

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P.

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Docket No. IS05-230-000

PREPARED ANSWERING TESTIMONY OF PETER K. ASHTON IN SUPPORT
OF TESORO REFINING AND MARKETING COMPANY

PUBLIC VERSION

November 4, 2005

I. Background/Qualifications

Q. Would you please state your name, address, and present employment.

A. My name is Peter K. Ashton and I am the President of Innovation & Information Consultants, Inc., (IIC, Inc.) an economics and management consulting firm. The address of the firm is 72 Junction Square, Concord, Massachusetts.

Q. Would you also please state on whose behalf you are filing this testimony?

A. I am filing this testimony on behalf of Tesoro Refining and Marketing Company (Tesoro). Tesoro is a refiner that ships petroleum products on the SFPP pipeline that is at issue in this case. I understand that Tesoro filed a Protest of rate increases that SFPP, L.P. is seeking for an interstate petroleum products pipeline from Concord/Richmond, California to Reno/Sparks, Nevada.

Q. What type of work do you and your firm perform?

A. IIC, Inc. performs applied microeconomic analysis of issues pertaining primarily to the energy industries. We have analyzed all facets of the petroleum industry, including regulatory issues related to pipeline ratemaking. I direct virtually all of our projects and spend as much as 75 percent of my time on energy matters.

Q. Could you describe your background?

A. I received my undergraduate degree in economics and government from Colby College in 1976, and a master's degree in economics and business from the School of International Affairs and Public Policy at Columbia University in 1978. Thereafter I worked at Charles River Associates Incorporated in Boston for two years as a Senior Research Associate and as an Associate and Project Manager at Putnam, Hayes &

Bartlett, Inc. for another four years. In 1984, I started IIC, Inc. where I have worked extensively on regulatory issues in the petroleum industry.

Q. Have you testified previously on matters relating to oil pipelines, including rates?

A. Yes, I have testified in a number of cases in the petroleum industry, including cases related to oil pipeline rates, terms of access, quality issues, and issues related to discrimination. I have also assisted others who have testified on these issues dating back over twenty years.

Q. Could you briefly describe some of the oil pipeline matters you have worked on?

A. Yes. I have filed testimony in several rate matters before FERC in which I analyzed rates and developed cost of service models and stand-alone cost models. These cases include *Big West Oil Co. and Chevron Products Co. v. Anschutz Ranch East Pipeline, Inc.* Docket No. OR01-03-000 and OR01-05-000 (consolidated); *Big West Oil Co. and Chevron Products Co. v. Frontier Pipeline Co.* Docket No. OR01-02-000 and OR01-04-000 (consolidated); *Big West Oil, LLC, Chevron Products Company, and Tesoro Refining and Marketing Company v. Express Pipeline LLC and Platte Pipe Line Company*, Docket No. OR02-5-000; *Big West Oil, LLC, Chevron Products Company, Sinclair Oil Corporation and Tesoro Refining and Marketing Company v. Express Pipeline LLC*, Docket No. OR02-8-000; *Big West Oil, LLC, Chevron Products Company, and Tesoro Refining and Marketing Company v. Platte Pipe Line Company*, Docket No. IS02-384-000; *Sinclair Oil Corporation v. BP Pipelines (N.A.), Inc.*, Docket No. OR02-6-02.

I also filed testimony before FERC relating to rates, terms of access, and the need for a quality bank in *UNOCAL California Pipeline Co.*, FERC Proceeding, Docket No. IS92-18-000. In addition, I provided testimony in *Market-Based Ratemaking for Oil Pipelines*, FERC Proceeding, Docket No. RM94-1-000 in which I focused on comparisons of the costs of trucking and various pipeline rates. I have worked on several other cases before FERC in which I performed research and analysis on behalf of various shippers who were challenging rates on various pipelines.¹ This work required me to analyze the Form 6 cost of service filings of the pipeline companies whose rates were being challenged and to develop alternative rates based on market and regulatory factors. I have also assisted various shippers in other matters before FERC, including FERC's review and analysis of the Form 6 reporting requirements (*Revision to and Electronic Filing of the FERC Form 6 and Related Uniform Systems of Accounts*, Docket No. RM99-10-000) and the five year review of the rate indexation rules (*Five Year Review of Oil Pipeline Pricing Index*, Docket No. RM00-11-000 and Docket No. RM05-22-00) of the Commission.

Q. Have you testified before any state regulatory commissions regarding oil pipeline issues?

A. In addition to the matters before FERC to which I just referred, I have also testified before various state regulatory commissions on pipeline rates, access, and other issues. For example, I testified on the rates set by Unocal Pipeline Company in *City of Long Beach v. UNOCAL California Pipeline Co.*, and I reviewed and analyzed the rates set by each and every oil pipeline company operating in California after these pipelines

¹ Examples include *Equilon Pipeline LLC*, Docket No. IS00-208-00; *Amoco Pipeline Company*, Docket No. IS99-268-00; *Sinclair v. Platte Pipeline Co.*, Docket No. OR99-4-000.

became regulated common carriers in 1992 and 1993. I also testified in *The People of the State of California, et al. v. Chevron Corp., et al.*, which involved the analysis of whether certain private carriers were acting in a discriminatory manner and whether their actions constituted the dedication of their pipelines to public use. I have also testified on the rates and terms of access of another pipeline in California, *Application of Pacific Pipeline System, Inc.*, before the California Public Utility Commission (CPUC). Finally, on behalf of several clients, I have performed analyses of the rates and terms of access of various oil pipelines throughout the country. I have also been extensively involved in financial issues, such as computation of required rates of return, the weighted average cost of capital, and the appropriate capital structure as part of numerous valuation studies. To provide more detail about my background and qualifications, I have attached a copy of my curriculum vitae as Exhibit No. PKA-2 to this testimony.

II. Summary of Issues to be Addressed

Q. What is your understanding of the issues and parties in this proceeding?

A. It is my understanding that on April 27, 2005, SFPP, L.P. filed a request with the Commission to increase its interstate rate on its North Line in FERC Tariff No. 111. The rate contained in this tariff pertained to movements from Concord/Richmond, California to Reno, Nevada and the increase was \$0.20 per barrel or an increase of about 17 percent. SFPP claimed that the rate increase was needed “to reflect costs incurred to replace the portion of the North Line that runs from Concord to Sacramento, California.” SFPP filed a cost of service study with its tariff, which it claimed justified the rate increase. Several shippers, including Tesoro, filed protests against this rate increase. Each shipper stated in its Protest that the rate increase proposed by SFPP cannot be justified based on a properly

performed cost of service analysis and therefore, the rate increase is unjust and unreasonable. It is my understanding that SFPP is also seeking a rate increase for the intrastate portion of the shipments on the North Line in a separate proceeding that is currently pending before the California Public Utilities Commission (CPUC). I understand that various protests have been filed against those rate increases as well.

Q. Could you briefly describe the issues you intend to address in your testimony?

A. Yes. My testimony focuses on the cost of service study performed by SFPP, L.P. in its attempt to justify its proposed rate increase for the interstate service on the North Line and the deficiencies I have found in that study. As an initial matter, I note that SFPP has a history of over-recovering its North Line cost of service. Furthermore, SFPP has made no showing as to how the additional revenues it is now seeking in this proceeding could possibly bring the firm into compliance with the Commission's cost of service rules. In other words, at the present time, SFPP is in a position of substantially over-recovering its cost of service. It would therefore appear that the rate increase that SFPP is seeking would simply augment that over-recovery. SFPP has not provided any material in response to discovery in this proceeding that would contradict this initial observation.

I also disagree with a number of aspects of the SFPP cost of service study including the following:

- Income tax allowance – SFPP should not be permitted to reflect any income tax allowance in its cost of service. Eliminating the income tax allowance has a very significant impact on SFPP's cost of service, reducing it by over 12 percent.

- Assumptions regarding test period throughput – SFPP assumes no increase in throughput in the test period relative to the base period, despite a clear indication that the quantity of petroleum products shipped on the North Line will be increasing in the future due to the expansion of the line.
- Capital structure - SFPP proposes to use a hypothetical capital structure based on a management “strategy.” SFPP’s use of this hypothetical capital structure is contrary to Commission precedent that dictates the use of SFPP’s *actual* capital structure or the *actual* capital structure of SFPP’s parent.
- Cost of debt – SFPP’s assumed cost of debt is too high and omits certain elements of debt that, when included in a correct statement of debt, reduces the total cost of debt.
- Return on equity – SFPP’s inclusion of limited partnerships in a proxy group that it uses to determine its return on equity is incorrect, since SFPP has failed to adjust the cash distributions of these partnerships in order to place them on a more equivalent basis to dividends.
- Operating expenses – The actual level of SFPP’s operating expenses in the test period is significantly less than the amount of expenses stated by SFPP. In addition, the amount of operating expenses that is properly allocable to the North Line is similarly less than the expenses stated by SFPP.

After making appropriate adjustments in order to correct SFPP’s cost of service for the North Line service, I conclude that there is no justification for any increase in SFPP’s rates, and indeed there is a stronger likelihood that SFPP will over-recover its cost of service under its existing ceiling rates than under-recover its cost of service.

Q. Before we go into the details of your testimony in this case, could you indicate what data, documents, and other materials you have reviewed and analyzed in preparing your testimony in this case?

A. Yes. I have reviewed the documents and data provided by SFPP in response to discovery in this case, as well as the initial April 27, 2004 tariff filing of SFPP with the attached cost of service study. I have also reviewed various public sources of data and information published by the U.S. Department of Energy, as well as the filings of a number of pipeline companies with the FERC. I have, in addition, consulted prior Commission rulings, orders and policies, prior court rulings, financial data sources such as Moody's, Standard & Poor's, I/B/E/S, *Wall Street Journal*, and annual and quarterly financial reports and SEC 10-K reports filed by SFPP's parent, Kinder Morgan Energy Partners, L.P.

III. History of Over-Recovery on the North Line

Q. You indicated that SFPP has a history of over-recovery of its cost of service on the North Line. Could you elaborate on what you mean by that and its significance?

A. Yes. The Commission has found in the past that SFPP was over-recovering its cost of service on the North Line during the mid and late 1990s.² Stated differently, SFPP has earned revenues that exceeded its cost of service on the North Line for a substantial period of time. This means that SFPP's rates have historically been higher than rates that the Commission would consider to be just and reasonable. In addition, my understanding is that various shippers have claimed that SFPP has continued to over-

² *ARCO Products Co., et al. v. SFPP, L.P.*, 106 FERC ¶ 61,300 (2004).

recover its cost of service on the North Line by a significant amount at least as recently as 2003.³

In fact, the Form 6 that SFPP filed with the Commission for 2004, reported a 16 percent over-recovery system-wide in 2004. SFPP's 2003 Form 6 indicates a 15 percent over-recovery. The expenses that SFPP included in both Form 6 filings include an income tax allowance that the United States Court of Appeals for the D.C. Circuit Court has ruled SFPP is not entitled to receive. Removal of the income tax allowance would increase SFPP's over-recovery to 32 percent in 2004 and 31 percent in 2003. Although the Form 6 data refers to SFPP's entire pipeline system, it certainly raises a substantial question as to whether SFPP's North Line cost of service could now have changed so dramatically that SFPP is likely to incur a substantial divergence between revenues and costs under existing rates as it claims. Obviously the relevance of these data must be viewed in the context of the expansion of the North Line, but given the long history of over-recovery by SFPP on its North Line, we should certainly carefully scrutinize all elements of SFPP's cost of service to ensure that its rates, and in particular its proposed rate increase, are just and reasonable.

