

Application No. 09-05-014 et. al.

ALJ Bemserfer

Exhibit No.: _____

Witness: Peter K. Ashton

Date: December 18, 2009

ANSWERING TESTIMONY OF

PETER K. ASHTON

ON BEHALF OF TESORO REFINING & MARKETING COMPANY

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of SFPP, L.P. for authority,
pursuant to Public Utilities Code Section 455.3,
to increase its rates for pipeline transportation
services within California.

And Related Matters.

Application.09-05-014 et. al.
(Filed May 12, 2009)

Application No. 08-06-008
Application No. 08-06-009
(Filed June 6, 2008)

PREPARED ANSWERING TESTIMONY OF
PETER K. ASHTON

I. INTRODUCTION AND SUMMARY OF CONCLUSIONS

Q1. Please state your name, address and position.

A1. My name is Peter K. Ashton and I am the President of Innovation & Information Consultants, Inc. (IIC, Inc.), an economics and management consulting firm located at 72 Junction Square Drive in Concord, Massachusetts.

Q2. Would you please state on whose behalf you are filing this testimony?

A2. I am filing this testimony on behalf of Tesoro Refining and Marketing Company (Tesoro). Tesoro is a refiner that produces refined petroleum products at its Golden Eagle refinery in Martinez and its Wilmington refinery in Los Angeles and ships these refined petroleum products within the state of California on various pipelines that are

owned by SFPP. It is my understanding that in June 2008, SFPP filed a rate application as a result of the Order in D.07-05-061 in an attempt to justify its existing intrastate rates. Subsequently, SFPP applied for two rate increases on its California pipelines between September 2008 and June 2009 amounting to an approximately a 10% rate increase or \$10 million in additional rates that it is charging the shippers on its pipeline system. Tesoro is one of the largest shippers on SFPP's intrastate pipelines, and is therefore directly affected to a very substantial extent by these rate increases.

Q3. What type of work do you and your firm perform?

A3. IIC, Inc. performs applied microeconomic analysis of issues pertaining primarily to energy industries. We have analyzed all facets of the petroleum industry, including regulatory issues related to pipeline ratemaking. I direct many of the firm's projects, and spend as much as two-thirds of my time on energy and regulatory matters.

Q4. Could you describe your background?

A4. 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.

Q5. Have you testified previously on matters relating to oil pipelines, including rates?

A5. 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 over the past thirty years.

Q6. Could you briefly describe some of the oil pipeline matters you have worked on?

A6. Yes. I have filed testimony in several rate matters before the Federal Energy Regulatory Commission (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, *SFPP, L.P.*, Docket No. IS05-230-000, and most recently in *SFPP L.P.*, Docket No. IS08-390.

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 *Review of FERC Form Nos. 6 and 6-Q*, Docket No. RM07-9-000) 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.

Q7. Have you testified before the California Public Utilities Commission regarding oil pipeline issues?

A7. Yes, in addition to the matters before FERC to which I just referred, I have also testified before the CPUC on pipeline rates, access, cost allocation, 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 oil pipeline company operating in California after these pipelines became regulated common carriers in 1992 and 1993. I also testified on behalf of various shippers before the CPUC regarding the transfer of control of SFPP and Calnev to Knight Holdco in A.06-09-021. I have in addition testified before the CPUC on the rates and terms of access of another pipeline in California, *Application of Pacific Pipeline System, Inc.*

Q8. Have you worked as a consultant on other regulatory matters?

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.

- A8. Yes, I have performed analyses of the rates and terms of access of various oil pipelines throughout the country for a number of different clients. 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.
- Q9. Have you also studied issues related to competition and the ability of firms to exercise market power?
- A9. Yes, I have worked on a number of cases involving the analysis of whether a firm or a group of firms possessed market power, including in the pipeline industry. To provide more detail about my background and qualifications, I have attached a copy of my curriculum vitae as Exhibit No. __ (PKA-1).
- Q.10 What is the purpose of your testimony in this proceeding?
- A10. I have been asked by counsel for Tesoro to evaluate the cost of service and achieved return analyses presented by SFPP in support of the rate increases it requests in its tariff filings. I have, accordingly, evaluated whether the rates that Tesoro has been paying for petroleum products it has shipped on the intrastate portion of SFPP's pipelines were just and reasonable. My testimony provides the results of my analyses including a calculation of SFPP's cost of service for the pipelines at issue in this case and just and reasonable rates for that service. In addition, I have been asked to comment on whether SFPP's rates should be evaluated solely on the basis of a cost of service analysis, or whether SFPP should be permitted to charge market-based rates. I have also analyzed whether SFPP's California pipeline rates should be analyzed under some type of indexing procedure.

Q11. Could you please summarize the conclusions that you reached as a result of your analysis?

A11. Based upon my review of the cost of service presented by SFPP's witnesses, and my own analyses, I have concluded the following:

- The rates SFPP was charging in June 2008 were not justified and are not reasonable. Similarly, the two rates increases that SFPP is proposing implementing are also not justified based on my test year (2009) cost of service and revenue requirement analyses.
- SFPP based its request for rate increases on changes that it claimed were occurring in throughput volumes. However, even after taking into consideration a decline in throughput volume, SFPP's cost of service still remains significantly below its revenues. That means that SFPP is over recovery its cost of service by charging its shippers excessive rates. As a result, SFPP has achieved a return that far exceeds any reasonable rate of return.
- By my calculation, SFPP is earning a total return of 25.15% during the test period (2009) using its June 2009 rates. In contrast, I calculate a just and reasonable return of 8.79%. With respect to equity alone, SFPP is achieving a return of 55%. SFPP's revenues using test period volumes result in an over recovery of its cost of service by 46%. These facts clearly show that SFPP's rates are unjust and unreasonable.
- I have developed a cost of service for SFPP's intrastate service which indicates that SFPP's rates should be lower by as much as 65 percent in some areas. My

rate design is based on a fully allocated cost model which provides an equitable basis for computing just and reasonable rates.

- My analysis of the possible competitive alternatives to SFPP's intrastate service using accepted principles of analysis demonstrates that Tesoro does not have any competing alternatives to continuing to use SFPP's California pipeline system. Trucking, marine movements and other pipelines are not readily available, do not provide the same quality of service and are not priced within a competitive range of SFPP's rates. As a result, none of these options constrain SFPP's rates from a market perspective. Contrary to SFPP's claim in its testimony, rate comparisons with pipelines that operate in distinct geographic and product markets are not useful in assessing SFPP's rates.
- My analysis based on actual costs shows that SFPP's rates should be substantially lower, and therefore, indirect approaches such as using various inflationary indices as a proxy to measure costs is wholly inadequate and not useful in assessing the reasonableness of SFPP's rates.

Q12. Thank you for that summary. Please describe your understanding of the SFPP pipeline system?

A12. SFPP's intrastate operations include several different pipeline system located throughout the state of California. These pipeline systems include the following:

- The North Line, which consists of approximately 860 miles of trunk pipeline in five segments that transports petroleum products from Richmond and Concord, California to Brisbane, Sacramento, Stockton, Rocklin, San Francisco and Oakland Airports, Chico, Fresno, and San Jose, California.

- The West Line, which consists of approximately 700 miles of pipeline that transports refined petroleum products from various refineries and terminals in the Los Angeles area to Colton, Imperial, Ontario Airport, and to the Calnev Pipe Line.
- The San Diego line, a 135 mile pipeline that serves Orange County and the San Diego area.
- The Bakersfield line, which is a 100 mile line that runs north from Bakersfield to Fresno.

Q13. How is the rest of your testimony organized?

A13. There are seven sections to my testimony covering the following topics:

1. The definition of the base period and the test periods and the development of throughput data for these periods;
2. The computation of the appropriate rate of return that the SFPP pipeline should be achieving and the consideration of an appropriate income tax allowance for SFPP;
4. An assessment of SFPP's claimed operating expenses;
5. My conclusion regarding SFPP's cost of service, achieved return and just and reasonable rates using a fully allocated cost rate design methodology;
6. My analysis of the extent to which SFPP faces competition for its services and whether it has market power; and
7. The utility of analyzing SFPP's rates by reference to various indices.

II. DEFINITION OF BASE AND TEST PERIODS AND DEVELOPMENT OF THROUGHPUT DATA

Base and Test Periods

Q14. What is a base year and a test period?

A14. In order to evaluate the costs associated with a regulated entity such as SFPP, we normally start with a base year which reflects the most recent 12 month time period for which we have reliable cost data. At the same time, we need to make appropriate adjustments for any extraordinary or non-recurring items. In this case, I selected 2008 as the base period. The Scoping Memo has defined the test year in this case to be 2009. A test period is intended to reflect changes that have occurred or may be expected to occur relative to the base period over some reasonable and foreseeable time period.

Q15. Does the Commission have rules that it uses in rate cases that relate to base and test periods?

A15. Not directly, although my understanding is that the Commission has procedures for General Rate Cases which define the information that a public utility is required to submit to support its proposed rate change. My analysis does make use of company records and other information that is consistent with these procedures, but more importantly the Scoping Memo provides the needed guidance with respect to the selection of the appropriate test period. I would also note that the FERC defines a test period in the following manner:

A test period must consist of a base period adjusted for changes in revenues and costs which are known and measureable with reasonable accuracy at the time of

filing and which will become effective within nine months after the last month of available actual experience utilized in the filing.²

The FERC's definition of a test period supports and is consistent with the Administrative Law Judge's determination that the test period in this case is calendar year 2009.

Q16. Does SFPP apply the same test period?

A16. No. As a general matter SFPP's witnesses have employed a test period that includes portions of 2008 and 2009 rather than only using 2009. This is not consistent with the Scoping Memo in this case.

Q17. But you have used 2009 as your test period?

A17. Yes, where possible I have used 2009 actual data and annualized it for a full year. In other cases where I do not have the data broken out in that manner or where SFPP has refused to provide such data, I have used the same data as SFPP, although I have made some additional adjustments which I discuss in my testimony.

Throughput

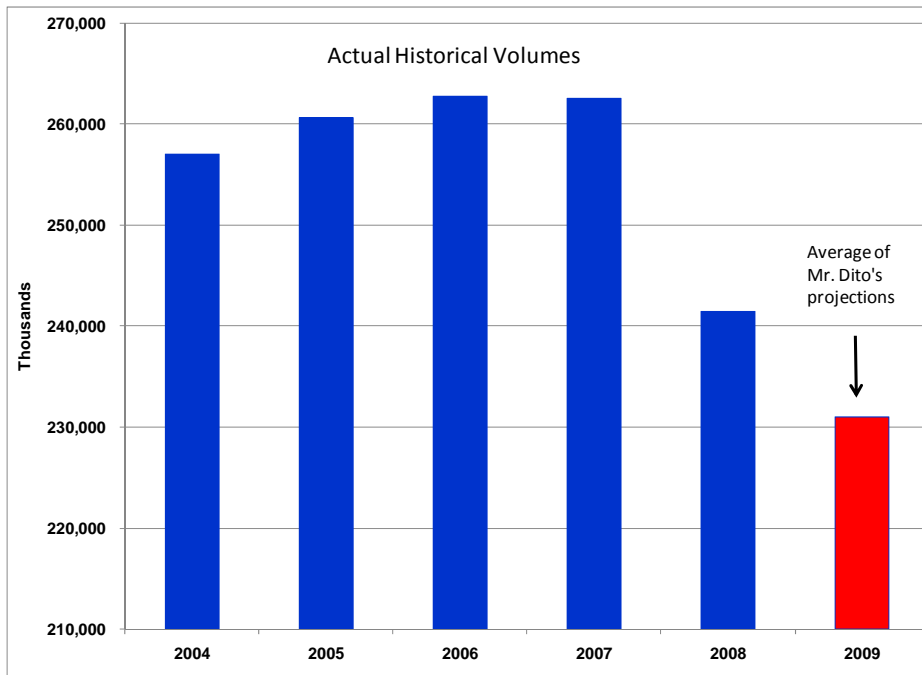
Q18. What does SFPP claim for test period throughput volumes for intrastate service?

A18. Through its witness Peter M. Dito, SFPP actually presents four different projections of volumes for the test period. In assessing the achieved return that SFPP says it expects to attain, SFPP witness Thomas A. Turner simply averages the revenues resulting from the four volume scenarios that Mr. Dito has presented. Mr. Dito presents a range of volume estimates between 226 million barrels (excluding Watson and Sepulveda services) and 239 million barrels. In contrast, throughput volumes in 2008 were 241.4 million barrels.

² 18 CFR §346.2(a)(ii).

Thus Mr. Dito's test period volumes represent between a 1% and a 6.25% decline from actual throughput in 2008 and an average decline of over 4%. I have depicted the average of Mr. Dito's test period volume in comparison with actual historical volumes in Figure 1 below.

Figure 1: Actual and SFPP's Projected Volumes for SFPP's Intrastate Service



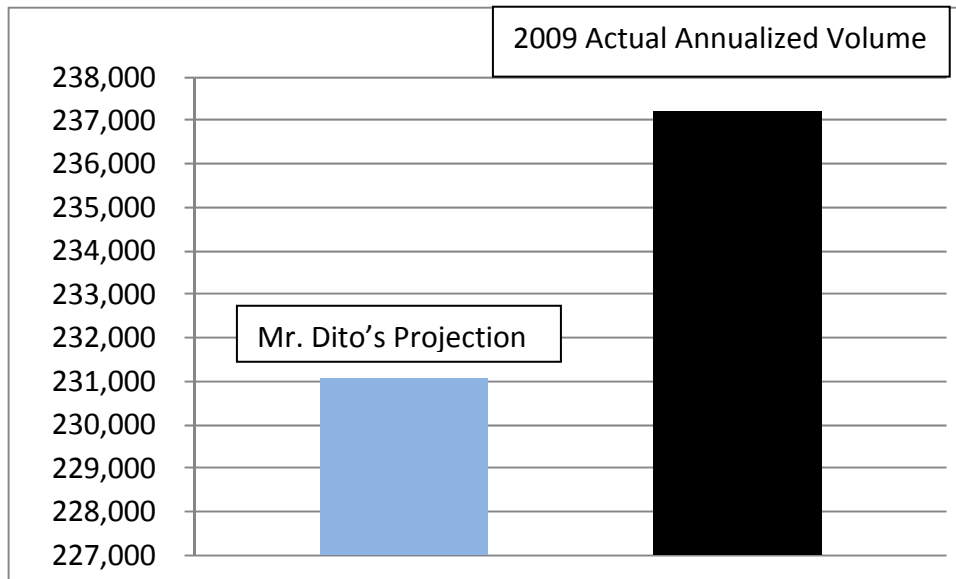
This figure shows that until 2008, volumes on SFPP's intrastate pipelines had been increasing or holding steady. With the downturn in the economy and rapid increase in product prices in 2008, demand fell and therefore, throughput volumes declined in 2008 by about 8% relative to 2007. However, most significant is the assumed continued decline in throughput assumed for the test year (2009). Figure 1 shows that the test period throughput volume assumed by Mr. Dito is 10 million barrels less than 2008 volumes. As I show below, this is at odds with what has actually happened in 2009 and with what most analysts expect demand will be in the future.

