UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

BP Pipelines (Alaska) Inc. ConocoPhillips Transportation Alaska Inc. ExxonMobil Pipeline Company Koch Alaska Pipeline Company LLC Unocal Pipeline Company	Docket No. IS05-82-002 Docket No. IS05-80-002 Docket No. IS05-72-002 Docket No. IS05-96-002 Docket No. IS05-107-001
State of Alaska v. BP Pipelines (Alaska) Inc ExxonMobil Pipeline Company ConocoPhillips Transportation Alaska, Inc. Unocal Pipeline Company Koch Alaska Pipeline Company	Docket No. OR05-2-001
Anadarko Petroleum Corporation v. TAPS Carriers	Docket No. OR05-3-001
BP Pipelines (Alaska) Inc.	Docket No. OR05-10-000
BP Pipelines (Alaska) Inc. ExxonMobil Pipeline Company ConocoPhilips Transportation Alaska, Inc. Unocal Pipeline Company Koch Alaska Pipeline Company	Docket No. IS06-70-000 Docket No. IS06-71-000 Docket No. IS06-63-000 Docket No. IS06-82-000 Docket No. IS06-66-000
Anadarko Petroleum Corporation v. TAPS Carriers	Docket No. OR06-2-000

INITIAL DECISION

(Issued May 17, 2007)

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CARMEN ANA CINTRON, Presiding Administrative Law Judge

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I. INTRODUCTION

1. This case set for hearing the 2005 and 2006 interstate rate filings of the TAPS Carriers.[1] This decision finds that the proposed interstate rates for 2005 and 2006 are not just and reasonable.

II. PROCEDURAL HISTORY

2. The "labyrinthine regulatory process" leading to the Commission's approval of the TAPS Settlement Agreement (TSA) is set forth in *Arctic Slope Regional Corporation v. FERC*, 832 F.2d 158 (D.C. Cir. 1987), and is not repeated here. The stipulated procedural history of the case is described below.[2]

3. In December of 2004, the TAPS Carriers filed their interstate rates for 2005, which ranged from $3.52 to $3.97 per barrel, for the transportation of ANS crude oil from Pump Station No. 1 to the southern terminus of TAPS at the Valdez Marine Terminal (Valdez). On December 15, 2004, the State of Alaska (State) filed a protest of the TAPS Carriers' 2005 filed rates and a complaint with respect to the TAPS Carriers 2003 and 2004 filed rates (State's 2005 Protest and Complaint).[3]

4. In its 2005 Protest and Complaint, the State alleged that the TAPS Carriers' 2005 filed rates (1) violated the unjust discrimination and undue preference provisions of sections 2 and 3(1) of the Interstate Commerce Act (ICA), (2) were inconsistent with the terms of the Interstate Settlement Agreement, (3) impermissibly included dismantlement, removal, and restoration (DR&R) expenditures as Operating Expenses, and (4) unlawfully included non-jurisdictional intrastate litigation costs. The State also protested (5) ConocoPhillips' alleged failure to make the required section II-10 adjustment to its 2005 maximum allowable rate under the TAPS Settlement Methodology (TSM), and (6) ConocoPhillips', Unocal's, and KAPL's alleged inclusion in their 2005 interstate tariffs of the intrastate portion of the DR&R Allowance that they had waived before the Regulatory Commission of Alaska (RCA).

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[1] The TAPS Carriers, or Carriers, are BP Pipelines (Alaska) Inc. (BP), ConocoPhillips Transportation Alaska Inc. (ConocoPhillips), ExxonMobil Pipeline Company (ExxonMobil), Koch Alaska Pipeline Company LLC (KAPL), and Unocal Pipeline Company (Unocal).

[2] The procedural history was submitted pursuant to an order of the Presiding Judge. Tr. at 6942-43 (January 11, 2007).

[3] "*Protest and Petition for Investigation into the Proposed 2005 TAPS Tariffs and Complaint and Petition for Investigation into the 2003 and 2004 TAPS Tariffs by the State of Alaska and Intervention in Any Subsequent Proceedings*," Docket No. OR05-2-000 (Dec. 15, 2004).

Further, the State complained that the TAPS Carriers' 2003 and 2004 interstate tariffs impermissibly included (7) non-jurisdictional intrastate litigation costs, and (8) DR&R expenses. The State subsequently reached a settlement with ConocoPhillips and withdrew the portions of its 2005 Protest and Complaint dealing with items (5) and (6) (as it pertained to ConocoPhillips).[4] The State also reached settlements with KAPL and Unocal, and withdrew the portions of its 2005 Protest and Complaint concerning item (6) (as it pertained to KAPL and Unocal).[5] On October 11, 2006, the State withdrew the portion of its 2005 Protest and Complaint concerning items (4) and (7).[6] On March 6, 2006, the Presiding Judge clarified that item (3) was to be considered along with the investigation of Strategic Reconfiguration Program costs in a later phase of the proceeding.[7] Items (1), (2) and (8), therefore, are the portions of the State's 2005 Protest and Complaint that remain at issue in this phase of the proceeding.

5. On December 16, 2004, Anadarko Petroleum Corporation (Anadarko) filed a protest and complaint (Anadarko's 2005 Protest and Complaint) alleging that the TAPS Carriers' 2005 filed rates were unjust, unreasonable and otherwise unlawful.[8]

[4] "Notice of Partial Withdrawal of State's Protest and Complaint Against ConocoPhillips Transportation Alaska Inc.," Docket Nos. IS05-80 and OR05-2 (Sept. 7, 2005); "Notice of Partial Withdrawal of State's Protest and Complaint Against ConocoPhillips Transportation Alaska Inc.," Docket Nos. IS05-80 and OR05-2 (Nov. 2, 2005); "Order Granting Partial Withdrawals," Docket Nos. IS05-82-002, *et al.* (Nov. 4, 2005).

[5] "Notice of Partial Withdrawal of State's Protest and Complaint Against Koch Alaska Pipeline Company LLC," Docket Nos. IS05-82, *et al.* (Jan. 24, 2006); "Order Confirming Partial Withdrawal," Docket Nos. IS05-82-002, *et al.* (Feb. 9, 2006); "Notice of Partial Withdrawal of State's Protest and Complaint Against Unocal Pipeline Company," Docket Nos. IS05-82, *et al.* (April 20, 2006); "Order Confirming Partial Withdrawal," Docket Nos. IS05-82-002, *et al.* (May 18, 2006).

[6] "Notice of Partial Withdrawal of State's Protests and Complaints Against BP Pipelines (Alaska) Inc., ConocoPhillips Transportation Alaska, Inc., ExxonMobil Pipeline Company, Koch Alaska Pipeline Company LLC, and Unocal Pipeline Company," Docket Nos. IS05-82-002, *et al.* (Oct. 11, 2006) (State's October 11, 2006 Notice);

[7] "Order Establishing New Procedural Schedule, Granting Request for Clarification and Confirming Withdrawal of Motion to Amend Procedural Schedule," Docket Nos. IS05-82-000, *et al.* (March 6, 2006).

[8] "Protest, Complaint, Motion to Intervene, Motion to Consolidate, and Request for Hearing and Other Relief of Anadarko Petroleum Corporation," Docket No. OR05-3-000 (Dec. 16, 2004).

Tesoro Corporation (Tesoro) subsequently intervened in both Anadarko's 2005 Protest and Complaint proceeding and the State's 2005 Protest and Complaint proceeding.[9]

6. On July 20, 2005, the TAPS Carriers filed a petition pursuant to section 13(4) of the ICA requesting the Commission to (1) investigate the 2005 intrastate rates imposed by the RCA, (2) find such intrastate rates to be unduly preferential and unjustly discriminatory against and an undue burden on interstate commerce, and (3) raise the 2005 intrastate rates to the level of the 2005 filed interstate rates.[10]

7. In December of 2005, the TAPS Carriers filed their interstate rates for 2006, which ranged from $3.78 to $4.41 per barrel, for the transportation of ANS crude oil from Pump Station No. 1 to Valdez. On December 14, 2005, Anadarko and Tesoro (along with its affiliate, Tesoro Alaska Company) (collectively, Anadarko/Tesoro) filed a joint protest and complaint of the TAPS Carriers' 2006 filed rates (Anadarko/Tesoro's 2006 Protest and Complaint), alleging that the 2006 rates were unjust, unreasonable, unduly discriminatory and otherwise unlawful.[11] On that same day, the State filed a protest of the TAPS Carriers' 2006 filed rates and a complaint with respect to the TAPS Carriers 2004 and 2005 filed rates (State's 2006 Protest and Complaint).

8. In its 2006 Protest and Complaint, the State alleged that the TAPS Carriers' 2006 filed rates (1) violated the unjust discrimination and undue preference provisions of sections 2 and 3(1) of the ICA, (2) were inconsistent with the terms of the Interstate Settlement Agreement, (3) improperly included intrastate litigation costs, and (4) impermissibly included imprudently incurred costs for the Strategic Reconfiguration Program. The State subsequently withdrew the portion of its 2006 Protest and Complaint dealing with item (3),[12] and on September 15, 2006, the Chief Judge severed the investigation of Strategic Reconfiguration Program costs (item (4)) from

[9] "Motion to Intervene of Tesoro Petroleum Corporation," Docket Nos. IS05-82-000, *et al.* (Jan. 5, 2005).

[10] "Petition of the TAPS Carriers for the Commission to Investigate and Set Intrastate Rates and Motion to Consolidate Proceedings," Docket No. OR05-10-000 (July 20, 2005).

[11] "Protest, Complaint, Motion to Intervene, Motion to Consolidate, and Request for Hearing and Other Relief of Anadarko Petroleum Corporation, Tesoro Corporation, and Tesoro Alaska Company," Docket No. OR06-2-000 (Dec. 14, 2005).

[12] *See* State's October 11, 2006 Notice.

this proceeding.[13] Consequently, items (1) and (2) are the only portions of the State's 2006 Protest and Complaint that remain at issue in this phase of the proceeding.

9. Arctic Slope Regional Corporation, Flint Hills Resources Alaska, LLC (Flint Hills), Williams Alaska Petroleum, Inc. (Williams), Petro Star Inc. (Petro Star), ConocoPhillips Alaska, Inc., and the RCA each moved to intervene in one or more of the proceedings described above.[14]

10. Except to the extent that issues were withdrawn or severed, the foregoing protests and complaints and the TAPS Carriers' section 13(4) petition were consolidated and set for hearing.[15] The parties filed direct (December 7, 2005), supplemental direct (with respect to the TAPS Carriers 2006 filed rates) (April 4, 2006), answering (May 26, 2006) and reply (August 11, 2006) rounds of prepared testimony on those remaining issues. The hearing commenced on October 31, 2006 and ended on January 11, 2007. Initial and reply briefs were filed on February 16, 2007 and March 21, 2007, respectively, by the TAPS Carriers, Commission Trial Staff (Staff), Anadarko/Tesoro, the State, the RCA, Flint Hills, and Petro Star.

III. ISSUES

ISSUE I: WHICH PARTIES BEAR THE BURDEN OF PROOF ON WHICH ISSUES?

Burden of Proof - Carriers' Filed Rate Increases and Anadarko/Tesoro's Protests and Complaints

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[13] *BP Pipelines (Alaska) Inc.*, 116 FERC ¶ 63,056 (2006).

[14] *See State of Alaska*, 110 FERC ¶ 61,129 at P 5 (2005); *BP Pipelines (Alaska) Inc.*, 112 FERC ¶ 61,219 at P 3 (2005); "Notice of Intervention of the Regulatory Commission of Alaska," Docket No. OR05-10-000 (August 5, 2005); *State of Alaska*, 114 FERC ¶ 61,174 (2006) at P 4; *BP Pipelines (Alaska) Inc.*, 110 FERC ¶ 63,015 (2005); "Order of Chief Judge Granting Motion for Leave to Intervene," Docket Nos. IS05-82-000, *et al.* (Jan. 10, 2005); "Order of Chief Judge Granting Motions for Leave to Intervene," Docket Nos. IS05-82-000, *et al.* (Jan. 25, 2005); "Order Further Modifying Procedural Schedule and Granting Motions to Intervene," Docket Nos. IS05-82-000, *et al.* (Jan. 19, 2006).

[15] *See BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 (2004); *State of Alaska*, 110 FERC ¶ 61,129; *BP Pipelines (Alaska) Inc.*, 112 FERC ¶ 61,219; *State of Alaska*, 114 FERC ¶ 61,174.

11. The Carriers, Anadarko/Tesoro, and Staff all agree that the Carriers bear the burden of proof with regard to the Carriers' filed rate increases for 2005 and 2006 under ICA section 15(7), 49 U.S.C. app. 15(7) (1994). The Carriers claim that Anadarko/Tesoro's protests and complaints propose that the TSM should no longer be used and that the Carriers be required to file one rate. Thus, the Carriers assert that this is a third party challenge to an existing rate, and accordingly, Anadarko/Tesoro bear the burden of proving that the existing rate is unlawful. With respect to Anadarko/Tesoro's proposal to adopt a different methodology for establishing interstate rate ceilings, the Carriers state that Anadarko/Tesoro bear the burden of proving both that the TSM is unreasonable and that Anadarko/Tesoro's proposed new rates are reasonable.[16] In sum, the Carriers claim that Anadarko/Tesoro, as the parties proposing a new methodology for establishing interstate rates, bear the burden of proving: (1) that the TSM is unjust and unreasonable and (2) the proposed replacement methodology is just and reasonable.

12. Staff and Anadarko/Tesoro state that it is the Carriers, and not Anadarko/Tesoro, that bear the burden of proving the TSM produces just and reasonable rates. Staff claims that the Carriers' argument that the burden of proving the unlawfulness of the existing rate and the reasonableness of a replacement rate rests with Anadarko/Tesoro, is incorrect. This is evident, Staff and Anadarko/Tesoro contend, because the Commission, in accepting the settlement did not find, and has never found, the TSA or the TSM it established just and reasonable.

13. Anadarko/Tesoro and Staff also argue that the Carriers' suggestion that they have no burden of proof as to unchanged components of their rates is also incorrect. Both Anadarko/Tesoro and Staff cite *Northern Border Pipeline Co.*, 89 FERC ¶ 61,185 at 61,574 (1999) (*Northern Border*) and *Williston Basin Interstate Pipeline Co.*, 107 FERC ¶ 61,164 at P 21-26 (2004) (*Williston Basin*), for the proposition that the Carriers' bear the burden of proof with respect to each element of the TSM. Moreover, Anadarko/Tesoro and Staff state that since each item in the pipeline's proposed cost of service is part of the proposed rate increase, the Carriers' ICA section 15(7) burden includes the burden of supporting the dollar amount of each item in the cost of service, including any unchanged items. Staff further argues that to the extent the Carriers fail to show the justness and reasonableness of their rates, the Commission may order refunds of the overall increase in the cost of service. Last, Anadarko/Tesoro state that they, as the complainants, carry the burden of supporting their complaints which they claim they have fully satisfied.[17]

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[16] Carriers' IB at 14-15 (citing *Sea Robin Pipeline Co. v. FERC*, 795 F.2d 182, 186-87 (D.C. Cir. 1986) (*Sea Robin*) for the proposition that a third party proposing to change a methodology bears the burden of proof).

[17] Anadarko/Tesoro IB at 11 (citing *Tesoro Refining and Mktg. v. Frontier*

14. The Carriers response states that they disagree with Anadarko/Tesoro's and Staff's contention that the Carriers bear the burden of proving that the TSM is just and reasonable. In fact, the Carriers contend, their burden only requires the Carriers to justify their filed rates as just and reasonable.

Discussion/Findings

15. The Carriers 2005 and 2006 filings propose rate increases. Accordingly, as discussed more in depth below, the findings with respect to this issue are as follows: (1) the Carriers bear the burden of proving that the TSM produces just and reasonable rates, and effectively, that the Carriers' proposed rate increases for 2005 and 2006 are just and reasonable and (2) Anadarko/Tesoro, as the complainants bear the burden of proof with respect to their complaints.[18] Anadarko/Tesoro and Staff are in agreement, and the Carriers concede, that section 15(7) of the ICA and the Commission in *Trans Alaska Pipeline Sys.*, 35 FERC ¶ 61,425 at 61,983 n.17 (1986), placed the burden of showing the proposed increases in the 2005 and 2006 rates are just and reasonable upon the Carriers.[19]

16. The only point of contention with regard to this issue concerns the Carriers' claim that because they have not proposed to change the TSM, Anadarko/Tesoro bear the burden of proving that the TSM, as an existing methodology, is unjust and unreasonable. Carriers IB at 14. As discussed by Anadarko/Tesoro and Staff, *Williston Basin* and *Northern Border* stand for the proposition that a pipeline proposing a change in its overall cost of service must justify each element in the new cost of service including the unchanged elements. In *Williston Basin*, the Commission stated that "[s]ince each item in the pipeline's proposed cost of service is a part of the pipeline's proposed rate increase, the pipelines' [NGA] section 4 burden to support the proposed general rate increase includes the burden of supporting the dollar amount of each item in the cost of service, including unchanged items."[20]

Pipeline Co., 105 FERC ¶ 61,227 at P 24 (2003)).

[18] *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 107 FERC ¶ 61,175 at P 150 (2004) ("In any complaint filed before the Commission, the complainant carries the burden of proof regarding the facts and law asserted.").

[19] The Commission, in approving the TSA, held that the Carriers' annual TSM tariff filings (like the ones at issue here) would be treated as "any rate change filing under the ICA," with the "burden of proof...upon the carrier to show that the proposed changed rate...is just and reasonable....". 35 FERC at 61,983 n.17.

[20] 107 FERC at P 24. Staff, the Carriers, and Petro Star agree that Sections 4 and 5 of the NGA are equivalent to the Section 15(7) and 15(1) of the ICA. Carriers

Thus, for the Carriers, this means proving that both the changed and unchanged cost of service elements, and effectively, the TSM itself and its derived rates, result in just and reasonable rates. Accordingly, since the Carriers have proposed an increase in their rates, it is found that the Commission requires the Carriers to justify each element of the proposed rates. This is confirmed by the Commission's pronouncements in adopting the TSA. To wit, the Commission stated that "the burden of showing that the new rate is just and reasonable will be on the TAPS Carriers, pursuant to section 15(7) of the ICA which provides that in any 'hearing involving a change in rate... the burden of proof shall be upon the carrier to show that the proposed changed rate...is just and reasonable. The carriers cannot rely on the approved settlements to establish the justness of these filed rate changes, since the settlement rates were never adjudicated to be just and reasonable." 35 FERC at 61,977 n.17.

17. The burden of proof with respect to the Carriers' section 13(4) petition and the State's section 2 and 3(1) claims will be addressed in the appropriate sections below.

ISSUE II: SHOULD THE TAPS SETTLEMENT METHODOLOGY BE USED TO DETERMINE TAPS RATES?

Issue II. A. Scope of the Issue

18. The TAPS Carriers argue that the Commission limited the scope of the hearing to the issue of whether the TAPS Carriers' filed rates comply with the TSM and did not include the issue of whether the TSM should continue to be the governing methodology for TAPS. Determinations by the Commission that the TSM is binding on all parties to the TAPS rate proceedings, the Commission's decision not to apply a different ratemaking methodology to TAPS, and the narrow scope of the issues in this proceeding show that the Commission views TAPS rates that comply with the TSM as lawful, the Carriers claim. Since the Commission's orders approving the TSA in 1985 and 1986, the Carriers aver, the Commission has affirmed that TSM is the ratemaking methodology that governs TAPS rates on several occasions. Specifically, the Carriers state that the Commission's original orders approving the TSM in *Trans Alaska Pipeline Sys.*, 33 FERC ¶ 61,064 (1985); 35 FERC ¶ 61,425 (1986), state that the TSM would not be binding on non-settling parties. However, the Carriers assert that the Commission's position on the TSM evolved following the enactment of the

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IB at 106; Staff RB at 4; PS RB at 4 n.3. Section 5 of the NGA is equivalent to Section 15(1) of the ICA and Section 4 of the NGA is the equivalent of 15(7) of the ICA. Carriers' IB at 106; PS RB at 4 n.3; *Texaco Refining and Marketing Inc. v. SFPP, L.P.*, 117 FERC ¶61,285 at 61,367 (2006) (*Sepulveda).*

Energy Policy Act of 1992 (EPAct of 1992). Evidence of this evolution, the Carriers contend, can be found in *Amerada Hess* where the Commission found that "[t]he TSM is now binding on the TAPS Carriers, all parties to TAPS rate proceedings, as well as the Commission" and "[t]he TAPS Carriers may not establish rates on any other basis." Carriers RB at 12 (citing *Amerada Hess Pipeline Corp.*, 79 FERC ¶ 61,300, 62,358 (1997) (emphasis omitted) (*Amerada Hess*).

19. In addition, the Carriers claim that in Order No. 561 the Commission followed the directive of Congress to exclude TAPS from the methodological reforms implemented in Title 18 of the EPAct.[21] In Order No. 561, the TAPS Carriers assert, the Commission required TAPS rates to be justified in accordance with the TSM and stated that the TSM would control if a conflict were to arise between the TSM and the revisions in Order No. 561. The Carriers further claim that Commission Order No. 588 states that the Carriers could continue to file rates based on the TSM and would only need to file rates pursuant to *Williams Pipe Line Co.*, 21 FERC ¶ 61,260 (1982) (Opinion 154) if their filings sought to charge rates under the Opinion 154-B methodology.[22] The positions taken by Anadarko/Tesoro and Staff are groundless, the Carriers claim. In conclusion, the Carriers state that the sole issue to be resolved is whether the TAPS Carriers' 2005 and 2006 filed rates comply with the TSM.

20. In contrast, Anadarko/Tesoro assert that the scope of this issue is defined by the protests and complaints that the Commission set for hearing. Anadarko/Tesoro state that their protests and complaints raised issues regarding whether the TSM and TSM derived rates are just and reasonable, and if such rates are not, how to develop just and reasonable cost-based rates for TAPS. The complaints and protests did not raise TSM compliance issues, Anadarko/Tesoro contend. Moreover, Anadarko/Tesoro argue, the scope is not limited to compliance with the TSM since the Commission in, *Trans Alaska Pipeline Sys.*, 35 FERC at 61,983 n.17, and the United States Court of Appeals for the District of Columbia (D.C. Circuit) in, *Arctic Slope Reg'l Corp. v. FERC*, 832 F.2d 158, 163 (D.C. Cir. 1987), held that the Carriers cannot rely on the TSM to establish the justness and reasonableness of their rates. Anadarko/Tesoro also state that when the Carriers submitted the TSA for approval they requested a ruling that it was in the public interest, not just and reasonable. Staff agrees with Anadarko/Tesoro's claims that the scope of the issue is not limited to whether the Carriers properly followed the TSM formula and that the scope of the issue is defined in the protests and complaints. According to Staff, the Commission

[21] Carriers IB at 16 (citing Order No. 561, *Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992*, FERC Stats & Regs. ¶ 30,985 at 30,961(1993) (Order No. 561)).

[22] Carriers IB at 16 (citing Order No. 588, *Oil Pipeline Cost-of Service Filing Requirements*, FERC Stats & Regs. ¶ 31,037 at 30,053 (1996) (Order No. 588)).

was clear, when it accepted the TSA, that challenges to the annual TSM rate filings would be allowed by non-signatories such as Anadarko/Tesoro and such rates would be judged under the just and reasonable standard.

21. Next, Anadarko/Tesoro and Staff aver that the TSM has not "evolved" as the Carriers contend, into a just and reasonable rate methodology that cannot be challenged by non-signatory parties. Specifically, Anadarko/Tesoro and Staff argue that the Carriers' claims that the Commission later reversed the holdings concerning the rights of non-signatory parties to challenge future rates and that the TSM has been adjudicated as just and reasonable rely primarily on *Amerada Hess*. Anadarko/Tesoro and Staff assert that *Amerada Hess*, is distinguishable because the issue in that case was limited to TSM compliance and, consequently, neither the justness and reasonableness of the TSM nor the shipper's rights to challenge the TSM were before the Commission.[23]

22. Moreover, Anadarko/Tesoro and Staff contend, the Carriers use of the *statement that the TSM is "binding on...all parties" is taken out of context.* Anadarko/Tesoro claim that the Commission was simply stating that for compliance purposes it could not order a change in the TSM retroactively and issues related to refunds had to be decided in accordance with the TSM. Thus, Anadarko/Tesoro and Staff conclude, nothing in *Amerada Hess* limited the statutory right of shippers to challenge future TSM filings under the ICA or suggested that the Commission intended to change its prior orders and deem the TSM just and reasonable.

Discussion/Findings

23. The scope of this proceeding is defined by the Commission's orders setting the issues in Anadarko/Tesoro's and the State's protests and complaints for hearing.[24] The Commission's language in each of the orders is virtually identical. In each order, the Commission described Anadarko/Tesoro's protests and complaints as arguing that

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[23] Anadarko/Tesoro and Staff state that the issue in *Amerada Hess* was strictly an accounting question. Staff states that the Commission examined whether certain oil spill costs were properly recorded in Account No. 610 or 680 of the Commission's Uniform System of Accounts for Oil Pipelines. The Commission also examined whether the TSM excludes amounts recorded in Account 680 from the definition of operating expenses to be recovered.

[24] *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 (2004) (protests to 2005 rates); *State of Alaska v. BP Pipelines (Alaska) Inc.*, 110 FERC 61,129 (2005) (complaints to 2005 rates); *BP Pipelines (Alaska) Inc.*, 113 FERC 61,332 (2005) (protests to 2006 rates); *State of Alaska v. BP Pipelines (Alaska) Inc.*, 114 FERC 61,174 (2006) (complaints to 2006 rates).

"the TSM does not produce rates that are just and reasonable under" the ICA. Then, the Commission, again in each order, established hearing procedures to examine the issues raised in the protests and complaints.[25] The Commission was clear that the issues raised by Anadarko/Tesoro, as well as the State, were to be the subject of the consolidated hearings. Thus, it is found that the scope of this proceeding, *inter alia*, includes the TSM calculated 2005 and 2006 rates as well as the TSM itself.

24. The Carriers claim that the Commission's orders defined the scope of the hearing as follows: "the issues of this case pertain to application of the TSM to the TAPS 2005 Tariffs. The parties have different understandings of how the terms of the TSM apply when there is an order from the RCA that may be inconsistent with the TSM."[26] This language does not indicate that the Commission intended to narrow the scope of the hearing. The Commission described the issues contained in Anadarko/Tesoro's protests and complaints, but never stated that it would not allow Anadarko/Tesoro's TSM arguments to be addressed, in their entirety, at the hearing. Consequently, it is found that the scope of the issues in the protests and complaints are significantly broader than those listed in the sentences cited by the Carriers. Limiting the scope as suggested by the Carriers would mean removing the main contention from Anadarko/Tesoro's protests and complaints – that the TSM itself results in rates that are not just and reasonable. It would be remiss to ignore the main arguments in Anadarko/Tesoro's protests and complaints especially in light of the fact that the Commission ordered that such arguments be considered.

25. The Carriers also contend that the Commission's perspective that the TSM would not be binding on non-settling parties has evolved, the TSM governs TAPS rates and the Carriers may not establish rates on any other basis, and the TSM is now binding on all parties. Carriers' IB at 16, RB at 11. As articulated by Anadarko/Tesoro, the gist of the Carriers' argument is that the "TSM has 'evolved' such that it now binds even non-settling parties and is thus immune to challenge under

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[25] *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 at P 10; *State of Alaska v. BP Pipelines (Alaska) Inc.*, 110 FERC ¶ 61,129 at P 3; *BP Pipelines (Alaska) Inc.*, 113 FERC ¶ 61,332 at P 20-21; *State of Alaska v. BP Pipelines (Alaska) Inc.*, 114 FERC ¶ 61,174 at P 16-17.

[26] Carriers' IB at 17 (citing *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 at P 10; *see also State of Alaska v. BP Pipelines (Alaska) Inc.*, 110 FERC ¶ 61,129 at P 3; *BP Pipelines (Alaska) Inc.*, 113 FERC ¶ 61,332; *State of Alaska v. BP Pipelines (Alaska) Inc.*, 114 FERC ¶ 61,174. In addition, the Carriers argue that the Commission also limited the scope by stating that the suspension order "benefits customers by ensuring that the rates for transporting petroleum on TAPS are consistent with the settlement." Carriers' IB at 17 (citing *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 at P 2).

the 'just and reasonable' standard." A/T RB at 11. Anadarko/Tesoro and Staff focus their rebuttal on the Carriers use of *Amerada Hess* to support the Carriers' position that the TSM is "now binding on... all parties." Carriers IB at 16, RB at 11-12, 16 (citing *Amerada Hess*, 79 FERC at 62,538).

26. Not even a cursory review of *Amerada Hess* would support the Carriers' contentions. *See Amerada Hess*, 79 FERC ¶ 61,300. This is because the Carriers' arguments rely on two sentences in the *Amerada Hess* order without placing them in the proper context. *Id.* Anadarko/Tesoro's and Staff's assertions that the issue in *Amerada Hess* was an accounting question limited to TSM compliance and that issues concerning the justness and reasonableness of the TSM were not before the Commission, however, are clearly supported by the text of the order. *Id.*; A/T RB at 12; Staff RB at 8-9. Moreover, Anadarko/Tesoro's and Staff's arguments that the Commission's statement that the TSM is now binding on all parties only referred to: (1) TSM compliance and (2) the Commission's decision that the Carriers were obligated to determine the refunds and address accounting issues consistent with the TSM are persuasive. A/T RB at 12; Staff RB at 8-9.

27. Contrary to the Carriers' assertions, the EPAct of 1992, Order Nos. 561, 561-A and 588, do not indicate an evolution in the Commission's previous determinations. Carriers' IB at 16 n.15. In fact, those pronouncements are congruent with previous orders concerning the TSA. The language in the Commission's orders approving the TSA indicate that the Commission intended the TSM to govern TAPS unless or until a challenge was filed by a non-signatory. The Carriers fail to cite any language in these EPAct of 1992 pronouncements that limits the rights of non-signatory parties. In conclusion, as discussed above, nothing cited by the Carriers indicates that the Commission changed its position with respect to the legal status of the TSM as articulated in *Trans Alaska Pipeline, Sys.*, 35 FERC ¶ 61,425[27] and *Arctic Slope Reg'l Corp. v. FERC*, 832 F.2d 158[28]. Importantly, it is found that the statement that "the

[27] *Trans Alaska Pipeline System*, 35 FERC ¶ 61,425 at 61,977 n.17 ("The [C]arriers cannot rely on the approved settlements to establish the justness of these filed rate changes, since the settlement rates were never adjudicated to be just and reasonable.") *Id.* at 61,981 ("we categorically state that our approval of this settlement is not a precedent as to future TAPs' rates"). *Id.* at 61,980 ("We affirm the conclusion of the ALJ that the settlement may not be imposed on any objecting party, including Arctic."). *Id.* at 61,982 ("Arctic, as well as any entity which is not a party to the settlement, may file at any time in the future for an adjudicated rate, which does not exceed the settlement rate....)

[28] *Arctic Slope Reg'l Corp. v. FERC*, 832 F.2d 158 at 161 ("Under the TSM,... rates are set on an annual basis, and are regarded under the regulatory schemes as any other rate filings by a common carrier. Thus, any such rates are subject to challenge

Carriers cannot rely on the approved settlements to establish the justness of... filed rate changes" remains intact and has not been reversed by the Commission. *See Trans Alaska Pipeline System*, 35 FERC ¶ 61,425 at 61,978 n.17.

Issue II. B. What Legal/Regulatory Principles Apply?

Just and Reasonable Rate Standards

28. Anadarko/Tesoro's assertion that the TSM cannot be used to determine the justness and reasonableness of the 2005 and 2006 rates since the TSM includes elements that are not cost-based is incorrect, the Carriers claim. The Carriers state that the TSM, although non-traditional, is a cost-based methodology. In addition, the Carriers claim that if it is determined that the TSM elements are not cost-based, the TSM could still be found to be in compliance with *Farmers Union Central Exchange, Inc., v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984) ("*Farmers Union II*"), which stated that departures from a cost-based approach may be legitimate if each deviation is found to be not unreasonable and consistent with the public interest. Accordingly, the TAPS Carriers conclude, the Commission would be justified in utilizing the TSM to determine the lawfulness of the TAPS interstate rates.

29. Next, Carriers again argue that the Commission's determination in *Amerada Hess* that the TSM is "now binding... on all parties" does not conflict with previous Commission orders approving the TSA which stated that non-settling parties would not be bound by TSM at that time. Carriers IB at 19; *Amerada Hess*, 79 FERC ¶ 61,300. In fact, the Carriers argue that the principle that future rate challenges must be brought pursuant to Opinion 154-B without relying on components of the TSM supports the Commission's findings in *Amerada Hess* that the TSM is "now binding... on all parties." *Amerada Hess*, 79 FERC ¶ 61,300. By the mid-1990's, the Carriers claim, rates calculated under the Opinion 154-B methodology (without use of TSM elements) would be greater than the TSM ceiling rates, and for that reason, the Commission was justified in concluding that the TSM was the only meaningful constraint on the TAPS Carriers' rates and that TSM is binding on all parties. The Carriers again claim that the legal status of TSM evolved after the enactment of EPAct of 1992.

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by non-settling parties, such as Arctic, as well as any other non-signatory." *Id.* at 166 n.16 ("FERC has explicitly stated... that its settlement approval in no way establishes the justness or reasonableness of any rates" and that "the agency was not even considering, much less near the point of decision on, the reasonableness of the TSM and the rates established under it".)

30. Anadarko/Tesoro and Staff state that the applicable standards for determining just and reasonable rates are set forth in *Farmers Union II* and Opinion 154-B.[29] Anadarko/Tesoro and Staff further assert that a just and reasonable rate is one that is cost-based with any departures specifically identified and justified as articulated in *Farmers Union II*, 734 F.2d at 1530, and Opinion 154-B.[30] The Commission adopted trended original cost (TOC) for determining rate bases and revenue requirements for oil pipelines in Opinion 154-B, Anadarko/Tesoro also state.

31. Staff similarly argues that although the TSM may contain some elements of a cost-based methodology, it is clear that the TSM also contains elements that are not appropriate for a cost-based rate.[31] In addition, Staff and Anadarko/Tesoro assert that the Carriers did not submit any evidence to support their TSM rates on a cost basis and even failed to discuss the justness and reasonableness of the TSM by eliminating section II.D from their briefs. Staff's reply brief also argues that the Carriers cite *Farmers Union II* to support the contention that non-cost factors can be considered, but fail to note that its application is limited. Specifically, Staff claims that *Farmer's Union II* states that deviations from cost-based pricing must be found not unreasonable and the resulting rate must be justified by those factors.

