% - 2.82%) (Exhibit No. APC-1, at 27).

410. This approach has the advantage of confining the analysis entirely to the base and test periods and averaging the disparate inflation experience during those periods. This approach would be appropriate if the Presiding Judge and the Commission determine that staying within the base and test periods was a paramount objective. However, it is quite likely that the distribution yields calculated during the test period ending September 2009 are also anomalous and therefore real equity cost rates of 10.12% and 9.54% are likely overstated on a going forward basis, keeping in mind the long-run horizon implicit in the DCF model (Exhibit No. APC-1, at 27-28).

411. For the foregoing reasons, Mr. Hanley does not recommend a cost of capital on a going-forward basis based upon the anomalous test year ending September 30, 2009. Rather, as indicated his primary case recommendation is to go outside the test period and utilize currently available data which indicate a real equity cost rate of 8.48%. In light of the anomalous test period, Mr. Hanley's primary recommendation is to develop a cost of capital using the most recent data available, generally through May of 2010 (Exhibit No. APC-1, at 28).

412. Mr. Hanley's recommended overall cost of capital is 7.13%, based on a debt cost of 5.97%, an equity cost of 8.48%, and a capital structure consisting of 53.89% debt and 46.11% equity. In the event the Commission declines to adopt the above recommendation, he presents an alternate case based on test period data with a

normalized inflation factor with a capital structure consisting of 52.21% debt and 47.79% equity and a debt cost of 6.14% (Exhibit No. APC-1, at 28-29).

413. Additionally, Mr. Hanley presents two approaches for normalizing the inflation factor in determining the real equity cost rate: (1) Normalized Inflation Approach 1 based on the inflation rate for the latest twelve months of 2.24% (resulting in a real equity cost of 10.12%), and (2) Normalized Inflation Approach 2 based on the inflation rate for the 21 months of the base and test periods of 2.82% (resulting in a real equity cost of 9.54%) (Exhibit No. APC-1, at 29).

414. As shown in the middle of Exhibit No. APC-17, the first approach results in an overall cost of capital of 8.04%. The second approach, shown at the bottom of Exhibit No. APC-17, utilizes the 2.82% inflation which occurred over the 21 months of the base and test years and results in an overall cost of capital of 7.77%. Mr. Hanley emphasizes that this alternate test period approach, notwithstanding the normalization of inflation overstates the cost of capital on an ongoing basis due to reliance on other test period financial data, such as anomalous and overstated distribution yields. Accordingly, the Commission should adopt his primary case recommendation based on updated information to develop representative going-forward rates (Exhibit No. APC-1, at 29).

## **2. John F. Brown**

415. Mr. John F. Brown is the chairman of and a consultant with the energy consulting firm of Brown, Williams, Moorhead & Quinn, Inc. and provides consulting advice and assistance to a wide variety of clients, including natural gas and oil pipeline companies, oil and gas producers, electric companies, trade associations, and various federal and state agencies. Mr. Brown has been employed in the energy industry since 1955. He received a B.S. degree in Business Administration, with a major in accounting from Washington University in St. Louis, Missouri. He also received a Juris Doctor from the St. Louis University School of Law (Exhibit No. APC-97, at 1-2).

416. In his answering testimony, Mr. Brown evaluates the pooling methods proposed by CPTAI and BPPA. Based upon his review, he recommends the Commission adopt the pooling method sponsored by CPTAI as modified by his recommendations. He demonstrates that CPTAI's method as modified by his recommendations would be consistent with the pooling method and policies that have successfully been in place on TAPS for over two decades. The major reason why the CPTAI method, as modified by his recommendations, is preferable is that it does not provide for the pooling of return elements, while the BPPA method includes the pooling of return elements (Exhibit No. APC-97, at 3).

417. Mr. Brown indicates that when the Commission approved Carriers' original pooling method in 1985, it recognized that the exclusion of return elements and Carrier-direct costs from the pooling mechanism served the public interest by promoting

economy of operations, encouraging exploration, production, and throughput, and providing an incentive for the Carriers to compete to earn their return. These important public-interest considerations have guided pooling on TAPS for over two decades and should continue to be applied today. Independent shippers and producers have an important stake in the pooling method approved for TAPS. The pooling method used will affect whether Carriers will compete for the throughput shipped by independent shippers as well as whether they will operate TAPS in a cost-efficient manner (Exhibit No. APC-97, at 4-5).

418. In addition to fostering the incentives, the pooling method must have no impact on the cost of service used to calculate the just and reasonable uniform ceiling rates charged to shippers. BPPA witness Van Hoecke recognizes this fact in his testimony, explaining that the pooling mechanism merely allocates costs to each Carrier and nothing in the mechanism affects the computation of the uniform rate. Mr. Brown asserts that the Commission should ensure that the pooling mechanism adopted in this proceeding has no impact on the cost of service used to derive TAPS rates (Exhibit No. APC-97, at 6).

419. Mr. Brown states that the uniform rate requirement should not be confused with the pooling requirement. The uniform rate requirement, which was previously litigated and adopted by the Commission is not at issue in this proceeding and is necessary to ensure just and reasonable rates as between Carriers and their shippers. The determination of the appropriate pooling method after Opinion 502 has not been previously considered by the Commission, is at issue in this proceeding, and is necessary to ensure that certain costs are reallocated among Carriers to reflect their TAPS usage (Exhibit No. APC-97, at 6-7).

420. The pooling requirement is necessary on TAPS to account for differences between TAPS ownership and usage regardless of whether there is a uniform rate in place or not. While the Commission has not addressed the appropriate pooling requirement that should be adopted after Opinion 502, the Commission has previously adopted a pooling requirement for TAPS. Carriers had requested and the Commission approved the pooling of all cost elements except for Carrier-direct costs and no return elements under TSA Section II-2(f). For approximately two decades Carriers have been pooling in the same basic fashion (Exhibit No. APC-97, at 7).

421. Mr. Brown further indicates that pooling is appropriate for TAPS because it is a single pipeline with five owners of an undivided ownership interest providing an identical transportation service. Under these circumstances, there are disparities between the ownership and the use of TAPS as among Carriers for which the pooling of cost elements other than Carrier-direct costs is appropriate. For example, BPPA currently owns approximately a 47% interest in TAPS, yet in 2009 it used only about 35% of the capacity of the pipeline. CPTAI, in contrast, owns approximately a 28% interest in the pipeline, but in 2009 used approximately 41.5% of the capacity (Exhibit No. APC-97, at 8).

422. While the Commission has required pooling under its ancillary powers and not under Section 5(1) of the ICA, the Commission has applied two tests in evaluating whether the public interest is met by approving a pooling method under Section 5(1) of the ICA. These are the same two tests the Commission applied in evaluating the public interest and approving pooling for TAPS in 1985. Accordingly, evaluating the public interest under these two tests seems like a reasonable approach when considering the pooling proposals in this proceeding. Those two tests are that the pooling method must be in the interests of better service to the public or economy of operation and that the pooling method must not unduly restrain competition (Exhibit No. APC-97, at 9).

423. Mr. Brown states that the Commission should approve the CPTAI method as modified by his recommendations. Under the circumstances of TAPS, pooling all cost elements except for Carrier-direct costs and without return elements is appropriate for use by Carriers and would satisfy both tests the Commission has previously applied in approving a pooling requirement for TAPS. According to Mr. Brown, the CPTAI method, as modified by his recommendations, is a simple method based upon the same method and policies relied upon by the Commission when it approved pooling for TAPS in 1985 (Exhibit No. APC-97, at 9-10).

424. Such a method, in Mr. Brown's view, will assign costs to the Carrier responsible for those costs and will encourage management efficiency and investment while preserving the incentives to compete for throughput and reduce costs. Similarly, such a method would also encourage an integrated Carrier to more fully utilize capacity on TAPS by increasing exploration and production of oil on the North Slope which may, in turn, result in additional throughput and reduce rates. A pooling method that includes Carrier-direct costs and return elements would reward poor management and inefficient operation and would discourage competition, in his opinion (Exhibit No. APC-97, at 10).

425. It would also inappropriately guarantee all Carriers their full return rather than provide an incentive for them to manage an efficient operation or compete to earn their return. As the Commission recognized in its order approving the prior pooling method, a pooling method that excludes return elements and Carrier-direct costs serves important public interests by promoting economy of operations, encouraging exploration, production, and throughput, and providing an incentive for Carriers to compete to earn their return. These interests promote efficient operations that lower costs, which translate into lower rates. Therefore, Mr. Brown believes that the Commission should adopt a mechanism that includes similar incentives in this proceeding (Exhibit No. APC-97, at 10-11).

426. Mr. Brown states that BPPA's concern with realizing its full return does not justify the pooling of return. BPPA's concern is not persuasive and does not justify the pooling of return. It also ignores its own previous endorsement of a pooling method without return, which operated successfully for approximately two decades. BPPA's concern is also inconsistent. On the one hand, BPPA suggests that there is no competition among

Carriers and its rates are mere transfer payments among its own affiliates of no economic consequence (Exhibit No. APC-97, at 10-11).

427. On the other hand, according to Mr. Brown, BPPA suggests that without the pooling of return it will not have an opportunity to realize its full return. If its rates are transfer payments among affiliates, then BPPA should not be heard to argue it is harmed by not paying itself a sufficient return. If its rates are not transfer payments among affiliates, then BPPA should be expected to compete for throughput for additional return or more efficiently manage its cost structure. BPPA's concern also does not give sufficient weight to the decreasing throughput on TAPS or to the increasing role of independent shippers and producers, both of which give rise to an increasing likelihood of Carriers competing for some additional throughput (Exhibit No. APC-97, at 11-12).

428. Additionally, he asserts that BPPA is not fully utilizing its pipeline capacity. Its underperformance should not be rewarded by guaranteeing its return through the pooling mechanism or resolved at the cost of unduly constraining competition by pooling return elements. Instead, BPPA should take the necessary steps to increase its utilization of its own pipeline capacity, attract other throughput, or cut its costs. If BPPA truly has an underperforming pipeline, it may consider selling some portion of its pipeline capacity to another potential Carrier more likely to utilize the excess capacity. At any rate, BPPA should not be permitted to effectively eliminate a real and growing likelihood of some competition for throughput among Carriers by now pooling return elements (Exhibit No. APC-97, at 11-12).

429. Mr. Brown believes that the importance of maintaining incentives for competition are more important today than when the Commission acted to preserve those incentives in 1985. TAPS has historically operated at almost full capacity, and there has been little competition for throughput among Carriers. In the Opinion 502 proceeding, evidence was presented that demonstrated that very little competitive discounting has historically occurred. Additionally, BPPA's witnesses have properly explained that Carriers predominately ship volumes produced by their affiliated exploration and production companies because of strong economic incentives to affiliate tender. That said, maintaining incentives for competition by not pooling return elements or Carrier-direct costs is more important today than when the Commission acted to preserve those incentives in establishing pooling in 1985 (Exhibit No. APC-97, at 12-13).

430. Today, according to Mr. Brown, there is less throughput than capacity and more independent producers on the North Slope. With less throughput than capacity and more independent producers, there is an increasing likelihood that Carriers will more actively compete for throughput than they have in the past. Preserving incentives for the Carriers to compete is consistent with the public interests recognized by the Commission when it approved pooling in 1985 (Exhibit No. APC-97, at 13).

431. Mr. Brown indicates that in 1984 ARCO, which then was an owner of a sizable percentage of TAPS, entered into a settlement agreement with the State. That settlement agreement did not have a pooling provision. Shortly after the settlement agreement between ARCO and the State was made, BPPA signed on to the settlement agreement, and, like ARCO, it agreed to the settlement without any pooling provision. Subsequent Carriers signed on to the settlement agreement; however, those Carriers successfully negotiated for a pooling requirement (Exhibit No. APC-97, at 13-14).

432. The pooling method ultimately agreed to among all Carriers and approved by the Commission permitted the pooling of all cost elements other than Carrier-direct costs and did not permit the pooling of any return elements. In fact, in their 1985 application, certain Carriers asserted that not pooling the Carrier-direct costs and the return elements would facilitate continued competitive behavior and serve as a spur to compete for additional traffic if throughput falls below mechanical capacity. In October 1985, the Commission approved the 1985 application and required pooling under the TSA, which did not pool Carrier-direct costs or the return elements (Exhibit No. APC-97, at 14).

433. Mr. Brown states that BPPA previously endorsed the CPTAI method as modified by his recommendations for pooling on TAPS. BPPA specifically endorsed the 1985 application by other Carriers to pool all cost elements except for Owner-direct costs and return elements for TAPS. In fact, BPPA specifically referred to the 1985 application in its comments by stating, as shown in the application, the provision for which approval is sought will be conducive to better service to the public and economy of operation. (Exhibit No. APC-97, at 15).

434. Mr. Brown further summarizes the cost of service elements that BPPA and CPTAI include in their pooling proposals and states that Anadarko's position of using the CPTAI method as modified by his recommendations is aligned with the 1985 pooling method endorsed by every Carrier and approved by the Commission. Both BPPA and CPTAI recognize that Alyeska's variable costs already are allocated among Carriers based on usage under Section 11.4 of the TAPS Operating Agreement, which remains effective (Exhibit No. APC-97, at 15-16).

435. Accordingly, there is no need to include variable costs in the pooling proposals in this proceeding, in his opinion. Mr. Brown agrees that variable costs should continue to be allocated based on usage. Both BPPA and CPTAI agree that fixed operating costs should be pooled. Mr. Brown supports pooling of these costs. Both BPPA and CPTAI propose to pool depreciation expense. Mr. Brown supports pooling of depreciation (Exhibit No. APC-97, at 16-17).

436. The difference between BPPA's and CPTAI's positions concerning the inclusion of return on investment is that BPPA proposes to pool return on investment whereas CPTAI excludes return elements from pooling. Mr. Brown believes that return elements

should be excluded from the pooling mechanism, as CPTAI has done in its proposal (Exhibit No. APC-97, at 17).

437. Mr. Brown agrees that these features serve the general public interest and interests of shippers. By contrast, including return in the pooling mechanism would eliminate these incentives for efficiency, increased throughput, and competition among Carriers, which is contrary to the interests of shippers, as well as the principles the Commission cited when it approved Section II-2(f). He believes that it is well established that a pipeline operator should have a reasonable opportunity to earn its allowed rate of return; however, such returns are not guaranteed (Exhibit No. APC-97, at 18).

438. Mr. Brown further asserts that without guaranteed return, owners may be inclined to offer rate discounts in order to increase their throughput and thereby collect additional revenues. Those added revenues will provide the means to recover added returns. This is consistent with the statement of the Commission when it approved the TSA that the exclusion of return from the TSA pooling arrangement will provide owners with an incentive to compete to earn their return (Exhibit No. APC-97, at 18-19).

439. Mr. Brown opines that the pooling mechanism adopted in this proceeding should, like Section II-2(f), maintain incentives for Carriers to compete to earn their return. The return differs from other elements of the cost of service. Although return is included in a cost of service used to determine just and reasonable rates, that inclusion differs from actual out of pocket costs such as labor and materials, taxes and the recovery over time of the cost of a pipeline company's investment in its facilities (Exhibit No. APC-97, at 19).

440. In essence, return on a pipeline investment is compensation for the investment made to build the pipeline facilities, and that compensation will vary depending on the factors used to determine a proper rate of return from time to time. Under established regulatory principles, a pipeline owner is provided only the opportunity to recover return, not a guaranteed return (Exhibit No. APC-97, at 19).

441. Mr. Brown notes that BPPA excludes Owner (Carrier)-direct costs from its pooling mechanism. CPTAI includes these costs in its proposal. Mr. Brown does not agree with CPTAI's pooling proposal that Owner-direct cost should be included in pooling. Unlike the common costs incurred on behalf of all Carriers by the operator of TAPS, Alyeska, Owner-direct costs are related to each individual Carrier's ownership of TAPS, which typically include allocations of overhead expenses from Carriers' corporate parents (Exhibit No. APC-97, at 19-20).

442. Pooling the Carrier/Owner-direct costs, in his view, eliminates the incentive to minimize these costs, which could increase the rate paid by shippers. Indeed, as the State and the Department of Justice explained in comments in support of the TSA, Owner-direct costs were excluded from the cost reallocation (in Section II-2(f)) in order to maintain the incentives owners have under the TSM to minimize those costs. This

reasoning likewise supports exclusion of direct costs from the pooling mechanisms at issue in this proceeding (Exhibit No. APC-97, at 20).

443. Mr. Brown notes BPPA includes intrastate costs in its pooling mechanism. CPTAI excludes these costs from pooling. BPPA proposes to apply its pooling mechanism to 100% of the barrels flowing through TAPS and then allocate costs between interstate and intrastate service based on the percentage of throughput flowing in interstate commerce and intrastate commerce (Exhibit No. APC-97, at 20-21). Mr. Brown initially provided testimony in support of inclusion of intrastate costs, but Anadarko changed its position on this issue and provided revisions to those portions of Mr. Brown's testimony relating to his support for inclusion of intrastate costs (Exhibit No. APC-96; Exhibit No. APC-97 (Revising Exhibit No. APC-18)).

444. Mr. Brown believes BPPA's pooling proposal is quite complex, whereas CPTAI's pooling method is simpler and based on a tested model. CPTAI's proposal is modeled after the Section II-2(f) method contained in the TSA. The essential features of this mechanism are familiar to the Commission and other interested parties, making it easier to implement and monitor (Exhibit No. APC-97, at 21).

445. Mr. Brown concludes in support of CPTAI's pooling proposal, with two modifications. CPTAI's proposal best captures the features important to shippers and serves the general public interest, however, it does not pool return elements, thereby preserving incentives for competition, operational efficiency, and increased exploration, production, and throughput. CPTAI's proposal is also less complex and easier to implement, since it is based on the familiar Section II-2(f) method (Exhibit No. APC-97, at 22).

446. Mr. Brown cannot support CPTAI's proposal in full, however, because CPTAI proposes to include Owner-direct costs because such would eliminate the incentive Carriers face to minimize these costs. The Commission should not adopt BPPA's proposal, in his view. By pooling return elements, BPPA's proposal would eliminate incentives that promote important public and shipper interests which the Commission has recognized (Exhibit No. APC-97, at 22).

## **I. State of Alaska – Answering Testimony**

### **1. Thomas Horst**

447. Dr. Horst is the Managing Director of Horst Frisch Incorporated, an economic consulting firm. His principal areas of specialization include tariff rate regulation of oil pipelines, transfer pricing, and economic substance of complex transactions. Dr. Horst's testimony addresses the appropriate valuation date to use in determining the real cost of equity capital; why he concludes that the nominal rate of return on equity derived from a proxy group consisting entirely of MLP pipelines overstates the cost of equity capital for

Carriers; and, why he believes any reallocation of Carriers total costs should not include the overall return on rate base or operating expenses that are incurred directly by a TAPS Carrier (Exhibit No. SOA-1, at 1-2).

448. Dr. Horst addresses the appropriate valuation date for determining the real rate of return on equity, which is equal to (1) the nominal rate of return derived from a proxy group of oil pipeline companies, minus (2) an inflation adjustment. In Dr. Horst's view, the issues relating to the two components are distinct. Dr. Horst also addresses whether the DCF nominal rates of return recommended by the Carriers' two cost of capital experts are overstated because of the valuation dates they chose. To illustrate the valuation date issues he evaluated various adjustments to the DCF return on equity calculations as of September 2009 made by Dr. Vander Weide. However, by using his calculations to illustrate valuation date issues, he is not endorsing Dr. Vander Weide's views on other cost of capital issues that may be disputed by other parties in this proceeding (Exhibit No. SOA-1, at 3-4).

449. Dr. Horst states that the median rates of return recommended by Dr. Fairchild and Dr. Vander Weide both overstate the best forward-looking estimate of the DCF return as of September 30, 2009. Dr. Vander Weide's estimate is overstated because he relies on the Commission's normal practice and uses a six month trailing average stock price in a period when MLP oil pipelines' stock prices were rising at a rapid rate. Dr. Fairchild's estimate is overstated because he chose a stale valuation month (April 2009). While a later valuation date could be considered, Dr. Horst would recommend calculating the proxy company's distribution yield based on the average stock prices for the three month period of August-October 2009, rather than the six month trailing average of April-September 2009 (Exhibit No. SOA-1, at 4).

450. Dr. Horst notes that Dr. Fairchild chose a valuation date of April 2009 and reported a median nominal rate or return on equity for an oil pipeline proxy group consisting of eight MLP pipelines of 14.01%. Dr. Vander Weide chose a valuation date of September 2009, which is nine months after the end of the base year (2008), and reported a median nominal rate or return on equity for an oil pipeline proxy group consisting of six MLPs of 12.35% (Exhibit No. SOA-1, at 4-5).

451. Dr. Horst references Exhibit No. SOA-3, which is a chart showing the DCF nominal rates of return for oil pipeline proxy groups at year-end from 1995 - 2009, which were calculated in Docket No. IS09-432-000 by Dr. Vander Weide. Dr. Horst draws two conclusions from Exhibit No. SOA-3: the median DCF rates of return at year end have generally been lower during the last seven years (2003-2009) than for the preceding eight years (1995-2002); and the median DCF rate of return at the end of 2008 was notably higher than the median rates were during either the immediately preceding five years (2003-2007), or the 11.69% per annum median rate that Dr. Vander Weide calculated for December 2009 (Exhibit No. SOA-1, at 5).

452. Dr. Horst points to Exhibit No. SOA-5 which illustrates the spike in the DCF rate of return during the last few months of 2008 and the first few months of 2009. The exhibit is a chart with indices showing how and why quarterly values of the average nominal rate of return for an eight-company oil pipeline proxy group has changed over the last three years. These indices compare values at the end of the current quarter to the value as of the end of the second quarter of 2007. The overall DCF rate of return increased by approximately 30% between June 30, 2007 and March of 2009, and has declined steadily over the last year. As of May 2010 (which is not the end of a quarter, but is the latest data available at this time), the DCF rate of return was approximately the same as it was in June 2007. Both the I/B/E/S growth rate and the Commission's two-stage growth rate fell between September 2008 and June 30, 2009 and have remained more or less flat since then (Exhibit No. SOA-1, at 5-6).

453. Dr. Horst states that the distribution yield increased by more than 160% between June 2007 and March 2009 and has fallen steadily since that latter date, but remains as of May 2010 approximately, 20% higher than it was in June 2007. While the average DCF rate of return as of May 2010 is approximately the same as it was as of June 2007, the small change in the overall DCF return results from an increase in the distribution yield that has been offset by a reduction in the growth rate. Exhibit Number SOA-6 shows what caused the spike in oil pipelines distribution yields in the latter half of 2008 and in 2009. This exhibit also shows the change over the last three years in the two components of the distribution yield, distribution per share and the average share price (Exhibit No. SOA-1, at 6-7).

454. Dr. Horst shows separately the average high-low stock price for the current month and the cumulative average of those monthly stock prices over the six preceding months, which the Commission applies in calculating the distribution yield. Dr. Horst states that it is clear the spike in the distribution yield resulted from the sharp fall and subsequent recovery in MLP stock prices. A company's average stock price over the last six months is not a good way of smoothing random fluctuations in stock market prices (Exhibit No. SOA, at 6-7).

455. While stock prices may fluctuate from month-to-month, they tend to grow over time. Even with their high cash distribution yields, the total DCF rate of return on MLP oil pipelines has a significant expected growth component, which translates into expected growth in stock prices. Dr. Horst believes that the average stock price over the last six months has a consistent tendency to understate the current market value of a company's stock. This tendency toward understatement was evident in the last six months of 2009. The Commission's use of the average stock price over the last six months is not a procedure generally used by financial analysts, in his view (Exhibit No. SOA-1, at 7).

456. Dr. Horst states further that all three DCF studies that Dr. Vander Weide cited in his direct testimony at Exhibit No. BPP-21, calculated a company's distribution yield as of December 31 based on its stock price on that date. Similarly, the one and three stage DCF rates of return that can be obtained from Morningstar both rely on a company's distribution yield as reported in the S&P Compustat database, which in turn reflects the current monthly close price. Dr. Horst concludes that the median rates of return recommended by Dr. Fairchild and Dr. Vander Weide both overstate the best forward looking estimate of the DCF return as of September 30, 2009. Dr. Vander Weide's estimate is overstated because he relies on the Commission's six-month trailing average stock price in a period when MLP stock prices were rising at a rapid rate. Dr. Fairchild's estimate is overstated because he chose a stale valuation date (Exhibit No. SOA-1, at 7-8).

457. Dr. Horst states that although a later valuation date might be considered by the Commission it does not address the real issue, which is the Commission's procedure of using a trailing six month average of stock prices. One way of addressing this issue is to average the high and the low stock prices for just the current month. A second alternative is to extend the price averaging period to include the previous, current and coming months. A three month price averaging period would smooth month-to-month fluctuations in stock prices, but avoid the tendency to understate the stock market value in the valuation month (Exhibit No. SOA-1, at 8).

458. Dr. Horst derives these alternative results in the table shown in Exhibit No. SOA-8. The first line in this table shows the DCF rates of return recommended by Dr. Vander Weide. The second and third lines show the effect of using just the current month or a three-month averaging period centered on the September 2009 valuation date. For comparison, the last line shows the result of using a December 2009, rather than a September 2009, distribution date for Dr. Vander Weide's six proxy companies (Exhibit No. SOA-1, at 9).

459. Based on this analysis, Dr. Horst recommends replacing the six month trailing average of a proxy company's stock price with a three month average that is centered on the valuation month. Dr. Horst recommends that the appropriate inflation rate to use in adjusting the nominal rate of return on equity to obtain the real rate of return to be applied to the equity portion of the rate base under the 154-B methodology the Commission applies to oil pipelines (Exhibit No. SOA-1, at 9-10).

460. He recommends that the inflation adjustment to the nominal return on equity be based on a medium term forecast of the CPI-U inflation rate, such as the five year forecast provided every March and October by Blue Chip Economic Indicators. The Blue Chip five year inflation forecast is more consistent with the Commission's preference for a forward-looking cost of equity, more appropriate to apply to use in determining a tariff rate that may be in effect for several years, and more consistent with

the Commission's understanding that fluctuations in the real rate of return would be driven mainly by fluctuations in the nominal rate of return calculated under the DCF method (Exhibit No. SOA-1, at 9-10).

461. Dr. Horst states that because the actual inflation rate over the twelve months ending with April 2009 (Dr. Fairchild's recommended valuation date) was negative, Dr. Fairchild would set the inflation rate equal to zero. His recommended real rate of return on equity is 14.01% per annum, the same as his recommended nominal rate of return. Because the actual inflation rate over the twelve months ending with September 2009 (Dr. Vander Weide's recommended valuation date) was negative, Dr. Vander Weide would also set the inflation rate equal to zero. Dr. Vander Weide's recommended real rate of return on equity is 12.35% per annum, the same as his recommended nominal rate of return (Exhibit No. SOA-1, at 10-11).

462. Dr. Horst states that the negative rates of inflation are due to the sharp reduction in energy prices that occurred in the last few months of 2008 and continued into 2009. Exhibit No. SOA-9 provides a table and a chart showing the frequency of various rates of inflation in the CPI-U over the preceding 12 months for each of the 180 months during 15 years ending with April 2010 (the latest month for which the CPI-U is available). Over that entire 15-year period, the average inflation rate over the preceding 12 months was 2.49% per annum. The eight months from March through October 2009 were the only months during that 15 year period covered by Exhibit No. SOA-9 when the 12 month CPI-U inflation rates were negative (Exhibit No. SOA-1, at 11).

463. Dr. Horst notes that in prior cases, the Commission has generally used the actual inflation rate for the twelve months prior to the valuation date to derive a real rate of return. This practice was based upon a belief that the actual inflation rate for the proceeding year would be relatively stable, so fluctuations in the real rate of return would result mainly from fluctuations in the nominal rate of return. Finally, the determination of the initial real rate of return involves the finding of the nominal rate and the extraction of the inflation component. He opines that the Commission sees nothing unusual about the determination of nominal rates. This is that standard practice for gas pipeline and electric companies. Moreover, changes in the real rate will also be determined by reference to changes in the nominal rate. (Exhibit No. SOA-1, at 12).

464. Dr. Horst asserts that Dr. Vander Weide in another proceeding highlighted the volatility of the CPI-U inflation rate compared to the nominal DCF rate of return (*SFPP, LP.*, Docket IS09-437-000). There he updated the DCF return on equity calculations to reflect a March 31, 2010 valuation date, rather than the June 30, 2009 valuation date used in his earlier direct testimony. Dr. Vander Weide calculated that there is a 6.16 percentage point reduction in the real rate of return, which resulted not only from a 2.42% reduction in the nominal rate of return, but also from a larger, 3.74 percentage

point increase in the inflation rate (which increased from minus 1.43% to plus 2.31%) (Exhibit No. SOA-1, at 12-13).

465. Dr. Horst states that Dr. Vander Weide presented historical data regarding the nominal rate of return on equity for his proxy group, the CPI-U inflation rate, and the resulting real rate of return as of December 31 for the fifteen years, 1995 through 2009. For those fifteen years, the average nominal rate of return was 13.15%, the average inflation rate was 2.48%, and the average real rate of return was 10.67%. Over the most recent five years, 2005-2009, the standard deviation (which is a measure of volatility) of the real rate of return, 2.68% per annum, was higher than the 1.51% standard deviation of CPI-U inflation rate, which in turn was higher than the 1.21% standard deviation of the nominal rate of return on equity. That is, over the last five years, actual inflation rates have not been more stable than the nominal rate of return on equity, with the result that the real rate of return has been notably more volatile than the nominal rate of return. Dr. Vander Weide recommended that the Commission set the inflation factor equal to the difference between the most recently estimated nominal rate of return and the average of the real rate of return over the last 15 years (Exhibit No. SOA-1, at 13-14).

466. Dr. Horst agrees with one part of Dr. Vander Weide's analysis in that using the actual inflation rate over the most recent 12 months makes the real rate of return more volatile than the nominal rate of return, which does not appear to be the result the Commission anticipated in 1985 when Opinion No. 154-B was issued. However, Dr. Horst thinks Dr. Vander Weide's recommendation to set the inflation factor by taking the difference between the estimated nominal rate of return and the average of the real rate of return over the last fifteen years would represent a radical departure from the Commission's objective of using the DCF Model to determine a forward-looking cost of equity capital (Exhibit No. SOA-1, at 14).

467. Dr. Vander Weide's proposal would calculate the real return on equity in *SFPP L.P.*, Docket No. IS09-437-000, by starting with the most recently estimated nominal rate of return, 11.03%. He would subtract from that nominal rate of return an inflation adjustment equal to the difference between: (1) the most recently estimated nominal rate of return, 11.03%, and (2) the average of the real rate of return over the last 15 years, 10.67%. That is, Dr. Vander Weide's inflation adjustment would be 0.36% (11.03% minus 10.67%), so his real rate of return would be 10.67% (i.e., 11.03% minus 0.36%) (Exhibit No. SOA-1, at 14).

468. In short, Dr. Horst states that Dr. Vander Weide's recommendation is mathematically equivalent to applying the moving average real rate of return over the last 15 years. The most recently estimated nominal rate of return would have the same impact on the real rate of return as the nominal rate of return estimated 15 years ago. This confirms for Dr. Horst the volatility of the CPI-U inflation rate compared to the nominal DCF rate of return. To avoid unintended volatility when determining the

inflation adjustment, Dr. Horst recommends that the Commission rely on medium term inflation forecast of the future CPI-U inflation rate, such as the five-year consensus forecast that Blue Chip provides in March and October of every year. Dr. Horst states that Exhibit No. SOA-10, provides the copies of Blue Chip's five year CPI-U inflation forecasts published on October 10, 2009 and March 10, 2010, respectively, based on economic forecasts prepared in the preceding month. Blue Chip is similar to I/B/E/S in that Blue Chip does not develop its own forecasts. Rather Blue Chip conducts monthly surveys of forecasts prepared by economic forecasters and tabulates consensus estimates based on the median results obtained in its surveys (Exhibit No. SOA-1, at 14-15).

469. Dr. Horst therefore recommends using an inflation forecast, rather than an actual inflation rate for some historical period. The Commission's DCF method for calculating the growth rate of current distributions takes a weighted average of: (1) the median of the I/B/E/S stock analysts' forecasts of the growth rate of a company's EPS over the next three to five years, and (2) an average of three economic forecasts of the long-term growth rate of GDP. Since the nominal rate of return on equity is based on forward-looking forecasts of the future growth in distributions, Dr. Horst sees no reason why the inflation adjustment should be based on a backward-looking inflation rate reflecting some past period, rather than a forward-looking estimate of future inflation (Exhibit No. SOA-1, at 15-16).

470. Dr. Horst recommends using a medium range inflation forecast, rather than a short term forecast of inflation. Under the 154-B method, the real rate of return that an oil pipeline applies to the equity portion of its rate base is used to determine tariff rates that will remain in effect until the oil pipeline elects to make a new cost of service filing. When the oil pipeline updates its rate base in its next rate filing, it applies the actual inflation rates for each year since its last tariff filing. The appropriate inflation forecast to apply should be consistent with the length of time the filed tariff is reasonably expected to remain in effect (Exhibit No. SOA-1, at 16).

471. Dr. Horst draws the following conclusions from the data and calculations shown in Exhibit. No. SOA-11: over the fifteen years 1995-2009 average Blue Chip five-year inflation forecast, 2.57% per annum, is very close to the average actual December to December inflation rates, 2.48% per annum; the volatility of the Blue Chip five year inflation forecast is substantially lower than the volatility of the nominal rate of return on equity and the actual December to December inflation rates, respectively. The volatility of the real rate of return based on the actual December to December inflation rates is notably greater than the volatility of the real rate of return based on the Blue Chip five year inflation forecast (Exhibit No. SOA-1, at 15-18).

472. Accordingly, Dr. Horst concludes that the Blue Chip five year inflation forecast is more consistent with the Commission's preference for a forward looking cost of equity, more appropriate to apply to use in determining a tariff rate that may be in effect for

several years, and more consistent with the Commission's understanding that fluctuations in the real rate of return would be driven mainly by fluctuations in the nominal rate of return calculated under the DCF method (Exhibit No. SOA-1, at 16-18).

473. The inflation rate adjustment that Dr. Horst recommends depends on the valuation date used to determine the nominal rate of return on equity: if the appropriate valuation date for the nominal return on equity is determined to be between September 30, 2009 and February 2010, he would apply the five year CPI-U inflation forecast, 2.2%, published by Blue Chip on October 10, 2009 based on forecasts prepared in September 2009. If the appropriate value date is on or after February 28, 2010, he would apply the five year CPI-U inflation forecast, 2.2%, published by Blue Chip on March 10, 2010 based on forecasts prepared in February 2010. If the Commission or the Presiding Law Judge decides not to adopt Dr. Horst's approach, he recommends that a later valuation date (December 2009 or later) be considered. Based on the data shown at the bottom of Exhibit No. SOA-9, Page 2 of 2, the actual CPI-U inflation rate reverted to its normal range, 2% - 3%, in December 2009 and subsequent months (Exhibit No. SOA-1, at 18-19).

474. Dr. Horst states that differences in the income tax treatment of MLP unitholders versus that of corporate shareholders result in an MLP oil pipeline having a DCF rate of return that is at least 2.0 percentage points higher than it would have had if it had been organized as a corporation. This increment in the DCF rate of return is over and above the effect of any difference in risk. He recommends that the return on equity derived from a proxy group consisting entirely of MLP oil pipelines be reduced by at least 2.0 percentage points to determine the cost of equity of Carriers because they are all organized as corporations. Dr. Horst believes this treatment is warranted because Carriers are entitled under existing precedent to an income tax allowance (Exhibit No. SOA-1, at 20).

475. Dr. Horst states that the Commission's 2008 Proxy Group Policy Statement conclusion that MLPs and corporations could be combined into a single proxy group was driven by the dwindling number of oil and natural gas pipeline corporations with publicly traded stock. He indicates that in Opinion No. 486-B, the Commission concluded a proxy group should consist of at least four, and preferably at least five members. Dr. Horst believes that in the Commission's view the principal obstacle to combining MLPs and corporations into a single proxy group is that MLPs have substantially higher distribution rates than corporations do. He quotes from the Commission that pipeline MLPs have typically distributed 90% or more of available cash flow. As a result, the MLP's cash distributions normally include not only the operating profit component of available cash flow, but also the depreciation component. This means that, in contrast to a corporation's dividends, an MLP's cash distributions generally exceed the MLP's reported earnings (Exhibit No. SOA-1, at 20-21).

476. Dr. Horst opines that the pipeline MLP's ability to distribute a high percentage of available cash flows reflects the stable cash flows underpinning its businesses. The Commission ultimately concluded that the long term growth component of its two-stage growth rate should be reduced by 50% when applied to an MLP pipeline, but not a corporate pipeline. In particular, the Commission concludes that corporations have greater opportunities for diversification because their investment opportunities are not limited to those that meet the tax qualifying standards for an MLP and are able to assume greater risk at the margin because of less pressure to maintain a high payout ratio (Exhibit No. SOA-1, at 21).

477. It is a corporation's higher retention ratio that allows this greater flexibility. This is consistent with the fact that Prudential Bache projected the long term growth rates of electric utilities to be less than that of the economy as whole because of their greater dividend payouts and lower retention ratios. Therefore, investors would quite reasonably conclude that MLP long-term growth rates would be lower than that of tax paying corporations, because MLPs have fewer opportunities to participate in the broad economy that underpins the Commission's current use of long-term growth in GDP (Exhibit No. SOA-1, at 21-22).

478. Dr. Horst states further that a corporate pipeline is subject to the corporate income tax, but an MLP pipeline is not. Since the Omnibus Budget Reconciliation Act of 1987 was enacted, MLPs with publicly traded units have generally been taxed as if they were corporations, but oil and gas pipeline MLPs were exempted and continued to be exempt from any entity level income tax. An MLP partner is taxed as if it had operated the pipeline and earned its allocable share of the pipeline's taxable income, whether or not that income was distributed. A corporate shareholder is generally taxed only on the dividends the corporation declares and pays. For most investors, dividend income is effectively taxed at a lower rate than is ordinary income derived from a partnership. A DCF rate of return measures the return after deducting corporate income taxes, but before deducting any income tax on the dividends for the pipeline's investors. That is, the corporation pays dividends to its shareholders out of its after corporate tax earnings (Exhibit No. SOA-1, at 22).

479. Dr. Horst opines that the distributions investors receive represent the investors' return before deducting the investors' tax on either the income they derive from a partnership or the dividends they receive from a corporation. Because the tax treatment of an MLP pipeline's unit-holders differs from that of a corporate pipeline's shareholders the DCF rates of return also differ. An investor generally seeks to maximize its after tax rate of return and so will require a higher before tax rate of return on an investment that is subject to a higher effective rate of income tax (Exhibit No. SOA-1, at 22-23).

480. Dr. Horst further describes that it is not unusual that differences in income tax treatment of investors have an impact on the yields that investors obtain in the market.

Yields on bonds that pay taxable interest income are higher than the yields on bonds of state and local governments that pay tax exempt interest after taking account of any differences in risk. The premium in the yield on taxable bonds over the yield on tax exempt bonds is what Dr. Horst refers to as a built in income tax allowance because it compensates investors for the additional tax they will incur if they invest in taxable bonds (Exhibit No. SOA-1, at 23).

481. Like a bond's interest yield, a DCF yield reflects an investor's before tax rate of return and includes a built in tax allowance to provide for the taxes the investor will have to pay. The impact is that the differences in the income tax treatment of MLP unitholders versus that of corporate shareholders result in an MLP oil pipeline having DCF rates of return that are at least 2.3 percentage points higher than they would have had if they had been organized as a corporation. This difference in DCF rates of return is unrelated to any difference in risk between the two types of entities. Accordingly, rates of return for corporations, based on unadjusted DCF rates of return for MLPs are not, to the extent they are so based, justifiable as being cost-based, in his view (Exhibit No. SOA-1, at 23-24).

482. Dr. Horst believes that the benefit to corporate shareholders of the tax preference for dividend income outweighs the benefit to MLP unit-holders of tax deferral effects. Investors will generally seek to maximize the after tax rate of return on their investment portfolio. If one type of investment has higher risk than a second type of investment, investors will generally require a higher before and after tax rate of return on the first type of investment to compensate for the higher risk. Similarly, if one type of investment is taxed at a higher effective rate of tax than a second type of investment, investors will generally require a higher before tax rate of return in order to obtain the same after tax rate of return, all other things being equal. The tax treatment of an investor's dividend income and capital gains from corporate shareholding is relatively straightforward, but the tax treatment of income and gains from MLP unit-holdings is very complex. In order to directly compare the effects of differences in the tax treatment of these two types of investments, one must construct a model that takes in account the complexity of these tax rules (Exhibit No. SOA-1, at 24-25).

483. Dr. Horst notes that an investor attempting to assess the after tax rate of return on MLP unitholdings would do so by projecting the cash distributions and MLP share prices over the investment holding period, calculating the income taxes that would be payable in each year and on the ultimate sale of the MLP units, and then deriving an internal rate of return on its after tax cash flow. Dr. Horst refers to these calculations as a projected cash flow analysis. In Exhibit No. SOA-13, he describes his comparison of the after tax rates of return for MLP unitholders and corporate shareholders (Exhibit No. SOA-1, at 25).

484. Dr. Horst's analysis compares the after tax rates of return between the two types of investments to determine whether there are any differences in rates of return caused by

different tax treatments of these two types of investments. In order to isolate the tax effects, Dr. Horst's model assumes the sum of the cumulative taxable income derived from the MLP units plus the total taxable gain when the MLP units were sold is equal to the cumulative dividend income plus the capital gain on the sale of the corporate shares. In other words, he states that his comparison is based upon the assumption that the total cash flows to the investor are the same for both types of investments, before taxes (Exhibit No. SOA-1, at 25-26).

485. Dr. Horst asserts that the tax treatment of MLP units differs from that of corporate shares in terms of when tax is imposed and the tax rate that applies to the taxable income or gain. The principal difference is that MLP unit-holders typically enjoy a deferral of taxes on cash distributions that corporate shareholders do not. This is normally a tax deferral, not a permanent tax exemption because the MLP's cumulative cash distributions (plus the investor's share of the MLP's retained income) will generally be taxable dollar for dollar to the MLP unit-holder when and if the MLP units are sold. Corporate shareholders typically enjoy two types of tax benefits that MLP unit-holders do not. First and foremost, dividends often qualify for lower effective rates of tax than ordinary income derived from a partnership (Exhibit No. SOA-1, at 26).