Q19. Please explain your disagreement with Mr. Dito's projections.

A19. With the exception of one scenario, all of Mr. Dito's assumed throughput projections give far too much weight to the period 2008 and 2009 which, in my opinion, represents an anomalous period of time. The downturn in the economy including the worst economic recession since the Great Depression has had a profound impact on the short-run demand for petroleum products. This is clearly shown in Figure 1 by the precipitous decline in the volume between 2007 and 2008. Actual demand for petroleum products during the first half of 2009 continued to decline, although at a much slower rate than was observed during 2008. During the second half of 2009, demand for petroleum products has leveled off and in some areas begun to rebound. SFPP's actual throughput on its intrastate pipelines shows that through the third quarter of 2009, volumes for the year are only slightly lower than 2008, and virtually all of this decline occurred during the first half of the year.

Figure 2 shown below, compares Mr. Dito's projection with actual throughput for 2009 on an annualized basis. This clearly shows the significant difference between his projection and events that actually transpired. I therefore do not expect that there will be a continued significant decline in volume shipped on SFPP's intrastate pipelines Mr. Dito projects and in fact volumes should recover as the economy recovers.

Figure 2: Comparison of SFPP’s 2009 Projection with Actual 2009 Annualized Volumes



Q20. Doesn't Mr. Dito's projection include an adjustment for the mandated increase in ethanol blended with gasoline?

A20. Yes, he makes a downward adjustment of about 4.5% in projected gasoline throughput volumes in each of his four scenarios even though an ethanol requirement is not scheduled to go into effect until 2010 which is outside the test period.

Q21. Does he offer any other reasons for the significant decline in test period volumes relative to the historical period?

A21. Yes. He states that the volume declines that he projects are explained by five reasons: (1) the effect of high prices on gasoline consumption; (2) economic impacts of the recession; (3) required increase in use of ethanol blended with gasoline; (4) increased use of

alternative fuels such as biodiesel; (5) increase in fuel economy standards; and (6) a “possible” paradigm shift in American driving habits.³

Q22. Do you agree with his reasons?

A22. Only partially. It is clear that some of the factors to which Mr. Dito refers will have only a temporary impact on the demand for petroleum products (such as the downturn in economy), and other factors are only likely to affect the demand for petroleum products at some future point far outside the test period. These factors therefore should not be used in an analysis of test period volumes.

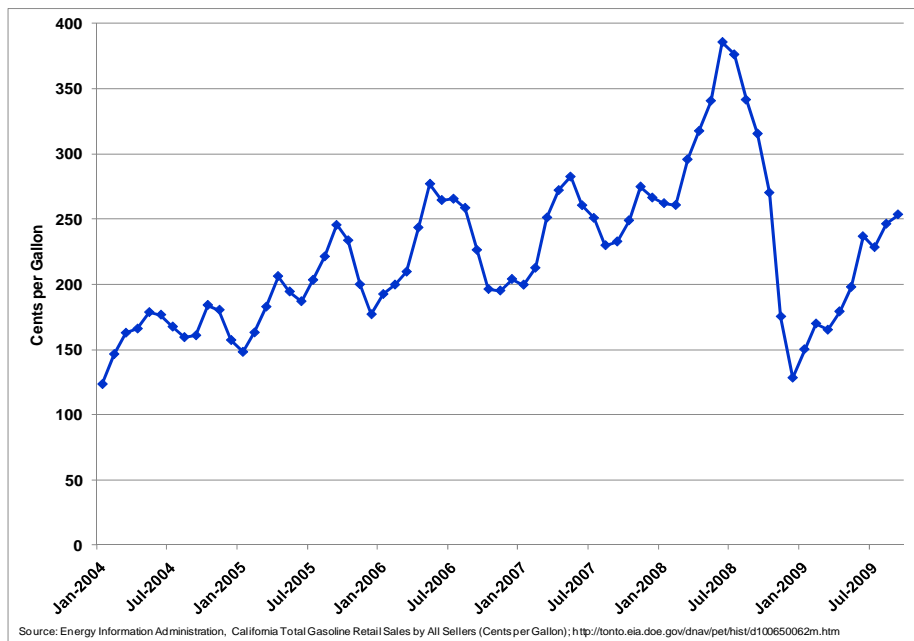
Q23. Can you explain your response in more detail?

A23. Yes. Although higher prices for gasoline do have some impact on driving habits, gasoline price increases are more likely to be reflected in long run impacts rather than having a short-run effect. The price elasticity of demand measures the responsiveness of demand to price changes. Economists have estimated that the short run price elasticity of demand of gasoline is a very low figure (less than -0.2) meaning that consumers do not reduce their demand by significant amounts in the short run, even as prices increase.

Furthermore, gasoline prices have tended to be quite volatile as Figure 3 shows, meaning that consumers have not faced sustained increases in prices, and thus the likely impact on demand has been tempered by periods of high prices followed by periods of low prices.

³ Dito prepared direct testimony, p. 6.

Figure 3: California Retail Gasoline Prices



With regard to Mr. Dito's second reason, the downturn in the economy, it is clear that we are seeing signs of a recovery. The economy has begun to grow again, recent data on unemployment is encouraging, and other reports indicate that the economy is recovering. So while I agree with Mr. Dito that the recession has had an impact on the demand for petroleum products, this impact is strictly a short-lived impact, and as the economy begins to grow, we can expect to see growth in petroleum demand once again. As I discuss later in my testimony, most forecasts of petroleum product demand show growth in 2010 and the years beyond.

Q24. What about the other reasons Mr. Dito offers for his throughput projections?

A24. With the exception of the ethanol mandate which I understand is scheduled to go into effect in 2010, the other factors to which Mr. Dito refers for his throughput projections

are speculative, and at best, are likely to impact demand only far out into the future.⁴ For example, other than increased ethanol use, most projections indicate that it will not be until about 2015 that other biofuels could have a significant impact on consumption habits in California.⁵ With regard to increases in fuel efficiency standards, Mr. Dito indicates that these standards will not go into effect until 2011, again, outside the 2009 test period. Therefore these factors as well will not have an immediate effect on SFPP's throughput. Furthermore, their projected impact even in the years directly following 2011 is likely to be extremely small since only cars produced in 2011 and beyond will be affected, and the total increase in average fuel economy is still only projected to be 0.3 miles per gallon.⁶ For these reasons, I do not see the factors to which Mr. Dito testifies as having any meaningful impact on throughput in the SFPP pipeline system during the test period, with the possible exception on the ethanol mandate which I will discuss in more detail below.

Finally Mr. Dito seems to believe that the current decline in gasoline consumption amounts to what he terms a "paradigm shift" that will lead to a continued decline in gasoline consumption. The evidence he points to however, is very thin. It consists largely of articles in newspapers and magazines commenting on the economic downturn which, as I already indicated, has now begun to reverse itself. Mr. Dito does point to some nationwide evidence regarding changes in commuting habits, but these factors are less likely to affect California. Most importantly, Mr. Dito's conjecture regarding future

⁴ Indeed Mr. Dito himself recognizes that biodiesel is not likely to have an immediate impact on SFPP's volumes. See Dito prepared direct testimony, p. 14.

⁵ California Energy Commission, *2009 Integrated Energy Policy Report*, December 2009, Final Committee Report, CEC-100-2009-003-CTF, p. 147-150.

⁶ If *all* vehicles were affected by this standard, which they are not, the maximum impact would be less than 0.5% decline in demand. Since in 2011 only those vehicles produced and sold in 2011 would be affected the likely impact of less than one tenth of one percent!

trends fails to consider any independent forecasts generated by experts including well-respected governmental agencies that analyze and forecast changes in the demand for petroleum products. Ironically, Mr. Dito has even failed to consider the forecasts generated by his own company⁷ as well as those generated by Energy Analysts Inc. (EAI), a consultant to SFPP, who has provided testimony in this case on other issues. All of these forecasts suggest a rebound in the demand for petroleum products in the near future which, in my opinion, casts serious doubt on Mr. Dito's projections.

Q25. Would you discuss how you considered the forecasts that you use?

A25. Yes, I reviewed a number of forecasts of petroleum product demand both nationwide and for California alone since that is the relevant area for analysis. Most of these forecasts consider the impact of the increase in the ethanol mandate, yet still forecast increases in the demand for gasoline and other products that would be shipped through SFPP's pipelines. For example, the California Energy Commission ("CEC") just recently published its final 2009 energy policy report which provides a forecast of the demand for gasoline in California after taking into account the use of ethanol and other biofuels.⁸ This new forecast represents a revision of the forecast that the CEC published in an August, 2009 report. The August report had forecast a more precipitous decline in gasoline demand. In contrast, the December, 2009 report predicts that gasoline demand in the so-called "Low Demand" case⁹ will increase in 2010 relative to 2009 and essentially return to 2008 levels (even after taking into account the effect of ethanol use).

⁷ KMEP regularly prepares forecasts of demand which are presented each January and are available on KMEP's web site, however, Mr. Dito makes no reference to these forecasts. In early 2009, for example, SFPP was projecting a 1-2 percent increase in throughput on its California intrastate service relative to 2008.

⁸ California Energy Commission, *2009 Integrated Energy Policy Report*, December 2009, Final Committee Report, CEC-100-2009-003-CTF, p. 150.

⁹ The CEC develops both a low demand and a high demand case where the difference is predicated in future prices.

The high demand case projects a slightly greater increase in gasoline demand in 2010.

The CEC further projects that until at least 2015, demand will remain at 2008 levels after taking into account the increased use of ethanol and other biofuels. The high demand case forecasts little or no decline in demand until 2020. With regard to all transportation fuels the CEC states:

The initial years in the Energy Commission's transportation fuel demand forecast show a recovery from the recession. Because the economic and demographic projections used in these forecasts indicate a return to economic and population growth, fuel demand in the light-duty, medium- and heavy-duty and aviation sectors tends to resume historical growth patterns. However, the mix of fuel types is projected to change significantly as the state transitions from gasoline and diesel to alternative and renewable fuels.

Thus the CEC's forecasts explicitly takes into account the shift to alternative and renewable fuels and, after doing so, shows no decline in demand relative to 2008 levels through at least 2015.

Q26. What other forecasts did you review?

A26. The CEC forecast is perhaps the most useful since it is the most recent and pertains specifically to California. It is therefore probably the most incisive commentary on the factors identified by Mr. Dito. I did, however, also examine forecasts produced by SFPP's consultant and testifying expert in this case, EAI. I also examined nationwide forecasts by the Department of Energy ("DOE") which generally corroborated these other forecasts.

Q27. Please describe the EAI forecasts.

A27. In December 2008, EAI provided forecasts of the demand for gasoline and other transportation fuels.¹⁰ Specifically EAI projected an increase in demand for gasoline as well as distillates and jet fuel beginning in 2010, continuing into 2011 and extending beyond that date. Essentially these forecasts predicted the result of these increases in 2010 would be to restore gasoline, distillate and jet fuel demand to 2008 levels and possibly even higher.

Q28. What about the DOE forecast?

A28. The Energy Information Administration (“EIA”) of the DOE just recently published its updated short-term energy forecast.¹¹ This reports states that although the demand for petroleum products had fallen in 2009, it also points out that since June 2009, the demand for gasoline has actually been increasing for the first time since September 2007, another sign of the economic recovery as well as an increase in the demand for gasoline. For 2010, the EIA projects a 1.6% increase in total liquid fuels consumption and a 1.35% increase in demand for gasoline, jet fuel and distillate combined. Although these forecasts are not specific to California, they do provide additional evidence that most experts are anticipating a rebound in the demand for gasoline and other transportation fuels in 2010 as the economy recovers, thereby reversing the trends observed in 2008 and 2009.

Finally as noted above, SFPP prepared its own forecasts for 2009 in late 2008 and it was projecting an increase of as much as 2% at some locations for its California

¹⁰ Energy Analysts, Inc. (EAI) “West Coast Downstream Business Analysis, Outlook and Strategy,” 2008-2009, Draft report; HIGHLY CONFIDENTIAL.

¹¹ Energy Information Administration, U.S. Department of Energy, “Short-Term Energy Outlook,” November 2009.

intrastate service over 2008 levels.¹² Clearly this forecast indicates that SFPP recognized that once the economy recovers, so too will the demand for petroleum products, and as well as throughput on its pipelines.

Q29. What is your test year forecast of throughput for SFPP's intrastate service?

A29. I began my analysis by analyzing actual 2009 volumes based on data that SFPP recently provided which shows the pipeline's actual throughput through September 2009.¹³ I recognize that there was a significant decline in throughput in 2008 that continued during the first part of 2009. However, the rate of decline has moderated and indeed it appears that over the July-October period it has essentially leveled off. To develop my initial test period volume, I made three adjustments to the annualized SFPP throughput date for 2009. First, I adjusted throughput volumes to Miramar Station in order to achieve consistency with the contracted volumes used by SFPP. Second, with regard to the SFPP deliveries into the Calnev Pipeline from its West Line, the data provided by SFPP did not distinguish between interstate and intrastate volumes. Therefore, I had to estimate 2009 intrastate volumes moved into the Calnev pipeline based on SFPP's historical relationship between interstate and intrastate throughput. I found that over the last three years approximately 11.25% of SFPP's West Line throughput to Calnev reflected intrastate movements and I applied this percentage to the 2009 volumes for this destination. Third, I assessed the volumes moving to Fresno from the north and the south. The Flying J Bakersfield has not been in operation for most of the past year and therefore, almost all volume moving to Fresno has originated from the San Francisco Bay area. In the past when the Flying J refinery had been in operation, approximately 15% of

¹² Response to CC Data Request 79.

¹³ Response to CC Data Request 81.

the volume moving to Fresno originated from Bakersfield. Since Flying J is actively seeking a buyer for the refinery and it is possible that it could reopen, I assumed that the source of test period volumes would revert to the historical division between Bakersfield and the San Francisco Bay area. I therefore took the annualized volumes and divided them between the two origin-destination pairs in that manner.

To develop volumes for Watson and Sepulveda, I followed the same method as Mr. Dito to determine these throughput volumes based on the relationship between base and test period volumes. The resulting throughput volume (excluding Watson and Sepulveda) is 239,476 million barrels which is approximately 0.8% less than SFPP's 2008 volumes.

I recognize that the Commission has ordered that 2009 be considered the test period, and therefore, the Commission might choose to consider the 239,476 volume as the test period volume. However, I also strongly believe that the 2009 volume is affected by the lingering effects of a temporary phenomenon, namely the downturn in the economy. I do not believe this temporary condition, which is rapidly changing, should be conclusive of the test period volume. Under established regulatory concepts, a test period volume should only reflect changes that represent a significant and enduring change, not a cyclical change.¹⁴ Time will obviously tell the full extent to which lower volumes on SFPP's intrastate service in 2008 and 2009 is a temporary phenomenon, but clearly a portion of the throughput decline that the SFPP pipeline system experienced in 2008 and 2009 will not be an enduring change. The forecasts I have cited to in my testimony agree with that position.