32. Anadarko/Tesoro and Staff claim that the Carriers concede that the TSM does not comply with just and reasonable rate standards. Specifically, Anadarko/Tesoro assert that: (1) the Carriers and their expert, Dr. Toof concede that the TSM is inconsistent with just and reasonable rate standards and cannot be approved outside the context of an uncontested settlement; (2) Dr. Toof acknowledged that ABP is not tied to the Carriers' costs; and (3) Dr. Toof agreed that neither the TSM true-up

[29] In addition, Anadarko/Tesoro contend that the applicable regulatory principles are those for setting the just and reasonable rates under the ICA, which include Sections 1(5) and 15(1) of the ICA. Section 1(5), Anadarko/Tesoro claim, requires all interstate rates charged for oil transportation to be just and reasonable and Section 15(1) requires the FERC to prescribe a just and reasonable rate if it finds a rate unjust or unreasonable or unjustly discriminatory.

[30] Anadarko/Tesoro claim that in *Williams Pipe Line Co.*, 21 FERC ¶ 61,260 (1982) (Opinion 154), the Commission issued a decision attempting to justify the retention of the ICC's "valuation" approach to ratemaking for oil pipelines. The Carriers state that Opinion 154 was rejected in *Farmers Union II* and in response, the Commission issued 154-B adopting an original cost rate method for oil pipelines.

[31] Staff states that the cost-based elements of the TSM include depreciation, DR&R, amortization of the $450 million rate base write-off, and deferred earnings. Some of the non-cost-based elements included in the TSM, Staff contends, are the inflation-adjusted, non-cost based APB, a 100% equity structure assumption, and a depreciable life known to be too short.

provision nor the method of allocating costs between federal and state jurisdictions is acceptable for use in making just-and-reasonable rate determinations. Thus, Anadarko/Tesoro contend, the Carriers agree that the TSM is incompatible with just and reasonable ratemaking standards.

Equitable Estoppel

33. The Carriers also argue that under the doctrine of equitable estoppel, Anadarko/Tesoro after waiting 20 years to challenge the justness and reasonableness of TSM interstate rates and reaping the benefits of the TSA, should not be allowed to invalidate the TSM. This late challenge regarding purported overcollections, the Carriers claim, also raises serious concerns about retroactive ratemaking. Anadarko/Tesoro's failure to challenge the rates over the years further supports the Commission's conclusion in *Amerada Hess* that the TSM is now binding on all parties, the Carriers contend. In addition, the Carriers state that the Commission should reaffirm its earlier finding that the TSM is binding on all parties and that rates that do not exceed the TSM rate ceilings are lawful. A ruling to that effect, the Carriers claim, would avoid many intergenerational equity issues, enhance prospects for building future infrastructure investments in Alaska and elsewhere, and would be appropriate since the TSA could be terminated in less than two years.[32]

34. Anadarko/Tesoro respond by arguing that they are not equitably estopped from challenging the filed rates because their right to challenge those rates is guaranteed by the Commission, the court orders approving the Interstate Settlement, and the ICA itself. In addition, Anadarko/Tesoro assert that they timely filed protests and complaints to the Carriers' 2005 and 2006 rates and the Commission recognized their standing to do so in setting the protests and complaints for hearing. Nothing cited by the Carriers alters these rights, Anadarko/Tesoro contend. Specifically, Anadarko/Tesoro assert, the case law on equitable estoppel requires, *inter alia*, false representation, reliance, and unjust enrichment involving a party to the agreement. None of those elements are present here, Anadarko/Tesoro claim.

35. Anadarko/Tesoro also aver that the Carriers' equitable estoppel argument fails because contrary to the Carriers' assertion that Anadarko/Tesoro have benefited from the TSA for more than 20 years without challenging the rates, Anadarko/Tesoro have only began producing oil on the North Slope in 2000 and have actually been paying excessive rates on TAPS since then. Staff's reply also states that the Carrier's

[32] The Carriers state that "[O]n January 1, 2007, the State exercised its right under Section I-8 of the TSA to commence negotiations regarding the replacement of TSM. If such negotiations are not successful the State can terminate the TSA as early as January 1, 2009." Carriers IB at 24 n.25 (citing Ex. ATC-14 at 11; FHR-55).

equitable estoppel and retroactive ratemaking arguments are without merit. With regard to equitable estoppel, Staff similarly argues that the Commission's orders approving the TSA guaranteed the shippers the right to seek just and reasonable rates under the ICA and that right was never waived. Staff claims that the retroactive ratemaking argument is moot because Anadarko/Tesoro have not requested any remedies prior to the date the rates in this proceeding were suspended, subject to refund.

Public Interest

36. Third, the TAPS Carriers argue that they have shown that the public interest supports a holding that the 2005 and 2006 rates are in compliance with the TSM. The public interest, the Carriers state, must be considered by the Commission in adjudicating the lawfulness of the Carriers filed rates and has been found, by the Supreme Court and other courts, to be a key factor in judging the lawfulness of rates under the ICA.[33] The public need for investors in energy infrastructure projects to make necessary investments and the public need for efficient investment in and long-term development of energy resources support upholding the TSM, the Carriers claim. In their reply brief, the Carriers further assert that a Commission decision rejecting the TSM would have a chilling effect on future investment.

37. In response, Anadarko/Tesoro aver that their initial brief shows that the Carriers have misused the public interest standard. It is the just and reasonable standard that is applicable here, Anadarko/Tesoro contend. Moreover, Anadarko/Tesoro claim that the Carriers incorrectly stated that Anadarko/Tesoro's position is that public interest considerations are irrelevant to a determination of whether the TSM-based filed rates are just and reasonable. Anadarko/Tesoro state that this is contrary to their position and what Anadarko/Tesoro actually assert is that the public interest is met by setting just and reasonable rates and providing adequate incentives for investment while protecting shippers from excessive rates. Thus, Anadarko/Tesoro claim, their position is consistent with the case law concerning the public interest cited by the Carriers. Staff also states that setting just and reasonable

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[33] In support of the proposition that the public interest should be considered in determining just and reasonable rates, the Carriers cite the Supreme Court in *Midstate Horticultural Co, Inc., v. Pennsylvania R.R.*, 320 U.S. 356 (1943) and *ICC v. Cincinnati, N.O. & T.P Ry.*, 167 U.S. 479 (1897). Carriers IB at 23 n.22. The Carriers' reply brief also cites *Farmers Union II* in arguing that the D.C. Circuit recognized that the Commission could and should take the public interest into consideration and did not foreclose departing from a "rigid cost-based approach to ratemaking."

rates is in the public interest and should give investors comfort since it allows the recovery of costs and a fair rate of return.

38. Flint Hills argues that the TSA should be allowed to continue until it terminates under its own terms because the TSA will likely terminate at the end of 2008, and both the Commission and public policy require that the settlement be allowed to run its full course. First, Flint Hills states that the TSA has two mechanisms for termination: (1) section III-12 of the TSA, where the TSA would run its course and terminate at the end of 2011 and (2) section I-8, whereby a party can seek to renegotiate the agreement beginning January 1, 2007, and if the parties fail to renegotiate within two years of that date the State or any of the TAPS owners can give written notice terminating the TSA as early as December 31, 2008. The State sent a notice of renegotiation on January 1, 2007, Flint Hills claims. The benefit of allowing the TSA to run its course, Flint Hills contends, is that the controversy with respect to what has been collected under the TSM (for example, DR&R) would be eliminated.

39. Second, Flint Hills argues that the United States Supreme Court recognizes the importance of upholding settlements. FH IB (citing *United Gas Co. v. Mobile Gas Corp.*, 350 U.S. 332, 344 (1956). The D.C. Circuit, Flint Hills asserts, has held that rate contracts should not be unilaterally modified unless required by the public interest and that the fact that a contractual rate may be higher than rates calculated under a different methodology does not necessarily trigger a public interest finding that the contract should be abrogated. Similarly, Flint Hills asserts that the federal courts do not favor allowing a party to undo a settlement that applies to others. Flint Hills also contends that the D.C. Circuit has also stated that the Commission has a preference to preserve the benefits of the parties' bargain in the contract. Moreover, Flint Hills adds, the State and Anadarko are not shippers on TAPS. Tesoro which does ship on TAPS, ships ANS petroleum which is not preferred by Tesoro at its Kenai Refinery in Alaska. In contrast, Flint Hills states that it and Petro Star fully support the continued use of the TSM and that significantly, they are refiners that can only run ANS petroleum and must ship all their refineries' crude on TAPS.

40. Third, Flint Hills claims that that the Commission's policy is to allow settlements to run their full course since it provides the benefit of certainty. Flint Hills also argues that the Commission's decision in *Kern River Gas Transmission Corp.*, 117 FERC ¶ 61,077 (*Kern River*) (2006), upheld a long-term levelized rate structure which was the product of settlement to allow shippers to realize the benefits bargained for in the settlement. The Interstate TSA and TSM are producing levelized rates and lower rates in outer years just as the parties intended, Flint Hills contends. For these reasons, Flint Hills concludes that the TSA and TSM have achieved the public policy goals and should be found just and reasonable.

41. Flint Hills also argues that the settlement principles in *Kern River* should also apply to the TSA since the rate design is analogous to the levelized rate design used by Kern River. Flint Hills claims that the rate designs share a common thread which is a key to the Commission's holding in *Kern River*. According to Flint Hills, in both cases, the pipeline carrier assumes some risk with respect to an element in the rate design. For Kern River, the risk was any depreciation not recovered within the first 15 years and the Carriers' assumed risk is tied to the APB since the dollar amount collected depends on throughput volume, Flint Hills contends.[34] In conclusion, Flint Hills asserts that the Commission's statement in *Kern River* that it is inherent in any levelization plan that the levelized rate will remain in effect for the entire agreed upon period should also apply to the TSA due to the trade-offs that occurred during the TSA's formation. In response, Staff states that Flint Hills's argument that the APB represents deferred return and must be retained so that the Carriers receive the benefit of their bargain is without merit. The TSM contains a separate element for deferred return and it is not the APB, Staff contends. Moreover, Staff avers, the only bargain struck was between the State and the Carriers and it only prohibited the State from protesting rates under the TSM ceiling.

42. Flint Hills further claims that the State and Staff have not rebutted the Commission's policy of ensuring that settlements, particularly those with levelized rates, run their full term. The Commission's recent pronouncements in *Sepulveda*[35] and *Kern River* support allowing the TSA and TSM to run their full term, Flint Hills asserts. Moreover, Flint Hills claims that when the TSA was approved, it was known that the rates of return under the TSM, including the APB, could be higher than otherwise allowed.

Discussion/Findings

43. As discussed further, *infra*, *Farmers Union II* and Opinion 154-B are the applicable ratemaking standards. First, the Commission has already held that the TSM cannot be used to establish just and reasonable rates. Second, Anadarko/Tesoro are not equitably estopped from challenging the TSM or the filed rates. Third, the Carriers public interest arguments are rejected since the applicable ratemaking standards perform a balancing act that protect investors' rate of return expectations. Flint Hills' assertions that the TSA should be allowed to run its course are rejected.

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[34] Flint Hills goes on to explain since the ABP was substituted for the original Rate of Return beginning in 1990, if actual throughput volumes prior to 1990 exceed projections, the Carriers would earn less than they would have earned had the switchover began before 1990.

[35] Flint Hills' arguments concerning *Sepulveda* are more appropriately discussed in Section III below.

44. As discussed above, section 15(7) requires the Carriers to prove that their 2005 and 2006 filed rates are just and reasonable. Anadarko/Tesoro, Staff, the Carriers, and Flint Hills agree that Opinion 154-B should be used to determine whether the rates filed by the Carriers are just and reasonable.[36] Thus, the applicable regulatory principles are stated in *Farmers Union II*, which provided guidance to the Commission on the factors to consider in formulating a rate making methodology, and the Commission's adoption of those guidelines in Opinion 154-B.[37] It is found that just and reasonable rates should be cost-based. *See Farmers Union II*, 734 F.2d 1486; Opinion 154-B, 31 FERC ¶ 61,377.

45. In seeking to define what the "just and reasonable" statutory requirement for ratemaking entails, the D.C. Circuit, in *Farmers Union II*, stated that "the statutory standard is, of course, not very precise." 734 F.2d at 1501. However, the Court went on to explain that as determined by "decades of judicial review of agency determinations of 'just and reasonable' rates: an agency may issue, and courts are without authority to invalidate, rate orders that fall within a 'zone of reasonableness,' where rates are neither 'less than compensatory' nor 'excessive.'" *Id.* at 1502. *Farmers Union II* also noted that the "zone of reasonableness" strikes a fair balance between the financial interests of the regulated company and the relevant public interests, both existing and foreseeable. *Id.* Finally, the court offered, "[b]ecause the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is 'less than compensatory' or 'excessive,' the most useful and reliable starting point for rate regulation is an inquiry into costs." *Id.* The court also stated that "non-cost factors may legitimate a departure from a rigid cost-based approach" and may "play a legitimate role in the setting of just and reasonable rates," but such deviations must be justified. *Id.* at 1502-03.

46. In closing, the D.C. Circuit provided "important and basic guideposts" to assist the Commission in establishing an appropriate ratemaking methodology. Specifically, *Farmers Union II* stated the following: (1) oil pipeline rates must be set within the "zone of reasonableness" as required by the ICC (and presumed market forces may not comprise the principle regulatory constraint); (2) departures from cost-

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[36] The Carriers' claim that the filed rates should be found just and reasonable if they comply with the TSM has been rejected as discussed in Section II.A, *supra*. In addition, the Commission has already made clear that the Carriers' cannot rely on the TSM to justify their rates. The Carriers and Flint Hills state that if TSM is not used to measure TAPS rates, then the appropriate methodology is set forth in Opinion 154-B. Carriers' IB at 19, FH RB at 18.

[37] Staff has provided a helpful summary of the history of *Farmers Union II* and Opinion 154-B in their brief. Staff IB at 11-14.

based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors; (3) the rate of return methodology should account for the risks associated with the regulated enterprise; and (4) the choice of a proper rate of return is only part of an integrated ratemaking method, thus, the FERC must scrutinize the rate base and the rate of return methodologies to see that they will operate together to produce a just and reasonable rate. 734 F.2d at 1530.

47. Opinion 154-B was issued in response to *Farmers Union II*. Opinion 154-B rejected the valuation methodology as the model for calculating rate base, and revenue requirements, and replaced it with the TOC methodology. 31 FERC at 61,833. Opinion 154-B acknowledged the guidelines set forth in *Farmers Union II*, including the "guideposts" stating that oil pipeline's rates must be set within the "zone of reasonableness" and that departures from cost-based rates must be clearly identified. *Id.* at 61,832 (citing *Farmers Union II*, 734 F.2d at 1530). It also announced that "[i]t is evident that oil pipeline rates as a general rule must be cost-based." *Id.* at 61,833. The methods for determining, *inter alia*, the rate of return, rate base, and a starting rate base were also established in Opinion 154-B. Accordingly, it will be the "guideposts" set forth in *Farmers Union II* and Opinion 154-B, and not the TSM, that shall be used as the regulatory framework for determining whether the TSM and the 2005 and 2006 rates it produced are just and reasonable.

48. The Commission and the D.C. Circuit have already stated that the Carriers cannot rely on the TSA, and accordingly, the TSM to establish the justness and reasonableness of its filed rates.[38] As articulated by the D.C. Circuit, "FERC has explicitly stated... that its settlement approval in no way establishes the justness or reasonableness of any rates." *Arctic Slope*, 832 F.2d at 166; *see Sohio Pipe Line Co.*, 35 FERC at 61,982. The Carriers correctly note that *Farmers Union II* allows departures from a "rigid cost-based approach," but "each deviation... must be found not to be unreasonable and to be consistent with the Commission's statutory responsibility" to serve the public interest. Carriers' IB at 19 (citing 734 F.2d at 1502). Thus, the elements of the TSM that depart from cost-based standards must be justified and only then can it be determined whether the TSM as a whole is just and reasonable.[39] It would be remiss not to perform a "reasoned inquiry" into such deviations and rely only upon a Commission approved settlement which the Commission itself stated is of no precedential value. *See Farmers Union II*, 734 F.2d

[38] The Carriers argument that they properly applied the TSM in calculating their filed rates is also rejected on the same grounds.

[39] This argument will be addressed in the following section where it will be determined whether the TSM comports with Opinion 154-B.

1502. Thus, it is *Farmers Union II* and Opinion 154-B that will serve as the standards for this inquiry and the Carriers' argument that the TSM should be used to determine just and reasonable TAPS rates is rejected.

49. Second, with regard to the Carriers' equitable estoppel arguments, Anadarko/Tesoro and Staff aptly note that the Commission's order approving the TSA preserved the rights of "Arctic, as well as any entity which is not a party to the settlement," to file "at any time in the future for an adjudicated rate, which does not exceed the settlement rate." *Trans Alaska Pipeline Sys.*, 35 FERC ¶ 61,425 at 61,982. In addition, the D.C. Circuit recognized that under the TSM, "rates are set on an annual basis, and are regarded under the regulatory scheme as any other rate filings by a common carrier... [t]hus, any such rates are subject to challenge by non-settling parties." *Arctic Slope Regional Corp.*, 832 F.2d 158 at 161. The time to challenge the Carriers' rates did not begin to toll from the moment the TSA was approved more than 20 years ago as the Carriers seemingly contend. Each yearly filing brings a new opportunity for a non-signatory, such as Anadarko/Tesoro, to challenge the justness and reasonableness of the rates. This was the Commission's intent when it approved that TSA and that intent was confirmed when Anadarko/Tesoro's and the State's protests and complaints were set for hearing. Finally, the Carriers' contentions concerning retroactive ratemaking are rejected, as Staff recognizes, since Anadarko/Tesoro's requested remedies only concern the 2005 and 2006 rate filings which the Commission accepted, subject to refund.[40]

50. Third, the public interest standard is not the standard that is applied in establishing just and reasonable rates; however, it is a key factor in such a determination. The Carriers contention that upholding the TSA is in the public interest is primarily based on financial factors. Specifically, the Carriers argue that the TSA should be upheld to preserve the sanctity of long term settlements and commitments regarding future rates and returns. Carriers RB at 14-15. Otherwise, the Carriers claim, investors in energy infrastructure projects will not make the necessary investments and there will be a "chilling effect on future investment." *Id.*

51. *Farmers Union II* states that the public interest should be taken into consideration, and to that end, the D.C. Circuit contemplated setting rates within the "zone of reasonableness." 734 F.2d at 1502. The D.C. Circuit stated that this zone would strike a fair balance between the financial interests of the regulated company

[40] *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376 at P 2; 113 FERC ¶ 61,332 at P 3. *See Oxy USA, Inc, v. FERC*, 64 F.3d 679 at 699 (D.C. Cir 1995) (the rule against retroactive ratemaking in Section 15(7) procedures is not violated where all parties are placed on notice that the agency has the authority to order a refund of any part of the increase that it finds to be unjustified).

(in this case the Carriers) and the relevant public interests, both existing and foreseeable. *Id.* (citations omitted). The "zone of reasonableness" also requires rates that are neither "less than compensatory" nor "excessive." *Id.* Again, the D.C. Circuit has taken the relevant financial interests of investors into consideration and established, in its guideposts to the Commission, a ratemaking framework that will compensate investors and ensure that such investors still receive a reasonable return on their investment.[41] Anadarko/Tesoro witness John F. Brown stated that "the Commission allows pipelines an opportunity to recover... a return of, and reasonable return on, the remaining investment in the pipeline. Thus, just and reasonable rates appropriately balance the pipeline's interest in maintaining service and attracting capital with the shipper's interest in paying rates that are not excessive." AT-78 at 6, 13 (citing *Farmers Union II*, 734 F.2d at 1502); A/T IB at 17 n.9.

52. More succinctly stated, "just and reasonable rates consider both pipeline and shipper interests." AT-78 at 13 (John Brown). The Carriers rely on Professor Joseph P. Kalt's testimony for the proposition that maintaining TSM will serve the public interest and investors will not make necessary investments if regulators do not preserve commitments regarding future rates and returns, and allow opportunistic conduct once the investment is made. Carriers IB at 22-23, RB at 14-15. However, the Carriers omit the portion of Professor Kalt's testimony that states that such concerns can be alleviated "through the consistent, proper application of an integrated ratemaking methodology, such as Opinion 154-B." ATC-4 at 38-40.[42] Establishing just and reasonable rates does not undermine the spirit of the TSA or the expectations of investors since the relevant regulatory principles ensure that the Carriers will still recover a fair return on their investment. Any expectation to receive more than that is contrary to Commission precedent.

53. In addition, the orders approving the settlement left the door open for non-signatories to challenge the rates established by the settlement, even if such rates are below the ceiling rate. *Arctic Slope*, 832 F.2d at 161; A/T-78 at 15. Signatories and investors were placed on notice that the TSM requires rates to be set on an annual basis and such rates, and the TSM itself, are subject to challenge by non-signatories.

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[41] *Farmers Union II* at 1502 (quoting *City of Chicago v. FPC*, 458 F.2d at 731, 750-51 (D.C. Cir. 1971) ("When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is *high* enough to both maintain the producer's credit and attract capital. To do this, it must, *inter alia*, yield to equity owners a return 'commensurate with returns on investments in other enterprises having corresponding risks.'").

[42] ATC-4 at 38-39. It is noted that Professor Kalt also states that "the more efficient outcome is to continue to abide by and support settlements, like the TAPS Settlement Agreement and TSM." ATC-4 at 39.

See Arctic Slope, 265 U.S. at 161. Moreover, setting rates within the "zone of reasonableness" as required by Opinion 154-B will establish just and reasonable rates for non-signatory shippers while allowing investors to continue to recover a reasonable return on their investment in TAPS. The sanctity of a long term settlement must be weighed against the risk of allowing unjust and unreasonable rates to continue.[43] Similarly, the Carriers' argument that by the mid-1990s rates calculated under Opinion 154-B exceeded TSM rates and that the TSM has kept rates below just and reasonable Opinion 154-B calculated rates does not automatically render the TSM or the TSM calculated rates just and reasonable. This will be further discussed in section III below.

54. Flint Hills fails to recognize that the Commission approved the TSA with a caveat – non-signatories are free to challenge the TSA and the rates it establishes using the TSM. *See Trans Alaska Pipeline Sys.*, 35 FERC ¶ 61,425 at 61,980-982. The fact that the remaining life of the TSA is now less than two years is not sufficient to (1) strip the rights of non-signatories to challenge filed rates as granted by the Commission and (2) allow the TSA to continue, in the face of such a challenge, when the Commission itself has stated that the TSA has not been shown to produce just and reasonable rates. Moreover, Flint Hills' arguments that the TSM has produced lower rates than projected, the State and Staff previously supported the approval of the TSM without a time limitation, and it was known that there was a possibility that TSM rates would be higher in the future fail with respect to Anadarko/Tesoro's challenge to the rates for the same reasons. FH RB 6-14, 17-18. Flint Hills cites *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (*Kern River*), for the proposition that the TSM must run its course to achieve the agreed upon levelized rates. The Commission allowed non-signatories to step forward and challenge the TSA, and accordingly, the TSA derived rates can only be allowed to run its course if the Carriers prove that the TSM results in just and reasonable rates. *See Arctic Slope*, 832 F.2d at 166 (the FERC had not considered the reasonableness of TSM and the rates established under it). Flint Hills is now requesting that the Commission impose the TSA on a non-signatory such as Anadarko/Tesoro, which is something the Commission has already declined to do. FH IB at 11; *See Trans Alaska Pipeline Sys.*, 35 FERC at 61,980-982.

55. In conclusion, the applicable ratemaking standards are set forth in *Farmers Union II* and Opinion 154-B. The Carriers arguments concerning equitable estoppel,

[43] As noted by the D.C. Circuit, FERC "was not even considering, much less near the point of decision on, the reasonableness of the TSM and the rates established under it." The Commission has also stated that the "Carriers cannot rely on the approved settlements to establish the justness of these filed rates changes, since the settlement rates were never adjudicated to be just and reasonable."

retroactive ratemaking, and the public interest are rejected. Flint Hills' arguments are also rejected. It is noted that the Commission does favor upholding the sanctity of settlements. However, with respect to the TSA, the Commission has explicitly stated that it did not enforce the terms of the TSA on non-signatories such as Anadarko/Tesoro.[44] For that reason, the arguments that the TSA should be allowed to terminate under its own terms and be upheld, solely on public interest grounds, are rejected.

Issue II. C. Have the Applicable Standards been Satisfied?

56. The Carriers aver that because the TSM is binding on all parties and the Carriers 2005 and 2006 rates comply with the TSM, the rates are lawful. The Carriers state that they have shown that they properly applied the TSM in calculating their filed rates by presenting the testimony of Dr. Toof, who concluded that the filed rates were equal or less than the TSM ceiling rates. The State did not present evidence directly responding to Dr. Toof's showing and Anadarko/Tesoro failed to dispute this showing as well, the Carriers contend.

57. The Carriers claim that by showing their filed rates are lower than rates calculated using the 154-B methodology, the Carriers have meet their burden.[45] The Carriers also claim that the Commission's regulations in 18 C.F.R. part 342, allow an oil pipeline to defend its rates on an Opinion 154-B basis even if the rates were negotiated or settlement rates. In addition, the Carriers cite *Magellan Pipeline Co.*, 105 FERC ¶ 61,390 (2003), for the proposition that a pipeline can submit a cost-of-service defense of the rate once it has been challenged in a valid protest. The Carriers claim that the rates can be defended by showing that the challenged rate is lower than the rate the pipeline could otherwise lawfully charge. Carriers' IB at 27 (citing *Sithe/Independence Power Partner, L.P. v. FERC*, 165 F.3d 944, 951 (D.C. Cir. 1999); *ARCO Pipe Line Co.*, 41 FERC ¶ 63,015 at 65,081, *aff'd*, 41 FERC ¶ 61,397 (1987).

58. Anadarko/Tesoro and Staff claim that the Carriers fail to address this central issue in the initial and reply briefs. Anadarko/ Tesoro argue that the Carriers have failed to satisfy the applicable legal standards in *Farmers Union II* and Opinion 154-B in two respects. First, Anadarko/Tesoro state that the Carriers incorrectly apply the less rigorous "public interest" standard which governs uncontested settlements,

[44] This addresses Flint Hills' arguments concerning its assertion that the Commission's policy is to allow settlements to run their full course. FH IB 12-21; RB 9-12.

[45] The Carriers discuss this in Section III of their reply brief; however, this discussion is more appropriately addressed here. Carriers RB at 27-28.

instead of the "just and reasonable" standard which governs rate proceedings and is applicable here. Anadarko/Tesoro also argue that when the Commission approves a settlement as being in "the public interest," the Commission does not make an independent finding that the settlement rates are "just and reasonable."

59. Second, Anadarko/Tesoro assert that the Carriers also failed to satisfy the legal standards because the Carriers did not provide any evidence that the TSM rate formula or the filed TSM rates reflect the Carriers' actual cost of providing service. Anadarko/Tesoro argue that the Commission has held that, with respect to formula rates, the formula is the rate and the formula itself must meet the just and reasonable standard. As a result, Anadarko/Tesoro claim that the Carriers must justify the TSM formula and its components and not just a specific rate level to satisfy the just and reasonable standard. Instead, Anadarko/Tesoro contend, the Carriers present two proxy cases that have nothing to do with the Carriers' cost of providing service. The Carriers present a SAC proxy based on hypothetical costs and an Opinion 154-B proxy based on a different methodology with different inputs, and consequently, Anadarko/Tesoro argue, both proxies fail to show the cost of providing service on TAPS and should be rejected.

60. Next, Anadarko/Tesoro argue that the "end result" test is incorrectly used by the Carriers. Anadarko/Tesoro contend that the Commission has held that the test is employed after the Commission has approved the specific elements of the rate and the Carriers are not relieved of the burden of proving the specific rate elements. Anadarko/Tesoro also claim that the Carriers use the "end result" test for the proposition that the Carriers do not have to consider the TSM rate elements, but only the final rate. Finally, Anadarko/Tesoro argue that the Commission in *Olympic Pipeline Co.*, 101 FERC ¶ 61,245 at P 17 (2002), held that in a rate hearing, a pipeline must support the rate case it originally filed and not a different case later developed at the hearing which created a "moving target."

61. Staff posits arguments similar to Anadarko/Tesoro's. Specifically, Staff states that the Carriers failed to submit cost information to support the elements of the TSM formula that make up their filed rates. The Carriers cannot simply rely on their argument that mechanical compliance with the TSM formula or public interest concerns establish the justness and reasonableness of their rates, Staff claims. Staff also states that the Carriers argument that demonstrating that the filed rates were all equal to or less than the TSM ceiling rates does not satisfy the standard. The Carriers' 154-B proxy, Staff avers, uses "costs" that fail to recognize the large amounts of depreciation, DR&R, deferred earnings, and amoritization already collected through rates. In fact, Staff contends, only Anadarko/Tesoro and the State provide Opinion 154-B presentations that accurately calculate the TAPS cost of service. Staff claims that the Carriers' application of the SAC presentation is unprecedented at the

Commission and is irrelevant. Accordingly, Staff concludes, the Carriers have not satisfied the applicable standards and the rates should be rejected.

Discussion/Findings

62. It has already been determined that the applicable ratemaking standards in *Farmers Union II* and Opinion 154-B require rates generally to be cost-based. More importantly, the relevant precedent mandates that each component of the cost of service be supported. *See Williston Basin*, 107 FERC at P 24. The Carriers bear the burden of proving that the TSM and the rates it produces are just and reasonable. As discussed above, this necessarily requires the Carriers to provide cost justification for each element of the TSM. This burden is not met by the Carriers' showing via Dr. Toof's testimony, or otherwise, that the 2005 and 2006 rates comply with the TSM. Nor can the burden be met by the Carriers use of hypothetical Opinion 154-B and SAC proxies to assert that the TSM ceiling rates produce lower, and therefore, just and reasonable rates.

63. The TSM cost elements and supporting justification must stand on their own. The Carriers have failed to provide cost data to support the elements of the TSM, and accordingly, the Carriers have not met their burden of proving that the TSM is just and reasonable. The Carriers' argument that Anadarko/Tesoro and the State failed to respond to Dr. Toof's testimony showing that the Carriers filed rates were equal or less than the TSM ceiling rates is irrelevant. It is the Carriers that have the burden of proving the TSM is just and reasonable and Dr. Toof's presentation did not satisfy this burden. Moreover, to the extent that the TSM contains elements that depart from a cost-based approach, such deviations must be shown not to be "unreasonable and ...consistent with the Commission's statutory responsibility." *See Farmers Union II*, 734 F.2d at 1502. Since the Carriers have not provided any supporting cost data to support their filed rates, they failed to meet their burden of proof.

64. The case law cited by the Carriers does not support the proposition that an Opinion 154-B proxy can be used to meet their burden of proof concerning the costs of providing service under the TSM. Carriers' IB at 27 (citing *Sithe/Independence Power Partner, L.P.*, 165 F.3d at 951).[46] Staff correctly states that such use of an

[46] For instance, *City of Holyoke v. FERC*, involved a comparison of a transmission rate *vis-a-vis* the integrated transmission rate, which is not the issue in the case at bar. *City of Holyoke Gas & Elec. Dep't v. FERC*, 954 F.2d 740 (D.C. Cir 1992). *Magellan Pipeline Company, L.L.C.*, involved a rate filing set for hearing. 105 FERC ¶ 61,390 (2003). *Sithe/Independence Power Partners, L.P., v. FERC*, in dicta talks about "end results" and comparing the rate charged to the rate that could legally be charged (citing the *City of Holyoke, supra*) in the discussion about rolled-in or incremental methodologies. 165 F.3d 944 (1999). These cases clearly do not

Opinion 154-B proxy "must be used in conjunction with the inputs that made up the filed rate. Otherwise, you have proven nothing, and certainly not the justness and reasonableness of the filed rate." *Id.* As discussed in more detail below, the inputs used by the Carriers' in their 154-B proxy, would allow an enormous double recovery of costs and do not reflect the actual balances. Moreover, Anadarko/Tesoro appropriately point out that the Carriers use the "end result" test incorrectly. A/T IB at 19 n.10 (citing *So. Co. Svcs., Inc.*, 80 FERC P 61,318 at 62,089 n.64 (1997)). "[T]he 'end result' test does not relieve Southern of the burden of supporting the specific elements of its rate, but is, instead, an additional test to which the rate is subject after the Commission has approved those specific elements." *So. Co. Svcs., Inc.*, 80 FERC at 62,089 n.64 (citing *Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1177-78 (D.C. Cir. 1987)*). Thus, the Carriers cannot just rely on the "end result" test – they must still prove each element of the TSM to meet their burden.

65. Anadarko/Tesoro's arguments addressing the Carriers' public interest arguments have been discussed above.

Issue II. D. Are the rates determined by the TSM just and reasonable?

66. The Carriers claim that the TSM methodology taken as a whole is cost-based.[47] According to the Carriers, Anadarko/Tesoro and Staff argue that the Carriers' failure to provide cost justification for specific elements of TSM means that the Carriers' filed rates are not just and reasonable. The Carriers claim that this argument is not sustainable since the TSM was not designed to be evaluated on an element-by-element basis. This is evidenced by statements made by the State and the U.S. Department of Justice (DOJ) in the Explanatory Statement submitted as part of the TSA, the Carriers assert. In sum, the Carriers contend that the statements provide that the elements of the TSM were drawn from general ratemaking principles and should not be evaluated independently since the elements were negotiated as a package tailored for TAPS to meet the objectives of the parties.

67. The Carriers also argue that the fact that the individual elements of TSM may not be justified on a cost basis does not mean that TSM or the ceilings it calculates are not cost-based. It is noteworthy, the Carriers assert, that the State and the DOJ compared TSM generated rates to rates generated by the ICC valuation methodology, a DOC methodology, and a TOC methodology and found that the TSM ceiling rates were at or below the other traditional methodologies. The Carriers contend that this

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parallel the facts in this case.

[47] This argument also includes the Carriers' contentions that the TSM is cost-based in Section II.B above.

confirms the TSM's reasonableness. In addition, the Carriers claim that there is also no merit to Anadarko/Tesoro's contention that the Carriers must justify the TSM formula itself as just and reasonable. According to the Carriers, this is because the TSM is not part of the Carriers' filed tariffs.

68. Anadarko/Tesoro and Staff posit extensive arguments that the Carriers have not shown that the TSM or the 2005 and 2006 rates are just and reasonable. The TSM includes non-cost based elements and the Carriers have failed to provide any direct evidence that shows the elements that comprise the TSM are just and reasonable, Anadarko/Tesoro and Staff contend. Specifically, Anadarko/Tesoro and Staff point to the following items and allege that the elements are not cost based or are inappropriate for cost-based ratemaking:

(1) The inflation-adjusted, non-cost-based allowance per barrel (ABP).
(2) The one hundred percent (100%) equity capital structure assumption.
(3) The subjective projections of costs and throughput.
(4) The depreciable useful life of the line that is known to be too short.[48]
(5) The true-up mechanism that guarantees cost recovery.
(6) The cost allocation/rate design mechanism that allows costs properly allocated to intrastate rates, but disallowed by the RCA, to be reallocated to the interstate rates.
(7) The DR&R collections premised on incorrect assumptions.