486. For individual investors, according to Dr. Horst dividends are currently taxed at the lower rates applicable to long term capital gains. Non-profit organizations (charitable organizations, universities), pension plans and other all other entities are subject to UBIT, which applies to partnership income, but not to dividends or capital gains, which are totally tax exempt. For corporate investors, dividends qualify for a 70% dividends-received deduction, so the effective tax rate is 30% of that applicable to ordinary income derived from a partnership. Dividends paid to foreign investors are subject only to a withholding tax that is reduced under most U.S. income tax treaties from 30% to 10% or 15%. Partnership ordinary income is fully taxable to a foreign investor (Exhibit No. SOA-1, at 26-27).

487. The magnitude of the additional tax cost of investing in MLP units versus corporations depends on how the investor is categorized for tax purposes (e.g., individuals, tax-exempt organizations, Subchapter C corporations, and foreigners) and how long the investor holds its investment and other facts and circumstances pertaining to the investor (Exhibit No. SOA-1, at 26-27).

488. However, Dr. Horst states that assuming that the investor eventually sells the MLP units, the internal rate of return on an investor's projected after tax cash flows from MLP units will generally be lower than the comparable rate of return on the same investor's projected after tax cash flow from corporate shares. Consequently, in order to attract investors, stock market prices of MLP units will have to be lower, and their distribution yields will have to be higher, than the comparable amounts for corporations, all other things (including investment risk and projected future growth of cash distributions) being

equal. Otherwise, without such higher returns, the MLP units would not be attractive to investors (Exhibit No. SOA-1, at 27-28).

489. Dr. Horst states further that he performed a regression analysis of actual rates of return in the marketplace that confirms MLPs generally have lower prices, and thus higher DCF distribution yields than corporations do, after adjusting for differences in DCF growth rates and various risk indices (Exhibit No. SOA-1, at 28).

490. Regression analysis is a widely used statistical method that is designed to isolate the impact of one explanatory variable (e.g., a company's organization as an MLP rather than as a corporation) on a dependent variable (e.g., a company's DCF distribution yield), after adjusting for the impact of other explanatory variables (e.g., the expected growth rate of future distributions, various indices of the equity's risk) (Exhibit No. SOA-1, at 28).

491. Dr. Horst states further that Dr. Vander Weide relied on three statistical studies, all of which employed similar regression analyses, to support his conclusion that the I/B/E/S growth forecasts were more reliable than the modified two stage growth rate forecast set forth in the 2008 Proxy Group Policy Statement. Dr. Horst's statistical analysis of the impact of the MLP form of organization on a company's DCF rate of return is based on the three statistical studies cited by Dr. Vander Weide. He took the common framework of those three statistical studies and updated the results to reflect DCF data as of December 2009, extended that framework to apply not only to the stock-price formulation, but also the return on equity formulation of the DCF model, and applied that broader framework to evaluate the impact of the MLP form of organization on a company's stock price and its return on equity (Exhibit No. SOA-1, at 29).

492. In Dr. Horst's opinion, the 1988 Vander Weide-Carlton Article's use of the DCF model differs from the Commission's use of the DCF model. In his view, the Commission uses the DCF model to determine a company's return on equity, rather than the value of its stock. This difference did not prevent Dr. Vander Weide from applying the results of the 1988 Vander Weide-Carlton Article, which the authors viewed as an analysis of a firm's stock price, to determine the most appropriate growth rate to apply in a DCF analysis of the proxy group companies' return on equity (Exhibit No. SOA-1, at 29-30).

493. Dr. Horst points out that in Exhibit No. BPP-20, Dr. Vander Weide testifies that the DCF model requires the growth forecasts of investors, and Dr. Horst's studies indicate that the I/B/E/S growth forecasts reflect the long-run growth expectations of investors. The I/B/E/S growth forecasts are the best estimate of future growth for use in the DCF model (Exhibit No. SOA-1, at 29-30).

494. Dr. Horst states that Dr. Vander Weide assumes that the statistical results that he obtained in his DCF analysis of utilities' stock prices apply when the DCF Model is used to calculate MLP oil pipelines' rates of return on equity. Dr. Horst explains that he broadened the framework to evaluate the impact of the MLP form of organization on a company's stock price and its return on equity. The two databases that he has analyzed include both MLPs and corporations. Dr. Horst states that his hypothesis is that an MLP will have lower stock price-earnings ratio, P/E, and a higher distribution yield, D/P, than a corporation does, all other things being equal (Exhibit No. SOA-1, at 30-31).

495. Dr. Horst further tests this hypothesis by including in the regression equation explanatory variables measuring the expected growth of future distributions, various indices of risk, and a dummy variable that indicates whether the company is an MLP or a corporation. The dummy variables, which are also referred to as binary variables and indicator variables, are widely used in regression analyses when an explanatory variable has only two possible outcomes (Exhibit No. SOA-1, at 30-31).

496. Dr. Horst's regression analysis is based on financial data as of December 31, 2009. His first database is a group of 67 companies, consisting of 58 utility corporations and 9 MLP oil pipelines. The names of these 67 companies, the process by which they were selected, and the technical explanation of the financial data on these companies are provided in Exhibit No. SOA-15, and related work-papers. Dr. Horst includes utility corporations in the same database as the oil and gas pipeline companies because there are no oil pipeline corporations that qualify to be included in a proxy group, and a rapidly diminishing number of gas pipeline corporations. He opines that any reliable statistical estimate of the impact of the MLP form of organization on the DCF rate of return must of necessity be based on a database that includes non-pipeline corporations (Exhibit No. SOA-1, at 31-32).

497. Utility corporations appeared to Dr. Horst to be the best candidates for inclusion in a broader database because utilities are similar to pipelines in terms of their substantial investments in long-lived depreciable property, their extensive reliance on long-term debt to fund their capital investments, and significant dividend payout rates, which is critical because the DCF method is based on an extrapolation of the current dividend yield. Utilities should not be combined with oil pipelines in a single proxy group, the two types of companies can be combined into a database for a multiple regression analysis when objective indices of risk are also included as explanatory variables in the regression equation (Exhibit No. SOA-1, at 32).

498. Dr. Horst states that this includes the same four risk indices that were included in both the 1988 Vander Weide-Carlton Article and the 2004 SSFA Update plus five other risk indices that were not reflected in those studies. He indicates that his second database combined the 9 MLP oil pipelines with 36 manufacturing companies. That is, the second

database includes no utilities, so there can be no issue that the absence of price competition has reduced the risk of the corporations included in Dr. Horst's database.

499. Dr. Horst began with all companies whose primary SIC code indicated that they were manufacturers. Dr. Horst then eliminated any company that failed to meet any one of the following criteria: was not followed by Value Line; did not have: I/B/E/S estimate of both EPS for 2010 (which is used in calculating the P/E and D/E ratios) and the median growth rate of EPS over the next three to five years; a stock-price history of at least five years; and a distribution yield as of December 31, 2009 of at least 2.0% per annum (Exhibit No. SOA-1, at 32-33).

500. He asserts that under the DCF method, the value of a company's stock is based on an extrapolation of its current distribution yield. The 2% minimum is based on the lowest distribution yield of any of the 58 utilities included in Dr. Horst's first database. The 36 high dividend manufacturing companies included in Dr. Horst's second database are not representative of manufacturing companies generally. Taken together, the selection criteria that he applied likely resulted in a group of manufacturers that are lower risk than what may be typical of manufacturing corporations generally (Exhibit No. SOA-1, at 34).

501. Dr. Horst's regression results for his first database are presented in Exhibit No. SOA-15, attachment B. In summary, he asserts that the 50% adjustment to the long-term growth rate for MLP pipelines resulting from the 2008 Proxy Group Policy Statement produced a better fit to the statistical data than did the I/B/E/S one-stage growth rate or the FERC two stage growth rate before making the MLP adjustment. In every regression equation, the MLP dummy variable had a statistically significant, positive impact on a company's distribution yield, D/P (Exhibit No. SOA-1, at 34).

502. He states that the estimated impact of the MLP form of organization on the distribution yield ranged from a low of 2.0% to a high of 2.3%, depending on which risk variables (if any) were also included in the regression equation. The only one of the nine risk indices that was statistically significant was the S&P Interest Coverage Before Tax ratio, which had the expected negative sign and a t-statistic equal to, 2.4. When the S&P interest coverage ratio and the MLP dummy variable were both included in the regression equation, the MLP form of organization resulted in a 2.3% increase in the investors' distribution yield, after adjusting for differences in companies' projected EPS growth rates and their S&P before tax interest coverage ratios (Exhibit No. SOA-1, at 34-35).

503. The regression results for Dr. Horst's second database are presented in Exhibit No. SOA-15, attachment C. In summary the 50% adjustment to the long-term growth rate for MLP pipelines resulting from the 2008 Proxy Group Policy Statement again produced a better fit to the statistical data than did the I/B/E/S one-stage growth rate or the FERC two-stage growth rate before making the MLP adjustment. In every regression equation,

the MLP dummy variable had a statistically significant positive impact on a company's distribution yield, D/P (Exhibit No. SOA-1, at 35-36).

504. Dr. Horst states that the estimated impact of the MLP form of organization on the distribution yield ranged from a low of 2.0% to a high of 2.9%, depending on which risk variables (if any) were also included in the regression equation. The risk variable that had the greatest statistical significance was the S&P credit rating, which had the expected positive sign a t-statistic of 3.5. When the S&P credit rating and the MLP dummy variable were both included in the regression equation, the MLP form of organization resulted in a 2.0% increase in the investors' distribution yield, holding constant the company's projected growth rate and its S&P credit rating (Exhibit No. SOA-1, at 36).

505. Dr. Horst believes that the impact of the MLP organizational form results in an increase in the DCF rates of return of an MLP oil pipeline of at least 2.0%. He derived this result from regression analysis of two databases: the first database included 9 MLP oil pipelines plus 58 corporations owning regulated utilities, and the second database included the same 9 MLP oil pipelines plus 36 unregulated manufacturing companies. Given that there are no oil pipeline corporations with publicly traded stock, regression analysis provides the most reliable way of estimating the impact of the MLP form of organization on a proxy companies DCF distribution yield that is separate and apart from the impact of differences in companies' projected growth rates and various ways of measuring risk (Exhibit No. SOA-1, at 36-37).

506. With regard to pooling of Carriers' cost Dr. Horst states that comparable costs were not covered by the cost pooling provided by Section II-2(f)(ii) of the TAPS Settlement Agreement. The State of Alaska has advocated excluding those costs from rates and believes that the comparable costs under the Commission's 154-B method should be excluded from any new cost pooling arrangement. He indicates that the State's interest is an indirect interest that arises because the cost-pooling provisions affect the incentives an individual Carrier may have to reduce its filed tariff to a rate below its full cost-of-service rate or to minimize Carrier's own direct costs. Dr. Horst recommends that total return (including income tax allowance) on rate base under the Commission's 154-B method be excluded from any new cost pooling arrangement (Exhibit No. SOA-1, at 38-39).

507. The exclusion of such costs strikes a balance between preserving the incentive an individual carrier would have to reduce its tariff below the maximum tariff rate and the inequities that may result when significant fixed costs are not apportioned based on the number of barrels or barrel-miles of transportation provided. When fixed costs are apportioned among the Carriers based on the number of barrels (or barrel-miles) transported, those fixed costs become incremental costs from the perspective of an individual Carrier. Assuming a Carrier would never choose to reduce its tariff to a level below its incremental cost, cost-pooling increases the incremental-cost floor under TAPS

tariffs and reduces the incentive an individual Carrier has to reduce its filed rates below the maximum rate allowed (Exhibit No. SOA-1, at 39).

508. Dr. Horst explains how apportioning fixed costs based on the number of barrels transported, rather than pipeline ownership percentages, results in fixed costs becoming incremental costs from the perspective of an individual Carrier. In Exhibit No. SOA-17, Dr. Horst provides a hypothetical example of a pipeline that has two owners. The key points to note are: Lines 2 - 9 present a Base Case. In Lines 4-6, Common Fixed Costs are allocated between the two owners based on the ownership percentages shown on Line 1. In Lines 7-9, Common Fixed Costs are allocated between the two owners based on the throughput percentages shown on Line 3. Lines 10 - 23 present an Incremental Throughput Case and compare its results to those of the Base Case. As shown on Lines 2 and 10, the difference between these two cases is that Carrier B's throughput goes up by one barrel (from 10 to 11 barrels) in the second case, while Carrier A's throughput does down by one barrel (from 90 to 89 barrels) (Exhibit No. SOA-1, at 39-40).

509. In Lines 12-17, Common Fixed Costs are allocated between the two owners based on the ownership percentages shown on Line 1. The result is that the Marginal Cost per Barrel for both Carriers is \$1.00, which is equal to the common variable cost per barrel. In Lines 18-23, Common Fixed Costs are allocated between the two owners based on the throughput percentages shown on Line 3. The result is that the Marginal Cost per Barrel for both Carriers has increased from \$1.00 to \$5.00, which is equal to sum of the common variable cost per barrel plus the common fixed cost per barrel. In short, the common fixed costs become incremental costs from the perspective of an individual carrier when fixed costs are allocated based on throughput shares, rather than the ownership percentages (Exhibit No. SOA-1, at 40).

510. Dr. Horst recommends excluding Carriers' total return (including the income tax allowance) on rate base from any new cost-pooling provision. In addition to the effect of cost pooling on the potential for tariff competition, pooling all common fixed costs would also eliminate the incentive a Carrier with excess capacity now has to compete to sell its excess capacity to unaffiliated TAPS shippers. The Commission should not be concerned about the inequity that would result if a Carrier is assured that it will recover its depreciation and operating expense, but not its total return on its rate base (Exhibit No. SOA-1, at 41).

511. In his view, the Commission's general objective is to assure that a regulated company has the opportunity to earn a rate of return on its rate base equal to the rate of return on investments of comparable risk, but the Commission does not and cannot guarantee that result. Any approved pooling agreement should not include operating expenses incurred directly by Carriers (as opposed to costs incurred by Alyeska on behalf of Carriers). The State continues to believe that Owner-direct costs other than the State

ad valorem tax should be excluded from any cost reallocation in order to maintain the incentives owners have always had to minimize those costs (Exhibit No. SOA-1, at 41).

512. Dr. Horst states that apportioning Owner-direct costs based on the number of barrels transported, rather than being borne by the owner that incurs those costs, reduces the incentive each owner has to minimize those costs. Exhibit No. SOA-18 provides a hypothetical example similar to that presented in Exhibit No. SOA-17. The key points in Exhibit No. SOA-18 to note are: Lines 4 - 11 presents a revised Base Case. A third category of costs, Carrier-Direct Costs (Incurred by Owners), has been added at Line 5. Line 9 shows the result of reallocating those Carrier-Direct Costs based on throughput, rather than having each owner to bear whatever costs it incurs. Lines 12 - 21 present an Incremental Cost Case and compare its results to those of the Base Case (Exhibit No. SOA-1, at 41-42).

513. The key difference between the two cases is that Carrier B's Carrier-Direct Costs increase from \$5 in the Base Case to \$10 in the Incremental Base Case (e.g., because it decides to litigate rather than settle a dispute). If each owner is responsible for its own Carrier-Direct Costs, Carrier B's own costs go up by the additional \$5 that Carrier B has incurred. Carrier A's total costs are unaffected. See Line 16. If Carrier-Direct Costs are reallocated based on ownership percentages, Carrier B's costs go up by only \$0.5. Carrier A's costs go up by \$4.5. That is to say, Carrier A bears 90% of Carrier B's direct costs (because Carrier A transports 90% of total throughput). If Carrier B had to bear only 10% of the costs it incurs, its incentive to minimize those costs would be greatly diminished. Dr. Horst recommends excluding Owner-Direct costs other than the State's ad valorem tax from any new cost pooling arrangement (Exhibit No. SOA-1, at 42-43).

## **J. FERC Staff - Answering Testimony**

### **1. Edward Alvarez III**

514. Mr. Edward Alvarez III is employed by the FERC as a Financial Analyst in the Technical Division of the Office of Administrative Litigation. Mr. Alvarez received a B.A. degree in Economics and Finance from New Mexico State University in 1999 and a M.A. in Economics with a focus on Public Utility Regulation from New Mexico State University in 2003 (Exhibit No. S-1, at 1-2).

515. The purpose of Mr. Alvarez's testimony is to provide an independent analysis of: (1) the appropriate ratemaking capital structure for TAPS as of December 2007, December 2008, September 30, 2009, and March 31, 2010; (2) the appropriate ratemaking cost of debt for TAPS as of September 30, 2009 and March 30, 2010; and (3) the appropriate ratemaking cost of equity and distribution yields for TAPS as of September 30, 2009 and May 31, 2010 (Exhibit No. S-1, at 3).

516. Mr. Alvarez states that the witnesses for the TAPS Owners, Dr. Fairchild and Dr. Vander Weide, rely on capital market data and other financial information from various points within and at the end of the test period in this proceeding, i.e., as of late April and early June of 2009 (Fairchild), and September 30, 2009 (Vander Weide). On the other hand, Anadarko's witness Hanley relies on an updated analysis as of the end of May 2010. Alaska witness Horst also recommends a later valuation date, such as December 31, 2009 or, as an alternative, addresses the timing issue by using a more current dividend yield calculation in the DCF formula and a forecasted (rather than an historical) inflation rate.

517. As described in detail in the testimonies of witnesses Hanley and Horst, Mr. Alvarez points out that the crisis that affected global financial markets at the end of 2008 and continuing into 2009 resulted in test period DCF cost of capital calculations that are anomalous and overstated. Even more significant, since the financial crisis has ended, DCF returns have returned to levels that are not only more consistent with oil pipeline returns from the last several years, but certainly more representative of the returns expected by investors today. As a result, they caution against using test period data for return calculations (Exhibit No. S-1, at 5-6).

518. Mr. Alvarez agrees with Mr. Hanley that using capital market data and other financial information from the test period in this proceeding, particularly as it relates to inflation rates, produces returns that are anomalous and not reflective of a reasonable cost of capital. Thus, his recommendation is to develop an updated capital structure, cost of debt and cost of equity for TAPS based on the latest available information. However, should the Commission choose not to rely on updated information and instead use test period data, Mr. Alvarez recommends that it at the very least adopt a reasonable rate of inflation to apply. To that end, he provided capital structure, cost of debt and cost of equity information both on an updated basis, and as of the end of the test period (September 30, 2009), and a reasonable rate of inflation to adopt as of September 30, 2009 (Exhibit No. S-1, at 6).

519. With respect to Commission guidelines for developing a capital structure to use in deriving a regulated oil pipeline's just and reasonable allowed return, Mr. Alvarez states that the Commission favors use of a company's actual capital structure rather than a hypothetical capital structure. However, in the case of TAPS, the Commission determined that a hypothetical capital structure developed from a proxy group composed of a representative group of oil pipeline companies will be used. Mr. Alvarez used the average capital structure of the proxy group as described in Opinion 502 (Exhibit No. S-1, at 7).

520. Mr. Alvarez notes that in Opinion 502, the Commission stated it is also not appropriate to use the capital structure of Carriers' parents companies because their risk

profiles are not comparable. Carriers' parents' business risks are high because they are involved in several highly risky undertakings. Even though the parents are diversified, their overall risk is still high because the projects they diversified into are risky projects (Exhibit No. S-1, at 7).

521. Mr. Alvarez notes that in Opinion 502 the Commission affirms the ALJ's determination that the appropriate capital structure is that of a hypothetical proxy group that mirrors a typical oil pipeline. The Commission has not yet adopted the use of a proxy group to determine hypothetical capital structures for an oil pipeline, but it has adopted proxy capital structures for other regulated entities. In addition, the Commission's policy for determining whether to use the capital structure of the pipeline, as opposed to the parent or a hypothetical capital structure is well-defined. Since here it has been found that Carriers' parent companies' capital structure is anomalous, it is both appropriate and consistent with Commission precedent to use a hypothetical capital structure (Exhibit No. S-1, at 7).

522. The proxy group the ALJ relied on in Opinion 502 for determining TAPS' capital structure consists of a representative group of oil pipeline companies previously found acceptable by the Commission and endorsed by the State. It is also the same proxy group the parties agreed to use to calculate return on equity. This matching of proxy groups makes sense because it ensures that the risks of the proxy groups are consistent for both capital structure and return on equity purposes (Exhibit No. S-1, at 8).

523. Mr. Alvarez states that it is important to determine an appropriate capital structure because the capital structure affects the overall rate of return allowed in a rate proceeding: the higher the equity component in a given capital structure, the higher the return to the shareholders and the greater the cost to the rate payers (Exhibit No. S-1, at 8).

524. While the test year in this proceeding for the TAPS cost of service is for the period ended September 30, 2009, Mr. Alvarez believes that the Commission often prefers to use the most recent data available for rate of return, particularly when consideration of such data prevents unreasonable, inequitable, and/or anomalous results. For this reason, Mr. Alvarez presents data as of March 31, 2010 for capital structure and cost of debt in this proceeding. He recommends an adjusted capital structure for TAPS for the updated period ended March 31, 2010 which consists of 54.76% long-term debt and 45.24% common equity. In the alternative, should the Commission choose not to rely on the latest available information, he recommends an adjusted capital structure for the test year ended September 30, 2009, which consists of 51.03% long-term debt and 48.97% common equity (Exhibit No. S-1, at 8-9).

525. The derivation of Mr. Alvarez's capital structure recommendations is included in Exhibit No. S-2. Mr. Alvarez started with the proxy companies' actual capital structures

for the applicable periods. Mr. Alvarez then adjusted Kinder Morgan Energy Partner, L.P.'s (KMEP) capital structure by removing Purchase Accounting Adjustments (PAA)s from the equity component. The Commission has required that PAAs be removed from KMEP's capital structure. Removing the PAAs causes the equity component to decrease in this proceeding (Exhibit No. S-1, at 9).

526. He indicates further that the Commission's TOC methodology is found in Opinion 154-B, where the Commission adopted the net depreciated TOC as the model for calculating rate base, and therefore, determining revenue requirements. TOC, just like net depreciated original cost, requires the determination of a nominal (inflation-included) rate of return on equity that reflects that pipeline's risks and its corresponding cost of capital. Next, the inflation component of that rate of return is extracted. This leaves what economists call a real rate of return. The real rate of return times the equity share of the rate base yields the yearly allowed equity return in dollars. The inflation factor times the equity rate base yields the equity rate base write-up. That write-up, like depreciation, is written-off or amortized over the life of the property (Exhibit No. S-1, at 9-10).

527. He notes further that it is important to emphasize that TOC and net depreciated original cost are essentially the same except for their treatment of inflation. TOC reflects inflation through an automatic adjustment to rate base. Net depreciated original cost reflects estimated inflation in the nominal rate of return. This difference between them results in a different timing of the recovery of the cost of equity capital, when inflation exists, over the life of the property. However, theoretically, TOC results in the same discounted value of the earning stream for the investor as does un-trended original cost (Exhibit No. S-1, at 10).

528. Mr. Alvarez further considered the capital structure for periods other than the year 2009, the starting point for the 2009 going forward rates that are at issue in this proceeding. The reason for doing this lies in the Commission's TOC methodology for oil pipeline rate cases. As a result of the requirement for an annual deferred return calculation, Mr. Alvarez calculated capital structures as of the end of 2007, 2008, and 2009. Mr. Alvarez bases his capital structures used to develop the deferred return component of the rate base for TAPS on the average capital structure for the proxy group, as reflected in their SEC Form 10-Ks for the years ended 2007 through 2009 and the SEC 10-Qs ended September 30, 2009 and March 31, 2010 (Exhibit No. S-1, at 10-11).

529. For the purpose of calculating the deferred return component of the rate base for TAPS in this proceeding, the capital structures Mr. Alvarez proposes are: (1) Period Ending - December 31, 2007, Long-Term Debt - 50.18%, Common Equity - 49.82%; (2) Period Ending - December 31, 2008, Long-Term Debt - 53.59%, Common Equity - 46.41%; (3) Period Ending - September 30, 2009, Long-Term Debt - 51.03%, Common Equity - 48.97%; (4) Period Ending - December 31, 2009, Long-Term Debt - 52.29%, Common Equity - 47.71%; and, (5) Period Ending - March 31, 2010, Long-Term

Debt - 54.76%, Common Equity - 45.24% (Exhibit No. S-1, at 11).

530. Mr. Alvarez states that a PAA or Purchase Price Adjustment as it is sometimes called is the premium paid for the purchase of an asset over its net book value. Net book value is the original cost minus accumulated depreciation. He states that the Commission rejected the inclusion of PAAs when calculating an equity ratio in prior proceedings. Specifically, the Commission removed PAAs from KMEP's capital structure in several proceedings in which KMEP's capital structure was used as a surrogate for its subsidiary SFPP, L.P. As the Commission stated that the general rule on the write-up of assets acquired by one company from another is that such assets must be included in the acquiring company's rate base for rate making purposes at no more than their depreciated original cost, unless it can be shown by clear and convincing evidence that the acquisition results in substantial benefits to the ratepayers. This is to prevent ratepayers from paying for the same assets twice. There was no showing of any benefit to ratepayers as a result of KMEP's PAAs in the cases noted above, and there has been no showing here. Therefore, he believes that eliminating the PAAs is appropriate (Exhibit No. S-1, at 12).

531. In accordance with the Commission precedents cited above, Mr. Alvarez made adjustments to the PAAs to reflect depreciation from the time of the asset purchase up to end of the test period on September 30, 2009, and up to the end of the updated period on March 31, 2010, and then removed the remaining amount from the equity component to derive KMEP's capital structure for the corresponding time period. The depreciation adjustment accounts for the fact that the amount of the PAA depreciates over time just as the original asset value depreciates. Taking depreciation into account assures that he has properly reflected depreciation in the PAA before removing it from equity. Mr. Alvarez calculated the depreciation expense for the various KMEP subsidiaries regulated by the Commission from FERC FORM Nos. 2 and 6 as they related to the PAAs described in Staff data request, Staff-SFPP-ROR-2.05 & 2.06 in Docket No. IS09-437-000 (Exhibit No. S-1, at 13).

532. Mr. Alvarez describes further how he calculates the capital structure for KMEP for the updated period ended March 31, 2010, and in the alternative, the test period ended September 30, 2009, as adjusted for PAAs. He began with the balances of long-term debt and partners' capital (equity) found in KMEP's SEC Form 10-K and 10-Q reports for the corresponding periods and then removed the depreciated PAA. For the period ending March 31, 2010 he removed \$718.232 million from partners' capital on account of PAAs, which resulted in a remaining equity balance of approximately \$6,160 million. For the test period ending September 30, 2009 he removed \$855.091 million from partners' capital on account of PAAs, which resulted in a remaining equity balance of approximately \$5,976 million (Exhibit No. S-1, at 13-14).

533. Mr. Alvarez proposes a cost of long-term debt for TAPS of 6.10% for the calendar year ending March 31, 2010. The calculation of the cost of long-term debt for the

calendar year is included in Exhibit No. S-2. The alternative cost of debt that Mr. Alvarez is proposing is 5.94% for the period ended September 30, 2009. To calculate TAPS' cost of long-term debt, Mr. Alvarez examined all of the outstanding long-term debt for the proxy companies as of March 31, 2010 and September 30, 2009, as reflected in their SEC Form 10-Qs. He then took the average of the weighted costs for the proxy companies as prescribed in Opinion 502 (Exhibit No. S-1, at 14).

534. The costs of long-term debt Mr. Alvarez proposes differs from the cost of long-term debt of 6.46% proposed by Dr. Vander Weide, and the debt cost of 6.19% proposed by Dr. Fairchild. One reason for this is that the two witnesses for the TAPS Owners use data from time periods that differ not only with each other, but also with the time period on which Mr. Alvarez relies. Dr. Fairchild bases his cost of debt on financial information as of December 31, 2008, while Dr. Vander Weide calculates a cost of debt as of December 2007, December 2008, and September 30, 2009. Mr. Alvarez uses the most recent data available as of March 31, 2010 to calculate the overall cost of long-term debt. Another source of the differences is Dr. Fairchild's and Dr. Vander Weide's exclusion of various bonds that Enterprise Products Partners, L.P. (Enterprise), KMEP, and NuStar Energy, L.P. (NuStar) treat as long-term debt from their computations of the weighted cost of long-term debt (Exhibit No. S-1, at 14-15).

535. Mr. Alvarez included Economic Development Revenue Refunding Bonds, Industrial Bonds, Zone Revenue Bonds, and OLP-A&B bonds in his cost of long-term debt calculation. These bonds, although issued for a named purpose, meet the definition of long-term bonds (more than one year in length), were ultimately used to meet the long-term financial needs of Enterprise, KMEP, and NuStar, and contributed to the consolidated total debt amount, and the total cost of capital for Enterprise, KMEP, and NuStar. Equally significant, all of these bonds are included in the debt portion of the proxy group capital structures that will be used to set jurisdictional rates in this proceeding. Mr. Alvarez does not believe that it would be appropriate to include the amount of these bond issuances in the debt portion of the jurisdictional capital structure calculation and then exclude their cost from the cost of long-term debt calculation, as Dr. Vander Weide and Dr. Fairchild have done (Exhibit No. S-1, at 15-16).

536. Mr. Alvarez explains that both financial and business risks are taken into account when a credit rating agency issues a rating on a company. In so doing, the credit rating agencies look at all of the debt outstanding, including Economic Development Revenue Refunding Bonds, Industrial Bonds, Zone Revenue Bonds, and OLP-A&B bonds, when they are considering the business and financial risk of Enterprise, KMEP, and NuStar, all of which is reflected in each company's credit rating. Excluding these bonds from the cost of debt calculation can increase the average debt cost which can increase the cost to ratepayers (Exhibit No. S-1, at 16).

537. In addition, he believes that the Commission's Code of Federal Regulations for electric utilities, natural gas pipelines, and oil pipelines all require that a utility's books, records and accounts show the weighted cost of its long-term capital, which for Enterprise, KMEP and NuStar includes Economic Development Revenue Refunding Bonds, Industrial Bonds, Zone Revenue Bonds, and OLP-A&B bonds (Exhibit No. S-1, at 16-17).

538. Moreover, he asserts that the Commission's rules and regulations recognize all long-term debt instruments (more than one year) as long-term, and make no exceptions based on their tax-exempt status (such as with Economic Development Revenue Refunding Bonds, Industrial Bonds, Zone Revenue Bonds, and OLP-A&B bonds), or on which statute they are regulated under, i.e., Federal Power Act, Natural Gas Act, or Interstate Commerce Act. These are long-term instruments and should be treated as such. In prior cases the Commission concluded that debt costs should be blended and that proceeds from financing are comingled with other liquid assets then dollar tracing is not only inappropriate, but impossible. Similarly in another prior case, the Commission required that a company design its rates based on its actual cost of debt. Mr. Alvarez states that if the Commission were to reverse its policy on this issue, it would invite controversy over every debt issuance in every case as to exactly what assets the debt was used to finance, and whether these issuances are properly the subject of that particular rate proceeding (Exhibit No. S-1, at 17-18).

539. With regard to the cost of long-term debt for the stated time periods, Mr. Alvarez's calculations are based on the SEC Form 10-Qs that the proxy companies filed for the periods ending March 31, 2010 and September 30, 2009. For each company he follows a four step process. In step one he starts by determining the dollar amounts of each individual long-term debt instrument and then adding them together to get the total dollar amount of debt outstanding for each of the proxy companies. In step two, he then takes the dollar amount for each debt instrument and divides it by the total dollar amount of debt outstanding. In step three, he takes the interest rate for each debt instrument and multiplies it by the ratio for that instrument as determined in step two, to give the weighted interest rate for each debt instrument. In step four, he sums up the weighted interest rates to get the cost of debt.

540. This is summarized by the formula of [cost of debt = (interest rate for each debt instrument) \* (dollar amount for each debt instrument / sum of the dollar amounts for all debt instruments)]. By using this formula, and then averaging the cost of debt for all the proxy companies, Mr. Alvarez calculates the cost of long-term debt to be 6.10% for the updated period ending March 31, 2010 and 5.94% for the test year end September 30, 2009 (Exhibit No. S-1, at 18-19).

541. Mr. Alvarez states that a regulated entity should be allowed to recover its prudently incurred costs, including the cost of common equity. The cost of common

equity is determined by investors, and changes in this cost to a company are reflected by changes in the price that investors are willing to pay for its common stock. The price investors are willing to pay is based upon their perceptions of the company's future financial prospects, and therefore, it is important to keep in mind that this investor-required return on common equity component is forward-looking, and cannot be assumed to be equal to the past required or earned returns on equity (Exhibit No. S-1, at 19-20).

542. Mr. Alvarez observes that this is a concept which all of the testifying return expert witnesses appear to agree. In responses to data requests, Dr. Fairchild stated that the cost of equity is a forward-looking concept and equity investors' required rates of return are based on their perceptions and expectations at any given point in time. Similarly, Dr. Vander Weide agreed that today's equity investors will determine their required equity returns based on their perception of market conditions looking forward from today (Exhibit No. S-1, at 19-20).

543. He believes that since investors' perceptions impact the cost of equity, public utility regulators must measure investors' required rate of return based on the market value of equity for a utility, and allow the utility an opportunity to earn a return that is equal to that rate on the book value of its common equity investment. Therefore, regulators must look to the data that investors collectively consider when determining the appropriate rate of return on equity for a utility. Whether the data estimates that investors collectively consider may later prove to be accurate or inaccurate is of no consequence to the determination of the current cost of common equity. All that matters is that regulators use as inputs into their analyses the data considered by investors when they collectively set the price for a company's common stock (Exhibit No. S-1, at 20-21).

544. Mr. Alvarez opines that the Supreme Court provided guidance in two often-cited decisions regarding requirements for setting allowed equity returns in utility rate cases. In *Bluefield Water Works and Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 693 (1923), the Supreme Court stated that the return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally (Exhibit No. S-1, at 21).

545. The second decision was in *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), where the Supreme Court provided additional guidance on the issue of equity returns stating that from the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with

returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital (Exhibit No. S-1, at 21-22).

546. Mr. Alvarez opines that together, these decisions established that a rate of return allowed for a public utility should be sufficient to: (1) maintain the financial integrity of the enterprise; (2) enable the company to attract new capital; and (3) provide a return to the common equity owner that is commensurate with returns on investments in other enterprises of corresponding risk. These three standards are interrelated and have been used widely for many years by regulatory commissions throughout the country to determine the rate of return allowance for public utilities (Exhibit No. S-1, at 22).

547. He opines that just as these standards provide that a utility company's rates must be structured to attract the capital necessary for its operations, they also provide that its customers must be protected from having to pay excessive rates. Therefore, in order to be fair to a utility's investors and its customers, ratepayers must be charged rates that reflect the cost of capital, neither more nor less. Mr. Alvarez's analyses and recommendations are based on the application of these standards to the facts of this proceeding (Exhibit No. S-1, at 22).

548. He states that the Commission's model for estimating the allowed equity returns for regulated entities is based on the DCF methodology. Inasmuch as the purpose of a DCF analysis is to determine the rate of return expected by investors, the Commission uses a DCF analysis to determine the appropriate ROE for a regulated pipeline. The basic premise of the DCF methodology is that the value of an asset is the present value of its expected future cash flows. The Commission model uses dividends to represent the cash flow. Such a model is often called the Dividend Discount Model or DDM. The Commission established a separate formula in Order No. 420 for oil pipelines. The Commission's DCF model for oil pipeline rate cases is a variation and reflects the fact that dividends do not grow continually but rather are paid gradually (Exhibit No. S-1, at 23-25).

549. Mr. Alvarez notes that the other rate of return witnesses in this proceeding adhere to this approach to determining the return on equity for oil pipelines. While Dr. Vander Weide suggests at various points in his testimony that he does not necessarily agree with all aspects of the Commission's approach for oil pipelines, he nevertheless has confirmed that he is adopting that approach without much adjustment. Dr. Horst recommended a variation on the Commission's use of a six-month average of stock price data to calculate the DCF return (Exhibit No. S-1, at 25-26).

550. Mr. Alvarez states that it is necessary to select a proxy group to determine the allowed rate of return on equity for TAPS in this proceeding. A proxy group is necessary because TAPS has no publicly traded stock. Thus, it is impossible to determine an

investor-required return on equity for TAPS directly. Therefore, it is necessary to select a proxy group to derive the return on equity. Mr. Alvarez uses updated data for his proxy group as of May 31, 2010. In the alternative, he also provides data as of September 30, 2009, the end of test period. The proxy group Mr. Alvarez recommends consists of the following eight companies for the updated period ending May 31, 2010: (1) Buckeye Partners, L.P.; (2) Enbridge; (3) Enterprise; (4) KMEP; (5) Magellan; (6) NuStar; (7) Plains All American Pipeline, L.P.; and, (8) Sunoco Logistics Partners, L.P (Exhibit No. S-1, at 26-27).

551. The proxy group of companies Mr. Alvarez used to derive the nominal cost of equity as his alternative for the end of test period ending September 30, 2009 consists of the following six companies: (1) Buckeye Partners, L.P.; (2) Enbridge; (3) KMEP; (4) NuStar; (5) Plains All American Pipeline, L.P.; and (6) Sunoco Logistics Partners, L.P (Exhibit No. S-1, at 27).

552. Mr. Alvarez selected his proxy groups based on the following criteria: (1) they are publicly traded; (2) they have not been involved in merger and acquisition (M&A) activity during the DCF analysis data period; (3) they have assets predominately in oil pipeline operations; (4) They have been in operation for at least five years; (5) They are followed by Value Line; (6) they have (I/B/E/S) growth estimates; and, (7) they have investment grade credit ratings. Mr. Alvarez provides Commission precedent that confirms the use of the criteria listed above (Exhibit No. S-1, at 28).

553. Mr. Alvarez excluded Enterprise for the test period ended September 30, 2009 because it was involved in merger activity during the last six months of Mr. Alvarez's DCF model data period. Specifically, Enterprise announced that it was merging with TEPPCO Partners, L.P. on June 29, 2009, and that its merger was completed on October 26, 2009. He excludes companies that are involved in M&A activity during the most recent six month data period because their stock may be affected by volatile trading activities associated with the M&A from the time it is announced, until the time it is completed. Unusual stock price volatility can distort inputs to the DCF and for this reason he will not include a company in his proxy until 6 months after the M&A has been completed or otherwise terminated (if the merger collapses) (Exhibit No. S-1, at 29).

554. Mr. Alvarez re-included Enterprise for the most recent period ending May 31, 2010, since that was at least six months after the conclusion of Enterprise's merger activity. He excluded Magellan for the test period ending September 30, 2009 because it was undergoing a major capital restructuring during the relevant time. Specifically, Magellan and Magellan Midstream Holdings GP, L.L.C. entered in to an agreement for simplification of capital structure in March 2009. Mr. Alvarez believes that this qualifies as an M&A event, and thus have excluded it for the same reason he excluded Enterprise. Mr. Alvarez re-included Magellan for the most recent period ending May 31, 2010. In addition, he excluded Holly Energy Partners, L.P. for both the most recent updated period

ending May 31, 2010 and the test period ending September 30, 2009 because it has a non-investment grade credit rating (Exhibit No. S-1, at 29-30).

555. Mr. Alvarez states that the other rate of return witnesses in this proceeding agree with developing a return on equity using a proxy group, and use an approach similar to that Mr. Alvarez describes above to select their proxy companies. Dr. Vander Weide, Dr. Fairchild, Mr. Hanley and Mr. Alvarez all develop a return on equity by use of a proxy group. Moreover, they all appear to rely on similar (although not identical) criteria to select the members of our groups. As a result, they all have nearly identical proxy groups, with the main difference being that the members of each group will vary depending upon the time frame being evaluated (Exhibit No. S-1, at 30).

556. Mr. Alvarez explains that S&P's assign two types of credit ratings – the issuer credit rating or corporate credit rating, and specific issue credit ratings. The corporate credit rating is the issuer credit rating that S&P assigns to a corporate issuer based on the business and financial risks of that company. The issue credit rating is assigned to individual corporate debt issues (or other financial obligations). The company's issuer bond rating plays a significant role because bond holders are the company's creditors and are the first in line to be paid from the company's revenues or liquidation in the event of bankruptcy. Shareholders by contrast are the last in line to be paid, and there is no guarantee that any money will be left in order to pay them a return of and on their investment. The higher a company's debt ratio is relative to its equity ratio, the higher the financial risk because the company has a higher fixed cost burden and less free cash flow for its operations. The higher a company's fixed cost burden, the higher is its risk of default and bankruptcy, in his view (Exhibit No. S-1, at 31).

557. Mr. Alvarez states that an overview of the issuer credit ratings given by rating agencies like S&P's and Moody's is shown in Exhibit No. S-3. The overview of issuer credit ratings shows a company's overall capacity to pay its financial obligations, i.e., its fundamental creditworthiness. The opinion of the rating agency focuses on the company's ability and willingness to meet its financial commitments on a timely basis in accordance with the terms of its obligations. It generally indicates the likelihood of default regarding all financial obligations of the company, because companies that default on one type of debt or file for protection under the Bankruptcy Code, usually stop payment on all of their debt obligations (Exhibit No. S-1, at 31-32).

558. Mr. Alvarez testifies that with regard to the value of using credit ratings to assess equity risk, the Commission specifically stated that a pipeline's credit ratings are an appropriate part of the risk analysis. Also, the Commission noted the value of credit ratings in the development of a proxy group for ROE analysis, stating in a prior case that it is reasonable to use the proxy companies' corporate credit rating as a good measure of investment risk, since this rating considers both financial and business risk. Mr. Alvarez

opines that excerpts from S&P's Corporate Ratings Criteria and their Key Credit Factors included in Exhibit S-3 validate the Commission's statement (Exhibit No. S-1, at 32).

559. The corporate credit rating of each proxy company is similar to the average of the proxy companies, i.e., all are in the BBB class which is investment grade. Mr. Alvarez states that this confirms the reasonableness of his oil pipeline proxy group. On May 31, 2010 his Proxy Companies S&P Corporate Credit Ratings had a proxy group average of BBB, all of which were rated BBB with the exception of Enterprise, NuStar, and Plains All American, which were rated BBB- (Exhibit No. S-1, at 32-33).

560. Mr. Alvarez states that a minimum of four proxy companies can even be a perfectly acceptable number of proxy companies. The primary consideration is that all of the companies in the group be similar in total risk. He believes the companies in the proxy group he selected are very similar in total risk and are appropriate to use in setting rates for TAPS. In fact, the Commission has accepted a proxy group consisting of as few as four companies, and therefore, Mr. Alvarez states that his comparable group of six oil pipelines for the alternative test period ending September 30, 2009 is sufficiently large enough to reflect the appropriate cost of common equity capital for TAPS in this proceeding (Exhibit No. S-1, at 33-34).