Q. And what have you have concluded about SFPP's proposed rate increase?

A. My analysis leads me to conclude that the proposed rate increase is not just and reasonable and under Commission precedent should not be allowed. I have properly computed SFPP's cost of service for the interstate portion of the North Line including the effects of the expansion of the line and the resulting cost of service is \$14,974,000. My analysis shows that even after considering the impact of SFPP's expansion of the North

³ Affidavit of Matthew O'Loughlin in ConocoPhillips Complaint in Docket No. OR-05-5-000, December 29, 2004.

Line, the existing ceiling rate currently being charged by SFPP exceeds the cost of service by 13 percent. Furthermore, the rate increase that SFPP is seeking would result in a 31 percent over-recovery in the firm's cost of service for the North Line. Such an increase is, therefore, not just and reasonable, and should not be permitted by the Commission.

IV. Income Tax Allowance

Q. Have you considered whether SFPP should be entitled to an income tax allowance in its cost of service?

A. Yes, and based on a number of factors, my conclusion is that SFPP is not entitled to an income tax allowance.

Q. Please explain.

A. Neither SFPP nor its parent Kinder Morgan Energy Partners, L.P. ("KMEP") pays income taxes because each entity is a limited partnership. Each company states this fact clearly in its financial filings as well as in its tax returns. For example, KMEP in its 2004 10-K states: "We are not a taxable entity for federal income tax purposes. As such, we do not directly pay federal income tax."⁴

Although a pipeline company is permitted under the Commission's cost of service rules to recover its allowed return after it pays income taxes, an entity that does not pay income taxes, such as SFPP or its parent, is not be permitted to take an income tax allowance in its cost of service. A recent ruling by the United States Court of Appeals for the D.C. Circuit confirmed this precept as it relates specifically to SFPP.⁵ In the D.C. Circuit case, the issue of whether SFPP is entitled to an income tax allowance was

⁴ KMEP 2004 SEC Form 10-K, p. 115.

⁵ *BP West Coast Products LLC v. FERC*, 374 F. 3d 1263 (D.C. Circ. 2004).

adjudicated with court ruling that “SFPP is entitled to no allowance for the phantom income taxes it did not pay.” Based on this legal finding with regard to SFPP specifically, I believe that SFPP should not be entitled to an income tax allowance.

Q. Are you aware that subsequent to the publication of that decision the Commission issued a “Policy Statement” with regard to income tax allowances?

A. Yes.

Q. Does that change your opinion?

A. No. It is my understanding that the Commission’s Policy Statement does not supercede controlling legal precedent which, as I indicated above, clearly indicates that SFPP is not entitled to an income tax allowance. In any event, the Policy Statement makes it clear that the burden of proof is on the pipeline company to establish that its partners have “actual or potential” tax liability.⁶ SFPP has not met that burden of proof and has not demonstrated actual or potential liability. Neither has SFPP demonstrated that the partners all faced a federal tax rate of 35 percent or a state tax rate of 5.3 percent which underlies its income tax allowance computation. The testimony of SFPP’s only witness on income taxes, Mr. Hrdlicka, also does not establish that the partners of SFPP, L.P. or KMEP, L.P. face an actual or potential tax liability on their public utility income.

Furthermore, in a recently issued decision in a separate proceeding involving SFPP,⁷ Judge Zimmet rejected the testimony of Mr. Hrdlicka and, after considering the potential impact of the Commission’s Policy Statement on SFPP, found as follows:⁸

⁶ Mr. Hrdlicka claims that he does not know who has the burden of proof to establish that SFPP should be granted an income tax allowance (see response to Staff Data Request 4.34(e)) even though the Policy Statement clearly indicates that it is the burden of the carrier to make that showing.

⁷ *Texaco Refining and Marketing et al. v. SFPP, L.P.*, Docket Nos. OR-96-2, OR96-10, OR-98-1 and IS98-1, August 24, 2005.

⁸ *Ibid*, paragraph 115.

SFPP has failed to justify an income tax allowance not only for Sepulveda, but for all of the other rates dealt with in Phase Two. They were based upon a 1999 test period, and there is enough that has been presented here that shows that the pipeline should get a zero income tax allowance.

Q. So you do not believe that SFPP should be granted an income tax allowance in its cost of service?

A. No. For the reasons stated above, I have not included any income tax allowance for SFPP in my analysis of its correct cost of service. I would like to point out that the elimination of an income tax allowance makes a significant difference in SFPP's statement of its total interstate cost of service for the North Line and my analysis of a correct cost of service for this portion of the SFPP pipeline system. In its cost of service filing, SFPP has claimed an income tax allowance of \$2.65 million in the test year, which represents over 12 percent of its total claimed cost of service. Indeed if one change alone were made – i.e., the elimination of the tax allowance in the SFPP cost of service – then, using SFPP's own remaining expense data, SFPP could not justify the rate increase that it is seeking in this proceeding.

Q: Suppose the Commission were to permit SFPP to take the full tax allowance proposed in SFPP's cost of service filing. Would SFPP then be entitled to increase its rates?

A: No. My analysis shows that even with a full allowance for income taxes, SFPP would still not be entitled to increase its rates. This is because the remaining adjustments that must be made to SFPP's cost of service indicate that the revenues that SFPP will attain at current rates will equal or exceed SFPP's true cost of service.

V. Assumptions Regarding Test Period Throughput

Q. You indicated that despite expanding a portion of the North Line, SFPP has not increased its throughput assumption for interstate service on the North Line.

Do you believe SFPP's assumption is correct?

A. No, I do not. SFPP has used the actual 2004 interstate throughput figure of 13,865,807 barrels as its assumed throughput for the test year (see Cost of Service Summary Schedule and SFPPNL 03933). The expansion of the North Line covers only that portion of the pipeline between Concord and Sacramento. It is also clear from various planning and financial forecasts developed by SFPP that SFPP expected the expansion of the North Line to create additional capacity for interstate service. Indeed it only makes sense that interstate service would be the beneficiary of the expansion of the pipeline since presumably that is the basis upon which SFPP is asking interstate shippers to pay a portion of the cost of that expansion. Otherwise these shippers should not be paying for these additional costs of the expansion of the line at this point in time. Part of that benefit is the ability to ship more volumes in interstate service. Further, I would note that the testimony of James B. Kehlet filed on behalf of SFPP agrees that a benefit to interstate shippers of the expansion of the pipeline is the ability for interstate shippers to ship greater volumes. Mr. Kehlet specifically states that the expansion of the North Line will mean that the North Line will be out of service for considerably less time, and as a result greater volumes may be shipped on the pipeline.⁹ Mr. Kehlet also testifies that the

⁹ Testimony of James B. Kehlet, SFN-1, pp. 5-6.

expansion of the North Line also means that future demand growth can be accommodated more easily.¹⁰

Q. You referenced certain planning and financial forecasts that projected increases in throughput for interstate service. What do those documents indicate with respect to interstate throughput increases?

A. SFPP's planning documents predicted a [] percent per year increase in throughput on the expanded line until full capacity is reached.¹¹ In view of the fact that the expanded pipeline will be able to transport 176,000 barrels per day, the SFPP analysis indicates that the throughput on the pipeline should continue to expand until at least 2013. It was not clear from the SFPP planning forecast whether growth in throughput on the North Line was being applied evenly to both interstate and intrastate service. I therefore analyzed other information regarding interstate throughput volumes.

Q. What else did you examine?

A. I reviewed the financial planning model used by SFPP for its North Line expansion in which SFPP projected the likely rate of return on its investment.¹² As part of that model, SFPP developed estimates of future throughput for both interstate and intrastate service. This projection uses a throughput assumption of [] b/d in 2005 for interstate volumes. The annual throughput volume amounts to [] barrels. Since SFPP's base period annual interstate volume is [] barrels, the SFPP planning model clearly shows that SFPP anticipates an increase in interstate volumes even in the short run.

¹⁰ SFN-1, p. 6.

¹¹ 1st Supplemental Response to BP et al's 1st Data Request, No. 15, SFPPNL03627.

¹² Response to Tesoro et al. Data Request 29, SFPPNL 07693-96.

I have also reviewed the projections of population growth in the Reno area relied on by Mr. Kehlet in his testimony. This underlying data was produced by Woods & Poole Economics, Inc. Mr. Kehlet relies on these projections as an indicator of future demand for product shipped through the North Line to various destinations including the Reno-Sparks area.¹³ The data indicates that between 2004 and 2005, population in the Reno-Sparks area will grow by 1.7 percent and over the 2005-2010 time period, population will grow by 1.6 percent per year, providing a justification for using these growth factors in throughput over the base period volumes used by SFPP.¹⁴

Finally, SFPP produced a confidential study prepared by Energy Analysts, Inc. (EAI).¹⁵ This study examines the West Coast supply and demand for petroleum products and contains regional projections of the demand for gasoline and other refined products including the demand for specific pipeline transportation including SFPP's North Line. On the basis of an analysis of growth trends, the EAI study projects an increase in the demand for gasoline movements on the interstate portion of the North Line of [] percent between 2004 and 2005 and an annual rate of increase of [] percent for each of the following five years. EAI also projects that the demand for other refined products such as distillate and jet fuel will grow at annual rate of [] percent. In addition, the study projects that gasoline consumption in Nevada as a whole will increase by between [] and [] percent per year over the next 5 years and that the demand for other refined products will increase at similar rates. It is therefore perfectly reasonable to conclude, as I have

¹³ Kehlet testimony, SFN-1, p. 5.

¹⁴ See SFPPNL 22075-077.

¹⁵ SFPPNL 10214-10599, provided in response to Staff D.R. No. 2.19. EAI, "West Coast Downstream Business Analysis, Outlook and Strategy," April 2005.

done, that throughput on the interstate portion of the North Line will increase between 1.6 and 1.9 percent each year for the next five years.

Q. What does this data tell you about the appropriate throughput level for the North Line for the test period?

A. Each of the studies to which I referred above provides a reasonable prediction of the growth that will take place on the interstate portion of the North Line over the next five years. To arrive at a “consensus” of the various studies I computed a simple average of the conclusions reached in these studies in order to determine a one-year rate of growth in throughput. I have reported the results of my calculations in Exhibit No. PKA-3. Based on the information in this Exhibit, I believe it is appropriate to use a test period throughput assumption of [] barrels for interstate service on the North Line. This throughput level reflects an increase of approximately [] percent over base period 2004 volumes.