Staff IB at 18-27, RB at 16; Anadarko/Tesoro IB at 20-34, RB at 22-26. Additionally, Anadarko/Tesoro claim that these elements are not cost-based and as a result of being included in the TSM: (1) produce excessive returns, (2) include excessive deferred returns, (3) include an excessive income tax allowance, and (4) include an unjustified DR&R allowance.

69. Staff again claims that the Carriers' have offered no cost evidence to support the TSM rates or any of the elements within the TSM. According to Staff, the closest the Carriers come to addressing whether the TSM produces just and reasonable rates is the Carriers' discussion of mechanical compliance, the public interest, equitable estoppel, and retroactive ratemaking. However, Staff contends, the Carriers fail to discuss just and reasonable or cost-based ratemaking standards. Similarly, Anadarko/Tesoro argue that the TSM produces rates that are inherently unjust and unreasonable and inconsistent with cost-based ratemaking standards. Anadarko/Tesoro also claim that the Carriers and Flint Hills failed to address issue II.D. Thus, Anadarko/Tesoro and Staff state, because there is no record evidence to

[48] Anadarko/Tesoro argue that this causes depreciation expense to be overstated.

demonstrate that that "costs" included in the filed rates represent the costs of service for TAPS and because the TSM violates just and reasonable ratemaking standards, the TSM cannot be used to determine just and reasonable rates.

Discussion/Findings

70. A discussion of the specific elements that Staff and Anadarko/Tesoro state are not cost-based is better left to section III where each of the items will be examined in detail *seriatim*. Although the Carriers have chosen not to follow the prescribed issues list format, it seems that the Carriers did include a discussion of whether rates determined by TSM are just and reasonable. In short, the Carriers argue that: (1) the TSM is a cost-based methodology and even if individual elements are not found to be cost-based, *Farmer's Union II* allows certain cost deviations; (2) the Commission found, in *Amerada Hess*, 79 FERC ¶ 61,300, that the TSM is binding on all parties; (3) Anadarko/Tesoro are equitably estopped from challenging the TSM; (4) Anadarko/Tesoro's challenge of the 2005 and 2006 filed rates raises concerns regarding retroactive ratemaking; (5) it is in the public interest to find the Carriers rates and the TSM just and reasonable; and (6) the Carriers have shown that they properly applied TSM in calculating their filed rates. All of these arguments have been rejected in the preceding sections of this decision.[49] One of the most important of these findings with respect to this issue is that the Carriers must submit evidence to support a finding that each element of the TSM is either cost-based or that the deviation from costs is justified. Staff and Anadarko/Tesoro aptly note that the Carriers' failed to place cost data to support the elements in the TSM in the record of this proceeding. As discussed above, without such evidence, the Carriers fail to meet their burden of proving the TSM and the rates it produces are just and reasonable. Accordingly, the rates determined by the TSM cannot be found just and reasonable.

Issue II. E. Do the TAPS Carriers' 2005 and 2006 TAPS Interstate Rates Comply with the TAPS Settlement Agreement?

71. Staff and Anadarko/Tesoro take no position on this issue. To the extent that the Carriers and Flint Hills assert a position, such arguments have been addressed above. As stated above, the mechanical compliance with the TSA does not, by itself, prove anything in this case, so this is a moot point.

[49] Anadarko/Tesoro's and Staff's arguments have already been considered with respect to these arguments.

ISSUE III: IF TSM SHOULD NOT BE USED, WHAT METHODOLOGY SHOULD BE USED AND HOW SHOULD THAT METHODOLOGY BE APPLIED?

Issue III. A. What is the Appropriate Methodology?

72. The Carriers state that if the TSM is not accepted as the governing methodology for determining the lawfulness of the Carriers' 2005 and 2006 rates, then Opinion 154-B and the Commission's cost of service regulations in, 18 C.F.R., part 346 (2006) apply. Since the parties agree that 154-B is the appropriate methodology, the large difference in the rates advocated by the parties, the Carriers contend, is due to the differences in the inputs each party uses in the formula. The Carriers state that their Opinion 154-B presentation uses the actual costs as recorded in their FERC Form 6 (Form 6) annual reports. Anadarko/Tesoro cannot "cherry pick" the most favorable terms of the TSM to use as inputs in their Opinion 154-B presentation, the Carriers claim. The Carriers also argue that no element of the TSA was to have any effect on the rights of non-settling parties and the non-setting parties have an all or nothing choice in litigating their rate challenge.

73. The Carriers argue that Anadarko/Tesoro's and Staff's attempt to apply *SFPP-Sepulveda*, 117 FERC ¶ 61,285 (2006) (*Sepulveda*), to this proceeding is unavailing because none of the fundamental underpinnings of the *Sepulveda* decision apply here. The Carriers assert that *Sepulveda* differs from the facts of this case because the contracts were between SFPP and the complaining shippers, the contract provisions did not limit the rights of third parties to rely on the contracts, and the Commission found that the contracts were fully performed on both sides.

74. Anadarko/Tesoro also state that although the parties agree that Opinion 154-B results in just and reasonable rates, there is a dispute concerning how to properly apply Opinion 154-B. Anadarko/Tesoro assert that just and reasonable rates should be established under either the TOC or DOC original cost rate methods. The Carriers' Opinion 154-B case is flawed because the Carriers do not use their actual costs as inputs, Anadarko/Tesoro contend. Anadarko/Tesoro claim that the Carriers have dramatically increased their total revenue requirement (TRR) by "restating and double counting their accumulated depreciation and deferred earnings, and by including a starting rate base adjustment." A/T IB at 40. Finally, Anadarko/Tesoro assert that the proxy cases presented by the Carriers have nothing to do with the Carriers' filed rates and fail to recognize 30 years of accelerated recovery of investment, deferred earnings, and DR&R.

75. Staff states that the appropriate methodology to use in setting TAPS rates is the TOC which is consistent with Opinion 154-B and *Farmers Union II*. Staff also claims that using either an Opinion 154-B TOC approach or the traditional DOC

approach as calculated by the State and Anadarko/Tesoro uses the proper inputs and are also similar to the DOC rate calculated by the RCA it its extensive proceeding. Staff concludes by stating that neither of the Carriers' proxies (SAC or Opinion 154-B) can be used to set rates or prove the justness and reasonableness of the Carriers' rates.

76. Proper application of the DOC and TOC methodologies, Anadarko/Tesoro and Staff claim, requires the inputs to reflect amounts actually collected by the Carriers. Staff contends that only the interstate rates calculated by the State and Anadarko/Tesoro are consistent with the Carriers' previous rate filings and the revenues already collected by the Carriers. The Carriers' Opinion 154-B proxy has nothing to do with the costs reflected in the Carriers' rate filings, Staff avers. In addition, Staff contends that in using an Opinion 154-B methodology to determine an oil pipeline rate, the inputs that made up the filed rate must be used.

77. The Carriers' argument that Anadarko/Tesoro are "cherry picking" elements of the TSM is incorrect, Anadarko/Tesoro claim. Anadarko/Tesoro state that their reliance on the annual rate filings has nothing to do with attempting to enforce rights under the TSA since Anadarko/Tesoro are simply including the current property balances from the Carriers' rate filings. Contrary to the Carriers' assertions, Staff also claims, using the actual recoveries does not constitute "cherry picking" from the TSA by Anadarko/Tesoro. Staff states that this argument fails for two reasons. First, Staff claims that the issue is not about enforcing the TSA, but the right of shippers to have just and reasonable rates in accordance with Commission policy and practice. Anadarko/Tesoro are simply accepting the balances as they find them and, Staff states, are not proposing to restate or alter these balances. Second, Staff claims that Anadarko/Tesoro are not selectively enforcing portions of the TSA because the bargain was only between the State and the Carriers and simply provided that the State would not protest or object to a maximum rate that complied with the TSM.

78. Staff claims that the numerous arguments forwarded by the Carriers to attempt to justify double recovery are without merit. Staff states that Commission precedent does not permit double recovery of investment. Staff also points to several reasons why *Sepulveda*, 117 FERC 61,285, applies to this proceeding and stands for the proposition that the Carriers' previous recoveries must be recognized for ratemaking purposes. Anadarko/Tesoro also assert that the Commission's decision in *Sepulveda*, which required SFPP to recognize prior recovery of investment in future rates is applicable here. *Id.* In addition, Staff avers that the Commission's decision in *Sepulveda* is consistent with its other rulings. Staff states that in *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006), which involved the continued use of a levelized rate, the Commission required Kern River to create a regulatory asset to reflect the difference between what is reflected in its accounting books and what it collected in rates. The Commission confirmed that the regulatory asset is

recognized as an adjustment to the rate base, Staff contends. In addition, Staff claims that *Entergy Services, Inc.*, also stands for the proposition that allowing an investment to be recovered a second time is not just and reasonable.[50]

79. The Carriers' reliance on accounting regulations to justify the use of Form 6 information is misplaced since ratemaking books must be used when there are differences between the ratemaking books and regulatory accounting books, Anadarko/Tesoro and Staff argue. Moreover, Anadarko/Tesoro and Staff state, Commission and court precedent are clear that when this difference occurs, ratemaking standards control and ratemaking balances must be used.

80. Flint Hills claims that the Carriers, and not the State and Anadarko/Tesoro have submitted proper Opinion 154-B presentations. According to Flint Hills, the rate methodologies submitted by Anadarko/Tesoro and the State are skewed and result in unreasonable rates because they omit the return elements deferred under the TSM. Anadarko/Tesoro's inclusion of the accelerated recovery items and the omission of the back-end deferred return items is the only way Anadarko/Tesoro was able to calculate a $2 per barrel rate range. In conclusion, Flint Hills claims that the TSM rates are lower than the Carriers' properly calculated 154-B methodology rates and are therefore just and reasonable. If either Anadarko/Tesoro's or the State's Opinion 154-B presentations are used, significant corrections need to be made, Flint Hills claims.

Discussion/Findings

81. Although the parties agree that Opinion 154-B is the appropriate methodology to employ in this proceeding, the consensus ends there. It is the discussion concerning which amounts are the proper inputs where the parties' opinions sharply diverge. The Carriers and Flint Hills are advocating the use of the Form 6 balances, while Anadarko/Tesoro and Staff fervently contend that the appropriate balances are in the Carriers' annual filings. Anadarko/Tesoro and Staff have proven that it is their arguments that should prevail.

82. First, the Carriers must recognize the amounts they have previously collected in rates. The cases cited by Staff and Anadarko/Tesoro are applicable. The Carriers' attempt to distinguish *Entergy Services* fails. Carriers' RB at 41 n.40. Contrary to the Carriers' assertions, Staff cited *Entergy Services* for the basic proposition that allowing costs to be recovered twice is not just and reasonable and that assertion is clearly supported by the text of the initial decision which was later approved by the

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[50] *Entergy Services, Inc.*, 102 FERC ¶ 63,016 (2003); 105 FERC ¶ 61,319 (2003) (*Entergy Services*).

Commission.[51] Anadarko/Tesoro and Staff cite *Sepulveda*, with respect to this issue, to assert that the Carriers must recognize the amount of investment previously recovered: (1) even if the amounts recovered are different from the amounts reflected in the Carriers' accounting books and records and (2) even if such records comply with the Commission's Uniform System of Accounts. A/T RB at 41-42; Staff RB at 33-34, IB at 35-39. Anadarko/Tesoro and Staff effectively refuted the Carriers' arguments in opposition on this point. *Id.*; Carriers IB at 53-55, RB at 40-42.

83. To wit, Anadarko/Tesoro and Staff specifically acknowledge the "fundamental underpinnings" that the Carriers use to contrast *Sepulveda* with this proceeding. Staff and Anadarko/Tesoro rebut the Carriers' arguments by stating that: (1) the fact that the contract was between the complaining parties is immaterial since what matters is that the money was already collected from the shippers, Staff RB at 34; (2) regardless of whether the settlement contracts have run their course, the Carriers cannot recover their investment twice;[52] and (3) it is irrelevant whether the SFPP contracts denied third-party beneficiary rights since parties to a settlement cannot restrict a third party's rights when determining a just and reasonable rate, Staff RB at 34. Importantly, Staff also notes that in *Sepulveda* "the contract's intentions regarding the recovery of investment were not explicitly stated and had to be presumed," but that is not the case here "where the recovery pattern for plant investment was explicitly described in the TSM." Staff IB at 38-39. Finally, *Kern River* also stands for the proposition that the Commission's objective is to ensure that entities do not double recover their investment.[53] The Carriers' arguments are without merit on this point and are therefore rejected. Carriers RB at 41 n.41.

84. The Carriers claim that Anadarko/Tesoro's use of the TSM balances constitutes "cherry picking" from the TSA and should not be permitted. Carriers' IB at 34-45. As discussed above, the Commission will not allow an investment to be

[51] *See* 105 FERC at P4; 102 FERC at 98-100 (the Commission affirmed the ALJ's decision "(I) requiring Entergy to develop its rates using the net non-levelized methodology" where the ALJ did not allow Entergy to switch to the gross plant levelized method because of the concern that it would allow Entergy to "recover some of the depreciation expense attributable to this equipment a second time, and the customers as a class will have to pay twice for use of these facilities. Clearly, this result would be unjust and unreasonable").

[52] The Carriers' argument that it is improper to recognize the accelerated recovery of any investment until it has been recovered in its entirety under the TSA also fails. *See Sepulveda*, 117 FERC 61,285; Staff RB at 34; IB at 39 n.103; (the Commission disallowed any over-recovery in *Sepulveda* and there was no indication that it was contingent on the amount of the investment recovered); A/T RB at 42-43.

[53] Staff IB at 40; *Kern River*, 117 FERC at P 48.

recovered twice. To that end, the mission here is to ensure that the inputs used in the Opinion 154-B methodology reflect amounts already recovered. Therefore, Anadarko/Tesoro and Staff are correct. The use of the amounts in the Carriers' filings has nothing to do with Anadarko/Tesoro or Staff attempting to enforce rights or provisions of the TSA.[54] Nor are Anadarko/Tesoro combining approaches by using the balances contained in the Carriers' filings. The Carriers collected rates pursuant to the TSA/TSM and, therefore, it is the filings made pursuant to the TSA that provide the most accurate picture of the Carriers' current property balances. Witness Sullivan's testimony provides a persuasive and an accurate explanation on this point.

> For the past, you look at what has been recovered in rates, and we know what has been recovered in rates, because [the Carriers'] made annual ICA filings under the interstate settlement agreement....
>
> ....
>
> [The filings] were made based on the TAPS settlement methodology... but it clearly shows the rate recovery, the past period rate of recovery that [the Carriers have] been able to recover, and going forward, you have to take those plant balances into account in establishing just and reasonable original-cost ratemaking standards.

Tr. at 5282:1-16 (Sullivan). Finally, where accounting regulations or balances do not match ratemaking standards or balances, it is the ratemaking balances that control.[55] Mr. Sullivan's testimony on this point is given significant weight.[56]

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[54] With that said, the Carriers' arguments that the TSA is an inseparable package and the independent items were not intended to be relied upon by third parties, are rejected.

[55] Staff IB at 44-46; 46 n.127 (citing (*Virginia State Corp. Comm'n v. FERC*, 468 F.3d 845, 847 (D.C. Cir. 2006) ("Petitioners' claim of a rate effect is belied by the proposition that '[a]ccounting practices are not controlling for ratemaking purposes'" (citation omitted)); *Consolidated Gas Supply Corp.*, 14 FERC P 61,029, 61,053-54 (1981) ("Accounting practices are not controlling for ratemaking purposes and deviations from normal accounting practices must be made where necessary to insure that rates established by the Commission are just and reasonable"); *Williston Basin Interstate Pipeline Co.*, 55 FERC at 62,008 ("the Commission has stated that accounting does not dictate ratemaking"); *Williston Basin*, 56 FERC at 61,104, 61,370 ("The Commission is not bound by accounting principles in determining whether proposed rates are just and reasonable")); A/T IB at 46 n.33 (citing *id.*); Tr. 1659-62 (Wetmore concedes at one point that ratemaking treatment should be used for just and reasonable rates).

[56] Conversely, the Carriers' witnesses' testimony concerning the Opinion 154-B analysis is not credible.

85. The crux of the matter is that the Carriers must recognize the previous recoveries of their investment, otherwise there will be an unjust and unreasonable double recovery. The Carriers have presented no fact in the case that calls for an opposite conclusion. The Carriers' theory that Opinion 154-B analysis has to start from the beginning of TAPS as if the TSA/TSM had never occurred, or that the revenues recovered until now cannot be considered is not given any weight. Furthermore, Staff's commonsensical argument that just and reasonable rates cannot result where *any* double recovery is allowed simply cannot be ignored. Staff IB at 39. Accordingly, it is found that the inputs into the Opinion 154-B presentation must reflect the actual amounts collected by the Carriers even if that means using amounts other than those found in Form 6. This is consistent with the Commission precedent which disallows the double recovery of investment. Moreover, this is not a small matter since the differences between Anadarko/Tesoro's and the Carriers' total revenue requirement is significant. Anadarko/Tesoro's revenue requirement is $647.32 million while the Carriers' is $1,751.18 million.[57] See Illustration No. 1 below. Anadarko/Tesoro's amounts from Illustration No. 1 below are the basis for the conclusions reached in this decision although the final numbers used by Anadarko/Tesoro may vary slightly based on findings elsewhere in this initial decision (i.e., ROE and income tax).

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[57] The main differences are attributable to deferred earnings, SRB, and depreciation and various rate base items.

Illustration 1

Comparison of Anadarko/Tesoro's Revised 154-B And TAPS Carriers' 154-B Proxy

Total 2006 Revenue Requirements and Rates
($Millions)

Line No.	Description	Revised A/T 154-B	TAPS Carriers 154-B
1	Operating Expenses*	$559.65	$559.65
2	Depreciation Expense	$13.48	$335.43
3	Amortization of Deferred Earnings	$7.13	$223.84
4	Amortization of AFUDC	$0.86	$11.63
5	DR&R Allowance	$0.00	$0.00
6	Return Allowance		
7	Return on Equity	$30.58	$281.62
8	Interest	$13.77	$9.59
9	Total Return Allowance	$44.34	$291.21
10	Income Tax Allowance	$22.13	$329.04
11	Non-Transportation Revenues	($0.27)	$0.38
12	Total Revenue Requirement	$647.32	$1,751.18
13	Composite System Barrels (Millions)	326.795	326.795
14	Composite Rate ($/Bbl)	$1.98	$5.36
15	Valdez Interstate Rate ($/Bbl)	$2.04	$5.53

* Includes amortization of FERC rate case litigation costs and RCA rate case litigation costs.

86. The parties' general arguments with respect to the proper Opinion 154-B inputs are better addressed in the individual sections where the parties contentions are more tailored.

Issue III. B. What is the Appropriate Rate Base?

Issue III.B.1. What are the appropriate property balances for original investment, additions, retirements, and accumulated depreciation?

87. The Carriers assert that the balances shown in Form 6 represent the Carriers' actual investment in TAPS. The Carriers contend that Mr. Van Hocke rejected Anadarko/Tesoro's exclusion of the $450 million in carrier property as of 1976 and further stated that as non-settling parties, Anadarko/Tesoro have no basis to claim the benefit of the $450 million exclusion. In addition, the Carriers contend that the $450 million should be included in the rate base because the amortization was a component of the settlement package that "assuredly [did] *not* set any rates." Carriers' IB at 50 (citing *Arctic*, 832 F.2d at 164 n.12). The Carriers also claim that the "amortization" of the $450 million was a product of the settlement negotiations and reflected an assumed recovery in early years. The Carriers assert that the reduction in refunds arguments forwarded by Anadarko/Tesoro and the State should be rejected because the TSA states that there would be no refunds from 1977 through 1981 and for the period 1982-1985. Nothing in the TSA or Commission's orders suggests that any amoritization or exclusion of the $450 million for that period is appropriate, the Carriers contend.

88. Anadarko/Tesoro and Staff state that the appropriate property balances for original investment, additions, and retirements are the balances reported in the Carriers' annual filings. In addition, Anadarko/Tesoro state that the amounts reported in the Form 6 original property balances advocated by the Carriers and the original property balances in the annual rate filings are virtually identical. The main difference, Anadarko/Tesoro claim, is $450 million excluded from the TAPS rate base that was separately amortized and recovered in rates from 1978-1984 pursuant to the TSA. The property balances reflected in the TSM filings are consistent with the rates charges and the revenues actually collected, Staff contends. Staff also states that, contrary to the Carriers' assertions, if the Commission would have intended to ignore costs already recovered when it established just and reasonable rates, it would have explicitly said so and provided legal justification. In addition, Staff states that contrary to the Carriers' assertions, *Boston Edison Company*, 61 FERC ¶ 61,026 (1992), actually supports Anadarko/Tesoro's position because unlike the Carriers the company voluntarily gave up the right to collect certain expenses and the Commission held the company to that decision and would not allow recovery later.

89. With regard to accumulated depreciation, the Carriers claim that they have followed Opinion 154-B and the Commission's order approving the 1982 Depreciation Stipulation (Stipulation) by using the actual investment costs and actual straight-line depreciation recorded in their Form 6 annual reports. The Carriers claim that Form 6 represents the actual depreciation expense incurred in past years and the sum of those amounts is the proper accumulated depreciation balance. Until changed by further order of the Commission, the Carriers contend, the Stipulation is binding in any proceeding involving the TAPS Carriers' interstate tariff rates.

90. The Carriers present several reasons in support of rejecting Anadarko/Tesoro's use of the TSM balances. First, the Carriers assert that Anadarko/Tesoro, as third party non-signatories, have no legal rights under and cannot enforce the TSA. Second, the Carriers argue that the Commission's order in, *Arctic*, 832 F.2d 158, approving the TSM clearly supports the assertion that the TSA was meant neither to burden nor benefit non-settling parties. Third, the Carriers claim that contrary to Anadarko/Tesoro's claims, the TSA did not supercede the Stipulation. Fourth, the Carriers claim that Anadarko/Tesoro have no basis to rely on TSM for depreciation or other rate base elements because the depreciation factors differ from traditional FERC approved depreciation.

91. The appropriate balances for accumulated depreciation are reported in the Carriers' annual filings, Anadarko/Tesoro aver. According to Anadarko/Tesoro, the Carriers Opinion 154-B utilizes an accumulated depreciation figure that completely ignores the accelerated depreciation: (1) used to calculate refunds for 1977 through 1985 and (2) reported by the Carriers in rate filings from 1986 to present. Anadarko/Tesoro assert that the Carriers' failure to recognize this prior recovery artificially inflates the rate base in the Carriers' Opinion 154-B presentation by over $481 million and will lead to the double recovery of investment. Anadarko/Tesoro state that the regulatory history of TAPS shows that the Carriers' recovery of investment was based on accelerated depreciation.[58]

92. Anadarko/Tesoro state that the Carriers' claim that all parties are bound to the 1982 Depreciation Stipulation fails because several witnesses have confirmed that the 1982 Depreciation Stipulation was not used for setting rates on TAPS. Furthermore, Anadarko/Tesoro claim that the Stipulation was superceded by the TSM.

[58] Anadarko/Tesoro state seven major aspects of that regulatory history that demonstrate that the Carriers' recovery of investment was based on accelerated depreciation. A/T IB at 49-59. To wit, representations to FERC and the Alaska Public Utilities Commission (APUC); the Carriers reduced their refund obligation; rates included accelerated depreciation; Carrier internal communications; expert testimony; other motives, and the 1982 Stipulation was never used to set rates. A/T IB 49-58.

Anadarko/Tesoro further assert that the Carriers' argument that the TSA and the Stipulation were expected to remain in effect simultaneously (the TSA would apply to signatories and the 1982 Stipulation would apply to shippers) is impossible because no party to the TSA is a shipper and only shippers paid the TSA rates. Thus, Anadarko/Tesoro conclude, the Stipulation and the TSA could not remain in effect at the same time. In conclusion, Anadarko/Tesoro assert that the book balances of accumulated depreciation reported in Form 6 were not used to set rates and the use of those balances will result in double recovery by the Carriers.

93. Staff also states that the TSM rates filed and collected from the shippers reflected an accelerated depreciation factor. This is clear, Staff contends, because the Carriers' annual rate filings, the supporting data and sections of the TSA itself show the depreciation expense, accumulated depreciation, and unrecovered property balances underlying the rate calculations.[59] Staff claims that the Carriers argument that without an explicit order from the Commission, the Stipulation remains in effect is incorrect. Contrary to the Carriers' assertions, Staff states, the Commission's orders were clear that it was approving TSM depreciation and even the Carriers Reply Comments (on the offer of settlement for the TSA) acknowledge that was what they were seeking from the Commission's approval of the TSA. Staff also states that the TSA provided that the only stipulations that were to remain in effect were those consistent with the TSA.

94. The shippers on TAPS pay rates based on the accelerated depreciation factors in the TSM and not the straight-line factors in the Stipulation, Staff claims. Thus, Staff contends, the Carriers' assertion that the TSM factors are only relevant to the settling parties is clearly incorrect since it is the non-signatory shippers and not the settling parties who have paid TAPS rates. Staff also claims that the Stipulation was replaced by the TSA. According to Staff, the language in the Stipulation gave the Commission and the parties the authority to terminate the provisions and the Carriers recognized and advocated the adoption of the TSM depreciation schedule in place of the Stipulation. Staff also claims that the Commission's orders accepting the TSA approved of the new TSM depreciation methodology in place of the Stipulation.

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[59] Staff states that Section II-5 and Exhibit F of the TSA show the annual depreciation expenses to be recovered in the TSM rates. Exhibit G to the TSA also shows accelerated depreciation. In addition, Staff states that the Commission's Order Approving Settlement, dated October 23, 1985 also acknowledged that accelerated depreciation is included in the TSM.

Discussion/Findings

95. The appropriate rate base is one derived following the Commission's Opinion 154-B analysis and conforms to original costs ratemaking standards. In this case, the rate base should reflect net depreciated original costs as reflected over the years in the Carriers' rate filings before this Commission for almost three decades.

96. The Carriers, Anadarko/Tesoro and the State filed testimony using the 154-B analysis used by the Commission in setting rates for oil pipelines. However, the Carriers position is that the inputs to an Opinion 154-B analysis should be based on Form 6 as opposed to what they filed to justify their rate filings. It is found that the appropriate property balances for original investment, additions, and retirements are contained in the Carriers' annual rate filings.[60] Anadarko/Tesoro's cost of service presentations use the property balances reported by the Carriers in their annual rate filings. Anadarko/Tesoro use the amounts collected from ratepayers by the Carriers. These figures are found in the Carriers' annual rate filings and supporting documents. Accordingly, Anadarko/Tesoro's witnesses testimony is given significant weight.[61]

97. The only major difference between the property balances in the Carriers' annual filings and Form 6 is $450 million which was excluded from the total TAPS rate base and separately amortized from 1978 through 1984 through TSM. A/T IB at 44; RB at 45 n.32; Staff RB at 21. The $450 million has already been fully recovered by the Carriers via amortization from 1978 through1984 under the TSM.[62] This

[60] The amounts for 2005 are as follows (in millions): Carrier Plant in Service - $10,294.12, Additions - $14.855, Net Retirements - $0.796, Non-Depreciable Plant - 68.161, Ineligible Plant - 97.24. A/T IB at 44; Ex. A/T-144, WP-2 at 5, ln. 1, 2, 3, 11, and 17 ("Col. 2004"). The amounts for 2006 are as follows (in millions): Carrier Plant in Service - $10,308.96, Additions - $19.991, Net Retirements - $0.000, Non-Depreciable Plant - 68.161, Ineligible Plant – 120.14. A/T IB at 44; Ex. A/T-146, WP-2 at 4, ln. 1, 2, 3, 11, and 17 ("Col. 2005").

[61] The Carriers' testimony is not credible. As a matter of fact Mr. Van Hoecke previously testified in RCA docket P-97-4 explaining the difference between Form 6 and the annual rate filings. Exs. A/T-143 at 27-28, A/T 234 at 1-2. This testimony is inconsistent with his testimony in this hearing. In the cited proceeding he testified that the primary differences are: (1) $450 million removed from TSM balances and amortized; (2) $17 million in land treated separately by TSM-6 and (3) $56 million of timing differences between property records and TSM-6. Ex. A/T-143 at 27-28.

[62] Ex. A/T-33 at 10 (Section II-2(c)) (the TSA states that the TAPS investment base is reduced by $450 million and that amount is amortized from the period 1978 through 1984); Ex. A/T-140 at 28-30; Ex. A/T-140 at 28 (Brown); Ex. A/T-196 at

amount was clearly excluded from rate base as stated in the TSA. Thus, since this amount was excluded and amortized by virtue of the TSA and the TSM and the rates were charged based on the TSM, it is found that this is the correct way to treat the rate base in a 154-B analysis, as Staff and Anadarko/Tesoro point out. If the $450 million is added back into rate base this would result in double recovery of investment which is not allowed by the Commission. Carrier witness Van Hoecke and Ganz advanced similar arguments in a previous proceeding which were rejected by the Commission. To wit, in *Sepulveda* [63] the Commission did not allow a carry over of 1983 construction costs since it would result in over-recovery of investment and is inconsistent with the depreciation method SFPP used in previous contracts. The same reasoning is applicable here where the Carriers have invested $11 billion since TAPS was placed in service and have collected $58 billion in revenues while expending $15 billion in operation and maintenance. Ex. A/T 233 at 1. The amounts actually recovered by the Carriers must be recognized to avoid double recovery. Commission principles and policy do not allow costs to be included in rates twice.[64] Thus, it is found that the $450 million of original investment has been properly excluded from the Carriers' rate base.

98. The appropriate balances for accumulated depreciation are reflected in the net plant balance in the Carriers' annual rate filings.[65] Anadarko/Tesoro cost of service presentation uses these correct balances. The Carriers' varied arguments contesting the use of the amounts in their annual filings are without merit. Again, the point of this exercise is to determine what the Carriers' actually collected. Anadarko/Tesoro have shown that the Carriers never used the Stipulation to set rates on TAPS via several witnesses in this proceeding.[66] In fact, the witnesses have verified that it has been the TSM and not the Stipulation that has been used to set rates on TAPS. *Id.*

237-8; A/T RB at 45 n.32. The State gave up refunds and the Carriers reduced their refund liability by this settlement. *See* A/T Ex -181 at 28; 116-125.

[63] 117 FERC ¶ 61,285 at P 18 (2006).

[64] *See, Town of Norwood v. FPC*, 546 F. 2d 1036 (D. C. Cir 1976); *Entergy Services, Inc.*, 109 FERC ¶ 61095 at P 55 (2004); *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 at PP 47-48 (2006).

[65] The amounts of accumulated depreciation are as follows (in millions): (1) for 2005 - $59.777 as shown in Ex. A/T-144, WP2 at 5, ln.7 ("Col 2004") and (2) for 2006 - $58.228 as shown in Ex. A/T-146, WP2 at 4, ln.7 ("Col 2005").

[66] Staff RB at 29. Tr. 2979-80 (Van Hoecke); Ex. A/T-196 at 234-26 (Dr. Horst); Tr. at 867 (Confidential) (Dr. Toof stated that rates were not calculated using the Stipulation); Tr. at 1666 (Wetmore, the Carriers' witness, also stated that he was not aware of the Stipulation being used to establish rates on TAPS); A/T IB at 55 (citing Ex. A/T-175 at 73 (witness Folmer who prepares the financial package that the

99. Additionally, further proof of the fact that the Carriers have recovered accelerated depreciation is the representations they made to the Commission recommending approval of the TSA. In the Explanatory statement the parties stated that if the TSA is approved accelerated depreciation will be recovered in rates. Ex. A/T-35 at 6, 33-32. Previously, in an APUC proceeding State witness Horst testified that the parties to the TSA used a unit of throughput depreciation schedule accelerated through multiplying throughput factors. Ex. A/T-180 at 7. Furthermore, in approving the TSA the Commission recognized that the depreciation schedule, based on an accelerated unit-of-production method, is fixed and heavily weighted towards the earlier years.[67]

100. The evidence in this case also establishes that from 1977-1985 the revenue requirements and rates were calculated in the TSM-6. Ex. A/T-44 and A/T- 155, line 163.[68] In the hearing proceeding in Docket No. P-86-2 Mr. Baden testified he reconciled actual property data with Form 6 reports and confirmed that the TSM had real numbers behind them. Ex A/T-178 at 19-20. Dr. Horst's deposition indicates that TSM-6 was split in half with the first half showing the historic pre-1983 numbers which became TSM-6. The ending balances from TSM-6 are identical to the beginning balances in Ex. G of the TSA. Ex. A/T-196 at 222-223. The historic balances in TSM-6, including operating expenses were used to determine refunds for the years 1982-1985 and for the determination that no refunds would be allocated prior to 1982. Ex. A/T 196 at 231, ln 1-6 and 236, ln. 7-16. The rates in TSM-6 for 1982-1985 match Ex. D-1 to the TSA. Ex. A/T -33.[69] The accelerated depreciation used for ratemaking purposes from 1977-1983 is specified in Ex. ATC-84 through ATC-88, Sheet E (2006) (Highly Confidential) in each of the Carriers past 100 annual rate filings.[70]

Carriers rely on in setting their rates stated that TSM depreciation was used to set rates)). *See also*, Ex. A/T-174 at 87-90 (Van Hoecke); Carrier witnesses Toof, Washington, Wetmore and Ganz (Tr. 867, 1542, 1666, 2040).

[67] *Trans Alaska,* 33 FERC ¶ 61, 064 at 61,139 (1985). The record reflects that the Carriers reduced their refund obligations through the accelerated depreciation. Exs. A/T-75 at 14; A/T-183.

[68] The deposition of Dr. Horst states that the TSM-6 applied back to 1969 (the first year of construction expenses attributable to TAPS. Ex. A/T-196 at 222 line 4-6.

[69] Other experts have testified in various proceedings. *See* Ex. A/T-238 (Williams) (he would expect depreciation in rates to be used for ratemaking purposes); Ex. A/T-212(Folmar) (TSM depreciation was used to set rates.)