561. Mr. Alvarez further states that after he selects the proxy group he then applies the Commission's DCF model for estimating allowed ROE in oil pipeline cases to each of the companies in the proxy group. Specifically, the formula is written:  $k = D/P (1 + .5g) + g$ . Where D, the annual dividend, is represented by the most recent quarterly dividend (cash distribution) declared per share (unit) in each month  $\times 4$ . The dividend (cash distribution) per share (unit) information is published by S&P's Research Insight for each of the proxy group companies, for most recent six-month period from December 1, 2009 to May 31, 2010 in this proceeding. As an alternative, Mr. Alvarez provides data for test period from April 1, 2009 through September 30, 2009 (Exhibit No. S-1, at 34).

562. The source of P in the formula is the monthly stock price data obtained from S&P's Research Insight for the updated six-month period from December 1, 2009 to May 31, 2010 and for the alternative six-month period from April 1, 2009 to September 30, 2009. The stock prices for each proxy company during the six-month periods are shown in Exhibit No. S- 2. Mr. Alvarez uses the average of the monthly high and low stock prices during each six-month period to calculate P for the proxy companies.

563. Using the average of the high and low stock prices during each month being examined levelizes any price swings that may occur, in turn producing a more accurate DCF calculation. The ratio of D over P for each month of the six-month time period being examined is the D/P cash distribution yield for that month, for the updated period from December 1, 2009 to May 31, 2010 and for the alternative test period from April 1,

2009 to September 30, 2009. The average of the six monthly cash distribution yields became the D/P yield for the company (Exhibit No. S-1, at 35).

564. Mr. Alvarez derives the cash distribution yield for each proxy company by dividing one annualized cash distribution by the average of all six-monthly high and low prices. This is so because generally dividends increase with time and the quarterly cash distribution to stockholders for each company can change at any time during each of the six-month time periods being examined for the DCF calculation, i.e., December 1, 2009 to May 31, 2010 and between April 1, 2009 to September 30, 2009. Given this fact, it would not be appropriate to choose and annualize any one quarterly cash distribution (Exhibit No. S-1, at 35-36).

565. As a result, Mr. Alvarez believes it is more reasonable and accurate to calculate a cash distribution yield for the proxy companies for each month of the time period being examined by dividing the annualized quarterly cash distribution by the average of the high and low stock price during each month for the six-month period being examined, and then averaging the cash distribution yields calculated for each month to derive one cash distribution yield for each of the proxy companies (Exhibit No. S-1, at 35-36).

566. The short-term growth rate Mr. Alvarez uses is the Commission-preferred, median five-year earnings growth estimates published by I/B/E/S. These five-year growth estimates for the next 5 years are published by <http://finance.yahoo.com>, because I/B/E/S no longer publishes its Monthly Summary Data (U.S. Edition). The Commission has stated that it accepts this source in its Proxy Group Policy Statement. Finally, PSCNY requests that the Commission clarify that Thomson Financial Data posted on Yahoo.com may be used in the DCF formula, since Thomson Financial owns IBES. The Commission clarifies that the growth projections to be used in the DCF model are those reported by IBES. If they are the same growth projections posted by Thomson Financial Data on Yahoo.com, then they are acceptable for the DCF model (Exhibit No. S-1, at 36).

567. Mr. Alvarez states further that the long-term growth rate he uses is based on the Commission-preferred long-term growth estimates of the economy as represented by the GDP. He used an average of the long-term GDP estimates published by three sources. They are: (1) IHS Global Insight (GI); (2) The Energy Information Administration (EIA); and (3) The Social Security Administration's Federal Old Age and Survivors Insurance and Disability Insurance (OASDI) Trustees Report (SSA) (Exhibit No. S-1, at 37).

568. Specifically, the GI data for the test period as of September 30, 2009 are from the Long-term Macro Forecast (U.S. Economy, The 30-Year Focus), updated September 2009. The EIA data are published in the Annual Energy Outlook dated April 17, 2009. The GI data for the updated period as of May 30, 2010 are from the Long-term Macro Forecast (U.S. Economy, The 30-Year Focus), updated May 2010. The EIA data is published in the Annual Energy Outlook dated December, 2009. The SSA projections

used in both time periods are published in the 2009 OASDI Trustees Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (Exhibit No. S-1, at 37).

569. Mr. Alvarez notes that the Commission has accepted the use of an average of three GDP growth estimates. Specifically, the Commission indicated that long-term growth estimates should be based on an average of the forecasted growth rate of nominal GDP from three sources: DRI, EIA and WEFA. He asserts that the Commission further stated that the average should be based on the longest period available from each source if a 25-year projection was not available from the source. DRI and WEFA has subsequently merged to form Global Insight, Inc. In October 2008 IHS, Inc. and Global Insight, Inc. merged to form IHS Global Insight (Exhibit No. S-1, at 37-38).

570. Consequently, the Commission's previous three long-term estimate sources became two, which gives considerably more weight to the remaining growth estimates than before. Inclusion of the SSA long-term growth estimate restores the number of growth estimates to three, and better reflects the spectrum of long-term growth estimates available to investors, in his view (Exhibit No. S-1, at 37-38).

571. Furthermore, Mr. Alvarez states that there other cases where the Commission accepted the use of SSA long-term GDP growth estimates in the development of a long-term GDP growth rate for use in the DCF model. In one case, the Commission accepted Staff's calculation of long-term growth in GDP, specifically noting that Staff used SSA's estimated growth in GDP in that calculation. Moreover, the Commission stated that it prefers to use a 50-year growth forecast of SSA long-term GDP growth estimates in the development of a long-term GDP growth rate for use in the DCF model (Exhibit No. S-1, at 38-39).

572. The long-term GDP growth rate Mr. Alvarez proposes is 4.60% for the updated period ending May 31, 2010 and 4.64% for the alternative test period ending September 30, 2009. To derive the long-term GDP growth rate for this proceeding for the updated period ending May 31, 2010, he first calculates the annual growth rate for nominal GDP from each of the three sources: 4.38% from GI data; 4.82% from EIA data; and 4.61% from SSA data. To derive the long-term GDP growth rate for this proceeding for the test period ending September 30, 2009, he first calculates the annual growth rate for nominal GDP from each of the three sources: 4.35% from GI data; 4.95% from EIA data; and 4.62% from SSA data (Exhibit No. S-1, at 39-40).

573. The Annual GDP Growth is calculated using the formula  $[(\text{Nominal GDP Year Ending}/\text{Nominal GDP Year Beginning})^{1/(\text{Year Ending} - \text{Year Beginning})} - 1]$ . For the updated period ending May 31, 2010, Mr. Alvarez takes the average of the three annual growth rates to derive the long-term GDP growth rate of 4.60%:  $[(4.38 + 4.82 + 4.61)/3] = 4.60$ . For the test period ending September 30, 2009, he takes the average of the three

annual growth rates to derive the long-term GDP growth rate of 4.64%:  $[(4.35 + 4.95 + 4.62)/3] = 4.62$ . The calculations and source data are shown in Exhibit No. S-3 (Exhibit No. S-1, at 39-40).

574. Mr. Alvarez made other adjustments to the long-term GDP growth rate. Specifically, he reflects the fact that the proxy group includes Master Limited Partnerships (MLPs). Moreover, he believes that the Commission adopts the APGA proposal to use a long-term growth projection for MLPs equal to 50% of the long term GDP. Therefore, the adjusted equation is  $(\text{GDP growth rate})/2$ , in his view. This in turn produces the adjusted GDP growth rate for the updated period ended May 31, 2010 of  $[2.30\% = (4.60\%/2)]$ . In the alternative, the adjusted GDP growth rate for the test period ending September 30, 2009 is  $[2.32\% = (4.64\%/2)]$  (Exhibit No. S-1, at 40).

575. Mr. Alvarez also states that after he calculates the long-term GDP growth rate he then calculates the composite growth rate, the G in the formula,  $k = D/P \times (1 + 0.5g) + g$ , by using the following equation:  $\text{Composite G} = (\text{I/B/E/S growth rate}) * 2/3 + [(\text{GDP growth rate}) * (1/3)]$ . He opines that the Commission indicated its preference for a DCF cost of equity methodology in which a two-stage (two-step) growth rate is established by calculating a weighted average of the short-term (the first stage) forecast and the long-term (the second stage) forecast. The Commission also confirmed that the appropriate short-term growth rate to use in its preferred DCF method is the estimate published by I/B/E/S, and the proper long-term growth rate is developed by averaging several publicly-available estimates of long-term GDP growth (Exhibit No. S-1, at 41).

576. After Mr. Alvarez calculates the composite growth rate G he applies the values of D, P, and G in the formula  $k = D/P * (1 + 0.5g) + g$  to derive investors' forward-looking required nominal ROE for each of his six proxy companies as shown in Exhibit No. S-2 (Exhibit No. S-1, at 41-42).

577. Mr. Alvarez states he does not make any flotation cost adjustments for any of the proxy companies. Flotation costs are costs associated with underwriting, legal work, and publishing of new stock issues. In his view, they are permitted, however, none have either been requested or supported in this proceeding and there is no evidence that new shares of common stock will be issued in the near future to finance TAPS operations (Exhibit No. S-1, at 42).

578. Moreover, he states that the Commission derives the allowed return on equity based on the range of DCF returns for the proxy group, with the median representing the return for a company of average risk in oil pipeline rate cases. The Commission found TAPS to be of average risk in Opinion 502 at P 196, and he has seen no evidence in this proceeding to indicate that TAPS is anything other than an average risk oil pipeline. Therefore, Mr. Alvarez relies upon the median return for his proxy groups. The range of

nominal ROEs within the proxy group for the updated period ending May 30, 2010 is 9.49% to 11.85%, with a median nominal ROE of 10.68%.

579. Mr. Alvarez states further that the range of nominal ROEs within the proxy group is 10.94% to 12.89%, with a median nominal ROE of 12.21%, for test period ending September 30, 2009. This reflects a difference in the median nominal ROE of 153 basis points, due solely to the use of time periods for the analysis that are only eight months apart. Mr. Alvarez's DCF analyses of the proxy groups are included in Exhibit No. S-2 (Exhibit No. S-1, at 42-43).

580. Mr. Alvarez recommends that the Commission adopt a nominal rate of return calculated as the end of May 2010, when the test period in this proceeding ends September 30, 2009. While some fluctuation in return from one period to another is inevitable and expected, the higher nominal test period returns appear to be chiefly due to the unstable conditions the financial markets experienced in late 2008 and during much of 2009, particularly with regard to inflation, bond yields and dividend yields. Inasmuch as Mr. Hanley and Dr. Horst provide a thorough discussion of these events before, during and after the test period, and their ramifications upon key inputs into the return calculations at issue here, Mr. Alvarez concurs with their conclusions regarding the inappropriateness of using test period inputs to calculate DCF returns, as well as with the need to adopt other, more reasonable, inputs (Exhibit No. S-1, at 43).

581. Mr. Alvarez places TAPS at the median of the range and propose that a 10.68% nominal ROE be used to develop the rates at issue in this proceeding, i.e., using the most recently updated ROE data available. However, if the Commission chooses not to accept his recommendation of using updated ROE data as of May 30, 2010, it could adopt a median nominal ROE of 12.21% for the test period ending September 30, 2009, based on the DCF analysis shown in Exhibit No. S-2 (Exhibit No. S-1, at 43-44).

582. He asserts that the nominal ROE is not used to develop the revenue requirement for TAPS in this proceeding. Rather it is the real return (nominal return less inflation) that will be applied to the equity rate base to develop the revenue requirement for TAPS. The most recent real ROE for the proxy group is 8.66%. The real ROE is developed by subtracting the inflation rate of 2.02% for May 2010 from the nominal ROE (10.68% – 2.02% = 8.66%,) as required in by the Commission. If the Commission decides that the most recent real ROE data as of May 31, 2010 is not appropriate, it will be faced with a dilemma, in his opinion (Exhibit No. S-1, at 44).

583. Mr. Alvarez notes that throughout his testimony he posited, as a second-best alternative to using current or updated data, the option of using end of test period data as of September 30, 2009. In this case, however, adhering to an end of test period approach would produce a real ROE of 13.49% as of September 30, 2009, or a real return of 129 basis points higher than the nominal return as of that date. This unprecedented result

occurs because the inflation rate for September 2009 was a negative 1.29%. Inasmuch as Commission policy requires inflation to be subtracted from the nominal ROE, this causes the real ROE as of the end of the test period to be higher than the nominal ROE (Exhibit No. S-1, at 44-45).

584. Specifically, the real ROE is developed by subtracting from the nominal ROE the inflation rate of -1.29% for September 2009 ( $12.21\% - 1.29\% = 13.49\%$ ). Even Drs. Vander Weide and Fairchild recognize the folly of using a negative inflation rate to determine a recommended real return in this proceeding. However, their recommendation to simply ignore inflation by adopting a zero percent inflation assumption is no better and certainly is no more realistic or representative of investor expectations than a negative percentage (Exhibit No. S-1, at 44-45).

585. The inflation rates that occurred during the test period represented an extraordinary event. The test period commenced on January 1, 2009. The inflation rate that month was flat – 0.0%. By March 2009 the inflation rate was negative (-0.2%) and it remained negative until October 2009. The United States economy almost never experiences negative inflation, and certainly has not experienced negative inflation of this magnitude for at least half a century. The last time the United States experienced inflation that was negative was the year 1955.

586. Even year end inflation below 1.0% has not been present since the year 1959. Using negative inflation (as was the case for the test period ended September 30, 2009) or even a zero inflation rate for forward-looking rates would be unrealistic as expressed by Mr. Hanley and Dr. Horst. Investors would not expect inflation to remain negative or zero for any prolonged period of time and, indeed, by the end of 2009 it had returned to a more typical positive balance. The Commission itself has expressed concern over the unusual negative inflation. Hence, a zero rate would be inappropriate for use here (Exhibit No. S-1, at 45-46).

587. Recognizing the unique and unusual circumstance surrounding inflation during the test period in this proceeding, Mr. Alvarez opines the Commission should adopt an inflation assumption that is either up-to-date along with the rest of the return components, or one that is at least reflective of a normalized rate that investors would expect. As a result, Mr. Alvarez recommends that, should the Commission not choose to use an updated analysis, it should adopt an average inflation rate of 3.0%. This represents a conservative estimate of inflation experienced over the years for which inflation data are available, 1914 to 2009 (the actual average is 3.4%). This would then produce an end of test period real ROE of 9.21%, developed by subtracting 3.0% from the nominal ROE as of September 30, 2009 ( $12.21\% - 3.00\% = 9.21\%$ ) (Exhibit No. S-1, at 46-47).

588. Mr. Alvarez calculates the inflation rate from the Consumer Price Index – All Urban Consumers (CPI-U) (Current Series) data published on the Department of Labor,

Bureau of Labor Statistics website at <http://www.bls.gov/data/>. The index rates from 1913 to May 2010 are shown in Exhibit No. S-3. In order to calculate the inflation rate for May 2010, Mr. Alvarez took the May 2010 index rate and divided it by the May 2009 index rate minus 1  $[(218.178/213.856)-1] = 2.02\%$ . To calculate the inflation rate for September 2009, he took the September 2009 index rate and divided it by the September 2008 index rate minus 1  $[(215.969/218.783)-1] = -1.29\%$ . To calculate the inflation rate of 3.40% he took the average of the annual end of year inflation rates from 1914 to 2009.

589. In his view, this represents the average inflation of all year end data available from the Bureau of Labor Statics. Mr. Alvarez's calculations are included in Exhibit No. S-2. To be conservative, he recommends using 3.0% as a representative rate of inflation for calculating a real return as of September 30, 2009 (Exhibit No. S-1, at 47-48).

590. Mr. Alvarez then used an average based on all available year end inflation data from the Bureau of Labor Statics. Indeed, since 1955 the annual rate of inflation was under 1.0% for only one year (1959), until 2009. On the other hand, in the 1970's and early 1980's, inflation rates fairly consistently ranged from the mid to high single digits, even rising above 10% for several of those years. Using an average of all available year end inflation data calculated from the Bureau of Labor Statistics' CPI-U, the Commission's preferred source of inflation data, will smooth out any unusual features in inflation (positive or negative) that may arise, because they will have little effect when averaged out over all available year end data. Rounding the average of 3.4% down to 3.0% simply adds a layer of conservatism to the resulting real rate of return (Exhibit No. S-1, at 48).

591. Mr. Alvarez recommends a real median ROE of 8.66% as of May 31, 2010, the most recent data period available. In the alternative, he recommends a real median ROE of 9.21% for the test period ending September 30, 2009. This includes using a 3.0% inflation rate (Exhibit No. S-1, at 48-49).

592. Mr. Alvarez's resulting overall weighted cost of capital of 7.26% is reflective of the latest financial information available. The weighted cost of capital is calculated using the formula  $[(\text{capital ratio} \times \text{cost of capital}) = \text{weighted cost}]$ . To calculate the overall weighted cost of capital one would sum up weighted cost of capital for long-term debt and equity to the total. The capital structure and debt are as of March 31, 2010 and the cost of equity is as of May 31, 2010. He indicates that specifically (prior to reaching the stipulation on this issue) Staff's initial overall recommended weighted cost of capital for TAPS was:

<u>Type of Capital</u>	<u>Ratio</u>	<u>Cost of Capital</u>	<u>Weighted Cost of Capital</u>
Long-Term Debt	54.76%	6.10%	3.34%
Real Common Equity	45.24%	8.66%	3.92%
Total Capital	100.00%		7.26%

(Exhibit No. S-1, at 49).

593. Mr. Alvarez presents as an alternative an overall weighted cost of capital of 7.54%. He includes the real ROE of 9.21% that was calculated using an average inflation rate of 3.0%. Mr. Alvarez uses a cost of debt and capital structure as of September 30, 2009, the end of test period in this proceeding.

<u>Type of Capital</u>	<u>Ratio</u>	<u>Cost of Capital</u>	<u>Weighted Cost of Capital</u>
Long-Term Debt	51.03%	5.94%	3.03%
Real Common Equity	48.97%	9.21%	4.51%
Total Capital	100.00%		7.54%

(Exhibit No. S-1, at 49-50).

594. Mr. Alvarez does not agree with Dr. Vander Weide's deferred equity calculations. Dr. Vander Weide's deferred equity calculations for the years 2007 through September 30, 2009 do not follow the Commission's precedent requiring the removal of PAAs from equity. Mr. Alvarez also notes that Dr. Fairchild did not present any deferred equity calculations for the years 2007 through 2010. The only data he presented was the capital structure for the period ending December 31, 2008, which similarly does not appear to remove the PAAs from equity (Exhibit No. S-1, at 50).

595. Mr. Alvarez also does not believe that Dr. Vander Weide's exclusion of Economic Development Revenue Refunding Bonds, Zone Revenue Bonds, Industrial Bonds, and OLP-A&B bonds is reasonable. These bonds have identifiable costs associated with them and were taken into account when S&P issued a credit rating to Enterprise, KMEP, and NuStar. Equally important, they were included in the computation of the capital structure ratios developed for ratemaking purposes in this proceeding. In addition, the Commission's rules and regulations make no exceptions for their tax-exempt status. As a result, these bonds should be included in the cost of debt calculation when designing rates based on the actual cost of debt, and that debt cost should be blended (Exhibit No. S-1, at 50-51).

596. Mr. Alvarez further states that for Dr. Vander Weide's September 30, 2009 proxy group, he agrees with his inclusion of Buckeye, Enbridge, KMEP, NuStar, and Plains All American Pipeline. Mr. Alvarez does not agree with the inclusion of Magellan. He also disagrees with Dr. Vander Weide's exclusion of Sunoco Logistics Partners (Exhibit No. S-1, at 51).

597. According to the Proxy Group Policy Statement, Sunoco Logistics Partners, L.P. qualifies to be included the proxy group because it is tracked by Value Line, has been in operation for 5 years, has significant operations in oil pipeline, and has I/B/E/S forecasts.

It makes no mention that a company must be tracked by Value Line for 6 months (or any minimum time) before it can be included in a proxy group, as suggested by Dr. Vander Weide in response to Staff's data request (Exhibit No. S-1, at 51-52).

598. He notes that the data that Dr. Fairchild presented for his ROE calculations are as of April 30, 2009, which does not represent the end of the test period and are certainly not the most current information available. There have been over a full year's worth of changes in stock prices, the oil pipeline proxy group, and growth rate data since then. Dr. Fairchild's data is stale and therefore inappropriate for determining a rate of return, particularly when there is ample opportunity at this stage of the proceeding to provide updated data.

599. He asserts that a data request response submitted recently by the witness for the other TAPS Owner, Dr. Vander Weide, suggests that he intends to do just that. When asked about the timing of investors' perceptions of the cost of equity, Dr. Vander Weide estimates the cost of capital as of September 30, 2009, because this date is the end of the test period. Dr. Vander Weide also believes that there will be an opportunity to update his cost of equity estimate at a later stage of this proceeding (Exhibit No. S-1, at 52).

600. Mr. Alvarez also takes issue with Dr. Vander Weide's and Dr. Fairchild's calculations of the dividend yield. He indicates that the problem with Dr. Vander Weide's Exhibit No. BPP 22 and Dr. Fairchild's Exhibit No. ITC-6 is that their dividend yield calculations use inconsistent data periods for their dividend and stock price calculations. Specifically, they calculated unadjusted dividend yields for each of their proxy companies using as the numerator the most recent month's indicated annualized dividend. However, for the denominator, they first averaged the company's low and high stock price for each month in the past six-month data period, arriving at a single average stock price for each month (Exhibit No. S-1, at 53).

601. Mr. Alvarez asserts they then averaged the six individual averages, arriving at a single average stock price for each company representing their six-month data period. By calculating each company's unadjusted dividend yield in this way, they combined the current dividend level with an average of stock prices that relies on prices up to one-half of a year old. This mismatch gives their unadjusted dividend yield calculation an upward bias for all companies in their proxy group that raised their dividend level during the six-month data period (Exhibit No. S-1, at 53).

602. Mr. Alvarez states that since the Commission uses six months of past stock prices as the Current stock price in order to provide a balance between overly long and excessively short measurement periods, the dividend yield calculation must also use six months of past annualized dividends to arrive at the current dividend level. Doing so matches the time periods used for both components of the unadjusted dividend yield calculation, dividends and stock prices.

603. Mr. Alvarez states that the correct unadjusted dividend yields are then multiplied by the adjustment factor, resulting in adjusted dividend yields that fully account for expected dividends to be received in the next year. Given that the unadjusted dividend yields in Dr. Vander Weide's and Dr. Fairchild's DCF analyses have an upward bias for all of the proxy companies that increased dividends during their data period multiplying them by the adjustment factor simply results in adjusted dividend yields that also have an upward bias. These adjusted dividend yields are then added to the growth rate, leading to overstated DCF results for each company that increased its dividend level during the data period (Exhibit No. S-1, at 53-54).

604. Mr. Alvarez states that there are cases that indicate that it is appropriate to use an average of the individual dividend yields for each month in the data period. Though specific dividend yield calculations are rarely challenged and hence are rarely specified in detail in rate case decisions, there are several cases that do specify the calculation of monthly dividend yields. Other cases imply the same approach by referring to an average dividend yield rather than a single dividend yield calculated by dividing one dividend by an average stock price as Dr. Vander Weide and Dr. Fairchild have done in this proceeding (Exhibit No. S-1, at 54-55).

605. Some of the companies in Dr. Vander Weide's and Dr. Fairchild's proxy groups increased dividends during their six-month data period, and therefore have DCF results that are overstated cost of equity estimates for oil pipelines. In particular, Mr. Alvarez notes that one of Dr. Vander's six companies increased its distribution (dividends) during his six-month data period ending September 30, 2009, and therefore it produces DCF results in his analysis that overstate its cost of equity: Buckeye Partners, L.P., from \$3.60 to \$3.65 (Exhibit No. S-1, at 55).

606. Mr. Alvarez observes further that four of Dr. Fairchild's eight proxy companies increased their distributions (dividends) during his six-month data period ending April 30, 2009, and therefore produce DCF results in his analysis that overstate their cost of equity: Buckeye, from \$3.50 to \$3.55; Enterprise, from \$2.09 to \$2.15; KMEP, from \$4.08 to \$4.20; and, Magellan from \$2.81 to \$2.84. He states that while the impact of these changes on DCF results can be small this approach should be rejected because it leads to DCF results that have an upward bias when performed on companies that increased their dividends during the data period (Exhibit No. S-1, at 55).

607. Mr. Alvarez also reiterates that he takes issue with both Dr. Vander Weide and Dr. Fairchild's calculation of the real ROE. In his opinion, they both have assumed zero inflation, resulting in a real cost of equity that is equal to that of the nominal cost of equity. Assuming a zero rate of inflation, and thereby setting the real return on equity equal to the nominal return on equity, has no rational or historical basis and it defies common sense. Mr. Alvarez states that Mr. Hanley and Dr. Horst have proposed

alternative rates of inflation that at least recognize its existence. Inflation simply cannot be ignored as Dr. Vander Weide and Dr. Fairchild have done (Exhibit No. S-1, at 53).

608. Mr. Alvarez, however, does not agree with Dr. Horst's recommendation to replace the Commission's use of the trailing six-month average of stock prices used in the DCF methodology. The Commission has long established precedent for calculating the DCF, including using the trailing six-month average of stock prices. Dr. Horst, in his Exhibit No. SOA-1 suggests replacing the trailing six-month average stock prices with the following: (1) averaging the high and low stock for the current month (e.g., September 2009); and (2) extending the price-averaging period to include the previous, current and coming months (e.g., August 2009 through October 2009).

609. Mr. Alvarez opines that he sympathizes with Dr. Horst's effort to avoid using the anomalous financial data from the test period by replacing the Commission's trailing six-month average of stock prices with later (i.e., more current) months in the calculation. However, his suggestion violates the Commission's long established precedent for calculating the DCF return on equity, in his opinion. Moreover, there is an easier, more practical way to avoid the unreasonable and distorted results associated with the use of test period data, and that is to adopt a current, updated approach as both he and Mr. Hanley have suggested (Exhibit No. S-1, at 56-57).

610. Mr. Alvarez also does not agree with Dr. Horst's recommendation to use an inflation forecast by Blue Chip Economic Indicators. Dr. Horst recommends the use of a medium-term five-year forecast by Blue Chip Economic Indicators. Although some recognition of inflation is preferable to no recognition at all (as advocated by Drs. Vander Weide and Fairchild) the Commission's policy has been to use actual inflation calculated from the CPI-U, not forecasted inflation rates. To the best of Mr. Alvarez's knowledge, the Commission has never accepted the use of Blue Chip Economic Indicators or any other forecast to calculate the real return on equity (Exhibit No. S-1, at 57-58).

611. Furthermore, Mr. Alvarez does not agree with Mr. Hanley's capital structure calculations for the March 31, 2010 and September 30, 2009 periods. Mr. Hanley's calculations for the referenced periods do not follow the Commission's precedent requiring the removal of PAAs from equity. Moreover, Mr. Alvarez does not agree with including Magellan in the proxy group for the period ended September 30, 2009 (Exhibit No. S-1, at 58).

**K. ExxonMobil Reply Testimony****1. Jeffrey M. Ray**

612. The purpose of Mr. Ray's reply testimony is to reply to the uniform rate issue submitted in the answering testimony of Mr. Van Hoecke on behalf of BPPA and the answering testimony of Mr. Brown on behalf of Anadarko (Exhibit No. EM-4, at 1-2).

613. In Mr. Ray's view, the Commission ordered TAPS Carriers to file uniform rates for transportation service on TAPS in Opinion 502. Although Opinion 502 is now on appeal, the order is currently in force and EMPCo is not challenging it in this proceeding. However, the issue of how the uniform rate requirement must be implemented by Carriers was not addressed in Opinion 502. Instead, that issue was set for hearing in this proceeding (Exhibit No. EM-4, at 2).

614. The basis for Mr. Ray's statement that implementation of the uniform rate is an issue set for hearing in this proceeding is based on his review of the Commission's order setting this matter for hearing. The June 30 Order observed that Carriers that had submitted TAPS rate change filings in the Spring and Summer of 2009 (EMPCo, BPPA and CPTAI) met the requirements of the Commission's cost of service regulations applicable to such rate change filings, but it further observed that these filings raised a number of issues of material fact that should be resolved through a hearing. Among those issues was the fact that the individual rates filed by Carriers vary, cover different periods of time, and are not uniform (Exhibit No. EM-4, at 3).

615. He notes that the Commission also observed that since Carriers no longer file rate changes pursuant to the TAPS Settlement Agreement – these were the first rate change filings submitted by Carriers since the termination of the TAPS Settlement Agreement – and since TAPS is expressly excluded from the Commission's oil pipeline indexing regulations, Carriers have no method for increasing their rates from year to year, except by making a rate filing with the Commission, proposing a uniform rate for TAPS. Accordingly, the Commission found that to implement the directive in Opinion 502 that Carriers charge a uniform rate it should consolidate and set for hearing individual Carrier rate filings to ensure that there will be one proceeding to determine a just and reasonable uniform rate for TAPS (Exhibit No. EM-4, at 3).

616. Mr. Ray observes that in an order on rehearing in this proceeding, the Commission addressed a request for clarification filed by Anadarko. Anadarko noted in its request for clarification that the June 30 Order stated that the uniform rate and pooling mechanism established in this proceeding will apply to all Carriers, so any Carrier that has not intervened or filed its own rate, may want to do so to ensure its interests are represented. Anadarko then requested that the Commission clarify that the uniform rate constitutes the maximum rate for TAPS, but it does not obligate all Carriers to file for and charge the

maximum rate. The Commission granted this request for clarification, thereby providing direction as to how the uniform rate should be implemented in one respect. The Commission also reiterated that the consolidated hearing proceedings would ultimately determine the uniform rate (Exhibit No. EM-4, at 4).

617. Mr. Ray states that he reviewed the Commission's brief in the appeal of Opinion 502 to the D.C. Circuit, and the Commission itself expressed its view that uniform rate implementation issues are set for hearing in this proceeding. More specifically, the Commission argued that TAPS Carriers' challenge to the uniform rate mandate is not ripe for appellate review as agency proceedings continue as to precise implementation of these requirements. The Commission further argued that it has not applied the uniform rate requirement in a concrete factual setting, and that postponing review will allow it to crystallize its uniform rate policy. The Commission then pointed to this proceeding as constituting the concrete factual setting in which it will address and resolve uniform rate implementation issues (Exhibit No. EM-4, at 4-5).

618. Mr. Ray testifies further that none of the other witnesses in this proceeding have challenged the approach used by EMPCo and the other Carriers to develop and file their 2009 uniform TAPS rates. Moreover, no witness has advocated Carriers must collaborate on the development of a single uniform rate, or file the identical rate on the same date. He opines that it important to EMPCo to resolve the implementation issues concerning the uniform rate at this time. The rate change filings at issue in this proceeding are the first rate change filings that Carriers have submitted in accordance with the Commission's uniform rate mandate (Exhibit No. EM-4, at 5-6).

619. While Mr. Ray does not believe that any participant in this case has filed testimony challenging how EMPCo and other Carriers calculated and filed their uniform rates in this proceeding, it is important that the Commission provide definitive guidance at this time as to how the uniform rate mandate should be implemented. Such guidance is important so that TAPS Carriers, as well as parties interested in TAPS rate filings, can have certainty as to the implementation of uniform rate filings going forward (Exhibit No. EM-4, at 6).

## **L. BPPA- Reply Testimony**

### **1. Charles J. Coulson**

620. The purpose of Mr. Coulson's reply testimony is to address factual issues that relate to the answering testimony of Dr. Hieronymus, Mr. Wetmore, and Mr. Brown. Mr. Coulson's testimony supports Dr. Cameron's reply testimony, in which she responds to the testimony of these witnesses. In addition, Mr. Coulson provides additional detail on two marine transportation issues: (1) Tesoro's interstate shipments of ANS crude; and (2) Chevron's participation in the Alaska tanker trade. The primary destination for Tesoro's tankers is its Nikiski refinery in Alaska. Tesoro occasionally transports crude to

the U.S. West Coast when crude oil imbalances occur between its ANS supply and its Nikiski refinery consumption rate. As a result, Tesoro has not accounted for significant interstate liftings from the VMT in the past, and that should not change in the future (Exhibit No. BPP-43, at 1-2).

621. In his view, although Chevron used to have a tanker participating in the Alaska trade, it no longer does. Their sole tanker used in the ANS trade had reached its allowable age limit under OPA 90 legislation, and was removed from ANS service in 2001. Since that time, Chevron has not replaced this tanker, and Mr. Coulson does not expect Chevron to re-enter the ANS tanker trade in the foreseeable future period that Dr. Cameron addresses (Exhibit No. BPP-43, at 1-2). Furthermore, Mr. Coulson addresses concerns over the impact of economic incentives on future capital investments in TAPS. For instance, Mr. Coulson reviewed Alyeska's 10-year Long Range Plan (LRP) for year 2010, and identified \$500 million of discretionary, economically-based capital investment projects that, to be approved by Carriers, will need to be judged on their economic merits (Exhibit No. BPP-43, at 2-3).

622. Mr. Coulson notes for example, the future decision concerning the VMT Power Vapor Lifecycle Replacement Project. This project is still under evaluation by Alyeska and the Carriers as to its potential engineering scope, cost and benefits. The intent of this project would be to install floating roofs inside the crude oil storage tanks at the VMT to reduce the quantity of vapors emanating from the crude oil within the tanks. The reduction in crude oil vapors would also allow the low-efficiency steam-powered generation facilities, which are fueled, in part, on these recovered vapors, to be replaced with a more efficient electrical power source (Exhibit No. BPP-43, at 3-4).

623. Additionally, the existing power generation and vapor recovery facilities are nearing the end of their serviceable life and require an increasing amount of maintenance costs. He asserts that modernization of this equipment would avoid the need for spending significant maintenance dollars that would otherwise be required to keep this equipment in working order. This project is estimated to have a capital cost at completion of \$152.2 million. The potential benefits of the Power/Vapor Lifecycle Replacement Project would be to reduce the amount of crude oil losses to shippers along with reducing operating costs at the steam-powered electrical generation facilities (Exhibit No. BPP-43, at 4).

624. Mr. Coulson opines that with an incomplete cost pool, an under-recovering Carrier such as BPPA would be burdened with a greater percentage of up-front capital costs (47%) for the Power/Vapor Lifecycle Replacement Project relative to the capital costs that it can hope to recover via the uniform tariff rate. Further, BPPA's upstream affiliate shipper would enjoy from this project only 35% of the reduction in operating costs (as these costs are passed through the tariff rates) and only 35% of the reduction in oil losses (a direct benefit not contained within tariff rates), despite its midstream affiliate (BPPA) paying out 47% of the up-front capital costs (Exhibit No. BPP-43, at 4-5).

625. In his view, this misalignment between capital cost incurrence on the one hand and capital cost recovery (through depreciation and return) and shipper related savings on the other, will directly impact how BPPA will evaluate the economic merits of this project. Conversely, over-recovering Carriers such as CPTAI, whose TAPS usage exceeds its ownership share, would be oppositely situated. CPTAI would have to contribute only 28% of the up-front capital costs for the Power/Vapor Lifecycle Replacement Project, but in the absence of full cost pooling, would collect more than 28% of these capital costs through tariff rates, while its affiliated shipper would enjoy 40% of the reduction in operating costs and oil losses arising from the investment. BPPA's economics would fall short of the system average economic result, while CPTAI's economic view would exceed the system average, giving rise to disparate views about the merits of this project (Exhibit No. BPP-43, at 5).

626. Mr. Coulson provides another example relating to the Pump Station No. 5 Renewal Project, denoted in the LRP as AFE No. F752. Pump Station No. 5 is actually a pressure relief station located on the southern side of Atigun Pass and is used to de-pressure the pipeline during shutdowns and low flow conditions in order to prevent over pressure of the line. He indicates that the equipment at this pump station is over 30 years old. The electrical power generators require high maintenance and are fuel inefficient, while the automation and control system also requires high maintenance and is nearing the end of its serviceable life, in his view (Exhibit No. BPP-43, at 6).

627. He states that the station requires on-site personnel to operate, while modernization could allow this site to be operated remotely, thereby reducing labor costs. The 2010 LRP indicates this project has an estimated capital cost of \$20 million. The potential benefits of such a project would be to lower fuel and operating costs, while ensuring the overall reliability of the TAPS system remains high. The majority of the Pump Station Renewal Project has been deferred, pending a decision from the Carriers on how and whether to proceed (Exhibit No. BPP-43, at 6).

628. A third example Mr. Coulson provides relates to the responsibilities imposed upon shippers in TAPS. He states that there is a lack of competition among Carriers. For instance, Dr. Cameron discusses the issue as to whether non-affiliated ANS producers would prefer to sell their ANS production at the oilfield instead of becoming shippers on TAPS and selling their production at Valdez to entities having access to oil tankers. Aside from the obvious disposition risk that a non-affiliated producer incurs by having crude oil inventory sitting in Valdez without access to an oil tanker, there are other considerations. If a producer chooses to become a shipper on TAPS, rather than selling its oil upstream of TAPS, it is required to provide its proportionate share of line-fill for the pipeline and Valdez tanks, which would tie-up working capital on its balance sheet. A sale of crude oil prior to entering TAPS puts this line-fill burden on the purchaser, who then becomes the shipper of record on TAPS. There are other multiple administrative considerations associated in such transactions as well (Exhibit No. BPP-43, at 7).

629. He observes further that an upstream sale of crude oil means that the producer will not have to engage in the administrative tasks of making nominations to TAPS, scheduling deliveries, arranging for tanker transportation, processing and paying tariff invoices, etc. Lastly, a producer that is not a shipper on TAPS is not exposed to pipeline transportation risks that a shipper bears, such as potential volume losses from spills and excess inventory penalties if the tanker scheduled to pick-up the shipper's crude is delayed or if the shipper is unable to arrange for tanker transportation or find a purchaser that is able to take delivery at Valdez (Exhibit No. BPP-43, at 7-8).

630. Mr. Coulson further notes that by selling its ANS production prior to entering TAPS, a non-affiliated producer's responsibility to market and transport its production ends at the outlet of the oilfield. This explains why as some newer North Slope oilfields have come on line recently, BPPA has not seen any new shippers of record utilizing its pipe space (Exhibit No. BPP-43, at 8).

## **2. Robert G. Van Hoecke**

631. Mr. Van Hoecke previously filed direct testimony on behalf of BPPA in which he recommended the Commission adopt the BPPA Cost Allocation Mechanism. Mr. Van Hoecke also filed answering testimony on behalf of BPPA in response to the direct testimony submitted by Joseph Falcone and Erik Wetmore, on behalf of CPTAI, and by Jeffrey Ray, on behalf of EMPCo. The purpose of Mr. Van Hoecke's reply testimony is to reply to criticisms of the BPPA Cost Allocation Mechanism by witnesses for CPTAI and Anadarko. The principal objection among these witnesses is the inclusion of return on investment in the BPPA Cost Allocation Mechanism (Exhibit No. BPP-58, at 1-2).

632. First, their justifications for excluding cost of capital generally fall into three categories. They allege that the Commission did not intend cost of capital to be included in cost pooling, as it was excluded from the prior settlement based pooling arrangement on TAPS. Second, they maintain that cost of capital is somehow different from the other elements of cost incurred in providing regulated service, and that those differences require that cost of capital be excluded from the BPPA Cost Allocation Mechanism. Third, they argue that price competition should be relied on for recovering cost of capital rather than including it in cost pooling. They assert that price competition is required in order to provide Carriers with an incentive for providing service and to prevent windfalls to Carriers who receive payments as a result of cost pooling (Exhibit No. BPP-58, at 2).

633. Mr. Van Hoecke states that the BPPA Cost Allocation Mechanism is aligned with the Commission's instructions and does not pose any of the problems alleged by the witnesses for other parties. Mr. Wetmore filed voluminous testimony in which he alleges that the BPPA Cost Allocation Mechanism is not consistent with the Commission's instructions, violates certain alleged principles of cost-based regulation, and would result in inappropriate windfalls for Carriers receiving payments as a result of cost pooling. Moreover, Dr. Hieronymus recommends that price competition be relied on to mitigate

the over- and under-recovery problem among Carriers that result when cost of capital is excluded from the cost pooling calculations. Mr. Van Hoecke states that these criticisms are based on a flawed analysis, which misinterprets the specific instructions in Opinion 502 regarding cost-based regulation of TAPS and the rehearing orders addressing cost pooling, as well as the Commission's approach to cost-based regulation generally (Exhibit No. BPP-58, at 3-4).

634. Mr. Van Hoecke disagrees with Mr. Wetmore's assertion in that the BPPA Cost Allocation Mechanism is not consistent with the applicable Commission orders regarding pooling because it is fundamentally different from TSA pooling mechanism. It is inaccurate for Mr. Wetmore to say that the Commission has accepted the cost pooling mechanism in the 1985 TSA at Section II-2(f) as an appropriate means for addressing the over-recovery and under-recovery that will occur under the uniform rate requirement established in Opinion 502 (Exhibit No. BPP-58, at 4).

635. Mr. Van Hoecke believes that the Commission specifically ruled otherwise. He states that on November 20, 2008, the Commission affirmed Opinion 502's ruling regarding the uniform rate, but found that the pooling mechanism in the TSA was an incomplete remedy to under-recovery. The Commission directed Carriers to implement a more inclusive pooling mechanism. Ignoring this explicit Commission ruling, Mr. Wetmore argues that Section II-2(f) pooling or something similar has been mandated by the Commission. He bases his argument on a single sentence in the 2009 Rehearing Order where the Commission, in the course of justifying its statutory authority to order cost pooling outside of Section 5(1) of the ICA, observed that the new pooling mechanism would be similar to Section II-2(f), which did fall within ICA Section 5(1) (Exhibit No. BPP-58, at 4-5).

636. Mr. Van Hoecke states that Mr. Wetmore has taken the Commission's statement completely out of context. The purpose of the cited passage is to support the Commission's determination that it has sufficient statutory authority to order a new pooling mechanism because it previously made a similar determination when approving the TSA. It does not state that the new cost pooling mechanism is or must be identical to Section II-2(f). If that were what the Commission intended, it could have easily just ordered Carriers to continue using the TSA Section II-2(f) cost pooling mechanism in its 2009 Rehearing Order and avoided this hearing. Instead, as the passage above demonstrates, the Commission has found that Section II-2(f) is inadequate and has ordered that a more inclusive cost pooling mechanism be developed (Exhibit No. BPP-58, at 5).