Q. How does this estimate compare with data provided by SFPP on actual throughput on the North line for 2005?

A. SFPP has now provided data on throughput for the first nine months of 2005. This throughput data does show a slight decline in volume relative to 2004. However, all available data suggests that throughput volumes will increase in the future, and will continue to increase on an annual basis until capacity constraints are hit on the pipeline. From a ratemaking standpoint, one must include the impact of this increase in volumes, particularly since as SFPP Witness Kehlet stated the anticipated increase in throughput is one of the primary benefits to interstate shippers on the North Line. I believe that my test year throughput estimates are conservative since I used only a one-year rate of increase in

my cost of service computation, even though all the independent studies I examined as well as SFPP's own internal data indicate that throughput will increase on a regular basis into the future.¹⁶

VI. Capital Structure

Q: Why is it important to correctly compute a base and test year capital structure for SFPP?

A: One of the principal objectives in determining an oil pipeline's cost of service is the calculation of a fair rate of return to be applied to the pipeline's rate base. A fair rate of return on total capital is a result of blending individual cost components of the firm's capital structure. These calculations then enable us to determine the measure of the financial risk assumed by the pipeline. Consequently, we must determine an appropriate capital structure for SFPP in order to compute SFPP's cost of service.

Q: What are the components of the capital structure?

A: Capital structure consists of a debt and an equity component, usually long-term debt and common and preferred equity. Once the capital structure is determined, the overall cost of capital is computed by weighting the cost of debt and the return on equity by the indicated capital structure.

Q: How did you determine the appropriate base and test year capital structures for SFPP?

A: Opinion 154-B (*Williams Pipeline Company* 31 FERC ¶61,377 (1985)) states that a pipeline should use its actual capital structure, or if the pipeline's actual capital structure is not representative of the risks faced by the pipeline, the capital structure of its

¹⁶ Alternatively, one could exclude from the rate base a portion of the costs associated with the expansion at this time, until interstate shippers will benefit from the expansion. At that point these costs could be rolled into the rate base.

parent company. As of December 31, 2004, SFPP did not have any outstanding debt, and relied instead on the debt financing of its immediate parent, Kinder Morgan Energy Partners L.P. (KMEP). Consistent with FERC precedent, I therefore used the actual capital structure of KMEP, adjusted for purchase accounting adjustments, as of December 31, 2004 as SFPP's capital structure for the base year. I used KMEP's capital structure as of June 30, 2005 for SFPP's test year.

Q: Why did you rely upon June 30, 2005 data for the test year capital structure?

A: At the time I performed my cost of service calculations, the latest financial data available for the test year was the quarterly 10-Q document filed by KMEP on August 1, 2005 for the period ended June 30, 2005.

Q: You mentioned purchase accounting adjustments. What are these?

A: Purchase accounting adjustments (PAAs) are restatements of equity and asset balances. These restatements are made when a company acquires assets.

Q: Why is it appropriate to adjust the capital structure for PAAs?

A: The inclusion of a positive PAA leads to an inflated restatement of the investment base and equity amount on the balance sheet, subsequently leading to an inflated allowed return on the rate base. For example, when KMEP acquired SFPP in 1998, SFPP wrote up its rate base to reflect the premium over the regulatory return that KMEP paid to acquire SFPP. The result was a write-up in both the carrier property and the equity component of SFPP's balance sheet. Concerning the capital structure, the write-up of the equity component will lead to an inflated capital structure, unduly weighted towards equity.

Q: Has the Commission rejected the inclusion of the SFPP PAA in prior proceedings?

A: Yes. In both the Order on Initial Decision¹⁷ and the Phase Two Initial Decision¹⁸ concerning the OR96-2 proceedings, the Commission recognized the impropriety of including the PAA in the equity component of the capital structure. I therefore adjusted KMEP's reported equity in its 2004 10-K (base year) and the June 2005 10-Q (test year) to reduce the equity component of the capital structure by removing applicable PAAs.

Q: How did you adjust the equity component to account for the PAAs?

A: I followed the recommended procedure discussed in the Phase Two decision of the OR96-2 proceedings. (*Texaco Refining and Marketing, Inc. et al. v. SFPP, L.P.*, (108 FERC 63,036 (2004) at P 341-343) In doing so, I relied on SFPP discovery responses Number 13(a) and 13(c) to the first set of discovery requests of ConocoPhillips Company, Chevron Products Company, and Valero Marketing and Supply Company. The information provided in these discovery requests identified the purchase accounting adjustments related to KMEP acquisitions and enabled me to remove the purchase accounting adjustments from KMEP's equity component. Based on this data, I removed five PAAs from KMEP's reported equity. The five adjustments relate to the following FERC regulated entities: Kinder Morgan Interstate Gas Transmission Co., Trailblazer Pipeline Company, SFPP, L.P., TransColorado Gas Transmission Company, and Kaston Pipeline Company, L.P. As shown in Exhibit No. PKA-4 and in accordance with the procedure described by the Commission in the Phase Two decision, I adjusted the

¹⁷ *ARCO Products Co., et al. v. SFPP, L.P.*, (106 FERC ¶61,300 (2004) at P 79 - 80)

¹⁸ *Texaco Refining and Marketing, Inc. et al. v. SFPP, L.P.*, (108 FERC 63,036 (2004) at P 336 – 345)

purchase accounting adjustment amounts to reflect depreciation in the underlying assets from the dates of the accounting adjustments to December 31, 2004 and June 30, 2005.

Q: What base and test year capital structures did you employ?

A: Relying on the actual KMEP capital structure, adjusted for PAAs, I computed a base year capital structure of 57.8 percent debt and 42.2 percent equity, and a test year capital structure of 64.6 percent debt and 35.4 percent equity. My methodology in calculating these figures is shown in Exhibit No. PKA-5.

Q: What test period capital structure did SFPP propose in its cost of service filing?

A: SFPP proposed to use a test year capital structure of 40 percent debt and 60 percent equity based on KMEP management expectations of a “target” capital structure.

Q: Do you feel that SFPP’s proposed structure is a reasonable capital structure to employ in determining the cost of service for the SFPP North Line?

A: No, I do not. It is not reasonable or appropriate for a pipeline to use its “desired” capital structure in determining its capital structure for FERC regulatory purposes. A “desired” capital structure is simply a hypothetical capital structure, and the Commission has clearly stated that the pipeline’s *actual* capital structure must be used. If the pipeline does not issue its own non-guaranteed debt and does not have a bond rating, then the *actual* capital structure of the pipeline’s parent must be used. These precepts are stated quite clearly in the following Commission decisions: *Williams Pipeline Company* 31 FERC ¶61,377 (1985) and *Transcontinental Gas Pipeline Corporation (Transco)* 84 FERC ¶61,084(1998).

The impropriety of using SFPP's or KMEP's "expected" capital structure for regulatory cost of service purposes is demonstrated by KMEP's failure over the past several years to come close to attaining that capital structure. Despite the fact that KMEP has had a "target" capital structure of 60 percent equity and 40 percent debt since at least 2001, KMEP has never actually achieved this ratio of equity and debt; nor is there any indication or guarantee that KMEP will achieve its so-called "desired" capital structure in 2005. In fact, as my test period capital structure shows, KMEP has actually increased its debt leverage with respect to equity capital in 2005. Thus KMEP is moving further away from, not closer to, its alleged "target" capital structure.

Q: SFPP Witness Williamson cites KMEP's issuance of long-term debt in a period of declining interest rates (2001-2004) as evidence that KMEP's "current book capital structure is not the best indication of a capital structure for cost of service test period purposes." (SFN-17, p. 33, ln 17-18) Is this a reasonable conclusion?

A: No. Dr. Williamson fails to provide any information or data that correlates interest rate movements with shifts in the capital structure of either SFPP or KMEP. In particular, there is no evidence that supports Dr. Williamson's expectation that a period of increasing interest rates, similar to that which has occurred over the past few months, will lead either to retirement of KMEP debt or issuance of new equity. In forming his opinion that KMEP's current book capital structure is not the best indication of an appropriate capital structure for test period purposes, Dr. Williamson relied solely on his review of the 2004 annual reports for KMEP.¹⁹ He failed to consider KMEP's historical

¹⁹ See SFPP response to questions 38(c) and 38(h) of the Second Data Request of Tesoro Refining and Marketing Company.

capital structure or its actual capital structure for the relevant time period including year-end 2004 as well as the most recent time period. As a result, Dr. Williamson failed to provide any corroborating evidence that debt levels, interest rates or interest rate expectations have in any way actually affected KMEP's capital structure. Moreover, aside from the absence of any empirical evidence to support his supposition that KMEP's level of debt will decline, particularly as interest rates rise, Dr. Williamson also failed to relate any of his findings regarding his selection of a hypothetical capital structure to the Commission's preference for using actual capital structures. In any event, however, KMEP's actual conduct contradicts Dr. Williamson's supposition. Even though interest rates have increased slightly over the past several months, KMEP has actually increased the amount of debt in its capital structure, thus contradicting Dr. Williamson's theories.

VII. Cost of Debt

Q: How did you determine SFPP's cost of debt for the base and test period in your cost of service models?

A: I examined the outstanding debt of KMEP as of December 31, 2004 for the base period and KMEP's outstanding debt for June 30, 2005 for the test period. As shown in Exhibit No. PKA-6, I computed KMEP's weighted average cost of borrowing for all long-term debt instruments with identifiable rates.

Q: What were your base and test year costs of debt?

A: As shown in detail in Exhibit No. PKA-6, I computed a base year cost of debt of 6.09 percent and a test year cost of debt of 5.96 percent.

Q: What cost of debt did SFPP compute its base period and test period?

A: SFPP computed a 6.57 percent cost of debt for both the base period and the test.

Q: Please explain how your base year cost of debt differs from SFPP's.

A: While both SFPP and I computed the cost of debt based on outstanding debt instruments, SFPP excluded approximately \$643 million of long-term debt from its weighted average cost of borrowing. I included the portion of this long-term debt that had identifiable cost of borrowings in my cost of debt calculations. As a result, my base period cost of debt calculation is different from SFPP's calculation.

Q: Why did SFPP exclude the long-term debt?

A: SFPP claimed that “[t]he \$643 million of ‘other debt’ and ‘market value of swaps’ is not long-term debt that was available to finance the North Line.”²⁰

Q: Is SFPP's exclusion of this debt reasonable?

A: No. With the exception of the market value of swaps, all of the long term debt that SFPP excluded from its debt calculation had identifiable cost of borrowing rates and could at SFPP's option be used as long-term debt for SFPP financial requirements. For example, on page 72 of the 2004 10-K, KMEP states “[w]e intended and had the ability to refinance all of [its] short-term debt on a long-term basis under our unsecured long-term credit facility.” In fact, SFPP's supposed “short-term” commercial paper borrowings were supported by a long-term credit facility.

Q: Did SFPP have a history of adjusting either its capital structure or current cost of debt with new long-term debt?

A: Yes. According to Workpaper 5 of SFPP's cost of service filing, between 1999 and 2003, SFPP adjusted its capital structure by considering within its long-term debt category short-term debt that SFPP expected would be refinanced with new debt.