Q30. What conclusions have you reached on the basis of this analysis?

¹⁴ The FERC has also agreed with this position regarding test period volumes. See *Texaco v. SFPP, L.P.*, 117 FERC ¶ 61,285, P 69 (2006).

A30. I have concluded that the decline in SFPP throughput volumes in 2009 is due to the economic recession. The recession also accounted for a portion of the decline in throughput volumes in 2008 as compared to 2007. It is therefore likely that 2009 volumes will not reflect the throughput of the SFPP system in the immediate future, even after accounting for the impact of the ethanol mandate. For example, the CEC projection explicitly includes the effects of the increased use of ethanol, and it appears that the EAI projection implicitly does so. Both of these projections suggest that after considering the increased use of ethanol, demand will shortly return to 2008 levels and will likely be higher in the near future. Therefore, I have computed a second volume estimate which assesses volumes at each destination and selects the higher of actual 2008 volume or the annualized 2009 estimate. In this way, I attempt to correct for the temporary effects that the recession has had on throughput and provide a better indication of the throughput on the pipeline in the immediate foreseeable future.

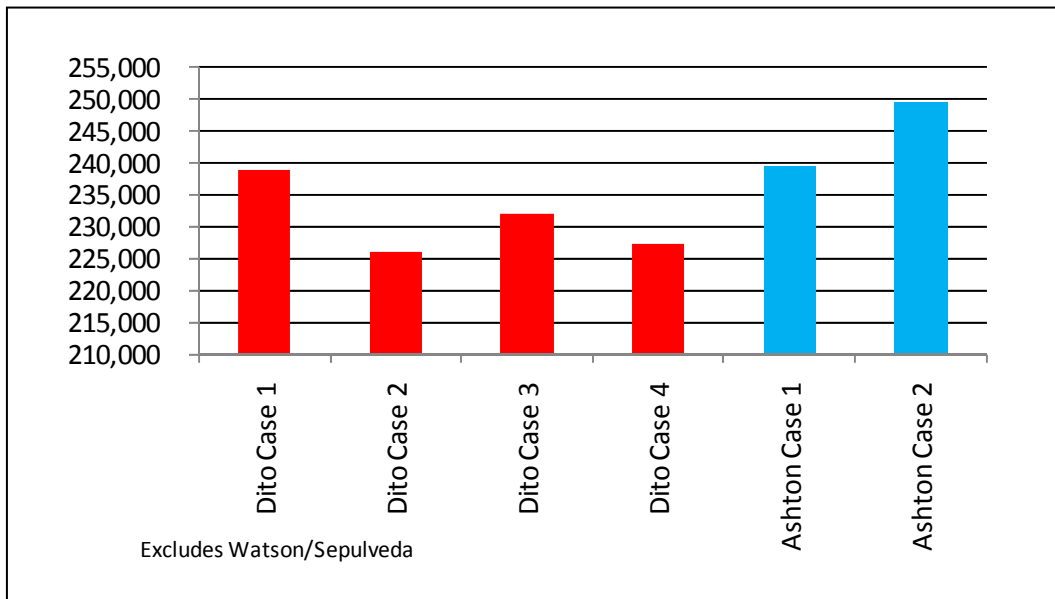
Table 1 below summarizes these two throughput volume cases I am recommending. The Table also depicts resulting SFPP pipeline revenues by applying alternative 2009 rates to the throughput of the pipeline. This data therefore establishes the revenue requirement which would then be used in evaluating SFPP's 2009 rates including the two rate increases that SFPP has requested. In addition, Figure 4 compares my test period volume with the four scenarios posited by Mr. Dito. As Figure 4 demonstrates, my projections fall at the high end of the range predicted by Mr. Dito. Finally, I have included as Exhibit __ (PKA-2) to my testimony, an exhibit which shows throughput volumes by destination and resulting revenues using SFPP's 2009 rates for my two volume scenarios.

Table 1

Summary of Test Period Volumes/Revenues		
	Volume	Revenue
2009 Without Adjustment for Economic Effects	324,687	\$ 121,679
2009 With Adjustment for Economic Effects	334,855	\$ 125,192

*Includes Watson/Sepulveda

Figure 4: Comparison of Dito Volume Projections with My Projections



III. COMPUTATION OF THE RATE OF RETURN AND INCOME TAX ALLOWANCE

Q31. Please explain what is meant by the term “required rate of return or cost of capital.”

A31. The term required rate of return or cost of capital refers to the expected return investors require in order to attract funds to a particular investment. It is the return investors

expect to receive on investments of comparable risk. Put differently, it is the opportunity cost associated with a particular investment—that is, the cost of foregoing the next best alternative investment. In regard to this proceeding, the cost of capital is used to assess the rate of return generated by SFPP based on its rates and whether that return is just and reasonable.

Q32. Do all investors have the same required rate of return?

A32. No. Investors in debt and investors in equity have different required rates of return.

Bond investors have a fixed claim on a firm's assets and any income must be paid to them before any equity investor. Equity investors have the residual claim on the firm's assets and income, and therefore, equity investments are riskier than debt investments.

Thus, the cost of equity and the cost of debt must be computed separately in order to determine the overall cost of capital for a company.

Q33. How is the overall cost of capital calculated?

A33. The overall cost of capital is the weighted average cost of debt and cost of equity, where the weights for each component are the percentages of debt and equity in the company's capital structure. The formula used is:

$$\text{Cost of Capital} = (\text{Cost of Debt} * \text{Percent Debt}) + (\text{Cost of Equity} * \text{Percent Equity})$$

Capital Structure

Q34. How have you determined the appropriate capital structure for SFPP?

A34. SFPP is not a publicly trade entity and does not issue its own debt. Therefore I have estimated the appropriate capital structure based on the capital structure of its parent, Kinder Morgan Energy Partners ("KMEP"). KMEP, SFPP's parent company, provided financing for SFPP operations. KMEP's actual capital structure represents the mix of

financial leverage (debt and equity) appropriate for operations under existing market conditions for a pipeline and therefore is representative of the risks faced by pipeline companies.

Q35. What have you concluded to be the appropriate capital structure for SFPP for the test period?

A35. I have calculated the capital structure for SFPP for the test period to be 38.3% equity and 61.7% debt.

Q36. How did you determine the appropriate capital structure for SFPP?

A36. I use KMEP's September 30, 2009 actual capital structure and adjusted that figure for purchase accounting adjustments for the test period. I therefore reflected the most recent period within 2009 for which there is actual data.

Q37. What is the rationale for adjusting KMEP's capital structure for PAAs?

A37. PAAs are restatements of equity and asset balances, made when a company acquires assets. PAAs may result in a situation in which the account balances no longer reflect the actual original cost of regulated assets, which, should not be permitted for ratemaking purposes.¹⁵ 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 equity portion of the rate base. For example, when KMEP acquired SFPP in 1998, SFPP wrote up the equity portion of the 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 components of SFPP's balance sheet.

¹⁵ Opinion No. 435, 86 FERC ¶ 61,022 at 61,097; *SFPP, L.P., et al.*, 111 FERC ¶ 61,334 at P 67 (2005) (“the purchase accounting adjustment, regardless of which entity's books it may be recorded on, cannot be reflected in rates absent a showing of specific benefit.”).

With respect to SFPP's capital structure, writing-up the equity component will lead to an inflated capital structure that is unduly weighted towards equity. It is therefore necessary to remove PAAs from SFPP's capital structure in order to ensure that SFPP's capital structure as used in determining the regulatory return is consistent with the rate base used to determine SFPP's cost of service. In other words, adjusting SFPP's capital structure to remove PAA ensures that the capital account is based on original cost.

Q38. Has the Commission or any other regulatory body rejected the inclusion of PAAs in prior proceedings?

A38. To my knowledge this Commission has never ruled on this issue, although, it certainly has steadfastly maintained the principle that ratemaking should be based on original cost, and the removal of PAAs is certainly consistent with that principle. The FERC has consistently upheld the position that PAAs must be removed from the equity portion of KMED's capital structure.¹⁶

Q39. Please describe how you adjust KMED's equity account in order to remove PAAs. I understand that you believe that step is necessary in order to correctly compute SFPP's test period capital structure.

A39. For the test period, I make five adjustments to KMED's reported equity as of September 30, 2009, as reported in its SEC Form 10-Q. I made all of these adjustments on the basis of data provided by SFPP in various administrative rate proceedings. First, I removed a \$788 million increase from SFPP's equity account. This PAA increase was made solely

¹⁶ See *ARCO Products Co., et al. v. SFPP, L.P.*, 106 FERC ¶ 61,300, PP 79- 80 (2004); *Texaco Refining and Marketing, Inc. et al. v. SFPP, L.P.*, 108 FERC 63,036, PP 336- 345 (2004); *SFPP, L.P.*, 114 FERC ¶ 61,277, P 65 (2005); and *SFPP, L.P.*, 114 FERC ¶ 61, 136, P 15 (2006) among others.

because KMEP acquired SFPP and thought that the value of the company was higher than its book value. I also added \$272 million in equity to offset the negative PAAs when KMEP acquired Trailblazer and Kinder Morgan Interstate Gas Transmission (KMIGT). In these situations the acquisition price was less than book value so a negative adjustment, i.e., an increase in value, is required. Other PAA adjustments to KMEP's equity that I also removed are a \$65 million increase in equity due that KMEP made when it acquired the Calnev pipeline system and a \$62 million PAA increase in equity that KMEP made when it acquired Kaston Pipeline Company, L.P. Finally, I removed a \$6.5 million increase in equity due to a PAA when KMEP acquired TransColorado Gas Transmission Company. As shown in Exhibit No. ___ (PKA-3), I adjusted the PAA amounts to reflect depreciation of the underlying assets from the dates of the accounting adjustments to September 30, 2009.

Return on Equity

Q40. Please explain how you determined the appropriate return on equity for SFPP?

A40. I calculated SFPP's return on equity by using the Discounted Cash Flow (DCF) methodology. I obtained the data which I used in the DCF methodology by selecting a proxy group of pipeline companies. This is similar to, but slightly different from the method used by SFPP witness James H. Vander Weide.

Q41. What is the DCF methodology?

A41. The DCF model is based on the theory that investors value an asset based on the expected future cash flows from owning that asset. For a stock, the value is based on the dividend payments expected to be received over the lifetime of holding the stock (plus the value of the stock if it is sold). An important assumption of the DCF method is that a company's

current stock price embodies the market's expectation of the rate of return that will be realized by investing in the company's stock. That is, the current stock price, P_s , is the sum of the present values of expected future returns:

$$P_s = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)^2} + \dots + \frac{D_n + P_n}{(1+k)^n}$$

where, D is the expected annual dividend, P_n is the stock price at the time the investor expects to sell the stock, and k is the investors required rate of return. Assuming that dividends grow at a constant rate, g , the DCF equation can be solved for k , to determine the required rate of return, or cost of equity. The re-written equation is:

$$k = \frac{D_1}{P_s} + g,$$

where $\frac{D_1}{P_s}$ is the dividend yield and g is the future growth rate.

The current equation assumes dividends are paid and adjusted annually; however, firms generally pay dividends on a quarterly basis and can adjust dividend payments at any point during the year. Therefore, to more accurately reflect an investors' required return on equity, I have assumed that firms on average adjust the level of their dividends in the middle of the year. The rewritten formula is,

$$k = \left(\frac{D_1}{P_s} \right) * (1 + 0.5g) + g$$

where $(1+0.5g)$ is the dividend adjustment factor for quarterly dividend payments.

Q42. How did you determine the appropriate distribution yield for each proxy company?

A42. I took the average monthly high and low prices over the last six months (April - September) and divided the average price into the annualized distribution for each proxy company

Q43. How did you determine the appropriate future growth rate, g , to apply to each proxy company?

A43. I used a two-step procedure in determining the future growth rate, taking a weighted average of short- and long-term growth rate projections. The short-term growth rate is drawn from security analysts' five-year forecasts for each proxy company, as published by I/B/E/S. The long-term growth rate is the forecasted growth rate for the economy as a whole, represented by the average GDP growth rate from three different sources.¹⁷ I weighted the short-term growth rate by two thirds and the long-term growth rate by one third.

For the short-term growth rate, I relied on the median growth rate for each proxy company from the December I/B/E/S Monthly Report for each year in question¹⁸. For the long-term growth rate, I took the average GDP growth forecasts from the Energy Information Administration, Global Insight, and the Social Security Administration for each year in question.

Q44. Did you made any other adjustments to the DCF methodology in determining the cost of equity?

A44. Yes, I did. All of the companies included in my proxy group are Master Limited Partnerships (MLPs). An MLP consists of a general partner, who is the manager of the partnership, and limited partners who provide capital through purchase of units traded on public exchanges just like corporate stock. MLPs generally distribute most of their

¹⁷ The three sources are Global Insight: *Long-Term Macro Forecast-Baseline (U.S. Economy 30-Year Focus)*; Energy Information Agency, *Annual Energy Outlook*; and the Social Security Association. These are the same as used by FERC in its recommended return on equity computation for oil pipelines.

¹⁸ Institutional Brokers Estimate System (I/B/E/S) reports analysts' EPS growth forecasts for a broad group of companies. The growth rates are widely circulated in the financial industry, include projections from multiple reputable financial analysts, are reported on a timely basis to investors, and are widely used by institutional investors.

available cash flow to the general and limited partners in the form of quarterly distributions in a similar fashion to corporations that distribute dividends to shareholders. However, unlike corporations, the MLP agreement usually provides that the general partner receives increasingly higher percentages of the overall distribution as the quarterly distribution increases. Historically, pipeline MLPs have typically distributed 90 percent or more of available cash flow and, unlike corporations, distributions generally exceed reported earnings. Additionally, MLPs may provide significant tax advantages to unit holders, which reduce the risk undertaken by the investor. Because of higher distributions and lower risk, MLPs have a lower long-term growth rate. To account for that situation, I multiplied the long-term growth rate by 50 percent for each MLP in my proxy group. This methodology is identical to that used by the FERC as described in its *Policy Statement on the Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*.¹⁹

Q45. You mention an FERC Policy Statement. Has the CPUC issued any guidance regarding the determination of capital structure and rates of return for oil pipelines?

A45. Not explicitly. The Commission has issued guidance with respect to determining the rates of return of natural gas and electricity companies. However, there is no CPUC regulation or policy issuance that reflects the Commission's views with respect to determining the rate of return of oil pipelines. The Commission has referred to the natural gas and electricity rules inferentially in some uncontested oil pipeline rate cases. But these cases do not provide any type of discussion or guidance that is, in my opinion, applicable in the present case involving SFPP. I have therefore used the FERC guidance

¹⁹ 123 FERC ¶ 61,048 *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*. (2008). Herein referred to as the "*DCF Policy Statement*".

which is specifically directed to oil pipelines. I then use the analysis of a public utility's achieved return, which the CPUC uses, as a further reference in determining what rate of return is just and reasonable for SFPP.