637. Mr. Van Hoecke testifies further that the BPPA Cost Allocation Mechanism is similar to Section II-2(f) in that it pools actual operating costs and depreciation, it excludes certain Owner-direct costs that are incurred by each Carrier, and it includes both the interstate and intrastate costs. Consistent with the Commission's findings that Section II-2(f) was not sufficiently inclusive, the BPPA Cost Allocation Mechanism

includes cost of capital for investments in TAPS carrier property as determined by application of the cost-based methodologies prescribed by Opinion 502 and RCA Order 151. Contrary to Mr. Wetmore's assertion that the CPT-8 Model is, and a new cost pooling mechanism must be, similar to the TSA pooling mechanism, the CPT-8 Model is similar to Section II-2(f) in some respects but differs substantially from Section II-2(f) in others (Exhibit No. BPP-58, at 5-6).

638. Mr. Van Hoecke notes that Mr. Wetmore attempts to exclude all intrastate costs, while they were included under Section II-2(f). He proposes to include certain Owner-direct costs which were excluded under Section II-2(f). The error of Mr. Wetmore's assertion can be demonstrated by examining the Commission's stated objective in ordering a new, more inclusive cost pool under the uniform rate requirement. The Commission states that the purpose of the pooling mechanism is to ensure that carriers do not over- or under-recover their costs. The CPT-8 Model that Mr. Wetmore presented in his direct testimony results in CPTAI significantly over-recovering its costs at the expense of other Carriers, most notably BPPA (Exhibit No. BPP-58, at 6-7).

639. Mr. Van Hoecke believes Mr. Wetmore ignores this fundamental requirement that the TAPS cost pool include all costs. In pursuing his point he argues both that the cost of capital is not really a cost to Carriers and that certain costs should not be included in the cost pool because they must be earned, presumably distinguishing them from other costs that a Carrier is entitled to recover without earning them. He asserts that Mr. Wetmore is incorrect that the Commission did not intend Carriers to pool return. He observes that Mr. Wetmore attempts to justify excluding cost of capital from the CPT-8 Model by asserting that the Commission excluded cost of capital from the settlement-based Section II-2(f) cost pool as part of the 25-year-old TSA, therefore, Carriers should be precluded from pooling the cost of capital under a uniform rate today (Exhibit No. BPP-58, at 7).

640. Mr. Van Hoecke states that this argument has no merit. First, the Commission did not construct the cost pooling mechanism contained in Section II-2(f) of the TSA; the parties to the settlement did. They also constructed the TAPS TSM, the centerpiece of the TSA. The Commission approved a comprehensive settlement agreed to by the parties ending eight years of litigation, and TSM and Section II-2(f) were elements of that settlement. As found by the Commission, the return element in TSM, the allowance per barrel (APB), was not cost-based; therefore, it could not have properly been included in a cost pool centered around the TSA. It was a stipulated amount, which was adjusted for inflation. In Opinion 502, the Commission determined that Carriers failed to demonstrate that the TSM rates were cost-based. In so determining, the Commission cites the APB as one of several TSM elements that were not based on costs (Exhibit No. BPP-58, at 7-8).

641. There is no merit to Carriers' claim, in Mr. Van Hoecke's opinion, that the TSM is a cost-based methodology. A number of elements within the TSM are unrelated to costs of providing service or are inappropriate for cost-based ratemaking. Specifically, as noted by Staff, inflation adjusted, non-cost-based APB and 100% equity capital structure

assumption. Moreover, he asserts that much has changed over the last 25 years. The TSA, and with it, TSM and Section II-2(f), has been terminated, Carriers are now required to file a cost-based uniform rate, and the Commission has mandated Carriers pool all costs and allocate them on the basis of usage. The Commission is aware of the provisions of Section II-2(f) and has found them not to be appropriate. In his view, Mr. Wetmore is erroneously arguing for implementation of a methodology the Commission has already evaluated and rejected as not sufficiently inclusive (Exhibit No. BPP-58, at 8).

642. Mr. Van Hoecke states further that Mr. Wetmore's contention that return, a term that is used interchangeably with cost of capital, is not a cost incurred by a pipeline carrier and not consistent with the principles or the practice of cost-based ratemaking. At the root of the regulation of oil pipelines by the Commission is the Commission's recognition of the cost of capital; the cost of the capital needed to supply the regulated service is one of the costs for which the regulated entity must be reimbursed. That cost does not differ in essence from such other costs as wages, fuel, and taxes (Exhibit No. BPP-58, at 9).

643. Just as unequivocal in his view, is the Commission's observation, when comparing the TOC methodology the Commission established in Opinion 154-B to the Net Depreciated Original Cost (DOC) methodology the Commission uses to establish cost-based rates for the gas and electric industries: TOC, just like DOC, requires the determination of a nominal (inflation-included) rate of return on equity that reflects the pipeline's risks and its corresponding cost of capital (Exhibit No. BPP-58, at 9).

644. Moreover, TOC's different time pattern for the recovery of the cost of equity capital also has other advantages. TOC comes closer to duplicating pricing in unregulated enterprises, and provides for greater intergenerational equity by providing relatively constant cost of equity capital charges in real terms (adjusted for inflation) to ratepayers over the life of the regulated property. When the Commission establishes a cost-based rate, it includes the cost of capital as an actual cost incurred by the carrier in providing the regulated service, just as it includes labor, power and other prudently incurred costs. Nonetheless, Mr. Wetmore implies that the Commission changed course in Docket No. IS05-82 and eliminated some prudently incurred costs, but not others, in mandating that Carriers should develop a pooling mechanism that reallocates all Carriers' costs based on throughput or usage (Exhibit No. BPP-58, at 9-10).

645. Mr. Van Hoecke testifies further that the Commission applied its general principles of cost-based rate making to TAPS in Opinion 502. In that proceeding, in his view, the ALJ held that to establish just and reasonable rates, the guidelines in Opinion No. 154-B should be used. Under those standards, each component of the cost of service must be supported. The components of cost of service enumerated in Opinion 502 include the return on investment as a cost element. Further, each Carriers' compliance filings following issuance of Opinion 502 and several subsequent rate filings made by

CPTAI have included cost of capital as a cost in computing the cost-based uniform rate. This cost of capital is identical to the cost included in the BPPA Cost Allocation Mechanism. Mr. Wetmore may have, after filing his testimony, changed his mind on the cost incurred versus compensation to be earned issue. In his response to data requests by BPPA, Mr. Wetmore now states that return on investment is a component of the cost of service ratemaking methodology under FERC Opinion 502 and RCA Order 151 (Exhibit No. BPP-58, at 10-11).

646. Mr. Van Hoecke asserts that Carriers initially fund operating and capital costs incurred by Alyeska through cash calls. Operating costs represent expenditures that relate to current period system costs (e.g., wages, fuel and power, supplies, taxes). Carriers will seek their recovery in the current period. Capital costs represent capital investment in TAPS that Carriers will seek to recover over multiple operating periods and give rise to the depreciation and cost of capital elements in the cost of service. Depreciation and cost of capital go hand-in-hand in the mechanism that the Commission uses to allow carriers the opportunity to recover their incurred capital costs. Depreciation represents the return of investment, while cost of capital represents the return on investment. One cannot truly be separated from the other because they both arise simultaneously from the same dollars of capital investment, and thus they should not be separated from each other in a properly constructed cost pool, in his view (Exhibit No. BPP-58, at 11).

647. Nonetheless, Mr. Van Hoecke states that Mr. Wetmore proposes to include depreciation in his CPT-8 Model cost pool but to exclude the cost of capital. The BPPA Cost Allocation Mechanism reconciles the actual costs incurred per the cash calls with each Carrier's usage of TAPS. Any transfer payments or receipts Carriers will recognize as a result of the BPPA Cost Allocation Mechanism merely adjust each Carrier's actual cost incurred (on an ownership basis) with its use of TAPS. Contrary to Mr. Wetmore's suggestion, these cash transfers do not impact operating revenue, according to Mr. Van Hoecke (Exhibit No. BPP-58, at 11-12).

648. Mr. Van Hoecke further disagrees with Mr. Wetmore who argues that cost of capital cannot be included in the cost pooling calculations because cost of capital is not reported in the Form 6 Annual Report. He argues that cost of capital cannot be included because Carriers are not guaranteed to recover their cost of capital. Mr. Wetmore attempts to distinguish the cost of capital from operating costs and depreciation by noting that the latter two items appear on the carrier's income statement in the Form 6, while the cost of capital does not. This proves nothing according to Mr. Van Hoecke. He argues that Mr. Wetmore fails to establish why the Form 6 income statement is relevant to the issue of costs included in the cost pooling (Exhibit No. BPP-58, at 12).

649. Mr. Van Hoecke also believes that the Commission rejected Mr. Wetmore's contention when it observed that the Form 6 does not reflect all costs of providing the regulated transportation service. The use of trended original cost to establish a rate base

for oil pipelines, as required by the Opinion No. I54-B methodology entails complex calculations to derive annual figures for equity and equity returns for ratemaking purposes. This calculation will differ from the book equity figures contained in Form No. 6, which are required for financial reporting purposes. To require the display of these calculations in the Form No. 6 would be cumbersome and not be of significant benefit in a shipper's determination of whether to protest a pipeline's indexed rate filing (Exhibit No. BPP-58, at 12-13).

650. The Commission makes no mention of the Form 6 in its instructions relating to cost pooling. Specifically, there is no reference made to reliance on the Form 6 report in any of the IS05-82 Orders, which is consistent with the Commission's recognition that Opinion 154-B methodology, the cost-based standard applied to TAPS, includes data that are not reported in the Form 6. In the discussion of the Opinion 154-B methodology and Form 6, the Commission makes specific references to the equity return element of cost of capital as data that are required for cost-based rate making and are not found in the Form 6 (Exhibit No. BPP-58, at 13).

651. Mr. Van Hoecke states that Mr. Wetmore does not conform to his Form 6 rule consistently throughout his cost pooling proposal. Mr. Wetmore fails to explain why he excluded the portion of the cost of capital funded by debt given that interest expense (i.e., the cost of debt funding) is recorded on the Form 6 Income Statement at line 8. Second, the depreciation expense that Mr. Wetmore includes in his pooling proposal differs markedly from the depreciation that Carriers reflect on their Form 6 Income Statement. Mr. Van Hoecke states that he offers these observations not to criticize the method under which depreciation is determined under Opinion 502 and Order 151, but to point out how unworkable Mr. Wetmore's Form 6 rule is. Form 6 does not contain all of the required data for cost pooling any more than it contains all of the data required to calculate cost of service under Opinion 502 (Exhibit No. BPP-58, at 13-14).

652. However, in his view the amounts required for cost pooling, such as depreciation, can be calculated as the BPPA Cost Allocation Mechanism does, and are tied to the costs that Carriers incur for providing regulated service. Mr. Wetmore's contention that a cost must be found in the Form 6 income statement in order for it to be included in cost pooling is not supported by either the principles or the practices that the Commission applies to cost-based ratemaking (Exhibit No. BPP-58, at 14).

653. Mr. Van Hoecke agrees with Mr. Wetmore that an oil pipeline is not guaranteed it will recover its full return, but hastens to add that this does not distinguish a carrier's recovery of return from recovery of any of its other costs—wages, benefits, power, material and supplies, taxes, and others that are properly included in a cost-based rate. While all of these are costs related to providing transportation service and are properly included in both the cost of service and the cost pool, the Commission does not guarantee that any Carrier will recover one cent of any of them. The recovery of each of them is dependent upon receiving payments for services rendered to shippers. Moreover,

although both depreciation and return represent the current recovery of costs associated with prior capital investments, Mr. Wetmore includes depreciation expenses in his cost pool without any suggestion that a Carrier must earn these costs before these costs can be reallocated in the CPT-8 Model (Exhibit No. BPP-58, at 14-15).

654. Mr. Van Hoecke further states that if Mr. Wetmore's reasoning were to be applied consistently (i.e. that all cost elements within the full revenue requirement must be earned before they can be pooled), there would be no cost pooling. If costs must be earned, then any form of cost pooling would guarantee a Carrier the recovery of some level of cost. After considering both revenue pooling and cost pooling, the Commission has chosen cost pooling. The Commission clarifies that Carriers should develop a pooling mechanism that reallocates all Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS (Exhibit No. BPP-58, at 15-16).

655. Mr. Van Hoecke disagrees with Mr. Wetmore's assertion that from the perspective of how revenues are collected the Opinion 502 uniform rate is not fundamentally different from the TSA rate ceilings, therefore, the BPPA Cost Allocation Mechanism is not required. Since Mr. Wetmore's whole argument is premised on revenue not cost, it is irrelevant. The Commission did not order Carriers to pool revenues; it ordered them to pool costs. Carriers should develop a pooling mechanism that reallocates all Carriers' costs based on throughput or usage. Moreover, turning to Mr. Wetmore's comparison of the current uniform rate to the TSM rates, the Opinion 502 uniform rates are different from the TSM rates (Exhibit No. BPP-58, at 16).

656. The uniform rate is a single cost-based rate that will apply to Carriers. TSM arose from a settlement and generated maximum rates that varied from Carrier to Carrier. Mr. Wetmore asserts that these variances in the TSM rates between Carriers were merely differences in each Carriers' (cost and volume) estimates. This is only partially true because Mr. Wetmore glosses over the point that the TSA included a carry-forward provision that allowed each Carrier to adjust its maximum rate in the current period based on cost recovery in prior periods (Exhibit No. BPP-58, at 16-17).

657. Mr. Van Hoecke notes the Commission's findings in Opinion 502 that the TSM rates were not cost-based because of the inclusion of certain non-cost elements, such as the APB, TSM Depreciation and 100% equity capital structure, rebut Mr. Wetmore's claim that in TSM the effective ceiling rates for all Carriers were based on total TAPS costs and throughput. If the Commission had not found that TSM rates were fundamentally different from the Opinion 502 uniform rate, the Commission would have had no reason for ordering a new uniform rate structure in Opinion 502 (Exhibit No. BPP-58, at 17).

658. Mr. Van Hoecke states that there are other examples where Mr. Wetmore interjects a revenue-based argument into his discussion of cost pooling. He notes that

Mr. Wetmore states that BPPA's pooling approach is fundamentally flawed because it is inconsistent with how carriers earn their revenues. He cites examples of Mr. Wetmore's confusion of whether Carriers are to develop a cost pool or a revenue pool. Mr. Wetmore is concerned with the relationship between the BPPA Cost Allocation Mechanism and actual revenue collected noting BPPA's proposed pooling mechanism pools and reallocates a hypothetical revenue requirement that reflects neither the actual revenue collected by Carriers during a given year nor the level of revenue that Carriers would necessarily be entitled to collect under properly calculated FERC or RCA rates (Exhibit No. BPP-58, at 17-18).

659. Mr. Van Hoecke notes that Mr. Wetmore makes a variation of the same argument related to phantom revenue finding BPPA's failure to incorporate discounts into its model can result in the reallocation of a hypothetical revenue requirement that exceeds what Carriers actually collected. This can result in the pooling of phantom revenue that causes Carriers who receive pooling payments to obtain more than their ownership share of return. Mr. Wetmore is concerned with the impact settlements might have on revenues and phantom revenues stating that BPPA's failure to incorporate Commission approved settlements into its model can result in the reallocation of a hypothetical revenue requirement that is unrelated to what Carriers actually collected that results in the pooling of phantom revenues. Mr. Wetmore states that because BPPA does not take into account the actual rates that were in effect during the year in question, its revenue requirement does not necessarily reflect the actual revenue collected by Carriers during the year in question (Exhibit No. BPP-58, at 18).

660. Finally, Mr. Wetmore states that he has discussed five different ways in which BPPA's hypothetical revenue requirement approach can pool and reallocate phantom revenues and asks him to provide an instance in which BPPA Cost Allocation Mechanism has done so. In response, Mr. Wetmore claims that Exhibit. No. CPT-15 demonstrates that BPPA proposes to reallocate approximately \$78.8 million in phantom revenues among Carriers, benefitting those Carriers whose ownership share exceeds their usage share (Exhibit No. BPP-58, at 18-19).

661. Mr. Van Hoecke believes the examples demonstrate Mr. Wetmore's failure to follow the Commission's instructions. Carriers are to pool costs, not revenues. This is precisely what the BPPA Cost Allocation Mechanism does. Actual costs incurred are allocated to Carriers based on their actual usage of the system, and reconciling transfers are made among Carriers to reflect the differences between the original funding of cost and the ultimate cost responsibility after making the cost pool adjustments. When a Carrier's ownership share exceeds its usage share, that Carrier will receive a payment from the cost pool to compensate the initially overfunded cost, and vice versa. Actual revenues collected are not a consideration for the scope of cost included in a cost pool. A cost pool focuses on cost incurrence, and the proper allocation of the incurred cost-based on usage. Revenues collected do not enter into it. Nonetheless, Mr. Wetmore's

testimony confuses the transfers of certain costs among Carriers with revenues collected from ratepayers (Exhibit No. BPP-58, at 19).

662. Mr. Van Hoecke observes that the TSA long ago made it clear that cost pooling is an arrangement among Carriers, has no effect on ratepayers, and is not directly related to the revenues collected from ratepayers. A Carrier is still at risk for not collecting its costs from ratepayers. The mechanism designed to align Carriers' costs and their collection of revenues from ratepayers is the uniform rate filing under Opinion 502 and Part 346 of the Commission's regulations. Cost pooling does nothing to change this paradigm. The CPT-8 Model recognizes this. It does not take into account the revenues that Carriers actually collect. It merely pools certain costs incurred by Carriers, but ignores others, such as cost of capital. The Section II-2(f) cost pool did not reflect revenue-based adjustments or rate discounts. Under TSM, rate discounts were considered voluntary revenue reductions which were borne solely by the Carrier offering the discount. Mr. Wetmore argues that under a uniform rate cost pool, discounts should be treated differently, although the CPT-8 Model does not appear to do so (Exhibit No. BPP-58, at 19-20).

663. Mr. Van Hoecke also does not share Mr. Wetmore's concern that a Commission approved settlement would impact the cost pool. Once the terms of the new cost pool are understood, settlements will be drafted accordingly. As to the 2008 TAPS Settlement, Mr. Wetmore's concern that it would not be reflected in the BPPA Cost Allocation Mechanism is misplaced. This settlement adjusted the interstate rate (revenues) but did not disallow any cost inputs. Since the settlement only affected revenues, it would not impact either BPPA's or CPTAI's proposed cost pool (Exhibit No. BPP-58, at 20).

664. Moreover, the BPPA Cost Allocation Mechanism, in his opinion, does not rely upon a hypothetical revenue requirement as Mr. Wetmore claims. Instead it proposes to use actual volume and cost data to determine each Carrier's cost responsibility. There is nothing hypothetical about the actual costs incurred. Mr. Wetmore claims that the BPPA Cost Allocation Mechanism is deficient because actual costs experienced may differ from cost expectations used to set rates that provide the basis for revenue collected. It is not deficient, but if it were, it would be a deficiency shared with Section II-2(f) and the CPT-8 Model, both of which are the same in this regard as the BPPA Cost Allocation Mechanism in that all three mechanisms pool known costs (after their incurrence) rather than an expectation of costs made at the time of a rate filing. That is because the potential for divergence in expected versus experienced cost levels is an inherent feature of cost-based ratemaking and ratemaking issues are distinct from cost pooling issues. Raising this issue serves no purpose other than to distract from the relevant issues, in his view (Exhibit No. BPP-58, at 21-22).

665. Mr. Van Hoecke further states that it is in the public interest for Carriers to charge a uniform rate for the identical transportation service they provide on TAPS and in order for this to occur without some carriers over- or under-recovering their costs, there must

be a pooling mechanism. Moreover, it will not unduly restrain competition for Carriers to allocate their costs in the same fashion as they already allocate their revenues. Concerning II-2(f) itself, many conditions have changed over the past 25 years since the Commission accepted the TSA and Section II-2(f). TAPS is currently operating with significantly lower throughput. For example, when the Commission approved the TSA in 1985, annual TAPS throughput was 1.777 million bpd and was expected to increase, which it in fact did (Exhibit No. BPP-58, at 22-23).

666. However, by 2009, throughput had dropped to 0.680 million bpd compared with the stipulated capacity of 1.1 million bpd with no increase expected in the foreseeable future, resulting in significant unused capacity. No witness has provided any evidence to suggest what, if any, concerns were expressed in 1985 regarding full cost pooling or whether any such concerns that may have been expressed would be relevant today. Despite all the importance and virtue that Dr. Hieronymus, Mr. Wetmore and Mr. Brown place on Carriers being allowed to compete freely, none are suggesting that Carriers currently are involved in real competition regarding interstate transportation, nor have they provided any analysis to support their position (Exhibit No. BPP-58, at 23).

667. Mr. Van Hoecke indicates further that only Dr. Cameron provides an analysis on competition. Her analysis demonstrates that given today's facts, a cost pool that includes return will not unduly restrain competition. Concerning the current competitive environment, the level of interstate volumes available to shift between Carriers is very small. Even if all of this traffic were to move on BPPA at the uniform rate, BPPA would still not recover its cost of capital under the CPT-8 Model (Exhibit No. BPP-58, at 23).

668. Mr. Van Hoecke testifies that Carriers' uniform cost-based rate represents a system average rate, which is computed by dividing the total cost of providing interstate transportation service for all Carriers by the total projected TAPS interstate volumes. Producers on the North Slope should require no additional incentive to move barrels on TAPS beyond the profit they stand to earn by bringing those barrels to market, and in doing so, none of them will have to pay more than the just and reasonable rate established by the Commission under Opinion 502. In his view, the Commission has found that a carrier is under no obligation to provide discounts or additional incentives for shippers to use the carrier's service (Exhibit No. BPP-58, at 24).

669. In Mr. Van Hoecke's view, if a Carrier offers discounts or incentives to attract incremental volumes on its capacity, it cannot increase the uniform rate above the cap in order to recover its remaining costs from other system users. In the TAPS uniform rate environment, discounting would be a one-way downward ratchet that would further frustrate the efforts of a Carrier in BPPA's situation to recover its cost of capital. Mr. Brown claims that the incomplete pooling mechanism that he advocates will provide a Carrier with the incentive to offer rate discounts in order to increase their throughput and thereby collect additional revenues. Those added revenues will provide the means to recover added returns (Exhibit No. BPP-58, at 25).

670. Mr. Van Hoecke states that he conducted a historical analysis in which he examines whether BPPA's achieved return in 2009 would have come significantly closer to its allowed return if it had somehow captured barrels that were travelling interstate but were either tendered by shippers without a Carrier affiliate, or were cross-tendered by Carrier affiliated shippers. Given that these barrels are not affiliate tendered, it is conceivable that they could be attracted to a Carrier that offered the lowest TAPS tariff rate. In addressing Mr. Brown's statement, these are the barrels that are appropriate to consider as throughput that could potentially be captured by a Carrier offering discounts (Exhibit No. BPP-58, at 25-26).

671. Mr. Van Hoecke's analysis indicates that for a major Carrier such as BPPA, the potential incremental volumes are so small in relation to its unused capacity that even if it were to capture all of these barrels, its achieved return would remain significantly below the just and reasonable level while the achieved return of a major Carrier such as CPTAI would remain significantly above the just and reasonable level (Exhibit No. BPP-58, at 29).

672. Mr. Van Hoecke states that he is not suggesting that CPTAI is physically moving barrels in BPPA's assigned capacity. Mr. Van Hoecke disagrees with Mr. Wetmore's suggestion that, simply because CPTAI is not using more than the portion of TAPS capacity to which it is entitled under the Amended Capacity Settlement Agreement, CPTAI is not recovering cost of capital associated with BPPA's capital investment (its contribution to rate base) in TAPS. Mr. Wetmore asserts that under the CPT-8 Model a Carrier is precluded from earning a return on an investment funded by another Carrier (Exhibit No. BPP-58, at 29-30).

673. However, the CPT-8 Model allows a Carrier in CPTAI's position that transports more than its proportionate share of TAPS throughput to pocket a return on capital invested by a Carrier in BPPA's position that transports less than its proportionate share of TAPS throughput. Mr. Van Hoecke disagrees with Mr. Wetmore's contention that, by excluding cost of capital from the CPT-8 Model, Carriers in the position of CPTAI are not capturing returns on rate base funded by other Carriers. In fact, the opposite is true. Under a uniform rate regime, inclusion of the cost of capital in cost pooling is required in order to prevent a Carrier from recovering a return on others' investments (Exhibit No. BPP-58, at 30).

674. The uniform rate allows each Carrier to charge a rate equal to the average cost per barrel for the entire TAPS system. Consequently, the cost of capital Mr. Wetmore would exclude from the pool is already pooled through the use of the system average costs before Mr. Wetmore's calculation begins. It was included as one of the aggregate costs to be considered in developing the cost-based uniform rate. The interstate uniform rate represents a volume weighted average rate since it is computed based on the aggregate interstate costs for all Carriers divided by the aggregate interstate volumes for all Carriers (Exhibit No. BPP-58, at 30-31).

675. In Mr. Van Hoecke's view these aggregate costs include the cost of capital. The Commission has recognized that this may lead to a cost-incurrence/cost-recovery misalignment because, while the bulk of each Carrier's costs—i.e., the capital investment and the operating cost incurred on behalf of Carriers by Alyeska—are funded based on ownership shares, each Carrier's throughput does not align with its ownership share. This misalignment causes actual costs per barrel incurred by a Carrier to vary significantly from the average, some higher than the average costs included in the uniform rate and others lower (Exhibit No. BPP-58, at 30-31).

676. Mr. Van Hoecke testifies further that the BPPA Cost Allocation Mechanism recognizes that, unless you include the cost of capital in the pool of costs to be reallocated on a usage basis, there is an inherent mismatch between the cost used to develop the uniform rate that is collected by each Carrier on the basis of usage and the cost assignment that is based on each Carrier's ownership. Cost pooling relies on reallocation of costs among Carriers in order to align their ultimate cost incurrence with their usage. The concept of cost pooling is intended to address the differences between (1) the cost incurrence, which arises based on the initial funding of TAPS costs (primarily via cash calls from Alyeska) and (2) each Carrier's usage of the system (Exhibit No. BPP-58, at 30-31).

677. In order to demonstrate the difference between the BPPA Cost Allocation Mechanism and the CPT-8 Model, Mr. Van Hoecke breaks down costs per barrel into three categories: Operating Expenses – Alyeska operating expenses and ad valorem taxes; Depreciation Expense – calculated in accordance with Opinion 502; and Cost of Capital – return portion of the TRR calculated in accordance with Opinion 502. Mr. Van Hoecke prepared analyses for three different scenarios: (1) no cost pooling: Presents the average cost per barrel without cost pooling; (2) the CPT-8 Model: presents the average cost per barrel after accounting for the cost pooling adjustments calculated using the CPT-8 Model; and (3) the BPPA Cost Allocation Mechanism: applies the BPPA Cost Allocation Mechanism. The calculations of each of these scenarios are presented in Exhibit. No. BPP-62 (Exhibit No. BPP-58, at 32-33).

678. When each Carrier's total interstate cost per barrel is determined based on its ownership share of aggregate TAPS interstate transportation, BPPA's total interstate cost per barrel is \$5.20, consisting of \$3.86 in operating expense, \$0.22 in depreciation expense, and \$1.13 in cost of capital. CPTAI's total interstate cost per barrel is \$2.35, consisting of \$1.74 in operating expense, \$0.10 in depreciation expense, and \$0.51 in cost of capital. The system average interstate cost per barrel is \$3.69, consisting of \$2.73 in operating expense, \$0.15 in depreciation expense and \$0.18 in cost of capital. Without any cost pooling, BPPA is under-recovering its costs by \$1.51 per barrel while CPTAI is over-recovering its costs by \$1.34 per barrel (Exhibit No. BPP-58, at 32-33).

679. Mr. Van Hoecke states that under the CPT-8 Model, operating and depreciation costs are reallocated and the end result is that after accounting for the pooling

adjustments, each Carrier incurs operating and depreciation costs equal to the average interstate cost per barrel for TAPS. However, the CPT-8 Model does not include the cost of capital in the pooling calculation. Consequently, there is a wide disparity between the cost of capital incurred by each Carrier and the average interstate cost of capital for TAPS (Exhibit No. BPP-58, at 33).

680. In his view, absent the pooling of cost of capital, BPPA still incurs a cost of capital per barrel of \$1.13, and CPTAI still incurs \$0.51 per barrel. The average interstate cost of capital for TAPS is \$0.80 per barrel. This benefits CPTAI, which incurs interstate cost of capital per barrel of \$0.29 per barrel less than the average for TAPS, and harms BPPA, which incurs interstate cost of capital of \$0.33 per barrel greater than the average of TAPS. This is the type of over-recovery and under-recovery situation under a uniform rate that the Commission sought to avoid when it ordered an all-inclusive cost pool. Under the BPPA Cost Allocation Mechanism, all three components of interstate costs are aligned with system usage for each Carrier, after accounting for cost pooling adjustments. This demonstrates that only the BPPA Cost Allocation Mechanism proposal meets the Commission's requirements for the cost pool. The purpose of the pooling mechanism is to ensure that carriers do not over- or under-recover their costs (Exhibit No. BPP-58, at 33-34).

681. Mr. Van Hoecke states that his analysis demonstrates that the BPPA Cost Allocation Mechanism achieves Mr. Wetmore's stated purpose of precluding one Carrier from earning a return on an investment funded by another Carrier. Mr. Van Hoecke states that his analysis also demonstrates that the CPT-8 Model is inconsistent with Mr. Wetmore's stated purpose that a Carrier should be precluded from earning a return on an investment funded by another Carrier. Mr. Van Hoecke believes that the results in Table 4, of his testimony, show that under the CPT-8 Model, CPTAI would recover cost of capital higher than the cost of capital it incurs. This is because its cost of capital is based on the capital it funded per Alyeska cash calls, while it received an amount assigned to cost of capital recovery based on its TAPS usage. Finally, Mr. Van Hoecke states that his analysis demonstrates that Dr. Hieronymus' statement that what BPPA seeks is nothing less than an uncompensated expropriation of CPTAI's property is inaccurate (Exhibit No. BPP-58, at 36-37).

682. Mr. Van Hoecke opines that BPPA is merely seeking to recover the capital costs for the investment it has already funded, the very costs that BPPA has contributed as its portion of capital to fund aggregate carrier property in service. Mr. Van Hoecke does not agree with Mr. Wetmore's statement that the BPPA Cost Allocation Mechanism allocates return on an ownership basis. Mr. Wetmore asserts that Exhibit No. CPT-13 proves that the BPPA Cost Allocation Mechanism does not put return on a usage basis but rather on an ownership basis. His analysis is conceptually flawed. It relies on erroneous calculations and misleading semantics to present an inaccurate example contrived to support his conclusion. Mr. Wetmore states he achieves his result by inappropriately

inserting revenue pooling concepts into what he represents is an analysis of cost pooling (Exhibit No. BPP-58, at 37).

683. Mr. Van Hoecke further states that Mr. Wetmore mischaracterizes the results of the BPPA Cost Allocation Mechanism by employing dual meanings of the word return. He substitutes achieved return, a performance concept, for allowed return, a cost concept. Allowed return is one of the elements of a Carrier's cost of service. It is a cost incurred by a Carrier in providing TAPS with funds required for capital investments in carrier property used to provide transportation service and is properly pooled in the BPPA Cost Allocation Mechanism. The return figures that Mr. Wetmore cites are not allowed return but instead represent achieved return. Achieved return is not a dollar value of cost; it represents a performance measure that is calculated (after the cost pooling adjustments are made) in order to determine if a Carrier is either under-recovering or over-recovering costs. The fact that both allowed return and achieved return include the word return does not mean that they have the same meaning (Exhibit No. BPP-58, at 37-38).

684. The costs considered by the BPPA Cost Allocation Mechanism include operating expenses, depreciation and cost of capital (Return Portion of TRR), all of which are allocated in the same manner to align cost with usage as instructed by the Commission. Mr. Wetmore's allegations are erroneous in his view. Only when each Carrier's cost incurrence is aligned with its usage of TAPS can each Carrier's achieved return equal the allowed return that the Commission has determined for TAPS. His example inappropriately mixes costs with revenues and is not consistent with Section II-2(f), which Mr. Wetmore cites as the basis for the CPT-8 Model. Section II-2(f), like the BPPA Cost Allocation Mechanism, addresses costs and is not related to the revenues collected from rate payers (Exhibit No. BPP-58, at 38).

685. Mr. Van Hoecke believes that the BPPA Cost Allocation Mechanism deals only with actual costs. Mr. Wetmore began his analysis with a cost perspective and then later shifted to a revenue perspective. When addressing operating expenses he notes that they are funded (costs) on an ownership basis; but when addressing cost of capital he notes it is collected (revenues) on a usage basis. Mr. Van Hoecke disagrees because for an analysis to be meaningful it must be performed on one basis or the other. Since the Commission has specified a cost basis, that is the proper basis to use for analysis in this proceeding. The relevant facts regarding cost of capital are the same as those for other cost of service elements; that is, all costs are initially funded on an ownership basis and then recovered on a usage basis. This is the reason that pooling is needed (Exhibit No. BPP-58, at 39).

686. Yet Mr. Wetmore's argument relies on mismatching these cost incurrence and recovery facts to create a false distinction. Allowed return is an actual cost that a Carrier incurs in order to provide service. Mr. Wetmore's Exhibit No. CPT-13 considers the alignment of tariff revenues with costs, and that alignment is not relevant to cost pooling. The fact that revenues may not precisely align with costs is not a defect in the BPPA Cost

Allocation Mechanism. It is unlikely that tariff revenues will exactly match costs for the entire period that any cost-based rate is in effect (Exhibit No. BPP-58, at 39-40).

687. The filed rate may allow collection of more or less in tariff revenues than the actual costs incurred. This has no relevance to cost pooling that deals only with actual costs and requires alignment of actual costs per barrel among Carriers. Mr. Wetmore asserts that his Exhibit No. CPT-13 represents the workings of the BPPA Cost Allocation Mechanism contained in Exhibit No. BPP-11 ((Exhibit No. BPP-58, at 40).

688. Contrary to Mr. Wetmore's claim, Exhibit No. CPT-13 does not accurately reflect the calculations made by the BPPA Cost Allocation Mechanism, but, instead, skews it in a way that supports Mr. Wetmore's flawed conclusion. Mr. Wetmore's attempt to shift the focus of his arguments regarding cost of capital—but not other costs—into a discussion of revenues is inappropriate and creates potential confusion relating to the reallocation of costs based on usage. In addition to the conceptual flaw of inappropriately mixing cost and revenues, there are mathematical errors that he relies on to support his conclusion. In order to illustrate these anomalies Mr. Van Hoecke provides in Exhibit No. BPP-63 observations for each of the five schedules in Exhibit No. CPT-13, and make corrections as required (Exhibit No. BPP-58, at 40-41).

689. Mr. Van Hoecke states that Exhibit No. CPT-13, Schedule 1 reflects the mixing of two different concepts – (1) return portion of TRR and (2) achieved return on rate base. Cost of capital, termed Return Portion of TRR in Exhibit No. BPP-11, is determined by applying the Opinion 502 and RCA Order 151 methodologies. Achieved return, after cost pooling adjustments are accounted for, is calculated as a performance measure in order to determine whether cost incurrence and cost recovery are aligned by the cost pooling process. He believes that Mr. Wetmore mischaracterizes achieved return, which he presents as if it is pooled in the BPPA Cost Allocation Mechanism (Exhibit No. BPP-58, at 41).

690. In his view the mislabeled items in Exhibit No. CPT-13, Schedule 1 must be corrected so as to avoid mischaracterizing the operating income calculated in this schedule as if it were achieved return. These items are all drawn from either Exhibit Nos. BPP-11 or BPP-19, and Mr. Wetmore changed the labels in his Exhibit No. CPT-13 to suit his purposes, according to Mr. van Hoecke. He believes the corrected labels are presented in Exhibit No. BPP-63, Schedule 1. When the labels are corrected, Exhibit No. CPT-13, Schedule 1 demonstrates that, after accounting of the reallocation of costs determined by the BPPA Cost Allocation Mechanism, all Carriers have the same achieved return (as presented in Lines 13 to 18), and achieved return is aligned with the allowed Weighted Average Cost of Capital (WACC). In other words costs are aligned with usage through the BPPA Cost Allocation Mechanism, and the Commission's goal of ensuring no Carrier over-recovers or under-recovers is achieved (Exhibit No. BPP-58, at 41).

691. He notes that in Schedule 2, Mr. Wetmore attempts to demonstrate that the BPPA Cost Allocation Mechanism places the return portion of TRR on an ownership basis. The amounts in Lines 18 and 20 of Schedule 2 are incorrect and are inconsistent with the pooling calculation in Exhibit No. BPP-11. Exhibit No. BPP-63, Schedule 2, presents Mr. Van Hoecke's corrections to Exhibit No. CPT-13, Schedule 2, which are highlighted. Mr. Van Hoecke corrects Mr. Wetmore's calculations in Lines 18 and 20 to provide for pooling of Return Portion of TRR (i.e., cost of capital) on the same basis as the pooling of all other costs (presented by Mr. Wetmore in his Lines 12 and 14). In order to reflect the actual calculations performed in Exhibit No. BPP-11, Line 18: Mr. Wetmore calculated Line 18 by subtracting Operating Expense and Depreciation (Lines 3 and 4) from Revenues (Line 17) (Exhibit No. BPP-58, at 42).

692. Mr. Van Hoecke states that the corrected calculation is determined by multiplying the Return Assumption (Line 5) by Ownership Share (Line 1). This correction properly treats Return Portion of TRR (cost of capital) as a cost that reflects the allocation by Alyeska of cash calls for capital items to each Carrier based on its ownership share. Mr. Wetmore's exhibit incorrectly treats this as tariff revenue that is to be pooled. Line 20: the BPPA Cost Allocation Mechanism treats all elements of cost (operating expense, depreciation and cost of capital) in the same manner. Therefore, the sign for the calculation in Line 20 should be changed to treat cost of capital in the same manner as other items included in cost pooling (Line 14) (Exhibit No. BPP-58, at 42-43).

693 Mr. Van Hoecke opines further that Mr. Wetmore has inappropriately reversed the sign in Line 20 in order to support his conclusion that Return After Pooling of Return (i.e. cost of capital) is allocated in Exhibit No. BPP-11 on an ownership basis, which he claims is not the case. Exhibit No. BPP-11 determines the cost pooling adjustments for the cost of capital element of costs in order to reallocate these costs on the basis of each Carrier's usage of TAPS. After correction, the results in Line 22 demonstrate that, with the BPPA Cost Allocation Mechanism approach, Return Share (Line 21) is equal to Usage Share Assumption (Line 2)(Exhibit No. BPP-58, at 43).

694. In addition, the calculations of Revenues in Lines 17 and 23 are irrelevant to the BPPA Cost Allocation Mechanism for the reasons discussed earlier. Mr. Van Hoecke replaced these calculations with the "Total Costs After Pooling" (Line 23a) to demonstrate that the BPPA Cost Allocation Mechanism properly places all costs on usage basis, with Carrier 1 recovering \$300 (40%) and Carrier 2 recovering \$450 (60%), the same percentages as the respective Usage Share Assumption (Line 2) for each Carrier (Exhibit No. BPP-58, at 43).

695. He adds that Mr. Wetmore provides Schedule 3 of Exhibit No. CPT-13. Schedule 3 differs from Schedule 2 only by the assumptions for revenues. Since analysis of revenues is irrelevant to cost pooling, Mr. Van Hoecke states that his observations concerning Schedule 3 are identical to those related for Schedule 2. The calculations in Schedule 4 are consistent with those performed by the BPPA Cost Allocation Mechanism

as presented in Schedule 1 of Exhibit No. BPP-11. However, Mr. Wetmore's terminology in his comments column misrepresents the calculations made in Exhibit No. BPP-11, Schedule 1, in regard to the adjustments made for Return Portion of TRR (Exhibit No. BPP-58, at 43-44).

696. Mr. Van Hoecke views Mr. Wetmore's errors here are the same as those noted for Schedules 2 and 3 and imply that Exhibit No. BPP-11 treats cost of capital differently from other costs, which is not the case. Exhibit No. BPP-11 begins with the costs as they are incurred, which is on the basis of ownership, and develops adjustments to align costs with usage. Mr. Wetmore follows this convention for Operating Expense (Lines 1-3) and Depreciation (Lines 4-9). When it comes to what he labels Return (Lines 11-16), his presentation implies that Return is treated differently by Exhibit No. BPP-11 than are the other items in costs, which is not the case (Exhibit No. BPP-58, at 44).

697. Rather than place cost incurrence first, which is how Exhibit No. BPP-11 begins the cost allocation process, Mr. Van Hoecke places the usage basis first. Lines 11 and 12 are presented in the reverse order of how the calculations are performed in Exhibit No. BPP-11 and are different from the convention that Mr. Wetmore applies for Operating Expense and Depreciation, which correctly reflect the logic in Exhibit No. BPP-11. Mr. Wetmore compounds his error by adding comments that mischaracterize the items in Lines 11-14. In Line 11 he substitutes the term Earn for Recover. This reflects an attempt to portray Exhibit No. BPP-11 as if it was a revenue pool that deals with revenues rather than a cost pool that reallocates actual costs among Carriers (Exhibit No. BPP-58, at 44-45).

698. Mr. Van Hoecke states that in Mr. Wetmore's comments for Line 12 he uses the term Hypothetical Return to describe allowed return (i.e., cost of capital). However, there is nothing hypothetical about the cost of capital. It is a real cost, calculated using the Opinion 502 cost-based methodology, the same methodology that Mr. Wetmore relies on for developing depreciation in his CPT-8 Model. Cost of capital represents an allowable cost under the Commission's methodology and is no more hypothetical than Depreciation. Mr. Wetmore's comment for Line 13, relying on the upside down logic in his reversal of Lines 11 and 12, alleges that Return is reallocated on an ownership basis, which is untrue. Cash calls to fund capital items are initially allocated to each Carrier based on its ownership. Because capital costs are initially incurred on an ownership basis through Alyeska cash calls, it logically follows that Exhibit No. BPP-11 assigns the initial incurrence of both the return of capital and the return on capital on the same ownership basis before making allocations to align cost recovery with usage. Exhibit No. BPP-11 shows the calculations for both depreciation and cost of capital in the same manner (Exhibit No. BPP-58, at 45).

699. Further, the calculation for depreciation pooling in Exhibit No. BPP-11 is identical in approach to that applied in the CPT-8 Model. Depreciation and return go hand-in-hand. Mr. Wetmore inaccurately characterizes the results for his calculations of Return

differently from those for Depreciation. Mr. Van Hoecke states that he corrected Schedule 4 to align the order for Lines 11-15 to that for the other costs pooled by Exhibit No. BPP-11 (Exhibit No. BPP-63, Schedule 4) (Exhibit No. BPP-58, at 45).