²⁰ See SFPP response to question 38(f) [sic] of Tesoro Refining and Marketing Company's Second Data Request.

VIII. Required Return on Equity

Q: How did you determine the base and test year return on equity for your model of SFPP's cost of service?

A. I used a Discounted Cash Flow (DCF) methodology similar to the one outlined and accepted by the Commission in its Initial Decisions in Docket Nos. RP95-364-005 (*Williston Basin Interstate Pipeline Company*, 91 FERC ¶63, 005 (2000)) and RP00-107-000 (*Williston Basin Interstate Pipeline Company*, 95 FERC ¶63, 008 (2001)).²¹ The DCF method provides a range of return for a particular company on the basis of the return on equity of an industry proxy group. The range of the rate of return of the proxy group companies is examined and then a particular rate within the range is selected that best represents the business risks that the particular company is encountering in the market. In selecting the particular rate of return for the cost of service model, we assume that the business risks that the company is encountering are not within its control.

Q. Could you briefly discuss how the DCF approach is used to compute the return on equity?

A. The DCF approach is based on computing a return on equity by measuring the cash flows generated by the company and available to stockholders, adjusted for future growth expectations. The DCF formula²² is:

$$K = [(D/P) * (1 + 0.5g)] + g$$

Where:

K = Market required return on equity

D/P = Dividend Yield

²¹ Also *SFPP, L.P.* 86 FERC ¶61, 022 Opinion 435 (1999), and *Transcontinental Gas Pipe Line Corp.* 80 FERC ¶61, 157 Opinion 414 (1997).

²² Opinion No. 414-A, *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶61,084 (1998)

g = Dividend growth rate
 $(1+0.5g)$ = Adjustment factor for quarterly dividend payments

Q: You mentioned following a methodology similar to the one outlined in prior Commission precedent. How does your methodology differ?

A: The formula to which I referred above contains a value for dividend yield. The primary difference between the methodology I am using and other methodologies that have been used in past FERC cases involves the computation of the dividend yield. Traditionally, the dividend yield is calculated by dividing the average expected dividend by the average stock price over a period of six months. However, in this proceeding, the proxy group of comparable companies are master limited partnerships, and therefore, do not report dividends.

Q: Is it nonetheless possible to calculate a dividend yield for the proxy companies?

A: In the strictest sense, no. We cannot calculate a dividend yield for the proxy companies because they do not report dividends. However, they do report cash distributions. Many individuals, including SFPP Witness Williamson,²³ have used a “distribution” yield in the DCF methodology.

Q: Has the Commission expressed concern over the use of distribution yields in determining the appropriate return on equity?

²³ In the “Prepared Answering Testimony of J. Peter Williamson”, filed May 15, 2001 in Docket No. OR96-2-000 *et al.*, Dr. Williamson employed the distribution yield for his proxy group of six MLPs.

A: Yes. In the recent *HIOS* decision (*High Island Offshore Partners, L.L.C.*, 110 FERC ¶61,043 (2005)), the Commission recognized that the cash distributions of master limited partnerships may contain a return of capital and therefore are not appropriate to use in a discounted cash flow analysis when determining an appropriate real return on equity. The *HIOS* decision eliminated the use of MLPs from the proxy group in computing a real return on equity.

Q: Is eliminating MLPs from the proxy group of companies a feasible option in this proceeding?

A: No. In the present proceeding, the most relevant companies to include in the proxy group are all MLPs. That is because the only companies that have been historically included in the oil pipeline proxy group have been MLPs. In contrast, the *HIOS* proceedings involved a natural gas pipeline, and non-MLP comparable companies were available to include in that proxy group. Other than MLPs, there are no other oil pipeline companies that are comparable to SFPP. Consequently, the Commission has, in the past, accepted the use of a proxy group consisting solely of oil pipeline limited partnerships in determining the real return on equity for SFPP.²⁴ As a result, we need to include master limited partnerships in the SFPP model and then make appropriate adjustments in the cash distributions of the members of the proxy group in order to address the point raised in the *HIOS* decision that the proxy group distributions should not include a return on capital for FERC regulatory purposes.

²⁴ In Opinion 435 (*SFPP, L.P.*, 86 FERC ¶61,022 (1999)), the Commission accepted the use of six oil limited partnerships as the proxy group for computing the return on equity for SFPP.

Q: Did the cost of service analysis that SFPP presented in this case take into account the *HIOS* decision by adjustments to the proxy group MLP cash distributions for potential return of capital?

A: No. SFPP Witness Williamson claimed that the Commission’s concerns over the inclusion of a potential return of capital “reflects a misunderstanding on the Commission’s part as to the nature of MLP distributions, and constitutes a serious disagreement with the investment community” (Exhibit SFN-20, p. 20, lines 14-17). Dr. Williamson ignored the *HIOS* ruling in his computation of the dividend yield. Dr. Williamson therefore computed a dividend yield by including the full cash distributions per unit of the proxy companies and divided that figure by the six-month average unit price.

Q: So Dr. Williamson implicitly assumed that despite the *HIOS* ruling, cash distributions do not represent a potential return of capital?

A: That is correct. Dr. Williamson indicated he believed that distributions do not include a return of the partners’ original investment in any “objective” sense.

Q: Does Dr. Williamson provide any support for his conclusion that MLP cash distributions do not represent a potential return of capital?

A: No, not really. Dr. Williamson attempts to equate corporate dividends, which represent a return on capital, with distributions, which may include a return of capital, by focusing on the perceived similarity in cash flows generated by MLPs and corporations. He notes that in both cases, the “total return to the investor is the series of (generally quarterly) cash flows – dividends or distributions – and the cash proceeds when the

shares or units are sold. In both cases, these cash flows are all that the investor expects to receive on his or her investment.”²⁵ While cash flows are important, Dr. Williamson is ignoring the fundamental concern, namely that an MLP cash distribution is a disbursement of cash and not an allocation of income. Indeed, there can be many possible sources of cash in a cash distribution that are not derived from earnings. On the other hand, as the ALJ in the *Sepulveda* proceeding noted:

a dividend paid by a subchapter-C corporation to a stockholder comes from the company’s profits (earnings), current or accumulated through the retention of earnings. Generally, a dividend is a return on capital, deemed to be income subject to income taxes in the year paid.²⁶

Q: Did the ALJ in the *Sepulveda* proceeding accept Dr. Williamson’s position that cash distributions are equivalent to dividends?

A: No. In fact, Judge Zimmet stated:

[Dr. Williamson’s] focus on cash is far too narrow, concentrating entirely on investors’ expectations and desires. True, investors need to be considered, but their hopes cannot be the sole criterion or final word to determine the equity-rate questions presented here. If cash received, without regard to its origins, is all that matters to investors, and therefore, should be all that counts in this case, the income-tax consequences would be overlooked, and the door would be open to all sorts of mischief contrary to the public interest.²⁷

Q: Do MLPs face different income tax considerations compared with companies that pay dividends?

A: Yes. Due to the partnership structure, MLPs generally do not pay income taxes.

Thus unlike corporate investors, investors in MLPs avoid double taxation that occurs

²⁵ See Exhibit SFN-17, p. 19, lines 20-24.

²⁶ 112 FERC ¶63,020 (2005) at 63.

²⁷ 112 FERC ¶63,020 (2005) at 71.

with corporate dividends. As a result, MLPs typically receive a tax shield on cash distributions.

Q: Do these different tax considerations support a conclusion that corporate dividends and MLP distributions are essentially the same?

A: No. As Dr. Williamson himself points out, “The difference in income tax treatment between the two ownership structures [corporations and MLPs] is another important factor that might affect an investor’s choice between the corporate form of organization and the limited partnership form.”²⁸ Dr. Williamson attempts to reason away the fact that cash distributions involve a potential “return of capital” by arguing that a “return of capital” is tax-free, but because taxes on cash distributions are only “tax-deferred,” they do not represent a “return of capital.” However, Dr. Williamson fails to provide any evidence that would support his position that a unitholder has a future income tax obligation when a unit is sold.

Q: In your opinion, does the fact that certain investment publications list distribution yields under a heading of “dividend yield” imply equivalency between dividends and distributions?

A: No. This is a question of semantics, and attempting to infer equivalency based on language, as opposed to facts, is absurd. Dr. Williamson and SFPP argue that because *Value Line* investment publications list the distribution yield to a partner under the heading of “dividend yield,” *Value Line* regards a partnership distribution as equivalent to a corporate dividend. It is irrational to assume that investors, basing investment decisions on a *Value Line* report, would not be cognizant of the fact that an entity is an

²⁸ Exhibit SFN-17, p. 28, lines 5-8.

MLP, and that the listed yield refers not to a dividend yield, since the MLP does not pay dividends but rather a distribution yield, since MLPs pay cash *distributions*. Despite Dr. Williamson's repeated efforts to equate "distributions" and "dividends", the very nature of the MLP organization delineates the differences. Due to its partnership structure, an MLP generally does not pay income taxes. Thus, unlike corporate investors, MLP investors are not subject to double taxation on dividends.²⁹ A prudent investor would probably not only consider how cash distributions are determined, but would also examine a number of other financial factors, including earnings estimates and tax implications.

Q: Dr. Williamson also refers to the *Wall Street Journal* as an example of a publication that equates distributions and dividends. Is this a reasonable assumption?

A: No. Again, this is an issue of semantics. In fact the *Wall Street Journal* is quick to point out that the daily reported "YLD %" represents "Yield – defined as the dividends or other distributions paid by a security, expressed as a percentage of price." In addition, the *Wall Street Journal* distinguishes between dividends and distributions, by listing both in the "Dividend/Distribution" definition. This is shown in Exhibit No. PKA-7. It is not unreasonable for the *Wall Street Journal* to include all securities in its alphabetical listing, as opposed to breaking MLPs into a separate section with unique and distinct column headings. A prudent investor familiar with the nature of MLPs will recognize that the yield refers to a distribution yield, as opposed to a dividend yield.

²⁹ Exhibit SFN-19, Appendix D, p. 12.

Q: In your opinion, is there any merit to the argument that because certain publications list “distribution yields” under a column heading of “dividend yields” that the two are equivalent?

A: No. As the ALJ correctly noted in the *Sepulveda* proceeding: “To be sure, the name of the payment [distribution yield or dividend yield] is not the critical factor. Instead what counts particularly are the payment’s origins (from earnings or some other source) and income-tax consequences.”³⁰ SFPP’s attempt to use semantics to argue equivalency is an incorrect approach to determining an appropriate real return on equity.

Q: Does Dr. Williamson provide other support for his conclusion that MLP distributions do not represent a return of capital?

A: Yes. Dr. Williamson provided a study, Exhibit SFN-22, which examines the “book value per unit” of each proxy group company over the past fifteen years. Dr. Williamson observes that the book value per unit increases over time for each proxy group company, stating,

“[t]he increase in unit prices over the years (the last data item) shows clearly that the value of MLP units grew over time and was not reduced by distributions Investors are fully justified in expecting a rise in the value of their investment in an MLP and at the same time regarding the distributions as equivalent to dividends, and not a return of investment.”³¹

Q: Do you agree with Dr. Williamson’s conclusions regarding the equivalency of distributions and dividends in light of increasing book value per unit prices?