Q46. Let's then return to the proxy group that you used in this case. Which particular companies are members of your proxy group for determining SFPP's cost of equity?

A46. The companies I selected for the proxy group are: Buckeye Partners, LP, Enterprise Products Partners, LP, Kinder Morgan Energy Partners, LP, Magellan Midstream Partners, LP, NuStar Energy, LP, and Plains All American Pipeline, LP.²⁰

Q47. Why do believe that these companies are an appropriate proxy group?

A47. Each of these companies is heavily involved in the pipeline industry and face similar risks and operating conditions to SFPP. In addition, investment services provide information on each of these companies, and investors themselves would be expected to view them as all quite similar from an investment standpoint.

Q48. What are the results of your application of the DCF methodology to SFPP?

A48. Using the DCF methodology and data from the proxy group, I determined that the cost of equity for the test year for the proxy group ranges from 11.31% to 12.83% with a median of 12.43% as of September 30, 2009. The calculation of the cost of equity using the DCF methodology for the proxy companies is shown in Exhibit No. __ (PKA-4).

Q49. What do you conclude to be the appropriate cost of equity for SFPP?

²⁰ In the past I have included at least two other companies in my pipeline proxy group. However, I was unable to locate September 2009 I/B/E/S data for Enbridge so I did not include them in our proxy group, although I would normally include Enbridge. I also exclude TEPPCO as it was acquired by Enterprise during the third quarter of 2009.

A49. I believe that SFPP's return on equity is best reflected by the median of the proxy group's return on equity. In this regard, I believe that unless a pipeline displays a highly unusual risk profile that is widely divergent from that of the proxy group, the most appropriate measure of a company's return on equity using a proxy group is the median of that group. My review of the facts and data relating to SFPP do not suggest any highly unusual circumstances. I therefore conclude that the relative risks facing SFPP would therefore fall within the range of those of the proxy group.

Q50. Don't Mr. Dito, the EAI Report, and Dr. Vander Weider suggest that SFPP faces a much higher level of risk?

A50. Yes, they attempt to make that argument, but there is no factual support for their position. In particular, they cite to the fact that SFPP must operate in so-called high consequence areas ("HCA") as increasing SFPP's risks. A HCA is defined by the federal government as geographical locations which require enhanced efforts and measures by pipeline operators to maintain pipeline integrity. EAI states that operating in HCAs increases risk because it "increase[s] costs of operating and maintaining these lines."²¹ While this may be true, and I have not attempted to evaluate this claim, the fact remains that if it does cost more to operate a pipeline in an HCA, then SFPP's cost of service, which includes its operating and maintenance costs, already takes these higher costs and risks into account.

In addition, several of the pipelines that are included in the proxy group used to compute the return on equity also operate portions of their pipelines in HCAs and thus face similar risks to the extent such risks exist. To place a company in a position other than the median of the range of results of the proxy group, requires a clear and

²¹ EAI report, p. 56.

convincing showing that business, operating, and financial risks of the subject pipeline are all significantly higher or lower than those in the proxy group. To my knowledge, Dr. Vander Weide has not performed any such analysis; nor has Mr. Dito or EAI done so. As I discuss later in my testimony, in view of SFPP's market power and dominant position in the California market, it faces less risk from a financial standpoint than most of the companies in the proxy group. Thus to the extent SFPP may face uncompensated, higher risks from operating in HCAs, these risks are more than offset by its market power.

Cost of Debt

Q51. How did you determine the appropriate cost of debt of SFPP?

A51. Consistent with using KMEP's capital structure, KMEP's cost of debt is appropriate to use for SFPP's test period. I determined KMEP's September 30, 2009 cost of debt to be 6.53%. Exhibit No. __ (PKA-5) provides my cost of debt calculations for the test period.

Computation of the Cost of Capital of SFPP

Q52. On the basis of all of these factors, what is the cost of capital for SFPP for the test period?

A52. Based on the methodology I described above, I calculated a weighted average cost of capital for SFPP of 8.79% for the test year. This chart below shows how I determined the 8.79% composite figure:

Year	Percent Equity	Cost of Equity	Percent Debt	Cost of Debt	Weighted Average Cost of Capital
2009	38.27%	12.43%	61.7%	6.53%	8.79%

Income Tax Allowance

Q53. What is the purpose of income tax allowance?

A53. In the context of a regulated utility, an income tax allowance is designed to permit the regulated utility that is subject to income taxes the opportunity to recover its allowed return in its cost of service after it pays income taxes.

Q54. Does SFPP pay income taxes?

A54. No. Neither SFPP nor its parent KMEP pays corporate income taxes since both companies are partnerships. Therefore SFPP does not need an income tax allowance in order to recover its allowed return.

Q55. Does SFPP compute an income tax allowance?

A55. Yes, SFPP witness Thomas Turner applies “the maximum corporate statutory” income tax rates including the maximum federal corporate income tax rate of 35% and the maximum California state corporate rate of 8.84%.²²

Q56. What rationale does SFPP provide for use of the maximum corporate rates?

A56. Although Mr. Turner prepared SFPP’s cost of service analysis and he is SFPP’s witness sponsoring the cost of service exhibits, he testifies: “Under the recommendation of Dr. Vander Weide, I included a full tax allowance . . .”²³ In his testimony Dr. Vander Weide’s generally advocates including an allowance for income taxes in SFPP’s cost of service, and contends that the allowance included in Mr. Turner’s cost of service is consistent with the FERC’s Policy Statement on Income Tax Allowances.²⁴ However, Dr, Vander Weide does not offer any opinion on what income tax rate to use. Furthermore, in response to a data request specifically asking whether Dr. Vander Weide is the SFPP witness responsible for recommending the income tax rate to be used, SFPP has stated that he “is not the SFPP witness responsible for recommending the income tax

²² Response to Tesoro Data Request 47.

²³ Turner prepared direct testimony, p. 19, lines 19-20.

²⁴ See 111 FERC ¶61,139, May 5, 2005, hereinafter *Income Tax Allowance Policy*.

rate to be used in computing SFPP's revenue requirement" and by implication SFPP's cost of service.²⁵ Thus if Mr. Turner is relying on Dr. Vander Weide for the rate and Dr. Vander Weide is not recommending a rate, it would appear that there is no basis for using the full corporate rate assumed by Mr. Turner. More importantly, SFPP has offered no rationale or basis supporting the use of the maximum corporate income tax rates.

Q57. Under these circumstances, is there any basis for SFPP to include an income tax allowance in its costs of service?

A57. I believe that SFPP has the burden of proof to demonstrate that it is subject to and actually pays the full corporate income tax rate in order to qualify for an income tax allowance using the maximum corporate rates. As I noted previously, SFPP as a partnership does not pay income taxes. Therefore, it is certainly possible to argue that SFPP is in a position to recover its allowed return without any increment for an income tax allowance. However, it is theoretically possible that the owners of SFPP may have paid income taxes, and it could be possible that SFPP might claim that on this basis, SFPP was subject to the payment of income taxes and thus should be permitted an income tax allowance. Indeed in several cases before FERC, this is exactly the position SFPP has taken, and would seem to be the position that Dr. Vander Weide is advocating in his reference to FERC's Income Tax Allowance Policy. But, SFPP has the burden of proof on this issue, i.e., the propriety of any income tax allowance and the use of the maximum corporate income tax rate to provide an income tax allowance. SFPP must therefore demonstrate through the submission of factual evidence that either SFPP or its owners paid that full corporate income tax rate. I do not believe SFPP can sustain that

²⁵ Response to Tesoro Data Requests 72 and 73.

burden; nor has it attempted to do so. Furthermore SFPP has disavowed that position in this case.

Q58. How has SFPP disavowed this position in this case?

A58. First, Tesoro requested information asking whether SFPP paid income taxes to which the answer was an unequivocal “no.”²⁶ Tesoro then requested information regarding whether “any person that had an ownership interest in SFPP paid taxes” and also requested data on the taxable income and cash distributions that was paid or distributed to the owners or partners of SFPP²⁷. This data request was an attempt to seek information about SFPP’s potential tax liability and the classification of entities that received income from SFPP in an attempt to determine the appropriate tax brackets or rates for these recipients of distributions or income. SFPP’s response to all of these requests has been virtually the same:

Whether or to what extent any affiliate or owner (whatever is meant by this ambiguous term) of SFPP has actual or potential income tax liability incurred with respect to the income of SFPP has no relevance to or bearing upon the income tax allowance assumed in the cost of service testimony of Thomas Turner, given Mr. Turner’s use of the maximum corporate statutory tax rates (as opposed to any so-called effective tax rate) in calculating the recommended income tax allowance.²⁸

In response to questions seeking information on the amount of any distributions which might possibly be used to establish appropriate tax rates, SFPP responded in similar fashion. According to SFPP, the information that Tesoro requested was *irrelevant* both

²⁶ Supplemental Response to Tesoro Data Request 16, dated November 25, 2009.

²⁷ See Tesoro Data Requests 16, 17, 18, and 19.

²⁸ Supplemental Response to Tesoro Data Requests 16 and 17, dated November 25, 2009.

in terms of Mr. Turner's testimony and also in the context of the CPUC's treatment of income tax allowances.²⁹

Thus SFPP has clearly taken the position that any attempt to seek data on whether SFPP's owners paid income taxes and at what rates is irrelevant. In my view this means that SFPP does not believe that an inquiry into whether and to what extent the owners of SFPP may have actually paid income taxes is a relevant undertaking. Therefore, SFPP cannot claim in this proceeding that it is entitled to an income allowance because the entities to whom it made distributions paid an income tax on those distributions.

Q59. In view of SFPP's position, what income tax allowance, if any, do you recommend in this case?

A59. Because SFPP has refused to provide any data that might enable me to determine whether the recipient of distributions paid any income taxes and because SFPP has offered no rationale or basis for the use of the maximum statutory corporate rates, I am tempted to recommend no income tax allowance at all be used. However, I am mindful that in recent cases the FERC has ruled that SFPP is subject to some level of income tax allowance. Therefore, I have reviewed data from SFPP's parent KMEP indicating what its effective income tax rate was in recent years. According to KMEP's 2008 SEC Form 10-K,³⁰ KMEP paid no corporate income taxes as a result of its partnership status. However it did pay income taxes at an average effective rate of 6.3% over the last three years. While this is apparently due primarily to certain foreign and corporate holdings of KMEP that are unrelated to SFPP, it provides some potentially plausible basis for estimating the effective income tax rate of SFPP's owners. In view of the fact that SFPP

²⁹ Supplemental Response to Tesoro Data Requests 18 and 19, dated November 25, 2009.

³⁰ KMEP, SEC Form 10-K, 2008, p. 150.

has refused to provide any other data that might be useful to this inquiry, I used this 6.3% figure in developing an income tax allowance in my cost of service analysis. It would, however, be equally plausible to use no income tax allowance at all in determining SFPP's cost of service.

IV. OPERATING EXPENSES

Q60. Have you reviewed the operating expenses SFPP is claiming for intrastate pipeline operations for the test period?

A60. Yes.

Q61. Do you believe they are just and reasonable?

A61. No. There are several expense categories in which I believe SFPP's claimed operating expenses are too high and cannot be justified.

Q62. Please describe those cost categories.

A62. The most egregious expenses that SFPP claims involve corporate overhead and so-called dismantlement expenses. In addition, I have made adjustments to SFPP's claimed test period environmental costs, litigation costs, and losses and shortages. Finally, I have increased SFPP's fuel and power costs to account for the the higher throughput volumes that I believe SFPP will transport on its pipeline.

Corporate Overhead Allocation

Q63. What is the amount of KMEP corporate overhead expenses in Mr. Turner's cost of service analysis?

A63. Mr. Turner includes KMEP corporate overhead expenses in his cost of service analyses as part of the operating expense of both SFPP and Calnev. Schedule 12 (Revised) of Mr.

Turner's SFPP cost of service analysis assigns approximately \$46.4 million in total KMEP corporate overhead expenses to SFPP during July 1, 2009 through June 30, 2009.³¹ That time period is the base period that SFPP uses in this case. Mr. Turner subsequently calculates the percentage of these total corporate overhead expenses that relate to SFPP's CPUC-jurisdictional service. This resulting amount is approximately \$16.8 million and is included in his cost of service determination. Mr. Turner then includes this base period amount in his test year operating expense calculations on Schedule 5. This is a significant amount, representing 25 percent of total test year operating expenses for SFPP.

Q64. Please summarize your understanding of how Mr. Turner allocates KMEP corporate overhead expenses to specific KMEP entities, including SFPP.

A64. Mr. Turner's prepared direct testimony briefly explains the process he uses in allocating KMEP expenses to SFPP.³² Specifically, SFPP has no employees and relies on KMEP for "management oversight." Mr. Turner indicates that this management oversight includes costs related to "accounting, tax, pipeline logistics, environmental compliance, and insurance." Mr. Turner and KMEP use a multi-step process in allocating corporate overhead costs. First, KMEP attempts to directly assign corporate overhead costs to specific entities or groups of entities, based on a review of time splits and salary surveys. These direct allocations include general and administration (G&A) and operations and maintenance (O&M) labor expenses, as well as "SFPP-Specific Legal Fees", and "Insurance." With respect to these direct allocations, KMEP claims it has matched

³¹ A revised Schedule 12 appears in Mr. Turner's underlying workpapers, received in response to Tesoro Data Request No. 26. The data response indicates that Mr. Turner's original schedule 12 contained a formula error, leading to a revised calculation in Mr. Turner's calculation of KMEP overhead attributable to the CPUC.

³² Turner prepared direct testimony at p. 14. Mr. Turner only discusses the allocation to SFPP, although the methodology is identical for Calnev.

specific costs to the entities or groups of entities that are solely responsible for incurring the costs.

As part of the direct allocation of labor expense, KMEP allocates costs that were directly assigned to groups of entities (as opposed to a specific entity) using the Massachusetts Formula (“MA Formula”). The MA Formula is a cost allocation methodology that relies on several cost drivers to allocate costs. I discuss the MA Formula in a subsequent section of my testimony.

Second, KMEP allocates any residual costs that cannot be assigned to an individual entity or group of entity, once again using the MA Formula. Finally, Mr. Turner allocates each KMEP Overhead category (e.g., directly assigned carrier G&A, SFPP-specific legal fees, Insurance and residual costs from KMEP MA Formula) for CPUC-specific jurisdictional property. As an example, Mr. Turner uses the Kansas-Nebraska Method (“KN Formula”) to allocate indirect costs to CPUC-jurisdictional service. These indirect costs include the directly assigned carrier G&A expenses, certain company-wide legal fees, and residual costs from the KMEP MA Formula.

Q65. Prior to the direct assignment and cost allocation, how does Mr. Turner determine the pool of corporate overhead costs to be assigned or allocated?

A65. As with SFPP, KMEP too does not have any employees. As a result, SFPP relies on two separate entities to provide corporate oversight. The first, KMGP Services Company Inc. (“GP Services”) provides operating support for KMEP and several business units that are subsidiaries of KMEP. These entities include the products pipeline group (including SFPP and Calnev), as well as the CO₂, Bulk Terminals, and Transmountain operations.