[70] The Carriers' rate filings use the amounts of accelerated depreciation. However, ATC-84 through ATC-88, Sheet N refers to the accelerated depreciation as

101. The Carriers posit varied arguments claiming that the Stipulation and Form 6[71] should be used in the Opinion 154-B presentation.[72] It is noted that the Carriers' claim that the Stipulation remains in place as to non-settling parties is baseless. First, the terms of the TSA rendered the Stipulation invalid.[73] The Stipulation is inconsistent with the TSA as it uses straight-line depreciation while the TSA uses accelerated depreciation.[74] Second, Anadarko/Tesoro's statement that "there is no realistic way for the 1982 Depreciation Stipulation and the Interstate Settlement to 'remain in effect simultaneously'" since no shipper is a signatory to the TSA is also a persuasive conclusion. A/T RB at 36. The Commission has previously held that the books of the regulated entities do not control in setting rates.[75] The evidence in this case reflects that the Carriers maintain four sets of books (Tax, GAAP, FERC reporting and FERC ratemaking for TAPS). Ex. A/T-229 at E-14000186. Moreover, the reporting books record depreciation on a straight line basis and the FERC

"book" depreciation. Thus, there is a contradiction between the Carriers rate filings and the position they have taken in this proceeding.

[71] The record demonstrates that the Carriers' Form 6 have not been maintained in a manner consistent with the 1982 Stipulation. Anadarko/Tesoro witness Sullivan testified on the multiple deficiencies in the quality of the data being reported to the Commission. Tr. at 5402.

[72] Internal reports and communications of the Carriers dating to 1998 contradict the Carriers current position. See Ex. A/T192 (graphs illustrating the front-end loading of the depreciation as amounts recovered thru tariffs); Ex. A/T-186 (memorandum explaining accelerated return on capital which caused a timing difference with book accounting); Ex. A/T-188 (memorandum responding to "profit" the depreciation allowance embedded in the revenues is greater than that reflected on the financial records). Other memos confirm that the Carriers may be motivated to have the highest rate possible to decrease the combined government income (taxes and royalties). Ex. A/T-187. The Carriers front-end loading of depreciation saved the owners of TAPS approximately $1.5 billion in windfall profits taxes. Ex. A/T-184.

[73] *See* A/T-190 at Section III-5 (p. 26) ("Any stipulation or agreement previously entered into in the TAPS proceeding by the parties to this Agreement shall continue to be, to the extent not inconsistent with the Agreement, in full force and effect between the parties to this Agreement."); Staff RB at 29.

[74] The accumulated depreciation exceeds the accumulated "booked" depreciation by approximately $1.7 billion. Ex. ATC-266. In comments opposing the TSA, Sohio illustrated that the TSM depreciation exceeds straight line depreciation from 1978-1991. Ex. SOA-57, Attachment B.

[75] *Virginia State Corp. Comm'n v. FERC*, 468 F. 3d 845, 847 (D.C. Cir 2006); *Williston Basin,* 55 FERC at 62,008, 56 FERC at 61,370 .

ratemaking books record depreciation on an accelerated basis pursuant to TSM.[76] Finally, Anadarko/Tesoro's and Staff's other arguments are similarly persuasive.[77] To apply the balances suggested by the Carriers would result in double recovery and an artificially inflated rate base by over $481 million.[78] Ex. A/T-143 at 20, Illus. 8. Thus, it is the amount of accumulated depreciation contained in the Carriers annual rate filings that will be plugged into the Opinion 154-B methodology. Ex. A/T-144, WP2 at 5:7; Ex. A/T -146, WP2 at 4:7.

Issue III.B.2. Are the Carriers entitled to an adjustment to rate base for deferred returns, and if so, what is the appropriate amount?

102. The Carriers claim that the deferred return amount used by Anadarko/Tesoro is not appropriate because it results in a low deferred return balance. The Carriers claim that the TSM deferred return is not consistent with Opinion 154-B deferred return. First, the Carriers state that Anadarko/Tesoro use the incorrect amortization schedule. According to the Carriers, *Lakehead Pipeline Company*, 71 FERC ¶ 61,338 (1995), *reh'g denied*, 75 FERC ¶ 61,181 at 61,591(1996) (*Lakehead*), requires the deferral to be capitalized and recovered through amortization charges (or trended) under Opinion 154-B for all years after 1983. The Carriers state that TSM uses the stipulated depreciation factors in TSA Exhibit F to amortize the deferred balance while the appropriate depreciation schedule for Opinion 154-B is set forth in the Stipulation. Second, the Carriers claim that under the TSM, both the TSM Depreciation and the recovery of TSM Deferred Return are subtracted from the rate base before applying the inflation factor thereby reducing the amount of TSM Deferred Return to be recovered in later years. In addition, the Carriers contend that the TSM carrier

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[76] The accelerated depreciation was established by the TSA which provided a "small upfront refund obligation." Ex. A/T -229 at 14000185.

[77] *See* A/T RB at 33-42; Staff RB at 30-42. The Carriers arguments concerning the Form 73 orders also fails because as witness Sullivan confirmed, those orders only required oil pipelines to begin submitting depreciation data in magnetic tape form. A/T RB at 39; Staff RB at 32 (citing Tr. at 5569-70, 5574-75, 5578 (Sullivan)). The Form 73 orders were not about ratemaking, so as Staff again clarifies, the orders did not change or address how ratemaking is affected when actual depreciation recoveries differ from book accounting depreciation. *Id.* [77] Moreover, the Carriers' position in the case at bar is contrary to their previous position regarding revisions to Sheet 700 of FERC Form 6 reports. They asserted in the cited proceeding that the most relevant information is the TSA supporting information provided to the Commission each year in annual tariff filings. Ex. A/T-191 at 4-5.

[78] A/T RB at 36 (citing Ex. A/T-143 at 20, Illus. 8 showing that to get to the Carriers' Opinion 154-B rate base accelerated depreciation has to be added back in).

property base to which TSM deferred return is applied, excluded $450 million excluded for settlement purposes.

103. Anadarko/Tesoro state that they will accept the deferred returns balances, and related amortization amounts contained in the Carriers' 2005 and 2006 rate filings ($175 million for 2006).[79] Although Anadarko/Tesoro have accepted these amounts, they still believe the amounts are excessive. Staff also agrees that Anadarko/Tesoro have used the correct amounts. Staff states that the amount of deferred returns included in rate base should also reflect the amounts previously amortized on an accelerated basis and collected in the Carriers' rates from 1977 forward. Staff also contends that the balances the Carriers use in their Opinion 154-B presentation are grossly overstated. Last, Staff states that if any deferred returns are to be included in rate base, the amounts proposed by Anadarko/Tesoro are the appropriate amounts to use.

104. However, Anadarko/Tesoro assert that they do not agree with the Carriers' restatement of their deferred returns balance to more than $1 billion in the Carriers' Opinion 154-B proxy. Anadarko/Tesoro contend that the Carriers' balance for deferred returns is inappropriate because the Carriers' witness Mr. Van Hoecke: (1) calculates deferred earnings based on a portion of the $450 million that has already been fully recovered; (2) retroactively inflates property balances by restating the Carriers' recovery of investment from an accelerated to a straight-line basis; (3) retroactively inflates AFUDC by recalculating the Carriers' actual balances with backcasted equity-rich capital structures and through inflated and uniform equity rates of return (as high as 22%); (4) inflates deferred earnings by including deferred earnings on the unamortized balance of unauthorized starting rate base; and (5) inflates deferred earnings by amortizing the deferred earnings balance on a straight-line basis ignoring that the Carriers have already recovered deferred earnings on an accelerated basis.[80]

Discussion/Findings

105. Staff correctly points out that deferred return is a ratemaking concept used in a TOC methodology in Opinion 154-B. Under TOC the inflation portion of the rate of return on equity is extracted, leaving a real rate of return. The real rate of return is

[79] Anadarko/Tesoro claim that there is evidence in the record that would support FERC's decision to eliminate the deferred return balance from the rate base. According to Anadarko/Tesoro, Exhibit A/T-261 illustrates that there was no return deferred and that the Carriers have overcollected at least $8 billion from shippers. A/T IB at 59 n.50 (citing Tr. at 6032-6035).

[80] A/T IB at 61-62.

applied to the pipeline's equity share of rate base to determine the yearly allowed equity return in dollars. The dollars related to the inflation portion of the equity return, are "deferred" for recovery in future rates. In future rates the deferred amounts are added to rate base as an equity rate base "write-up" (the equity portion of rate base is "trended" up), and amortized as an expense like depreciation over the useful life of the pipeline.[81]

106. Staff's reasoning is correct and falls in line with the conclusions reached above.[82] The Carriers' arguments concerning the differences between the TSM deferred returns and Opinion 154-B returns has no decisional impact *vis a vis* the amounts collected in the Carriers' rates over the years. *See id.* It is irrelevant that the TSM calculations of deferred returns is inconsistent with Opinion 154-B calculations and the Commission's pronouncements implementing Opinion 154-B in *Lakehead*.[83] Mr. Van Hoecke's (Carriers witness) approach (adding anew the deferred earnings) results in double recovery and is rejected.

107. Staff and Anadarko/Tesoro are correct that the deferred return amounts have already been collected via the TSM through the Carriers' use of a 100% equity structure[84] and APB.[85] The TSM acted much like TOC, deferring a specified amount of return dollars from early years to later years. The accelerated depreciation schedule and the plant balances are stated in the TSM formula and in the Carriers rate fillings, the accelerated recovery of deferred return and the specific TSM deferred return balances and annual deferred return expenses were included in the Carriers 2005 and 2006 rate filings.[86] The Carriers have already recovered the deferred return element; however, as Staff notes, "to be true to the approach, we must take the state of the ratemaking record as we find it." *See* Staff IB at 53, A/T IB at 60.

108. The Carriers argue that *Lakehead* and other Commission pronouncements require pipelines that existed prior to Opinion 154-B to begin the calculation of

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[81] *Opinion 154-B*, 31 FERC, *supra,* at 61,834-35; Staff IB at 51-52.

[82] Staff RB at 36.

[83] *See* A/T RB at 45.

[84] *See* Staff IB at 53; ATC-14, Sections II-6 (p. 15), II-7 (p.17), II-8 (p.18) (stating that the amounts are to be included in the TRR); Ex. A/T 3 at 39-40 (Brown); Ex. A/T-79 at 23 (Sullivan).

[85] *See* Staff IB at 53; Ex. A/T-3 at 39-41 (Brown); Ex. A/T-79 at 23 (Sullivan).

[86] ATC-84, Sheet E, line 121 at 34, 40, 46, 52; Toof, Tr. 5101-02; Grasso, Tr. 5985-86.828, 836, 839-40, 853-56; Brown, Tr. 4679-8.

deferred return with the pipelines' rate base beginning December 31, 1983.[87] Staff agrees that in *Lakehead* the Commission determined that in transitioning from a valuation to a cost-based TOC, the appropriate starting rate base under the TOC methodology is the balance as of the date Opinion 154-B became effective (December 31, 1983). Staff IB at 55. However, Staff effectively refutes the Carriers' argument that the correct deferred return balance must be calculated in accordance with the Carriers' Opinion 154-B proxy. *Id.* [88] As a matter of fact, citing SFPP[89] Staff correctly argues that the Carriers cannot backcast and recreate rates. The holding in SFPP is right on point, when setting a cost based rate for the future there is no need to allow an additional adjustment for inflation already recognized and collected in rates.[90]

109. Staff states that Lakehead's rates were charged under the valuation methodology and did not include a deferred return cost component. *Id.* Additionally, Staff aptly notes that in this case, the deferred balances and annual deferred costs are known and reflected in the Carriers' TSM filings. *Id.* Staff's arguments are persuasive, and as discussed above, the appropriate amounts to use are those that reflect what the Carriers' have actually collected in rates. Those amounts are

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[87] Carriers' IB at 56; *Lakehead*, 75 FERC at 61,591.

[88] Evidence in this case indicates that the Carriers have collected approximately $6.6 billion in deferred earnings. Ex. A/T-44 & ATC-23, Sum Ln. 121, Amortization of Differed Returns, minus Ln. 7, Accumulated Amount of AFUDC; Ex. A/T-145, Stmt. E.

[89] *SFPP supra*, 117 FERC at 12-16.

[90] Anadarko/Tesoro and Staff explain that it could be concluded that there should be no allowance for deferred return from prior periods due to the TSM. Witnesses Brown and Sullivan (A/T) testified that TSM calculated deferred returns on remaining investment using 100% equity structure. This assumes incorrectly that the pipeline was constructed with only equity, overstates the deferred return, and violated the principle of Opinion 154-B that deferred returns are not allowed on debt-financed rate base. Ex. A/T-3 at 39-41. Additionally, after 1989, TSM allowed a larger nominal return known as Allowance Per Barrel (APB) adjusted for inflation yearly back to 1983. ATC-14, §II-7(b); Ex. A/T 3 at 40; Ex. A/T-79 at 23; Tr. 38 at 5924-26; Ex. A/T-180 at 13. (Horst described APB as allowing the Carriers to earn a profit as long as ANS was transported. Id. at 14. The APB charge was originally $0.35 in 1989 and now is $1.19 in 2006. In conclusion, both Staff and Anadarko and Tesoro assert that the TSM overstated deferred return and after 1989 inflation for return purposes has been more than recovered in TSM. However, since Anadarko and Tesoro accept the amounts in the Carriers' rate filings this point is made for illustrative purposes only.

contained in the Carriers' TSM filings. The Carriers' attempt to use the amount of their deferred returns reflected in Form 6 is therefore rejected. Carriers' RB at 45. The Carriers' claims that the TSM item labeled "deferred return" cannot be considered "actual return" is accordingly rejected.[91]

110. Thus, the appropriate adjustment and amounts for deferred returns are reflected in Anadarko/Tesoro's Opinon-154-B cost-of-service presentation. The amount of deferred return in 2005 is $198.31 (in millions). Ex. A/T-144, WP2 at 5:18 (Col. "2004"). The amount for 2006 is $175.283 (in millions) A/T 146, WP2 at 4:18 (Col. "2005").

Issue III.B.3. What is the appropriate amount of AFUDC?

111. The Carriers contend that Mr. Van Hoecke's Allowance for Funds Used During Construction (AFUDC) balances must be used for Opinion 154-B. According to the Carriers, Mr. Van Hoecke calculated the AFUDC in accordance with the Commission's oil pipeline cost of service regulations set forth in 18 C.F.R. § 346.2(c)(6) (2006). The Carriers state that Anadarko/Tesoro have incorrectly extracted the amounts in the Carriers TSM submissions and, in addition, did not follow the Commission's regulations. However, the Carriers do not recognize that this issue is purely derivative of other issues.[92]

112. Anadarko/Tesoro and Staff state that the appropriate balance for AFUDC to be included in rate base is the amount reported in the Carriers' annual rate filings. Anadarko/Tesoro state that the AFUDC amounts included in the Carriers' rate base for the period 1977 through 1983 are shown in TSM-6. All subsequent years are shown in the Carriers' annual rate filings, Anadarko/Tesoro contend.[93] Anadarko/Tesoro and Staff also state that these balances reflect the amounts that have

[91] The Carriers state that contention is based on the same arguments in Section III.A. which basically claims that third parties cannot rely on TSM elements which are an inseparable settlement package. In addition, the Carriers' arguments concerning Staff's and Anadarko/Tesoro's statements that the Carriers' over collected deferred return and this component could be eliminated from the Opinion 154-B calculation is not addressed (along with the Carriers' retroactive ratemaking arguments) since Anadarko/Tesoro and Staff have agreed to accept the Carriers' balances which includes deferred return.

[92] Carriers RB at 47.

[93] Anadarko/Tesoro state that the AFUDC balances are calculated consistently with the principles in Opinion 154-B, but are for a different period because they pre-date Opinion 154-B. A/T IB at 63.

already been collected by the Carriers. In addition, Anadarko/Tesoro state that the deferred balance has been amortized from 1977 through 2005.

113. Staff states that AFUDC is also included in rate base and recovered in basically the same manner as the property balances discussed in Issue III.B.1. Staff IB at 56. Thus, Staff asserts, the amount used for AFUDC must be consistent with the property balance issue. Staff also claims that AFUDC was one of the rate elements whose recovery was accelerated under the TSA in order to allow the Carriers to avoid making any refunds for the 1977 thorough 1981 period and limited refunds for the 1982 through 1985 period. The Carriers' balances for AFUDC are inappropriate, Anadarko/Tesoro and Staff assert, because the Carriers ignore the AFUDC that has been included in the Carriers' rates and instead, recalculate it. Thus, using the Carriers' amounts would result in double recovery, Anadarko/Tesoro and Staff contend.

Discussion/Findings

114. As Staff explains, AFUDC "is a method of deferring, in a capital account, costs associated with plants under construction for inclusion in a utility's rate base once the plant is put into service." Staff IB at 56 (citing *Kentucky Utilities Co. v. FERC*, 760 F.2d 1321, 1323 (D.C. Cir. 1985)). The amounts used by Anadarko/Tesoro reflect the amount of AFUDC actually collected by the Carriers. A/T-3 at 31 (Brown); Tr. 5930,5954-55, 5983 (Grasso); Tr. 5824-25 (Grasso). Thus, the appropriate amounts of AFUDC to include in rate base are listed in Exhibits A/T -144 Stmt. F (2005), A/T-146, Stmt F (2006).

Issue III.B.4. What is the appropriate amount of ADIT?

115. The Carriers state that the only issue with regard to Accumulated Deferred Income Tax (ADIT) is the appropriate input for past depreciation expense. The Carriers claim that Mr. Van Hoecke has correctly used the depreciation expense balances recorded in the Form 6 annual reports pursuant to the Stipulation. TSM derived depreciation should not be used, the Carriers assert.

116. Anadarko/Tesoro contend that the appropriate balance for ADIT is reflected in the Carriers' annual rate filings. The Carriers' Opinion 154-B presentation, Anadarko/Tesoro assert, ignores the ADIT that has been included in the rate filings, and instead, recalculates the amount. Anadarko/Tesoro claim that the Carriers have added $183.11 million to their Opinion 154-B rate base in 2006 for items including ADIT. A/T IB at 65 (citing Ex. A/T-78 at 55; Ex. A/T-143 at 20 Illus. 8). According to Anadarko/Tesoro, this additional amount is the derivative result of the impact on ADIT, AFUDC, and working capital when the Carriers' Opinion 154-B recalculates and adds deferred earnings, a starting rate base adjustment, and then ignores the

accelerated portion of the depreciation to the Carriers' filed rate base. Staff states that ADIT is a mechanically calculated number that partially derives from the deferred earnings, depreciation, and other rate base assumptions used to calculate the rates. Staff IB at 57 (citing A/T-78 at 55). Thus, Staff asserts, once these issues are resolved ADIT can be determined.

Discussion/Findings

117. The parties seem to agree that the resolution of the issue concerning the appropriate depreciation expense will determine the outcome of this issue. ADIT arises because "certain deductions from income are recognized by the IRS for tax purposes before they are recognized for book or rate purposes. The effect of the earlier recognition of deductions for tax purposes is that ratepayers will provide the pipeline with revenues to cover taxes which will not actually be paid until some time in the future." Staff IB at 57. In addition, Staff states that "ADIT is the cumulative amount of such revenues which have been supplied by ratepayers but not yet paid out in taxes by the pipeline, and Commission practice requires this prepaid expense to be deducted from rate base." Staff IB (citing *Trans Alaska Pipeline Sys.*, 10 FERC ¶ 63,026 at 65,218 (1980); Opinion 154-B, 31 FERC at 61,837 n.55).

118. Based on the determinations in this decision it is found that the appropriate amounts of ADIT are reflected in the Carriers annual rate filings as stated by Anadarko/Tesoro and Staff. Thus, the amount of ADIT for 2005 is $46.20 (in millions). A/T IB at 64; Ex. A/T-144, Stmt. E, ln. 11. The amount for 2006 is $43.00 (in millions). A/T IB at 64; A/T-146, Stmt. E, ln. 11.

Issue III.B.5. Are the Carriers entitled to a starting rate base write-up, and if so what is the appropriate amount?

119. The Carriers claim that Opinion 154-B presumed that all oil pipelines in existence as of the date of the opinion (June 28, 1985) would be allowed the starting rate base (SRB) write-up. Thus, the Carriers contend, the burden is on the challenging party to show why the SRB write-up should not be permitted in a particular case. Carriers' IB at 61 (citing *Lakehead*, 71 FERC at 62,311). The Carriers state that the portion of the SRB that exceeds the Carriers' depreciated original cost rate is referred to as the SRB write-up. Mr. Van Hoecke, the Carriers assert, correctly calculated the SRB using the Cost of Reproduction New (CRN) calculated by Mr. Ganz.

120. Flint Hills claims that a total of $322.52 million or $.99 per barrel needs to be added to the SRB. This consists of two components which Flint Hills claims are an inclusion of an SRB amount and a corresponding deferred return back to 1983. Flint Hills also contends that Anadarko/Tesoro's rejection of a SRB write up is meritless.

Flint Hills posits arguments similar to the Carriers' which, for the most part, state that without the TSA, the TAPS rate base would have been calculated using valuation and that prior to the TSM the TAPS rates were filed under the ICC valuation methodology. Alternatively, Flint Hills suggests a transition cost adjustment for the remaining APB as compensation for the loss of the APB if the TSA does not run its course.

121. The Carriers state that Anadarko/Tesoro's arguments that the Carriers are not entitled to a SRB write-up are incorrect. First, the Carriers assert that contrary to Anadarko/Tesoro's assertions, the Carriers relied on the ICC valuation methodology for the entire period from start-up through approval of the TSA. Second, the Carriers claim that they relied on the valuation methodology long after the initial rates were filed. The Carriers claim that they worked with the Commission's Valuation Branch to finalize the valuation reports on TAPS and that they continued to be subject to the Commission's valuation regulations even in late 1984. The Carriers claim that it was not until seven years after the initial TAPS rates were set that it can be fairly said that an oil pipeline should no longer rely on valuation. Third, the Carriers assert that Anadarko/Tesoro's contentions that final TAPS rates were not set under valuation and that a final valuation report was not issued do not rebut the presumption of their entitlement to an SRB write-up. Last, the Carriers claim that inclusion of the SRB write-up does not inflate their Opinion 154-B rate base since, as Mr. Van Hoecke has shown, including the SRB write-up results in a lower rate base figure as of December 31, 1983.

122. Anadarko/Tesoro and Staff argue that the Carriers are not entitled to a SRB write-up because the Carriers are not transitioning from regulation under the valuation methodology. According to Anadarko/Tesoro and Staff, the Commission only intended the SRB to be a transitional rate base for existing pipelines that had assets that were valued under the valuation formula. In fact, they state that Opinion 154-B only allowed a SRB adjustment for assets that were transitioning from valuation to TOC. No valuation order was ever issued for TAPS by the ICC or FERC, Anadarko/Tesoro and Staff claim. Anadarko/Tesoro also assert that every final rate on TAPS for the past 30 years has been based on the TSM and not the valuation methodology. Thus, Anadarko/Tesoro state, they did not include a SRB adjustment in their Opinion 154-B presentation. The Carriers inflate their Opinion 154-B proxy with a SRB adjustment of $421.10 million calculated (backcasted) for 2006, Anadarko/Tesoro and Staff contend. Staff further asserts that neither the TSA nor the TSM mention the valuation methodology. This is relevant Staff states, since from the commencement of TAPS operations to date, the TSA has established the revenue requirements on TAPS.

Discussion/Findings

123. The Carriers are not entitled to a SRB write-up because the Carriers' assets were never valued under the valuation methodology. The Carriers and Staff aptly note that with respect to the SRB write-up, Opinion 154-B left the door open for "a participant in a rate case [to] raise this issue and attempt to prove that a particular company is not entitled to the instant starting rate base."[94] Staff and Anadarko/Tesoro have shown that the Carriers are not entitled to a SRB write-up and, accordingly the Carriers' and Flint Hills' arguments are rejected. Accordingly, it is found that Anadarko and Tesoro have rebutted the Carriers' alleged presumption and thus, the Carriers are not entitled to an SRB write-up.

124. First, the Carriers never relied on valuation. The Commission's language in Opinion 154-B is clear. The SRB write-up was only *intended* for "existing assets that are currently valued under the valuation formula...." Opinion 154-B, 31 FERC at 61,833. Importantly, the TAPS rates were never calculated under the valuation formula. The Carriers claim that their interim rates were based on valuation. Carriers' IB at 62-64. However, Staff and Anadarko/Tesoro have shown that this argument fails for several reasons. The Carriers' interim rates were not final and subject to refund and when the final rates were set on TAPS, those rates were based on the TSM and not valuation.[95] The Carriers simply never had an approved rate on TAPS under the valuation method. *Id.*; Staff RB at 39. It is also telling that the Commission never issued the Carriers a valuation report.[96] In addition, the Carriers' initial filings were based on different methods.[97]

[94] Opinion 154-B, 31 FERC at 61,836 (citation omitted); The Carriers argue that *Lakehead Pipe Line Co., L.P.*, stands for the proposition that all oil pipelines are presumptively entitled to a SRB write-up. 71 FERC ¶ 61,338. The Commission noted that Lakehead had used the valuation method "long-term" and this is why the Commission stated that Lakehead was presumptively entitled to a SRB. *Id.* at 62,309. The record here, as discussed below, indicates that the Carriers never used valuation.

[95] A/T IB at 68; RB at 47-48; Staff RB at 39; IB at 59-60; Ex. A/T-79 at 19-20 (Sullivan stated that the Carriers were never regulated under the valuation rate method); Ex. A/T-3 at 35 (Brown stated that "[t]he Carriers' rates from 1977 to date have been calculated under the TSM and accepted under the terms of the Interstate Settlement... the Carriers have never had their rates approved or set by the ICC or by the Commission under the ICC valuation methodology.").

[96] A/T RB at 47; IB at 65; Staff IB at 60; RB at 41; Ex. A/T-79 at 20 (Sullivan); Tr. 2074 (Ganz).

[97] A/T RB at 51; IB at 67 n.55; Tr. 5800-01 (Grasso) (The eight Carriers filed their initial rate filings at the ICC using different rate theories: some were original

125. The Carriers' arguments concerning *Lakehead Pipe Line Co., L.P.*, 75 FERC at 61,591 are flawed. Contrary to the Carriers' assertions, in Opinion 154-B, the Commission specifically stated that it does make a difference which methodology the pipelines' rates were based on. Carriers RB at 47-48. The Commission stated that the SRB adjustment was intended for "existing assets that are *currently valued under the valuation formula*...." Opinion 154-B, 31 FERC at 61,836 (emphasis added). This language precludes pipelines that were not using the valuation method at the time Opinion 154-B was issued from entitlement to a SRB write-up. *See id.*

Issue III.B.6. What is the appropriate amount of other rate base items?

126. The Carriers state that for the reasons listed in section III.B.1 the other rate base items which include land, working capital, and miscellaneous plant adjustments must be based on the Carriers' Form 6 balances. Anadarko/Tesoro claim that there should be no other material rate base items except for the credit to rate base for DR&R collections. Staff states that other rate base items such as land and working capital are derivative of other issues and will follow from rulings on those other issues.

Discussion/Findings

127. The parties recognize that the resolution of this issue is tied to the findings concerning Issue III.B.1. In that section, it was found that the correct inputs are found in the Carriers' annual rate filings. Staff discusses the $450 million exclusion from rate base in this section. It has already been found that the $450 will be excluded from rate base as discussed above. Thus, there are no other material rate base items at issue with the exception of the DR&R rate base credit issue discussed below.

Issue III.B.7. Should asserted DR&R collections and earnings be credited against rate base, and if so, what is the appropriate amount?

128. This issue is discussed in section III.D.

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cost: and some were "original cost filings guised as valuation." Tr. at 5800-5801. The common theme being to file "the highest possible tariff... in order to minimize government income [taxes and royalties] from the field and the pipeline." Ex. A/T-187 at 1. The ICC interim rates were not intended to have permanent effect and were not "prescribed" rates. Ex. A/T-157 at 1, 4, 7. Therefore, it is found that the Carriers interim rates do not support their claims. Consequently, the Carriers SRB calculations are not given any weight.

Issue III.C. What is the appropriate level of operating expenses excluding depreciation and DR&R?

129. Anadarko/Tesoro and Staff state that they accept the Carriers' operating expenses, exclusive of depreciation for 2005 and 2006. Ex. A/T-143 at 5-6, and Illus. 6; Ex, ATC 37-41, Stmt. B (2005); Ex. ATC-90-94, Stmt. B (2006); Carriers IB at 70 n.63. As a result, there is no issue to resolve.

Issue III.D. What is the appropriate depreciation expense?

130. The Carriers argue that the Stipulation is still in effect, and accordingly, the proper amount of depreciation expense is reflected in Form 6. Moreover, the Carriers assert, since they have not proposed to change the approved depreciable life of 2011, that end-life remains in effect. The Carriers contend that if the Commission opts to revise the depreciable life, the Carriers have also produced a depreciation study using an end-life of 2034. These recalculated amounts, the Carriers assert, were plugged into the Opinion 154-B model and also prove that the Carriers' rates are just and reasonable using the 2034 depreciable life. The Carriers claim that Anadarko/Tesoro's depreciation study, done by Mr. Sullivan, is flawed. According to the Carriers, Mr. Sullivan's study is flawed because: (1) the property and accumulated depreciation balances are derived from the TSM and (2) because TSM-derived balances are not broken out by property account, Mr. Sullivan had to allocate TSM amounts arbitrarily based on Form 6.

131. Anadarko/Tesoro state that they have calculated the correct depreciation expense using the Carriers' annual rate filings that reflect the Carriers' previous recovery of investment and a remaining life of 2034. Anadarko/Tesoro claim that all the parties agree that the useful life of TAPS will extend through at least 2034. According to Anadarko/Tesoro, the Carriers' rate position is inconsistent because their Opinion 154-B presentation uses a useful life ending in 2034 while their filed rates use an ending date of 2011. Anadarko/Tesoro contend that the Carriers' depreciation study is flawed because it relies on incorrect plant balances from Form 6 that do not reflect their previous investment and Mr. Spanos failed to adjust for an overaccrual.

132. Anadarko/Tesoro state that contrary to the Carriers arguments, Mr. Sullivan only had to allocate the property balances to individual accounts because the Carriers failed to properly update their depreciation study. The Carriers TSM filings did not break out the overall property balances by account, Anadarko/Tesoro claim, and consequently, the lack of accurate account-by-account balances was caused by the Carriers. Staff states that the appropriate property balances are found in the Carriers'

rate filings. In addition, Staff contends that the Carriers' 2034 depreciation study conducted by Mr. Spanos, should also be used.

Discussion/Findings

133. The parties agree that depreciation expense is calculated using the appropriate net property balance and a reasonable estimate of the remaining useful life of TAPS. Carriers RB at 55; A/T IB at 73; Staff IB at 66; RB at 46. First, the correct plant balances are those proposed by Anadarko/Tesoro as discussed in section III.B.1. The Carriers' depreciation study based on an end-life of 2034 used the Form 6 balances which do not reflect previously recovered amounts.[98] The Carriers take issue with Anadarko/Tesoro's property allocation. Mr. Sullivan properly allocated the correct property balances to individual accounts using the proportions employed by Mr. Spanos. Tr. 5468-71 (Sullivan). Anadarko/Tesoro's study used the balances from the Carriers' TSM filings and the survivor curves used by Mr. Spanos.[99] In addition, Mr. Sullivan corrected for an overaccrual of $147 million which Mr. Spanos admittedly had not done in his own study. Tr. 1741-44 (Spanos); Tr. 5470-71 (Sullivan). Again, Mr. Sullivan's testimony is credible and is accorded substantial weight. Thus, Anadarko/Tesoro's depreciation study will be used since it is based on correct and more reliable data. Second, the correct end-life of TAPS is 2034 as corroborated by several witnesses.[100] Accordingly, it is found that the correct depreciation expense balances are those proposed by Anadarko/Tesoro.[101]

[98] Tr. 1707, Ex. A/T-141 at 7. The Stipulation is no longer in effect, therefore the Form 6 balances should not be used. *See* Section II.B.1, *supra*.

[99] Staff and the Carriers advocate the use of Spanos's study which includes his survivor curves, as long as it applies the correct property balances. Staff IB at 66; Carriers IB at 70-71; Tr. 5471 (Sullivan).

[100] Ex. A/T-141 at 4 (Sullivan); A/T-79 at 18-19 (Sullivan); ATC-4 at 46 (Kalt); ATC-154 at 4 (Spanos); A/T-32 at 4 (TAPS right-of-way-extended to 2034); Carriers' RB at 56.

[101] The depreciation expense for 2005 is $14.06 (in millions). Ex. A/T-144, Stmt B4, ln. 6. The depreciation factor for 2005 is 3.8095. A/T-142; Tr. at 5745-46 (Grasso describes the calculation of the depreciation factor). The depreciation expense for 2006 is $13.48 (in millions). Ex. A/T-146 Stmt. B4, ln. 6; Ex. A/T-142. Anadarko/Tesoro note that Mr. Grasso agreed that for 2006 it would be appropriate to modify the depreciation factor to reflect one year less of remaining life (from 3.8% to 3.9%). Mr. Grasso verified that the change would increase depreciation expense slightly, but would not impact the overall TAPS rate. A/T IB at 75; Tr. 5988-89.

Issue III.E. What is the appropriate DR&R expense?[102]

134. The Carriers state that the TSA included a negotiated DR&R allowance in the TSM ceiling rates ($2.2 million for 2005 and $2.1 million for 2006). Mr. Van Hoecke did not include any amounts for DR&R when calculating the Opinion 154-B rates, the Carriers assert. However, the Carriers note that in deciding to exclude these amounts, Mr. Van Hoecke did not make a determination as to whether DR&R expenses were necessary or appropriate. The Carriers contend that their filed rates are just and reasonable whether or not they include any amounts for DR&R and, accordingly, they should be able to recover the full amount of their filed rates for 2005 and 2006.

135. Anadarko/Tesoro and Staff argue that there should be no expense allowed for DR&R. The Carriers have failed to support the allowance for DR&R included in their filed rates, Anadarko/Tesoro contend. In addition, Anadarko/Tesoro and Staff assert that the Carriers' Opinion 154-B proxy did not include any DR&R allowance and the Carriers did not provide any evidence related to this issue. Thus, Anadarko/Tesoro and Staff conclude, the Carriers' DR&R allowance should be rejected. Anadarko/Tesoro and Staff contend that the Carriers fail to account for the amounts of DR&R they have already recovered and associated earnings. The Carriers' massive front-loaded recovery of DR&R is well documented in the record, Anadarko/Tesoro claim. Anadarko/Tesoro and Staff also argue that the Carriers' parents used the funds as unrestricted capital and should be required to account for such earnings. Finally, Anadarko/Tesoro claim that the Carriers now have approximately $15 billion more in DR&R funds than they would need to conduct DR&R activities.