700. Mr. Van Hoecke opines that in Schedule 5, Mr. Wetmore also consistently mixes costs and revenues (tariff collections) and refuses to treat the Return Portion of TRR as allowed costs incurred. Mr. Van Hoecke revised his Schedule 5 to correct these errors. The corrections are presented and highlighted in Exhibit No. BPP-63, Schedule 5. Calculations of Revenues in Lines 1 and 6 are irrelevant to the analysis of the BPPA Cost Allocation Mechanism. Mr. Wetmore's analysis inappropriately mixes revenue pooling and cost pooling concepts. In Line 1, Mr. Van Hoecke have replaced hypothetical Tariff Revenue calculations with the TRR (cost of service), which reflects the actual costs incurred determined in compliance with the Opinion 502 and RCA Order 151 cost-based methodologies. Mr. Van Hoecke also states that he added detail for the Exhibit No. BPP-11 pooling adjustment components in Lines 5a to 5f (Exhibit No. BPP-58, at 46).

701. Lastly, Mr. Van Hoecke states he corrected Return calculations in Lines 11 and 12 to reflect the actual pooling calculations in Exhibit No. BPP-11. After Mr. Van Hoecke's corrections, he states that CPT-13, Schedule 5 demonstrates that the BPPA Cost Allocation Mechanism properly places the Return Portion of TRR on a usage basis as reflected in Line 14, which now correctly shows the same percentage for Return Share, after pooling, as in Line 16 (Barrel-Mile Usage Share) (Exhibit No. BPP-58, at 46).

702. Mr. Van Hoecke states that the Commission has ordered, and the BPPA Cost Allocation Mechanism implements, a cost pool that re-allocates costs among Carriers. He opines that Mr. Wetmore's examples mix tariff revenues and costs. In addition Mr. Wetmore confuses receipts due to a pooling adjustment with tariff revenues collected from shippers. Cash received from a cost pooling mechanism is not revenues. Rather it is a reimbursement of prior overfunded cash calls that were initially paid on the basis of ownership (Exhibit No. BPP-58, at 47).

703. According to Mr. Van Hoecke, the effect of Mr. Wetmore inserting revenue pool concepts in Exhibit Nos. CPT-18 and CPT-19 leads to results that do not reflect the workings of the BPPA Cost Allocation Mechanism and ignores the Commission's instructions regarding the purpose of the cost pool. The purpose of the pooling mechanism is to ensure that carriers do not over- or under-recover their costs. In order to demonstrate the effects of Mr. Wetmore's conceptual error Mr. Van Hoecke prepared a corrected version of Exhibit No. CPT-18 that accurately reflects how the BPPA Cost Allocation Mechanism works. Exhibit No. BPP-64 includes three schedules. Schedule 1 reproduces Mr. Wetmore's calculation on the left-hand portion (labeled CPT-18) and presents Mr. Van Hoecke's corrections on the right-hand portion (labeled CPT-18 Corrected) (Exhibit No. BPP-58, at 47-48).

704. In this schedule, Mr. Van Hoecke makes changes to remove the revenue link and convert his analysis to a cost pooling analysis. Schedules 2 and 3 present calculations of amounts required to make corrections to Mr. Wetmore, which are discussed below. In Mr. Wetmore's Line 7, he introduces Unocal's Average 2009 Tariff Rate, which he then relies on for his Tariff Revenue calculations in Lines 8 and 12. Tariff revenues have no direct relationship to cost pooling, according to Mr. Van Hoecke. The fact that Mr. Wetmore refers to revenue numerous times in Exhibit No CPT-18 is an additional indication that Exhibit No CPT-18 relies in part on revenue pooling concepts and is not a valid cost pool (Exhibit No. BPP-58, at 48).

705. Mr. Van Hoecke states that he replaced Mr. Wetmore's Tariff Rate, a revenue based concept, with the average cost per barrel, a cost-based concept. These are the amounts that are included in the BPPA Cost Allocation Mechanism. Schedule 2 presents the calculation of the average cost per barrel for both the interstate and intrastate shipments. Mr. Van Hoecke substituted these costs in Line 7 of his corrected Exhibit No. CPT-18 and labeled it TAPS 2009 Cost per barrel. In his opinion, the BPPA Cost Allocation Mechanism allocates costs based on usage and then computes the necessary cost pool adjustments to reconcile initial cost funding based on ownership with actual usage of TAPS. This correction accounts for the vast majority of the differences in the results in CPT-18 Corrected vs. CPT-18 (Exhibit No. BPP-58, at 48-49).

706. Mr. Van Hoecke continues on that his calculations demonstrate that the cost adjustments calculated by the BPPA Cost Allocation Mechanism produce results consistent with the Commission's directive that cost pooling among Carriers result in a situation in which Carriers do not over-recover or under-recover their costs (Exhibit No. BPP-58, at 49-50).

707. Mr. Van Hoecke argues that when corrected, Mr. Wetmore's labels of Cost Recovery Before Pooling minus Cost Recovery Hypothetical should equal the required cost pooling adjustment amount of \$10.4 million (Line 8). Indeed, this amount, \$10.4 million, equals the pooling adjustment calculated by Exhibit No. BPP-11 (Line 13 + Line 14). Accordingly, contrary to Mr. Wetmore's analysis, Unocal does not enjoy a windfall or suffer a penalty as indicated by the \$0 in Line 18 of Corrected Exhibit No. CPT-18, but instead recovers exactly its incurred costs after the cost pooling adjustments calculated by the BPPA Cost Allocation Mechanism are accounted for. It makes sense that Unocal would have the same level of allowed return in both scenarios when you consider the fact that Unocal's capital investment contribution to rate base used to compute that uniform cost-based rate is precisely the same in both scenarios (Exhibit No. BPP-58, at 50).

708. Mr. Van Hoecke claims that under the CPT-8 Model, BPPA will not have the same incentive as CPTAI to invest in efficiency enhancement investments because the CPT-8 Model does not include the cost of capital for investments in carrier property, and this would result in BPPA under-recovering. Mr. Coulson has testified that the 2010

Alyeska Long Range Plan forecasts more than \$1.2 billion in additional capital investment required for TAPS for the period 2010-2019. He believes that Mr. Wetmore's argument that recovery of the cost of capital associated with investments is not a consideration for carriers is wrong, and the evidence he presents provides no support for the argument (Exhibit No. BPP-58, at 51-52).

709. He argues that Mr. Wetmore's assertion that other carriers fail to fully recover their costs is not sufficient justification to exclude cost of capital from the TAPS cost pool, thereby denying certain Carriers the ability to recover these costs. The carriers listed in Exhibit No. CPT-14 are not similarly situated with the TAPS Carriers. To the extent one Carrier in his exhibit chooses to invest in expansion or efficiency related capital projects, it would pay all of the capital costs and, in return, would reap all of the benefits. This is not the case with the Carriers. Under the CPT-8 Model, BPPA would fund approximately 47% of the capital cost but would receive less than 47% of any benefits based on usage (Exhibit No. BPP-58, at 52-53).

710. Moreover, Mr. Wetmore's analysis assumes that all segments of the pipeline have similar operating performance. Often carriers will consolidate and report financial information related to several operating segments or pipeline systems in one single Form 6 report. To the extent that a carrier has multiple pipeline systems or several discontinuous segments on the same system, there is no reason to assume that each is performing at the same level, as Mr. Wetmore suggests. One segment could be over-subscribed, over-earning and in a position to benefit from a discretionary investment, while another segment within the same company could be under-utilized, under-earning, and not a candidate for a discretionary investment. Finally, Mr. Wetmore erroneously claims that Exhibit No. CPT-14 documents the level of reported under-earning by the 92 carriers he lists in this exhibit (Exhibit No. BPP-58, at 53).

711. Mr. Van Hoecke also notes that the Net Change in Carrier Property that Mr. Wetmore presents in Exhibit No. CPT-14 does not necessarily reflect capital additions. Mr. Wetmore computes his figure based on the Carrier Property found in Account 30 of page 110. These figures include the effects of any sales, acquisitions, retirements, abandonments, adjustments and transfers that the carrier may have made during the year. When Mr. Van Hoecke compares the figure he reports in CPT-14 to the investment activity reported in the Form 6 cash flow statement, he opines that there are meaningful variances to the figures Mr. Wetmore computes in Exhibit No. CPT-14 (approximately 69% of the carriers reporting information on page 120 have a variance that exceeds +/- \$1000) (Exhibit No. BPP-58, at 57).

712. Mr. Van Hoecke further opines that Mr. Wetmore's assumption that page 700 can be used to assess whether a company is under-earning is wrong. His conclusion that a significant portion of oil pipelines under-earn may be wrong as well because he is combining the Total Company Cost of service with an accounting for revenues that likely reflects only interstate operations (Exhibit No. BPP-58, at 57).

### 3. Dr. Lisa Cameron

713. The purpose of Dr. Cameron's reply testimony is to respond to the answering testimony of Dr. Hieronymus, Mr. Brown, Mr. Wetmore, and Dr. Horst. She indicates that none of these witnesses presents any analyses that would undermine her prior conclusion that the regime created by the cost pooling methodology presented in Exhibit No. BPP-10 by BPPA's witness Mr. John Haines is in the interest of better service to the public and of economy in operation, and will not unduly restrain competition in the foreseeable future (Exhibit No. BPP-44, at 1).

714. r. Cameron responds to Dr. Hieronymus who makes four claims and presents arguments related to those claims. The four claims are: (1) the Commission's uniform rate requirement is not the cause of some Carriers under-recovering their costs and other Carriers over-recovering their costs on a persistent basis, and the uniform rate requirement does not necessitate implementation of the BPPA Cost Allocation Mechanism or any other form of cost pooling; (2) over-recovery and under-recovery of costs by individual Carriers is not inconsistent with cost-based regulation and does not require implementation of the BPPA Cost Allocation Mechanism or any other form of cost pooling; (3) the BPPA Cost Allocation Mechanism would not result in improved investment incentives relative to the status quo; and (4) implementation of the BPPA Cost Allocation Mechanism would restrain competition (Exhibit No. BPP-44, at 5-6).

715. Dr. Cameron states that Dr. Hieronymus' first two claims directly contradict the Commission's prior decisions with respect to the need for cost pooling. Dr. Hieronymus' third claim is irrelevant. Finally, Dr. Hieronymus provides no analysis or evidence to support his fourth claim (Exhibit No. BPP-44, at 6). Given that the Commission has already ruled on Dr. Hieronymus' first and second claims, Dr. Cameron's rebuttal testimony will focus on his claims with respect to competition and investment incentives. First, Dr. Cameron shows that Dr. Hieronymus has provided no analysis to undermine her conclusion that it is unrealistic to expect significant interstate tariff rate competition on TAPS in the foreseeable future. Dr. Hieronymus does not investigate whether there is significant interstate tariff rate competition on TAPS. Instead he assumes such competition into existence, an assumption that is contradicted by the evidence (Exhibit No. BPP-44, at 6-7).

716. She argues that Dr. Hieronymus then incorrectly asserts that her analysis understates the amount of interstate volumes potentially affected by the TAPS tariff rate competition that he has assumed to exist. Dr. Cameron states that given its absence of meaningful analysis, Dr. Hieronymus' testimony cannot provide guidance to the Commission in its search for a cost pooling mechanism that will not unduly restrain competition with respect to interstate TAPS tariff rates. In contrast, Dr. Cameron states that implementation of the BPPA Cost Allocation Mechanism will not result in a significant restraint on competition. Second, Dr. Cameron states that while

Dr. Hieronymus unreasonably rejects implementation of the BPPA Cost Allocation Mechanism, he fails to consider the investment incentives created by any alternative cost pooling regime, including the one created by Mr. Wetmore's cost pooling mechanism (the CPT-8 Model) (Exhibit No. BPP-44, at 7).

717. She opines that Dr. Hieronymus provides no guidance to the Commission on what type of cost pooling mechanism is in the interest of better service to the public and economy in operation. In contrast, Dr. Cameron claims that her analysis shows that the BPPA Cost Allocation Mechanism creates a regime that is in the interest of better service to the public and economy in operation and that the incomplete cost pool advocated by Mr. Wetmore, which is very similar to the one advocated by Mr. Brown (Exhibit No. BPP-44, at 7).

718. As shown in Exhibit No. BPP-46, Dr. Cameron states that Dr. Hieronymus admits that he has not analyzed whether there is a significant likelihood of interstate rate competition on TAPS. Dr. Hieronymus refers to a 1985 decision in which the Commission approved the TAPS TSA, a comprehensive settlement proposed by and agreed to by numerous parties who were seeking to end eight years of litigation. He focuses on the decision's discussion of the Section II-2(f) cost pool, in which the Commission stated that it did not foresee that Section II-2(f) mechanism will restrain competition (Exhibit No. BPP-44, at 8).

719. She states that Dr. Hieronymus then assumes that the BPPA Cost Allocation Mechanism, which is more inclusive than the cost allocation mechanism used in the Section II-2(f) cost pool, would unduly restrain competition today. In her view, there is no evidence to suggest that interstate rate competition on TAPS will be significant in the foreseeable future. First, for the foreseeable future, producer/shipper affiliates of Carriers that also have affiliated tankers calling at Valdez will continue to ship almost all of the oil that is subject to TAPS interstate rates. This is because these three firms have tanker affiliates that enable them to transport oil from Valdez to West Coast markets. Second, producer/shipper affiliates, BP, CP and XOM (EMPCo) each has a strong incentive to tender the oil that it controls to its affiliated Carrier's space (Exhibit No. BPP-44, at 8-9).

720. This, in her view, is because none of these affiliated shippers has enough oil to fill its affiliated Carrier's space for the foreseeable future. If one of these shippers were to cross-tender (ship on a non-affiliated Carrier), it would be paying a third party when it could have instead paid its affiliate (and indirectly, the shipper's integrated firm) for the same transportation service. All else equal, such cross-tendering would be economically irrational because it would reduce the profits of the integrated firm. Third, each of BPPA, CPTAI, and EMPCo has a significant disincentive with respect to offering an interstate TAPS tariff rate discount. She states this is because producers pay royalties on the wellhead value of production, where that value includes a deduction for the TAPS transportation costs computed using the weighted average interstate TAPS transportation

rate. Importantly, the weight in this calculation is based on each Carrier's ownership share (Exhibit No. BPP-44, at 9-10).

721. Dr. Cameron indicates further that a reduction in a major Carrier's rate could significantly increase its affiliated producer's royalty payments and consequently reduce the profits of the integrated firm (Exhibit No. BPP-44, at 10). Fourth, the number of barrels of oil controlled by shippers that seek to purchase interstate transportation services on Carriers with which they are not affiliated will remain at or below the relatively low levels currently observed (Exhibit No. BPP-44, at 10).

722. Dr. Cameron states that for the foreseeable future, the number of barrels of oil controlled by shippers that seek to purchase interstate transportation services on Carriers with which they are not affiliated will remain at or below the relatively low levels currently observed. The rewards for their integrated enterprises that BPPA, CPTAI, and EMPCo could reap through discounting (in the form of additional shipments of oil) would be de minimis. Further, a major Carrier that discounts its interstate TAPS tariff rate in an effort to attract the de minimis amount of oil that might respond to discounting will significantly increase the royalty payments of the integrated firm of which it is a member (Exhibit No. BPP-44, at 10-11).

723. As a result, Dr. Cameron opines that it is unrealistic to expect significant interstate TAPS tariff rate competition in the foreseeable future. For the foreseeable future, the number of barrels of ANS oil controlled by shippers that seek to purchase interstate transportation services on TAPS Carriers with which they are not affiliated will remain at or below the levels currently observed (Exhibit No. BPP-44, at 11).

724. Dr. Cameron additionally testifies that none of the major Carriers has discounted its interstate TAPS tariff rate in the last five years. It is extremely unlikely that a major Carrier would discount its interstate tariff rates to attract the shipments of affiliates of other Carriers or to attract shipments from shippers not affiliated with any Carrier. However, the smallest Carrier, Unocal—which owns approximately 1.4% of TAPS—discounted its interstate TAPS tariff rate in 2005, 2006, and 2009. Since 2008, none of the Carriers has been full, a situation that can be expected to persist for the foreseeable future since overall TAPS throughput is declining. Unocal was unable to attract significant volumes when it offered a discount on its interstate tariff rate in 2009, and it was left empty on an interstate basis in much of 2009 (Exhibit No. BPP-44, at 12-13).

725. According to Dr. Cameron, an additional factor explaining Unocal's inability to attract more cross-tendered barrels in 2009 may have been that its 2009 incentive rate discount required an individual shipper to ship at least 5 thousand barrels per day (KBD). The rewards that any major Carrier could reap through discounting (in the form of additional shipments of oil) would be de minimis. Further, if BPPA, CPTAI, or EMPCo were to discount its interstate TAPS tariff rate, it could significantly increase the royalty payments of the integrated firm of which it is a member. In contrast, if Unocal were to

discount its interstate TAPS tariff rate, the effect on Chevron/Unocal's royalty payments would be de minimis. This is because each producer pays royalties on the wellhead value of its non-RIK production. That wellhead value computation includes a deduction for TAPS transportation costs, where TAPS transportation costs are measured by the weighted average interstate TAPS transportation rate (Exhibit No. BPP-44, at 13-14).

726. She notes further that the royalty impact declines with TAPS ownership share; the smaller the Carrier's ownership share, the less its affiliate's royalty payments increase for any given level of discount. This royalty payment also declines with the amount of non-RIK production; the less the amount of non-RIK production, the less the loss. Relative to the major Carriers, Unocal's ownership share of TAPS is small (1.4% compared to BPPA's 47%, CPTAI's 28% and EMPCo's 20%). Chevron/Unocal's non-RIK production is also small compared to other carriers. BPPA, CPTAI and EMPCo face much stronger disincentives for discounting than does Unocal (Exhibit No. BPP-44, at 14).

727. Dr. Cameron further notes that while Chevron/Unocal has had enough production to keep Unocal full or almost full in each year between 2005 and 2009, Chevron/Unocal does not have the means to bring its oil to market. It sells its oil at the wellhead either to Tesoro, which can use the Chevron/Unocal oil in its Nikiski refinery, or to shippers such as BP, which can transport the oil from Valdez to West Coast markets because it has affiliated tankers calling at Valdez. In 2009, Chevron/Unocal sold its oil to BP, which then affiliate-tendered this oil on BPPA. FHR ships interstate on TAPS even though it does not have tankers calling at Valdez (Exhibit No. BPP-44, at 14-15).

728. With RIK barrels intended to supply the FHR refinery in North Pole, Alaska, FHR appears to have been shipping oil on TAPS on an interstate basis in order to dispose of RIK oil that it had arranged to purchase from the State but that exceeded the requirements of this in-state refinery. FHR's interstate shipments should decline significantly as demand for output from FHR becomes more predictable. Dr. Cameron concludes the scope for competition on TAPS is extremely limited (Exhibit No. BPP-44, at 15).

729. Dr. Cameron argues she refutes Dr. Hieronymus's claims that her analysis: (1) ignores sales at the wellhead by producers without a TAPS affiliate; (2) ignores the potential for the State to take RIK oil; (3) overestimates the volumes of shippers that are not TAPS affiliates moving in intrastate commerce; (4) ignores movements by shippers affiliated with Carriers on other Carriers' capacity; and (5) ignores the potential for future growth in volumes of TAPS non-affiliates (Exhibit No. BPP-44, at 17).

730. In addition, she states that Dr. Hieronymus asserts that intrastate competition is relevant to Dr. Cameron's analysis and that she ignored it. Dr. Cameron states that Dr. Hieronymus's claims that her analysis of sales by non-TAPS affiliates at the wellhead does not recognize that discounting of a TAPS tariff rate could induce a non-Carrier affiliated producer to ship oil under its own name on TAPS rather than sell its barrels at

the wellhead is incorrect. Producers without a TAPS affiliation and without tankers calling at Valdez do not ship oil interstate on TAPS under their own name. Instead, they typically sell their oil at the wellhead in order to get it to market while avoiding a number of risks including Valdez disposition risk. Unocal's shipping affiliate, Chevron/Unocal, which has an affiliated Carrier but does not have tankers calling at Valdez, has regularly sold its oil at the wellhead for the past five years (Exhibit No. BPP-44, at 17-18).

731. Dr. Hieronymus suggests that Dr. Cameron's analysis does not take into account how non-affiliated producers' incentives to sell their ANS oil at the wellhead are affected by interstate TAPS tariff rate competition. However, she asserts that shippers, not Carriers, compete with in-state refiners at the wellhead to purchase ANS volumes from producers without ready access to tankers for transportation to interstate destinations. In her view, if Carrier affiliated shippers with tankers calling at Valdez purchased this oil, they would tender these purchased volumes to their Carrier affiliates. Further, there is no evidence that Carriers discount their interstate TAPS tariff rates to enable their affiliated shippers to compete more aggressively at the wellhead. A Carrier cannot discount its interstate TAPS tariff rates to help its affiliated shipper compete at the wellhead unless it files that discount with the Commission, making that discount available to all (Exhibit No. BPP-44, at 18).

732. However, Dr. Cameron states that the only Carrier to file such discounts with the Commission in the past five years has been Unocal, a Carrier whose affiliated shipper, Chevron/Unocal, cannot effectively compete for oil at the wellhead because it has no in-state refinery or tankers to lift oil from Valdez (Exhibit No. BPP-44, at 18).

733. Dr. Cameron observes further that the State has never been a shipper of record on TAPS. Like other owners of oil without tankers calling at Valdez, the State sells its RIK oil at the wellhead thereby avoid transportation and disposition risks. Dr. Hieronymus' argument that the availability of discounts on interstate TAPS tariff rates would cause the State to modify its behavior does not address the risks associated with transportation and disposition. The State can avoid these risks by taking RIV (royalty in value) rather than RIK (royalty in kind). The State did not respond to Unocal's discounted tariff rate by taking additional RIK oil (Exhibit No. BPP-44, at 19).

734. Dr. Cameron states that her analysis does not ignore RIV oil, but instead recognizes that each ANS producer that supplies RIV oil remains the shipper of record for that oil on TAPS; the State only receives the revenues earned on that oil once it is sold in the market. If a Carrier affiliated shipper has RIV oil—either from its own production or from that of another producer who sold its oil at the wellhead—it will have a strong incentive to tender that oil to its affiliated Carrier. It is economically appropriate to recognize that Flint Hill Resources Alaska (FHR) has a strong incentive to affiliate tender the RIK oil that it buys from the State to its Carrier affiliate, KAPCO (Exhibit No. BPP-44, at 19-20).

735. She states further that the State has agreed to provide FHR with the barrels that it requires to supply its refinery at North Pole, Alaska. FHR has an incentive to ship as many of these barrels as possible on KAPCO and to tender only the excess to other Carriers for intrastate transportation to FHR. FHR interstate shipments should decline significantly as demand for FHR output becomes more predictable (Exhibit No. BPP-44, at 20).

736. Dr. Cameron projects in-state demand for supplies of producers without tankers calling at Valdez based on a number of assumptions that are very conservative in the sense that they are much more likely to understate the in-state demand for these supplies rather than overstate it. Shipping costs make it more economical for all of the in-state refiners to purchase oil in-state rather than import oil from the Lower 48 or abroad, all else equal. The two PetroStar refineries could choose to meet at least part of their needs with barrels from producers without ready access to tankers calling at Valdez. In addition, there are strong policy arguments as to why the State may wish to increase its RIK oil take from producers not affiliated with a Carrier and reduce its RIK oil take from TAPS affiliated producers (Exhibit No. BPP-44, at 21-22).

737. Even though all of the in-state refineries could potentially absorb unaffiliated oil, Dr. Cameron states she conservatively assumed that only Tesoro will continue to do so for the period 2010 through 2013. When TAPS was fuller and interstate tariff rates varied from Carrier to Carrier, it was sometimes possible for a shipper affiliated with one Carrier to cross-tender and take advantage of another Carrier's lower rates without reducing its affiliated Carrier's transportation revenues. In such cases, the Carrier affiliated shipper would cross-tender an amount of affiliated barrels to an already full Carrier with a lower TAPS tariff rate (Exhibit No. BPP-44, at 22).

738. Pro-rationing of the over-subscribed space on the already full Carrier would then push an equivalent number of barrels back into the space of the cross-tendering shipper's affiliated Carrier, in her view. However, this is no longer a profitable strategy. As a result of declining throughput, there are no longer any Carriers that are already full. In fact, since 2007 BP, CP, and XOM have elected to affiliate tender almost all of their volumes in order to maximize throughput levels on their Carrier affiliates (Exhibit No. BPP-44, at 22-23).

739. Dr. Cameron states that with ANS production trending downward, these affiliate tendering incentives will remain in place for the future. Since no Carriers are full, occurrences of cross tendering after 2007 have been relatively infrequent and have involved relatively small amounts of oil. Several have coincided with periods in which a shipper's usage of storage tanks at Valdez caused its affiliated Carrier to be sufficiently close to its allocated storage capacity that it risked incurring penalties, which would be passed through to the shippers. Moreover, in her opinion, shippers do not necessarily choose the lowest priced Carrier as an alternative when they cross-tender. This indicates

that other factors such as the need for storage capacity or tanker space are likely at work (Exhibit No. BPP-44, at 21-23).

740. Dr. Cameron does not agree with Dr. Hieronymus that there will be significant growth in the volume of unaffiliated oil in the future that could lead to increased interstate tariff rate competition on TAPS. She states that the results of including intrastate volumes and costs in the BPPA Cost Allocation Mechanism is to decrease BPPA's receipts from the pool by \$3 million. Dr. Hieronymus asserts that BPPA's experience in attracting intrastate oil in 2009 by not increasing its intrastate rates when others did so shows that discounting can increase volumes and market share. However, this observation is not relevant to the issue of interstate tariff rate competition on TAPS, in her view (Exhibit No. BPP-44, at 23-25).

741. Moreover, she asserts that two of the three main shippers on the intrastate side, Tesoro and FHR, are better positioned to respond to discounting than the main shippers on the interstate side, BP, CP and XOM. Tesoro has no Carrier affiliate and should be willing to take advantage of intrastate tariff rate discounts. Further, royalty payments are not affected by intrastate TAPS tariff rates. The disincentive to discount interstate rates that arises because a reduction in the weighted average TAPS interstate tariff raises producers' royalty payments is not relevant to the intrastate side. BPPA's experience in attracting intrastate oil in 2009 by not increasing its intrastate rates when others did so does not imply that discounting of interstate TAPS tariff rates can significantly increase volumes and market share, in her opinion (Exhibit No. BPP-44, at 26).

742. Dr. Cameron further states that Dr. Hieronymus provides no evidence to undermine her conclusion that pooling is in the interest of better service to the public and economy in operation. Dr. Hieronymus fails to recognize that depriving a Carrier of opportunity to recover its cost is inconsistent with good public policy and the principles of cost of service regulation. The cost of capital is the minimum rate of return necessary to attract capital to an investment opportunity. When a regulated firm is deprived of the opportunity to recover its cost of capital, investors earn less than they could elsewhere on comparable risk investments (Exhibit No. BPP-44, at 27).

743. She states that in a well known study prepared by Dr. Hieronymus' firm, managers of an under recovering firm will recognize that they are penalizing their investors whenever they make a new investment, because the expected return will fall short of the cost of capital. If these conditions persist long enough, customers will have to make do with less efficient equipment and with less capacity and a lower safety margin (as indicated by more frequent service outages). Although less easily quantified, inferior service is as much a cost to customers as excessive rates (Exhibit No. BPP-44, at 27).

744. Dr. Cameron argues that investors voluntarily commit investments to regulated firms based on their belief that regulators will abide by the principles of cost-based regulation. It is good public policy to follow these principles, thereby encouraging a

future supply of necessary investment in regulated infrastructure. It is for this reason that the Commission has recognized the need for a pooling mechanism to address the problem of under-recovery and over-recovery in this proceeding. During the 1960s and 1970s, many U.S. railroads were unable to recover their cost of capital on new investment under regulation (Exhibit No. BPP-44, at 27-28).

745. She asserts that by the late 1970s, \$15 billion of railroad investment had been deferred or postponed. Investment increased tremendously with deregulation, which enabled firms to profitably adjust rates to economic conditions. Leading economists note that during 1981-1985, \$27 billion was spent on railroad structures, roadways and maintenance of way while \$30 billion was invested in rail cars, locomotives, and other equipment. Dr. Cameron states that Dr. Hieronymus has not identified a cost pooling mechanism that will provide efficient incentives to invest in TAPS and will allow Carriers to provide the same service to the public and economy in operation as the BPPA Cost Allocation Mechanism (Exhibit No. BPP-44, at 28-29).

746. Dr. Cameron explains her conclusions in the comparison of incentives to invest in a hypothetical investment project under the BPPA Cost Allocation Mechanism, and the CPT-8 Model in Exhibit No. BPP-56. Under the BPPA Cost Allocation Mechanism Dr. Cameron expects the investment incentive of the integrated firm of which BPPA is a member to be the same as the net benefit that BPPA realized from the project. The integrated firm's investment incentives are computed by summing the net benefits of the project to BPPA and its shipping affiliate. The net benefit of the investment to BPPA is zero (Exhibit No. BPP-44, at 29-32).

747. According to Dr. Cameron, under the BPPA Cost Allocation Mechanism, the net benefit of the investment to BPPA's shipping affiliate is also zero; the upward pressure on the TAPS tariff rate (due to increased rates to recover incremental depreciation and return associated with the investment) is exactly offset by the combination of the two investment related benefits: (1) downward pressure on the TAPS tariff rate (due to decreased operating costs); and (2) the realization of shipper-specific benefits—i.e., reduced oil losses (Exhibit No. BPP-44, at 28-32).

748. She believes that the integrated firm's investment incentives are the same as BPPA's net benefit from the project. Because the integrated firm will recover all of its costs associated with the investment, including its cost of capital, it will have the appropriate incentive to undertake this investment. Under the CPT-8 Model, the benefits realized by BPPA's shipper affiliate are also zero on net (because the benefits of the investment exactly offset the costs). BPPA's loss of \$6.89 million on the investment is not offset by any net gains to BPPA's shipper affiliate. As a result, the integrated firm would not want to under take this investment (Exhibit No. BPP-44, at 32).

749. Dr. Cameron also states that under the CPT-8 Model, because return is not pooled, that part of the return on BPPA's investment goes to CPTAI (and other over-recovering

Carriers). This is incompatible with the principles of cost of service regulation. The \$6.89 million is return on part of BPPA's investment contribution to rate base, which, under the BPPA Cost Allocation Mechanism, properly accrues to BPPA. Dr. Cameron used a hypothetical example to demonstrate that the CPT-8 Model will provide BPPA and other under-recovering Carriers with an incentive to under-invest in potentially beneficial projects (Exhibit No. BPP-44, at 32-33).

750. Dr. Cameron states that Mr. Brown agrees with BPPA in part and disagrees with BPPA in part. Mr. Brown agrees that an appropriate cost pool would include depreciation and exclude owner-direct costs. He disagrees that return should be included. Mr. Brown attempts to justify his exclusion of return from the pool with two arguments. First, he asserts that if return is excluded from the pool, competition will not be unduly restrained. Second, he claims that even if return were excluded from the pool, a Carrier could recover its return by discounting and attracting additional barrels of oil (Exhibit No. BPP-44, at 33-34).

751. Dr. Cameron states that for the foreseeable future, interstate TAPS tariff rate competition will be relevant only to the very small fraction of barrels shipped interstate on TAPS that will not be affiliate-tendered (mostly, if not exclusively Tesoro's interstate shipments). Given this, there is no basis for the concern that implementation of the BPPA Cost Allocation Mechanism will lead to a significant restraint on competition. Moreover, Mr. Brown provided no analysis to assist the Commission in addressing whether significant interstate TAPS tariff rate competition exists now or will exist in the future. Because Mr. Brown has conducted no such analysis, his testimony is unhelpful as a guide to constructing a cost pool that complies with the Commission's IS05-82 Orders (Exhibit No. BPP-44, at 34).

752. Dr. Cameron additionally responds to Mr. Brown's claim that a Carrier can earn its return by discounting to attract additional unaffiliated barrels. As a matter of simple arithmetic, both Carriers as a group and individual discounting Carriers will be deprived of the opportunity to recover their costs under Mr. Brown's pooling proposal. The empirical evidence, in her view, indicates that Mr. Brown's claim is unsupported because there is insufficient oil available that could potentially be attracted by discounting (Exhibit No. BPP-44, at 34-35).

753. Furthermore, she asserts that Mr. Brown claims that maintaining incentives for competition by not pooling return elements or Carrier-direct costs is more important today than when the Commission acted to preserve those incentives by establishing pooling in 1985. She asserts that Mr. Brown has neither presented facts nor undertaken analysis to support his claim. He has merely made an allegation that should not be accepted at face value. While Ms. Cameron has not analyzed the incentives for interstate tariff rate competition that existed in 1985, her analysis indicates that today the major Carriers face significant disincentives for discounting in the foreseeable future. It is unrealistic to expect that the Commission's implementation of the BPPA Cost Allocation

Mechanism will have any significant impact on interstate TAPS tariff rate competition in this period (Exhibit No. BPP-44, at 35).

754. Dr. Cameron states further that Mr. Wetmore compares the BPPA Cost Allocation Mechanism with the defunct Section II-2(f) TSA pooling arrangement. Mr. Wetmore notes that the BPPA Cost Allocation Mechanism pools the return element of cost, whereas Section II-2(f) did not. Mr. Wetmore has earlier testified that the CPT-8 Model is similar to Section II-2(f), so Dr. Cameron believes that he understands the addition of return to the pool to be a major difference between the BPPA Cost Allocation Mechanism and the CPT-8 Model (Exhibit No. BPP-44, at 36).

755. In Mr. Wetmore's testimony there is a heading that BPPA's proposal treats return as the recovery of a cost that is incurred instead of as compensation that a Carrier may earn. In addition to the implication in the section heading, Mr. Wetmore answers in the negative to the question, "[d]o the return elements of a revenue requirement represent costs that have been incurred by the TAPS Carriers?" Dr. Cameron argues that Mr. Wetmore appears to distinguish between some elements of cost of service that he characterizes as costs which have been incurred and the return element, which is the opportunity to earn compensation for the use of its capital" (Exhibit No. BPP-44, at 36-37).

756. Dr. Cameron states further that when a Carrier makes use of the labor of employees or the services of contractors, the Carrier incurs a cost. In just the same way, it incurs a cost when it uses the capital of investors. When a Carrier hires a manager, it must pay that manager a salary which is sufficient to compensate that individual for the opportunity he or she lost through accepting employment with the Carrier to earn a salary elsewhere or to enjoy more leisure time. In just the same way, if the Carrier wishes to make an investment it must pay investors a return on investment sufficient to compensate the investors for the opportunity they have lost to earn a return on alternative investments or to fund their current consumption (Exhibit No. BPP-44, at 37-38).

757. In her view, the return on capital is part of the total cost for providing service and Mr. Wetmore seems to recognize this in his data responses. Mr. Wetmore's position is that all Carriers should have the opportunity to recover their incurred operating costs and depreciation, irrespective of throughput, but that the opportunity to recover the return element of costs should be contingent on the amount of throughput that each Carrier is able to attract (Exhibit No. BPP-44, at 37-38).

758. Mr. Wetmore's distinction between operating costs and capital costs is not appropriate from an economic perspective and the Commission has stated that the pooling mechanism should cover all elements of cost, and should not exclude return on investment. The Commission clarifies that Carriers should develop a pooling mechanism that reallocates all Carriers' costs based on throughput, so that the allocation of costs matches the allocation of revenues on TAPS (Exhibit No. BPP-44, at 38).

759. Dr. Cameron notes that Mr. Wetmore's claims that under the BPPA Cost Allocation Mechanism, Carriers will have an incentive to shut down and instead collect money from the pool (minimizing usage collection and maximizing pool collections). However, Mr. Wetmore fails to recognize that these incentives are likely to have no practical impact because the major Carriers' shipping affiliates have countervailing incentives to affiliate tender, including the benefit of timely payment between affiliates, rather than money going out the door subject to recovery through delayed payments from the pool (Exhibit No. BPP-44, at 38).

760. Moreover, Dr. Cameron argues, it is not realistic for any Carrier to shut down completely due to its common carrier obligation. As long as a Carrier is in business, it must, subject to pro-rationing, accept all oil that is tendered to it for transportation. Mr. Wetmore also claims that the BPPA Cost Allocation Mechanism will reduce competitive incentives, which she disagrees with (Exhibit No. BPP-44, at 39).

761. Like Dr. Hieronymus and Mr. Brown, Mr. Wetmore simply assumes the existence of tariff rate competition and then suggests that implementation of the BPPA Cost Allocation Mechanism will cause this competition to be restrained. However, Dr. Cameron states that her analysis demonstrates that the Commission's implementation of the BPPA Cost Allocation Mechanism will have no significant impact on interstate TAPS tariff rate competition for the foreseeable future (Exhibit No. BPP-44, at 39).

## **M. ConocoPhillips- Reply Testimony**

### **1. Erik G. Wetmore**

762. The purpose of Mr. Wetmore's reply testimony is to respond to the answering testimonies of BPPA witnesses Charles Coulson, John Haines, and Robert Van Hoecke; Anadarko witness John Brown; EMPCo witness Jeffrey Ray and KAPCO witness Mike Hoover. He indicates that all of the parties submitting testimony on the pooling issue agree that – to the extent the Commission requires TAPS Carriers to enter into a new pooling arrangement – the following items should be included in the new form of pooling: (1) Alyeska fixed operating expenses, (2) depreciation, and (3) ad valorem property taxes. The parties disagree as to whether the following items should be included in the new form of pooling: (1) return on investment, (2) intrastate costs, (3) Carrier-direct operating expenses (other than ad valorem taxes), and (4) Alyeska variable operating expenses. The parties do not agree on when the new pooling should commence (Exhibit No. CPT-33, at 1-2).

763. He notes that based on the filed testimony, there are at least three different positions on the issue. In CPTAI's view, the Commission intended for any new pooling to take effect when the uniform rate established in this proceeding takes effect. EMPCo's position is that any pooling established in this proceeding should take effect January 1,

2009. BPPA contends that the new pooling should take effect January 1, 2005 (Exhibit No. CPT-33, at 3).

764. Mr. Wetmore's opinion is that Alyeska's fixed operating expenses, ad valorem taxes, and depreciation should be included in the new pooling mechanism, especially since all of the parties filing pooling testimony agree on those items. However, in his view, return on investment should not be included in the new pooling mechanism. Since return is already collected by Carriers on a usage basis, reallocating return to an ownership basis would violate the Commission's directive that the revenue requirement be placed on a usage basis (Exhibit No. CPT-33, at 4-5).

765. Mr. Wetmore states that the return elements of a revenue requirement do not represent operating costs that have been incurred by Carriers. Pooling of return would also be inconsistent with the Commission's instruction that the form of pooling here should be similar to the Section II-2(f) pooling previously in place under the TSA. In addition, it would contradict the Commission's finding in approving Section II-2(f) that exclusion of the return components from the pooling arrangement provides the owners with an incentive to compete to earn their return, and ensures that the pooling arrangement does not unduly restrain competition (Exhibit No. CPT-33, at 5).

766. Moreover, Mr. Wetmore believes that Alyeska variable operating expenses should not be included in the new pooling mechanism because those costs are already shared in proportion to actual usage in accordance with the TAPS Operating Agreement. BPPA's approach unnecessarily complicates the treatment of these expenses for what it concedes is an immaterial impact on the pooled costs (Exhibit No. CPT-33, at 5).

767. Mr. Wetmore states further that other Carrier-direct operating expenses should be included in the new pooling mechanism to comply with the Commission's requirement that the new form of pooling be more inclusive than the TSA pooling and that all costs be reallocated based on usage. Intrastate costs should not be included in the new pooling mechanism because the Commission did not intend that these costs be pooled (Exhibit No. CPT-33, at 5-6).

768. He also opines that the new form of pooling should begin when the uniform rate established by the Commission in the 2009 proceedings takes effect. Mr. Wetmore states that BPPA's criticisms regarding the mechanics of the CPT-8 Cost Pooling Model fail to undermine the validity of that approach. The stated purpose of the CPT-8 Cost Pooling Model is to create a pooling mechanism similar to Section II-2(f) that is understood by the parties, easy for them to apply, and complies with the Commission's orders regarding pooling. BPPA's proposed adjustments create additional complexity without attaining the precision BPPA claims is necessary and without making a significant difference in the ultimate results. In Mr. Wetmore's opinion, the CPT-8 Cost Pooling Model is the only approach set forth by any of the parties that fully complies with the Commission's orders (Exhibit No. CPT-33, at 6-7).

769. Mr. Wetmore states that the Commission did not intend to ensure that each Carrier earns precisely the same level of overall return. Instead, the purpose of the pooling arrangement mandated by the Commission is to pool all costs that are initially incurred by Carriers on an ownership basis and reallocate them on a usage basis, so that Carriers do not over- or under-recover their costs. The Commission's Opinion 502 methodology establishes a uniform TAPS rate for all of Carriers based on a system-wide revenue requirement and system-wide throughput (Exhibit No. CPT-33, at 11).

770. It does not set rates based on an individual Carrier revenue requirement, as Mr. Coulson's statement suggests. The Commission's goal in Opinion 502, in his opinion, is to establish a uniform rate that was just and reasonable for all Carriers as a whole – not to ensure individual Carriers a specific level of return. Nevertheless, the Commission recognized that under a uniform rate methodology, some Carriers might over- or under-recover their costs due to the cost allocation agreements in place among Carriers. The Commission plainly did not intend to equalize the overall level of recovery among Carriers, because the Commission did not require Carriers to pool their revenue on an ownership basis. Instead, the Commission made clear that it was requiring a cost pooling rather than a revenue pooling (Exhibit No. CPT-33, at 11-13).

771. Mr. Wetmore also disagrees with BPPA witness Van Hoecke who asserts that because the CPT-8 Cost Pooling Model does not pool and reallocate return on investment, it fails to comply with the Commission's instructions that the pooling mechanism should be all-inclusive, so that the revenue requirement is based on usage, not the ownership share (Exhibit No. CPT-33, at 14). Mr. Wetmore believes that CPT-8 Cost Pooling Model is all-inclusive, because it takes all interstate costs that are incurred by Carriers on an ownership basis and reallocates those costs based on usage. CPT-8 therefore complies with the Commission's requirement that costs must be allocated in the same manner as revenues, based on throughput. Return in his view is already both earned and collected based on each Carrier's usage of TAPS (Exhibit No. CPT-33, at 14).