KMEP claims that GP Services employees are “KMEP-dedicated” employees and only provide operating support and corporate overhead for KMEP-owned entities.

In addition, Knight Inc. (formerly Kinder Morgan, Inc. or “KMI”) provides additional corporate oversight to KMEP-owned entities, as well as KMI-owned and KMI-operated entities. KMI employees include “KMI-shared” and “KMI-dedicated” employees. Supposedly, the “KMI-shared” employees provide support to both KMEP- and KMI-owned entities, while “KMI-dedicated” employees provide support only to KMI-owned entities. As a result, the pool of corporate overhead costs include costs associated with GP Services and purportedly, the KMEP-specific corporate overhead costs incurred by KMI-shared employees performing services for the KMEP-owned and operated entities, including SFPP.

Q66. You referred previously to the MA Formula. Please explain how the MA Formula is used in allocating corporate overhead to subsidiaries.

A66. The MA Formula is designed to allocate corporate overhead costs that cannot be directly charged to particular subsidiaries.³³ The MA Formula allocates corporate overhead expenses to a regulated utility subsidiary by using the average of three specific ratios. These ratios for each particular subsidiary are compared to overall corporate totals. The resulting figure is then applied to the dollar amount of the corporate overhead to be allocated. The three ratios are: (1) the regulated subsidiary’s gross revenue as compared to total corporate gross revenues; (2) the regulated utility subsidiary’s gross property, plant, and equipment as compared to total corporate gross property, plant and equipment;

³³ An overview is included in the FERC proceeding, *Northwest Pipeline Corp.*, 71 FERC ¶ 61, 253 at 61, 984 (1995).

and (3) the regulated utility subsidiary's gross payroll (or direct labor costs) as compared to total corporate gross payroll.³⁴

After computing each of the three ratios for each subsidiary an average is computed of the three ratios. That average ratio is then applied to the overall corporate overhead expenses to determine the specific amount of corporate overhead expenses that should be allocated to each regulated utility subsidiary.

Q67. Are any other formulas used in allocating overhead expenses in regulatory proceedings?

A67. Yes, the Kansas-Nebraska, or "KN" formula

Q68. Please provide an overview of your understanding of the KN Formula for allocating indirect operating expenses.

A68. While the MA Formula allocates corporate overhead to specific subsidiaries, the KN Formula allocates these indirect expenses to jurisdictional service as compared to the non-regulated business activities in which a company engages. The KN Formula uses an average of the ratios of direct investment and labor expense to total direct investment and labor expenses to isolate the jurisdictional expenses for regulated carrier operations.

Q69. Has Mr. Turner correctly used the MA and KN formulas to allocate KMEP corporate overhead expenses to the CPUC-jurisdictional operations of SFPP in his test period?

A69. No. The KMEP corporate overhead cost allocation methodology that Mr. Turner uses is contrived and inappropriately inflates the amount of corporate overhead expenses attributable to the CPUC-jurisdictional operations of SFPP.

Q70. What are the specific issues you have identified in your analysis of Mr. Turner's allocation of KMEP corporate overhead allocations to SFPP?

³⁴ See *KN Interstate Gas Transmission Co.*, 88 FERC ¶ 61,270 at 61,848 (1999), citing *Williams Natural Gas Co.*, 77 FERC ¶ 61,277 at 62,188 (1996).

- A70. There are several. First, I disagree with the reliability and consistency of KMEP's "direct" assignments of corporate overhead cost. In assigning "direct costs," KMEP primarily relies on employee-based survey information in which individual employees assign the time they believe that they spent working on a specific entity. Second, I disagree with Mr. Turner's use of several "tiers" of corporate overhead cost allocations. These tiers involve grouping corporate overhead expenses and then allocating them to groups of entities. KMEP then uses a MA Formula specific to each group to allocate corporate overhead costs. Third, the allocation of corporate overhead costs for the KMI-shared employees lacks foundation and basis. These costs flow into the residual corporate overhead MA Formula applicable to all KMEP-owned and KMEP-operated entities. The primary mechanism for including these costs is the KMI cross-charge, which I discuss in further detail later in my testimony. This process as I will discuss further is not at all transparent. It is, to the contrary, convoluted and virtually impossible for anyone to replicate. The MA and KN formulas were formulated to avoid these very problems in a company's allocation of indirect costs for regulatory rate-making.
- Q71. Please explain how SFPP's "direct assigns" is used in KMEP's corporate overhead costs.
- A71. In the current proceeding, KMEP directly assigns over \$34 million in corporate overhead costs to SFPP. As a result, KMEP and Mr. Turner are *directly* assigning 73 percent of all KMEP corporate overhead costs to SFPP. Mr. Turner claims that KMEP implemented new time reporting procedures that "identify, to the extent possible, how general and administrative personnel relevant to KMEP's products pipeline division spend their time specific to individual entities within that division and assigns their salary costs

accordingly.”³⁵ Mr. Turner claims these direct assignments more accurately reflect the cost incurrence of the overhead services performed.

Q72. Did Mr. Turner or KMEP provide any underlying support for this new accounting implementation?

A72. Yes, in response to CC Data Request No. 31, KMEP provided a September 24, 2008 study performed by KPMG, an accounting firm that purportedly justifies the direct assignment of salary costs based on interviews with employees providing services to SFPP. The KPMG report accepts KMEP’s tiered system of different groups of subsidiaries and operating platforms. KPMG then conducted a number of surveys and created different splits of employee time related to specific subsidiaries or groups of subsidiaries.

Q73. How did Mr. Turner use these salary splits in his direct assignment of KMEP corporate overhead expenses?

A73. In response to CC Data Request No. 29 and Tesoro Data Request No. 44, KMEP provided the different salary splits pertaining to employees with directly assigned costs to SFPP and Calnev. For example, Employee Number 16104 “allocates” his time 15 percent to Calnev-Carrier, 4 percent to Cochin, 1 percent to Cypress, and 75 percent to SFPP-Carrier. Mr. Turner and KMEP subsequently directly assign his overall salary in proportion to these percentages. On the basis of that type of employee survey, KMEP directly assigns over \$6.8 million in G&A labor costs to SFPP’s Carrier operations.

Q74. Why do you believe this direct assignment methodology is flawed and should be rejected?

³⁵ Turner prepared direct testimony at p. 15.

A74. First, SFPP has attempted to use this direct assignment in several FERC cases. Notably, in the IS08-390 proceeding, SFPP included direct assignments based on an employee survey method. However, Dr. Daniel Arthur (witness for ACV shippers) noted that SFPP included 100 percent of employee costs to SFPP, despite clear evidence that these employees provided services to non-SFPP entities. As a result, SFPP had to quickly modify the direct assignments to correct this error. In fact, the error rate in survey accuracy was 64 percent in that proceeding. I certainly do not believe that error ratio represents an acceptable reliability rate when attempting to directly assign costs. In this proceeding, SFPP once again tries to justify its methodology, but appears to place the burden of justifying the accuracy of accounting records on shippers, when in fact the burden is on SFPP to prove that its overhead cost allocation methodology is reliable. Second, from a theoretical standpoint, SFPP's direct assignment of costs does not necessarily match costs, cost causation or benefits. KPMG provides lip service in its report to matching costs with causation, but often ignores an assessment of whether the cost causation truly comports with benefits enjoyed by KMEP subsidiaries.

Q75. Please explain this relationship between cost causation and benefits.

A75. Consider a situation in which two pipelines are owned by the same parent company, one that is a regulated entity and one that is a non-regulated entity. In each case, the pipelines have similar assets, revenues and payroll expense. However, the parent company has an economic incentive to load overhead costs into the regulated entity. As a result, parent company employees might be directed or encouraged to assign their time to services related to the regulated pipeline, despite the fact that both pipelines might benefit from the provision of services. For example, assume that in the course of working on IT issues

specific to the regulated pipeline, the parent company identifies efficiencies which are subsequently implemented at the non-regulated pipeline as well. While all costs are assigned to the regulated pipeline, both pipelines in fact benefit from the provision of the corporate overhead services. In contrast, the MA Formula is based on the principle of cost causation by relying on three cost drivers to allocate corporate overhead costs.³⁶ Given a lack of reliability in the direct assignments, the MA Formula represents the best measure of matching costs, cost causation and benefits.

Q76. Do you have additional concerns with the direct assignment of costs?

A76. Yes. The KPMG Study relies on 2007 salary surveys which are outdated. Presumably, Mr. Turner is also relying on information obtained from interviews, although it is unclear whether these interviews were conducted in 2007 or at some other time period. However, both KPMG and Mr. Turner note that KMEP is a complex organization that has changed significantly over time.³⁷ As a result, there is an inherent reliability problem in using outdated surveys to determine how employees truly spend their time. Furthermore, as I previously pointed out, the testimony that SFPP submitted in prior regulatory proceedings using salary surveys turned out to be inaccurate in most cases. As a result, I do not accept SFPP's use of the direct assignments from the salary surveys, and find them inherently unreliable.³⁸

Q77. You mentioned that SFPP also assigns costs to groups of subsidiaries, and then makes allocations using the MA Formula. Could you elaborate on the issues you identified with respect to this assignment and allocation procedure?

³⁶ See *Midwestern Gas Transmission Co.*, 32 FPC 1012, 1022-1025 (1964), *aff'd in pertinent part*, 32 FPC 993, 995 (1964).

³⁷ Turner prepared direct testimony, at p. 14, KPMG Study at p. 4.

³⁸ If they were in fact reliable, one would expect that KMEP's audited financial data would report these direct expenses as part of SFPP's profit and losses, not as unallocated, indirect corporate overhead expenses.

A77. This second type of allocation represents a hybrid between “direct” assignments and cost allocation. In essence, SFPP assigns costs to groups of entities, e.g., the product pipelines group, and subsequently allocates costs across different subsidiaries that fall in each group. As a result, SFPP is stating that while it cannot directly assign an overhead cost to a specific entity, it can reasonably state that a particular cost is associated with a group of entities. However, this methodology suffers from the same flaws as directly assigning costs to a specific entity. As a result, the correct method is the use of a single tier MA Formula that allocates all KMEP corporate overhead costs to subsidiaries that benefit from the corporate overhead services.

Q78. You stated that SFPP employs a MA Formula for KMEP overhead costs applicable to all KMEP subsidiaries. What are the shortcomings of this approach?

A78. The major shortcoming is that the SFPP MA Formula does not include the direct assignments I discuss previously. Given the inherent unreliability of these direct assignments, the SFPP MA Formula should appropriately capture these corporate overhead costs, in addition to the corporate overhead costs that SFPP feels are truly residual in nature. For example, SFPP only allocates \$55.5 million in corporate overhead costs across all KMEP-subsidaries. In fact, the majority of this amount (\$43.9 million) represents the KMI cross-charge for overhead services provided by KMI employees.³⁹ For comparison purposes, the 2008 KMEP 10-K specifies close to \$300 million in corporate overhead. As a result, SFPP is in effect, directly assigning and allocating over 80 percent of total corporate overhead expenses to specific subsidiaries or groups of subsidiaries.

Q79. You mention the KMI cross-charge, do you believe this amount is appropriate?

³⁹ See response to Tesoro Data Request 45c.

A79. No. The major issue with the KMI cross-charge is the lack of data supporting the amount included in Mr. Turner's MA Formula. The cross-charge represents the allocation of corporate overhead expenses incurred by KMI-shared employees providing services to both KMEP-owned and KMI-owned entities. Specifically, the cross-charge purportedly represents only those corporate overhead expenses allocable to the KMEP-owned and operated entities. As a result, the amount does not include corporate overhead costs allocable to KMEP-owned but KMI-operated entities. As a result, Mr. Turner excludes the KMEP-owned but KMI-operated entities from his MA Formula.

Q80. Have you attempted to verify the cross-charge amount?

A80. Yes, but I am unable to do so with the data available to me. For example, CC Data Request Nos. 34 and 35 requested pertinent information on the allocation of KMI corporate overhead expenses to KMEP subsidiaries. SFPP objected to these data requests and did not provide the necessary information to reconcile the cross-charge. SFPP's refusal to provide substantiating data further supports my position that a KMEP system-wide MA formula is the only appropriate method to use in this case in allocating corporate overhead costs.

Q81. In light of the data deficiencies and lack of responses from SFPP, how do you propose to allocate corporate overhead expenses to SFPP in your cost of service analysis?

A81. I propose using a single MA Formula that includes all of KMEP's corporate overhead expenses. This method represents the best allocation methodology in view of the lack of supporting data provided by SFPP and the numerous deficiencies in SFPP's overhead allocation procedures that I addressed previously in my testimony.

Q82. Please describe your methodology for computing the allocation of corporate overhead expenses for SFPP's cost of service analyses.

A82. I begin with the total KMEP corporate overhead of \$238.8 million listed on page 47 of the KMEP September 2009 10-Q. This amount represents total general and administrative expenses for the nine months ending September 30, 2009.

Q83. Do you believe any of the \$238.8 million in KMEP corporate overhead expenses should be excluded from a corporate overhead allocation using the MA formula?

A83. Yes, the September 2009 10-Q indicates that a portion of the costs represent a \$4.3 million increase in non-cash compensation expense, allocated to KMEP from Knight. KMEP states that "we do not have any obligation, nor do we expect to pay any amounts related to [these] expense[s]." ⁴⁰ As a result, these purported expenses are non-recurring and not properly recovered in forward-looking rates since the expenses do not provide a benefit to KMEP or SFPP. As a result, I deduct \$4.3 million in corporate overhead expenses from the nine month 2009 KMEP total, resulting in \$234.5 million of allocable corporate overhead operating expenses. I then annualized this amount to present a full twelve month overhead amount, resulting in a value of \$312.7 million. ⁴¹

Q84. Did you directly assign any of these expenses to any KMEP subsidiaries?

A84. No. As discussed previously in my testimony, I do not believe that SFPP appropriately justifies the direct assignment of corporate overhead expenses. As a result, I allocate these corporate overhead expenses in a single MA Formula applicable to all KMEP-owned entities.

⁴⁰ KMEP September 2009, 10-Q, p. 48, footnote (n).

⁴¹ I multiply the \$234.5 million by (12/9) to annualize the nine month value into a twelve month value.

Q85. Once you had the total KMEP corporate overhead amount, how did you allocate the portion specific to SFPP operations in the single tier MA method?

A85. The data included in Mr. Turner's MA method only pertains to the KMEP-owned and operated entities. For example, the KMI cross-charge included in Mr. Turner's analysis only applies to shared services for the KMEP-owned and operated entities. As a result, Mr. Turner's MA Formula excludes a number of KMEP-owned subsidiaries. Furthermore, Mr. Turner's MA Formula uses gross property, payroll and revenue balances as of June 30, 2009. Although as discussed elsewhere I disagree with Mr. Turner's definition of the test period, I have used the MA allocation factors as of June 30, 2009, as these data represent the most accurate and up to date information consistent with my annualized expenses for 2009 and most closely comport with the Commission's directive to use 2009 as the test period.