136. Anadarko/Tesoro and Staff assert that several key assumptions underlying the DR&R collection schedule have changed and will cause the Carriers collections to grow faster than originally anticipated when the schedule was established. They state that the assumptions changed as follows: (1) the life of TAPS was extended from 2011 to at least 2034; (2) the federal corporate income tax rate changed from 46% to the current 35%; and (3) the IRS allowed the Carriers to deduct an unanticipated $900 million. The Carriers do not dispute these changes, Anadarko/Tesoro and Staff contend. Anadarko/Tesoro and Staff claim that based on applying an average earnings rate (attributable to the parents) the total for DR&R collections and earnings is more than $17.2 billion. When compared to the undisputed DR&R obligation

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[102] This section discusses all DR&R related issues including those addressed in Issue III.B.7 (Should asserted DR&R collections and earnings be credited against rate base, and if so, what is the appropriate amount?) and Issue III.M (Are any other remedies related to DR&R appropriate in this proceeding?).

amount of $2.63 billion proffered by the Carriers, Anadarko/Tesoro and Staff assert, there is clearly no need for further DR&R collections.

137. Staff states that the question here is what earnings assumption accurately reflects the time value of the accelerated collection of the DR&R funds and the unrestricted use of these funds by parents. Anadarko/Tesoro advocate, and Staff endorses, the use of the actual, historic, after-tax earnings rates of the parents. Staff RB at 49; A/T IB at 109. The Carriers claim that the risk-free rate is the proper rate and the rates requested by Anadarko/Tesoro and Staff are unjustified. Carriers' IB at 124.

DR&R Rate Base Credit[103]

138. The Carriers argue that DR&R collections and earnings should not be credited against rate base. Anadarko/Tesoro's and Staff's reliance on *Kuparuk Transportation Co.*, 55 FERC ¶ 61,122 at 61,382-83 (1991) (*Kuparuk*), is misplaced, the Carriers contend. According to the Carriers, this is because in *Kuparuk* the Commission adopted an accrual methodology for DR&R and, in contrast, an annuity methodology is used for TAPS. The difference, the Carriers contend, is that the DR&R amounts in this case were computed on an annuity basis and the earnings on the collections are assumed to be necessary to fund the ultimate DR&R obligation. Thus, the Carriers assert, the funds will not be sufficient to cover the obligation if the Carriers do not retain the amounts collected. Allowing a rate base credit would amount to crediting the shippers with presumed earnings twice – once in the annuity formula and again through the rate base deduction, the Carriers contend. Finally, the Carriers claim that their DR&R collections and earnings are insufficient to fund the Carriers' ultimate DR&R obligation and crediting the rate base for these amounts would only further complicate the problem.

139. According to Flint Hills, the principle of intergenerational equity attempts to treat shippers equally over a period of time by ensuring that shippers during one period do not pay disproportionately higher costs than later shippers. Virtually all of the DR&R funds were collected during the first half of the TAPS life, so no funds need to be collected going forward, Flint Hills asserts. Flint Hills argues that intergenerational equity is a requirement for rates to be just and reasonable and must be applied to part of the DR&R funds. Flint Hills claims that intergenerational equity should prevent the use of DR&R funds to reduce the rate base and future shipper's rates. Therefore, Flint Hills asserts, Anadarko/Tesoro's request to credit the rate base should be rejected. In addition, Flint Hills argues that the solution is for DR&R funds to be collected from future shippers and paid to past shippers that paid the majority of

[103] This is issue III.7.

the DR&R expense such as Williams. Since 2006 is approximately the midpoint in the life of TAPS, Flint Hills states that half of the funds can refunded to shippers who paid the DR&R funds from 1978-2006, without interest, and those funds can then be collected from shippers from 2005 forward. Finally, Flint Hills claims this solution would also avoid the controversy as to which rate of return should apply to the earnings on these funds.

140. Anadarko/Tesoro and Staff state that DR&R should be credited to rate base. The Carriers' understate the DR&R balance and do not reflect the use of funds as unrestricted capital, they claim. Moreover, Staff states that the prepayments represent interest free loans from ratepayers, that if not properly recognized, would allow a pipeline to benefit from the time value of the funds without compensating the ratepayers. According to Anadarko/Tesoro and Staff, *Kuparuk* requires pipelines to credit rate base with DR&R collections. 55 FERC at 61,382-83. Anadarko/Tesoro state that this is to: (1) compensate ratepayers for advancing those funds before they are needed for DR&R activities and (2) eliminate the issue of the interest rate at which DR&R funds will grow in the future.

141. Anadarko/Tesoro state that the Carriers' witness, Mr. Van Hoecke, has recognized that in a similar situation, pre-collected funds for future expenses should be deducted from rate base. The amount of the rate base credit in this case, Anadarko/Tesoro assert, will be limited to the amount of the Carriers' current rate base because the amount of DR&R collections and earnings exceed the rate base of $576.86 million. Anadarko/Tesoro state that the amount of collections and earnings through 2005 totals $17.265 billion. Staff asserts that the amount through 2004 is more than $1.5 billion. Anadarko/Tesoro and Staff state that they are not proposing a negative rate base or automatic zeroing out of future Carrier investment. Anadarko/Tesoro claim that even with such a rate base credit, the Carriers would still recover all their operating expenses, a depreciation allowance, an amortization of deferred return from prior periods, and a tax allowance on those deferred returns.

142. Staff states that the problem in this case is that the Carriers began collecting DR&R early and in huge front-loaded amounts and, as a result, the actual collections plus the associated earnings have produced an enormous DR&R fund. The total amount, Staff contends, is both greater than the Carriers' rate base and the amount that will eventually be required to complete the DR&R task. The Commission, Staff states has allowed pipelines with a zero rate base a management fee if needed as an incentive to continue operating the line.

Other DR&R Remedies

143. The Carriers argue that the remedies requested by Anadarko/Tesoro are not necessary or appropriate. The Carriers claim that there has been no overcollection of

DR&R funds. First, the Carriers assert that this is because their liability for DR&R is unlimited and the ultimate scope and costs of DR&R is uncertain. Thus, the Carriers conclude, the relief sought is speculative and premature. Second, the Carriers argue that Anadarko/Tesoro's assumption that specific DR&R collection amounts are identifiable is inconsistent with the TSA. The Carriers were not required to account separately for such amounts and neither the TSA or the Commission's orders accepting it suggested that the amounts collected in rates were traceable to the amounts in the DR&R allowance exhibit. The Carriers assert that the overcollection analysis presented by Anadarko/Tesoro was flawed and when corrected, showed that the 2005 earnings and collections of DR&R would be $2.365 (invested at the Moody's Double A bond rate) or $2.06 billion (invested at the risk-free earnings rate). Use of the Carriers' parents' rate of return on the book value of equity to determine DR&R earnings is contrary to *Kuparuk* that allowed an earnings rate base on the pipeline's weighted average after-tax cost of capital. *Kuparuk*, 55 FERC at 61,382. Next, the Carriers argue that the risk-free rate is the proper rate because that is the only prudent investment strategy. The Carriers also assert that this is the proper rate because they bear the risk with regard to such investments.

144. Third, the Carriers claim that granting a refund, rate base credit or requiring a separate DR&R fund as proposed by Anadarko/Tesoro would violate the rule against retroactive ratemaking and constitute an unlawful taking. The Carriers also argue that the rule against retroactive ratemaking bars the requirement of an accounting, and in addition, argue that it is not required by the TSA. The Carriers state that any revenues that the TAPS Carriers collected for DR&R prior to 2005 have become final, are no longer subject to refund, and were collected without any restrictions or conditions. The Carriers argue that Flint Hills' proposed relief should also be rejected because Flint Hills' proposed reallocation also violates the filed rate doctrine and is not supported by precedent.

145. Anadarko/Tesoro request three additional remedies related to DR&R. First, Anadarko/Tesoro request a full accounting for all DR&R collections and earnings to date. According to Anadarko/Tesoro, the Carriers have never accounted for their DR&R collections and earnings. Anadarko/Tesoro argue that their DR&R calculations, which use the actual, historic, after-tax earnings rates of the Carriers' parents, should be accepted. The Carriers' admittedly did not invest the DR&R funds in treasuries, but instead used the amounts as unrestricted funds, and for that reason the Carriers' proposal to use the "risk free" rate should be rejected. Staff states that this request is reasonable and necessary before the Commission can consider what to do with the fund. The Commission has required an accounting for these types of funds previously and should do so here, Staff contends. Staff states that the accounting must allow the Carriers' to maintain an adequate reserve to meet the estimated costs of DR&R plus inflation for another 25 years until work is completed. Staff states that in addition to the $576 million that the Carriers may retain, the

Carriers should also be allowed to retain the remaining obligation of $2.054 billion. This remaining balance may still be commingled with the parents' general corporate funds, but should also be presumed to continue to earn a return at the parents' book equity rate. Staff also states that if the earnings on the $2.054 billion does not keep up with the cost of inflation, or other changes in the cost of DR&R then the Carriers should be allowed to come to the Commission to request an adjustment to their rates. Staff RB at 78-79.

146. Second, Anadarko/Tesoro and Staff request that the amount of the overcollection be refunded to the ratepayers. Staff and Anadarko/State that the amount of funds collected far exceeds the final cost of DR&R and that amount will only grow for another 25 years. The Carriers should not be allowed to reap a windfall on the excess DR&R collections and Commission precedent does not allow pipelines a return on expense, Anadarko/Tesoro and Staff claim.

147. Third, Anadarko/Tesoro and Staff request that the Carriers be required to account for the collections and earnings and report such amounts to the Commission annually. Anadarko/Tesoro also request the establishment of either a segregated fund if an accounting is not required. In *Kuparuk*, Anadarko/Tesoro claim, the Commission declined to establish a segregated DR&R fund, on the condition that the pipeline establish internal accounting for DR&R. Anadarko/Tesoro assert that the Carriers' claim that DR&R recovery has no meaning outside the TSM is meritless. Anadarko/Tesoro claim that the remedies they are proposing will put the Carriers' DR&R recoveries and projected expenses in sync and ensure that DR&R revenues retained by the Carriers are accounted for in accordance with FERC guidelines.

148. Finally, Anadarko/Tesoro and Staff state that contrary to the Carriers' assertion, implementing a rate base credit on a prospective basis, terminating DR&R collections in the current rates which are subject to refund do not constitute retroactive ratemaking or an unlawful taking. Staff states that the uncertainty of the final cost of DR&R is not a reason for the Commission to abdicate its responsibility to monitor the amount of DR&R collected, recognize and account for the earnings the Carriers (or their parents) have made, to periodically adjust the size of the fund, and insure that in the end, the Carriers will have enough to perform the DR&R without retaining excess amounts. In addition, Staff states that DR&R costs by their nature are unlimited and unknown. However, Staff argues, this is why regulated utilities periodically adjust their rates to keep them in line with the most current cost estimate.

Discussion/Findings

149. Anadarko/Tesoro and Staff are requesting several remedies in this proceeding related to DR&R: (1) a credit to rate base (discussed by the parties in section III.B.7); (2) termination of further DR&R collections in rates (discussed by the parties in

section III.E); (3) a full accounting of DR&R collections and earnings to date; (4) refunds to ratepayers of DR&R over-collections to date; and (5) establishment of either a segregated fund or specific accounting procedures for the DR&R amounts the Carriers are permitted to retain.

DR&R expense

150. The Carriers arguments concerning specific elements of the TSA not being applicable to non-signatories was rejected above. The TSA states: "The DR&R Allowance to be included in the Total Revenue Requirement for each year to provide for the eventual dismantlement, removal and restoration of TAPS is given in Exhibit E. Ex. T/A 33 at 14 §II-4.[104] Exhibit E actually sets forth the DR&R allowance starting from 1984-2011. *Id.* at E1. Therefore, it is clear that the TSA included the recovery of DR&R. It is further found that the TSA DR&R amounts were collected in rates.[105] As Staff correctly points out, the amount collected can be pulled from the TSM. Ex. A/T-33 Ex. E; A/T-44 at 15-20. Addition of "Actual DR&R Collections" from Ex.149 totals over $1.5 billion. So the issue remaining is what earnings these funds have accrued and what the ultimate dismantlement costs will be at the end of the useful life of the pipeline.[106] Until that determination is made, there can be no asserted overcollection as claimed by Anadarko/Tesoro and Staff. The parties have presented various studies and estimates of what they believe the amount of collections and earnings total to date.

151. The evidence in the record supports Anadarko/Tesoro's and Staff's contention that the assumptions underlying the DR&R payment calculations changed over time which potentially caused the Carriers to earn more interest on the collected amounts than originally anticipated. Ex. A/T-140 at 92-93. As pointed out by Mr. Brown, who provided credible testimony on this issue, these changes result in a larger amount of after tax DR&R earnings than originally anticipated when the DR&R collection schedule was established. *Id.* For instance, the useful life of TAPS is now longer

[104] Ex. ATC-14 at 14 (§II-4), ATC-14 at 54 (Ex. E).

[105] Ex. A/T-140 at 17; Ex. A/T-75 at 38-41; Ex. A/T-3 at 51; A/T-33 at Sec. II-4, Ex. E; A/T-35 at 33-34; Ex.A/T-44 at 20 ln. 117 ("DR&R Allowance"); *Trans. Alaska Pipeline Sys.*, 33 FERC at 61,139 (the Commission stated that the DR&R was based on an accelerated schedule and therefore, the expense is front-end loaded).

[106] Ex. ATC-157 at 11 (Browning stated since TAPS is expected to operate through 2034, "it is practically impossible to estimate, today what the ultimate costs of DR&R will be."). Browning estimated actual cost of performing DR&R at $2.63 billion (in 2005 dollars). However, he also asserts that it could require an additional $2.44 billion presuming removal of the entire pipeline. Exs. ATC-115 at 31, 53; ATC-157 at 3-4, 8-10.

than originally anticipated. The record evidence in this case establishes the useful life needs to be corrected to 2034. Federal corporate tax rates declined from 46% to 35%; the Carriers reached an agreement with the IRS which allowed a $900 million tax deduction for DR&R. Ex. A/T-3 at 77, A/T-78 at 57; A/T-140 at 92-93. The record in this case also shows that the Carriers had unrestricted use of the DR&R collections. Exs. A/T-160 at 42-43; Tr. 6529-31; 6505-06 (Hanley); Tr. 5513 (Sullivan); Tr. 6040-41 (Grasso); Tr. 4030-31 (Olson).

152. While Anadarko/Tesoro's and the Carriers' yearly DR&R allowance amounts are mostly similar (with the exceptions noted below), *see* Ex. A/T-30; Ex. ATC-130, it is the earnings rate that is causing the large disparity in the parties' calculations. Anadarko/Tesoro and Staff argue that the Carriers' earnings on DR&R should account for the fact that the funds were used as unrestricted capital by the Carriers' corporate parents. A/T IB at76; Staff IB at 68. These parties and Staff propose the use of the actual historic earnings rate of the Carriers' parents (after-tax composite returns on equity) which is as high as 28.29 percent and 27.98 percent. *See* A/T-149 at 1; A/T-143 at 46. Anadarko/Tesoro witnesses Brown and Grasso claim that the DR&R collections growing at the parents' actual historic rates will equal $17.265 billion through 2005. Ex. AT-140 at 99-100; Ex. A/T-149.[107] The Carriers claim this study is riddled with errors and have offered their own "corrected" calculations which state that the DR&R collections and earnings total for 2005 would be $2.364. Carriers IB at 119; Ex. ATC-115 at 40-43.

153. The Carriers' flatly reject the use of their parents' rate of return on equity as being too high and, similarly, that is the finding here. As the Carriers' point out, this earning rate assumes that that Carriers are engaging in risky investments. ATC-113 at 42; Carriers' IB at124. It is not surprising that using this extraordinarily high rate results in a DR&R calculation of over $17 billion. *See* Carriers' IB at 121; A/T IB at 77; Carriers' IB at 121. Neither Mr. Brown nor Mr. Hanley (who calculated the return on equity for the parents from 1977-2005) knew of any precedent that supports the use of the parent's return on equity. Tr. 6667, 4989; Staff IB at 68. In addition, Anadarko/Tesoro and Staff fail to cite any precedent for such a rate of return. Thus, Anadarko/Tesoro's proposed earnings rate is rejected and, accordingly, Anadarko/Tesoro's DR&R calculation using the Carriers' parents return on equity is rejected. *See* A/T-149. This is consistent with the conclusions below concerning capital structure where use of the Parent's capital structure is rejected.

[107] State witness Ives using a weighted cost of capital for the Carriers calculated collections and earnings as of 2005 to be $5.64 billion. Exs. SOA-8 at 43-44; SOA-13.

154. Conversely, the Carriers' proposed rate comes in at the lower end of the spectrum with a proposed risk-free earnings rate of United States Treasury securities. Carriers' IB at 120-21; Ex. ATC-113 at 44. This rate is simply too low and fails to take into account that the Carriers basically have failed to create a separate DR&R account and, thus, have had free rein to use the funds as they please. *See* Ex. ATC-113 at 38-39; Staff IB at 68-71; A/T IB at 76-77. Additionally, the Carriers did not invest these funds in these securities. The Carriers also fail to cite any precedent to support their rate and Dr. Kalt's testimony on this issue is not credible. Ex. ATC-113 at 42-44. In refuting Mr. Brown's and Mr. Grasso's "grossly exaggerated rates of return," Dr. Kalt takes issue with such a rate because it essentially requires the Carriers to participate in risky investments. *Id.* However, in light of the fact that there is no DR&R fund at all, it is disingenuous for Dr. Kalt to argue that the appropriate rate is that which "the prudent and rational" investor would take. *Id.* at 44; ATC-113 at 38-39. While the Carriers used the DR&R monies collected as they pleased, they should be required to recognize a reasonable return on such funds. The Carriers' overly conservative "risk-free" rate is also rejected.[108] Thus, the quandary here is to find a balance between the earnings rate of a risky investor and the conservative "risk-free" investor, and more importantly, one that is supported by Commission precedent.

155. Dr. Toof's DR&R calculation in Exhibit ATC-130 (as directed to be corrected below) is the most credible DR&R earnings calculation. First, Anadarko/Tesoro's calculation in Exhibit A/T-30 incorrectly uses the 12 percent Moody's Aa bond rating for the period 1985 through 2005 without adjusting the percentage for changes in subsequent years. Carriers' IB at 120; Ex. ATC 115 at 41. This failure to use actual amounts (the same criticism Anadarko/Tesoro had of the Carriers' DR&R Actual Collected amounts for the period 1977-1981 in their DR&R study) renders this study flawed.[109] Dr. Toof's Exhibit ATC-130 DR&R calculation uses the actual Moody's Aa bond rating for each year. Ex. ATC-115 at 45. Dr. Toof explained that Exhibit ATC-130 presents the results of substituting Moody's Aa rate for the risk-free rate. The record shows that Dr. Horst created the underlying TSM DR&R allowance schedule in the TSA assuming that the revenue stream would earn Moody's Aa bond yield to achieve the desired DR&R expense amount of $872.1 million (in 1977 dollars).[110] Exhibit ATC-130 is Dr. Toof's DR&R calculation using the actual

[108] Exhibit ATC-129 is based on the "risk-free" rate and is therefore rejected.

[109] A/T IB at 72 n 61.

[110] ATC-115 at 32-33. Dr. Horst's analysis adheres to the depreciation factors included in Exhibit F to the 1985 Settlement Agreement. Mr. Horst also assumed that the cost of DR&R would increase by the Gross National Product (GNP) deflator. Additionally, Dr. Horst (back in 1985) for the period 1985 to 2015 fixed the inflation rate at 6 percent and estimated a Moody's Aa bond yield at 12 percent. Ex. ATC-115 at 33.

Moody's Aa bond rate.[111] In making this calculation, Dr. Toof started with the data from Dr. Horst and corrected Mr. Grasso's methodological and data errors.[112] It is found that use of the actual Moody's Aa bond rate for the years 1977-2005 is the most reasonable approach here. This is consistent with what Dr. Horst did in 1985 to reflect DR&R allowances in the TSA. However, since he was forecasting he presumed a 12% rate for future years. Now that the rates have actually been collected (including the DR&R allowances) consistent with his approach, the actual Moody Aa bond rates can be used to establish earnings on the DR&R funds. This is consistent with the approach utilized in the TSA and it is found that it is equitable to continue such an approach.

156. Anadarko/Tesoro claim that Dr. Toof's calculations do not reflect actual collections for the period 1977-1981.[113] Anadarko/Tesoro are correct in that Dr. Toof replaces the TSM numbers with what he claims are the actual collections for this period. There is no evidence in this record to justify Dr. Toof's replacement numbers for this period. The Carriers claim that Mr. Grasso's calculation incorrectly includes the TSM-6 amounts that are not based on the amounts included in the TAPS Carriers' tariffs for the period 1977 through 1981. Carriers' IB at 119. This argument is rejected and it is found that the correct amounts are indeed found in the TSM-6. As discussed above, the evidence in the record clearly shows that TSM-6 was used to calculate the Carriers' revenue requirements and refund liabilities from the period from 1977- 1985 under the TSA. A/T-140 at 96; A/T-35 at 25, 107; A/T-44 at ln. 117 (TSM-6 data from 1968-2011); A/T-196 at 229-31, 236-37; Staff IB at 68; A/T-195 at ln. 117. The evidence shows that the amounts shown in Dr. Horst's schedule and used by Mr. Grasso reflect the amounts that were used to calculate the TSM revenue requirements and refunds for those years. A/T-140 at 100. Accordingly, the Carriers'

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[111] ATC-130 is ATC-129 substituting the "risk free" rate for the Moody's Aa bond rate. ATC-115 at 45.

[112] Dr. Toof states that Mr. Grasso's errors are that he: (1) incorrectly used the DR&R amounts for the period 1977 to 1981 included in the Dr. Horst schedule which are not the actual amounts collected by the Carriers; (2) incorrectly computes the Carriers' tax saving over the period 1977 to 2003 (Dr. Toof states that it should only be from 1988 to 2003); (3) ignores that the Carriers have waived collection of the TSM DR&R allowance on intrastate throughput and did not include the short fall in the interstate revenue requirement and; (4) he incorrectly uses the 12 percent rate assumed by Dr. Horst in 1985 instead of the Moody's Aa bond yield for the period 1985 through 2005. *Id.* at 40-41.

[113] Dr. Toof claims that he used the numbers used in the ICC filings. However, as discussed above, these numbers were not collected through the Carriers rates for TAPS for the years in question.

attempt to use the numbers they claim were in their initial ICC filings is rejected. Carriers' IB at 119-20; ATC-115 at 41.

157. Consequently, it is found that the record reflects that the TSM model numbers for these years should be used since this is what was actually collected in rates. Support for this is found in Dr. Toof's testimony at Ex. ATC-126 column titled "1985 TSM Model." These are the numbers used by Grasso for the same years. See Ex. A/T-149. These numbers are also corroborated by Ex. A/T-195. As a result, Dr. Toof's study will be corrected by replacing the TSM numbers in his "Adjusted DR&R Allowance" column, starting with 1977 through 1981 in Exhibit ATC-130.[114] Thus for 1977- 1981 the numbers found in Grasso's Ex. A/T-149 for DR&R allowances collected will be used. The results of this amended exhibit will be reported to the Commission in a compliance filing.

158. The evidence in the record supports a finding that the Carriers' weighted average nominal after tax cost of capital is the most reasonable rate for reflecting future earnings on DR&R monies already collected. Since a Carrier is presumed to eventually earn the weighted average nominal after tax cost of capital on rate base items a similar assumption can reasonably be applied here. Thus, it is found that from 2006 forward, the Carriers will calculate the earnings of the DR&R account using their weighted average nominal after tax cost of capital[115] (with the adjustments from above as their starting point). Anadarko/Tesoro's argument is now moot since their argument has been addressed by the mandated adjustment above which modifies the 1977-1981 data to reflect the TSM amounts of DR&R for this period (found in Dr. Horst's TSM-6 schedule). A/T-44 at ln.117.

159. Accordingly, pursuant to the findings above, it is concluded that the amount of DR&R collections and earnings to date will be calculated using the methodology in ATC-130 (page 1 of 2) with the following modifications: (1) Exhibit ATC-130 shall be modified to replace the "Adjusted DR&R Allowance" for years 1977 through 1981 with the amounts from the "Actual" column in Exhibit ATC-126 (*see also* A/T 149 column "Actual DR&R Collections") for years 1977 through 1981 and (2) Exhibit ATC-130 "Moody's Aa" column shall be utilized to calculate the Carriers' after tax accumulated balance for the every year starting with 1977 thru 2005 and starting in

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[114] Exhibit ATC-130 shall be modified to replace the "Adjusted DR&R Allowance" for years 1977 through 1981 with the amounts from the 1985TSM Model column in Exhibit ATC-126 (*see also* A/T 149 column "Actual DR&R Collections"). In other words, the DR&R numbers for 1977-1981 will be the numbers reflected in the TSM.

[115] For clarity, this equals the addition of nominal weighted rate of return on equity and the weighted cost of debt.

2006 and forward, the earning on DR&R shall be calculated using the Carriers weighted average nominal after tax cost of capital. Thus, the funds collected will continue to earn at a reasonable rate consistent with this decision.

160. Anadarko/Tesoro and Staff argue that there should be no further collections for DR&R expense because: (1) the Carriers failed to support any DR&R allowance; (2) the Carriers have failed to account for amounts collected and associated earnings thus far; (3) the Carriers have already overcollected DR&R; and (4) basic assumptions underlying the original DR&R schedule have changed. Anadarko/Tesoro and Staff are correct that the Carriers have failed to make a showing, *prima facia* or otherwise, that further DR&R collections are required. *See* Staff IB at 66-70; A/T IB at 75-77. Further corroboration of this is that the Carriers failed to include DR&R in their Opinion 154-B presentation and Dr. Toof and Mr. Van Hoecke only offer terse DR&R discussions that also fail to support any further DR&R collections.[116] In addition, although Mr. Browning provides extensive testimony regarding his DR&R cost estimates, the Carriers fail to show that they still have not collected sufficient DR&R to cover the estimated amount. *See* ATC-157 (Browning). Thus, it is found that the Carriers have not cost justified additional collections of DR&R expense through future rates and, accordingly, the expense is not permitted to be collected in the cost based 2005 and 2006 Carriers' rates. This is consistent with Commission policy.[117]

Rate Base Credit

161. Anadarko/Tesoro and Staff contend that a portion of the amount collected should be credited to rate base or refunded because the Carriers have amassed "a DR&R fund that is enormous" and "far outstrips anyone's estimate of what the eventual DR&R task will require." Staff IB 64, 90-94; A/T IB at 106-10. Anadarko/Tesoro and Staff advocate a rate base credit for DR&R while Flint Hills and the Carriers vehemently oppose such a credit. Anadarko/Tesoro and Staff cite

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[116] Staff IB at 70; A/T IB at 75; ATC-12 at 27, 29 (Dr. Toof's mention of DR&R expense only includes a reference to the stipulated DR&R allowance in the TSM); ATC-35 at 33 (Van Hoecke simply states that that he did not include any DR&R in his Opinion 154-B analysis). An inference is made that the Carriers deemed they did not need to collect any additional DR&R in costs based rates. This is distinguishable from their rate filings for 2005 and 2006 which included an allowance for DR&R. Ex. ATC-12 at 27, §II.D.10. Dr. Toof acknowledged that the TAPS TSA *revenue requirement included an allowance for DR&R but the Carriers* did not support such under their 154-B proxy.

[117] *See Sabine River Authority*, 10 FERC ¶ 61,241 at 61,451 (1980); *FPC v. Natural Gas Pipeline Co*, 315 U. S. 593-96.

Kuparuk in support of the proposition that the Carriers must credit rate base so that the Carriers do not "reap the time value of these funds without compensating rate payers" and to "eliminate the contentious issue of the interest rate at which DR&R funds will grow in the future."[118] The rate base in this case is $576.86 million. The remaining rate base in TAPS will be fully depreciated by 2011. Tr. 2685 (Van Hoecke). However, Strategic Reconfiguration will add some rate base as it is built. Anadarko/Tesoro argue that only a portion of the DR&R be credited against rate base. Essentially, crediting rate base would zero it out. The Carriers have effectively distinguished *Kuparuk* from this case by pointing out that in *Kuparuk*, the Commission adopted an accrual methodology for DR&R amounts, while the DR&R here was collected based on the annuity method. *Kuparuk*, 55 FERC at 61,382; Ex. ATC-115 at 33.[119]

162. Noting the impact of this difference is critical. The accrual method takes the total amount of the estimated DR&R expense and divides it into equal payments to be made by the shippers. Tr. 4959. Whereas, under the annuity method, the shippers do not pay the full amount, but some lesser amount which is expected to grow over time to cover the total expense. Tr. 4959-60; Carriers IB at 69; RB at 53-54; Tr.6669. Crediting the rate base for the amounts of collected DR&R under the annuity method would prevent the Carriers from earning the interest on those funds that is to be added to the DR&R "fund" to cover the final DR&R costs.[120] Unlike the instant case in Kuparuk the DR&R did not exceed the rate base. Moreover, the earnings in the instant case have been earning interest for years. Whereas, in Kuparuk the issue was whether the accruing funds should be deducted from rate base rather than from the rate of return.

163. In addition, the other cases cited by Anadarko/Tesoro and Staff for the proposition of crediting rate base are distinguishable.[121] Staff points out correctly

[118] Staff IB at 63; A/T IB at 71.

[119] Carriers IB at 69-70; RB at 53-54.

[120] It is noted that in *Kuparuk* the Commission was setting rates close to the beginning of service on the pipeline. This is not the case here were we are looking backwards to establish the remaining rate base and looking forward to establish cost based rates under Opinion 154-B which has never been followed to set rates on TAPS.

[121] Staff IB at 63 n. 90 (*Kansas Pipeline Co.*, 96 FERC ¶ 63,014 at 65,100-01 (2001); *ARCO Pipe Line Co.*, 52 FERC ¶ 61,055 at 61,238 (1990)).; A/T IB at 71 n.60 (citing *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260 at P 289-95 (2002); *Koch Gateway Pipeline Co.*, 79 FERC ¶ 61,388 at 62,648 (1997); *Williston Basin*, 72 FERC at 61,365; *Endicott Pipeline Co.*, 55 FERC ¶ 63,028 at 62,648 (1991); *Tennessee Gas Pipeline Co.*, 25 FERC ¶ 63,052 at 65,153 (1983), *aff'd in part*, 32 FERC ¶ 61,086 at

that the instant case is different from any cited case. This is because the DR&R collections began early in the TAPS line, in front-loaded amounts contrary to any Commission precedent. The fund outstrips the TAPS current rate base and probably what the eventual DR&R task will require.[122] It is the Carriers who, admittedly, will bear the obligation of paying for the DR&R of TAPS, regardless of the final cost.[123] As discussed above, the final amount of DR&R costs is speculative at this point. Thus, it is concluded that at this time the Carriers will not be required to credit rate base or refund any amounts.

164. The Carriers' arguments that refunds or a rate base credit amount to retroactive rate making or a taking are rendered moot by this finding. Flint Hills' arguments concerning the rate base credit are also moot. Finally, Flint Hills' request that a refund for one-half of the DR&R collected be given to past shippers in the interest of intergenerational equity is also denied due to the unsettled nature of the final DR&R cost issue. The conclusions here synchronize the DR&R balances retained by the Carriers with the expected expense level. This is a reasonable approach which protects rate payers under the circumstances of this case.

Other Remedies

165. Staff and Anadarko/Tesoro correctly classify the DR&R collections and earnings as a prepayment. Staff IB at 93; A/T IB at 71; Tr.5507-08. The shippers' payment of DR&R is indeed a prepayment of an expense that may be refundable in the event that there is a surplus once the DR&R is completed. *See Kuparuk*, 55 FERC at 61,382.

61,220 (1985)). The various cases do stand for the proposition that DR&R should be credited to rate base because the pipeline is assumed to recover the full amount of its costs from the ratepayers and any interest is considered an excess (or compensation). However, in the case at bar the amounts collected and the interest earned become part of the DR&R expense "fund" which are necessary to meet the future total costs. The collections plus the interest earned are needed to meet the total DR&R expense. This is the reality of what the TSA parties agreed to early in the life of TAPS. Moreover in this regard, the shippers have been paying less as a result of this methodology.

[122] Staff IB at 64.

[123] Dr. Toof stated that "[i]t is certainly my testimony that TAPS carriers and their parents have unlimited liability to do the DR&R remediation... if the TSM ran through 2011 to its conclusion, absent extraordinary events that the TAPS Carriers would have the total liability and collected all the DR&R they could collect." Tr. 655. ATC-113 at 38 ("What stands behind the ultimate DR&R expenditures are the TAPS Carriers, themselves, and the parent company guarantees that the Secretary of the Interior has required under the Federal Right-of-Way grant").

166. The Carriers argument that they should not be required to account for DR&R is rejected. The record in this case shows that in fact they have collected DR&R in rates for almost three decades. Importantly, the Carriers admit that there is no "stand-alone" DR&R fund maintained by the TAPS Carriers." Ex. ATC-115 at 33:1-2. Thus, although these arguments were presented to support denying further DR&R collections, they provide additional support for the requirement that the Carriers account for the funds collected.

167. Accordingly, the Carriers will be required to account for the DR&R funds collected and the earnings on such funds. Thus, it is concluded that the Carriers will be required to maintain an accounting of the DR&R and earnings to date using the methodology prescribed above and report such amounts on Form 6 on a yearly basis.[124] These reports will utilize the amounts from the corrected Ex. ATC-130 up to 2005. Starting in 2006 the annual reports shall show the sums credited yearly to DR&R earnings based on the Carriers weighted average nominal after tax cost of capital.

168. The Carriers' argument that requiring them to maintain an accounting of their DR&R collections and earnings constitutes retroactive ratemaking is meritless. Staff and Anadarko/Tesoro are correct. The case cited by the Carriers is distinguished and there is no retroactive ratemaking issue here where the money was collected in jurisdictional rates and related to a jurisdictional service such as the TAPS pipeline.[125] In addition, there are no retroactive ratemaking implications where the remedy is only forward looking, such as the accounting requirement imposed here.[126] Requiring an

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[124] In Kuparuk, supra the Commission required an internal accounting for DR&R and details in annual reports of the sums credited to the DR&R fund. Kuparuk, 55 FERC at 61,382.

[125] The case cited by the Carriers is distinguishable. The Carriers cite, *Public Utilities Commission of California v. FERC*, 894 F.2d 1372 (D.C. Cir. 1990) (*California*), for the proposition that requiring refunds, a rate base credit, or an accounting related to DR&R refunds constitute retroactive ratemaking. Staff and Anadarko/Tesoro correctly point out that in *California* the deferred tax reserve had been collected in jurisdictional rates and the rate base credit would have been to non-jurisdictional assets. 894 F.2d at 1380. The court's concern there was that the Commission's credit for the funds collected was "not attached to, derived from, or related to" the service. *Id.* at 1379. In contrast, here there is no matching issue since "the DR&R funds were collected in jurisdictional rates and relate to the jurisdictional TAPS pipeline." A/T RB at 89.