772. Mr. Wetmore also states that the CPT-8 Cost Pooling Model is more inclusive than the TSA pooling, since CPT-8 pools other Carrier-direct operating expenses, which were not pooled under the TSA. By pooling all costs incurred on an ownership basis and reallocating them based on usage, the CPT-8 Cost Pooling Model fully complies with the Commission's requirements (Exhibit No. CPT-33, at 15). He also believes that BPPA witness Mr. Coulson is incorrect that circumstances have changed since the TSA was executed, specifically that the Commission has ordered Carriers to calculate rates on a uniform basis and that throughput on TAPS has fallen below capacity. These examples do not represent fundamental changes that would alter the purpose of the Section II-2(f) pooling mechanism or how it operates in the TAPS context. With respect to the Carriers having to calculate their rates on a uniform basis, the Opinion 502 uniform rate is not fundamentally different from the TSA rate ceilings that were in effect on TAPS for most

of its history from the perspective of how revenues are collected by Carriers, in his view (Exhibit No. CPT-33, at 15-16).

773. Mr. Wetmore states further that under both the TSA and Opinion 502, maximum ceiling rates are uniformly developed using total TAPS revenue requirement and total TAPS volumes (as opposed to using an individual Carrier's revenue requirement and volumes). The fact that TAPS throughput has fallen below capacity also does not fundamentally change the purpose or operation of Section II-2(f). The stated purpose of Section II-2(f) was to prevent certain possible inequities among the Carriers arising from historical circumstances. One such circumstance explicitly contemplated was that TAPS might operate below its mechanical capacity. Section II-2(f) was purposely designed to correct for this by providing for reallocation of costs on the basis of the differential between a Carrier's barrel-mile share and its composite ownership share (Exhibit No. CPT-33, at 16-17).

774. In Mr. Wetmore's view, the decline in TAPS throughput makes it even more important to exclude return from the pooling mechanism. With less throughput than capacity and more independent producers, there is an increasing likelihood that Carriers will more actively compete for throughput than they have in the past. Preserving incentives for the Carriers to compete is consistent with the public interests recognized by the Commission when it approved pooling 1985 and is more important today than ever before (Exhibit No. CPT-33, at 17). He believes the Commission intended that Carriers put in place a pooling arrangement similar to Section II-2(f) of the TSA, where costs initially incurred on an ownership basis are reallocated based on actual usage. The purpose of this form of pooling is to ensure that costs are ultimately placed on a usage basis, not to eliminate all risks related to market uncertainties (Exhibit No. CPT-33, at 18).

775. Mr. Wetmore testifies further that Alyeska's variable operating expenses are not included in the CPT-8 Cost Pooling Model because those costs are already shared in proportion to actual usage in accordance with the TAPS Operating Agreement. This approach is similar to the pooling arrangement in Section II-2(f) of the TSA, where the cost allocation provisions set forth in Section II-2(f) of the TSA were not extended to Alyeska variable operating costs because those costs are already shared in proportion to actual use. Since Alyeska's variable operating expenses are pooled in accordance with the TAPS Operating Agreement, the pooling of those costs was not affected by the termination of the TSA. He notes that Anadarko agrees that since variable costs already are allocated among Carriers based on usage there was no need to include variable costs in the pooling proposals in this proceeding (Exhibit No. CPT-33, at 19-20).

776. He asserts that except for BPPA, the other parties do not appear to address this issue. BPPA witness Haines asserts that allocation of Alyeska variable costs under the TAPS Operating Agreement is not sufficient, because it does not precisely follow the manner in which costs are recovered under the tariff rate design. Mr. Haines describes

his alternative method for reallocating Alyeska variable costs in his testimony (Exhibit No. CPT-33, at 20). Mr. Wetmore does not agree with using Mr. Haines' method for reallocating Alyeska variable costs. The CPT-8 Cost Pooling Model follows the approach used in Section II-2(f) of the TSA, which did not pool Alyeska variable costs. That method is much simpler than BPPA's unnecessarily complicated approach. Moreover, as Mr. Haines calculated, the difference between BPPA's approach and the CPT-8 Cost Pooling Model is less than \$3000 in total for all Carriers. In Mr. Wetmore's view this small difference does not justify the added complexity of the BPPA method.

777. He also indicates that the CPT-8 Cost Pooling Model includes other Carrier-direct operating expenses in response to the Commission's requirement that the pooling arrangement be more inclusive than the TSA pooling and that all Carriers' costs be based on throughput or usage. However, he states that Mr. Brown, Mr. Haines and Mr. Ray all assert that excluding other Carrier-direct costs from the pooling mechanism will provide each Carrier with an incentive to keep those expenses as low as possible. Mr. Wetmore agrees with the other parties that excluding other Carrier-direct costs from the pooling mechanism will provide each Carrier with an incentive to keep those expenses as low as possible (Exhibit No. CPT-33, at 21).

778. In Mr. Wetmore's view the Commission's orders stated that the pooling arrangement should be more inclusive than the TSA pooling and that all costs should be allocated based on usage. Since other Carrier-direct costs represent operating costs that are not incurred on a usage basis and are included in the revenue requirement, it is his view that the Commission intended to include other Carrier-direct costs in the new form of pooling. However, he believes that intrastate cost should not be included in the new form of pooling because there is no mandatory uniform rate or pooling requirement at the RCA. Intrastate rates vary substantially, and the Commission orders did not state an intent to pool intrastate costs or refer to any specific statutory or other basis for doing so. Mr. Wetmore excluded intrastate costs from the CPT-8 Cost Pooling Model (Exhibit No. CPT-33, at 22-23).

779. Mr. Wetmore states that Section II-2(f) reallocated both interstate and intrastate costs. The Commission's methodology for setting TAPS rates is based on system-wide costs and throughput. However, the CPT-8 Cost Pooling Model was developed to comply with the Commission's orders regarding pooling. The Commission orders did not state an intent to pool intrastate costs or cite any authority to pool intrastate costs. The Commission intended to pool interstate costs only. In accordance with the Commission's orders pooling is to begin when the uniform rate resulting from the 2009 proceedings is established (Exhibit No. CPT-33, at 23-24).

780. To ensure there is no misunderstanding, Mr. Wetmore believes this is the date when the uniform rate from the 2009 proceedings takes effect, not necessarily the date that the ultimate Commission order is issued. EMPCo and BPPA each have views that differ from CPTAI on this issue. EMPCo asserts that if mandatory pooling and a uniform

rate are imposed on TAPS Carriers, a new pooling mechanism should simply replace the now-expired Section II-2(f). If the effective date is set at January 1, 2009, there will be no time period in which pooling was not in effect. He notes that BPPA contends that the effective date should be January 1, 2005 (Exhibit No. CPT-33, at 24).

781. He also asserts that EMPCo's position is not consistent with the Commission's directive that pooling should start when the uniform rate established in the 2009 proceedings takes effect, especially since the earliest effective date for any of the rates at issue in this proceeding was May 1, 2009. The Commission intended that the pooling take effect prior to the effective date of the new uniform rate to be established in this proceeding. During the period January 1, 2005 through December 31, 2008, the TSA (which included the Section II-2(f) pooling) was in effect (Exhibit No. CPT-33, at 24-27).

782. Mr. Wetmore believes BPPA's criticisms of the mechanics of the CPT-8 Cost Pooling Model are without merit. BPPA's primary criticism relates to the factors used to pool and reallocate the various categories of costs included in the CPT-8 Cost Pooling Model. BPPA claims that the factors used in CPT-8 do not accurately reflect how TAPS costs are incurred by or allocated among Carriers before any pooling and how TAPS costs are treated for ratemaking purposes (Exhibit No. CPT-33, at 27).

783. Mr. Wetmore believes that the differences between CPT-8 and the BPPA model with respect to these issues do not represent computational errors on either side. Instead, they are the result of the different goals of the CPT-8 Cost Pooling Model and the BPPA proposal. Fundamentally, each of BPPA's criticisms regarding the mechanics of the CPT-8 Cost Pooling Model stems from BPPA's assumption that the purpose of the new form of pooling is to guarantee that Carriers' returns are equal (Exhibit No. CPT-33, at 28). In his opinion, this focus on equalizing Carrier returns leads BPPA to develop an unnecessarily complex model that attempts to compare each specific category of economic costs that BPPA deems to be incurred by Carriers with how each category of economic costs is theoretically recovered in BPPA's hypothetical revenue requirement. In his view, since the purpose of the Commission's mandated pooling approach is to pool operating costs and not to equalize return, the additional complexity of the BPPA model is entirely unnecessary (Exhibit No. CPT-33, at 28-29).

784. Mr. Wetmore believes BPPA's criticisms of the treatment of other Carrier-direct operating expenses is also unfounded. Under the CPT-8 Cost Pooling Model, other Carrier-direct operating expenses are allocated in the same fashion as all other costs (based on the difference between each Carrier's composite ownership percentage and its barrel-mile share). BPPA argues that these costs should be allocated based on the difference between each Carrier's share of actual Carrier-direct costs and each Carrier's share of barrel-miles or barrels (depending upon whether the Carrier-direct cost are distance or non-distance based) (Exhibit No. CPT-33, at 34). In connection with Alyeska fixed operating costs and ad valorem property taxes, there is no reason in Mr. Wetmore's opinion to move away from the straightforward allocation approach contained in Section

II-2(f). The additional calculations proposed by BPPA do not make its calculations more accurate or make a difference in the payments sufficient to justify the change (Exhibit No. CPT-33, at 35).

785. Mr. Wetmore further asserts that while BPPA claims to reflect accurately how specific categories of costs are incurred and recovered in ratemaking, it fails to take into account various ratemaking adjustments to other Carrier-direct operating expenses. In Exhibit CPT-36 Mr. Wetmore calculates the amount of pooling payments and receipts assuming the CPT-8 Cost Pooling Model and assuming the CPT-8 Cost Pooling Model as modified in accordance with BPPA's recommendations regarding how other Carrier-direct operating expenses should be allocated. BPPA's proposed adjustments increase the pooled amount of other Carrier-direct costs by less than \$3 million above those calculated in the CPT-8 Cost Pooling Model (Exhibit No. CPT-33, at 35-36).

786. Mr. Wetmore testifies that BPPA's modified approach reallocates the pool of other Carrier-direct operating expenses based on the difference between Carrier-direct share and usage (barrel or barrel-mile) share. As BPPA explains, its method ensures that each TAPS Carrier recovers no more and no less than its actual Carrier-direct costs. By ensuring that each Carrier recovers the full amount of its Carrier-direct costs, BPPA provides no incentive for any Carrier to operate efficiently (Exhibit No. CPT-33, at 36). By contrast, under the CPT-8 Cost Pooling Model, there remains an incentive for Carriers not to exceed the average Carrier-direct costs of all the Carriers since other Carrier-direct operating costs are reallocated based on the difference between the composite ownership share and system-wide barrel-miles. BPPA benefits from its proposed modification, because its share of total Carrier-direct non distance costs (the vast majority of Carrier-direct costs) exceeds its ownership percentage (Exhibit No. CPT-33, at 36-37).

787. Thus, with BPPA's modified approach, BPPA would ultimately recover (both through its tariffs and through pooling receipts) its full Carrier-direct share of these costs, which exceeds not only its barrel usage share, but also its ownership share (less than 47%). Mr. Wetmore believes the difference in pooling payments between BPPA's method and the CPT-8 approach are not justified by the added complexity in BPPA's model and its elimination of any incentive to keep Carrier-direct costs as low as possible (Exhibit No. CPT-33, at 37).

788. Mr. Wetmore further testifies that BPPA's criticisms of the treatment of interstate costs are unfounded and lead to unreasonable results in the absence of a corresponding intrastate pooling mechanism. BPPA asserts that there are two flaws with the approach used by the CPT-8 Cost Pooling Model to pool and reallocate interstate costs (Exhibit No. CPT-33, at 37-38). First, BPPA asserts that the CPT-8 Cost Pooling Model misstates the interstate costs by improperly calculating the amount of intrastate costs to be excluded from pooling. Second, BPPA argues that the interstate costs should be allocated based on interstate barrels and barrel-miles rather than total system barrel-miles. Contrary to BPPA's suggestion, there is minimal practical difference between the CPT-8

Cost Pooling Model and BPPA's approach with respect to the separation of interstate costs from intrastate costs (Exhibit No. CPT-33, at 38).

789. Mr. Wetmore states that BPPA claims the CPT-8 Cost Pooling Model improperly uses a single allocation factor to separate interstate and intrastate costs. BPPA asserts that it resolves this computational problem by starting with the specific categories (and dollar amounts) of costs that need to be individually allocated in the first instance, rather than using a single blended allocation factor (Exhibit No. CPT-33, at 38). The intrastate percentage used in the CPT-8 Cost Pooling Model, however, is the result of a series of underlying calculations. As shown on Exhibit CPT-10, the intrastate percentage is the sum of: (1) the non distance related operating expense incurred by Alyeska divided by all operating expense incurred by Alyeska for the calendar year, multiplied by the percentage of total barrels transported through TAPS in intrastate commerce for that calendar year; plus (2) the distance related operating expense incurred by Alyeska divided by all operating expense incurred by Alyeska for the calendar year, multiplied by the percentage of total barrel-miles transported by TAPS in intrastate commerce for that calendar year (Exhibit No. CPT-33, at 38-39).

790. Mr. Wetmore argues that BPPA arrives at a similar result by another method. Instead of using one blended allocation factor that is calculated using both barrel and barrel mile data (as is done in the CPT-8 Cost Pooling Model via the intrastate percentage), Mr. Haines uses two allocation factors: one calculated using barrel data and one calculated using barrel-mile data. For those costs Mr. Haines categorizes as distance related, he multiplies the total costs to be pooled by his Interstate Barrel-Mile Percentage. For those costs Mr. Haines categorizes as non-distance related, he multiplies the total costs to be pooled by his interstate barrel percentage. In his opinion, there is minimal practical difference in the CPT-8 and BPPA approaches (Exhibit No. CPT-33, at 38-39). Mr. Wetmore also believes that BPPA's assertion that pooling calculations should be limited to interstate components generates unreasonable results. According to Mr. Wetmore, the CPT-8 Cost Pooling Model allocates costs using the same system-wide barrel-mile allocation factor used in Section II-2(f) (Exhibit No. CPT-33, at 40).

791. He opines that BPPA fails to show modification is necessary. As BPPA acknowledges, the use of its modified approach leads to peculiar results. When only interstate costs are pooled and reallocated using interstate only barrels and barrel-miles, BPPA's method produces some peculiar imbalance effects. For example, Carriers that tend to have near zero interstate traffic and relatively high levels of intrastate traffic (such as KAPCO in 2009) should be expected to receive substantial dollar amounts out of an interstate-only cost pool (since their interstate usage is low relative to their initial interstate cost contribution) (Exhibit No. CPT-33, at 40).

792. However, in the absence of an intrastate cost pool, there is no corresponding offset to balance their interstate pooling receipts. He further argues that it is worth noting that BPPA would also benefit from modifying the CPT-8 Cost Pooling Model to use interstate

barrels instead of system-wide barrels, since BPPA's overall share of intrastate barrel-miles increased from 29.6% in 2008 to 52.5% in 2009. The CPT-8 method reduces the imbalance effects associated with BPPA's approach and makes the pooling payments less volatile and more predictable (Exhibit No. CPT-33, at 40-41).

793. Mr. Wetmore further states that BPPA's assertion that interest on certain pooling payments needs to be factored into the new form of pooling is incorrect. BPPA argues that the new pooling mechanism should provide for interest on the depreciation and return elements of the cost pooling adjustments for the period from January 1 through the date pooling payments are made. In accordance with the Commission's orders, the CPT-8 Cost Pooling Model begins with Section II-2(f) of the TSA, and then makes certain adjustments so that the revenue requirement is based on usage. Section II-2(f) of the TSA did not pool any return elements, nor did it provide for interest on any of the items that were pooled, such as operating expenses or depreciation. Furthermore, the additional interest expense calculated in BPPA's proposed pooling mechanism is not an actual cost that is paid for by TAPS Carriers on an ownership basis, nor is it included in the revenue requirement calculated in accordance with Opinion 502. BPPA's prospective achieved return test fails to justify BPPA's approach (Exhibit No. CPT-33, at 41-42).

794. Mr. Wetmore additionally states that Mr. Van Hoecke's answering testimony contains various calculations purporting to show the returns that Carriers would achieve under the CPT-8 Cost Pooling Model as modified by BPPA. Mr. Van Hoecke is attempting to show that the achieved returns of Carriers will not be precisely equal (Exhibit No. CPT-33, at 42). In his view, Mr. Van Hoecke contrasts that result with BPPA's approach, which he claims gives all Carriers an opportunity to earn an equal return on their investment in TAPS. Mr. Van Hoecke's calculations have little relevance here. Mr. Wetmore argues that the CPT-8 Cost Pooling Model does not attempt to equalize Carriers' returns (Exhibit No. CPT-33, at 42-43).

795. In his view, if a Carrier such as CPTAI is able to move more barrels than other Carriers, it will ultimately pay a greater share of the costs to operate TAPS, but it may also earn a greater share of the revenue and a larger return. An individual Carrier's level of recovery does not come at the expense of other Carriers since each TAPS Carrier uses its own capacity to move volumes. Mr. Van Hoecke acknowledges that CPTAI is not transporting more oil than its allotted space on TAPS allows. Moreover, as Dr. Hieronymus stated in his answering testimony, differences in profitability among TAPS Carriers are the result of conscious business decisions, including voluntary agreements entered into by Carriers. Cost-based regulation does not guarantee a carrier a particular profit margin or level of return. In providing such an opportunity, the Commission is not required to protect individual carriers from the results of their business decisions (Exhibit No. CPT-33, at 43-44).

## **N. Anadarko – Reply Testimony**

### **1. John Brown**

796. The purpose of Mr. Brown's testimony is to review the answering testimony submitted by BPPA relating to its proposed pooling mechanism and to respond to the testimony of BPPA witnesses Mr. Coulson and Mr. Van Hoecke. In Mr. Brown's answering testimony, he explained why the pooling mechanism proposed by BPPA, which includes return, eliminates incentives that promote important public and shipper interests the Commission has recognized (Exhibit No. APC-98, at 1).

797. Mr. Brown disagrees with Mr. Coulson who states in his answering testimony that the Commission has directed Carriers to calculate rates on a uniform basis. Mr. Brown states that the uniform rate requirement is not at issue in this proceeding. In the Commission's Order on Rehearing issued June 20, 2009, the Commission specifically stated that it will not address whether the Commission erred in requiring Carriers to charge a uniform rate. That issue was already resolved on rehearing (Exhibit No. APC-98, at 2). With regard to the November 20 Order on Rehearing and Compliance, the Commission concluded that a uniform rate was appropriate because Carriers have essentially the same cost of service, given that virtually all of the costs of operation are allocated to TAPS Carriers in proportion to their ownership (Exhibit No. APC-98, at 2).

798. In his view, Mr. Coulson wrongly implies the Commission's recent adoption of a uniform rate requirement impacts the necessity for pooling. For the past two decades, Carriers have not had a uniform rate requirement, but have needed to pool. Nothing has changed with the Commission's adoption of the uniform rate requirement (Exhibit No. APC-98, at 3-4). He also believes that BPPA's proposed pooling mechanism is not consistent with the Commission's prior approach to pooling on TAPS (Exhibit No. APC-98, at 4).

799. On the central issue in this proceeding—whether pooling on TAPS should include return—he argues that the commission has already ruled that the exclusion of return provides necessary incentives and that a pooling mechanism that excludes return is in the interest of better service and economy of operation. BPPA's proposed pooling mechanism includes return and ignores both the Commission's prior holding on this very point and the efficient operation of the prior pooling mechanism without return for over two decades. There is no doubt that the inclusion of return in BPPA's pooling mechanism will not provide the proper incentives and will unduly constrain competition, in his view (Exhibit No. APC-98, at 4-5).

800. Mr. Brown states that Mr. Coulson is incorrect in his answering testimony that the Commission ordered that Carriers should adopt a pooling mechanism that is all inclusive rather than including only certain costs as was the case under the TSA's Section II-2(f). In his view, It is not plausible to suggest the Commission intended to substantively

decide the very issue it was simultaneously setting for hearing. The very same day the Commission made the statement relied on by Mr. Coulson (June 30, 2009), the Commission set the TAPS pooling mechanism for hearing in Docket Nos. IS09-348, *et al.* The purpose for setting an issue for hearing is to establish a record so the Commission may properly consider and decide the issue. In his view, there would be no need for the Commission to set an issue for hearing if the Commission had already substantively decided the issue. Mr. Coulson's reading of the Commission's order inappropriately converts the Commission's general discussion of an issue it set for hearing into a substantive ruling on the issue. It is also unlikely the Commission would substantively decide that return must be pooled without dispositive pleadings, a hearing, or a record when the only time the Commission has previously considered the same issue it held that return should not be pooled (Exhibit No. APC-98, at 5-6).

801. Mr. Brown further disagrees with Mr. Van Hoecke's testimony where he states that the result of not including return in the Ex. CPT-8 Model is that CPTAI is over earning while BPPA is effectively guaranteed that it cannot recover its cost of service. In his view, BPPA has the same opportunity to earn return as every other Carrier under the CPT-8 Model. The pooling mechanism in Exhibit CPT-8 is neutral in his opinion (Exhibit No. APC-98, at 7).

802. Mr. Brown believes that if BPPA performs as efficiently in managing its capacity as other Carriers, BPPA will have the same opportunity to recover its return. In his view, Mr. Van Hoecke's comment also shifts responsibility for BPPA's underperformance away from BPPA to other Carriers. While BPPA has 46.9% of the total capacity in TAPS it only transported 34.6% of the total throughput (2009). On the other hand, CPTAI has 28.3 percent of the total capacity and transported 40.7% of the total throughput (2009). CPTAI has outperformed BPPA in managing its capacity on TAPS. BPPA should be held responsible for its underperformance and should be expected to compete for or encourage the development of additional throughput volume or take other steps to manage its capacity on TAPS more efficiently. If BPPA manages its capacity as efficiently as CPTAI, BPPA will recover the same relative return as CPTAI under the CPT-8 Model (Exhibit No. APC-98, at 7-8).

## **2. Gary Grasso**

803. Mr. Grasso is a consultant with Benjamin Schlesinger and Associates, LLC., a management consulting firm practicing in the national and international energy markets. Mr. Grasso has a B.S. degree in Economics from George Mason University. The purpose of his testimony is to provide comments on the answering testimony filed by witnesses Coulson, Haines, and Van Hoecke on behalf of BPPA and witness Wetmore on behalf of CPTAI (Exhibit No. APC-99, at 1).

804. Mr. Grasso testifies that the methodology set forth in the TSA and approved by the Commission for pooling among Carriers is a straightforward reallocation of cost elements

to correct any disparity between the ownership and use of TAPS. BPPA's proposed pooling methodology approximates the effort necessary to make an entire rate filing and is not straight forward. To simply pool certain costs, BPPA's proposed pooling methodology requires the construction of a cost of service for the pipeline, the construction of a cost of service for the VMT, jurisdictional assignments for all common costs, and an allocation of all common costs across the entire TAPS system. BPPA's proposed pooling model includes unnecessary and detailed calculations (Exhibit No. APC-99, at 3).

805. Mr. Grasso also states that BPPA's proposed pooling methodology is inconsistent with the pooling methodology and approach taken by the Commission in the past for pooling on TAPS. The Commission previously considered and approved pooling based upon Section II-2(f) of the TSA. That pooling methodology was simple and did not pool return. The Commission held that not pooling return provided a necessary incentive for the efficient operation of TAPS. BPPA supported pooling under Section II-2(f) of the TSA, and the Commission found the pooling methodology to be in the public interest. BPPA's proposed pooling methodology is inconsistent with its historic support for pooling without return and with the Commission's holdings in support of pooling without return. Moreover, BPPA's proposed pooling methodology can not be conceptually reconciled with the approach it and the Commission have taken in the past on TAPS (Exhibit No. APC-99, at 3-4).

806. Moreover, according to Mr. Grasso, the uniform rate requirement is not at issue in this proceeding and should not be at issue regardless of how the Commission determines to reallocate costs among Carriers. BPPA has attempted to suggest that pooling return is necessary under a uniform rate. However, pooling is not linked to the uniform rate requirement but to resolving the practical disparity that arises when one Carrier uses more or less capacity than it owns (Exhibit No. APC-99, at 5-6).

807. Mr. Grasso states that he agrees with Mr. Wetmore in describing the flaws with BPPA's proposed pooling mechanism with his observations, especially those related to BBPA's proposal to include return and return-related components in any pooling mechanism. However, he does not agree with the criticism related to the allocation of intrastate costs, which was done under Section II-2(f), or to the pooling and allocating of carrier-direct expenses, which also has never been done. Mr. Grasso takes issue with the achieved return analysis propounded by BPPA witness Van Hoecke. Mr. Grasso states that the achieved return analysis where all returns are equal can only be accomplished by allocating return on an ownership basis. In this regard, BPPA is not achieving return through usage, but confiscating returns earned by the other carriers (Exhibit No. APC-99, at 6).

808. Mr. Grasso concludes in supporting CPTAI's suggestion, as modified by Mr. Brown, to include intrastate costs and exclude carrier-direct costs. This methodology

would most closely match the Commission's approach and holdings when it approved Section II-2(f) pooling under the TSA, in his opinion (Exhibit No. APC-99, at 6).<sup>47</sup>

## **O. Koch- Reply Testimony**

### **1. Mike E. Hoover**

809. Mr. Hoover is the Accounting Manager and Tariff Coordinator for Koch Pipeline Company, L.P., the immediate parent of Koch Alaska Pipeline Company, L.L.C. (KAPCO). In that position, Mr. Hoover is responsible for developing KAPCO's tariffs, providing necessary documentation to FERC and carrying out the decision of KAPCO's Board of Directors with respect to the management of KAPCO's ownership interest in TAPS. Mr. Hoover earned B.S. degrees in Business Management and Accounting from Kansas State University and has worked for KPL since graduation in 1989 (Exhibit No. KAP-1, at 1).

810. The purpose of his testimony is to explain how KAPCO's interest in TAPS is qualitatively different from those of the other TAPS owners, why KAPCO is opposed to any cost pooling mechanism that may be imposed on the TAPS owners by FERC, which of the two pooling mechanisms that have been presented to FERC for consideration in this proceeding are more appropriate, and the initial time period for which KAPCO believes any cost pooling mechanism should be implemented (Exhibit No. KAP-1, at 2).

811. Mr. Hoover testifies that KAPCO is different from the other owners of TAPS. Unlike all of the other TAPS owners, KAPCO is not an integrated oil company. Neither KAPCO nor any of its affiliates own any interest in ANS oil fields from which crude oil is shipped through TAPS. Similarly, unlike the other TAPS owners, none of the oil moving through TAPS is transported to the United States for refining and/or marketing by KAPCO or its affiliates. KAPCO transports crude oil to an affiliate, Flint Hills Resources Alaska, LLC (FHR), which owns a refinery at the GVEA connection of TAPS. However, FHR also does not have any ownership interest in ANS leases or other production facilities (Exhibit No. KAP-1, at 3). Instead, FHR is dependent on the receipt of oil that is owned by the State RIK interests in 12.5% of production on State lands. KAPCO or its affiliates do not own, operate or time charter tankers for the movement of ANS out of the VMT (Exhibit No. KAP-1, at 3).

812. While KAPCO's throughput percentage in the past has been roughly equivalent to its ownership percentage of TAPS, that is by no means assured in the future. Currently, almost all KAPCO's throughput on TAPS consists of crude oil shipments for its affiliate, FHR. However, FHR must purchase crude oil either from the various producers or from the State under the RIK program. Consequently, if FHR was no longer operating at GVEA or unable to purchase oil from the State, KAPCO would have no affiliate with any

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<sup>47</sup> As indicated both *supra* and *infra*, Anadarko now favors excluding intrastate costs.

interest in ANS crude oil. If that were to occur, there is no reason to believe that the throughput percentage moving via KAPCO would in any way approach its ownership percentage in TAPS (Exhibit No. KAP-1, at 3-4).

813. Mr. Hoover states further that neither KAPCO nor any of its affiliates have any ownership interest in any of the producing fields for ANS. As a result, KAPCO would have to attract shipments from ANS oil producers, most of which are TAPS owners. Since these shippers have a strong interest in using the TAPS capacity of their corporate affiliates, it would be extremely difficult for KAPCO to attract sufficient shipments of crude oil to fill its TAPS capacity. Regardless of any incentive rates or discounts KAPCO might publish, it would likely not be able to attract any significant volumes of oil from the affiliates of the other TAPS owners (Exhibit No. KAP-1, at 4).

814. Mr. Hoover states that KAPCO believes FERC does not have the authority to require either that Carriers establish a uniform rate or that they enter into a FERC-imposed pooling arrangement without their unanimous consent. Mr. Hoover understands that KAPCO and other TAPS owners are challenging FERC's authority on these issues. BPPA and CPTAI have separately proposed pooling models for FERC's consideration in this proceeding. Of the two models proposed, KAPCO believes that—with one important exception—the pooling model set forth in the Cost Allocation Methodology proposed in the direct testimony of BPPA witness Mr. Haines is the most appropriate for use in this proceeding (Exhibit No. KAP-1, at 6).

815. Mr. Hoover states that the BPPA Cost Allocation Methodology is generally more appropriate than that of CPTAI. Considerations of integrated corporate economics suggest that ANS crude oil owners will tend to ship using their affiliated pipeline company interests rather than that of another pipeline owner. Mr. Hoover also believes that this will be the case whether or not its affiliated pipeline owner has the lowest tariff (Exhibit No. KAP-1, at 6). In his view, if there is a significant mismatch between a company's ownership in TAPS and ANS production—or its equivalent through the State's RIK—an owner could be unfairly penalized (or rewarded) based on considerations that have nothing to do with the level of its tariff or its operation of the pipeline. With those considerations in mind, it is appropriate that all costs other than Carrier-direct operating expenses relating to the pipeline, including depreciation and return on investment, should be reallocated based upon each company's relative usage of the various TAPS assets (Exhibit No. KAP-1, at 6-7).

816. Mr. Hoover agrees with BPPA's treatment of carrier-direct operating expenses. Specifically, that its Cost Allocation Methodology would not reallocate carrier-direct. Mr. Hoover states that it would be inappropriate to reallocate or pool carrier-direct operating expenses because each TAPS owners has significantly different management and overhead structures, and the relative costs of these expenses are not dependent upon their usage of the pipeline. Moreover, as neither the Operating Agreement nor the TSM

reallocated those costs, the owners have always understood that they would each bear those expenses individually (Exhibit No. KAP-1, at 7).

817. Mr. Hoover would make modifications to the BPPA pooling methodology. BPPA contends that its pooling methodology should be imposed retroactively going back to 2005. Mr. Hoover states that this approach is fundamentally inappropriate and unfair for several reasons. First, the TAPS owners did pool their costs pursuant to the TSM until the end of 2008, at which time the TSA was terminated. As such, BPPA's proposal literally seeks to retroactively amend, without the consent of at least KAPCO, an approved pooling methodology that was already in place (Exhibit No. KAP-1, at 7-8).

818. Similarly, since the TSA expired on December 31, 2008, neither the TAPS owners nor the FERC have agreed to or imposed a pooling methodology on the continued operations of TAPS. Instead, each of the owners has continued to operate without any pooling arrangement based upon their respective evaluations of the economics of continued operation. Until such time as some change is made, a carrier can only fairly be expected to operate based upon the facts that it either knows or can reasonably anticipate. As Carriers have still not agreed that any pooling arrangement is necessary, let alone which methodology should be used, it would again be inappropriate to retroactively impose such an arrangement and thereby alter the economics of decisions that the various owners previously made (Exhibit No. KAP-1, at 8).

## **IV. FINDINGS**

### **A. Summary of Findings**

819. The parties agreed to a stipulation to resolve all of the cost of capital issues in this case. The undersigned accepts the stipulation of the parties pertaining to the cost of capital issues, and adopts them verbatim, and incorporates them by reference herein in this Initial Decision. The undersigned finds that the interstate portion of the fixed operating expenses incurred by Alyeska on behalf of the TAPS Carriers, State ad valorem property taxes, and depreciation (return of investment), should all be included in the pooling mechanism. The Alyeska variable operating expenses are already shared in proportion to actual usage in accordance with the TAPS Operating Agreement, and it is therefore not necessary to include them in a new pooling mechanism.<sup>48</sup> Moreover, the undersigned finds that a percentage of return (return on investment), other Carrier-direct operating expenses, and intrastate costs should be included in the pooling mechanism.<sup>49</sup>

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<sup>48</sup> Adopting the position of ConocoPhillips; CPTAI IB., at 37; CPTAI RB., at 35.

<sup>49</sup> Variable operating expenses are generally accepted by all parties but is not included in the pooling mechanism because they are already being allocated on usage pursuant to Section 11.4 of the TAPS Operating Agreement, and thus do not necessarily have to be in the pooling mechanism. As discussed, the undersigned adopts CPTAI's

Additionally the undersigned finds 100% of the costs related to the cost of debt and AFUDC should be included because these are real, fixed costs which do not directly relate to the profit margin of the Carriers.

820. The undersigned agrees with BP's argument that debt is a cost that must be paid when due to avoid default and its consequences.<sup>50</sup> Moreover, the undersigned finds a sliding scale approach is warranted to evaluate the remaining equity components of return on investment associated with costs relating to investing in TAPS, which relate to operational efficiency and profit. The undersigned further finds that the record supports a finding that 50% of all other equity return items should be included in the pooling mechanism at this time to balance costs and lessen financial distress upon TAPS. This will provide all Carriers an opportunity to recapture the costs associated with investing in TAPS. However, as indicated, the undersigned finds that the Commission should utilize a sliding scale approach, so that it may adjust these percentages if circumstances warrant such action in future proceedings.<sup>51</sup> The undersigned further finds that the pooling mechanism should be effective no earlier than January 1, 2009, and that the previous TAPS Settlement Agreement was in effect and binding for the period prior to this time. Additionally, the BP methodology for pooling should be applied, as necessarily modified in accordance with this decision. Finally, the undersigned finds that implementation of the uniform rate requirement has been set for hearing in this proceeding and further accepts the position of the parties as set forth in the TAPS Carriers' unanimous motion for partial summary disposition.

821. However, the undersigned further finds that there are certain preliminary steps the parties should take in the process of developing a uniform rate. These steps are further addressed in the Initial Decision below, and include holding mandatory Rule 601 conferences, which may include holding technical conferences, to attempt to agree upon a uniform rate early in the process after a new proceeding has been initiated seeking to change the uniform maximum rate already in effect. The Commission should require certain progress be made in a Rule 601 conference prior to ordering normal settlement and/or hearing proceedings and the parties should submit progress reports to the Commission. The undersigned finds that the Commission had, in particular, a problem

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approach on this issue. Elements of return on investment include cost of debt, return on equity, AFUDC, deferred return, and income tax allowance (*see* BPPA IB., at 2, n.4; APC Pre-Hearing BR., at 6).

<sup>50</sup> BPPA IB., at 38. Moreover, Mr. Wetmore, whose approach to cost pooling excludes costs of debt, conceded this point at hearing (Tr. Vol. 9, at 1198-1199).

<sup>51</sup> The undersigned considered a range from zero to one hundred percent, and the Commission may if it adopts this sliding scale approach, determine another percentage is warranted. The undersigned decided on 50% because this figure appears to be a suitable compromise which balances the Carriers economic interests, future investment interests, and market forces and competition on TAPS.

with the latest multiple individual filings of the TAPS Carriers which covered varying time filing periods. The undersigned finds that early collaboration of the parties would be efficient and more in line with what the undersigned finds the Commission has previously ordered the parties to accomplish.

## **B. Cost of Capital Issues**

822. As indicated, all cost-of-capital issues have been resolved by a joint stipulation of all participants in this proceeding (Exhibit No. JPS-1). Initially, the parties declined to produce additional evidence to address these issues, and withdrew their pre-filed and offered exhibits involving this issue. The undersigned initially attached the cost of capital issues exhibits to the record as withdrawn exhibits pursuant to the Chief Judge's OALJ Manual requirements and took administrative notice that some of these exhibits relate to the pre-filed exhibits filed with the Secretary's Office in this case. However, finding this insufficient, the undersigned re-opened the record on December 2, 2010, and admitted the previously withdrawn exhibits; admitted Staff's exhibits (which had not been initially offered at the hearing), and admitted joint comments submitted by the parties in support of the stipulation. This evidence provides sufficient factual support to evaluate and adopt the stipulation.<sup>52</sup>

823. In the stipulation the parties mutually resolve all pertinent cost of capital issues including the nominal rate of return on equity, real rate of return on equity, inflation rate, cost of debt, and capital structure issues in this proceeding, as described below, for purposes of calculating the cost of service. The participants stipulate that the following cost of capital agreements resolves all issues pertaining to cost of capital. The parties stipulate that the nominal and real rates of return on equity, inflation factor, cost of debt, capital structure, and nominal and real weighted average cost of capital set forth in the table below in this Paragraph 1 (collectively, the "Cost of Capital Values") are fair and reasonable, are otherwise in accordance with the Interstate Commerce Act, and shall be used for purposes of calculating the cost of service applicable to the rate filings of the TAPS Carriers in this consolidated docket:

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<sup>52</sup> The joint stipulation is in evidence as Joint Parties' Stipulation (JPS), Exhibit No. JPS-1.

Nominal <sup>53</sup> Rate of Return on Equity	Inflation Factor	Real Rate of Return on Equity	Cost of Debt	Capital Structure	Weighted Average Cost of (Equity) Capital
11.51%	1.05%	10.46%	6.16%	53.07% (Debt) 46.93% (Equity)	Nominal: 8.67% Real: 8.18%

824. The parties further agree that this Stipulation resolves all controversies between them regarding the Cost of Capital Values in this proceeding (including, but not limited to, any arguments regarding the effect, if any, of master limited partnership oil pipeline proxy companies on the nominal or real rates of return on equity in this proceeding). The parties further agree that this Stipulation shall be offered to the undersigned by the participants as a fair and reasonable offer as to what the Cost of Capital Values in this proceeding should be. The parties further request that the undersigned incorporate the Cost of Capital Values agreed upon by the parties into the Initial Decision.

825. The participants further stipulate that interim refunds due pursuant to the Stipulation shall be paid, with interest at the rate specified in 18 C.F.R. § 340.1(c)(2) (2010) of the Commission's Regulations calculated from the date rates were paid until the date interim refunds are made. The parties further agree that the TAPS Carriers shall submit a compliance filing calculating interim refunds as directed by the Commission in its order on the Initial Decision in this phase (the non-SR phase) of this proceeding and pay interim refunds as directed by the Commission upon the Commission's approval of the compliance filing.

826. The parties also stipulate that they shall seek to expedite the filing of the compliance filing or payment of interim refunds beyond what is agreed to in the Stipulation. Furthermore, in the event that the rate level used to calculate interim refunds is lower than the rate the TAPS Carriers are ultimately found to be permitted to charge, the parties further agreed that the TAPS Carriers have the right to obtain from shippers, whether by lump sum payment or a prospective surcharge, any amounts paid in interim refunds above what the TAPS Carriers would have been required to pay in refunds under the rate ultimately determined to be appropriate. By agreeing to the above lump sum payment/surcharge provision, no party may be said to necessarily agree that such an eventuality will occur in this case.

827. The parties further agree that this Stipulation is intended to amicably resolve their differences regarding the Cost of Capital Values for the purpose of avoiding the burdens

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*Id.*

and risks of litigating those issues. Nothing in the stipulation is intended to reflect any admission regarding the merits of the respective cases of any of the parties. The stipulation further sets forth that all discussions took place within the context of settlement discussions, and the parties agree that such discussions are confidential in accordance with the applicable sections of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission and the Federal Rules of Evidence. The parties agree to maintain the confidentiality of those discussions in accordance with these rules.

828. The parties agree they would not take a position in the hearing that is contrary to the stipulation and would not assist any other entity or individual in taking such a position. The parties also agree that the stipulation is solely for the purpose of settling this proceeding, and that nothing in the stipulation restricts them from taking any position or other lawful action, or making any filing in any future proceeding regarding the Cost of Capital Values. Furthermore, the parties agree that the stipulation does not resolve or establish any substantive or procedural precedent with respect to any future proceeding.

829. The undersigned accepts the stipulation and finds it is in the public interest. The stipulation is a result of combined efforts by the parties to ultimately establish a just and reasonable uniform rate which essentially resolves and settles if accepted by the Commission, the outstanding cost of capital issues in this proceeding. The undersigned finds the position of FERC Staff, which strongly endorsed this stipulation, to be very probative in reaching a conclusion that the stipulation will help achieve just and reasonable rates. The undersigned therefore adopts the stipulation as the findings of the undersigned pertaining to the Cost of Capital issue(s).

### **C. Pooling Issues<sup>54</sup>**

#### **1. Discussion of Parties' Positions and General Findings Regarding the Proposed Costs Pooling Mechanisms and How They Manage/Determine Certain Costs.**

830. The principal issue remaining to be resolved in this proceeding before the undersigned, is how best to “develop a pooling mechanism that reallocates all of TAPS Carriers’ costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS,” in accordance with the Commission directives.<sup>55</sup> The

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<sup>54</sup> As indicated, not all of the parties agreed initially that the Commission has jurisdiction to order a pooling under the circumstances of this case. The issue has been on appeal, but as discussed below has been recently ruled upon in the Commission’s favor by the Court of Appeals for the District of Columbia.

<sup>55</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,317, at P 42 (2009) (“2009 Rehearing Order”). On December 3, 2010, the Court of Appeals for the District of Columbia denied all pending issues before it, either on the merits or because the issue(s) were not ripe for adjudication; *Flint Hills Res. Alaska, LLC v. FERC*, No. 08-1270, *et al.*, U.S. App.

purpose of such a mechanism is to prevent Carriers from over- or under-recovering their costs under the uniform tariff. An early evaluation of the issue surrounding the choice for which proposed model offered by the parties to implement the pooling mechanism is appropriate because it is so interrelated with the determination of what costs should be included. As to the specifics of each mechanism, a central question is whether the return on equity and other return elements should be included in the cost allocation mechanism?

831. All participants that have taken a position on the pooling arrangement to be established in this proceeding agree that the interstate portion of fixed operating expenses incurred by Alyeska on behalf of the TAPS Carriers, State ad valorem taxes and depreciation should be pooled. There is substantial disagreement among some of the parties as to what other items should be included in that pooling and some of the parties have changed positions on some of the items for inclusion.