Q86. Do you also exclude the same entities that Mr. Turner excluded from his analysis?

A86. No. In my MA Method, I include all KMEP-owned entities responsible for the annualized \$312.7 million in corporate overhead. SFPP provided the relevant MA allocation factors as of June 30, 2009 for the excluded entities in response to CC Data Request No. 33. I have included as Exhibit ____ (PKA-6) my overhead allocation calculation using the MA Method.

Q87. Did you include purchase accounting adjustments for all KMEP subsidiaries when considering the gross property, plant and equipment factors?

A87. In contrast to Mr. Turner, I only include purchase accounting adjustments for regulated KMEP subsidiaries. Mr. Turner included purchase accounting adjustments for both regulated and unregulated entities.

Q88. Please explain why you disagree with SFPP's removal of PAAs from both regulated and unregulated entities.

A88. The removal of PAAs from regulated entities is necessary in order to preserve the direct relationship between prices, revenues and profitability and the original cost of the regulated subsidiary's gross property. In contrast, there is no necessary relationship between the prices, revenues, and profitability of unregulated subsidiaries and the original cost of the subsidiary's gross property. If one were to remove a PAA from an unregulated subsidiary's gross property balance, the resulting value would have no necessary relationship to the original cost of the assets, and furthermore, it could include previous PAAs resulting from payments made by prior owners. Thus it makes no sense to remove such PAAs from unregulated subsidiaries whereas there is good reason to do so for regulated entities. FERC has long advocated the removal of PAAs associated with regulated entities to ensure that gross property balance reflects original cost, and thus avoids any allocation of overhead expense that is unduly influenced by the purchase price of the regulated subsidiaries.⁴²

Q89. Besides the PAAs, did you include any other adjustments to the MA Formula allocation factors in your 2007 analysis performed in the FERC proceeding to which you previously referred?

A89. Yes. One of the KMEP-owned, but KMI-operated entities that Mr. Turner implicitly excludes is Tejas Gas LLC and its subsidiaries ("Tejas Consolidated"). In recent FERC proceedings involving the SFPP MA Formula, ALJ rulings note a preference to use net

⁴² 125 FERC ¶63,018 P795; 113 FERC ¶61,277, citing 21 FERC ¶61,260 (*Williams Pipeline Co.*) and *Arkla Energy Resources*, 61 FERC ¶ 61,004 at 61,037.

revenues to remove the impact of gas purchase costs associated with Tejas Consolidated.⁴³ Although I do not necessarily agree with these rulings, I used net revenues, defined as gross revenues less the cost of goods sold for gas purchases rather than gross revenues. However, I did not have the annualized cost of goods sold for gas purchases ending June 30, 2009 for Tejas Consolidated. As a result, I used data provided in FERC Docket No. IS08-390 concerning the 2007 level of gross sales and cost of goods sold to impute a net sales margin applicable to the 12 month gross revenue data provided by SFPP in response to CC Data Request No. 33. I also adjusted the MA allocation factors for Rockies Express Pipeline and Mid Continent Express Pipeline to reflect KMEP's 50% equity interest in each pipeline.⁴⁴ Finally, KMEP sold the Cypress pipeline in July 2009 and as a conservative measure, I removed this pipeline from my MA formula.

Q90. What are the results of your MA Formula?

A90. Exhibit __ (PKA-6) contains my revised MA formula calculations. I allocate to SFPP approximately \$20.7 million in overhead expenses based on the single-tier application of the MA Formula. I subsequently applied the KN factors for the corporate overhead allocable to the CPUC-jurisdictional operations of SFPP. The resulting base period corporate overhead expenses allocable to jurisdictional service is approximately \$6.4 million for SFPP. This value represents a decrease of \$9.5 million in overhead expenses allocated to SFPP CPUC jurisdictional service from Mr. Turner's analysis.

⁴³ 125 FERC ¶ 63,018 at P783.

⁴⁴ I am operating under the assumption that the gross revenue, gross property, plant and equipment, and direct labor reflect a 100 percent equity interest in the data provided in response to CC Data Request No. 33. As a result, I reduce each MA allocation factor by 50 percent.

Dismantlement Expenses

Q91. Please explain SFPP's dismantlement expenses?

A91. Mr. Turner proposes to include a \$2.0 million CPUC-jurisdictional charge for what he terms the "dismantlement, removal and restoration" ("DRR") of the SFPP pipeline. Mr. Turner claims that this charge allows SFPP to collect transportation-related costs that will not be incurred until after the termination of SFPP's services – when he claims it will be too late to collect them from shippers.⁴⁵

Q92. Do you think there is any validity to this dismantlement charge?

A92. No. I recommend that no DRR expense be included in SFPP's cost of service for several reasons. First, SFPP does not appear to be incurring any DRR expense at this current time and thus any such charge is more properly regarded as an accrual. For all other operating expense items in his proposed cost of service, Mr. Turner excludes accrual additions to reserves for his cost of service and instead only includes cash expenses. In this case Mr. Turner is doing exactly the opposite, and he has ignored the fact that SFPP has made no cash expenditures and is instead proposing to collect a "reserve" from ratepayers.

Second, Mr. Turner states in his testimony that the relevant time period is not the end of the useful life of the pipe, but the cessation of services by SFPP. He points out that pipe is retied all the time and any cost associated with the removal of that pipe is rolled into the ultimate cost of the replacement line.⁴⁶ This means that his DRR calculation is speculative and overstated since he uses a calculation based on the

⁴⁵ Turner prepared direct testimony, pp. 16-17.

⁴⁶ Turner prepared direct testimony, p. 17.

remaining useful life of the pipe rather than on the cession of SFPP's service.⁴⁷ Moreover, SFPP's California intrastate service is likely to continue to function indefinitely since it is an ongoing business that is essential to the petroleum product delivery infrastructure in California.

It is therefore not surprising that SFPP does not appear to have established a separate fund to retain the proceeds of the DRR reserve. As a result, these revenues, if allowed to be collected, will simply provide additional cash flow to SFPP which will then be paid out as cash distributions to the owners of SFPP. Indeed the partnership agreement governing distributions by KMEP mandates that it pay out 100% of available cash to its partners.⁴⁸ As a result, neither SFPP nor KMEP will actually have these funds if and when they might be needed at the conclusion of SFPP's business.

Environmental Expenses

Q93. What has SFPP claimed for environmental expenses?

A93. Mr. Turner includes almost \$8.0 in environmental expenses that he believes ratepayers should be charged for SFPP's environmental expenses. This calculation is based on actual environmental costs incurred and allocated to SFPP's CPUC-jurisdictional service for the last six months of 2008 and the first 6 months of 2009.

Q94. Do you agree with that amount?

A94. No. First, SFPP seems to be continually recording higher environmental expenses for which it claims reimbursement from ratepayers. The increasing level of these

⁴⁷ Mr. Turner's Schedule 13 shows that his calculation relies on the remaining useful of the pipeline without considering continued replacement of existing pipe as well as the strong likelihood that SFPP will remain in the pipeline transportation business far beyond 2034.

⁴⁸ KMEP SEC Form 10-K, 2008, p. 87.

environmental expenses raises serious questions regarding the prudence of SFPP's operations from an environmental standpoint. As long as SFPP is not responsible for paying the costs of environmental clean-ups, it may not have sufficient incentives to operate in a prudent, environmentally sensitive manner. Further, my analysis of SFPP's claimed environmental expenses indicate that 62% of the total claimed expenses relate to a single project at Mission Valley that apparently is also the subject of litigation. It is not clear how long cleanup of this site will last, but clearly once completed, a major portion of SFPP's environmental expenses should disappear.

Q95. How have you developed an appropriate environmental expense estimate for the SFPP cost of service?

A95. I annualized data for the first half of 2009, following the Commission's directive to apply a test year for 2009. This results in a slightly lower level of environmental expenses for 2009 than Mr. Turner's calculation.⁴⁹ Then in order to control for the fact that SFPP's environmental expenses have been increasing markedly in the last two years which, as I stated above, I believe is an anomalous period, I normalized SFPP's environmental expenses by taking the average of SFPP's jurisdictional environmental expenses for the three year period 2007-2009. This analysis results in a total test period environmental expense for CPUC jurisdictional service of \$6.0 million.

Losses & Shortages

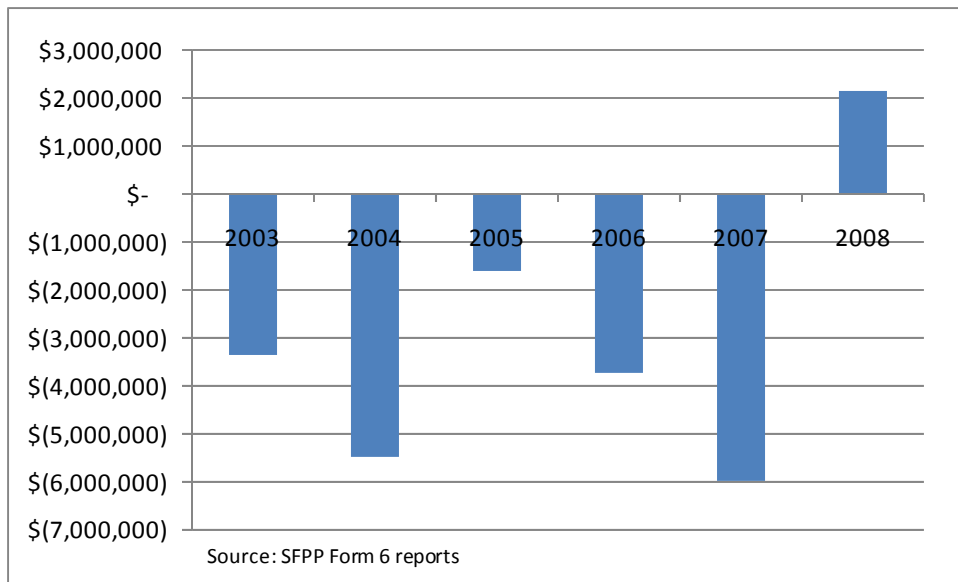
Q96. What does SFPP claim for oil losses and shortage?

⁴⁹ In contrast to Mr. Turner's \$8.0 million in environmental expenses, my unadjusted 2009 value is \$7.1 million.

- A96. Mr. Turner reports a test period oil losses and shortage expense of negative \$1.3 million. This item is typically a “negative expense” or in reality a revenue item based the manner in which SFPP reports it each year.
- Q97. Do you believe that SFPP has included an appropriate losses and shortage figure in its cost of service?
- A97. No. Mr. Turner’s test period calculation for losses and shortages includes the last six months of 2008 as well as the first six months of 2009. 2008 was a very unusual year with regard to pipeline losses and shortages. This is seen clearly in Figure 5 below which plots SFPP’s total losses and shortages as reported on its FERC Form 6 for the last six years. Whereas SFPP typically reported a negative expenses (or revenue) of about \$4 million, in 2008 it reported an actual expense of \$2 million including \$1.8 million in CPUC jurisdictional expense. However, the trend in 2009 has reverted back to the 2003-2007 period, which is why Mr. Turner reports a negative number even though he has included six months from 2008. I believe that it is inappropriate to include any portion of 2008 in a losses and shortage calculation because 2008 was an anomalous period of time and does not reflect SFPP’s normal operating condition. It is also outside the test period that the Scoping Memo defined.
- Q98. How have you calculated the appropriate oil losses and shortages amount for the test period?
- A98. First, I considered the average of 2007 and 2008/09 CPUC jurisdictional losses and shortages which was approximately negative \$1.9 million. I also examined the relationship in 2007 between CPUC losses and total losses as reported on the FERC Form 6. I took this ratio and applied it to the average of 2003-2007 losses and shortage

expenses on the FERC Form 6 to derive a value for CPUC jurisdictional losses and shortage which was negative \$1.7 million. Since this is relatively close to the other value, i.e., 1.9 million, I averaged the two amounts to arrive at a figure of negative \$1.8 million which is the negative revenue amount that I use in my cost of service.

Figure 5: SFPP Oil Losses and Shortage Expense – 2003-2008



Litigation Expenses

Q99. What costs has SFPP claimed for litigation expenses?

A99. Mr. Turner has included in his cost of service approximately \$557,000 in litigation expenses as well as another \$5.5 million in directly assigned overhead legal costs for a total litigation expense of slightly over \$6 million.

Q100. Do you believe this is an appropriate amount?

A100. No. I have already discussed the problems with SFPP’s direct assignments and the \$5.5 million in legal costs are largely unrelated to transportation service provided to ratepayers. I capture a portion of those expenses in my MA method. The additional

\$557,000 apparently reflects direct costs related to this litigation. These costs are not likely to be recurring in the future and they will disappear once this litigation is resolved. Therefore these litigation costs should be recovered through a temporary surcharge but should not be embedded in the cost of service in perpetuity. I would recommend that they be amortized over a five year period and then be removed from the cost of service.

Fuel & Power Expenses

Q101. Have you made any adjustments to the fuel and power account?

A101. Yes. To account for the increase in throughput volumes that I believe will occur, I increased fuel and power expenses by 1.66% relative to 2008 fuel and power expenses. This increase reflects the increase in volume from my average test period calculation relative to the base period. As a result my fuel and power costs are about \$510,000 higher than those claimed by Mr. Turner.

V. SFPP's COST OF SERVICE, ACHIEVED RETURN AND JUST AND REASONABLE RATES

Q102. Have you evaluated whether SFPP's CPUC jurisdictional rates are just and reasonable?

A102. Yes.

Q103. What have you concluded?

A103. The initial rates SFPP charge its shippers in June 2008 are not justified and are not reasonable. Furthermore, the two rate increases SFPP is proposing are also excessive and are not justified based on my test year (2009) cost of service analysis. SFPP's cost of service remains significantly below its revenues leading to a substantial over recovery and an achieved return that far exceeds any reasonable rate of return.

Q104. Please explain why you do believe that SFPP's CPUC-jurisdiction rates are not justified?

A104. My cost of service analysis which is presented in Exhibit __ (PKA-7) shows that the total test period cost of service for SFPP is \$84.6 million. I determined that SFPP's 2009 rates including the two rate increases it requested since June 2008 when applied to the test period volumes result in total revenue of approximately \$123.4 million.⁵⁰ Using this revenue estimate as shown in page 2 of Exhibit __ (PKA-7), SFPP's achieved rate of return is 25.15%, almost three times the rate of return I believe is reasonable for regulated oil pipelines (8.79%). The achieved return on equity is 55% whereas the return on equity that I believe is reasonable is 12.43%. Clearly these results show that SFPP's rates are too high. Another way to see this is to compare the \$84.6 million cost of service I computed with SFPP's revenues of \$123.4 million. At these rates SFPP would be over recovering its cost of service by 46 percent, yet another indication that SFPP's rates are not just and reasonable. I have included this calculation at line 18 on page 1 of Exhibit __ (PKA-7) as well.

Q105. Were SFPP's existing rates in June 2008 just and reasonable based on your analysis?