³⁰ 112 FERC ¶63,020 (2005) at 61.

³¹ Exhibit SFN-17, p.22, lines 7-13

A: No, I do not. The fact that book value (equity) per unit may increase over time does not preclude the further fact that a cash distribution contains a return of capital. There are a variety of reasons that can cause the book value per equity unit to fluctuate in any given year. For example, an MLP may be in the business of acquiring other companies and increase its equity value solely as a result of an acquisition. We only need to look at KMEP, which has acquired a substantial number of other companies over the past seven years, and in many cases, adjusted its equity balance to reflect a write-up in asset value.

Q: Does Dr. Williamson or SFPP provide any further rationale for justifying the equivalency of MLP distributions and corporate dividends for use in the Commission's DCF methodology?

A: Yes. Dr. Williamson and SFPP claim that a higher distribution yield is offset by lower growth expectations for MLPs, and in the end, there is little difference in the nominal return on equity rates.

Q: Does Dr. Williamson provide any support for this argument?

A: Dr. Williamson points to Kinder Morgan Inc. (KMI) and KMEP, where the "yield" for KMEP is significantly higher than KMI, but the growth rate is lower, leading to a lower return on equity for KMEP compared with KMI.

Q: Is this example pertinent or relevant to the current proceeding?

A: No. In fact, attempting to compare KMI's and KMEP's return on equity values is an apples to oranges comparison. There are significant functional differences between KMEP and KMI, and for this very reason, KMI is not included in the proxy group.

Besides the obvious functional difference in corporate organization, KMI regards itself as “one of the largest energy transportation and storage companies in America” while KMEP considers itself “one of the largest publicly traded pipeline limited partnerships in the United States.”³² On one hand, KMEP’s operations focuses primarily on the midstream operations of pipeline transportation, whereas KMI includes upstream operations (e.g. gas gathering) that will lead to different perceptions of future earnings expectations. The situation is further clouded by attempting to compare an earnings estimate of a corporation (KMI) that owns the general partner of the MLP (KMEP) and the earnings of the MLP itself. Inherent in the earnings estimation of KMI is the influence of the earnings estimate of KMEP, which blurs the distinction between a true corporate earnings estimate and a comparable MLP estimate.

Q: Does the ALJ in the *Sepulveda* proceeding accept Dr. Williamson’s position in permitting the use of distribution yields in the DCF methodology?

A: No. The ALJ stated:

[SFPP] has tried through another argument of Professor Williamson to change the subject at hand, dividend yield. It does so by raising the irrelevant point that in the end a higher dividend yield may not matter if it causes the future growth rate to be lower. But it is the unduly inflated dividend yields caused by cash distributions that are the source of the problem here, and will not be erased by an argument about growth.³³

Q: The Commission has stated that it prefers using the DCF methodology, which includes the “dividend yield” as a key input in determining an appropriate

³² See Kinder Morgan website, http://www.kindermorgan.com/about_us/default.cfm

³³ 112 FERC ¶63,020 (2005) fn. 22

rate of return for cost of service purposes. In light of the *HIOS* and *Sepulveda* proceedings, how can you justify the inclusion of MLPs, and the return of capital associated with distributions, in calculating real return on equity for SFPP's base and test periods?

A: There is no difficulty in including these companies in the proxy group – but *only* if we also eliminate the return of capital component from the cash distributions of each MPL in the proxy group. We can accomplish that objective by examining and relying only on earnings per unit of each MLP. These earnings represent a return *on* capital rather than a distribution *of* capital.

Q: How did you use earnings per unit to compute the “dividend yield” for each proxy group company?

A: I used a methodology that was first introduced by Matthew O’Loughlin, an expert in CPUC Application No. 03-02-027. This methodology was further discussed in Mr. O’Laughlin’s affidavit supporting a ConocoPhillips Complaint challenging the reasonableness of SFPP tariffs-- FERC Nos. 103 through 108.³⁴ Based on that methodology, I computed a modified dividend yield for each MPL proxy group company by using earnings per unit divided by the six-month average stock price. My calculations in deriving these modified dividend yields are presented in Exhibit No. PKA-8.

Q: Does this methodology satisfy the concern expressed in the *HIOS* decisions regarding potential return of capital being intermingled with dividends that represent earnings or income?

³⁴ Complaint of ConocoPhillips Company, filed with FERC on December 29, 2004.

A: Yes. By limiting the dividend yield to 100 percent of the net income per unit, I am eliminating any return of capital that would otherwise be included in the cash distributions of the MPL proxy group of companies.

Q: Did the ALJ in the *Sepulveda* proceeding discuss the use of earnings per unit as a substitute for dividends in the DCF methodology?

A: Yes. The ALJ expressed concern over the use of earnings based on the fact that dividends tend to be fairly stable, while net income may fluctuate greatly from year-to-year depending on gross-income levels and costs. In addition, the ALJ noted that a dividend usually represents only a portion of a corporation's earnings, with the rest of the earnings retained.

Q: How do you account for these concerns in using your earnings estimate?

A: Regarding the variability of the earnings estimate, I examined the earnings data for each of the proxy companies and found that while variations exist, these variations were not sufficient to exclude the use of earnings per unit as a proxy for the dividend yield. Second, the use of the full earnings estimate represents a conservative estimate, in view of the fact that we expect a portion of the earnings to be retained.

Q: Once you computed the modified dividend yields, what was the next step in computing SFPP's correct base and test year return on equity?

A: The next step was to calculate the growth factor in the DCF methodology. The Commission employs a two-stage DCF approach, where the growth factor is calculated by weighting a short-term growth component and a long-term growth component.

Q: How is the short-term growth component computed?

A: The short-term growth component consists of the three- to five-year median forecast of earnings per share, as reported by professional security analysts. There are several services that report this data, including IBES data, which has been relied upon in prior proceedings.

Q: What source of short-term earnings growth estimates did you employ?

A: I relied upon the median of the IBES earnings estimates as of December 2004 for the base period and June 2005 for the test period. This data is attached as Exhibit No. PKA-9.

Q: How is the long-term growth component computed?

A: The long-term growth is a long-term forecast of the nominal Gross Domestic Product (GDP). I focused on the long-term nominal GDP forecasts of a number of sources, including the U.S. Department of Energy, Energy Information Administration (EIA), Global Insight (formerly DRI-WEFA), and the Social Security Administration (SSA).

Q: Has the Commission previously used multiple GDP forecasts to determine the long-term growth component, including the SSA forecast?

A: Yes. The Commission has used multiple GDP forecasts, including the SSA forecast in several recent proceedings. Examples of proceedings in which the Commission has done so are *High Island Offshore Partners, L.L.C.*, 110 FERC ¶61,043 (2005), *Williston Basin Interstate Pipeline Company*, 104 FERC ¶61,036 (2003), *Williston Basin Interstate Pipeline Company*, 91 FERC ¶63,005 (2000), *Stingray Pipeline Company*, 98 FERC ¶63,004, and *Enbridge Pipeline*, 100 FERC ¶ 61,260 (2002).

Q: SFPP Witness Williamson raises several concerns regarding the SSA forecast, and he ultimately excludes it from his long-term growth component? Is this exclusion reasonable?

A: No. Excluding the SSA GDP forecast is unreasonable, and inconsistent with Commission precedent. As SFPP points out in Dr. Williamson's testimony,³⁵ there is a clear preference by the Commission to include the SSA forecast. The Commission in *High Island Offshore Partners, L.L.C.*, 110 FERC ¶61,043 (2005) clearly stated that the SSA GDP forecast should be included as one of several projections to be used:

The Commission also approved use of the SSA GDP growth estimate in *Enbridge*. The fact that no party opposed the inclusion of SSA forecasts in the calculation of long-term growth rates in those cases does not make them a less valid element in the analysis. Projecting long-term growth in GDP is an inexact science. The Commission believes that use of an average of the projections of a number of professional organizations making such projections is appropriate. While those organizations may make those projections for varying purposes, the use of a number of projections made from such different viewpoints may produce a more reliable projection than the use of any single projection.³⁶

Finally, Dr. Williamson has stated that he is unaware of any Commission precedent that adopted his methodology of using only EIA and Global Insight forecasts to derive the long term growth rate.³⁷

Q: Does SFPP produce any evidence that justifies the exclusion of the SSA GDP forecast?

A: No. SFPP does not provide sufficient evidence to support excluding the SSA GDP forecast from the long-term growth forecast. Dr. Williamson simply states that

³⁵ Exhibit SFN-20, p. 14, lines 12-18.

³⁶ *High Island Offshore Partners, L.L.C.*, 110 FERC ¶61,043 (2005), P 153.

³⁷ SFPP Response to Trial Staff's Fourth Data Request 4.30.

GDP forecasts published by the SSA reflect “extreme conservatism,” and bases his conclusion on the observation that the SSA GDP forecast is lower than the other two forecasts he has relied upon. The fact that a recognized index is “conservative” does not justify ignoring it, particularly when the index is simply one of a number of indices, all of which are used to compute an average growth expectation. By arbitrarily excluding the SSA forecast, Dr. Williamson has unreasonably skewed his data as well as ignoring Commission precedent.

Q: How did you weight the short-term and long-term growth rates to arrive at a combined growth factor?

A: Once I had the two components, I followed Commission precedent in Opinion 414-A³⁸ and determined a final growth factor for each company in the proxy group by weighting the short-term earnings forecasts by two-thirds, and the long-term GDP forecast by one-third. These calculations are presented in Exhibit No. PKA-10.

Q: Did SFPP express reservations about using this two-stage growth methodology?

A: Yes. Dr. Williamson stated “that the use of the second stage growth forecast does not accurately reflect investor behavior and that the Commission's method does not qualify as a true ‘market based’ method.”³⁹ However, unlike his decision to ignore the *HIOS* decision, in this instance, Dr. Williamson elects to follow Commission precedent and use the two-stage growth method.

³⁸ *Transcontinental Gas Pipe Line Corporation*, Opinion 414-A (1998).

³⁹ Exhibit SFN-20, p. 13, lines 23-25.

Q: What were the results of your proxy group computations concerning the base and test period returns on equity?

A: The return on equity calculations are also presented in Exhibit No. PKA-10. For the base period, the nominal return on equity ranges from a high of 11.89 percent, to a low of 9.29 percent, with a median value of 10.21 percent. For the test period, the nominal return on equity ranges from a high of 12.0 percent, to a low of 8.99 percent, with a median value of 9.91 percent.

Q: Given this range of values, how did you select the appropriate return on equity for SFPP?

A. The last step in determining an appropriate return on equity is to assess where SFPP falls within this “range of reasonableness,” given the risks that SFPP faces in comparison to the companies that comprise the industry proxy group. As outlined in *Transco* Opinion 414-A (84 FERC ¶61,084 (1998)), the Commission prefers using the median of the proxy group as an indication of the average return on equity for the proxy group. I have followed that guidance and used the median.