832. Therefore, the pooling issue is the major issue of disagreement in this case. As a general matter, pooling is an issue that affects only the TAPS Carriers, because pooling involves the reallocation of costs among the TAPS Carriers and has no direct effect on the rates paid by shippers. However, Anadarko (a non TAPS Carrier) alleges it is impacted by the pooling mechanism in multiple ways, including the impact it may have upon competition on TAPS. The parties vehemently disagree as to which methodology should be used, what cost items should be included in pooling, and the effective date. The most contentious issue relates to whether return on investment costs should be included. BPPA, KAPCO and Unocal all favor inclusion of return on investment. The other parties are opposed.

833. There is likewise, disagreement over whether intrastate costs and Carrier-direct costs should also be included. All of these issues are interrelated, and it is critical to adopt the best model to implement the costs which the undersigned finds should be included. The undersigned finds that the appropriate pooling mechanism is one that pools and reallocates costs among the Carriers in an equitable manner. That being said, there are three methodology proposals submitted: one by BPPA, one by ConocoPhillips and one by Anadarko, which advocates for adoption of the ConocoPhillips proposal with some modification. However, Anadarko changed its position at the hearing regarding one major cost item and now seeks to exclude intrastate costs, rendering its proposed modified model moot. The major difference between the proposals is BPPA's position to include return on investment. BP's model includes return, the CPTAI model does not.

834. As discussed more fully below, the undersigned accepts in part, the BPPA proposal to include return on investment, and chooses its implementing model as being the most appropriate for use. While more complex than the ConocoPhillips model, it is

completely severable (can add or subtract cost elements) and is better situated to accomplish the all inclusive approach which the Commission has directed (Tr. Vol. 6, at 815-817 (Haines)). The undersigned further adopts the BP model because the CPTAI model does not sufficiently account for inclusion of return on investment elements, which the undersigned has included in the pooling mechanism.

835. Regarding the position of other parties, the State of Alaska offered no evidence at the hearing on the pooling issue and indicated its principle concern was that any pooling scheme be structured in a manner that preserves incentives for the TAPS Carriers to compete against each other for shipments of oil from non-affiliated shippers. The State would not like to see a pooling mechanism which includes return, as proposed by BPPA. At a minimum the State argues that the TAPS carriers should not be allowed to pool any portion of their return and that they not be allowed to pool Carrier-direct costs other than the State's ad valorem tax.<sup>56</sup>

836. EMPCo indicated it had reviewed the pooling proposals that were advanced in direct testimony by BPPA and CPTAI, and submits that each proposal contains some terms that foster equitable pooling among the Carriers, but that neither proposal, standing alone, achieves this goal. EMPCo points out that some substantive terms and conditions of the pooling mechanism are not in dispute at this time, including the pooling and reallocation of the interstate related fixed operating expenses incurred by the TAPS Carriers' agent in the operation and maintenance of TAPS, Alyeska Pipeline Service Company, Alaska ad valorem (property) taxes, and depreciation expenses. With respect to the issues that are in dispute, EMPCo supports BPPA's original exclusion of Carrier-direct costs<sup>57</sup> from the pooling mechanism; BPPA's inclusion of intrastate costs in the pooling mechanism; and CPTAI's exclusion of return on investment from the pooling mechanism.

837. Accordingly, EMPCo submits that the undersigned should direct the TAPS Carriers to enter into a pooling agreement that pools and reallocates all of the TAPS Carriers' costs but that does not pool Carrier-direct costs or cost of capital (return on investment) elements. Finally, EMPCo submits that the appropriate effective date for the pooling mechanism is January 1, 2009, the first day on which the previously effective (and now expired) pooling mechanism in Section II-2(f) of the TAPS Settlement Agreement (TSA) was no longer in effect.<sup>58</sup>

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<sup>56</sup> SOA IB., at 3-12.

<sup>57</sup> As discussed more fully below, BPPA now would propose or at least not object to including Carrier-direct costs, although its Initial Brief still advocates, somewhat half-heartedly, for exclusion of these costs.

<sup>58</sup> EMPCO IB., at 7-8. By way of background it is important to note that pooling of expenses among the TAPS Carriers has actually occurred on TAPS since 1985, within the

838. To summarize, the Commission ordered that costs be pooled based upon usage because of the Commission's requirement in Opinion 502 that the TAPS Carriers calculate their rates on a uniform basis. The purpose of the pooling mechanism is to ensure that Carriers' do not over- or under-recover their costs.<sup>59</sup> Achieving this goal is critical for the future, long-term operation of TAPS. The Commission clearly recognized the impact its order placing a uniform rate upon the Carriers would have, and ordered implementation of a pooling mechanism to expressly mitigate against the over- and under-recovery of costs, which it expected to flow from the imposition of a uniform rate.

839. The Commission recognized that throughput on TAPS has fallen below capacity and the pipeline is undersubscribed, which creates a situation in which some TAPS Carriers will transport a percentage of TAPS throughput that is greater than their respective ownership percentages in TAPS and others will transport less throughput than their respective ownership percentages.<sup>60</sup> In that situation, absent a pooling mechanism, TAPS Carriers will over- or under-recover their costs.<sup>61</sup> The Commission ordered "that the TAPS Carriers . . . develop a pooling mechanism that reallocates all of TAPS Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS."<sup>62</sup>

840. The undersigned essentially finds that both the ConocoPhillips and BPPA proposals have benefits and problems, but both generally can accomplish the purposes set forth by the Commission (Exhibit No. EM-1; EM-3, at 5 (Ray)). Although there is substantial dispute between the parties as to which should be adopted and in what format, the undersigned finds the CPTAI model is simply not suitable to implement the included costs consistent with the undersigned's findings.

841. While noting the BPPA proposal is more complex, the undersigned finds the BPPA Cost Allocation Mechanism achieves the Commission's objectives more

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TAPS Settlement. In approving pooling on TAPS in 1985, the Commission applied two tests. First, the Commission found that the pooling method was in the interests of better service to the public or economy of operation. Second, it determined that the pooling method did not unduly restrain competition (Exhibit No. CPT-5). In 1985, the Commission applied those two tests and approved pooling based upon Section II-2(f) of the 1985 TAPS Settlement Agreement. The Section II-2(f) pooling mechanism pooled both interstate and intrastate operating expenses and depreciation. The Section II-2(f) pooling mechanism did not pool return or Carrier-direct costs.

<sup>59</sup> *Id.* The Commission has clarified that a Carrier may charge less than the uniform rate. See *BP Pipelines (Alaska) Inc.*, 129 FERC ¶ 61,211, at P 31 (2009).

<sup>60</sup> *BP Pipelines (Alaska) Inc.*, 125 FERC ¶ 61,215, at P 37 (2008).

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

efficiently. It more accurately reflects how actual costs are incurred on TAPS (through Alyeska, on an ownership basis), and it accurately reflects how such costs are recovered under tariff ratemaking principles (on a distance and non-distance basis). The undersigned finds that the cost pooling mechanism BPPA proposes in this proceeding<sup>63</sup> complies with the Commission's directions regarding how the TAPS Carriers should pool their costs.

842. Regarding the inclusion of return, the undersigned substantially agrees with BPPA that without including return, there will eventually be severe financial distress upon TAPS.<sup>64</sup> However, as indicated above, the undersigned recommends using a sliding scale approach and capping the inclusion of return at 50% for the remaining equity elements: return on equity, deferred return, and income tax allowance.<sup>65</sup> This balance will preserve some of the other viable economic incentives to assure some degree of future competition on TAPS. BP's 100% inclusion for all return on investment elements will unduly restrain any potential for future competition on TAPS, and this position is rejected by the undersigned.

843. In evaluating the evidence, BPPA has extensively argued that inclusion of return in BPPA's Cost Allocation Mechanism will not impact interstate competition in the foreseeable future, and the undersigned accepts this argument, in part. BP cites Exhibit No. BPP-5HC, at 14-20, as evidence in support of this premise. It claims that producers that are vertically integrated with a TAPS Carrier supply almost all of the interstate barrels shipped on TAPS (Exhibit No. BPP-1, at 8; Exhibit No. BPP-5, at 10). Each of those vertically-integrated shippers has strong economic incentives to nominate its barrels to its affiliate Carrier (Exhibit No. BPP-1, at 20-22 and BPP-5HC, at 10, 15-16).

844. According to BPPA, its witness, Dr. Cameron, demonstrates through her study that there remains only an insignificant volume of available throughput for which any Carrier can compete (Exhibit No. BPP-44HC, at 8-16). BPPA claims she shows that the BPPA Cost Allocation Mechanism would provide each Carrier with appropriate incentives for investing in TAPS while the alternative cost pooling mechanism presented by ConocoPhillips, which would exclude return on investment from the cost pool, would provide inappropriate incentives for investing in TAPS and contravene the Commission's requirement that the cost pool include all elements of cost, including the cost of capital (Exhibit No. BPP-44HC, at 10, 27-30).

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<sup>63</sup> BPPA's Cost Allocation Mechanism is attached to the direct testimony of Mr. Haines as Exhibit No. BPP-11HC.

<sup>64</sup> The individual cost elements, including return on investment will be discussed more fully in the following sub-sections of this decision.

<sup>65</sup> Costs of debt and AFUDC should not be subject to the sliding scale approach and are included at 100% because these costs are firm, fixed costs, not related to the Carriers' profit margins.

845. BPPA argues further that Dr. Cameron based her conclusions regarding the impact pooling return would have on a study of competition for interstate throughput on TAPS (Exhibit No. BPP-5HC, at 14-20; Exhibit No. BPP-44HC, at 8-16). BP argues that all parties who oppose including return (ConocoPhillips, Staff, the State of Alaska, ExxonMobile and Anadarko) claim that FERC should exclude return because otherwise it will impede competition (Exhibit Nos. CPT-24HC, at 32-46, CPT-12, at 38-43; APC-18, at 10-12, 16-18; and EM-3, at 9). BP notes that while they argue that including return in a cost pool for the TAPS Carrier would harm competition, the witnesses they presented did not provide any evidence of real competition to rebut Dr. Cameron's study or her conclusions (*See* Exhibit No. BPP-44HC, at 3-5).<sup>66</sup> Moreover, BP argues that in no instance will shippers on TAPS be charged more than the just and reasonable uniform tariff under Opinion 502.

846. BP takes the position that return elements are costs the Commission ordered the TAPS Carriers to pool. As shown by BPPA's witness, Mr. Van Hoecke, in his reply testimony, the Commission's decisions make it clear that the cost of capital and other return elements are costs, which should be included in pooling (Exhibit No. BPP-58, at 8-11). BPPA further argues that Dr. Cameron shows in her testimony that, from an economic perspective, return is clearly a cost (Exhibit No. BPP-44, at 36-38). As such, return elements are manifesting costs that should be included in the Commission mandated "all-inclusive" cost pool.

847. As Mr. Van Hoecke for BP explains, the fact that the requirement that the TAPS Carriers pool their costs was intended to prevent the TAPS Carriers from under-recovering or over-recovering their costs as a result of the Commission's adoption of a uniform rate requirement for the TAPS Carriers (Exhibit No. BPP-58, at 29-37, 49-50). Mr. Van Hoecke demonstrates that, unless return is included in the cost pool, some TAPS Carriers (primarily ConocoPhillips) will be in a position to substantially over-recover their costs while others will be forced to under-recover their costs (including BPPA), thus thwarting the Commission's objective in ordering cost pooling (Exhibit No. BPP-14, at 8-13). BPPA asserts that CPTAI's efforts to avoid the Commission's Order that the TAPS Carriers pool all costs by claiming that the cost of capital and the other return elements are not costs, are simply invalid and not supported by evidence in the record.

848. Regarding other costs, BPPA further asserts that the Commission's pooling orders require that the cost pooling mechanism include all costs and do not distinguish between interstate and intrastate costs, thus intrastate costs should be included. It asserts that BPPA, KAPCO, EMPCo, and Anadarko (initially) all support including interstate and

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<sup>66</sup> Although, it is apparent from the undersigned that experts Dr. Hieronymus and Mr. Wetmore have opposing views to many of BP's arguments.

intrastate costs in the cost pool (Exhibit No. KAP-1, at 4;<sup>67</sup> Exhibit No. EM-3, at 9; Exhibit No. APC-18, at 19-20). CPTAI was initially the only participant that proposed to exclude intrastate costs from the cost pool (Exhibit No. CPT-6, at 6).

849. Moreover, BPPA asserts it has shown through the testimony of Mr. Haines that ConocoPhillips witness Mr. Wetmore's proposed approach to cost pooling in Exhibit No. CPT-8 is flawed because, while the mechanism attempts to allocate only interstate costs, it then distributes those costs among the TAPS Carriers on the basis of interstate and intrastate volumes (Exhibit No. BPP-34, at 5-9), resulting in skewed results. BPPA further argues Mr. Wetmore attempts to excuse this error by arguing that allocating interstate costs on interstate barrels alone would give unreasonable results (Exhibit No. CPT-33, at 40-41). However, BPPA argues that the solution is to allocate total costs—both interstate and intrastate—on the basis of total volumes, not to adopt a mechanism that mismatches costs and throughput based upon a knowingly flawed approach which produces a result more in line with expectations ConocoPhillips wants to see.

850. The following chart from Anadarko's Pre-Hearing Brief<sup>68</sup> summarizing the positions of ConocoPhillips, BP, and Anadarko in this proceeding prior to the hearing and compares those positions. As indicated, during the hearing, BPPA indicated it would now consider including Carrier-direct costs, while Anadarko did an about face and now argues intrastate costs should not be included in the pooling mechanism. Moreover,

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<sup>67</sup> BPPA asserts KAPCO supports BPPA's approach to cost pooling, except with respect to the effective date. This appears to be a correct view as to Koch's position (KAPCO IB., at 2). Moreover Unocal supports BP's position to a large extent, but clearly wants Carrier-direct costs included. BP asserts these costs have a de minimis impact to the pooling mechanism, which is one reason BP initially excluded them (UPC IB., at 10, 14-15; BP IB., at n.6). However, Anadarko had a change of position and argued at the hearing that intrastate costs should not be included in the adopted pooling mechanism (Tr. Vol. 9, at 1359 (Brena)). The difficulty of assessing a resolution in this case is apparent as even the parties continue not only to disagree, but to change their positions as to what should be in a pooling mechanism. In this regard, BPPA has also indicated through the cross-examination testimonials of Mr. Coulson and Mr. Haines, that BPPA would no longer object to including the other Carrier-direct costs in its proposed pooling formula, if its methodology is adopted (BP IB., at 46). It is also apparent that BP's position was not crystal clear to all parties regarding inclusion of the variable costs incurred by Alyeska, as BP asserts it has included these costs in its model, although it acknowledges these are also de minimis costs (*see* BP RB., at 34).

<sup>68</sup> APC Pre-Hearing Br., at 6. BP only half-heartedly argues in its Reply Brief that Carrier-direct costs should not be pooled (BPPA RB., at 33). The BP model can readily add Carrier-direct costs. With the inclusion of a portion of return, intrastate costs and Carrier-direct costs, the undersigned finds the BP model is the best model which can most efficiently be used.

KAPCO, which was not included in Anadarko's chart, seems to have changed its position regarding inclusion of Carrier-direct costs.

	<b>CPTAI</b>	<b>BPPA</b>	<b>Anadarko</b>	<b>1985 FERC Approved Pooling Agreement</b>
Variable Operating	Yes	Yes	Yes	Yes
Fixed Operating Expenses	Yes	Yes	Yes	Yes
Depreciation (return of investment)	Yes	Yes	Yes	Yes
Return (return on investment)**	No	Yes	No	No
Owner Direct Costs	Yes	No	No	No
Intrastate Costs	No	Yes	Yes	Yes
* Variable operating expenses are not included in the proposed pooling mechanisms because such costs already are being allocated based on usage pursuant to Section 11.4 of the TAPS Operating Agreement. <i>See</i> Falcone, Exhibit No. CPT-1, at 7 (lines 3-5, 10, 12-15).				
** Includes debt cost, return on equity, amortization of AFUDC, deferred return, and related income taxes.				

851. As indicated above, the third proposal offered by Anadarko, involved an initial recommendation to adopt and modify ConocoPhillips' pooling mechanism to include both interstate and intrastate expenses, and to exclude Carrier-direct costs. Anadarko initially argued that once modified in this fashion, ConocoPhillips' pooling mechanism would be entirely consistent with the Commission's approach and holdings when it last considered pooling for TAPS in 1985. Since, the undersigned has decided to include some portion of return, and because Anadarko has changed its position as to what should be included in the pooling mechanism, this modified approach is not warranted.

852. Furthermore, Anadarko's initial position seemed to mirror in large part that the undersigned should accept a pooling arrangement similar to the original pooling mechanism contained in the TSA, but as indicated above, that changed somewhat at the hearing, as intrastate costs were in the TSA. ConocoPhillips seems to embrace that notion as well, as does EMPCo. However, as is now evident, BPPA, ConocoPhillips and Anadarko, have all supported positions which deviate to some degree from the TSA contained pooling provision. Thus, while the undersigned initially found it comforting to rely on the previous TSA as being probative in this case, in large part because the parties had actually reached some consensus there, due to changed circumstances since the TSA was agreed to and the shifting positions of the parties, looking to the TSA as a model has only minimal probative value here.

853. The undersigned finds merit in BPPA's argument that cost pooling should be done in accordance with BPPA's Cost Allocation Mechanism, as presented by Mr. Haines (Exhibit No. BPP-11HC). As Mr. Haines further explains, the Cost Allocation Mechanism complies with the Commission's order that the TAPS Carriers should adopt a pooling mechanism that reallocates all of the TAPS Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS (Exhibit No. BPP-10, at 3).

854. The undersigned also finds probative, Mr. Van Hoecke's testimony that BPPA's Cost Allocation Mechanism allocates all of the TAPS Carriers' costs, including return elements, based on throughput or usage, in accordance with the Commission's directives (Exhibit No. BPP-14, at 5). Mr. Van Hoecke also explains, as discussed previously, that BPPA's mechanism properly aligns costs with usage and, accordingly, will prevent Carriers from under-recovering or over-recovering their costs.

855. BPPA relies on Dr. Cameron's testimony for support that BPPA's Cost Allocation Mechanism provides each TAPS Carrier with an opportunity to earn a fair return on its investment in TAPS and eliminates incentives for under-investment and over-investment (Exhibit No. BPP-5HC, at 7-14). Dr. Cameron argues that she opines that BPPA's mechanism is in the interest of better service to the public as well as economy of TAPS operations, and would not unduly restrain competition (Exhibit No. BPP-5HC, at 14-20).

856. As indicated, the only real separate alternative mechanism presented in this proceeding is that sponsored by CPTAI through its witness, Mr. Wetmore (Exhibit No. CPT-8). Mr. Haines explains that for a cost pool to allocate costs on the basis of usage, as the Commission directed, the cost pooling mechanism must accurately reflect (i) how costs are incurred initially by the TAPS Carriers; and (ii) how costs are recovered on a usage basis through tariff ratemaking (Exhibit No. BPP-34, at 3). Mr. Haines argues that the CPT-8 Model inaccurately identifies how costs are initially incurred by the TAPS Carriers and misapplies the level of usage by the TAPS Carriers.

857. Mr. Van Hoecke shows that, even if the CPT-8 Model were revised to correct the errors that Mr. Haines identified, the CPT-8 Model would still result in some TAPS Carriers under-recovering their cost of service and other TAPS Carriers over-recovering their cost of service because the CPT-8 Model does not include the cost of capital in the cost pool (Exhibit No. BPP-41, at 7-10). Moreover, as demonstrated by Unocal, the model would not allow Unocal to adequately recover its Carrier-direct costs (Tr. Vol. 9, at 1241-1269 (Wetmore)). Accordingly, while it may generally fulfill the objective that the Commission established for cost pooling, use of the BPPA Model is more appropriate when the pooling mechanism adopted is more inclusive, especially where as here, the undersigned has included a portion of return on investment.

858. Evaluating the effective date for pooling, BPPA proposes that its cost pooling mechanism be effective as of January 1, 2005 and accordingly has included an adjustment for the years 2005-2008 (Exhibit No. BPP-1, at 24; Exhibit No. BPP-10, at 22-23). It argues that commencing cost pooling as of January 1, 2005 is consistent with the Commission's directive in the 2008 Rehearing Order that cost pooling should be effective from the date when the uniform rate becomes effective.<sup>69</sup>

859. BPPA's Cost Allocation Mechanism achieves this result by reallocating 2005-2008 costs on the basis of usage (Exhibit No. BPP-10, at 22-23). BP's alternative proposal argues that if the cost pooling adjustment is not made effective from 2005 forward, it should be effective no later than January 1, 2009, which is the position the undersigned accepts. EMPCo presented testimony supporting a January 1, 2009 effective date, which would coincide with the termination date of the TSA (Exhibit No. EM-3, at 10). BPPA admits that having cost pooling be effective from January 1, 2009 finds some support in the 2009 Rehearing Order.<sup>70</sup> As discussed more fully below, the undersigned accepts this later position as being consistent with the Commission's orders, since the undersigned finds the TSA was controlling prior to this date, and those costs have already been finalized and allocated.

## **2. Cost of Debt and AFUDC Should be Pooled; The Remaining Return-Related Cost Elements Should be Pooled Using a Sliding Scale Approach.<sup>71</sup>**

860. The undersigned finds that return-related elements should be pooled, but that only cost of debt and AFUDC elements should be pooled at 100%. These are real and fixed costs not associated with profit margins of any Carrier. The other equity return elements which relate to operational efficiency and profit, including deferred return, return on equity, and income tax allowance, should be pooled on a sliding scale approach. The undersigned finds this inclusion using a sliding scale approach is necessary to prevent substantial over- and under-recovery of costs, lessen the financial distress upon TAPS, but still balance other vital economic interests, such as preserving market forces and competition.

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<sup>69</sup> BPPA IB., at 47-48.

<sup>70</sup> *Id.*, at 48.

<sup>71</sup> Elements of return on investment include cost of debt, AFUDC, return on equity, deferred return, and income tax allowance (*see* BPPA IB., at 2, n.4; APC Pre-Hearing BR., at 6). Koch agrees with BPPA's analysis to include return on investment arguing through its expert witness, Mr. Hoover, that including return elements in the pooling model will not harm competition and better addresses the disproportionate incentives and risks of the TAPS Carriers (*see* KAPCO Pre-hearing Br., at 3; KAP-1; KAPCO RB., at 2-5). The undersigned finds Mr. Hoover's testimony to be probative, but as indicated finds competition would likely be harmed if all return elements are included at 100%. Unocal also favors inclusion of return (UPC IB., at 10; Staff RB., at 12).

861. The undersigned relies heavily on Mr. Coulson's and Mr. Van Hoecke's testimony in reaching this finding, and to some extent Dr. Cameron and Mr. Haines. The undersigned finds that the record supports the remaining equity return elements be pooled at only 50% at the present time. The evidence at the hearing established that a compromise approach is needed to balance the economic impacts upon all TAPS Carriers and shippers, and the impact upon potential competition. Using a sliding scale approach allows further adjustments, upward or downward in future proceedings, if circumstances change.

862. The undersigned finds merit in BP's argument that the Commission has acknowledged that any new pooling mechanism should be more inclusive than the one contained in the original 1985 TSA. Including some percentage of return on investment is necessary to address the disproportionate financial incentives and risks of some of the TAPS Carriers, including BP Alaska. BP should have an opportunity to recapture the costs incurred for investing in TAPS. Because of the uniform rate requirement, some Carriers, including BPPA at this time, will always under-recover their costs unless some return on investment is included in the pooling mechanism. While certainly this may be attributable in part to business decisions made by BP, as advocated by Anadarko and its expert, Mr. Brown, this will eventually impact future investment decisions in TAPS (Exhibit No. BPP-32, at 2; Exhibit No. BPP-43, at 1-10). The undersigned finds the Commission has expressly ordered some mitigation to the Commission's uniform rate requirement should be afforded through a pooling mechanism, and including return elements provides the most comprehensive means to achieve the directives pronounced by the Commission in Opinion 502.

863. Mr. Coulson's testimony supports this finding. He testified that the distinction and reason why a new pooling mechanism must include return elements is tied directly to the fact that the Commission has determined that a uniform rate is necessary (Exhibit No. BPP-32, at 2). Opinion 502 was not the law of the land when the Carriers implemented the pooling mechanism in the TSA. The evidence presented by both BPPA's expert Van Hoecke as well as Conoco Phillips' expert Wetmore, establishes return is indeed a cost of doing business, although Mr. Wetmore views it as a cost that should not be included in pooling (Exhibit No. BPP-106; Tr. Vol. 7, at 965-966 (Van Hoecke); Tr. Vol. 9, at 1177-1197 (Wetmore)). Both Coulson and Van Hoecke describe the negative impact upon BP, not including return would have. The evidence supports a finding that return on investment are legitimate costs which warrant consideration for inclusion in any new pooling mechanism, and that the circumstances of TAPS warrant inclusion at this time, in the percentage found by the undersigned.<sup>72</sup>

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<sup>72</sup> The return on investment issue is an area of great disagreement by the parties. As discussed more fully herein, the undersigned finds, using a sliding scale approach, that 50% of the TAPS' Carriers' return on investment, relating to equity return items should

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be pooled. Cost of debt and AFUDC should be included at 100%. This will help balance the need for economic viability and the need to allow the TAPS Carriers to maintain market forces, competition and economic incentives. The record supports this limited inclusion of return (Tr. Vol. 7, at 940-948) (for example, Mr. Van Hoecke discussing financial distress upon BPPA and perhaps other Carriers if return is not included); and, (Tr. Vol. 9, at 1322-1325) (Mr. Wetmore discussing impact upon Anadarko and independent shippers and loss of competition incentives completely if all return is included in pooling). While probative, both witnesses' opinions in response to questions by the undersigned attempting to quantify real world impact were vague; they preferred to speak in terms of economic incentives rather than to quantify the results of what including return elements in pooling would mean to each TAPS Carrier and other intervenors. Other probative testimony came from Dr. Hieronymus' response to questions at the hearing, who more elegantly described the balancing of economic incentives involved with pooling, and the issue of return. He recognized the need to have a compromise balance between the need for competition and the opportunity to be allowed to earn a sufficient return to continue to encourage investment in TAPS (Tr. Vol. 8, at 1138-1140 (Hieronymus)). While neither witness Van Hoecke nor Wetmore would offer much insight into where on the economic continuum a balance might be achieved, both finally conceded to some degree that at least a 50% return inclusion would strike some balance for BPPA while still preserving some incentive for competition (Tr. Vol. 7, at 964 (Van Hoecke); Tr. Vol. 9, at 1315-1316 (Wetmore)). In its Initial Brief, BPPA cites to a more extensive analysis based upon the current record to show the effect of pooling upon the TAPS Carriers based upon a partial inclusion of return. While the undersigned does not adopt that specific approach offered by BPPA in its Initial Brief, the analysis provides additional support for the undersigned's findings that partial inclusion of return will significantly lessen BP's under-recovery. BP's analysis, deemed the middle ground approach, includes a cost pool of all return on equity attributable to investment after 2008, but excludes some portion of return on equity attributable to plant investment in place as of year's end in 2008. It also includes debt costs from both periods, which as indicated, the undersigned largely accepts. Its analysis concludes such partial pooling of return would still result in under- and over-recovery by the TAPS Carriers; although, arguably a much better result than if no return was pooled at all (BP IB., at 34-36). For parties like Anadarko and the State of Alaska, the ability to have some competition on TAPS is crucial (Tr. Vol. 9, at 1351-1359 (Brena Opening Statement); Pre-Hearing Br. State of Alaska; APC IB., at 12-16); and that being said, there is some merit in Anadarko's argument that the pooling mechanism cannot completely overcome the result of BP's own business decisions on TAPS. The undersigned finds an economic balance is sufficiently maintained if only a portion of return is included. While the evidence supports BP's argument that there are few interstate barrels available to compete for on TAPS, as FERC Staff argues in its Initial Brief, this may be subject to change in the future and it is still important to encourage competition as a positive Commission policy, rather than require certain quantitative results, or ignore market

864. However, by not adopting BP's argument in full, the undersigned also finds persuasive in part, the arguments of Anadarko, EMPCo, ConocoPhillips, Staff, and the State of Alaska, that some degree of competitiveness must be preserved on TAPS and that inclusion of 100% in the pooling mechanism of all of the equity return elements, would reduce or eliminate potential future competition. For instance, the Commission in its Pooling Rehearing Order held that the TAPS carriers should:

[D]evelop a pooling mechanism that reallocates all of TAPS Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS. Beyond this, the Commission will not dictate the particulars of the pooling mechanism, as the TAPS Carriers, including BP, are in a better position to work out the details of such an arrangement themselves. The Commission will have an opportunity to consider the appropriateness of the pooling provision when it is submitted in the above-mentioned tariff filing.<sup>73</sup>

865. The undersigned finds the Commission language to be clear, that all costs are subject to consideration for inclusion in the pooling mechanism, including return, unless the Commission determines, presumably for good cause, certain costs warrant exclusion from the pooling mechanism.<sup>74</sup> As indicated, the undersigned finds that 100% of costs associated with cost of debt and AFUD should be included, and that, using a sliding scale approach, 50% of the remaining return equity costs should be included. This partial inclusion will maintain market forces and provide some incentive for potential competition on TAPS.

866. Pooling 100% of all return elements, as BPPA has proposed, would eliminate an opportunity for incentives for future competition among the TAPS Carriers. In attempting to find the proper balance, the undersigned has noted that the Commission has in the past looked carefully at all factors which serve the public interest, and in fact conducted such an analysis when it approved the original TAPS pooling mechanism, Section II-2(f), in 1985.<sup>75</sup> Section II-2(f), which BP supported, did not pool any return.

867. While the undersigned found the testimony of BPPA's witnesses Mr. Coulson, Mr. Haines, Dr. Cameron, and Mr. Van Hoecke to be probative, and largely persuasive in

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forces and competition completely (Staff IB., at 10).

<sup>73</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61,317, at P. 42 ("Pooling Rehearing Order" 2009); Exhibit No. BPP-107.

<sup>74</sup> As the above cited order makes equally clear, if the Commission determines it doesn't agree with the inclusion of a particular cost then it will make that determination in its final order, be that whether it holds to include all return costs, partial return costs, as found by the undersigned, or no return costs.

<sup>75</sup> *Trans Alaska Pipeline Sys.*, 33 FERC ¶ 61,064, at 61,140 (1985).

their description of the financial distress BPPA faces on TAPS, the undersigned is equally convinced that a balance can be achieved which maintains some level of competitiveness on TAPS. Maintaining incentives for efficiency and competition among the Carriers serves the public interest and the interest of independent shippers, as convincingly argued by Anadarko at the hearing (Tr. Vol. 9, at 1350-1360 (Brena)).

868. The undersigned additionally gives some probative weight to the position of the State of Alaska which vehemently supports competition as well.<sup>76</sup> While BPPA maintains there is no significant interstate competition, its President, Mr. Coulson admitted on cross-examination that the potential for future incentives for competition would be eliminated by including 100% of all return elements in the pooling mechanism (Tr. Vol. 3, at 290-293 (Coulson); CPT-48). The undersigned finds that the potential for future competition should be preserved.

869. Mr. Coulson further admitted that there is a degree of intrastate competition on TAPS, that could be impacted if 100% of all return elements is included in any pooling mechanism (Tr. Vol. 3, at 293 (Coulson)). Moreover, while describing the negative impact on potential investment in TAPS, which a non-inclusive pooling arrangement may produce, he also acknowledged that there is no known instance where failing to include return during the time period in which the TSA contained pooling mechanism was in effect, caused any discretionary investment spending project to be canceled, postponed, or otherwise eliminated (Tr. Vol. 3, at 24-248).<sup>77</sup>

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<sup>76</sup> SOA Pre-Hearing Br., at 2; SOA IB., at 12-18 (arguing no return on investment should be pooled and that its inclusion would violate Commission policy objectives and basic rate making principles).

<sup>77</sup> BPPA's position on return is largely based upon the testimony of its experts, Dr. Cameron, Mr. Coulson, Mr. Van Hoecke and Mr. Haines. The undersigned finds expressly that the current time is different from the 1985 time period when the TSA was executed. The undersigned finds Mr. Van Hoecke's analysis to be probative in support of the undersigned's limited findings relating to inclusion of return. He bluntly describes the financial distress BP will encounter without including return on investment elements in any new pooling mechanism. He opines in such a situation, ConocoPhillips will obtain an "economic windfall" and that BPPA will not have any opportunity to earn a return on investment (Exhibit BPP-14; BPP-58, at 34-36, Tables 2-4-2-6; Tr. Vol. 7, at 940-948 (Van Hoecke)). However, the undersigned finds Dr. Cameron's analysis on competition is not complete. She admitted her study is limited and does not address any time period beyond 2013 (Tr. Vol. 4, at 449-450). Moreover, while Mr. Coulson indicated he relied on Dr. Cameron's analysis, Dr. Cameron likewise indicated she based a great deal of her analysis on information derived from Mr. Coulson. Dr. Cameron's study, while somewhat probative is not a totally independent product. The study appears to be more of a collaborative effort by her and BPPA. It was certainly influenced and based upon Mr. Coulson's input and cannot be deemed to be as probative as it may have been had it

870. Although the circumstances are clearly different than they were in 1985, when the Commission approved the Carriers' original pooling method in 1985, the Commission recognized that the exclusion of return elements from the pooling mechanism served the public interest by promoting economy of operations, encouraging exploration, production, and throughput, and providing an incentive for the Carriers to compete to earn their return.<sup>78</sup> The Commission explained that the Section II-2(f) mechanism, which excluded return elements, "will provide the owners with an incentive to compete to earn their return."<sup>79</sup> Therefore, the undersigned finds that the compromise approach adopted in this Initial Decision clearly serves valid policy and economic concerns expressly pronounced and recognized by the Commission.

871. At the time, BP agreed with these principles. BP was a signatory to the TSA and supported the original Section II-2(f) pooling mechanism, which did not include the pooling of return. In their application for approval of the Section II-2(f) pooling mechanism, certain Carriers explained that not including pooling of return "would facilitate continued competitive behavior" and "serve as a spur to compete for additional

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been a totally separate and independent examination of the facts (Tr. Vol. 5, at 518, 531 & 566 (Cameron)). Furthermore, a former affidavit by Dr. Cameron which had been submitted to support a merger by BP and ARCO is moderately probative to show Dr. Cameron at one time more fully recognized the existence of interstate and intrastate competition on TAPS, than her current position portrays (Tr. Vol. 3, at 423-428 (Cameron)); CPT-27; *see also* CPT-26). Counsel for Anadarko and ConocoPhillips also established upon cross-examination of BP's witnesses that BP understated the impact upon competition its pooling proposal may have upon State of Alaska royalty transactions (Tr. Vol., at 552-557; Exhibit No. APC at, 91-95). Nevertheless, Dr. Cameron's testimony is deemed moderately probative to establish that there are multiple factors which place severe limits on the amount and quality of competition on TAPS. However, the undersigned finds it is clearly not authoritative, and does not support the undersigned reaching a conclusion that all interstate or intrastate competition on TAPS is not viable in the future. The undersigned also finds Dr. Hieronymus' testimony to be moderately probative in that while he recognizes the importance and necessity of competition on TAPS, he realistically knows there are limits. The undersigned's compromise approach is meant to maintain the potential for competition on TAPS, while equitably reallocating costs and reducing the financial distress upon BPPA and other Carriers. As indicated above, Mr. Van Hoecke and Mr. Wetmore evaded quantification of the return issue during questioning, but both admitted that there is a point on the continuum where some equitable balance can be achieved. BPPA's analysis in its Initial Brief and Mr. Van Hoecke's testimony provides additional support that the figure found by the undersigned is an equitable balancing of the economic interests involved in this case, at the present time.

<sup>78</sup> *Id.* at 22.

<sup>79</sup> *Id.*

traffic if throughput falls below mechanical capacity.”<sup>80</sup> In comments “fully support[ing]” this application, BP stated that, “[a]s shown in the application, the provision for which approval is sought will be conducive to better service to the public and economy of operation. Moreover, it will not unduly restrain competition.”<sup>81</sup>

872. While the situation is different now, these principles accord with a basic tenet of FERC ratemaking—that a pipeline owner has the opportunity to earn this return on its investment, but it is not guaranteed that it will actually recover a specific return.<sup>82</sup> While return is included in the cost of service used to compute just and reasonable rates, equity return differs from out-of-pocket costs spent to operate and maintain the pipeline, taxes, and depreciation. Return is also compensation which the pipeline has the opportunity to earn to compensate it for its investment in facilities that provide a regulated service.<sup>83</sup> Nevertheless, there is a cost associated with debt, AFUDC, equity return and a cost of investment, which all Carriers should have an opportunity to recover.

873. While the undersigned does not disagree with the basic policy arguments set forth in the Initial Briefs filed by FERC Staff and the State of Alaska, arguing for open competition, and against inclusion of any return in the pooling mechanism, the undersigned is convinced that without inclusion of some return, BPPA will have limited opportunity to recover its return on investment, and that this financial distress will eventually impact the efficient operation of TAPS at some point.

874. That being said, the purpose behind the pooling mechanism cannot be achieved without pooling some return elements. BPPA has demonstrated to the satisfaction of the undersigned that unless some return elements are included in the pooling mechanism, charging uniform rates will result in some TAPS Carriers substantially over-recovering their costs and others under-recovering their costs. BP argues that Mr. Van Hoecke’s

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<sup>80</sup> Exhibit No. APC-19, at 27-28 (Application of Certain Owners of the Trans Alaska Pipeline System for Approval under 49 U.S.C. Section 5(1) of an Agreement for the Reallocation of Certain Costs and Revenues, Docket No. OR78-1-000 (Sept. 3, 1985)).

<sup>81</sup> Exhibit No. APC-20 (Statement of BP Pipelines Inc. in Support of Application for Approval Under 49 U.S.C. Section 5(1) of an Agreement for Reallocation of Certain Costs and Revenues, Docket No. OR78-1-000 (Sept. 12, 1985)).

<sup>82</sup> *ISO New England, Inc.*, 130 FERC ¶ 61,108, at 61,501 n.14 (2010) (“[T]he Commission has no obligation . . . to guarantee Bridgeport its full traditional cost of service. Rather, . . . the Commission is responsible only for assuring that Bridgeport is provided the opportunity to recover its costs.”); *Pac. Gas & Elec. Co.*, 91 FERC ¶ 63,008, at 65,111 (2000) (citing *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Carolina Power & Light Co. v. FERC*, 860 F.2d 1097, 1098 (D.C. Cir. 1988)).

<sup>83</sup> Answering testimony of Mr. Brown on behalf of Anadarko (Exhibit No. APC-18, at 17-18).

answering testimony shows that an incomplete pooling mechanism, such as Mr. Wetmore's CPT-8 model, "results in certain Carriers, most notably CPTAI, over-recovering their costs and earning elevated returns at the expense of other Carriers" (Exhibit No. BPP-41, at 4).

875. Mr. Van Hoecke further presented evidence to establish that the BP model should be implemented. He showed that even after correcting for the computational errors Mr. Haines identified in the CPT-8 Model, that model—which excludes return elements—"still results in some Carriers ... over-recovering their costs and earning elevated returns at the expense of other Carriers" (Exhibit No. BPP-41, at 6).

876. Mr. Van Hoecke confirmed this analysis in his reply testimony: "unless you include the cost of capital in the pool of costs to be reallocated on a usage basis, there is an inherent mismatch between the cost used to develop the uniform rate that is collected by each Carrier on the basis of usage and the cost assignment that is based on each Carrier's ownership" (Exhibit No. BPP-58, at 31). Mr. Van Hoecke used 2009 actual costs to calculate and present in graphic form the effects on BPPA and CPTAI of (1) no cost pooling, (2) incomplete cost pooling under the CPT-8 model (after correcting computational errors), and (3) cost pooling under the BPPA Cost Allocation Mechanism. (Exhibit. No. BPP-58, at 33-36).

877. Mr. Van Hoecke's Table 3 (Exhibit No. BPP-58, at 34) illustrates the effects of no cost pooling, in which the system-average TAPS costs were \$3.69 per barrel, while CPTAI's total interstate costs per barrel were \$2.35 and BPPA's were \$5.20. Thus, in a uniform rate world and, with no cost pooling, CPTAI is under-contributing costs by \$1.34 per barrel, while BPPA is over-contributing costs by \$1.51 per barrel.

878. Mr. Van Hoecke's findings regarding the impact on CPTAI of no cost pooling are consistent with testimony CPTAI's Mr. Falcone gave on cross-examination. Mr. Falcone conceded that had CPTAI calculated an individual rate using the assumptions for its 2009 rate filing at issue in this proceeding (Exhibit No. BPP-85), it would have calculated an individual rate that is approximately \$1.34 per barrel lower than the system-average amount used in its rate filing, an amount identical to Mr. Van Hoecke's calculation in Table 3 (Exhibit No. BPP-105).

879. Further, Mr. Falcone conceded the amount of over-collection of revenues that would occur under the assumptions used in the CPTAI rate filing would cause CPTAI to over-collect by approximately \$118.6 million annually (Tr. Vol. 7, at 986 (Falcone)). That amount is remarkably close to the \$114.7 million of 2009 pooling payments assignable to CPTAI that was calculated by Mr. Haines' complete pooling mechanism in Exhibit No. BPP-11 (Tr. Vol. 7, at 988 (Falcone)).

880. Mr. Van Hoecke also showed that, under the CPT-8 model's partial cost pool (which pools operating expenses and depreciation but not the cost of capital) some TAPS Carriers would still over-recover their costs while others would under-recover their costs. Under the CPT-8 Model's partial cost pool, and considering interstate costs only (which CPTAI advocates), CPTAI's cost of capital per barrel would be \$0.51, while BPPA's cost of capital per barrel would be \$1.13 (Exhibit No. BPP-58, at 34-35) (after making corrections for computational errors in the CPT-8 model). Since the system-average interstate cost of capital per barrel was \$0.80, CPTAI would, under its approach to cost pooling, over-recover its costs by \$0.29 per barrel while BPPA would under-recover its costs by \$0.33 per barrel.

881. BPPA argues that no party demonstrated in reply testimony (responding to Mr. Van Hoecke's answering testimony) that there were flaws in Mr. Van Hoecke's calculations. Moreover, no participant showed through cross-examination of Mr. Van Hoecke that his analysis or his calculations were incorrect. The undersigned agrees that Mr. Van Hoecke's analysis is largely un-rebutted on this point, but also finds that the experts for Anadarko and ConocoPhillips have sufficiently provided probative testimony to establish that including 100% of all return elements in a pooling mechanism will provide other economic disincentives and impacts upon competition, which will also negatively impact the future operation of TAPS.