A105. No. Although I have not computed a separate cost of service for 2008, if anything it would likely be lower due to the effects of inflation. Therefore, using my test period cost of service together with lower SFPP revenue figures in June 2008 and 2008 volumes demonstrate that SFPP's rates as of June 2008 were not just and reasonable. SFPP would have been over recovering its cost of service by at least 18%, and its achieved return would have been far outside the range of a just and reasonable return. Therefore, I conclude that SFPP's rates as of June 2008 were not just and reasonable.

⁵⁰ This reflects the average of my two volume scenarios.

Q106. Have you performed a computation of just and reasonable rates for SFPP's intrastate service for the test period?

A106. Yes. I have designed rates using a fully allocated cost model applicable to a pipeline that has multiple origin and destination points. A fully allocated cost model allocates the cost of service between distance and non-distance factors.⁵¹ This process ensures that all costs are recouped in the rates being charged. Costs that do not vary with distance, i.e., non-distance costs, are divided by total throughput to determine a fixed cost per barrel element of the rate. In the case of SFPP, this fixed cost element is slightly over \$0.02 per barrel.

Costs that are distance related, (those that vary with distance, e.g., fuel and power costs) are applied to various origin/destination pair and then, based on volume and mileage, a variable rate element is computed. Thus for origin/destination pairs that involved short distances, this element will be low; for longer distances, this element of the rate will be higher. Thus for movements from Watson to San Diego, a distance of 138 miles, the variable component of the rate is about \$0.53 per barrel whereas for the shorter movement between Watson to Orange of 28 miles, the variable element of the rate is only about \$0.11 per barrel.

Q107. What costs do you use in your fully allocated cost model?

A107. The costs I include in my fully allocated cost model are the costs that are used to establish the revenue requirement that a regulated utility is permitted to earn under a cost-based regulatory approach to ratemaking. I have calculated a cost of service for each

⁵¹ As the charge at Watson does not involve an actual movement, I have separated this out from the rate design and simply apply the existing rate of \$0.003 per barrel to this charge. I add this back in to ensure complete, but not excess recovery of the cost of service.

year for the common carrier portion of the pipeline. A cost of service typically includes the following elements:

- Rate base
- Rate of return
- Rate of return on the rate base
- Operating expenses including depreciation
- Income tax allowance (if the entity pays income taxes)
- Amortization of AFUDC and ADIT

In this case, as discussed above, I computed the weighted average cost of capital which I apply to the rate base to compute the rate of return on the rate base. I then added operating expenses and depreciation. Finally, I included an income tax allowance and an allowance for the amortization of AFUDC and ADIT.

Q108. Which costs are considered variable and which are not distance related?

A108. In my model, I treat all elements of the cost of service as varying with distance with the exception of two operating cost categories: outside services (FERC Acct. 520) and other general expenses (FERC Acct. 590). These two accounts are largely, although not exclusively, overhead costs and might not be expected to vary with distance. I considered only these two FERC account categories as reflecting expenses that do not vary with distance. I believe that the rate design I employed is reasonable and is consistent with the manner in which the FERC has approached cost of service rate-making.

Q109. What are the results of your rate design?

A109. Exhibit __ (PKA-8) presents a table of the just and reasonable rates I have computed for SFPP's test period intrastate service along with a graph comparing the rates I have calculated with SFPP's rates as of June 2009 for each destination. As the graph indicates there are actually a few destinations for which the rates I have computed are actually slightly higher than what SFPP was charging. However, for the vast majority of destination points, the rates I have computed are between 20 and 70 percent lower than SFPP's rates.

VI. ANALYSIS OF COMPETITIVE OPTIONS TO SFPP

Q110. Have you reviewed the EAI report regarding the extent of competition faced by SFPP for its intrastate service?

A110. Yes.

Q111. Do you agree with the conclusions of the EAI report?

A111. No.

Q112. Please briefly summarize EAI's conclusions and the reasons for your disagreement.

A112. The EAI report claims that SFPP faces competition from several sources including certain proprietary pipelines, marine shipments, terminals, and trucking. The EAI report, however, concedes that there are areas in California, particularly long haul movements and outlying areas where SFPP provides virtually all of the transportation services and possesses market power. Although EAI claims that trucking is economic in certain markets, its own analysis and cost data demonstrates clearly that the cost to transport product by truck is not competitive with SFPP's rates. In these markets trucking, by

SFPP's own admission, cannot serve as a competitive constraint on its rates. The EAI Report also fails to consider the fact that trucking is only an option for a relatively small volume of product.

The EAI further claims that most of the markets served by SFPP have a relatively modest level of concentration based on the Herfindahl-Hirschman Index (HHI). However, the HHI measure that the EAI employs is incorrect for a number of reasons, including the fact that it understates SFPP's shipments in certain market areas. In addition, the EAI report appears to overstate market demand, and it makes erroneous assumptions about the market shares held by non-SFPP competitors. Finally, EAI's analysis of comparative tariff rates fails to take into account the fact that the other pipelines which it considers operate in separate and different geographic and product markets, and cannot be used as a basis for comparison.

Q113. Please briefly describe how an economist such as yourself goes about analyzing whether a pipeline has market power?

A113. Economists and regulators have examined this issue over the past 25 years as the effort to deregulate energy markets has progressed. First it is important to recognize that the Department of Justice ("DoJ") has well established rules and methods for analyzing whether firms may have the ability to exercise market power in the context of its Merger Guidelines.⁵² In the mid-1980s the Department of Justice issued a report on Oil Pipeline Deregulation which was preceded by a report on competition in the pipeline industry.⁵³

⁵² U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, 1992, revised 1997, hereinafter, "Merger Guidelines," available at <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.

⁵³ U.S. Department of Justice, *Oil Pipeline Deregulation*, May 1986; and U.S. Department of Justice, *Competition in the Oil Pipeline Industry*, May 1984.

Subsequently, the FERC issued a Final Rule regarding oil pipeline rates as well as a Notice of Inquiry regarding market-based rates and the determination of market power. The DoJ addressed these issues including the analysis of market power by oil pipelines.⁵⁴ The DoJ analysis is consistent with manner in which an economist would assess market power, and in particular provide guidance regarding definition of relevant markets and measures of market power including the use of the HHI.

Q114. Is there any current guidance regarding the methods used to evaluate market power?

A114. Yes. A case before FERC, *Mobil Oil Pipeline Company* (128 FERC ¶63,008), provides helpful guidance on how to examine whether a pipeline has market power. In that case, the Administrative Law Judge performed a detailed threshold price test analysis to determine the extent of the relevant geographic and product markets before computing the HHI. This enabled the ALJ to evaluate potential sources of competition to the pipeline and eliminate those companies that were not economic alternatives to shippers on the pipeline. The ALJ used a three-step test to evaluate various alternatives. These steps included:

- (1) whether the alternative was readily available;
- (2) whether it was comparable in quality; and
- (3) whether it was comparable in terms of price.

The ALJ ultimately found that there were no competitors and thus no HHI calculation was necessary.

⁵⁴ Comments of the U.S. Department of Justice in Response to Notice of Inquiry, FERC Docket No. RM94-1-100, January 21, 1994, available at <http://www.usdoj.gov/atr/public/comments/200223.htm>

Q115. Does the CPUC approach the analysis of market power in a similar fashion to the FERC?

A115. Yes, It is my understanding that the CPUC evaluates the extent of competing alternatives and then, if necessary, performs a calculation of the HHI to evaluate the level of concentration in the market or markets and hence whether under the DoJ Merger Guidelines the pipeline may possess market power.

Q116. How would you define “market power?”

A116. The Merger Guidelines and most economists define market power as the ability of a firm to profitably maintain prices above competitive levels for a significant amount of time.⁵⁵ This requires the economist to define a base price approximating the competitive level, establish a reasonable amount of time to observe the price impact and define what reflects a significant price increase.

With regard to these three tests, one usually looks to a period of time of not less than one year to see whether the market could respond to the price increase. Typically, economists have looked at a 5 to 15 percent increase as the threshold for market power and market definition.⁵⁶ With regard to a base or competitive price, the particular price level is often difficult because the existing price or rate may in fact be above the competitive level if the market is not functioning competitively. My cost of service analysis certainly suggests that SFPP’s existing rates are significantly above the competitive level as were its rates in 2008. For purposes of my analysis, I will use SFPP’s June 2008 rates as “base rates” although I do not believe they necessarily reflect competitive rates.

⁵⁵ Department of Justice, *Merger Guidelines*, §0.1.

⁵⁶ For example, the recent Mobil case referenced above used a 15% threshold.

Q117. Using this methodology have you performed an analysis of whether there are any competitive options to SFPP's intrastate service?

A117. Yes. First, I examined potential alternatives to the SFPP pipeline system to see if any of them can be considered competitive alternatives. My focus is on the destination markets served by SFPP. It is important to note at the outset (and I believe EAI agrees) that there are *no* competing common carrier pipelines in California that serve any SFPP destination markets. As a result, we are left to consider other alternatives. The EAI report generally discusses three potential alternatives: proprietary pipelines, marine movements, and trucks. I examined each of these alternatives.

The EAI report notes that certain companies own relatively short haul pipelines in the San Francisco Bay area as well as in the Los Angeles area. For example, Chevron Pipe Line Company (CPL) owns a proprietary line that runs from Richmond to Sacramento and San Jose. ExxonMobil owns a private line that runs from the Long Beach area to Anaheim. Although these pipelines do have the ability to transport product to a limited number of the destination markets served by SFPP, they are not openly available to shippers other than the owner of the pipeline. They also serve only a very limited number of destinations that are also served by SFPP. Therefore, they do not meet the first test of ready availability.

Q118. What about the ability to use exchanges to gain access to these proprietary pipelines?

A118. While these proprietary pipelines may engage in exchanges that permit others to use these lines from time to time, there is no guaranteed right of access and no published price or terms and conditions of access. Thus it is impossible to know what the price

would be that these pipelines could or would charge. Indeed since they own the pipeline and are unregulated they could charge any price they want. Furthermore, there is no basis to judge the quality of service provided by these proprietary lines. In addition, the owner of the pipeline will undoubtedly prioritize its volumes first, and these lines tend to be relatively small so it is not possible for a shipper on SFPP's pipelines to expect to gain access and move all of its product on the proprietary line. Therefore, not only are these pipelines not readily available, a price test is not possible, and the quality of service is also not comparable. For these reasons I do not believe that proprietary pipelines meet any of the tests described above.

Q119. What about marine terminals, ships and barges?

A119. Waterborne delivery of refined products is usually used to move large volumes of product among various refining centers (e.g., from the Bay Area to L.A.), but not to move product to SFPP's destination markets. Those destinations that theoretically could be served by waterborne vessels generally are not equipped to handle light products such as gasoline or diesel which are the products shipped on SFPP's pipelines. Furthermore, my understanding is that the cost to transport petroleum products by barge or vessel would not fall within the 15% upper range of SFPP's rates. Therefore, both the high cost and lack of infrastructure make waterborne vessels a non-economic alternative for those few destinations that could possibly be served by marine movements. In sum, for most destinations, marine transportation is not available, and even for those few instances in which marine transportation might be used, the facilities do not exist to handle light products in a cost competitive manner.

Q120. Let's turn to trucking as a competing alternative. What do you conclude about trucking as a competitive alternative to serve SFPP's destination markets?

A120. In my opinion trucking does not provide a competitive alternative to any of SFPP's destination on the basis of cost alone. Furthermore trucks cannot be used to transport all of the volume of petroleum products that are shipped to any of SFPP's destination markets.

Q121. Would you please elaborate on your answer?

A121. I will first discuss whether trucking is a reasonable alternative to handle the entire volume of petroleum products that are transported through SFPP's pipelines. It would require at least 104,000 truck trips a month to carry the test period monthly volume of SFPP's intrastate pipeline service. These trucks would travel more than 2,000 miles each week. I estimate that it would require almost 1,600 additional truck movements per day to supplant SFPP's volume movements in the Los Angeles area alone and a similar number for the San Francisco area.⁵⁷ This enormous fleet of trucks would not only congest California's already busy freeways, but they would also pose additional environmental, air quality, and other potential risks.

Q122. Are there any other problems in using trucks to replace the shipments of petroleum products made on SFPP's pipelines?

A122. Yes. First, it is my understanding that physical facilities do not exist to handle the level of volume that trucking entails. In order to handle these additional volumes a substantial number of new storage and loading facilities would have to be constructed and a trucking

⁵⁷ This calculation assumes 200 barrels of product per truck and uses my test period volumes.

fleet would have to be built. I also doubt that governmental agencies or the public would put up with this additional traffic and the environmental costs associated with this level of additional trucking.

Q123. You previously allude to the cost of trucking? Does the price of trucking meet the 5-15% price threshold test?

A123. No. I have compared the cost to transport product to SFPP's destination markets on SFPP's pipelines as compared to the cost to transport product to each of the same destination points by truck. In doing so, I used the trucking costs relied on by EAI to analyze the cost competitiveness of trucking in comparison to SFPP's rates. EAI claims to have developed trucking rates based on a survey; the rate that it applies is composed of a fixed (\$0.48 per barrel) and a variable element (\$0.139 per barrel).⁵⁸ I used these rates as a basis for comparing trucking costs with SFPP's pipeline rates. I calculated the trucking rate for each of SFPP's destinations and then compared it to SFPP's 2009 rate and found that on average the trucking rates were over 260% higher than the SFPP rates. This analysis is included in Exhibit __ (PKA-9) to my testimony. I also compared the price difference between short haul and long haul movements to see if there was any appreciable difference which would make the price difference for short haul movements significantly lower. In this analysis, I divided SFPP's rates into different mileage groups (under 25 miles, 25-50 miles, 50-75 miles and so on) and calculated a rate per barrel mile which I could then compare directly with the trucking rates for the different distances.

This analysis is shown in Exhibit __ (PKA-10). As Exhibit __ (PKA-10) indicates, even

⁵⁸ See spreadsheet "TSRO-86TableCSS-1_Competitive Cost Grid_CAGridAvg2009Basis.xls." Typically the fixed cost element covers the costs to load and unload the truck and the variable element covers the cost to move the truck a certain distance and thus increases with mileage.

for the short haul distances of less than 25 miles trucking is over 175% more expensive than transportation on SFPP's pipelines and this cost differential increases as the distances travelled become longer.

Q124. Does EAI recognize that trucking is more expensive than SFPP's pipeline rates and not readily available?

A124. EAI never addresses the availability test, and simply assumes that the facilities exist to handle the very large additional volumes of product that would have to be transported by truck. This is a serious flaw in EAI's analysis. It means that EIA's analysis is incomplete and its conclusions are erroneous.

Furthermore even EAI's analysis, although flawed, demonstrates that in most markets trucking is not cost competitive. EAI focuses its trucking analysis on seven "core" destination markets (Chico, Stockton, Sacramento, Fresno, San Jose, San Diego, and Colton). EAI's own analysis which compares the cost of trucking to pipeline costs shows that in none of the seven core markets is trucking an economic alternative strictly on a price comparison basis.⁵⁹ Exhibit __ (PKA-11) recreates EAI's Table CCC-1 which presents an analysis comparing trucking with pipeline costs shows that in none of these "core" markets is trucking able to reach the destination market on an economic basis even employing EAI's other assumptions.