Q: What is that median nominal rate of return on equity for the test period?

A: As Exhibit No. PKA-10 indicates, it is 9.91 percent.

Q. Once you determined the proper return on equity to use for SFPP in determining its cost of service, did you have to make any other adjustments in order to compute the overall rate of return?

A. Yes. The nominal rate of return on equity must be adjusted to a real basis by subtracting an inflation rate. Under the cost of service methodology discussed in *Williams Pipeline Company* 31, FERC ¶61,377 (1985) Opinion 154-B, the allowed return

on the equity rate base is computed in real terms (i.e., after taking out the effects of inflation) and the inflationary aspect is captured in the equity rate base write-up. This write-up is reflected in the amortization of deferred income, and is computed by multiplying the equity rate base by the inflation factor. Once I determined the nominal return on equity, I subtracted the annual price change in the Consumer Price Index (CPI) for all urban consumers - all items from the nominal return on equity. For the base period, I used the December to December annual change for 2004, which was 3.26 percent, leading to a real return on equity of 6.95 percent. For the test period, I used the June to June annual change for 2005, which was 2.53 percent, leading to a real return on equity of 7.38 percent.

Q: The ALJ in the *Sepulveda* proceeding rejected the arguments proffered by SFPP and Dr. Williamson for using distribution yields in lieu of dividend yields, yet the ALJ ultimately relied upon a DCF calculation using distribution yields. Does the ALJ's ruling provide justification for using the real return on equity computed by Dr. Williamson and SFPP, as opposed to the return on equity computed in your DCF methodology?

A: No. While I firmly believe that the use of earnings per unit represents a better alternative to using cash distributions in a DCF methodology concerning MLPs, I recognize that the ALJ relies upon the use of distribution yields. However, the ALJ clearly states:

Stemming from a wide range of unduly inflated 'dividend yields' caused by cash distributions, there is a need to keep the rate of return on equity as reasonably low as possible toward the bottom of the range.⁴⁰

⁴⁰ 112 FERC ¶ 63,020 at 49.

SFPP and Dr. Williamson erred by selecting the median return on equity from the range defined by the proxy group. Consistent with the ALJ's ruling, I have selected the lowest observation in the range as the appropriate base and test period return on equity.

Q: Have you calculated the base and test period return on equity using “distribution” yield as opposed to “dividend” yield?

A: Yes. I computed base and test period returns on equity for each of the proxy group companies, following a methodology similar to the one employed by Dr. Williamson. I computed a range of nominal returns on equity for the base and test period, and used the lower end of the range and then subtracted the inflation rate to determine a base and test period return on equity.

Q: How do these results compare with the computation of the base and test period real return on equity determined from your methodology of employing earnings per unit?

A: The results are within one percent for both the base and test years, further supporting my use of the earnings per unit methodology. For the base year, the real return on equity would be 7.68 percent compared with the value of 6.95 percent I computed using the earnings per distribution method. For the test year, the real return on equity would be 8.33 percent, compared with the value of 7.38 percent I computed using the earnings per distribution method.

Q. Which method do you use?

A. For my cost of service computations, I use the former method that uses earnings per unit. I merely show that the alternative method would make a relatively small difference in the overall calculation.

IX. Allocation of Costs to North Line Interstate Service

Q: What conclusions have you reached after investigating the allocation of costs that SFPP attributed to the North Line interstate service?

A: I believe that SFPP has not correctly allocated costs to the North Line interstate service. As a result, SFPP has overstated the base period, and subsequent test period operating expenses attributed to the North Line interstate service.

Q: How did SFPP allocate costs to the North Line interstate service?

A: In his direct testimony SFPP Witness Thomas A. Turner describes SFPP's North Line cost allocation procedure. According to Mr. Turner, several costs from several different cost categories were allocated, notably (1) expense allocation between carrier and non-carrier operations, (2) allocation of investment and expense between interstate and intrastate operations, (3) allocation of KMEP overhead to SFPP, and (4) subsequent allocation of this overhead to the North Line interstate service.

Q: Could you please explain the derivation of base period operating expenses in light of the different allocation cost categories you mention?

A: SFPP lists its base period operating expenses on Schedule 18 which SFPP maintains supports its North Line cost of service filing and allocation process. SFPP lists five columns on this Schedule, including "Carrier Amount," "COS Adj.," "Adjusted Carrier," "North Line Percentage" and "North Line Amount." The first step in allocating costs is to derive the "Carrier Amount" listed on Schedule 18. These amounts are costs that are supposedly incurred for the North Line of SFPP, including both interstate and intrastate volumes. The primary source of the operating expenses listed on Schedule 18

is the “04 Expenses.mdb” file (“expenses database”).⁴¹ The expenses database includes both *direct* and *indirect* expense items. In generating the “Carrier Amount” of operating expenses on Schedule 18, it is necessary to separate each *direct* and *indirect* line item expense between carrier and non-carrier portions. This is the first allocation I mention above. It is accomplished by removing the non-carrier portion of the expense through an allocation factor.

Q: Did SFPP provide information regarding the carrier and non-carrier allocation factors it used for direct and indirect expenses?

A: In response to ConocoPhillips’ First Data Request, Number 1, SFPP listed the carrier allocation percentages that it used in the expenses database.⁴² These carrier percentages are provided by location code and pertain to both direct and indirect expenses.

Q: Do any of the carrier percentages appear to be incorrect?

A: Yes. The “Corporate Unallocated” carrier percentage of [] percent is overstated.

Q: How was the 81.60 percent Corporate Unallocated percentage determined?

A: In response to question 1 of the First Set of Discovery Requests submitted by BP West Coast Products, SFPP provided a file entitled, “04AllocationsP700.xls,” which includes the application of the Kansas/Nebraska (“K/N”) allocation method to allocate carrier and non-carrier indirect expense.⁴³ The K/N method involves segregating gross property and direct labor between carrier and non-carrier operations, and averaging the relative ratios. SFPP determined an “estimated” carrier percentage of [] percent

⁴¹ Provided in response to question 2 of BP, *et al.* First Set of Data Requests, under SFPPNL 00264.

⁴² SFPPNL 22538.

⁴³ Provided electronically under SFPPNL00250.

Q: Why was this percentage “estimated”?

A: The spreadsheet indicates that the [] percent was based on 2004 estimates of gross property, as opposed to the actual amount.

Q: Did SFPP provide the actual 2004 gross property amounts to compute the carrier/non-carrier percentages?

A: Yes. The revised calculation in the spreadsheet using actual values leads to a K/N computation of carrier percent of [] percent.

Q: Did SFPP employ the actual carrier percent of [] percent?

A: No. In determining the 2004 base period operating expenses, SFPP employed the [] percent.

Q: Aside from the fact that SFPP should have used an [] per cent allocation factor, are the estimated and actual carrier percentages computed by SFPP accurate?

A: No. SFPP’s computations erroneously exclude the impact of a Purchase Accounting Adjustment (“PAA”) related to the acquisition of SFPP by KMEP in 1998.

Q: Is this one of the PAAs discussed in the context of the capital structure?

A: Yes. When KMEP acquired SFPP, it subsequently wrote up the SFPP rate base to reflect the premium over the regulatory return that KMEP paid to acquire SFPP. The result was an increase in the investment base, including a greater portion of carrier property relative to non-carrier property. This unjustifiably shifts a larger percent of carrier property and expense to shippers by allocating a higher percentage to carrier property. Under the Phase Two Initial Decision in Docket No. OR96-2 *et al.*, the Commission “generally requires for ratemaking purposes that the costs of acquired assets

be set no higher than their net investment – i.e. the original costs, minus accumulated depreciation.”⁴⁴ Therefore, it is necessary to make an adjustment to the carrier property for the PAA.

Q: What adjustment did you make in the K/N formula to account for the PAA related to SFPP?

A: I adjusted the carrier and non-carrier gross property amounts to remove the PAA from the property balances.

Q: What was the source of your gross property division between carrier and non-carrier property concerning the PAA amount?

A: In testimony filed in Docket OR96-2-000, *et al.*, SFPP Witness Turner referenced the appropriate carrier and non-carrier portions of the PAA.⁴⁵ As shown in Exhibit No. PKA-11, I reduced the 2003 and 2004 gross property amounts and then calculated new carrier and non-carrier percentages using the K/N formula. The appropriate carrier percent determined from the K/N formula is [] percent, as opposed to the erroneous [] percent used by SFPP.

Q: What is the impact of using the revised carrier percentage in the determination of base period operating expenses?

A: Replacing the [] percent indirect expense allocation with the corrected amount of [] percent leads to a reduction of indirect expenses in the “Carrier Amount” account that appears on Schedule 18.

Q: Please continue with the process of determining SFPP’s base period operating costs through the cost allocations.

⁴⁴ *SFPP, L.P.* 108 FERC ¶63,036 at PP337, (2004).

⁴⁵ See Exhibit No. SFPP-106 (TAT-1), page 23 of Public Version.

A: Once the “Carrier Amounts” in Schedule 18 are calculated, SFPP makes a number of adjustments pertaining to reserve accruals and the inclusion of expense items not contained in the expenses database. I will discuss several of these cost adjustments in my discussion of the test period operating expense adjustments. After SFPP determines the “Adjusted Carrier” expenses for the base period by adding and removing these reserve accruals and additional expenses, it locates expenses to the North Line. In doing so, SFPP uses the allocation percentages listed in the column labeled “North Line Percentage.” The *direct* expenses are allocated volumetrically based on location. This volumetric allocation is determined by separating interstate and intrastate volumes. This is the second allocation that I mentioned previously. SFPP used a route directory schedule labeled Schedule 11 to segregate direct expense for interstate and intrastate volumes.

Q: You mentioned that SFPP had both direct and indirect expenses. What types of indirect carrier expenses did SFPP include in its base period operating expense category?

A: The two primary types of indirect expenses are those related to the Northern region jurisdiction and the corporate allocation of KMEP overhead.

Q: How did SFPP allocate KMEP overhead costs to SFPP?

A: SFPP relied on the testimony of two witnesses, Mr. Bullock and Mr. Turner, to determine corporate overhead allocation to SFPP. A portion of the overhead expenses of KMEP were allocated to SFPP using an annualized Massachusetts (“MA”) methodology. This allocation is the third allocation to which I referred above. The MA method determines allocation factors on the basis of three factors: gross property, gross revenue,

and direct payroll expense. In applying the MA formula to determine the corporate overhead allocation, SFPP separates KMEP's corporate overhead costs into four "tiers" related to different types of services.

Q: What are the four tiers?

A: The first tier contains costs that are applicable to all KMEP entities. Tier 2 contains overhead costs associated with an Orange, California and an Alpharetta, Georgia office. Tier 3 contains overhead costs associated with all entities other than KMEP's dry bulk terminals. Finally, Tier 4 relates to overhead costs associated with KMEP's dry bulk terminal entities and selected liquids terminal entities.

Q: Did you adjust SFPP's use of the MA method in determining the appropriate KMEP overhead allocated to SFPP?