[126] The Carriers cite *Tarpon Transmission Co.*, 57 FERC P 61,371 (1991), to support their argument that the Commission lacks authority to return overrecoveries

accounting of DR&R collections and earnings is wholly consistent with Commission precedent.[127] DR&R collections are for an anticipated expense that may need to be refunded to the shippers in the event there is a surplus. Flint Hills' requested remedy is also denied due to the speculative nature of the actual DR&R expenses at this time and up to the time the Carriers have to undertake the dismantlement. In addition, as Staff points out, granting the refund contemplated by Flint Hills will be a monumental task that, if undertaken at all, should be when all final costs are known. *See* Staff RB at 87 n.285.

169. In conclusion, it is found that while the question of the ultimate cost of DR&R lingers, the question of whether refunds are necessary is premature. The Carriers will not be required to credit rate base or refund any DR&R at this point. However, the Carriers will be required to maintain an accounting of the DR&R amounts collected and returns on such amounts in their Form 6 report as described above.

Issue III. F. What is the appropriate return on investment?

1. The Carriers claim that the cost of capital should be based on the capital structure of the Carriers' parent companies, the parents' companies cost of debt, and a cost of equity established using the DCF methodology with oil pipeline proxy companies or using a risk premium methodology if appropriate oil pipeline proxy companies are unavailable. Additionally, the Carriers argue that they should get a two percentage point equity risk premium to reflect the extraordinary risks associated with TAPS.

Issue III. F. 1. What is the appropriate capital structure?

170. The Carriers and Flint Hill claim, the appropriate capital structure to be used by each TAPS Carrier is the actual capital structure of its parent company. The Carriers assert that in Opinion 154-B, the Commission required oil pipelines to use actual rather than hypothetical capital structures of either the pipeline or its parent. Carriers' IB at 74 (citing Opinion 154-B, 31 FERC at 61,836). In addition, the Carriers claim that the Commission also held that a pipeline should use its parent's

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to ratepayers. This case is inapplicable since the accounting requirement only concerns the 2005 rates forward. In addition, Anadarko/Tesoro cite Tarpon to argue that a surplus must be refunded to ratepayers. As discussed above this request has been denied as premature.

[127] *See Kuparuk*, 55 FERC at 61,382; *see Sepulveda*, 117 FERC at P 74-75 (The Commission required SFPP to provide an accounting of "regulatory costs outstanding at the beginning and end of each year and the amount of those costs recovered during each year.").

actual capital structure if the pipeline has issued no long-term debt, has issued long-term debt to its parent, or has issued long-term debt to outside investors guaranteed by its parent. That is the case here, the Carriers claim. The Carriers also assert that the Commission has approved the use of pipeline's parent company's capital structure in each oil pipeline filing it has considered and never imposed a hypothetical capital structure on an oil pipeline.[128] Moreover, the Carriers add that the 71.42% equity ratio that represents the ownership weighted average equity ratio for the TAPS Carriers' parents from 1968 through 2005 is similar to the 71% equity ratio allowed in *Colonial*.

171. The Carriers state that the ICC and the Commission have recognized that the TAPS project produces a higher risk factor than is normal in crude oil operations and that at one point there was a risk that TAPS would not be completed due to cost overruns.[129] The Carriers claim that these risks had a substantial impact on the financing of TAPS that was so significant that TAPS could not have been financed without the full backing of the TAPS Carriers' parent companies. Therefore, the Carriers contend, it is appropriate that the TAPS Carriers' rates be based on the parent companies' capital structures. This will reflect the capital structure underlying the investment, the Carriers assert.

172. Further, the Carriers claim that the parent companies are vertically integrated, highly diversified oil companies that engage in numerous businesses that have offsetting risks. This is also confirmed by the parent companies' Form 10-K Annual Reports to the SEC, the Carriers claim. In contrast, the Carriers state that they are much less diversified and they have a single asset, in a single location, dependent upon production from one area—the TAPS pipeline. These differences make the business of the TAPS Carriers riskier than the businesses of their parent companies, the Carriers contend. Thus, the Carriers conclude both Commission precedent and the

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[128] The Carriers cite *Kuparuk, supra* and *Colonial Pipeline Co.*, 116 FERC ¶ 61,078 at P 62 (2006) (*Colonial*)(constitutes provisional acceptance of an equity ratio as high as 71%).

[129] The Carriers state that these risks include the concentration of TAPS assets in Alaska, the hostility of the Alaskan terrain and weather, the environmental and technical challenges faced by the Carriers in designing, constructing, etc. TAPS, the continuing sensitivity of various state and federal government authorities, the stringent legal requirements imposed on TAPS, the number of time consuming delays caused by the need to obtain multiple approvals from state and federal authorities, the enormous capital investment ultimately required to construct TAPS, the need for investors to fund the entire $9.1 billion project before TAPS could generate any revenue to return to investors, and sabotage.

facts of this case which show that the Carriers' business is more risky than that of the parent companies supports the use of the parent companies' capital structures.

173. The Carriers claim that the capital structure used by the State's and Anadarko/Tesoro's proxy group is inappropriate. First, the Carriers argue that the use of a proxy group to determine the capital structure of an oil pipeline company is unprecedented. The Carriers state that the Commission uses a proxy when applying the DCF methodology to determine the cost of equity. However, Anadarko/Tesoro and the State take the unprecedented approach of using their proxy group as a measure of capital structure in an oil pipeline case. Second, the Carriers assert that the proxy group companies face lower risks than the Carriers because those businesses acquired already built pipelines and have diversified businesses. Third, the Carriers contend that the proxy group companies' capital structures are not all comparable to the capital structures of oil pipeline companies. Fourth, the proxy companies do not have oil pipeline operations in Alaska, and therefore these companies are not subject to the risks associated with the extreme climate and harsh terrain as is TAPS. Fifth, the Carriers argue that determination of a capital structure is not an exact science and involves other factors such as the need for funds and the ability to raise debt. Sixth, the Carriers claim that the capital structure proposed by Anadarko/Tesoro and the State would eliminate the Carriers' ability to raise any debt because the cash flow generated from rates would be insufficient. Finally, the Carriers contend that the bond rating of the DCF proxy group members is just above junk bond status and the suggested proxy structures would cause the Carriers to be on the verge of junk bond status.

174. Next, Flint Hills argues that the oil pipelines cannot be used to establish capital structures in this proceeding. Flint Hills claims that in *Sepulveda*, 117 FERC at 62,376, the Commission rejected the use of the sixth member of the oil pipeline proxy group (Enron Liquids) because its distributions per unit exceeded per unit income in each of the years. In *Sepulveda*, the Commission held that MLPs cannot be used as proxy companies for return on equity if distributions exceed earnings, Flint Hills claims. Flint Hills asserts that during the cross-examination of Mr. Henley it was established that all four of the remaining oil pipeline MLP proxies now have distributions per unit that exceed income per unit for the relevant time periods. In addition, Flint Hills states that Mr. Hanley agreed that based on *Sepulveda*, there was the potential that each of the MLPs might be disqualified for use in an oil proxy to establish capital structures for oil pipelines. Flint Hills claims that Anadarko/Tesoro ignored this decision.

175. Flint Hills also argues that there is no basis for using gas pipeline proxies because in Opinion No. 435, the Commission found that the use of gas companies in proxy groups for oil pipelines was no longer necessary and that using gas pipelines as a proxy for data that was not readily available no longer has to control. Since the

proxy group cannot be used, Flint Hills claims, the only other option is to use the TAPS Carriers' parent's weighted average capital structure. Flint Hills claims that Staff's assertion that all of the parties have constructively agreed to use the same MLP proxy group and that the Commission could accept that agreement as a trial stipulation is preposterous. Flint Hills states that the proposition is flawed because it is likely that not all of the parties (or none of the parties) would have used an oil pipeline proxy group if SPFF Sepulveda would have been issued before testimony was filed and Flint Hills has never agreed to use the oil pipeline MLP proxy group. In addition, Flint Hills states that Anadarko/Tesoro also claim that earnings-capped distributions could be used in the DCF calculation. This approach was rejected in *Kern River*, Flint Hills contends. Thus Flint Hills concludes, the parent company capital structures should be used for return and deferred earnings purposes. Alternatively, Flint Hills argues that the record must be supplemented for cost of equity purposes.

176. Flint Hills claims that no Commission authority exists to use gas pipeline proxies in this proceeding. Staff suggests the use of a gas pipeline proxy group as an alternative, Flint Hills claims. Flint Hills states that Staff supports this proposition by citing *SFPP L.P.* which stated that the Commission used to rely on gas pipelines as a proxy. Flint Hills asserts that since this evidence is no longer available, it is inappropriate to go back to using gas pipelines as a proxy. In addition, Flint Hills claims that Anadarko/Tesoro witness Mr. Hanley did include an analysis using gas pipelines. However, Flint Hills claims, Mr. Hanley made it clear that he had not included the gas pipeline proxy as a recommended basis for determining the capital structure of TAPS or as a substitute for the four oil pipeline MLPs. Finally, Flint Hills states that no party's rate of return witness was on notice with respect to the possible problem with the use of oil pipeline MLP proxies prior to filing written testimony and therefore none of the witnesses addressed the problem or other avenues to address the issue. If any of these issues, including using the proposed oil pipeline MLP proxies are to be considered in the Initial Decision, in light of the *Sepulveda* decision, the hearing in this proceeding would have to be reopened so that additional pre-filed testimony could be submitted and witnesses cross-examined, Flint Hills claims. Flint Hills states that this can be avoided if the parents' weighted average capital structure is used.

177. Anadarko/Tesoro state that the appropriate capital structure for TAPS for 2005 is 55% debt/45% equity and for 2006, 58% debt/42% equity per the evidence sponsored by Mr. Hanley. Anadarko/Tesoro claim that the Carriers' capital structures are inappropriate because the parents have unusually high equity ratios.[130]

[130] Anadarko/Tesoro state that the Carriers propose capital structures for each of the Carriers while Anadarko/Tesoro propose only one overall capital structure.

Anadarko/Tesoro state that their study focuses on the cost of capital for 2005 and 2006 while the Carriers have attempted to reconstruct capital structures, equity costs and debt costs back to 1984. First, Commission precedent requires the rejection of "anomalous" capital structures, Anadarko/Tesoro contend. Specifically, Anadarko/Tesoro argue that where the regulated entity does not provide its own financing, the Commission uses either the capital structure of the regulated entity's parent or a hypothetical capital structure. Anadarko/Tesoro assert that the Commission has recognized that typical equity ratios are in the range of 45%-55%.

178. Second, Anadarko/Tesoro argue that the Carrier's equity-rich capital structure with an equity ratio as high as 87 percent or 85 percent is unprecedented and unsupported by case law. Anadarko/Tesoro claim that the Carriers structures are anomalous as compared to both Commission precedent and the DCF calculations. In fact, Anadarko/Tesoro claim, the Carriers' witness Prof. Williams confirmed that equity ratios as high as those proposed by the Carriers (85% for 2005, 87% for 2006) have never been approved by the Commission. In addition, Anadarko/Tesoro state that nothing cited by Flint Hills supports the Carriers' unreasonable capital structures. Anadarko/Tesoro also assert that the equity structures proposed by the Carriers are also anomalous when compared to the proxy group used by all the parties for the DCF calculation (including the Carriers). The Carriers' use of an equity rich structure is not justified by the risk associated with TAPS, Anadarko/Tesoro assert. Anadarko/Tesoro claim that the original risks associated with TAPS are irrelevant for setting current rates. According to Anadarko/Tesoro, the Carriers do not have greater risks than their parent companies that participate in the risky world-wide business of oil and gas exploration and production (E&P).

179. Anadarko/Tesoro claim that the cases cited by the Carriers are inapposite. The first case, *Colonial*, is simply a declaratory order and does reach any just and reasonable findings or approve any specific rate of recovery and was conditional subject to reexamination in the pipeline's next rate proceeding, Anadarko/Tesoro claim. Anadarko/Tesoro assert that the 71% equity ratio in Colonial was described as the extreme of what the commission has approved and provides no basis for the Carriers proposed 87%. The second case Anadarko/Tesoro assert, does not support the Carriers 87% equity ratio because in *Kuparuk*, the Commission rejected the use of the parent's 70% equity ratio. Anadarko/Tesoro also argue that the cases cited by Flint Hills were subsequently distinguished by the Commission and do not support the use of their proposed 71.46% equity ratio.[131] Thus, Anadarko/Tesoro conclude, the Carriers proposed parent-based capital structures are unjust and unreasonable and a proxy-based capital structure should be used.

[131] *See* FHR IB at 34 (citing *Midwestern Gas Transmission Company*, 31 FERC ¶ 61,317; *Alabama-Tennessee Natural Gas Co.*, 13 FERC ¶ 61,224; A/T RB at 65 (citing *Alabama-Tennessee Natural Gas Co.*, 40 FERC ¶ 61,244 at 61,814).

180. Anadarko/Tesoro claim that their proxy-based capital structure, sponsored by Mr. Hanley, is supported by substantial record evidence and Commission precedent. Anadarko/Tesoro state that this is the only hypothetical that is supported by substantial evidence in the record. Mr. Hanley's capital structure was supported by the State, Anadarko/Tesoro contend. Moreover, Anadarko/Tesoro assert, the Carriers' witness Mr. Williamson used the same proxy group for his test period DCF analysis. According to Anadarko/Tesoro, the Carriers claim that Mr. Hanley's proxy group is appropriate for determining the DCF-based cost of equity for TAPS, but not for determining capital structures. Anadarko/Tesoro state that the Carriers' arguments that the use of a proxy group capital structure is unprecedented for an oil pipeline, is not reflective of the operation and business risks of TAPS, is not representative of the capital structures of other Alaskan oil pipelines, and would impair the Carriers' ability to raise capital. These claims have been addressed by the showing that the parent-based capital structures are unjust and unreasonable and that the Commission's policy is to reject parent-based capital structures that are anomalous or unrepresentative of the pipeline's risks, Anadarko/Tesoro claim. Furthermore, Anadarko/Tesoro state that the Commission has adopted hypothetical capital structures for regulated pipelines in order to mitigate the effects on ratepayers of paying abnormally high equity ratios.

181. Anadarko/Tesoro also assert that the Commission has never approved a capital structure anywhere close to the 100% equity ratio suggested by Professor Williams. The Carriers claim that the equity ratio in Kuparuk is instructive here, Anadarko/Tesoro contend. Anadarko/Tesoro state that contrary to the Carriers' position, Anadarko/Tesoro's equity ratio of 45% for 2005 and 42% for 2006 are closer to Kuparuk's 57% equity ratio than the Carriers' 85% for 2005 and 87% for 2006. Anadarko/Tesoro also state that unlike TAPS the Kuparuk system is anchored by a single small supply source and has historically faced throughput risks; however, the Carriers still argue that Kuparuk was less risky than the proxy companies used in the DCF calculation.

182. Anadarko/Tesoro also state that Flint Hills' argue that Master Limited Partnerships (MLPs) should not be used as proxy companies to determine the TAPS capital structure, to the extent that MLP distributions exceed earnings. However, Anadarko/Tesoro claim, that the distribution vs. dividend distinction only arises in the context of calculating equity returns under the DCF analysis and has never been cited by the Commission as a relevant consideration in the determination of an entity's capital structure. Anadarko/Tesoro also state that the Carriers' concerns about the ability to raise capital under Mr. Hanley's capital structure are without merit since the evidence cited by the Carriers to support these claims was discredited at the hearing.

183. Staff states that since TAPS does not provide its own debt financing all the parties have proposed an alternative. The Carriers' proposal to use the capital

structure of each parent presents the kind of "anomalous" situation the Commission wants to avoid, Staff asserts. The Carriers' proposal averages about 85% equity and 15% debt and does not reflect the risk of the Carriers and it is not similar to the capital structures allowed for other oil pipelines. The proxy group used by Anadarko/Tesoro and the State are based on a hypothetical proxy group that is identical to a typical oil pipeline. Staff states that this is the same hypothetical proxy group used in *SFPP, L.P.*, 69 FERC P 61,279. The applicability of the proxy group used by Anadarko/Tesoro and the State was shown through an empirical study which showed the risk profile of TAPS was comparable to that of the oil pipeline proxy group and Mr. Hanley's alternative gas pipeline proxy group.

184. Staff states that the only potential problem is that all of the members of Anadarko/Tesoro's and the State's proxy group are MLPs. In *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005), *order on reh'g*, 112 FERC ¶61,050 (200), *order on reh'g*, 113 FERC ¶ 61,280 (2005) (*HIOS*), the Commission excluded MLPs from the proxy group used to determine a jurisdictional partnership's equity cost unless the distributions by the MLPs have the same characteristics as a corporate dividend. Additionally, Staff states that *Sepulveda)*, 117 FERC ¶ 61,285, addressed the use of MLPs in the same equity proxy group and determined it was flawed.[132] Staff states that the Carriers' parents are highly-diversified and different companies than their regulated pipeline subsidiaries (the Carriers). The parents do not represent the same risk profile as the Carriers and are therefore anomalous for capital structure purposes, Staff argues. In addition, Staff states that whatever proxy group is adopted for equity purposes should also be used for capital structure purposes.

185. Staff's reply brief also states that Anadarko/Tesoro and the State rely on the average capital structure derived from the same proxy group they used to determine ROE. This "matching" of proxy groups for purposes of return on equity and capital structure is both rational[133] and consistent with Commission precedent. According to Staff, the Carriers' request to use the capital structures of their parent companies, but never actually state what those equity/debt rations are in their initial brief. Staff suggests that this is because the result is an 85% equity ratio for base year 2004 and 87% equity ratio for base year 2005 which is higher than any ratio ever approved by the Commission. Staff states that in light of the Commission's requirements, the Carriers' proposed equity structure cannot be accepted. Staff claims that all the parties that presented ROE evidence used the identical proxy group in their DCF

[132] Staff also cites *Kern River Gas Transmission Company*, 117 FERC ¶ 61,077 (2006) (Opinion No. 486).

[133] Staff states that this "matching" is rational because since the ROE and capital structure are supposed to reflect the level of financial risk, it makes sense that they both reflect a similar financial risk. Staff RB at 52.

calculations, but the Carriers refuse to use Anadarko/Tesoro's and Staff's proxy group for the capital structure. Staff states that the Carriers' refusal to match the proxies, and thus, the risks used to determine both ROE and capital structure, makes the Carriers' proposal anomalous and it should be rejected by the Commission.

186. Staff also states that the Carriers' attempt to cite *Colonial* to support their high equity ratio fails for a number of reasons. Staff asserts that the State claims that Colonial does not apply to this case because: (1) the Commission never in fact approved the proposed 71% equity ratio as just and reasonable, (2) the order only mentioned the proposal to note that it was "at the extreme" of anything approved in the past, (3) the order pledged to review the proposal upon completion of the project based upon Colonial's circumstances and Commission precedent at the time, (4) the proposal concerned financing for an expansion project yet to be built, not a thirty-year old pipeline with a successful operating and earnings history, and (5) the order was not premised on any evidence in a litigated record. Staff RB at 55, State IB at 51-52. Staff claims that *Kuparuk* is also distinguishable because the 58% equity ratio approved in *Kuparuk* is nowhere near the 85-87% proposed by the Carriers. Staff claims that the 58% approved for Kuparuk is still too high for TAPS because Kuparuk faces additional risks that TAPS does not encounter today. Staff RB at 55, *Kuparuk*, at 55 FERC at 61,378. Finally Staff states that the Carriers' criticisms of Anadarko/Tesoro's proxy capital structure are unfounded.

187. The Carriers' arguments concerning the operating, economic, and regulatory risks of TAPS is unconvincing, Staff claims. Contrary to the Carriers' contentions, Staff states that the fact that all of the TAPS assets are in Alaska is no different from any other pipeline that is tied to a specific field and location. Staff further notes that the proven reserves are enormous, most of the volumes are shipped by the Carriers' affiliated producers that help assure consistent throughput and revenues, the hostile Alaskan terrain is not unusual as many oil pipelines operate in hostile environments. In addition, Staff states that the scrutiny of the State and Federal authorities over TAPS operations suggests that TAPS is a safer operation. Staff also asserts that diversification may reduce risk; however, there is no evidence showing that diversification among risky projects results in overall low risk as suggested by the Carriers.

Discussion/Findings

188. The appropriate capital structure is an integral part of any return calculation. Staff IB at 70. In calculating the rate of return, the first step in the process is to determine the appropriate capital structure which consists of the appropriate debt and equity percentages. A/T-4 at 2. The capital structure of an entity should also be commensurate with the business risks of the enterprise. *Id.*; *SFPP L.P.*, 96 FERC at 62,066. In addition, the capital structure should not be based on the parent company's

capital structure unless the parent company's business risks are equivalent to those of an operating oil pipeline. *Id.* The Commission will usually use the capital structure of the regulated entity unless it does not provide its own financing, in which case, the Commission will look to the parent company. Staff IB at 71; *Entrega*, 113 FERC at P 32. The Commission, in Opinion 435-B 96 FERC at 62,066, stated that there is a strong presumption in favor of using the parent company's capital structure Staff IB at 71; *see ARCO Pipeline Company,* 52 FERC ¶61,055 (1990) at 61,233 (*ARCO*). However, if the Commission finds that the parent company's capital structure is "anomalous relative to the capital structures of the publicly-traded proxy companies used in the DCF analysis and capital structures approved for other regulated pipelines," the Commission will use a hypothetical capital structure.[134] In addition, Opinion 154-B states that "the Commission shall use a pipeline's or its parent's actual capital structure, but will allow participants on a case-specific basis to urge the use of some other capital structure." 31 FERC at 61,833.

189. None of the TAPS Carriers issues debt without guarantees by the parent.[135] Ex. ATC-45 at 5; ATC-56 at 42-43. Thus, in cases such as this where the regulated entity has no debt of its own, the next step is to look to the capital structure of the Carriers' parents. *See SFPP,L.P.*, 96 FERC at 62,067. The Carriers' parents' capital structure is inappropriate because: (1) it falls well outside the range of capital structures normally approved by the Commission and (2) does not reflect the risks faced by the Carriers. First, the Carriers' proposal to use the weighted average equity ratio of the parent companies for the period 1968-2005 (71.42%) is rejected since no support can be found in Commission precedent or the record to support the use of such a high ratio.[136] The Carriers cite *Colonial* and *Kuparuk* in support of their 71.42% equity ratio; however, those cases simply do not support the Carriers' claim.

190. The Carriers argue that the Commission accepted a 71% equity ratio in *Colonial*. 116 FERC at P 59, 61-62, 65; Carriers' IB at 59. However, Colonial does

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[134] Staff RB at 53 (quoting *Entrega*, 113 FERC at P 32); A/T IB at 79. Although as the Carriers argue, *SFPP, L.P.* did not impose a hypothetical capital structure on the pipeline, this case does, however, stand for the proposition that the Commission will impose a hypothetical capital structure where the capital structure is "clearly contrived, and...its financial risk [is] clearly different from that of its parents." 96 FERC at 62,068.

[135] Carriers' IB at 74 n.68.

[136] *See Entrega Gas Pipeline Inc.*, 113 FERC ¶ 61,327 at P 32 (2005) (*Entrega*) (65% equity); *ARCO Pipeline Co.*, 52 FERC ¶ 61,055 at 61,243 (1990) (*ARCO*) (44.12% equity); *Transcon. Gas Pipeline Corp.*, 84 FERC ¶ 61,084 (1998) (*Transcon*)(57.58% equity); *Mobile Oil Corp., v. SFPP, L.P.*, 96 FERC ¶ 61,281 at 62,068 (2001) (*SFPP, L.P.*) (39.26%).

not support the Carriers proposals. In Colonial the Commission never accepted the proposed 71% equity ratio as just and reasonable stating that such a ratio is "at the extreme of what [the Commission has] approved in the past," "toward the upper end of the zone of reasonableness." The Colonial order stated it would review the proposal upon completion of the project. The order was based on several factors that applied to Colonial, but do not apply to the Carriers. *See id.* at P 62. Colonial was embarking on a proposed mainline pipeline expansion that the Commission recognized was going to present "substantial challenges" such as the length and scope of the project, enormous investment involved, financing challenges, the challenges of constructing a multi-state project, and the short time for completion of the project. *Id.* at 59. As discussed more below, the Carriers are not facing such risks since TAPS is complete and the Carriers have no further need to raise funds for construction. Thus, the risks facing Colonial are not analogous to those facing the Carriers and therefore *Colonial* does not support granting the Carriers an equity ratio "toward the upper end of the zone of reasonableness." *See id.* Moreover, the Colonial order (a declaratory order) was not premised on a litigated record unlike the instant case.

191. *Kuparuk* also fails to lend support to the Carriers' proposed equity ratio. First, as Anadarko/Tesoro point out, the 57.8% equity ratio approved in *Kuparuk* simply cannot be read to support the Carriers' much higher proposal of 71.42% (87% according to Anadarko/Tesoro and 85% according to Staff). A/T RB at 61; Carriers' IB at 75-76; Staff IB at 74. The Carriers also state that in *Kuparuk*, the Commission reversed the initial decision's refusal to use the parent companies' capital structure because the initial decision's "analysis [did] not overcome the strong preference in Opinion 154-B for the use of a parent company's capital structure if the parent guarantees the oil pipeline's external debt." Carriers' IB (quoting *Kuparuk*, 55 FERC at 61,377). However, in Kuparuk the Commission rejected use of the parent's 70% equity ratio for 1984. Id. at 61,378. In Kuparuk the Commission noted risks in Kuparuk then that do not apply to TAPS. The risks in Kuparuk are not present in TAPS and as a result it is concluded that the 58% equity ratio approved there is too high for TAPS. Kuparuk, does not support the Carriers' contentions because there is substantial evidence in the record to support a finding that the Carriers' risks are not at all comparable to the risks of their parent companies.

192. Second, the record shows that the Carriers' parents' risks are simply not representative of the Carriers' risks. The Carriers' parents are involved in various highly risky and competitive world-wide E&P undertakings.[137] E&P is "an intensely

[137] A/T IB at 81-82; Staff RB at 55-59. *See* Ex. A/T-205 at 5 (S&P Report Table 2 listing all of the Carriers' parents as comparable E&P companies, except for Koch which is not publicly traded and only has a 3% ownership interest in TAPS.); Tr. 1419-20; Ex. ATC-1 at 5; A/T-206 at FS-2; Exs. A/T 207-209. *See also* Hanley, Ex. A/T-53 at 8-9; A/T-59. The parent's earnings are derived mostly from E&P from

competitive, capital intensive, volatile, and cyclical industry." Ex. A/T-205 at 6. Conversely, the Carriers are solely engaged in the TAPS pipeline monopoly with little remaining unrecovered investment.[138] More specifically, the evidence in the record shows the following: (1) TAPS has no direct competition and it is extremely unlikely that TAPS will face competition from another pipeline in the future[139]; (2) there is "no alternate means of transporting crude oil out of Prudhoe Bay" and "revenues will be generated by the Pipeline Companies as long as Prudhoe Bay crude oil is being marketed," Ex. A/T-160 at 26; Ex. A/T 169; (3) "the likelihood that additional reserves would be found was high and proved to be true," Ex. A/T-100 at 26; and (4) there remains no competition for getting ANS oil to market and the threat of interruption is no greater than average, *id.* In addition, TAPS has "an impressive safety and reliability record" so there is no high risk associated with TAPS operations as argued by the Carriers.[140] The record "runneth over" with evidence that the risks associated with TAPS encountered by the Carriers is simply not comparable to that of the Carriers' parent companies' line of business.

193. Anadarko/Tesoro's witness Hanley confirmed that the risks associated with the original construction of TAPS have no bearing here some 35 years later. Ex. A/T-160 at 19-20, Tr. 2329-34; Ex. A/T-60 (revised at 4-5). Commission precedent instead looks forward to the current risks affecting current rates.[141] Furthermore, the cost of capital is prospective, and here, the examination is focused on the years 2005 and 2006 forward. A/T-160 at 19. Therefore, the Carriers' attempts to impute the risks

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overseas. An insignificant amount of the Carriers' parents earnings are from pipeline operations. *See* Tr. 1419.

[138] TAPS has no competition and is the only means of transporting Alaska North Slope (ANS) oil to market. Hanley, Ex. A/T-160 at 23, A/T-100. A/T at 26, A/T-132 at 8; Baumol, Tr. 3589. The Carriers, pursuant to the TSA, have recovered more than 80% of their investment and by 2006 have recovered more than 96% of their investment (including AFUDC). Ex. A/T-35 at 87; Ex. A/T-146, WP-4 at 4 (compare line 3 with line 7).

[139] Ex. A/T-132- at 9-10; Ex. A/T-100 at 26-27; Ex. A/T-132 at 51; *Trans Alaska Pipeline System*, 10 FERC ¶ 63,026, 65,203 (1980).

[140] Ex. A/T RB at 63; Tr. 2138, 2142; Tudor, Tr. 2135; Wells Tr. 2384; Tye, A/T-214 at 2-3.

[141] *Transcon*, 60 FERC ¶ 61,246 at 61,827. Staff also notes that the rate of return is forward looking and while construction risks may be relevant for newly developed or developing projects, such risks are for the most part irrelevant for a project that was completed 30 years ago. Staff RB at 56. Staff further states that this is another important reason to match a forward looking ROE with a forward-looking capital structure. *Id.*

they faced during the construction and start-up phases of TAPS to the inquiry here are rejected as both irrelevant and disingenuous. Assuming *arguendo*, that it were proper to consider the risks of the original TAPS project, the record also shows that there was no risk that TAPS would not be completed.[142]

194. The Carriers claim that because their parent companies are involved in diverse ventures, this diversification offsets their risks. Thus, the Carriers assert, the parent companies' diverse business is not riskier than the Carriers who have only one asset in one location. The Carriers cite *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 178-79 (1983), for the proposition that such diversification of risk serves to lower a company's risk. The testimony offered by Mr. Wells on risks of the Carriers and their parents is not persuasive in light of the evidence that at least a few of the TAPS Carriers' parents are dependent upon E&P for much of their earnings. Ex. A/T-205 at 5; Ex. A/T-206 at FS-2; Ex. A/T-209 at 39. Furthermore, Mr. Wells' testimony that the parent companies are "far less risky than the TAPS Carriers" is not convincing. Ex. ATC-203 at 12. The extensive record evidence supports the conclusion that the Carriers' parents risks are not comparable to that of the Carriers. Thus, it is found that the Carriers' parents' and the Carriers' business risks are clearly not comparable and that the parent's capital structure should not be used. Ex. A/T-53 at 8-10; Ex. A/T-100 at 6-10; Ex. A/T-160 at 6-8.

195. "The Commission reviews a pipeline's capital structure to assure that it is not contrived, or that the parent company's capital structure is not unrepresentative of the pipeline's risks." *SFPP, L.P.*, 96 FERC at 62,068. The Carriers capital structure (71.42% equity) falls outside the perimeters normally approved by the Commission.[143] While Anadarko/Tesoro claim that typical equity structures fall in the range of 45-55% equity, *see* A/T IB at 80, the Commission clearly views a capital structure with an equity percentage as high as 71% as being at the "at the extreme of what [the Commission has] approved in the past." *Colonial*, 116 FERC at P 62. The Commission's policy is to take those anomalous capital structures or those that are unrepresentative of a pipeline's risks and adjust them so that they are more

[142] *See* A/T RB at 61-63; A/T-167 (Revised); Ex. SOA-72 at 2; Ex.SOA-73 at 6,891-20; *Trans Alaska Pipeline Sys.*, 10 FERC ¶ 63,026 at 65,198-204 (1980).

[143] *See* Tr. 1408-12, 1414-15 (Williamson states that the carriers' average 87 percent equity ratio is unprecedented); Ex. A/T-53 at 6-7, A/T-100 at 29 (Hanley stated the typical FERC approved capital structure in the rage of 45 percent to 55 percent equity); *see also SFPP, L.P.*, 96 FERC at 62,065 (a capital structure of 45% to 55% debt is consistent with structures generally approved in the oil pipeline industry). Williamson, Tr. 1408-12, 1414-15; Ex. A/T-4 at 5, 12-13; Ex. A/T-53 at 5, 6-14; Ex. A/T-100 at 6-11; Ex. A/T-160 at 5-12, 37-39.

representative of the pipeline's risks.[144] In conclusion, it is found that the Carriers' parents' over-weighted equity structure is anomalous and falls outside the confines of debt to equity ratios previously approved by the Commission and will not be allowed here. In addition, it is found that the Carriers' proposed capital structures are inextricably high when compared to the DCF proxies forwarded by the parties.[145]

196. As Staff points out, the Commission is against using an "unrepresentative parent company capital structure." Staff RB at 60; *SFPP, L.P.*, 96 FERC at 62,068. Staff also states that although the Commission has not yet adopted the use of a proxy group to determine hypothetical capital structures for an oil pipeline, it has adopted proxy capital structures for other regulated entities.[146] Since it has been found that the TAPS Carriers' parent companies' capital structure is "anomalous," a hypothetical capital structure will be employed.[147] This falls in line with Commission precedent using a hypothetical pipeline where the equity structure of the parent is "anomalous." *Id.* The Carriers' parents' equity structure is over-weighted with equity[148] and is not

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[144] In *SFPP, L.P.*, 96 FERC 62,068 (the Commission rejected the use of the parent's capital structure with a 100% equity component in favor of a debt-to equity ratio 61%/29% more consistent with those used in the pipeline industry 45 to 55%); *Alabama-Tennesse*, 40 FERC at 61,814; *HIOS*, 110 P 143,147 *Entrega*, 113 FERC at P 32; *ARCO*, 52 FERC at 61,243; *Transcon*, 84 FERC ¶ 61,084: *SFPP, L.P.*, 96 FERC at 62,068.

[145] The Carriers' equity ratios of 85% and 87.5% as compared to the equity ratios of the proxy companies used in the DCF calculation of 45% for 2005 and 42% for 2006. Ex. A/T-5; Ex.A/T-53 at 5.

[146] *Id.* (citing *Alabama-Tennessee Natural Gas Co.*, 40 FERC at ¶61,244 at 61,814; *HIOS*, 110 FERC 61,043 at P 143,147).

[147] Staff RB at 53; A/T IB at 79; *see Entrega*, 113 FERC ¶ 61,327 at P 32; *see Transcontinental Gas Pipe Line Corp.*, 90 FERC at 61,928 (The Commission's policy on determining whether to use the capital structure of the pipeline, as opposed to the parent or a hypothetical capital structure, is now well-defined.); *Michigan Gas Storage Company*, 87 FERC at 61,160; *Alabama-Tennessee Natural Gas Co.*, 40 FERC at ¶61,244 at 61,814 (1987) (*Alabama-Tennessee*); *HIOS*, 110 FERC 61,043 at P 147.