Q125. If trucking is not readily available and not price competitive, why is any refined product trucked?

⁵⁹ In certain markets, EAI used incorrect mileages in comparing SFPP's rates with the trucking option and in our replication of the EAI analysis we have corrected for these errors. In addition, it appears that EAI has at times only used the variable component of the trucking rate in its calculations and did not include the fixed component.

A125. It is my understanding that trucks are generally used to distribute petroleum products within local refining areas whereas the SFPP system is used largely to move product to more distant locations. Trucking may also be used if a pipeline is under prorating. In addition, as I discussed earlier in my testimony, ethanol which is used as a blending component for gasoline is transported by trucked in significant volumes because it cannot be commingled with other products in SFPP's pipelines. This is the principal reason there has been an increase in trucking in the petroleum industry in recent years. Other than ethanol, petroleum products are generally shipped in much smaller volumes and generally only for short haul distances. Another area in which trucks are used by major oil companies is to meet the need to keep their service stations supplied. Trucks are used for this purpose and transport petroleum products from terminals to service stations, particularly within the major refining areas of Los Angeles and San Francisco. SFPP's pipelines, on the other hand, are used for longer haul movements where trucking is not a competitive alternative.

Q126. So what do you conclude about trucking as a competitive alternative to SFPP's intrastate pipeline service?

A126. Under the three step test that I discussed above, trucking cannot be considered a competitive alternative. Trucking is not readily available and for most movements is not price competitive. In addition, because of environmental and traffic issues, trucking simply does not provide the same level of quality of service as SFPP's pipelines. Therefore, I conclude that trucking is not a competitive alternative.

Q127. Are there then any competing alternatives to SFPP's intrastate pipelines?

A127. No. I have concluded that existing proprietary pipelines, marine movements and trucking are not competitive alternatives as discussed above. The one remaining factor which could conceivably pose a competitive constraint would be the entry of a new pipeline system.

Q128. Is that likely?

A128. No. EAI discusses the possible entry of a new pipeline that would serve the Las Vegas, Nevada market, but that is unlikely to have any impact on SFPP's California intrastate service. Furthermore, KMEP, SFPP's parent, has explicitly stated that it does not anticipate the entry of any new pipeline that would directly compete with SFPP's California system in the foreseeable future:

We believe that high capital costs, tariff regulation, and environmental and right-of-way permitting considerations make it unlikely that a competing pipeline system comparable in size and scope to our West Coast Products Pipelines operations will be built in the foreseeable future.⁶⁰

Therefore I do not believe that the entry of a new pipeline is likely or could be considered a competing alternative to SFPP.

Q129. What overall conclusion have you therefore reached regarding the level of competition faced by SFPP?

A129. Using the tests discussed above, I conclude that there are no competing alternatives for the service provided by SFPP's intrastate pipelines. While in limited cases other modes of transportation may provide complementary services, none are readily available as a substitute for SFPP's service, and none are able to provide transportation services on a

⁶⁰ KMEP, SEC Form 10-K, 2008, p. 11.

price competitive basis. As a result, following the logic of the ALJ in the *Mobil* case cited above, I do not believe that it is even necessary to calculate an HHI since there are no competing alternatives to SFPP.

Q130. Then you obviously disagree with the HHI analysis presented in the EAI report?

A130. Yes, I do for three reasons. First, as I have pointed out, the alternatives that EAI includes do not meet the economic tests of ready availability, comparable quality, and comparable price. Therefore, these alternatives should not be included. Second, EAI's own analysis shows that virtually all of the destination markets served by SFPP are highly concentrated and that SFPP is the dominant supplier. Third, even if one did believe there were competing alternatives in certain markets, the computation of HHI's presented by EAI is incorrect and yields unreliable results.

Q131. Please explain your answer.

A131. I have already discussed the first reason and the basis for my conclusion that there are no competing alternatives. Next, it is clear that in most of the destination markets analyzed by EAI, even its own flawed data shows extremely high levels of market concentration and that SFPP possesses a very high market share in those markets. For example, Figure CSS-1 to the EAI report shows that in seven of the nine destination markets in which it computes an HHI, EAI finds the HHI to exceed 4,000 which, under the DoJ Merger Guidelines, means that the market is highly concentrated if not a virtual monopoly. Indeed in those seven markets, even EAI's flawed analysis shows that SFPP had an average market share exceeding 80%. Thus, EAI's own analysis demonstrates that SFPP has a very significant degree of market power in those markets.

Third, EAI's own analysis of HHI's is flawed and contains numerous assumptions that are not reliable. In performing its HHI computation, EAI first calculates total demand based on its own "proprietary" model which it has refused to provide in discovery in this case.⁶¹ Without this model it is impossible to determine how EAI determined market demand, or the specific products that were included in the model,⁶² let alone the way in which the model was used to reach its conclusions. Moreover, the very few facts that SFPP has been willing to disclose about the EAI calculations indicate that EAI included petroleum products in its market analysis that are not shipped on SFPP's pipelines. Consequently, the product market that EAI defined in its analysis is incorrect and biased to produce a lower market share and market concentration estimate than in fact exists.

In addition, EAI has failed to measure all of the throughput on SFPP's intrastate pipeline system in its market share and HHI calculations. EAI claims to use 2008 data for its analysis, yet total SFPP deliveries shown in the EAI computation is 580,786 barrels per day or a total of 212.6 million barrels. SFPP's own data for 2008⁶³ shows that it moved 241.4 million barrels on its intrastate service *excluding* Watson and Sepulveda. If we were to include the Watson and Sepulveda volumes, the total increases to 321 million barrels. Clearly, EAI omitted a significant portion of SFPP's own shipments in computing the HHIs. This flaw in EAI's approach again leads to estimates of market concentration and market share for SFPP that are incorrect and much lower than an accurate study would produce.

⁶¹ See response to Tesoro Data Request 94.

⁶² EAI simply indicates it includes gasoline, distillate, and jet fuel in its model.

⁶³ Cite

EAI also assumes that any terminal owner in a particular market is a competing supplier. It has no data on the actual volume supplied by these claimed competitors nor whether they actually used non-SFPP modes of transportation to transport supply to the terminals. It is therefore very likely that EAI overstated the number of competitors in a number of destination markets. This is particularly true since EAI's analysis appears to be based on the hypothetical proposition that such a company "could" supply the destination market using a transportation mode other than SFPP, not whether it actually did so, since it has no data on the volumes actually supplied by any of SFPP's alleged competitors.

Still another flaw in EAI's analysis is that in computing HHIs, it assumes that the non-SFPP suppliers all contribute equally to the "competing" supply. Each competitor is assumed to supply the same amount because EAI does not possess any data regarding actual supply volumes. This is another fatal flaw in EAI's analysis because this assumption serves to minimize the resulting HHI calculation. EAI contends that it performed a "reality check" to determine whether this assumption was significant and concluded that it was not.⁶⁴ I will illustrate this flaw with a simple hypothetical example indicating that the difference could be highly significant.

The HHI represents a calculation of the sum of the squares of each company's market share. Consider two different markets with the same number of competitors (five) and the largest firm (SFPP) has 30% share of the market in each market. In the first market (Market 1), the remaining four companies have equal shares consistent with EAI's assumption; as shown below the resulting HHI is 2,125. However in the second

⁶⁴ See response to Tesoro Data Request 98.

market (Market 2), the second and third firms have market shares equal to the first, and the fourth and fifth are only a fringe competitors with 5% of the market each. As shown below the resulting HHI is much higher at 2,750. This is almost a 30% increase in the HHI which I would deem as highly significant. If one tests this hypothetical against the data presented by EAI, it becomes clear that in two markets the swing in the HHI can be quite significant and these two markets are the San Francisco Bay area and Los Angeles. In the other markets because SFPP has such a high market share to begin with, the existence of competitors is essentially meaningless and thus the distribution of their shares has little impact on SFPP's market power. However, because EAI attempts to draw conclusions based on a state-wide calculation of the HHI as well as the Los Angeles and San Francisco markets in particular, EAI's treatment of the distribution of competing suppliers in San Francisco and L.A. is important and leads to erroneous results.

Competitors' Market Share (%)	Market 1	Market 2
A	30	30
B	17.5	30
C	17.5	30
D	17.5	5
E	17.5	5
HHI	2,125	2,750

Q132. Is the calculation of a state-wide HHI as performed by EAI relevant?

A132. No, I do not believe it is. As I have discussed previously the relevant level of inquiry as recognized by the Department of Justice, FERC and others is at each of the destination markets served by SFPP. It is inappropriate to lump supply delivered in San Diego with

supply delivered to San Jose because they are located hundreds of miles apart and do not compete from a geographic standpoint. Aggregating market shares across different, distinct relevant markets is improper economic analysis and leads to an incorrect view of market concentration even assuming there are competing alternatives. Market shares and measures of market concentration such as HHIs must be measured at each individual destination market. As I have indicated even EAI's flawed analysis indicates that seven of the nine destination markets that EAI examines have extremely high levels of concentration and a very high SFPP market share.

Q133. Have you made any attempt to adjust EAI's analysis for the flaws you have described?

A133. No. As I testified earlier I do not accept EAI's conclusion that there are readily available alternatives to the transportation service that SFPP provides, and therefore no HHI calculation is necessary. In addition, even assuming that competing alternatives exist, EAI's HHI computations are so seriously flawed, that they cannot be corrected. Without more concrete data regarding EAI's assumed supply from supposedly "competing" suppliers as well as access to the total demand projected by EAI's claimed proprietary model, it simply makes no sense to try to recompute any of EAI's analyses. Furthermore, as I pointed out above, EAI's own data support the conclusion that SFPP has market power and faces no viable competing alternatives in virtually all of the destination markets that it serves.

Q134. Finally, EAI presents an analysis of other pipeline rates. Have you had a chance to review these data?

A134. I have reviewed the summary data provided by EAI in Appendix Table 1 to the report. However, although I requested the underlying data and documents supporting this appendix, SFPP refused to provide this information. EAI claims that it consulted literally hundreds of tariffs published by many different pipeline companies as well as other data and maps showing mileage. But, despite the fact that it was asked to do so SFPP has refused to provide any of this underlying data.⁶⁵ Therefore it has been impossible for me to determine whether EAI has properly included the correct rates in its analysis. For example certain pipelines publish incentive rates; based on the data provided by EAI, I have no way of knowing whether or not those rates have been included in its analysis. The same is true of gathering charges, surcharges and an entire range of other factors that could be determined only through by reviewing the hard copy tariffs that serve as the basis for EAI's analysis. Since SFPP refused to provide this information, I could not verify any of the underlying bases of EAI's analysis.

In addition, EAI performs its computations on a per barrel mile basis which means it had to estimate mileage for transportation on each of the pipeline segments that it examined. Since mileage information is not included in the tariffs, themselves, EAI had to consult other sources, presumably maps and other sources. These underlying source documents were also not provided, so I have no way to verify the accuracy of the mileages used by EAI or the resulting per barrel mile rates which is at the heart of EAI's comparative analysis. I did perform a check of a sample of mileages and found that they were not always accurate. In view of the other errors that EAI made in its Report, I have no confidence that it calculated mileages correctly for purposes of this analysis.

⁶⁵ See responses to Tesoro Data Request 102.

Q135. Based on what you have been able to review, do you have any conclusions regarding the usefulness of the EAI rate comparison?

A135. Yes. The analysis is inherently unreliable because it mixes pipeline with different characteristics which will influence operating costs, rate base, and other factors that ultimately influence rates and could likely cause justifiable differences in rates. Pipelines of different diameter (size) may have very different operating costs. Different pipelines in EAI's sample transport different products which may affect operating costs. EAI has not controlled for the age of the different pipelines in its sample which will have a direct impact on the value of the rate base, income tax allowance, as well as depreciation expenses. Different pipelines in EAI's sample are located in different areas of the country and subject to different operating environments. These factors too influence operating costs. These are just a few examples of the different factors that will influence the rates that these different pipelines may be able to charge under the regulatory regime to which they are subject.

It is important to note that this Commission has previously held that "rate comparisons are of little probative value unless there is persuasive showing that factors influencing rates are substantially similar."⁶⁶ None of the rates presented by EAI in its Appendix Table 1 are from pipelines that compete with SFPP's intrastate service and EAI has made no attempt to either compare pipelines of similar characteristics or make adjustments that would permit such comparisons. Indeed given the fact that all of the pipelines that EAI used were outside of California and do not compete with SFPP, I

⁶⁶ *City of Long Beach v. UNOCAP*, Decision No. 94-05-022, p. 5, citing *Krieger Oil v. Southern Pacific Company* (1938) 41 CRC 521.

believe that EAI's analysis of the rates charged by other pipelines is of absolutely no value in assessing the reasonableness of SFPP's intrastate rates.

VII. WHETHER INDEXATION OF RATES IS A USEFUL TOOL TO ANALYZE SFPP'S RATES

Q136. Have you reviewed the testimony of Mr. Dito in which he suggests that the use of an index might be a useful mechanism to evaluate the reasonableness of SFPP's intrastate rates?

A136. Yes, and I do not agree with Mr. Dito.

Q137. Why?

A137. The use of an index is at best a proxy for measuring the actual costs that a specific pipeline incurs. Indeed that is how the FERC uses its indexation methodology, so that it does not have to perform a detailed review of every pipeline's costs each year to determine whether a rate increase is justified. Yet, in this case we do have data on SFPP's actual costs, and in addition, it is my understanding that there is a long history of complaints and protests against SFPP's rates, many of which have yet to be resolved. Therefore, it makes no sense to use any type of index to evaluate SFPP's rates because actual cost data is more reliable and directly reflects SFPP's own operating experience. An index can only serve as a proxy for an individual pipeline's own costs, and where specific costs are known it make sense to use that data to evaluate the reasonableness of rates. Also given the disagreement over SFPP's historical rates, any attempt to apply an index to those rates may lead to very misleading results.

Finally, even the use of the FERC indexing procedure in recent years has led to anomalous results. FERC's index is reevaluated every five years. However, market and operating conditions can change much more rapidly as the last few years attest. Over the last two years inflation has been relatively modest, yet the FERC index permitted rate increases of 5.2% in 2008 and 7.6% effective June 2009.

Mr. Dito's own data illustrates this point. He presents data on the change in the Consumer Price Index ("CPI"), an inflation index through March 2009.⁶⁷ For the prior two years (March 2007 through March 2009) the annual rate of inflation as measured by the CPI was 1.8 percent, yet FERC indexation allowed an annual rate increase of 6.4% over these same two years. This demonstrates the fact that an indexation procedure is inexact and over various periods of time can lead to anomalous results. Thus where actual cost data is available, I recommend that the Commission rely strictly on that data and not on inexact and non-specific indexes as a basis for evaluating rates.

Q138. Does that conclude your testimony?

A138. Yes.

⁶⁷ Response to Tesoro Data Request 120.