A: Yes. I performed two adjustments related to the MA method employed by SFPP. First, I adjusted the gross property factors used in the MA method in order to reflect the PAAs that SFPP did not include in its own analysis. These adjustments are required by the Commission's ruling in the OR96-2 proceeding.

Q: What was the second adjustment?

A: The second adjustment pertains to the exclusion of several entities from the MA method. Mr. Bullock indicated that these entities were excluded because "inclusion of the subsidiar[ies] would distort the allocation formula."⁴⁶ I elected to include these companies in the first tier of the MA method.

Q: Did Mr. Bullock or SFPP provide a rationale for excluding these entities?

A: In response to ConocoPhillips discovery request 7(c)(ii), SFPP indicated the subsidiaries had been excluded because their analysis determined that the inclusion of the

⁴⁶ Exhibit SFN-3, page 10, lines 18-19.

subsidiary would distort the allocation formula. However, SFPP did not provide the referenced analysis.

Q: Why did you include these entities in the “first tier” of the MA method?

A: As Mr. Bullock notes, the intention of the MA method is to ensure that the overhead expenses incurred on behalf of KMEP are appropriately allocated among KMEP subsidiaries.⁴⁷ Neither Mr. Bullock nor SFPP has provided information concerning the ability to separate out the specific corporate overhead associated with the excluded entities. In order to ensure that all KMEP subsidiaries are accounted for, I elected to include the previously excluded entities into the MA method.

Q: What are the results of your revised MA method concerning the allocation of corporate overhead to SFPP?

A: Exhibit No. PKA-12 presents my revised MA method, which includes the PAA adjustments, as well as the inclusion of the previously excluded entities. As a result, the appropriate KMEP overhead allocated to SFPP is reduced from \$[] to \$[].

Q: How does the KMEP overhead allocated to SFPP relate to the base period operating expenses?

A: Once SFPP determined the overall KMEP overhead allocable to SFPP, it was necessary to separate out the portion of the total overhead related to only the North Line interstate service. SFPP employed another K/N allocation formula that is specific to the North Line, to determine the allocation of KMEP’s indirect expenses, including the corporate overhead, to SFPP. Schedule 14 of SFPP’s cost of service filing illustrates SFPP’s use of the K/N methodology for determining this indirect expense allocation factor. SFPP computed direct property investment and direct labor expense based on the

⁴⁷ Exhibit SFN-3, page 9, lines 6-8.

direct separation factors determined from the route directory. SFPP states that the result of its use of the K/N method is that [] percent of KMEP's indirect expenses should be allocated to SFPP as corporate overhead and a [] percent of indirect expenses should be allocated as specific North Line expenses.

X. Base Period Operating Expenses

Q: Based on the corrections you made to the K/N Carrier/Non-Carrier and MA Overhead allocation calculations, did you compute the base period operating expenses?

A: Yes. Using the appropriate allocation factors, I recomputed the base period operating expenses, shown in Exhibit No. PKA-13.

Q: Are there any additional changes between the base period operating expenses you computed, compared with those included in Schedule B of the SFPP North Line cost of service filing?

A: Yes, I adjusted base period litigation expenses using more appropriate allocation factors. I will address the base period litigation expense allocations later in my testimony.

XI. Test Period Adjustments

Q: What adjustments did SFPP make in computing test period operating expenses for its North Line cost of service?

A: In its North Line cost of service filing and in the testimony of Mr. Turner (Exhibit SFN-26), SFPP adjusted its test period for six FERC account items listed on Schedule B of the cost of service filing. These items are Salaries & Wages (FERC Account 300), Environmental Remediation Expense (FERC Account 320), Operating Fuel & Power

(FERC Account 330), Right-of-Way Expense (FERC Account 350), and Litigation Expenses (FERC Account 520), and Depreciation Expense (FERC Account 540).

Q: Are the adjustments made by SFPP reasonable in order to determine its test period operating expenses?

A: In several instances, including environmental remediation and litigation expenses, it appears that SFPP overstated the test period adjustment, while simultaneously underestimating the potential cost savings in operating fuel and power that result from the North Line expansion.

Environmental Remediation Expense

Q: How did SFPP determine the test period adjustment to environmental remediation expense?

A: SFPP “normalized” environmental remediation expenses by taking a five-year average of all of the costs incurred in the 2000-2004 period. By using this arbitrary five-year average, SFPP was able to increase its test period environmental remediation expenses by more 40 percent as compared with base period environmental remediation expenses.

Q: Does SFPP and/or Mr. Turner provide any justification for using a five-year “normalization” applied to determine test period environmental remediation expenses rather than determining the environmental expenses that SFPP will actually incur in the test period?

A: In Exhibit SFN-26, Mr. Turner states that “[e]nvironmental projects often take many years to remediate, as shown in Workpaper 9 of Exhibit SFN-28, and the resulting costs can vary year to year.”

Q: Did SFPP provide any justification for using a period of five years, as opposed to three years, seven years, or some other time period?

A: In response to Discovery Request number 36(e) of Tesoro Refining and Marketing Company's Second Data Request, Mr. Turner indicated that he "used a five-year normalization period for environmental remediation costs consistent with his test period adjustment for environmental remediation costs in the Docket No. OR96-2 proceeding."

Q: In view of the fact that Docket No. OR96-2 involved the system-wide SFPP pipeline, did you request SFPP to provide information with regard to the timing of its environmental remediation projects?

A: Yes. We requested information with respect to the timing of remediation projects in Discovery Request 36(f) of Tesoro Refining and Marketing Company's Second Data Request.

Q: Did SFPP provide this information?

A: SFPP objected to this request stating:

"[b]y requesting data on *all* SFPP environmental remediation projects and costs, rather than those specific to the North Line, Tesoro seeks the production of data that is neither relevant nor reasonably calculated to lead to the discovery of admissible evidence. For example, as to subpart (f), the average length of completion for environmental remediation on all SFPP pipelines, which would include the West Line and East Line that both pass through enormous expanses of desert, would likely not be representative of the average length of time for environmental remediation on the North Line."

The objection also notes that remediation projects on the East and West line "would not likely be representative" of the average length of time for projects on the North Line.

Q: Does SFPP's position as expressed in its objection to discovery raise concerns over using the five-year normalization factor Mr. Turner relied upon in Docket No. OR96-2?

A: Certainly. It undercuts the entire basis of Mr. Turner's position that SFPP's experience demonstrates that a five-year period accurately reflects the costs of environmental remediation projects for the North Line.

Q: Does the use of the five-year normalization period raise any other concerns regarding the environmental remediation expense data provided by SFPP?

A: Yes. An examination of Workpaper 9 of the SFPP North Line cost of service filing indicates that environmental remediation expenses in 2001 were significantly higher than those in more recent years. If we were to employ a three-year normalization period, which excludes the potentially anomalous 2001 time period, the test period adjustment would be reduced from approximately \$[] to \$[]. However, even the three-year normalization period is questionable, since there is no evidence that it accurately reflects environmental costs that SFPP will actually incur for the North Line either in the base period or test period.

Q: Are you concluding that the normalization of environmental remediation expenses is an inappropriate method for computing the test period adjustment?

A: Not necessarily. As Mr. Turner points out, normalization, if done appropriately, can be a useful procedure to ensure that one captures the variation in expenses that may occur from year to year. However, common sense must be used in assessing the results of a normalization of expenses over any length of time. Mr. Turner and SFPP blindly

attempt to force a five-year average of environmental remediation expenses from 2000 through 2004, leading to an unreasonable test period adjustment.

Q: How is the test period adjustment unreasonable?

A: As I mentioned previously, the test period adjustment represents an increase of over 40 percent from the base period. Examination of Workpaper 9 from the SFPP North Line cost of service filing indicates that almost [] percent of the net increase is associated with a perceived increase in the environmental remediation expense associated with the Elmira – A Street project. Based on the calculations shown in Workpaper 9, the environmental remediation expense associated with this project for the test year represents a 392 percent increase over the base period.

Q: Are these increases consistent with actual and forecasted 2005 environmental remediation expenditures attributable to the North Line interstate carrier portion of the Elmira – A Street project?

A: No. In response to FERC Staff Data Request 1.13, SFPP provided a schedule of actual 2005 environmental remediation expenses through August 2005, as well as forecasted expenditures for 2005.⁴⁸ This schedule indicates that through August 2005, the interstate carrier portion of Elmira – A Street environmental remediation expenses was \$[]. If we were to annualize this figure for the remaining four months of 2005, the total amount of remediation expenses for the entire year would be \$[], a figure that is *significantly* less than the SFPP test period estimate of \$485,000. In fact, the SFPP test period estimate for just the interstate North Line amount *exceeds* the average forecast estimate, shown on this schedule provided by SFPP for the entire project in 2005. In this

⁴⁸ See SFPPNL 22189

case, examination of the actual data clearly shows that SFPP has substantially overstated environmental remediation expenses.

Q: How do you respond to the potential SFPP response that the normalization procedure undertaken by Mr. Turner is aimed at estimating expenses associated with environmental remediation projects as a whole, as opposed to specific projects?

A: If we were to examine SFPP's actual and forecasted 2005 environmental remediation expenses for all projects, the data would still indicate that SFPP and Mr. Turner's use of the five-year average environmental remediation expenses from 2000 through 2004 leads to a substantial overstatement of this expense item for the test period.

Q: Please explain.

A: I performed several analyses to determine if SFPP's proposed test period adjustments were consistent with FERC regulations which state that adjustments should be made to base period expenses only for cost changes that are known and measurable with reasonable accuracy. In doing so, I first examined SFPP's forecasts for 2005 environmental remediation expenses. As shown in Exhibit No. PKA-14, I took the average of the 2005 "High" and "Low" estimates for environmental remediation projects from SFPPNL 22189 and computed the North Line interstate percentage consistently with the SFPP methodology outlined in Workpaper 9. The results show that using the SFPP forecast reduces the SFPP test period adjustment by approximately \$[] or [] percent. Second, I examined the actual environmental remediation expenses that SFPP incurred through August 2005. I annualized these expenses by increasing the actual expenditures by 50 percent to capture expenses incurred in September through December. As shown in Exhibit No. PKA-14, the annualized North Line environmental remediation

expenses were approximately \$[], a significant reduction compared with the test period environmental remediation expenses proposed by SFPP.

Q: Please summarize your conclusions regarding the proposed test period adjustment for environmental remediation expenses.

A: SFPP and Mr. Turner overstate the test period adjustment for environmental remediation expenses by arbitrarily averaging SFPP's expenses between 2000 and 2004. The expenses in 2001 are significantly higher than any other year, leading to a distortion of that expense category. In fact, the proposed test year environmental remediation expenses for SFPP exceed the "high" forecast estimate of expenses for 2005. In my opinion, the most appropriate indication of the excessive nature of test period environmental remediation expenses is the examination of actual expenses incurred in 2005. The data show that environmental remediation expenses are significantly lower than the test period estimates assumed by SFPP and Mr. Turner.

Q: What test period adjustment did you rely upon in computing environmental remediation expenses?