[148] Flint Hills argues that the parent companies' weighted average equity ratio for the period 1984-2004 of 71.46%, Ex. ATC-47, is close to the equity ratios for some natural gas pipelines. FHR IB at 34 (citing *Midwestern Gas Transmission Company*, 31 FERC ¶ 61,317; *Alabama-Tennessee Natural Gas Co.*, 13 FERC ¶ 61,224. The cases cited by Flint Hills to support their contention that a 71.46% equity ratio is close the equity ratios of some natural gas pipelines has been distinguished by the Commission in a subsequent decision. Anadarko/Tesoro and

comparable with the risks associated with the Carriers. Commission precedent mandates using a proxy group in such situations.

197. Anadarko/Tesoro's proxy-based capital structure sponsored by Mr. Hanley is appropriate. As a threshold matter, it is important to note that Mr. Hanley's testimony is credible and afforded considerable weight. Mr. Hanley's proxy is well supported in the record and the Carriers' attempts to discredit this capital structure are baseless.[149] The Commission will use a hypothetical capital structure based on the average equity ratio of a group of comparable MLP companies.[150] First, Mr. Hanley's proxy group is based on a representative group of oil proxy companies previously found acceptable by the FERC, and endorsed by the State.[151] Specifically, Mr. Hanley used Buckeye Partners, L.P., Enbridge Energy Partners, L.P., KinderMorgan Energy Partners, L.P., and TEPPCO Partners, L.P. which are the same four pipeline companies that were used in *SFPP, L.P.*, 96 FERC at 61,099-100.[152] In addition, Mr. Hanley further verified the reasonableness of his capital structure by using bond benchmarks. Ex. A/T-4 at 15; A/T-53 at 12-13. Mr. Williamson used this same proxy group for his test-period DCF analysis. Ex. ATC-45 at 16-17; Tr. 6860-61, 6864-65. Mr. Hanley also demonstrated that "the risk profile of the TAPS Carriers is comparable to both the four oil pipeline proxy group and the alternative gas pipeline proxy group, but significantly below that of the Carriers' parents, who exhibited nearly double the risk of the Carriers and the proxies."[153] A/T IB at 86.

Staff aptly note that a later Commission decision distinguished the two orders cited by Flint Hills and the underlying rational was abandoned. A/T RB at 65 (citing *Alabama-Tennessee Natural Gas Co.*, 40 FERC ¶ 61,244 at 61,814).

[149] Hanley, Ex. A/T-4 at 5, 11-18; Ex. A/T 5 at 1; Ex. A/T-53 at 5-14; Ex. A/T-54 at 1; Ex. A/T-100 at 6-11; Ex. A/T-160 at 5-13, 37-39.

[150] Staff RB at 53; *Alabama-Tennessee*, 40 FERC at 61,815; *HIOS*, 110 FERC 61,043 at P 143,147.

[151] A/T IB at 85; Ex: A/T-4 at 5, 11-18; Ex. A/T-5 at 1, Ex. A/T-53 at 5-14; Ex. A/T-54 at 1. Mr. Hanley's capital structure was endorsed by the State. Ex. SOA-44 at 53-62. Mr. Hanley's proxy group consists of four oil pipeline companies used by the FERC in *SFPP, L.P*, 86 FERC ¶ 61,022 at 61,099-100 (1999).

[152] Ex. A/T-4 at 13-14; Ex. A/T-6 at 6; Tr. 6821-22. These company names have been modified to reflect the impacts of name changes and acquisitions. Ex. A/T IB at 85.

[153] Thus, the record reflects that even as compared with different proxy groups, the parent's equity ratio is still significantly high.

198. The Carriers and Flint Hills take issue, and Staff notes a problem, with all of the members of the oil pipeline proxy group being MLPs. The concern stems from *HIOS*, 110 FERC ¶ 61,063, where the Commission excluded MLPs unless the MLPs' distributions had characteristics similar to a corporate dividend and *Sepulveda* in which the Commission found one company in the proxy group should be excluded for HIOS concerns. 117 FERC at P26. *Sepulveda*, *Kern River*, and *HIOS* present potential problems, as noted by Staff. *HIOS* excluded the use of MLPs unless distributions by the MLPs have the same characteristics as a corporate dividend. 113 FERC ¶ 61,280. As stated by the Commission, the "HIOS issue centers on a concern that the cost of equity capital may be skewed if distributions exceed earnings." *Sepulveda*, 117 FERC P 61,285 at P 26. More pointedly, the Commission explained that:

> [T]he cash distributions of the MLPs it seeks to add to the proxy group in this case include a return of invested capital, in addition to a return on invested capital through an allocation of the partnership's net income..... the Commission uses the DCF analysis solely to determine the pipeline's return on equity. The Commission provides for the return of invested capital through a separate depreciation allowance. For this reason, to the extent an MLP's distributions include a significant return of investment, a DCF analysis based on those distributions, without any adjustment, will tend to overstate the estimated return on equity because the "dividend" would be inflated by cash flow representing return of equity, thereby overstating the earnings the dividend stream purports to reflect.

Kern River, 117 FERC at P 150.

199. In *Sepulveda* the Commission addressed a similar proxy group[154] used by Anadarko/Tesoro and the State and determined that one of the companies exhibited a HIOS issue. 117 FERC ¶ 61,285. The *Kern River* order also casts doubt on whether the oil pipeline proxy can be used to calculate equity return for capital structure purposes.[155] Staff properly notes that in *Sepulveda* and *Kern River*, the Commission did not preclude the use of MLPs if proper adjustments are made to account for the differences between MLPs and corporations.[156] In addition, in a Commission order

[154] Anadarko/Tesoro eliminated the company the Commission rejected in Sepulveda.

[155] 117 FERC ¶61,077; Staff IB at 26.

[156] Staff IB at 73; *Sepulveda*, 117 FERC at 30 (the Commission did not preclude the inclusion of Enron Liquids (the eliminated MLP) or its predecessor Kinder Morgan Energy Partners in the proxy group in any pending proceedings based on further analysis of the HIOS issue in those proceedings); *Kern River*, 117 FERC at

that was issued after the record in this proceeding was closed (March 27, 2007), the Commission stated that:

> As we noted in *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 154 (2006), "[w]e do not intend in this order to foreclose non-MLP pipelines from proposing to include MLPs in the proxy group, with an appropriate adjustment to reflect the differences between MLPs and corporations.

Mojave Pipeline Company, 118 FERC 61,252 at P 14 n.4.[157] The four MLP proxy companies in this case have distributions per unit exceeding income per unit for a portion of the relevant time periods. Tr. 6815-6830:13; Ex. FHR IB at 37. Mr. Hanley addressed the MLP adjustment issue. First, Mr. Hanley stated that there is sufficient evidence in the record to make the adjustments; however, the effect of such adjustments would be minimal. Staff IB at 73; Hanley, Tr. 42/6826/66; Ex. FHR-56, 57, 58, 79. In addition, Mr. Hanley developed a separate proxy group of four diversified gas companies and confirmed that the gas proxy and the oil proxy are comparable from a financial and a business risk view point.

200. The oil proxy group (using the MLPs) yields a significantly lower equity ratio than that of the TAPS Carriers' parents' capital structures (71.42% parents vs. 45% MLP oil proxy). *See* A/T-4 at 4-5; A/T-5 at 1-2. It is relatively close to the capital structure of the gas proxy group (gas proxy 55% vs. 45% MLP oil proxy). *See id.* However, the overall effect as discussed further, *infra*, yields a significantly similar overall nominal cost of capital for 2005 (8.66% MLP oil proxy vs. 8.63% gas proxy). It would not be reasonable, in light of the discussion concerning the risk factors, to scrap Mr. Hanley's MLP analysis in favor of using the Carriers' parents' capital structure that is clearly outside the range usually approved by the Commission.

P 147 (the Commission stated that it was "not making a generic finding that MLPs cannot, in future cases, be considered for inclusion in the proxy group if a proper evidentiary showing is made").

[157] On April 11, 2007, Anadarko/Tesoro filed a motion to lodge the Commission's order in *Mojave Pipeline Company*, 118 FERC ¶61,252 (2007) asserting that the order is relevant to the use of MLPs. Flint Hills filed an answer on April 26, 2007 stating that although it does not agree with Anadarko/Tesoro's arguments, it does agree that the order is relevant and also requests that the order be lodged in this proceeding. Anadarko/Tesoro filed a reply on April 27, 2007. It is found that the *Mojave* order is relevant to the issues in this proceeding and is thus lodged to this record. Anadarko/Tesoro's motion is hereby granted. Although Rule 213, 18 C.F.R. § 385.213 generally does not allow responses to answers good cause exists to allow Anadarko/Tesoro's answer to further supplement the record.

Notwithstanding, the inclusion of MLPs, the equity structure produced by the oil proxy group are reasonable and credible when compared to the other proposed equity structures. Mr. Hanley acknowledged that there were differences in the capital structures of his oil and gas proxy groups (42% vs. 47% equity), but stated that the overall nominal after tax weighted return of both are similar for 2006 (8.60% vs. 8.05%). Ex. A/T-53 at 3-6; Tr. 42/6821, 6832. Moreover, the Commission's concern with MLPs is that "a DCF analysis based on those distributions, without any adjustment, will tend to overstate the estimated return on equity." *Kern River*, 117 FERC at P 150. As shown by Mr. Hanley, the MPL proxy yields an equity ratio lower than both the Carriers' parents capital structure and the gas proxy.

201. Staff also supports the proxy group and finds it particularly persuasive, as it is also found here, that the proxy group risk profile is comparable to Mr. Hanley's alternative gas pipeline proxy group.[158] In addition, Mr. Hanley's proxy group is comparable to capital structures adopted by the Commission for oil pipeline ratemaking purposes. Staff RB at 61. Thus, it is found that the oil pipeline proxy group supported by Mr. Hanley is credible and will be adopted to determine the appropriate capital structure for the Carriers. The capital structure adopted here is comprised of 55% debt and 45% equity for 2005 and 58% debt and 42% equity for 2006 based on the oil pipeline proxy companies.[159] The Carriers claim that each of the Carriers should be able to use its parent's capital structure in its return calculation.[160] The business risks for TAPS are virtually identical for each Carrier. Ex. A/T at 100. Thus, there should be only one rate of return which necessarily means there should be only one capital structure. *Id.* Thus, the Carriers proposal to use individual capital structures for each Carrier is rejected as Anadarko/Tesoro have shown that a single capital structure is more reasonable. Ex. A/T-100 at 11-13; Ex. A/T-160 at 5-6. Moreover, this is further corroborated by the Carriers' witness Williamson's calculation of a singe capital structure. *See* Ex. A/T-100 at 11-13.

Issue III.F.2. What is the appropriate return on equity?

202. The Carriers state that the parties generally agree that the Commission's Discounted Cash Flow (DCF) methodology should be used to calculate the cost of equity (before the risk premium). Although the DCF models used by the Carriers,

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[158] A/T-163; Staff IB at 73; RB at 60-61.

[159] The above findings are dispositive of Flint Hills' argument concerning proxy groups.

[160] The Carriers argue that the use of a proxy group capital structure is unprecedented for an oil pipeline, does not reflect the risks of TAPS, does not represent the capital structures of other Alaskan oil pipelines, and would serve as an impediment to the Carriers' ability to raise capital. Carriers IB at 83-86.

Anadarko/Tesoro and the State are substantially similar, there are still differences. The Carriers state that Anadarko/Tesoro and the State used an additional forecast from the Social Security Administration (SSA) which skews the forecast, resulting in a lower and, thus more favorable cost of equity for Anadarko/Tesoro. The Carriers also state that Anadarko/Tesoro failed to follow Commission precedent and failed to use the Global Insight Gross Domestic Product (GDP) forecasts for years prior to 2005 instead, relied on SSA and Energy Information Administration (EIA) forecasts. Finally, the Carriers state, the principal difference between the TAPS Carriers' position and the opposing parties' position involves the appropriateness of the risk premium.

203. Mr. Williamson applied the DCF methodology to the DCF proxy Group[161] companies for the years in which it was possible to perform that analysis (1994-2004), the Carriers state. Next, for the period 1984 through 1993, for which the necessary data was not available, Professor Williamson used a Commission-approved Risk Premium approach. Last, the Carriers claim, to account for the fact that the risks faced by the TAPS Carriers exceed the risks faced by the proxy companies, Professor Williamson added a two percentage point risk premium to his cost of equity. The Carriers argue that this approach is reasonable. The Carriers state that Professor Williamson conducted a "backcasting" analysis utilizing the Risk Premium approach because the DCF proxy Group did not exist during 1984-1993. The Carriers claim that the Risk Premium approach has been accepted in Commission decisions.

204. Next, the Carriers claim that the Commission will add a risk premium to the midpoint of the DCF Proxy Group Range if the regulated pipeline is riskier than the pipelines in the proxy group. The Carriers state that TAPS is riskier than any Lower-48 oil pipeline and that warrants a risk premium of at least two percentage points. In concluding that a two percentage point risk premium is warranted, Professor Williamson relied on testimony from the original TAPS rate case which documented significant problems regarding TAPS construction. The Carriers argue that this percentage premium is consistent with the two percent risk premium approved by the Commission for Alaska Natural Gas Transportation System (ANGTS) where the Commission concluded that it was appropriate to compensate for the risk of non-completion. The Carriers state that since all of the proxy companies acquired pipelines already in existence and faced no risks associated with building a new pipeline, the two percentage point risk premium is particularly appropriate for TAPS. In addition, the Carriers state that over the period for which Professor Williamson

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[161] "A "proxy group" is a group of comparable companies used to determine a zone of reasonableness of rates of return, and to establish what the proper rate of return should be for the company under consideration." *Petal Gas Storage, L.L.C.*, 106 FERC ¶ 61,325 (2004) (*Petal Gas Storage*).

employed DCF analyses to determine a range of reasonable equity returns for the DCF Proxy Group, the average difference between the high end of the range of returns and the median return was 3.23 percentage points, which is well above the two percentage point risk premium that Professor Williamson recommends.

205. Anadarko/Tesoro claim that the record reflects that using the Commission's preferred DCF model, the appropriate ROE for TAPS for 2005 is 12.16% on a nominal basis (8.90% inflation adjusted), and for 2006 it is 12.31% on a nominal basis (8.89% inflation adjusted). First, Anadarko/Tesoro state that all the parties agree on application of the Commission approved DCF model. Each of the parties that presented evidence on the cost of equity, which includes Anadarko/Tesoro, the State and the Carriers, employed the DCF approach. However, Anadarko/Tesoro contend, because of internal input variations, minor, insignificant differences appear in the parties' calculated ROEs for 2005 and 2006. Anadarko/Tesoro state that Flint Hills who offered no evidence on this point, attempted to cast doubt on the use of MLPs as proxy companies where MLP distributions exceed earnings. Tr. 6814-34. Anadarko/Tesoro state that based on this record, where all the parties sponsoring cost-of-capital evidence agreed on the use of the four MLP oil pipeline proxies for purposes of their DCF analyses the Commission need not consider arguable distinctions between the composition of MLP distributions and corporate dividends. Additionally, Anadarko/Tesoro assert that impact of any such distinctions is minimal and, based on record evidence, could be accounted for through an earnings-capped adjustment to distributions used in the DCF calculation. In conclusion, Anadarko/Tesoro state that there is no material dispute regarding the use of the DCF method, the appropriate proxy companies, or the DCF-determined cost of equity.

206. Second, Anadarko/Tesoro claim that there is no support for a risk premium ROE adjustment. According to Anadarko/Tesoro, the Carriers propose to add a 200 basis point risk premium to the nominal ROE calculated under the DCF method based on the alleged risks facing TAPS. Anadarko/Tesoro claim that it and the State oppose any risk premium adjustment and that the proposal was discredited in its entirety by witnesses Hanley, Makholm, and Ives. Anadarko/Tesoro claim that Commission precedent confirms that the Commission presumes all pipelines to be of average risk. Accordingly, Anadarko/Tesoro claim, the Commission will generally approve ROEs that fall in the median of the DCF range, absent highly unusual circumstances and a showing of anomalously high or low risk. In this case, Anadarko/Tesoro claim the record shows that TAPS has no greater operating risks and its risks from environmental and property damage are less than the proxy group.

207. The construction of the line is irrelevant or of historic interest only, Anadarko/Tesoro claim. In short, Anadarko/Tesoro conclude, since TAPS: (1) was built without any meaningful threat of competition, (2) anchored by vast proven reserves, (3) has shippers who are largely affiliates strongly motivated to ensure the

project's success, and (4) has investment costs that are essentially already recovered (and indeed over-recovered) through nearly 30 years of operation cannot credibly claim entitlement to any risk premium adjustment. Anadarko/Tesoro also argue that the Carriers backcasting is unnecessary because it is improper to recalculate the deferred returns and AFUDC balances in the Carriers' rate filings which already reflect the Carriers' balances from 1977. In addition, the Carriers' backcasting is flawed as shown by Mr. Hanley.

208. Staff states that the parties consistently applied the four proxy companies to the DCF analysis and that there is no material dispute among the parties as to the use of the DCF method or the nominal cost of equity. Staff does, however, note that there is a *de minimus* difference in the parties' DCF-based ROEs which Staff states is due to internal input variations and calculation errors. According to Staff, Anadarko/Tesoro witness Hanley has verified these variations and has shown that they do not result in significant differences in the nominal cost of equity. Staff also states that, as noted previously, the proxy consists of the four MLP oil pipeline proxies the Commission questioned in *Sepulveda* which casts some doubt on the use of MLPs. However, Staff asserts, the unique circumstances of this proceeding may still permit the Commission to accept the group. Alternatively, Staff suggests that the Commission should require the use of a gas pipeline proxy which was shown to represent risks comparable to TAPS and overall returns similar to the oil pipeline group. Staff states that the Commission previously relied on gas pipelines as a proxy for oil pipelines until sufficient evidence on oil pipelines became available. Since with the elimination of the oil proxy group such evidence would no longer be available, Staff asserts, it would be appropriate to go back to using gas pipelines as a proxy.

209. However, Staff states no matter which proxy group is used, the Carriers are not entitled to a special risk premium on their equity rate of return. The Carriers proposed risk premium must be rejected because (1) the rate of return is a forward-looking concept and the TAPS risks of construction are irrelevant and (2) the risks related to the construction and completion of TAPS were not that unusual. Staff claims that the Commission considers all pipelines to be of average risk and will generally adopt ROEs that reflect the median of the DCF range, absent highly unusual circumstances and a show of anomalously high or low risk. In instances where the Commission has deviated from the median to allow a ROE adjustment, it did so based on forward looking-risk factors unique to the regulated enterprise or shortcomings in the available proxy companies, Staff contends. Here, Staff asserts, there is no credible evidence that TAPS faces extraordinary, forward-looking, operational risks. Staff states that the arguments made by Carriers' witness Mr. Wells relate to the risk of construction and/or non-completion, and the risk that the investment will not be recovered. There is no persuasive rationale for burdening current ratepayers for these asserted risks, Staff states.

210. Staff states that the Carriers brief clarifies that their risk premium proposal is entirely related to the construction and completion risks of TAPS which are no longer present. The Carriers' proposal must be rejected because the Carriers have not met their burden to demonstrate that they require a return well outside the median of the DCF range. Staff concludes that the Carriers cannot credibly claim entitlement to any risk premium. Accordingly, Staff states, the appropriate return on equity using the consensus proxy group and applying the Commission's preferred discounted cash flow model is 12.16% on a nominal basis (8.90% inflation adjusted), and for 2006 it is 12.31% on a nominal basis (8.89% inflation adjusted).

Discussion/Findings

211. The DCF approach is based on the premise that a stock's price is a function of expected future cash flows, calculated using current dividend yields and estimated growth in dividends. A/T IB at 87; Tr. 6865. The DCF analysis is applied to the selected proxy group to produce a range of equity returns. A/T IB at 87; *see* Opinion 435, 86 FERC at 61,099. The median range is used by the Commission to set the return on equity for the regulated entity. *Id.* There is a noted exception to this practice. While the DCF analysis is applied in the same fashion to gas and oil pipelines, the calculation for gas pipelines, establishes a "nominal" return on equity, which includes a component for inflation and for oil pipelines a "real" ROE is calculated that subtracts the inflation factor from the "nominal" return on equity. *Id.*

212. The parties agree that the DCF Methodology is the appropriate methodology to employ in calculating the return on equity in this proceeding.[162] In addition, the parties agree that the main point of contention is the 2% risk premium requested by the Carriers. Thus, the argument at hand is focused on whether the imposition of a risk premium is appropriate; however, the issues concerning the *de minimus* differences in the DCF model inputs must first be addressed. The parties agree that their application of the DCF proxy results in a difference that is immaterial.[163] However, the parties do note some difference.

213. First, the Carriers claim that the State and Anadarko/Tesoro used an additional SSA forecast which allegedly skews the DCF calculation and results in a lower cost of equity, to the benefit of Anadarko/Tesoro. Carriers' IB at 89. As stated by

[162] A/T IB at 87; Carriers' IB at 89; Staff IB at 74-75, *see SFPP*, 86 FERC at 61,099. With regard to the use of MLPs in the proxy group, the Carriers, Staff and Anadarko/Tesoro agree that the use of such a proxy group is appropriate in this proceeding. Carriers' RB at 62 n.199; A/T RB at 69; Staff IB at 75.

[163] Staff IB at 75 n.237; Carriers' IB at 89; A/T IB at 87; Ex. A/T-100 at15-17; Ex. A/T-104 (Column 11).

Anadarko/Tesoro and the State, the differences in the DCF-determined cost of equity is insignificant and attributable to input and calculation differences. A/T RB at 69 n.81; Staff IB at 75 n.237 A/T IB at 87; Ex. A/T-100 at15-17; Ex. A/T-104 (Column 11). Contrary to the Carriers' assertions, Anadarko/Tesoro's use of the EIA and SSA for the long term growth rates is consistent with Commission precedent.[164] The Commission rejected the same argument forwarded by the Carriers' and their witness Mr. Williamson. The argument was that two of the forecasts should be rejected because the forecasts were lower than the others and were thus, as Williston Basin claimed, unreliable. *Williston Basin*, 104 FERC at P31; Carriers' IB at 89; ATC-45 at 23; *See* State IB at 57. The Carriers' witness Mr. Williamson admitted that in *Williston Basin* the "Commission accepted the inclusion of GDP growth forecasts from SSA" for the DCF calculation 104 FERC at P 32; ATC-45 at 45:5-6.

214. Mr. Williamson's reason for excluding the SSA GDP forecasts, *inter alia*, was because they "reflect extreme conservatism" and as stated by the Carriers, "skews the forecast, resulting in a lower and, for Anadarko/Tesoro, a more favorable cost of equity." Carriers' IB at 89; Ex. ATC-45 at 23; *see* Ex. A/T-100 at 24:18-21. Mr. Hanley used the information from the SSA and EIA because it was "freely available and cost-free" whereas getting the DRI/WEFA estimates is "time-consuming and extremely costly." Ex. A/T-100 at 24. A reasonable inference can be drawn here that Mr. Williamson's main purpose for excluding the SSA GDP forecasts in his DCF analysis is because they would yield a lower cost of equity (which is unfavorable to the Carriers). Carriers' IB at 89; ATC-45 at 23, *see* State IB at 57; *see* Staff IB at 62; *see* Ex. AT-100 at 24. In addition, Mr. Williamson's choice to exclude the SSA forecast after admitting that the Commission accepts the SSA forecast in DCF calculations is suspect particularly when the point of the exercise is to determine a range (both high and low) and not just an exact number. Thus, Mr. Williamson's testimony with respect to this issue will be accorded little weight. Mr. Hanley's use of an additional GDP SSA forecast, approved for use in the DCF analysis by the Commission, in his calculation renders his study more reliable than Mr. Williamson's.

215. As an additional ground for rejecting Mr. Williamson's DCF analysis Mr. Hanley notes that Mr. Williamson's calculations contain timing mismatches. To begin with, Mr. Hanley points out that the cost of common equity is prospective, and thus applicable to a future period. A/T-100 at 16. Mr. Hanley states that the calculation should take into account the time period in which investors would examine the data to form their expectations and that is usually the end of the proceeding year (when they form expectations for the following year). Mr. Hanley states that since investor's expectations are formed in the previous year, there is a

[164] State IB at 57; *Williston Basin*, 105 FERC ¶ 61,036 at 21-33; Ex. ATC-45 at 23.

mismatch between the data used and the expectational cost of common equity capital. *Id.* at 18-19. Mr. Hanley further states that the actual result is not what should be considered, but instead what the investors expected. Thus, the expectational cost for one year is measured by the actual data from the previous year. Mr. Williamson's calculations do not reflect this practice and, accordingly, result in a mismatch between the data used and the expectational cost of common equity capital. *Id.* at 17.

216. Accordingly, the Carriers' DCF analysis is rejected in favor of adopting Anadarko/Tesoro's analysis.[165] As explained previously the differences in the DCF calculations of the Carriers and Anadarko/Tesoro are insignificant. It is found that the appropriate return on equity (ROE) calculated using the DCF methodology inputs of Anadarko/Tesoro for TAPS for 2005 is 12.16% on a nominal basis (8.90% inflation adjusted or real equity return), and for 2006 is 12.31% on a nominal basis (8.89% inflation adjusted or real equity return). Hanley, Ex. A/T-5 at 5, 11-18, A/T-53 at 5, 6-14, A/T-100 at 10, 25-30, A/T-160 at 5-13, 37-39.

217. Now, considering the more significant point, the Carriers claim that a risk premium of 2% or 200 base points should be added to their return on equity because TAPS is "riskier than any Lower-48 oil pipeline." Carriers IB at 90. In *Petal Gas Storage*, the Commission stated that

> [I]t begins the risk analysis for proposed projects with the assumption that pipelines generally fall into a broad range of average risk. Absent highly unusual circumstances that indicate an exceptionally high or low risk as compared to other pipelines, the assumption is made that a pipeline faces average risks (though an examination of a particular pipeline's risk factors may warrant adjusting the ROE higher or lower than the middle of the zone of reasonableness established by the proxy group).

106 FERC at P 8 (citations omitted). The Commission further stated that "we conduct our risk analysis with the presumption that existing pipelines fall into a broad range of average risk, absent highly unusual circumstances that indicate anomalously high or low risk as compared to other pipelines." *Id.* at P 29; Staff IB at 76; A/T IB at 88. Additionally, the Commission requires a "sufficient showing that [the pipeline] is outside the broad range of average risk." *Id.*; *see Kern River*, 117 FERC at P 160-161. Thus, the inquiry here begins with the presumption that the Carriers as an existing pipeline "fall into a broad range of average risk" and await "a sufficient showing" that the Carriers fall outside this broad range. *See id.*

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[165] The HIOS issues in the oil proxy group are discussed under Issue F.1, *supra*.

218. As discussed in Issue III.F.1, *supra* the Carriers have failed to prove that operating TAPS is riskier than the operations of other oil pipelines.[166] In addition, Mr. Hanley notes that TAPS' business risk is average and TAPS's financial risk is average. A/T-4 at 22. The Carriers state that *Colonial* confirms that a rate of return toward the top of the range of reasonableness is justified based on the facts of this case. Carriers' RB at 70-71. Colonial was distinguished from TAPS in Issue III.F.1. The Commission's decision to grant Colonial a provisional acceptance of its equity ratio at the high end of the "zone of reasonableness" was based on the Commission's recognition that Colonial's construction project was going to present "substantial challenges" such as the length and scope of the project, enormous investment involved, financing challenges, the challenges of constructing a multi-state project, and the short time for completion of the project. *Colonial*, 116 FERC at P 59, 61-62, 65. TAPS is a completed pipeline and does not face such challenges at this time.

219. The Carriers assert that the risks TAPS faced during construction merits a 2% risk premium since the challenges and risks that TAPS faced in the past are relevant in the present. However, the case law indicates that the risk premium inquiry is forward-looking. In *Iroquois Gas Transmission Sys., L.P.*, 84 FERC ¶ 61,086 at 61,455-56 (1998) (*Iroquois*), the Commission upheld the ALJ's decision not to move the pipeline's ROE outside the range established by the proxy companies after finding that the pipeline's risk was average and that an "established pipeline serving an expanding market, that it has the security of long-term shipper contracts, and that any risks associated with construction or certification are either past or speculative." The forward-looking nature of the Commission's risk determinations was also confirmed in *Transcon. Gas Pipeline*, 60 FERC at 61,287, where the Commission stated that the inquiry is

> [B]ased on the Commission's evaluation of [the pipeline's risks] which investors perceive while the rates in this proceeding are effective. The Commission establishes rates to apply in the future that reflect projections of what costs, and risks, the pipeline is likely to incur during the period the rates will be in effect. These projections are based on historical experience, adjusted for known and measureable changes that will occur to affect costs or risks during the period the rates will be in effect.

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[166] *See* A/T IB at 88-90; Staff IB at 76. TAPS has an impressive safety and reliability record. Tr. 2138, 2142; Tudor, Tr. 2135; Wells Tr. 2384; Tye, A/T-214 at 2-3. TAPS has no greater than average operating risk. Tr. 2135. TAPS has not had a reportable spill of crude in 4 ½ years. Tr. 2142.

Transcon. Gas Pipeline, 60 FERC at 61,287. Thus, the testimony of witness Wells and the Carriers' other arguments concerning construction risk are irrelevant. Wells, ATC-151 at 6-7. Tr. 2329.

220. The fact still remains that the record does not support a finding that TAPS was a risky enterprise in either its construction phase or its operational phase, and more importantly prospectively.[167] The Commission requires the risks to be sufficiently high to justify a further increase in return. *See Kern River*, 117 FERC at P 177. The Carriers have not satisfied this requirement. Thus, Professor Williamson's extensive discussions concerning risk premiums is rejected. The Carriers' have not cited a case where the return on equity and associated risk premium issue was not a prospective inquiry. It is found that the Carriers failed to rebut the presumption that they face average risks and it is found that the Carriers are not entitled to a 2% risk premium.

Issue III. F. 3. What is the appropriate cost of debt?

221. The Carriers claim that the appropriate cost of debt is that of the Carriers' parent companies. The Commission's policy is that capital structure and long term debt cost should be based on the same entity, the Carriers claim. According to the Carriers, the Commission's policy in Opinion 154-B is to use the pipeline's parent company's capital structure and cost of long-term debt where the pipeline company does not provide its own financing. The Carriers state that the reasons they provided for using the parent company capital structure also support the use of the parent company's cost of long-debt. The Carriers claim that they and the State generally followed the same approach in determining the cost of debt using the parent companies. The actual long-term debt costs of the Carriers' parent companies are not uniform, and accordingly, Anadarko/Tesoro's proposal to use a uniform hypothetical debt cost for all TAPS Carriers would violate the requirement that each of the Carriers parents be compensated for the debt costs it has actually incurred, the Carriers contend.

[167] As Staff and Anadarko/Tesoro succinctly state "here there is no credible evidence that TAPS faces extraordinary, forward looking, operational risks. Indeed, the record supports the conclusion that TAPS: (1) was created without a threat of future competition, (2) has recognized oil reserves, (3) is contractually subscribed by affiliated shippers with interests to continue to ensure the success of TAPS, (4) whose original investment has already been substantially recovered, and, accordingly, (5) cannot credibly claim entitlement to any risk premium." Staff IB at 76 (citing Hanley, A/T-4 at 5, 11-18, A/T-53 at 5, 6-14, A/T-100 at 10, 25-30, A/T-160 at 5-12, 37-39). A/T-IB at 91. Ives, SOA-8 at 80; Makholm, SOA-44).

222. Anadarko/Tesoro state that the appropriate cost of debt for TAPS for 2005 is 5.80% and for 2006 is 5.91% as determined by the oil proxy group. The Carriers' use of the parent company debt costs is inappropriate because the parents have materially different risk profiles and capital structures than TAPS. Anadarko/Tesoro claim that where the use of parent company capital structures is inappropriate and unreasonable, it follows that using the Carriers' parents' cost of debt to TAPS is also unreasonable. Anadarko/Tesoro state that Mr. Hanley's cost of debt calculations should be accepted because although the variations in recommended debt rates are minimal, only Mr. Hanley's proposal reflects the consistent use of proxy companies to determine all cost of capital elements. Mr. Hanley's proposal is consistent with Commission precedent that requires the use of a proxy group to develop a hypothetical capital structure where the use of the parent's capital structure would produce anomalous results.

223. Staff agrees with the cost of debt proposed by Anadarko/Tesoro. Staff states that although the State calculated the cost of debt using the weighted average embedded cost of debt of the Carriers parents, the variations are insignificant. However, Staff asserts that the record does not support the use of parent company debt costs because the Carriers' parents have materially different risk profiles and capital structures than TAPS. Staff states that as with the determination of the TAPS equity return, it is also appropriate here to utilize a proxy group of risk-comparable pipeline companies to determine the cost of debt for TAPS. Moreover, Staff claims that as a matter of policy, the debt cost should be in synch with the capital structure. It follows that where the use of parent company capital structures is inappropriate and unreasonable, ascribing the parents' cost of debt to TAPS is likewise unreasonable. Staff states that the Carriers' arguments must be rejected because it is inappropriate to apply the Carriers' parents' capital structures to TAPS and, thus, using the parents' cost of debt for TAPS is precluded.

Discussion/Findings

224. The parties agree that Commission precedent mandates that the cost of debt be consistent with the capital structure. As discussed above, it was found that the Carriers' parents' capital structures are anomalous and cannot be used. The hypothetical capital structure was adopted and, thus for the sake of consistency, the cost of debt will be of the same design as the capital structure implemented in this decision. Staff, Anadarko/Tesoro, and the Carriers all cite *Enbridge Pipelines*, 100 FERC ¶61,260 at 61,944 (2002) and *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038 at 61,166 (1999) for the proposition that the capital structure imputed to a pipeline should also be imputed to the cost of debt.[168] Thus, they all agree (whether or not

[168] *Enbridge*, 100 FERC at 61,944 ("when the Commission imputes the capital structure of a corporate parent to a subsidiary, it also imputes the parent's costs of debt and preferred stock to the subsidiary"); *Michigan Gas Storage Co.*, 87 FERC ¶ 61,038

they agree with the final outcome of the capital structure findings) that this is the appropriate result. Staff IB at 78; RB at 64; Carriers' RB at 69; IB at 92; A/T IB at 91; RB at 72. Accordingly, it is found that the cost of debt will be calculated in accordance with the findings concerning capital structure.

225. As a result of all the findings above on Issue III. F. or the appropriate return on investment, it is concluded that the weighted cost of capital in this case is 7.20 percent in 2005[169] and 7.16 percent in 2006.

Issue III. G. What is the appropriate income tax allowance?

226. The parties agree that this issue is derivative of other issues. Accordingly, this issue is not in dispute. *See* A/T IB at 92; Carriers' IB at 94; Staff IB at 78.

Issue III. H. What level of throughput is appropriate to use in developing rates?