882. The undersigned agrees that unless some return elements are included in a cost pool, some TAPS Carriers will dramatically over-recover and some will under-recover and the pooling mechanism will largely fail to achieve what the Commission intended. While including 100% of all return elements in the pooling mechanism may arguably guarantee that all Carriers achieve a guaranteed return in proportion to their ownership interest, rather than provide an incentive for them to earn return by maximizing efficiency or competing for throughput, the modified sliding scale approach found by the undersigned to be appropriate for use here, will balance the competing economic interests in this case, and can be modified by the Commission in future proceedings, up or down as necessary.

883. In reaching these findings, the undersigned also carefully considered the position of Anadarko's expert witness Mr. Brown, who took a more narrow view testifying that excluding all return is necessary to achieve competition on TAPS. He opines that no return in the pooling agreement is necessary to encourage the Carriers "to more fully utilize capacity on TAPS by increasing exploration and production of oil on the North Slope which may, in turn, result in additional throughput and reduce rates."<sup>84</sup> Without guaranteed return, Carriers may seek to maximize throughput by offering rate discounts.<sup>85</sup>

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<sup>84</sup> *Id.* at 9.

<sup>85</sup> *Id.* at 17.

884. Mr. Brown explains that fostering competition on TAPS is more important today than it was in 1985, when the Commission originally approved pooling on TAPS.<sup>86</sup> At that time and for a period subsequent, TAPS operated at full capacity and there was little competition among the Carriers. In general, the Carriers shipped oil that was produced by their affiliated production companies.

885. Anadarko argues that ConocoPhillips “has simply outperformed BPPA in managing its capacity on TAPS,”<sup>87</sup> and that if BP is not fully utilizing its capacity on TAPS, it should “take the necessary steps to increase its utilization of its own pipeline capacity, attract other throughput, or cut its costs.”<sup>88</sup> It should not be allowed to eliminate incentives for efficiency and competition, which the Commission has found to be in the public interest, so it can achieve a guaranteed return.

886. However, the Opinion 502 proceeding included evidence that very little competitive discounting occurred.<sup>89</sup> Indeed, BP witnesses Mr. Coulson and Dr. Cameron have testified in this proceeding that the Carriers have predominately shipped volumes produced by their affiliated exploration and production companies, and have strong incentives to “affiliate tender.”<sup>90</sup>

887. Today, “there is less throughput than capacity on TAPS and more independent producers on the North Slope. With less throughput than capacity and more independent producers, there is an increasing likelihood that Carriers will more actively compete for throughput than they have in the past.”<sup>91</sup> The undersigned finds Mr. Brown’s testimony in general is moderately probative, but that a broader and suitable balance must be achieved to reduce the likelihood of financial distress upon BPPA, and other Carriers, as described by Mr. Van Hoecke, and that it is doubtful that BP would have any opportunity to recapture its investment in TAPS, under the present circumstances.

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<sup>86</sup> Exhibit No. APC-18, at 12.

<sup>87</sup> *Id.* at 8.

<sup>88</sup> *Id.* at 11; Exhibit No. APC-21, at 8 (“BPPA should be held responsible for its under-performance and should be expected to compete for or encourage the development of additional throughput volume or take other steps to manage its capacity on TAPS more efficiently”).

<sup>89</sup> *Id.* at 11-12.

<sup>90</sup> Direct testimony of Mr. Coulson on behalf of BP (Exhibit No. BPP-1, at 21-22); direct testimony of Dr. Cameron on behalf of BP (Exhibit No. BPP-5, at 6).

<sup>91</sup> Exhibit No. APC-18, at 12; *see* Exhibit No. CPT-1, at 9 (ConocoPhillips’ witness Falcone stating that “[a] TAPS Carrier cannot transport oil using space that belongs to another Carrier . . . . Any excess barrels would then be transported by a competing Carrier that has available capacity, with that Carrier collecting the revenue for moving those barrels.”)

888. Mr. Brown's testimony is probative in support of the undersigned's finding that including 100% of all equity return elements in the pooling proposal, as BP advocates, will impact the likelihood of future competition for throughput among the TAPS Carriers.<sup>92</sup> The undersigned finds the pooling mechanism should function to reallocate those costs and disparities caused by the TAPS ownership arrangement, and that some percentage of return should indeed be included in the pooling mechanism. The undersigned further finds that including the equity return elements in the pooling mechanism at a reduced percentage, as proposed by the undersigned, will not significantly harm competition and will better address the disproportionate incentives and risks of the TAPS Carriers.

### **3. Costs Related to Intrastate Transportation Should be Pooled.**

889. The undersigned finds the totality of the evidence warrants inclusion of these costs. The Commission's pooling orders required that the cost pooling mechanism include all costs and did not distinguish between interstate and intrastate costs. BPPA, KAPCO, and EMPCo, all support including interstate and intrastate costs in the cost pool. Up to the time of the hearing, Anadarko, also formerly endorsed inclusion of intrastate costs (Exhibit No. KAP-1, at 4; Exhibit No. EM-3, at 9; Exhibit No. APC-18, at 19-20). ConocoPhillips was the only participant that proposed to exclude intrastate costs from the cost pool consistently (Exhibit No. CPT-6, at 6).

890. As indicated previously, BPPA argues that it has shown through the testimony of Mr. Haines that CPTAI witness Mr. Wetmore's proposed approach to cost pooling in Exhibit No. CPT-8 is flawed and this becomes obvious when discussing intrastate costs. BP argues that the ConocoPhillips mechanism attempts to allocate only interstate costs, it then distributes those costs among the TAPS Carriers on the basis of interstate and intrastate volumes (Exhibit No. BPP-34, at 5-9). BPPA argues that Mr. Wetmore attempts to excuse this error by arguing that allocating interstate costs on interstate barrels alone, would give skewed and unreasonable results (Exhibit No. CPT-33, at 40-41).

891. Mr. Brown for Anadarko explains that because TAPS rates must be based on system-wide costs and throughput, the pooling mechanism should include all TAPS costs, not only those costs that will be allocated to federal rates.<sup>93</sup> This reasoning appears sound, even though Anadarko changed its position on this issue at the hearing. Indeed, Section II-2(f) pooled both interstate and intrastate costs. The pooling mechanism

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<sup>92</sup> Exhibit No. APC-18, at 11.

<sup>93</sup> Exhibit No. AP-18, at 20. The undersigned gave no weight to any specific testimony which was withdrawn by the parties.

adopted in this proceeding should likewise include intrastate costs. ExxonMobile and Koch agree.<sup>94</sup>

892. Furthermore, the undersigned finds ConocoPhillips' position that the FERC lacks jurisdiction to include intrastate costs to be unpersuasive. It cites no authority to support this position. Moreover, this is not a case where the FERC is attempting to set intrastate rates. The inclusion of intrastate costs in the pooling mechanism is merely an item in a cost reallocation system among the TAPS carriers. It does not usurp the authority of the Alaska Commission or attempt to set intrastate rates.

893. One would think if it did it would have been challenged on this basis long ago, since it remained an included cost item from 1985 through 2008, as part of the TSA. To the extent CPTAI and Anadarko have argued pooling intrastate costs is improper because it would be inconsistent with how the Regulatory Commission of Alaska sets rates for TAPS, these arguments are rejected and the undersigned accepts the arguments made by BP on this point.<sup>95</sup> The undersigned finds the testimony of BPPA witness Mr. Haines who gave persuasive testimony that results would be skewed if intrastate costs were not included in the pooling mechanism, to be very probative (Exhibit No. BPP-10; Tr. Vol. 6, at 821-825 (Haines)). As Mr. Haines explains:

If we don't have an intrastate pool here at the moment, then if you flip over to page 26 (BPP-34), there's another table 8, and if you look down to the KOCH Alaska Pipeline entry, 4g there, what we were looking at in this table is if you did an exclusive pool on the intrastate side all on its own. What you naturally would expect to be happening there is KAPCO, as we had been talking about, had lots of intrastate traffic. They were paying system-wide costs. So because their usage on the intrastate side was very high relative to ownership, you would expect them to be a payer into the pool. This shows \$18.6 million as a payer into the pool because of the relative skew going on between interstate and intrastate. On an interstate-only pool, what happens-back to table 1, they would receive \$17 million out of the pool, but in the absence of an intrastate pool, they would not have to pay \$18.6 back into the pool, so you get the skew. Not to pick on KAPCO. It's the nature of the interstate/intrastate balance going on.

(Tr. Vol. 6, at 823-824 (Haines)).

894. The undersigned also finds the position of Koch and ExxonMobile to be persuasive on this issue. They both argue for inclusion of intrastate costs in the pooling mechanism, asserting that it is necessary because intrastate costs are significant, represent

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<sup>94</sup> EMPCo RB., at 5; KAPCO RB., at 5.

<sup>95</sup> BPPA IB., at 43-46.

an increasing percentage of the total TAPS cost of service, and will promote efficiency and ease of administration in that TAPS Carriers will have only one pooling mechanism to implement.<sup>96</sup>

895. ExxonMobile further warns that exclusion of intrastate costs could add unnecessary complexity to the pooling mechanism because the TAPS Carriers might not be able to all agree on which costs should be excluded.<sup>97</sup> ExxonMobile points out that its expert, Mr. Ray, testified that intrastate costs were included in the former TSA and worked very well for the TAPS carriers when it was in effect (Exhibit No. EM-3, at 9). The undersigned finds these positions have merit. Accordingly, these costs should be included.

#### **4. Carrier-Direct Costs Should Be Pooled.**

896. The undersigned finds that Carrier-direct costs should be included in the pooling mechanism. First and foremost, the testimony of BPPA witness Mr. Haines highlights that these costs have a minimal and perhaps even a *de minimis* impact overall on the pooling mechanism, but can impact a smaller Carrier more, like Unocal, if not included (Tr. Vol. 6, at 818-821 (Haines)). All experts who discussed these costs admit this point. Moreover, while BPPA initially determined that Carrier-direct costs<sup>98</sup> should not be pooled, it has to some extent re-assessed that position, and now arguably endorses this inclusion.<sup>99</sup> BPPA did not include Carrier-direct costs in its initial Cost Allocation Mechanism<sup>100</sup> (Exhibit No. BPP-10, at 19-20; Exhibit No. BPP-14, at 5 n.10), but

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<sup>96</sup> KAPCO IB., at 2; EMPCo IB., at 16-20; EMPCo RB., at 5-13; accord Unocal, UPC IB., at 13-14; *see also* EMPCo RB., at 5; KAPCO RB., at 5.

<sup>97</sup> KAPCO Pre-Hearing Br., at 3; EMPCo Pre-Hearing Br., at 7-8; EMPCO IB., at 16-20.

<sup>98</sup> All parties agree that these costs refer to those left after State ad valorem taxes are included. All parties agree ad valorem taxes should be included in pooling. Mr. Haines testified that BPPA would accept the position that Carrier-direct costs be included in pooling if done properly, following BP's approach, such as he showed in critique of Mr. Wetmore's model (Tr. Vol. 5, at 669-670 (Haines)).

<sup>99</sup> KAPCO Pre-Hearing Br., at 3-4 (noting that excluding these costs from pooling would have a significant adverse financial impact on those TAPS Carriers with smaller ownership shares). Interestingly, continuing with the theme of musical chairs, KAPCO subsequently submitted an eratta and changed its position, noting it had erred. It now argues for exclusion of Carrier-direct costs from any Cost Pooling Mechanism (KAPCO RB., at 6).

<sup>100</sup> As Mr. Van Hoecke has explained in his testimony, if the Commission decides that Carrier-direct costs should be included in the cost pool, the BPPA model can be modified to include those costs (Exhibit No. BPP-14, at 5, n.10; Tr. Vol. 5, at 669-670 (Haines)). Unocal clearly argued at the hearing that it as a small TAPS Carrier, wants

according to BP's witnesses, this mechanism can easily be adjusted to include these costs.

897. BPPA argues initially it excluded Carrier-direct costs for two reasons. First, Carrier-direct costs can be controlled only by an individual Carrier, and if Carrier-direct costs are pooled, the incentive to keep those costs to a minimum is reduced (Exhibit No. BPP-10, at 19-20). Second, information regarding Carrier-direct costs is available only from individual carriers. As a result, if Carrier-direct costs are to be pooled, a mechanism would have to be put into place by which the Carrier-direct costs would be available to all TAPS Carriers and their agent, Alyeska Pipeline Service Company. Anadarko and ExxonMobile also favor exclusion and seemingly endorse this reasoning.<sup>101</sup>

898. Carrier-direct costs are the costs incurred by the Carriers themselves rather than incurred in the first instance by Alyeska and then allocated to the Carriers.<sup>102</sup> Excluding Carrier-direct costs will result in the over-collection of those costs by some TAPS Carriers and under-collection by others, with the under-recovery most dramatically falling upon UPC, the smallest of the TAPS Carriers.

899. Under the uniform rate methodology required for TAPS, total Carrier-direct costs (as part of total system costs) are divided by total system throughput; as a result, the uniform rate includes a per barrel level of Carrier-direct costs equal to the average level of such costs (Tr. Vol. 5, at 681, (Haines); Tr. Vol. 9, at 1255, (Wetmore)); Exhibit No. BPP-33, at 2-3).

900. It necessarily follows that TAPS Carriers with above average Carrier-direct costs will under-recover their actual costs while Carriers with less than average Carrier-direct

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Carrier-direct costs included in pooling (Tr. Vol. 5, at 669-687 (Haines)).

<sup>101</sup> APC Pre-Hearing Br., at 12; APC IB., at 35-39; EMPCo Pre-Hearing Br., at 8; EMPCo IB., at 20-21.

<sup>102</sup> As previously noted, all participants here agree that ad valorem taxes (which are generally considered Carrier-direct costs) should be pooled. Depreciation and amounts related to Asset Retirement Obligations also are excluded from the definition of Carrier-direct costs used by the witnesses here (*See* Exhibit No. CPT-33, at 2 & n.1; Exhibit No. BPP-34, at 22 & n.20). Mr. Wetmore refers to the resulting category of costs as "other Carrier-direct operating expenses" while Mr. Haines refers to them simply as Carrier-direct costs. In addition, Alyeska already allocates fuel and power costs (also considered a Carrier-direct cost) based on usage and whether those costs are included in the pooling mechanism or not makes very little difference (Exhibit. No. CPT-33, at 21). Accordingly, the focus on Carrier-direct costs here excludes those "distance-related" costs from consideration as well.

costs will over-collect their costs. This point was explained, by all the TAPS Carriers, in their request for rehearing of Opinion 502.<sup>103</sup>

901. Moreover, at that time, all the TAPS Carriers told the Commission that under uniform rates “a Carrier with a relatively small ownership share will be precluded from fully recovering its fixed baseline costs that are necessarily incurred in the Carrier’s operation of the pipeline.”<sup>104</sup> They further explained that, “[g]iven that a significant portion of a Carrier’s direct cost will necessarily be fixed and thus will not vary by throughput or ownership share, this result [*i.e.*, uniform rates] unreasonably penalizes the smaller Carriers.”<sup>105</sup> This explanation was a prominent part of the TAPS Carriers’ presentation of the problem of over- and under-recovery of costs under uniform rates that led the Commission, on rehearing, to require pooling as incident to the establishment of a just and reasonable rate.<sup>106</sup>

902. Unocal persuasively argues that the issue of pooling Carrier-direct costs affects mainly the smaller Carriers and especially UPC.<sup>107</sup> Mr. Wetmore recognized both in filed testimony and on the stand, that Carrier-direct costs are generally incurred disproportionately by the small Carriers<sup>108</sup> (Tr. Vol. 9, at 1245, 1252). In his answering testimony, Mr. Haines similarly explained that Carrier-direct costs are not proportionate to ownership percentage, and quantified the significant differences in the percentages of Carrier-direct costs incurred by each owner compared to its ownership share.<sup>109</sup> Mr. Ray, for EMPCo, explained that while his company stands by the positions taken by all the Carriers in their joint request for rehearing (Exhibit No. BPP-33), the problem identified there of small Carriers under-recovering their Carrier-direct costs is “an issue, but it’s not an issue for EMPCo” (Tr. Vol. 7, at 1002 (Ray)).

903. At the hearing, Mr. Coulson, recognized that “the smaller Carriers might struggle to be able to recover their proportionate shares of Carrier-directs simply because on a

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<sup>103</sup> Exhibit No. BPP-33, at 2-3.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 5.

<sup>106</sup> UPC IB., at 14-21.

<sup>107</sup> UPC RB., at 2-17.

<sup>108</sup> Exhibit No. CPT-6, at 6; UPC RB., at 6.

<sup>109</sup> Exhibit. Nos. BPP-34, at 22, 24 (Table 5), and BPP-38. Table 5 of Mr. Haines’ answering testimony shows that, in 2008, BPPA, KAPCO and UPC each incurred a percentage of Carrier-direct costs greater than its ownership percentages while EMPCo and CPTAI’s shares of the Carrier-direct costs were less than their respective ownership percentages. *See also* Tr. Vol. 6, at 725 (Mr. Haines’ statement that: “I will agree that there is a ‘disproportionality’ in those percentages between what Unocal has as an Owner-direct cost and what it would otherwise be able to collect at system average levels based on its ownership share.”)

man-hour basis they have to devote more to their smaller percentage, more time and manpower” (Tr. Vol. 3, at 297 (Coulson)). Mr. Coulson explained that there are certain things that each Carrier must do, and costs it must incur, regardless of its ownership or usage percentage (Tr. Vol. 3, at 301 (Coulson)).

904. He also agreed that, as all the TAPS Carriers stated in their request for rehearing of Opinion 502, “a significant portion of a Carrier’s direct costs will necessarily be fixed and thus will not vary by throughput or ownership percentage”<sup>110</sup> (Tr. Vol. 3, at 301 (Coulson)). The smaller Carriers necessarily must spread these “baseline” costs over fewer volumes, which necessarily results in higher Carrier-direct costs on a per barrel basis.<sup>111</sup> As a consequence, Mr. Wetmore testified that “[a] smaller Carrier would incur likely a larger portion or a larger than system average Carrier-direct cost. And given that the total revenue requirement is based on total system costs, that Carrier would be limited in its ability to recover its Carrier-direct costs” (Tr. Vol. 9, at 1245 (Wetmore)).

905. The dramatic effect of this result on UPC was illustrated at the hearing. Based on 2008 data, the uniform rate would include approximately \$0.1228 cents of Carrier-direct costs (excluding ad valorem taxes and fuel and power costs). In contrast, even assuming that UPC transported a share of system throughput equal to its ownership share, it would incur Carrier-direct costs of approximately \$0.58 cents per barrel.<sup>112</sup> The results are similar for 2009, when the system average Carrier-direct costs included in the uniform rate was approximately \$0.13 cents, while UPC’s actual Carrier-direct costs on a per barrel basis were approximately \$0.55 cents.<sup>113</sup>

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<sup>110</sup> See also Exhibit No. BPP-33, at 5 (request for rehearing where all the Carriers were in accord). Section 6.2 of the TAPS Operating Agreement, Exhibit No. BPP-4, at 16, requires each of the TAPS Carriers to operate its ownership interest as a common carrier, and requires it to do certain things for itself like file tariffs, solicit and receive tenders from shippers, and the like. In addition to these basic operations, Mr. Coulson noted other activities required of each TAPS Carrier such as complying with “government regulations” and “sitting in rate hearings”; (UPC IB., at 14-21).

<sup>111</sup> Mr. Haines agreeing that the larger Carriers spread baseline costs over larger volumes than smaller Carriers (Tr. Vol. 6, at 728 (Haines)); Mr. Ray agreeing that the larger Carriers spread the baseline costs over larger volumes than smaller Carriers (Tr. Vol. 7, at 1004 (Ray)).

<sup>112</sup> These calculations are based on the 2008 cost data in Exhibit No. BPP-38, and were discussed during cross-examination of Mr. Haines (Tr. Vol. 5, at 679 (Haines)). The Carrier-direct costs for both the system as a whole and for UPC specifically are shown on Exhibit No. BPP-38. Dividing the system Carrier-direct costs by total throughput shows the Carrier-direct costs included in the uniform rate. Dividing UPC’s Carrier-direct costs by its throughput (assumed to be proportional to its ownership share to clarify the issue) shows UPC’s actual Carrier-direct costs on a per barrel basis.

<sup>113</sup> These calculations, based on data for 2009 shown in work-paper 10 of UPC’s

906. Unocal argues that while the BPPA and CPTAI witnesses did not necessarily vouch for these precise calculations, the basic conclusion is un-rebutted. As a result of the Commission's uniform rate requirement, UPC can recover only about one-fourth or less of its actual Carrier-direct costs, resulting from its perspective in very significant under-recovery. The undersigned agrees with Unocal that the Commission ordered pooling to prevent this inequitable type of result.<sup>114</sup>

907. While Mr. Wetmore for CPTAI advocated pooling Carrier-direct costs, his method would allow a Carrier to collect only the system average level of Carrier-direct costs regardless of its throughput. It would not allow a Carrier to collect its actual Carrier-direct costs.<sup>115</sup> Thus, this is another reason not to use the CPTAI approach. In his answering testimony, Mr. Haines explained the proper way to pool Carrier-direct costs is to prevent the over- and under-recovery of costs, and he proposed changes to Mr. Wetmore's approach to do just that.<sup>116</sup>

908. In his reply testimony, Mr. Wetmore quantified the differences in the two approaches to pooling Carrier-direct costs and asserted that the Haines modification was unnecessary because it would increase the total amount of Carrier-direct costs to be pooled, in 2008, by less than \$3 million.<sup>117</sup> Yet, according to Unocal, Mr. Wetmore's own calculations show just why the issue is so important to UPC: for instance \$2 million of the total system difference relates to UPC alone.<sup>118</sup> Under Mr. Wetmore's approach, UPC would have paid \$200,000 into the pool for Carrier-direct costs in 2008 even though it was dramatically under-collecting its actual Carrier-direct costs.<sup>119</sup> In contrast, Mr. Haines' pooling approach to allow the collection of actual Carrier-direct costs would have led to the receipt by Unocal of \$1.8 million.<sup>120</sup> Unocal therefore strongly advocates for adoption of the approach to pooling Carrier-direct costs advanced by Mr. Haines.<sup>121</sup>

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2010 rate filing marked as Exhibit No. ALJ-12, were discussed during cross-examination of Mr. Haines (Tr. Vol. 6, at 713 (Haines)). Mr. Wetmore also generally agreed with the accuracy of such calculations showing the dramatic difference between the system average Carrier-direct costs included in the system rate and UPC's actual Carrier-direct costs (Tr. Vol. 9, at 1256 (Wetmore)).

<sup>114</sup> UPC IB., at 18-19.

<sup>115</sup> Mr. Wetmore agrees this is the result of his approach (Tr. Vol. 9, at 1260 (Wetmore)).

<sup>116</sup> Exhibit Nos. BPP-34, at 24-25 and BPP-35.

<sup>117</sup> Exhibit No. CPT-35, at 35-36.

<sup>118</sup> *Id.* at 36 & Table 3; Exhibit No. CPT-38.

<sup>119</sup> Exhibit No. CPT-38; Tr. Vol. 9, at 1265, lines 6-23 (Wetmore).

<sup>120</sup> Exhibit No. CPT-38; Tr. Vol. 9, at 1265-1266, lines 5-24 (Wetmore).

<sup>121</sup> UPC RB., at 2-17.

909. Unocal also argues that the main objection advanced against this approach is that it would eliminate an incentive for Carriers to minimize their Carrier-direct costs, is erroneous.<sup>122</sup> The undersigned agrees with the position of Unocal that the issue of pooling Carrier-direct costs here turns simply on whether the Carriers that over-collect the costs, as a result of how the uniform rate is designed, should pass the collections on to the Carriers that actually incurred the costs. This result is necessary to prevent cost under- and over-recovery and to ensure that the rates, for both sets of Carriers, are just and reasonable.

910. The claim that a Carrier will not seek to minimize its Carrier-direct costs to an efficient level if the costs can be collected via pooling has no evidentiary support in the record. Indeed, the fact that a TAPS Carrier would expect to collect its actual Carrier-direct costs through the pooling mechanism therefore creates no different incentive than that which routinely exists for any regulated entity that expects to collect its actual costs in rates. The undersigned also finds merit in Unocal's position that any allegation that Carrier-direct costs are unreasonably high can be addressed through the Commission's normal regulatory processes, as Mr. Haines observed (Tr. Vol. 6, at 730 (Haines)).

911. The undersigned did not find persuasive the arguments of Anadarko witness Mr. Brown, who takes issue with the Carrier-direct costs and explains the Carriers will have no incentive to minimize these costs if they are pooled, which could increase the rate paid by shippers. Carrier-direct costs "were excluded from the cost reallocation [in Section II-2(f)] in order to maintain the incentives owners have under the TSM to minimize those costs."<sup>123</sup> The undersigned finds this reasoning does not apply today, and in any event, the impact upon UPC outweighs this type of speculation.

912. BPPA argues and the undersigned accepts the premise that Carrier-direct costs should not be pooled in the manner presented by CPTAI witness Mr. Wetmore. BPPA argues that Mr. Haines shows in his testimony that Mr. Wetmore's proposed allocation of Carrier-direct costs assumes that the costs are incurred on a basis that is proportional to each Carrier's composite ownership interest in TAPS (Exhibit No. BPP-34, at 22). Mr. Haines has indicated the BPPA model can add these costs to its calculations, and this approach is adopted by the undersigned.

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<sup>122</sup> See Exhibit Nos. CPT-33, at 36 (Wetmore); EM-3 at 8 (Ray). See also Tr. Vol. 9, at 1262 (Wetmore) ("[t]o the extent the Commission is not concerned about the incentives to keep those costs as low as possible, then I could be comfortable with that approach" (*i.e.*, the approach advocated by Mr. Haines in answering testimony)). Mr. Haines also noted this concern in his pre-filed testimony (Exhibit No. BPP-10, at 19). At the hearing, however, BPPA witnesses clarified that they do not oppose pooling Carrier-direct costs provided that it is done properly, as described in Mr. Haines' answering testimony (Tr. Vol. 3, at 303 (Coulson); Tr. Vol. 6, at 817 (Haines)).

<sup>123</sup> Exhibit No. CPT-5, at 149.

913. ConocoPhillips also supports the position that Carrier-direct costs should be pooled.<sup>124</sup> The undersigned finds the inclusion of Carrier-direct costs is appropriate. As indicated above, the majority of the experts testified or agreed that inclusion of these costs is either *de minimis* or at least minimal for all practical purposes, with the exception, that for the small TAPS Carriers the under-recovery could be substantial, if these costs are not included.

914. The testimony at the hearing, especially the cumulative cross-examinations of Mr. Haines, Mr. Coulson, and Mr. Wetmore, by Unocal counsel signify that failure to include these costs in pooling would have an unfair impact upon Unocal and to some degree Koch. Unocal, by being the smallest TAPS Carrier may under-recover its Carrier-direct costs by \$2 million if these costs are excluded (Tr. Vol. 3, at 296-303 (Coulson); Tr. Vol. 5, at 684-688; Tr. Vol. 6, at 715-721 (Haines); Tr. Vol. 9, at 1242-1270 (Wetmore)),

915. As already indicated, the undersigned finds the incentive to TAPS carriers to be thrifty, is not undermined by the inclusion of such costs and there is no direct evidence that TAPS Carriers would or really could, deliberately pad their costs to take advantage of pooling, especially when considering the disparities upon Carriers such as Unocal and Koch, when not included (Tr. Vol. 5, at 684-690; Tr. Vol. 6, at 705-720 (Haines)).<sup>125</sup> The undersigned therefore finds they should be included in the pooling mechanism as in the manner described by Mr. Haines at the hearing (Tr. Vol. 6, at 815-817 (Haines)).

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<sup>124</sup> CPTAI Pre-Hearing Br., at 20-21; CPTAI IB., at 36; CPTAI RB., at 33-35. Likewise, CPTAI argues that the Alyeska variable operating expenses are already shared in proportion to actual usage in accordance with the TAPS Operating Agreement and should not be pooled, because it is not necessary. As indicated above, this has seemed to be one area of agreement between the Carriers. However, CPTAI points out that BP initially in pre-filed testimony, claimed such expenses should be included in the pooling mechanism (Exhibit BPPA-34, at 5). As indicated by CPTAI, BP has not initially briefed this issue, although BP does comment on this issue in its Reply Brief. CPTAI argues the amount involved is also *de minimis*. To the extent there is disagreement remaining on this issue, the undersigned adopts the position of CPTAI (*see* CPTAI RB., at 35). These costs are adequately covered by the TAPS Operating Agreement, and do not need to be included.

<sup>125</sup> The State of Alaska argues for exclusion of Carrier-direct costs based upon general economic incentives. It produced no evidence at the hearing to support its position; SOA Pre-hearing Br., at 3; SOA IB., at 10-13; SOA RB., at 12-13.

## 5. The New Pooling Mechanism Should be Applied as of January 1, 2009.

916. Anadarko did not address this issue in its pre-filed testimony, but notes in its Reply Brief that the TSA was in effect through 2008, inferring the new pooling mechanism should not be effective prior to January 1, 2009.<sup>126</sup> BPPA's initial position is to readjust the TSA pooling agreement and apply the new pooling mechanism to January 1, 2005.<sup>127</sup> The undersigned agrees with the position offered by ExxonMobile and ConocoPhillips (and the alternative position offered by BPPA) that pooling should be applied as of January 1, 2009.

917. The undersigned finds ExxonMobile and ConocoPhillips reasoning to be persuasive, that the old pooling mechanism under the TSA was in effect and applicable through December 31, 2008, the date the TSA terminated. The undersigned agrees that the Commission's pooling orders make clear that it did not intend to modify the TSA.<sup>128</sup> Accordingly, the earliest the pooling mechanism should be implemented is January 1, 2009.

## 6. The BPPA Proposal Should Govern the Mechanics of the Pooling Mechanism.

918. The two offered proposals, and the one modified proposal submitted by Anadarko, were discussed above. The undersigned finds both BPPA's proposal and the ConocoPhillip's proposal to be in substantial compliance with the directives of Opinion 502, and both models have some commonality of features, as well as strengths and weaknesses (BPP-14, at 3; Tr. Vol. 6, at 824-827 (Haines)).

919. As indicated, the undersigned finds that the totality of the evidence establishes that cost pooling should be done in accordance with BPPA's "Cost Allocation Mechanism", as presented by Mr. Haines (Exhibit No. BPP-11HC). As evident by the testimony of Mr. Haines, the Cost Allocation Mechanism complies with the Commission's order that the TAPS Carriers should adopt "a pooling mechanism that reallocates all the TAPS Carriers' costs based on throughput or usage, so that the allocation of costs matches the allocation of revenues on TAPS" (Exhibit No. BPP-10, at 3).

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<sup>126</sup> APC RB., at 66-67.

<sup>127</sup> BPPA Pre-Hearing Br., at 10-11; BP IB., at 47-48.

<sup>128</sup> Koch argues pooling should apply only from the date the Commission adopts the new pooling mechanism (KAPCO IB., at 3). This position has some merit but the undersigned finds the Commission intended to have pooling in effect continuously to reduce the disparities pronounced in its previous orders. As indicated, January 1, 2009, is BPPA's alternate acceptable date and the date adopted by the undersigned.

920. The undersigned finds the BPPA proposal to be most efficient for use herein and adopts it in this Initial Decision; especially, if the Commission agrees that some return on investment should be included in the pooling mechanism. The BPPA proposal provides the necessary framework and flexibility to adapt to and make the necessary adjustments. Mr. Van Hoecke's testimony establishes that BPPA's Cost Allocation Mechanism allocates all of the TAPS Carriers' costs, including return elements, based on throughput or usage, in accordance with the Commission's directives (Exhibit No. BPP-14, at 5). The ConocoPhillips proposal does not. Mr. Van Hoecke also explains that BPPA's mechanism properly aligns costs with usage and, accordingly, will prevent Carriers from under-recovering or over-recovering their costs (Exhibit No. BPP-10, at 8-12).

921. Dr. Cameron's testimony establishes that BPPA's Cost Allocation Mechanism provides each TAPS Carrier with an opportunity to earn a fair return on its investment in TAPS and eliminates incentives for under-investment and over-investment (Exhibit No. BPP-5HC, at 7-14). She additionally finds that BPPA's mechanism is in the interest of better service to the public as well as economy of TAPS operations, and would not unduly restrain competition (Exhibit No. BPP-5HC, at 14-20). The undersigned finds the testimony of BPPA witness Mr. Haines to be probative on this issue as well. The BPPA model is overall more comprehensive and better fitted for use in the pooling mechanism (Exhibit No. BPP-10 and Exhibit No. BPP-14).

## **D. Uniform Rate**

### **1. Implementation of a Uniform Rate Has Been Set for Hearing.**

922. Anadarko initially argued that the Commission's hearing order in this proceeding did not set for hearing issues concerning implementation of the uniform rate requirement, asserting that the uniform rate requirement was established in Opinion 502, and that Opinion 502 is straight-forward and controlling.<sup>129</sup> All other parties accept this as an issue, and Anadarko did not oppose the earlier motion for summary disposition filed by the TAPS carriers pertaining to this issue.

923. In Opinion 502, the Commission required the TAPS Carriers to file a uniform rate for transportation service on TAPS. The Commission has further determined that implementation issues relating to the process for achieving a uniform rate would be resolved in this proceeding. In essence, Judge Cintron in the latter portion of this bifurcated hearing will ultimately determine the actual uniform rate for the 2009 and later filings. However, the undersigned is tasked to determine what if any additional processes should be adopted for determining uniform rate in future proceedings, and to address concerns the parties had regarding "collusion and price-fixing" liability.

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<sup>129</sup> This maximum rate will in essence determine the uniform rate, and set a maximum ceiling.

924. In its protests of the EMPCo, BPPA, and CPTAI rate-change filings that were submitted in the spring and summer of 2009, Anadarko argued initially that the Carriers had not shown that their rate filings were “consistent” with the Commission’s ruling in Opinion 502. Anadarko argued that as a result of those rate filings, there could be multiple rates governing oil shipments on TAPS in July 2009. Consequently, Anadarko urged the Commission to determine whether this situation is consistent with Opinion 502.

925. The undersigned finds that the Commission has made it clear that the uniform rate implementation issue should be resolved in this proceeding. In setting the subject rate filings for hearing, the Commission concluded in its June 30, 2009 Order that whether the Carriers’ filed rates were calculated consistent with the Commission’s uniform rate requirement was a material issue of fact (Exhibit No. BPP-107). The stipulated division of issues in this case by the parties puts the implementation process regarding uniform rates before the undersigned.<sup>130</sup> Therefore, the undersigned finds that uniform rate implementation is an issue in this proceeding.

**2. In Addition to the Process Agreed to by the TAPS Carriers, the Undersigned Finds that Rule 601 Conference(s) Should be Used Extensively by the TAPS Carriers to Discuss Uniform Rate and Other TAPS Issues.**

926. The TAPS Carriers argue they should not be required to collude or collaborate with each other before any new filing changes to the existing uniform rate. They argue such pre-filing gatherings subjects them to multiple practical problems, including the sharing of proprietary information and potential charges of “price fixing” and anti-trust liability issues (Exhibit No. CPT-1, at 15 (Falcone); Exhibit No. EM-1, at 12 (Ray)). The undersigned finds use of Rule 601 conferences render moot any claims by the parties for potential liability due to collusion and price-fixing, and any issues relating to confidential information sharing.

927. The parties are in general agreement that if the Commission requires the TAPS Carriers to file a single uniform maximum rate, it will also need to provide the Carriers with immunity from antitrust liability and to indicate the legal authority under which that immunity is provided, inferring the Commission has put them in a legal Catch-22 dilemma.

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<sup>130</sup> *BP Pipelines (Alaska) Inc.*, 127 FERC ¶ 61316 (2009). The parties agreed to this process even though the SR phase before Judge Cintron will ultimately determine what the just and reasonable uniform rate is for the 2009 and 2010 filings (*see* division of issue documents in Exhibit No. ALJ -7).

928. The undersigned finds the position of the parties to be a valid concern but since the FERC ultimately determines the just and reasonableness of any rate, any allegation of price fixing has in the undersigned's view very limited anti-trust (or other) legal liability, if any.<sup>131</sup> Moreover, the exchange of confidential information is commonly involved in any rate proceeding and generally protected through adoption of a protective order. Still, the parties have some genuine concern due to the arguable lack of regulatory authority to start a process for adoption of a new uniform rate through a collaborative effort, prior to the formal initiation of a proceeding before the Commission.

929. Therefore, The TAPS Carriers take a united position that the only method available for them to attempt to meet the Commission's directives in Opinion 502, is for them to: calculate any future uniform rates based upon an analysis of the total-system-wide cost of service and throughput (as the TAPS Carriers assert they did in their 2009 and 2010 filings); and that filing of such rates may be based upon each TAPS Carrier's own initiative, and without consultation or collaboration with any TAPS Carrier.

930. The TAPS Carriers argue they may file individual rates on their own initiative that do not exceed the existing uniform rate ceiling, and the undersigned agrees with and adopts this position, but finds that some additional process is needed in the event a new filing seeks to increase the maximum ceiling. As previously indicated, after issuance of the Commission's Order in Opinion 502, EMPCo, BPPA and CPTAI all filed for rate changes in 2009. They assert they made an independent calculation of the uniform rate ceiling, and submitted a rate filing based on that calculated ceiling. They also assert their 2009 rate was calculated by dividing the total TAPS cost of service allocated to interstate operations by the total TAPS interstate deliveries (throughput).

931. The new rate filings filed in this case in 2009 and 2010 included system-wide data, rather than rates based on each Carrier's individual cost of service and throughput. The applicable Carriers assert these proposed rates were calculated in accordance with the ratemaking methodology prescribed by the Commission in Opinion 502.<sup>132</sup> The

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<sup>131</sup> As indicated above, the recent decision by the Court of Appeals for the District of Columbia seems to give little weight to these concerns, "[d]espite FERC's seemingly unequivocal instructions to the carriers to file uniform rates, FERC does not seem to contemplate sanctioning them for failure to agree."; *Flint Hills Res. Alaska, LLC v. FERC*, No. 08-1270, *et al.*, U.S. App. LEXIS 24826 (D.C. Cir. Oct. 7, 2010).

<sup>132</sup> The TAPS Carriers unanimously endorse this position, which was the basis for their joint motion for summary disposition, which was denied at the hearing on procedural grounds by the undersigned who found that it was necessary to hear evidence at the hearing, pertaining to this issue. Anadarko's response to the joint motion concurs, so long as normal intervention and protest rights are maintained. At the hearing the State of Alaska and FERC Staff concurred with this position. FERC Staff took the position at

undersigned notes that the Commission was disturbed that some of the filings covered varying time periods, and the Court of Appeals for the District of Columbia Circuit commented that it did not appear that the Carriers had complied with the Commission's directive to file a uniform rate.<sup>133</sup>

932. The undersigned accepts and adopts the unanimous position of the TAPS Carriers, and the other parties in this proceeding, as a mechanism to use in future proceedings and notes that this is essentially how the process has been working in the current proceeding. The undersigned further adopts the position of Anadarko as contained in its response, which requests assurance that the normal regulatory intervention and protest rights procedures are maintained.<sup>134</sup>

933. However, although the undersigned adopts the parties' consensus position, it is obvious to the undersigned that the Commission has attempted to order a more direct involvement for the parties to attempt to achieve just and reasonable rates in the future, and for them to do so as a matter of substantial cooperation and agreement between themselves, whenever practicable. The undersigned therefore further finds that compliance with Opinion 502 also requires that the TAPS Carriers, in conjunction with any new TAPS filing which impacts the then existing uniform rate, participate in mandatory Rule 601 conferences, unless otherwise determined by the Commission.<sup>135</sup>

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the hearing that the Commission's multiple acceptances of the 2009 and 2010 filings by the TAPS Carriers constitute an implied acceptance that this practice meets the directives set forth in Opinion 502 (Tr. Vol. 3, at 176-177 (Melvin)); Staff IB., at 445-47). The undersigned gives great weight to the position advocated by FERC Staff on this issue (Staff RB., at 49).

<sup>133</sup> *Supra* nn.124 & 125.

<sup>134</sup> As indicated already, but worthy of repeating, the undersigned gives great weight, in part, to the position of the FERC Staff which as indicated, agrees that this consensus process for implementation of the uniform rate complies with the Commission's directives in Opinion 502.

<sup>135</sup> The undersigned acknowledges that the parties were able to fully utilize the benefits of the TSA for several years. Rule 601 (18 C.F.R. § 385.601 (2010)) provides an existing regulatory framework for Carriers, once a proceeding has been initiated, to discuss matters relating to uniform rate and other TAPS issues, in an atmosphere free from concerns of allegations of collusion and price-fixing. The rule allows the Commission to order participants to convene a conference for any purpose related to the conduct or disposition of a proceeding. Such matters could include discussions and agreements applicable to filing times and test periods; the concerns of protestors; an opportunity to hold technical conferences and exchange information (including an opportunity to have the Chief Judge issue a protective order if applicable); participate in alternative dispute resolution procedures; agreements to move to consolidate pending or

934. Therefore, in addition to adopting the position of the Carriers as set forth in their partial motion for summary disposition, the undersigned finds that immediately after any new filing to change the existing uniform rate, the TAPS Carriers (and intervenors/protestors) should participate in mandatory Rule 601 conferences to discuss matters relevant to uniform rate issues, unless otherwise determined by the Commission. The Commission has the option of either holding any new filing in abeyance, pending resolution and agreements reached from participation in any Rule 601 conference, or proceeding with action, as set forth in the Commission's regulations, including if determined applicable, ordering formal settlement procedures and hearing, or requiring certain progress be made during the course of a Rule 601 conference, prior to issuing such orders.

### ORDER

935. The omission from discussion in this Initial Decision of any argument, testimony or exhibit, raised or offered by the parties at the hearing or in their briefs, does not mean that it has not been considered; rather, it has been evaluated and found to either lack merit or significance, or has been raised sufficiently in another context or by another party, such that inclusion would only tend to lengthen this Initial Decision without altering its substance or effect. Accordingly, all arguments, testimony and evidence made by the Participants which have not been specifically discussed and/or adopted by this decision have been considered and rejected or deemed not significant or repetitive.

936. **IT IS ORDERED**, subject to review by the Commission on exceptions or on its own motion, as provided by the Commission's Rules of Practice and Procedure, that within thirty (30) days of the issuance of the Final Order in this proceeding, all parties shall take appropriate action to implement all the rulings in this decision.

**Michael J. Cianci, Jr.**  
**Presiding Administrative Law Judge**

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future like proceedings; reach stipulations; and other matters, including consideration of possible early settlement offers. In other words, the Carriers would be free to discuss and come up with proposals for what any new uniform rate should be.

Document Content(s)

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