A: I employed the annualized environmental remediation expenses from actual test period data. This leads to a test period reduction of approximately \$[] from the base period environmental remediation expenses.

Litigation Expense

Q: How did SFPP compute base and test period litigation expenses applicable to the interstate portion of the North Line?

A: SFPP Witness Turner describes the process in his direct testimony. Mr. Turner explains:⁴⁹

I considered the FERC proceedings to which SFPP is a party and determined whether the costs of each should be allocated to the North Line. Second, I considered how each SFPP pipeline system should in my judgment bear a portion of the litigation costs for each proceeding and then allocated the costs among those pipeline systems accordingly. Third, I determined whether a normalizing adjustment should be made to the base period costs.

Q: Do you agree with the methodology employed by Mr. Turner to allocate litigation expenses to the North Line?

A: No. Mr. Turner's allocation percentages are extremely subjective and lead to an overstatement of the actual base period litigation expenses associated with the interstate service of the North Line. Furthermore, Mr. Turner's "normalization" procedure leads to unreasonable test period adjustments.

Q: What litigation proceedings does Mr. Turner include in his base period analysis?

A: Mr. Turner includes FERC dockets OR92-8, OR96-2, IS98-1, OR98-11, OR03-5 and OR04-3.

Q: What allocation factors does Mr. Turner use in his litigation expense methodology?

A: Mr. Turner allocates 25 percent of 2004 base period litigation expenses associated with OR96-2, OR03-5 and OR04-3, and 12.5 percent of 2004 base period litigation expenses associated with OR98-11, IS98-1.

Q: How did Mr. Turner determine these allocation percentages?

⁴⁹ See Exhibit SFN-26, p. 9.

A: With respect to dockets OR96-2 and OR92-8, Mr. Turner relied upon SFPP's method of equally distributing costs among the different lines. As a result, he allocates zero percent of litigation expenses from Docket No. OR92-8 to the North Line since only East and West Line rates were at issue. For Docket No. OR96-2, Mr. Turner allocates 25 percent of litigation expenses to the North Line, since rates involving all four lines were at issue.

Q: Do you agree with this “equal distribution” of litigation costs depending on rates at issue?

A: No. This simple averaging across pipeline systems unduly places the litigation expense burden on lower volume shippers.

Q: Has the Commission taken a position on the allocation of litigation expenses associated with Docket No. OR92-8?

A: Yes. In the recent Order on Remand and Hearing concerning OR92-8, the Commission stated that allocation of regulatory litigation expenses on a volumetric basis is appropriate.⁵⁰

Q: How did you determine the appropriate base period litigation expenses for the North Line interstate service associated with Docket Nos. OR92-8 and OR96-2?

A: I used a volumetric approach. Since the North Line was not party to the rate issues in OR92-8, the appropriate allocation percentage is zero. Regarding OR96-2, I relied upon the system-wide interstate volumes provided by SFPP in response to Discovery Request 1 of BP's First Set of Data Requests to calculate an allocation percentage of [] percent. Exhibit No. PKA-15 indicates the volumes on each line

⁵⁰ *SFPP, L.P.*, 111 FERC ¶ 61,334, at 44 (2005).

owned by SFPP which form the basis for the allocation percentage applied to the North Line.

Q: With respect to Docket Nos. IS98-1/OR98-11, did Mr. Turner follow his methodology of allocating litigation expenses equally among the pipeline systems involved in the litigation?

A: No. The rates at issue in IS98-1 and OR98-11 pertain to the Sepulveda pipeline, and do not pertain to the North Line rates. Despite his methodology and reasoning for allocating litigation expenses for OR92-8 and OR96-2, Mr. Turner changes his methodology with respect to IS98-1 and OR98-11 by allocating a portion of costs to the North Line.

Q: Mr. Turner states at page 12, lines 20-23 of his Prepared Direct Testimony in this case that “cost responsibility should follow cost incurrence, and the issues being addressed in the Sepulveda proceeding are relevant to all SFPP rates, the regulatory litigation costs incurred for that proceeding should be allocated to all SFPP pipelines.” Do you agree with this reasoning?

A: Absolutely not. Attempting to disproportionately shift litigation expenses to pipeline systems whose rates are not at issue is an unreasonable approach that leads down a slippery slope. The result of such a procedure is to unduly penalize shippers on pipeline systems that are not litigating rate issues. By attempting to allocate litigation expenses that pertain to “general issues,” SFPP is penalizing these unaffected shippers for the possibility of future regulatory issues. Moreover, SFPP presents no evidence or justification that unaffected shippers will eventually encounter regulatory issues

pertaining to the issues that were litigated in the Sepulveda proceedings. In essence, SFPP is charging shippers for a “cost” that may never relate to them.

Q: What base period litigation expenses are you proposing to use for Docket Nos. IS98-1 and OR98-11?

A: Since the North Line rates are not at issue in these proceedings, I employ an allocation percentage of zero.

Q: How did Mr. Turner allocate base period litigation expenses associated with Docket Nos. OR03-5 and OR04-3?

A: Mr. Turner uses an allocation percentage of 25 percent, based on the assumption that the issues in these proceedings are “essentially the same as addressed in Docket No. OR96-2” (Exhibit SFN-26, p. 13, line 17).

Q: Do you agree with this allocation percentage?

A: No. First, Docket No. OR04-3 does not pertain to the North Line service. Second, even if one were to accept the supposition that the issues are “essentially the same” as OR96-2, then the appropriate allocation of litigation expenses should be made on a volumetric basis.

Q: What allocation percentages did you employ concerning these proceedings?

A: Although I do not believe that Docket No. OR04-3 costs should be applicable to all systems of SFPP, I nevertheless rely upon the North Line volumetric allocation computed for the Docket No. OR96-2 litigation expenses.

Q: SFPP computed test period adjustments to litigation expenses by “normalizing” historical litigation over the length of each proceeding. Are these test period adjustments reasonable?

A: No. The effect of SFPP's proposed normalization is to include some of the high litigation costs incurred by SFPP from 2000 through 2002 associated with Docket No. OR96-2. SFPP provides no justification or reasoning that test period litigation expenses will reach the levels experienced in 2000 through 2002. The test period adjustment reflects an increase of 46 percent in litigation expense associated with Docket No. OR96-2. Furthermore, SFPP "normalizes" the expenses by simply looking at the annual case average, and assumes this will continue indefinitely in the future by setting the test year amount equal to this average. This has the effect of building into the operating expenses an unlimited regulatory-expense account funded by ratepayers.

Q: Has the Commission addressed this issue in prior proceedings?

A: Yes. In the Phase Two Initial Decision of *SFPP, L.P.* 108 FERC ¶63,036 (2004), the Commission rejected the type of normalization proposed here. In that proceeding, SFPP attempted to use an average of 1996-2000 litigation expenses as the basis of the test year litigation expense. The Commission correctly noted the fallacies of this method and prescribed using actual costs amortized over a five-year period. Upon completion of the five year amortization period, the litigation expenses would be removed from SFPP's rates.⁵¹

Q: In light of the Commission's decision in *SFPP, L.P. 108 FERC ¶63,036 (2004)*, how did you compute the appropriate test period litigation expense?

A: I computed test year litigation expenses in conformance with the Commission's decision. I elected to examine actual litigation expenses for the OR96-2, OR03-5, and OR04-3 proceedings over the five-year period 2001 through 2005. In addition, I examined and incorporated the actual 2005 litigation expenses occurred in this

⁵¹ *SFPP, L.P.* 108 FERC ¶63, 036 (2004) at 423.

proceeding, Docket No. IS05-230. SFPP provided the 2005 actual litigation expenses for the period January 2005 through August 2005 in response to FERC Staff data request 4.51, SFPPNL 23750. I annualized these eight-month amounts to determine 2005 litigation expenses by proceeding. I subsequently amortized each annual litigation expense over a five-year period, and multiplied the amortized amounts by the appropriate North Line allocation percentage. Exhibit No. PKA-16 presents these calculations. The test year litigation expense is the sum of the amortized amounts adjusted for the North Line percentages and equals \$[].

Q: Why did you limit the inclusion of amortized litigation expense to annual amounts beginning in 2001?

A: The final year of amortization of 2001 expenses occurs in 2005. In accordance with the Phase Two decision, the pre-2001 litigation expenses would be fully amortized by 2005, and should be removed from SFPP's rates.

Q: Please state your conclusions regarding the base and test period litigation expenses.

A: The base period litigation expenses proposed by SFPP are based on unreasonable allocation factors leading to an overstatement of actual North Line expense. In addition, the test period adjustments are based on an inappropriate "normalization" procedure, leading to excessive adjustments. I have corrected these issues as shown in Exhibit No. PKA-16, leading to a revised base period litigation expense of \$[], with a test period adjustment of \$[].

Fuel and Power Savings

Q. Have you analyzed the fuel and power savings that SFPP believes it will realize with the expansion of the line?

A. Yes, SFPP witness Turner computes an adjustment for the test period of approximately \$345,000 reflecting a reduction in electric power costs.

Q. Do you agree with this adjustment?

A. I do agree that a reduction in fuel and power costs is warranted due to the expansion of the line and the elimination of the Elmira station; however, it appears that the amount computed by Mr. Turner is insufficient to reflect the full savings.

Q. What do you believe should be the adjustment?

A. My review of the financial projections for the expanded pipeline provides a direct computation of the savings and shows that it would be substantially greater. In particular my review of the spreadsheet “NLIRR9.28.04.xls” shows that the incremental power savings associated was estimated to be approximately \$[] annually. Exhibit No. PKA-17 allocates this total cost to interstate service and, as shown, results in a total savings of \$[] as opposed to the savings computed by Mr. Turner of only \$345,000. I reflect this as a test period reduction in line 330 – Operating Fuel and Power in the Operating Expenses portion of the cost of service model.

XII. Cost of Service Analysis

Q: Have you incorporated the changes and issues discussed in your testimony into the SFPP cost of service model to determine just and reasonable rates?

A: Yes. I have relied upon the cost of service model provided by SFPP in SFPPNL 00264. I incorporated the changes to the base and test years as outlined in my testimony. As a result, I determined a test year cost of service of \$14,974,000 as shown in Exhibit

No. PKA-18. This cost of service reflects the allocation of the new investment to interstate service. This reflects a substantial reduction from the cost of service computed by SFPP.

Q. What have you concluded about SFPP's application for a rate increase based on your analysis and calculation of SFPP's cost of service for interstate service on the North Line?

A. Based on my analysis and calculations described in detail in my testimony, SFPP's cost of service after including the effect of the new investment does not support any increase in rates over the existing interstate rate. To allow the rate increase requested by SFPP would lead to an over-recovery of 31 percent, a clear and unequivocal indication that such a rate increase would not be just or reasonable. Indeed the current rate charged by SFPP for interstate service on the North Line will result in an over-recovery in the test year of almost \$2 million or approximately 13 percent. Thus I see absolutely no basis upon which the Commission should permit this application for an increase in the interstate rate.

Q. Does that conclude your testimony?

A. Yes.