227. The parties have agreed to accept the Carriers' estimated throughputs for 2005 and 2006, accordingly, this issue is not in dispute. *See* A/T IB at 92; Carriers' IB at 94; Staff IB at 78. The Carriers' throughput figures are found in Exhibits 37-41, Statement A2 and Workpaper1 for 2005 and Exhibits 90-94, Statement A2 and Workpaper 1 for 2006.[170]

Issue III. I. What cost allocation and rate design is appropriate?

228. This issue is not in dispute. *See* A/T IB at 92; Carriers' IB at 94; Staff IB at 78.

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at 61,166 (1999) ("when the Commission imputes the capital structure of a corporate parent to a subsidiary, it also will impute the parent's costs of debt and preferred stock").

[169] Exs. A/T-13, WP1; A/T-144, WP1.

[170] Ex. A/T-146, WP1.

Issue III. J. Does the Designated TAPS Carriers' SAC presentation show that the filed 2005 and 2006 interstate rates are just and reasonable?

Parties' Contentions

229. The Designated TAPS Carriers (the Designated Carriers)[171] propose the stand alone cost (SAC) methodology as an additional benchmark to show that their filed rates are just and reasonable. The Designated Carriers claim that if their filed rates are lower than the rates determined under SAC, that will serve as an additional indicator that the Carriers' filed rates are just and reasonable. Precedent from the D.C. Circuit, the Supreme Court, other commissions, and this Commission support the use of SAC to evaluate the reasonableness of TAPS rates, the Designate Carriers claim. The Designated Carriers state that the average rate derived by Mr. Klick for all New Alaska Pipeline System (NAPS) is $5.34 per barrel in 2005 and $5.52 per barrel in 2006. Since these rates are higher than the Carriers' filed rates for 2005, the Designated Carriers claim that this proves the filed rates are just and reasonable.

230. In addition, the Designated Carriers assert that SAC acts as a surrogate for competition by replicating the competitive market in situations where competition is absent and enables regulators to determine the maximum rate a carrier could charge if competition existed. In sum, the Carriers state that SAC shows the rates that could be charged if TAPS was subject to effective competition. Thus, the Designated Carriers contend, the SAC analysis determines the maximum rate that an economically efficient new entrant could charge for the same service. If the SAC rate is higher than the filed rate, the Designated Carriers assert, then the filed rate is deemed just and reasonable.

231. The Designated Carriers state that they are not using SAC to establish the Carriers' rates. The Designated Carriers claim that it is irrelevant that SAC is not an original cost methodology because the Commission is not required to adhere exclusively to original cost ratemaking. Revenue adequacy principles are not important, the Designated Carriers argue, since they are not arguing that the SAC rates should be submitted for their filed rates.

232. Anadarko/Tesoro state that the SAC does not support the justness and reasonableness of the Designated Carrier's filed rates. SAC is a form of a replacement cost method grounded in hypothetical costs of operating a hypothetical

[171] The Designated TAPS Carriers are: BP Pipeline (Alaska); Exxon Mobile Pipeline Company; Koch Alaska Pipeline Company, LLC and Unocal Pipeline Company.

pipeline and contradicts the original cost method required by *Farmers Union II* and Opinion 154-B. First, Anadarko/Tesoro state that the SAC is fundamentally inconsistent with original cost ratemaking because it fails to take any actual costs of TAPS into consideration. Anadarko/Tesoro state that the SAC is a replacement cost valuation methodology that has been repeatedly rejected by the courts and the Commission. According to Anadarko/Tesoro, SAC is an allocation methodology used to allocate a total revenue requirement among competitive and noncompetitive services. The Designated Carriers incorrectly use SAC to justify their revenue requirement Anadarko/Tesoro claim. Anadarko/Tesoro also claim that the Designated Carriers SAC presentation is unreliable because even the hypothetical pipeline is substantially different from TAPS. The SAC is incapable of distinguishing among rates lower than the SAC ceiling rate, Anadarko/Tesoro contend. Anadarko/Tesoro state that the case law cited by the Designated Carriers misstates relevant precedent and that the SAC analysis has not been used or recognized by the Commission.

233. Staff agrees with Anadarko/Tesoro and also states that the Designated Carriers' SAC proxy is deficient and does not support a finding that the filed rates are just and reasonable. Staff presents many of the same arguments as Anadarko/Tesoro concerning SAC including that it ignores front loaded accumulated depreciation and all other actual costs. First, Staff states that the SAC is inconsistent with original cost ratemaking as adopted in Farmers Union II and Opinion 154-B and should be rejected. Staff claims that SAC does not make an assessment as to the justness and reasonableness of the individual TSM elements and only evaluates the overall rate and thus fails to satisfy the requirement that all non-cost elements of the TSM be justified. The Designated Carriers have not supported the SAC they advance and the SAC does not support the Carriers' filed rates, Staff claims. Second, Staff asserts that SAC is premised on replacement costs principles rejected by the Commission and the courts. Third, Staff states that the SAC is inappropriately used by the Designated Carriers to establish a purported new revenue requirement. The Commission has specifically rejected the use of SAC to set an overall revenue requirement, Staff states. SAC, Staff contends, may have some value as an allocation method however, the Designated Carriers are using SAC to assess the reasonableness of their rates and not simply to provide a benchmark. Finally, Staff states that the Designated Carriers' arguments stating that SAC should be applied to alleviate concerns about generational equity should carry no weight.

Discussion/Findings

234. As Staff correctly points out, the SAC methodology was primarily used by the Interstate Commerce Commission and its successor agency the Surface Transportation Board to allocate costs between captive and non-captive customers of coal-hauling railroads. *See* Staff IB at 86 n. 271. This methodology attempts to

determine the rate that a shipper would pay if the market were competitive by calculating the costs of a hypothetical pipeline. Carriers' IB at 94; A/T IB at 94.

235. As a threshold matter, it is noted that this initial decision has already found above that *Farmers Union II* and Opinion 154-B are the applicable ratemaking standards in this proceeding. Thus, this issue can easily be disposed of using the basics set forth in these two precedents. As discussed, *supra*, in Issue II.B, *Farmers Union II* provided the Commission with several "guideposts" to use in setting just and reasonable rates. *See Farmers Union II*, 734 F.2d at 1530. Under the original cost methodology articulated in Opinion 154-B, the Commission stated that "original cost is a 'proven alternative'" and "is the best yardstick" to use in determining revenue requirements. 31 FERC at 61,833. In addition, Opinion 154-B stated that "oil pipeline rates as a general rule must be cost-based." *Id.* SAC runs afoul of the cost-based principles established in Opinion 154-B.

236. The SAC is based only on forward-looking costs and does not take the original cost of the rate base into consideration.[172] This methodology fails to take any cost into consideration including actual accumulated depreciation and the original cost of rate base and starts from scratch to create a "different rate base, different expenses, different everything." Overcast, Tr. 6272-6273. As noted by Anadarko/Tesoro, the SAC ignores the accelerated depreciation already collected by the Carriers that has resulted in a 97% recovery of their original cost investment in TAPS. A/T IB at 95-96; Ex.A/T-33; Ex. A/T-35. Moreover, implementing costs derived under SAC would permit the Carriers to cover costs completely unrelated to their original investment in TAPS. A/T IB at 95; Ex. A/T-79 at 31-32. Contrary to the Carriers' assertions, Dr. Overcast states that "SAC cannot be used to test the revenue requirement because it does not reflect any of the elements of the total revenue requirement calculation as is required under the regulatory model."[173] Even the Carriers' witness Dr. Baumol agrees that SAC "has nothing to with the revenue requirements" and [a]s one of the inventors of the concept, I can guarantee you that that is not its purpose." A/T IB at 100 (quoting Tr. 3588). Thus, the Carriers' witnesses also agree that SAC cannot be used to determine just and reasonable rates. A/T IB at 101. Anadarko/Tesoro also point out that no witness knew of a case where an agency used SAC to determine the total revenue requirement.[174] Dr. Baumol, the methodology's originator, admitted

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[172] Overcast, Tr. 6272-2673; Ex. A/T-93at 17, 24-26, 28; Ex. A/T-78 at 60-62, 65-66; Ex. A/T-140 at 14-15; A/T at 28,29-34; DTC-1 at 16; DTC-2 at 10; DTC-5 at 11-12; DTC-36 at 14.

[173] A/T-93 at 24. In addition, Dr. Baumol stated that the SAC computes a competitive ceiling; however, it does not determine what the competitive rate should be. Tr. 3612.

[174] *See* A/T IB at 100 (citing Klick, Tr. 3444, Tr. 3467; Overcast, Ex. A/T-93 at

that the SAC has been rejected by the courts and the FERC. A/T IB at 100 (citing Tr. 3588). In addition, Dr. Overcast notes that the SAC rate does not equal a cost-based rate." *Id.*

237. In addition, what makes the Designated Carriers' SAC presentation more troubling is that although they have created a hypothetical pipeline out of thin air, the *pipeline is not similar to* TAPS. The Designated Carriers' SAC presentation is based on a hypothetical, stand alone pipeline called New Alaska Pipeline system (NAPS). Ex. DTC-1 at 13; Ex. DTC-2 at 3. Anadarko/Tesoro also point out that this hypothetical pipeline is substantially different from TAPS in that NAPS is a 36 inch pipeline that moves a million barrels a day and TAPS is a 48-inch pipeline that moves more than a million barrels a day. A/T IB at 102. In addition, the costs associated with this pipeline are not at all reflective of the costs of providing service on TAPS. *Id.* The fact that this hypothetical pipeline is dissimilar to TAPS, presents yet another reason why the SAC lacks credibility.

238. SAC is a replacement cost methodology. Tr. 3413-14; ATC-161 at 31; Overcast, Ex. A/T-93 at 18-19; Tr. 6831. Replacement cost methodologies such as the SAC have been rejected by the courts. To wit, *Farmers Union II* rejected the ICC "valuation" ratemaking approach because it failed to use original cost and relied instead on replacement costs. *Farmers Union II*, 734 F.2d at 1495, 1511-18; A/T IB at 97. The case law and evidence set forth by Anadarko/Tesoro and Staff describing how utterly inapplicable SAC is to cost-based ratemaking and this proceeding is staggering. *See* Staff IB at 79-87; RB at 64-71; A/T IB at 94-103; RB 73-80. The testimony and case law in this record in favor of rejecting SAC as wholly inconsistent with cost based ratemaking principles are overwhelmingly persuasive. Furthermore, Anadarko/Tesoro's and Staff's exhaustive citations to the record and case law in their briefs are accorded considerable weight with respect to this issue. SAC is nothing more than an allocation method that has no place in the business of ratemaking or the inquiry here.[175] *In re Chicago District Elec. Generating Corp.*, 2 F.P.C. 412 (1941), the Commission explained that replacement cost evidence is "inherently fallacious and should be confined to those rare cases where evidence of original cost or prudent investment cannot be reasonably assembled."[176] Accordingly, it is found that the SAC methodology runs afoul of the cost based ratemaking principles articulated in Opinion 154-B and *Farmers Union II*. The SAC methodology does not, and in fact cannot, support the Designated Carriers' assertion that their rates are just and

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24-25; Tr. 6376; Brown, Ex. A/T-78 at 62).

[175] *See* Staff IB at 82 n. 259; n.260.

[176] *In re Chicago District Elec. Generating Corp.*, 2 F.P.C. at 419; A/T IB at 97.

reasonable and is rejected as irrelevant. Moreover, the Designated Carriers' contention that SAC is a benchmark for their filed rates is rejected as preposterous.

Issue III. K. If the filed 2005 and 2006 interstate rates are not just and reasonable, what is the appropriate remedy?

239. The Carriers state that under the ICA any refunds ordered for a change in methodology must be prospective only from the date of the Commission's final order in this proceeding and solely concerning the 2005 and 2006 rate filing. The Carriers state that the Commission's ability to award refunds in response to Anadarko/Tesoro's and the State's protests is limited to the amount of the increase from the preexisting rates, subject to refund, under section 15(7). Thus, the Carriers state, the only issue is whether the Carriers must pay refunds for the 2005 through 2006 period and how much.

240. Anadarko/Tesoro state that just and reasonable rates should be established on TAPS for 2005 and 2006 forward and refunds of amounts collected above those rates commencing January 1, 2005 should be ordered. Anadarko/Tesoro state that the Carriers' claims that this remedy can only be applied prospectively from the date of a final Commission order and that monetary relief is precluded, are mistaken.

241. Staff asserts that in the orders setting the Carriers' rates for hearing, the Commission stated that as in any section 15(7) proceeding in which proposed rates have been suspended and set for hearing, the proposed 2005 rates were allowed to become effective January 1, 2006 subject to refund and further order of the Commission. In addition, Staff states that a refund in the amount of the difference between the just and reasonable rates and the rates the Carriers have charged subject to refund since January 1, 2005 (the effective date), could be ordered.

242. Petro Star states that Commission prescribed rates may be implemented prospectively only. Any refunds should be limited to the difference between the rates proposed in the Carriers' 2005 and 2006 filings and the unchallenged 2004 rate, Petro Star claims. Petro Star also argues that the Commission should not order refunds in this case to enforce the strong policy favoring settlements. Anadarko/Tesoro have an adequate remedy in damages, Petro Star claims and ordering general refunds would benefit Tesoro to the detriment of other Alaska refiners.

Discussion/Findings

243. Based on the findings and conclusions above it is decided that the just and reasonable rates determined here will be for 2005, 2006 and prospectively and not just for a locked-in period as the Carriers aver.

244. The Commission's orders established hearing procedures to address Anadarko/Tesoro's protests and complaints regarding the Carriers' 2005 and 2006 rates pursuant to section 15(7) of the ICA. The Commission accepted the Carriers' filed 2005 and 2006 rates and made them effective beginning January 1, 2005, and January 1, 2006, respectively, subject to refund and further order of the Commission.[177] It has been found that the Carriers' have failed to prove that the proposed increases in their 2005 and 2006 rates are just and reasonable. Thus, refunds[178] are ordered effective January 1, 2005.[179] Furthermore, consistent with Commission policy[180] refunds will be limited to the difference between the 2004 rate and the rates set forth in the 2005 and 2006 rate filings.[181]

Issue III.L. Should the TAPS rates be set on an individual TAPS Carrier basis or should a uniform rate for all TAPS Carriers be determined?

245. The Carriers state that under the language of the ICA and the Commission's long standing practice, the Commission may not require the Carriers to file a single tariff or calculate their rates jointly. Next, Carriers state that they currently calculate and file their rates individually. The Carriers claim that ordering a uniform rate structure would exceed the Commission's authority under the ICA. Under section 6(1) of the ICA, every common carrier must file its tariffs with the Commission, the Carriers contend. Each Carrier publishes its own tariffs, accepts nominations and its share of TAPS capacity and invoices its own customers. The Carriers assert that the Commission has always treated each owner of TAPS as an owner of undivided joint interests (UJI) as separate common carriers.

246. The Carriers claim that a uniform rate structure would deprive the Carriers of a reasonable opportunity to recover their costs and would be confiscatory. The Carriers

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[177] *BP Pipelines (Alaska) Inc.*, 109 FERC ¶ 61,376; *BP Pipelines (Alaska) Inc.*, 113 FERC ¶ 61,332.

[178] No reparations have been requested by Anadarko/Tesoro. A/T IB at 11; Staff IB at 88.

[179] Once the Commission has found the proposed rates unjust and unreasonable, the Commission can order the "carriers to refund, with interest....such portion of such increased rates or charges by its decision shall be found not justified." 49 U.S.C. app. § 15(7).

[180] *Distrigas of Massachusetts Corp. v. FERC*, 737 F. 2d 1208 (1st Cir. 1984).

[181] Staff's recommendation that refunds to the just and reasonable rate could be ordered constitute a policy change which is outside the jurisdiction of this tribunal. Staff RB at 73-5.

state that contrary to the assertions of Anadarko/Tesoro, their costs are not essentially the same. Anadarko/Tesoro's proposal would deprive any Carrier with greater than average individual costs of a reasonable opportunity to recover its costs and that is unlawful, the Carriers claim. In addition, the Carriers state that throughput is not likely to be distributed among the Carriers in proportion to their percentage ownership of TAPS capacity. Anadarko/Tesoro have failed to show that the practice of filing individual rates or filing a uniform rate structure is just and reasonable, the Carriers contend. The Carriers claim that neither Staff not Anadarko/Tesoro acknowledge that they have the burden of proof on this issue. The Carriers also state that Staff's contention that rates should be based on average overhead cost is a concession that some TAPS Carriers will not have a reasonable opportunity to recover their prudently incurred costs and others will recover more of their costs. The Carriers also state that section II-2(f) cannot be used to address this issue since it is a voluntary agreement among the Carriers and it only pools part of the Carriers' costs.

247. Anadarko/Tesoro claim that the Carriers should be required to establish a single, or at least uniform, interstate rate because each Carrier provides the same interstate service based on essentially the same costs. Anadarko/Tesoro argue several reasons why single rates are practical for TAPS. First, Anadarko/Tesoro claim that the Carriers' rates are based on a system-wide and not individual basis. Second, Anadarko/Tesoro assert that a uniform rate would only need to be revised when there was a change in either system-wider costs or system wide throughput. Separate rates would need to be revised when there is a change in individual throughput. Third, Anadarko/Tesoro state that because separate rates are based on system-wide cost allocations, a change in the costs allocated to one Carrier would likely result in changes to the costs associated with another other Carrier, Anadarko/Tesoro claim.

248. In addition, Anadarko/Tesoro claim that a shift in throughput would result in cascading changes in rates. Anadarko/Tesoro also argue that every other pipeline in Alaska that is subject to Commission regulation has a single rate regardless of the type of ownership. The Carriers' current rates for identical service vary significantly in the same year for no apparent reason, Anadarko/Tesoro assert. The Carriers essentially have the same cost of service and requiring the Commission to determine up to six individual rates each year is impractical and unwarranted, Anadarko/Tesoro claim. The Carriers' arguments that individual costs may need to be allocated would be necessary under either a uniform or single rate regime, Anadarko/Tesoro claim. Anadarko/Tesoro also state that the Carriers can amend their operating agreement or pooling agreement to adjust for reallocations.

249. Staff states that no one contests that all the Carriers provide an identical transportation service to the shippers. Staff also states that the cost s of TAPS are almost all common costs that are allocated among the Carriers based on ownership share. When expected throughput is less than maximum, Staff contends, each Carrier

has to estimate its annual throughput and the resulting individual rates may vary significantly. Staff claims that Anadarko/Tesoro's concern is that once each Carrier estimates its throughput and a rate is set accordingly, the shippers are not tied to those estimates. To the extent that the amount actually shipped by a Carrier is greater or less than the volume level the Carrier assumes for ratemaking, the Carrier will over or under recover its costs, and all the individual rates would require adjustment. Staff states that under a single per barrel rate, rates for all the Carriers would only need to be adjusted when the total throughput on TAPS changes.

250. Staff states that each Carrier will realize its required revenue requirement as long as its actual volume coincides with its estimate. The advantage of a uniform rate, Staff states is that the situation only arises when the total throughput on TAPS changes, not every time the throughput for any individual Carrier changes. Staff asserts that the problem with over or under recoveries result under either approach, but less often under the uniform rate approach. Staff also agrees that this concern can be addressed under the pooling agreement in section II-2(f)(ii) of the TSA. In addition, Staff states that the advantage of a uniform rate is that it is more reflective of the cost to ship a barrel of oil on TAPS and it is in line with the RCA's single rates for shipments on TAPS, as well as with the uniform rates used on every other Alaskan pipeline subject to the Commission's jurisdiction. Staff also contends that a miniscule portion of each Carrier's individual rate represents that Carrier's direct expenses, primarily fuel gas costs and overhead.

Discussion/Findings

251. The Carriers cite various cases for the proposition that the Commission cannot require the Carriers to file a single tariff. However, nothing in the ICA prohibits the Carriers from filing a uniform tariff. *See* 49 U.S.C. app. § 1(3); *see* 49 U.S.C. § app. 6(1); Staff RB at 77.[182] Although, as the Carriers argue, they were not required to file a single tariff or calculate their rates jointly under the TSA, the circumstances here warrant such a requirement. The Carriers have charged individual rates that vary significantly within the same year and from year to year. A/T IB at 106; Ex. A/T-252; Ex. A/T-252-A; Ex. A/T-3 at 45. However, these changes are not caused by differences in the cost of service because all of the Carriers basically have the same cost of service. Ex. A/T-3 at 45.

252. Anadarko/Tesoro witness, Mr. Brown states that the "differences in rates among that TAPS Carriers are due primarily to the highly subjective manner in which each individual Carrier determines an annual revenue requirement and rates under the TSM, coupled with the TSM's 'Net Carryover' provision." Ex. A/T-3 at 45.

[182] For instance, section 6(1) contemplates a tariff filing under a joint rate.

According to Mr. Brown, this allows the "Carriers free reign to set rates largely as they choose." *Id.* This is unduly discriminatory, Mr. Brown states, because the differences in the TAPS rates are not based on differences in the cost of providing service. *Id.* Ex. A/T-3 at 45-46. The Carriers' individual rates have substantial variations. Tr. 2567; A/T IB at 104. This testimony is persuasive as the Carriers have not provided a reasonable explanation as to why their rates should vary significantly when their costs are virtually identical. It is found that Anadarko/Tesoro have shown that the Carriers' filing of individual rates results in unjust and unreasonable rates. Staff and Anadarko/Tesoro propose the use of a uniform rate to alleviate this problem.

253. Anadarko/Tesoro and Staff have identified factors that support requiring the Carriers to file one, uniform rate. First, as stated above, the Carriers' costs associated with TAPS are similar. Staff IB at 88; A/T IB at 104. The Carriers incur minimal costs of their own; however, much of this cost is related to the cost of gas which each Carrier supplies to help run the pump stations. Staff IB at 89. Second, the Carriers provide identical interstate transportation service. Staff IB at 88; A/T IB at 104. The Carriers' main concern is that under a uniform rate, a Carrier with greater than average individual costs may not recover all of its costs. Carriers' RB at 81. The Carriers allocate costs based on ownership shares. However, TAPS revenue requirements are based, in large part, on system-wide cost reallocations based on actual usage. Tr. 5992-97. Thus, the Carrier will over or under recover its costs based on whether it ships more or less than its percentage ownership share of the total volumes.

254. Staff acknowledges this problem and also notes that this problem also occurs for rates established on an individual basis. Staff and Anadarko/Tesoro recommend either adopting a pooling mechanism such as the one in TSA section II-1(f)(ii), or a similar version to correct this problem. The pooling mechanism in section II-1(f) of the TSA remains in effect notwithstanding this Initial Decision. Thus, it could be used to alleviate the Carriers' concerns. In addition, Staff and Anadarko/Tesoro note that the amount of direct expenses for all the Carriers together was approximately $24 million in 2004 when throughput was 326.7 million barrels which likely had almost no impact on rates. A/T IB at 106; Ex. A/T-20, Sch. II-B at 21; Ex. A/T -140 at 45; Staff RB at 76. In addition, the Carriers' rates remain virtually stable from year to year. Ex. A/T -252, Ex. A/T-252-A; Staff RB at 76. Thus, any direct costs would have an insignificant impact.

255. The use of a uniform rate would result in several advantages.[183] Rates would only require adjustment when total throughput on TAPS changes.[184] Brown, Ex. A/T-

[183] Carrier's witness Ray testified that a uniform state rate "hadn't been a problem in my mind." Tr. 1603.

3 at 45-74; Ex. A/T-140 at 101-102. The uniform rate involves a more simplistic calculation. The uniform rate would be determined by dividing total system costs by total system throughput.[185] The advantage of using a uniform rate is that it better represents the cost to ship a barrel of oil on TAPS. Staff RB at 76. Utilizing a uniform rate will also eliminate the need for the Commission to consider several different tariffs. A uniform rate is also consistent with rates established for other pipelines.

256. As the complainants, Anadarko/Tesoro have met their burden of proving that the use of individual rates by the Carriers has an unjust and unreasonable result. In addition, Anadarko/Tesoro have shown that employing a uniform rate is reasonable since among other things, it results in a rate that is more representative of the cost to ship a barrel of oil on TAPS and the use of a uniform rate would likely result in less filings due to individual Carrier changes in throughput. A uniform rate is also consistent with the RCA's requirements for TAPS (intrastate rates). All parties agree that the rates must be established on a system-wide basis.[186] Thus, it is found that the each Carrier will file a tariff based on a uniform rate in accordance with the findings in this decision.

Issue III.M. Are any other remedies related to DR&R appropriate in this proceeding?

257. This issue was discussed above under the heading Issue III.E.

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[184] Separate rates need to be revised based on allocations of system-wide costs, system-wide cost allocations and individual throughput. Costs shift based on usage and throughput may shift based on monthly nominations, thus separate rates would result in constant imbalances among the Carriers' revenue requirements. Exs. A/T-140 at 101-02; A/T-3 at 45-47.

[185] To calculate the individual Carriers' rates the system costs and system throughput must go through another step. Staff RB at 75 n.244. The system costs have to be allocated between each of the Carriers and the system throughput has to be divided by Carrier. Then, to determine each Carriers' individual rate, each Carriers' allocated cost is divided by its estimated throughput.

[186] See A/T IB at 92; Carriers IB at 94.

Issue IV. Do the TAPS Carriers' 2005 and 2006 interstate rates comply with Section 2 of the ICA, Section 3(1) of the ICA, and Section II-11(E) of the TSA?

258. The State charged that the Carriers' rates are unduly discriminatory and preferential in violation of sections 2 and 3(1) of the ICA. The Carriers assert that the States' claims are based on the large disparity between the Carriers rates and the intrastate rates imposed by the RCA. The Carriers argue that the State's discrimination claim should be rejected because it is barred by the TSA [section II-11(e)]. *The State has no legally valid claim that the interstate rates are unlawfully* discriminatory under ICA sections 2 or 3(1), and the State has failed to support the remedy it is requesting. The Carriers state that section II-11(e) of the TSA explicitly limits the State's ability to file a protest or otherwise contest the interstate rates if the issue being contested was resolved by the TSA. In addition, the Carriers claim that the rate differential which forms the basis of the State's discrimination claim was anticipated and resolved by the revenue crediting mechanism provided in section II-11(a) of the TSA. The Carriers claim that the disparity between the intrastate and interstate rates must be remedied by an increase in the intrastate rate and not by a decrease in the interstate rate. The State has failed to establish a valid claim of unjust discrimination under the ICA because the ICA applies to discrimination between two different interstate rates for a like kind of transportation in interstate commerce. In addition, the Carriers claim that under section 2 of the ICA the State, as the complainant, must prove that it was injured by the actions of the Carriers. According to the Carriers, under section 3 of the ICA the state must prove, among other things, that that Carriers have taken an action that has conferred an undue preference or prejudice on a TAPS' shipper.

259. The State asserts that the Carriers' 2005 interstate rates exceed their intrastate rates by approximately $1.56 to $2.02 per barrel (approximately 100%) in 2005 and $1.82 to $2.45 more in 2006. The State contends that this substantial disparity constitutes (i)unjust discrimination against interstate ratepayers in violation of section 2 of the TSA; (ii) undue disadvantage against interstate ratepayers in violation of section 3(1) of the ICA; and (iii) a violation of section II-11(e) of the TSA. The State claims that it is not contractually barred by the TSA from asserting that the Carriers' 2006 and 2006 interstate rates are unjustly discriminatory or unduly preferential. The State claims that it is enforcing the specific provision of the ICA that prohibits discriminatory and unduly preferential rates. Section III-11(e) of the TSA provides that the State can protest or contest any Carriers' tariff filing which is inconsistent with the terms and agreements of the TSA or the law, the State contends. The State claims that there can be no question that it is entitled to bring an unjust discrimination claim under section II-11(e) of the TSA. According to the State, it has proven all of the necessary elements required for relief under section 2 and 3(1) of the ICA and the

TSA. Finally, the State asserts that under sections 2 and 3(1) of the ICA, the lowering of an interstate rate is the appropriate remedy for a discrimination caused by the intrastate and interstate rates for the same service.

260. Staff asserts that it supports the State of Alaska with regard to the issues concerning issues IV.B (if the interstate rates are unjustly discriminatory or preferential) and IV.C (appropriate remedy for discriminatory and preferential rates) in the list of issues, but takes no position regarding issue IV.A (whether State is contractually barred by the TSA from asserting these claims). In addition, Staff states that once cost-based just and reasonable interstate rates are set on TAPS, such rates should be similar to the cost-based intrastate rates set for TAPS established by the RCA. This will eliminate any discrimination that currently exists between the rates, Staff claims.

261. Flint Hills argue that the State's pursuit of its discrimination claim is an attempt to circumvent its duties to defend the TSA. Flint Hills claims that this is an attempt to cut the interstate rates in half to the State's financial advantage. According to Flint Hills, the TSA provides that if a discrimination claim is proved, the remedy is to raise the intrastate rate to the level of the interstate rate.

262. Anadarko/Tesoro state that they take no position on the merits of this discrimination issue. However, Anadarko/Tesoro claim that if just and reasonable interstate rates are set on TAPS as Anadarko/Tesoro have proposed, then the discrimination issues in under sections 2 and 3(1) of the ICA will disappear and be moot.

Discussion/Findings

263. Section 2 of the ICA prohibits common carriers from engaging in unjust discrimination by charging customers different rates for a "like kind" of service. 49 U.S.C. app. §2. Section 3(1) of the ICA prohibits a carrier from charging rates that give any "undue or unreasonable preference or advantage" to a particular customer. 49 U.S.C. app. § 3(1). The State's claims are based on the large disparity between the intrastate rates and the interstate rates. According to the State, the interstate TAPS rates exceed the TAPS interstate rates by $1.56 to $2.02 per barrel in 2005 and $1.82 to $2.45 in 2006. State IB at 1. It has been found in this initial decision that the TAPS interstate rates for 2005 and 2006 are unjust and unreasonable. Thus, this decision contemplates new rate filings that will be substantially less than the Carriers 2005 and 2006 original filings. This new rate will be similar to the rates proposed by Anadarko/Tesoro. Anadarko/Tesoro's Opinion 154-B TOC interstate rate calculation for transport of a barrel from Pump Station No.1 to the Valdez Marine terminal is $2.04 for 2006 and $1.83 for 2006. Anadarko/Tesoro's calculations shown in Illustration Number 1 above were adopted in this decision. The State's Opinion 154-

B reference rate in this proceeding for the interstate rates, for transport of one barrel from Pump Station No. 1 to the Valdez Marine Terminal is $1.96 and $2.05 for 2005 and 2006, respectively.[187] The intrastate rate set by the RCA is $1.96 to transport a barrel of oil from Pump Station No.1 to the Valdez Marine Terminal.[188] The difference between these rates and the RCA established intrastate rate are minimal. Accordingly, the discrimination has been alleviated and the State's discrimination claims are rendered moot.

Issue V. Do the TAPS Intrastate rates established by the Regulatory Commission of Alaska violate Section 13(4) of the ICA, and if so, what is the appropriate remedy?

264. The Carriers filed a petition under ICA section 13(4). In the petition they request the Commission find the RCA-imposed intrastate rates to be unduly preferential, unduly discriminatory and an undue burden on interstate commerce. As a result, the Carriers requested remedy is for the Commission to set intrastate rates equal to the TAPS Carriers' filed interstate rates, adjusted for length of haul. The Carriers assert that section 13(4) is applicable to oil pipelines and intrastate rates need not be noncompensatory to violate section 13(4). The RCA set intrastate TAPS rates that are substantially lower than the interstate rates filed by the Carriers for similar service, even considering the shorter length of haul to certain intermediate intrastate points. The Carriers state that the $1.96 rates prescribed by the RCA for deliveries to Valdez and Petro Star Valdez Refinery are approximately half the level of the filed interstate rates to Valdez. In addition, the Carriers claim that the $1.25 intrastate rate prescribed by the RCA for the shorter haul intrastate movement to Golden Valley Electric Association is disproportionately low when compared to the filed interstate rates to Valdez. The Carriers claim that they provide exactly the same service on a length of haul basis to both interstate and intrastate shippers and that there are no underlying economic or cost justifications for a disparity between interstate and intrastate rates on TAPS.

265. The RCA claims that the Commission does not have jurisdiction to raise intrastate oil pipeline rates since the section 13(4) of the ICA did not confer jurisdiction on the ICC to establish intrastate rates for oil pipelines. The RCA asserts that the Carriers have failed to prove any of the five elements of a *prima facie* section 13(4) case. According to the state, Congress adopted section 13(4) to the ICA for the limited purpose of allowing the ICC to establish intrastate rates for railroads. Order 151[189] was issued by the RCA after an extensive proceeding which found that the

[187] Ex. SOA-8 at 25:7-8 (Ives).

[188] State IB at 6; SOA-1 at 4-6.

[189] Order 151, 2002 Alas. PUC LEXIS 630 (Nov.27, 2002); Ex. A/T-31.

intrastate rates charges by the Carriers for the years 1997-2000 were not just and reasonable, set just and reasonable rates for those years, and ordered that the Carriers pay the shippers refunds. Next, the RCA argues that any Commission authority under section 13(4) to supplant an RCA prescribed intrastate rate is narrow. The Carriers failed to meet their burden of proof under section 13(4) to show that the existing intrastate rates are abnormally low and do not contribute a fair share of the Carriers' revenue needs and that the intrastate rates cast an undue burden on interstate commerce. Thus, the RCA argues, the Carriers' section 13(4) claim should be rejected.

266. The State contends that the Carriers' intrastate rates do not impose any burden on interstate commerce and the Carriers have failed to carry their burden to demonstrate that intrastate rates are not covering at least their fair share of the costs of operating TAPS. Conversely, the State claims that its cost based reference rate calculations demonstrate that the intrastate rates cover at least their fair share of the costs of operating TAPS. According to the State, section 13(4) only permits limited relief and the Commission may only require that an intrastate rate be increased to the amount that is (1) necessary to intrastate ratepayers to contribute their fair share of the *earnings required to meet maintenance and operating costs* and (2) *to yield a fair* return on the value of property directed to the transportation service of both interstate and intrastate. Thus, the State claims, because it has shown that the intrastate contributes its fair chare and yields a fair return no change in the intrastate rate is permissible.

267. Anadarko/Tesoro state that the intrastate rates established by the RCA do not violate section 13(4) of the ICA. Anadarko/Tesoro claim that the Carriers have failed to support their section 13(4) petition and it should be denied. Neither the ICC nor the Commission has ever acted to preempt an intrastate rate for an oil pipeline and the legislative history does not support the claim that Congress intended to grant the Commission the authority to preempt intrastate rates for oil pipelines. Anadarko/Tesoro state that a high level of proof is required to find a violation of section 13(4) and list several requirements the Carriers must meet to prevail under this section. According to Anadarko/Tesoro, the intrastate rate is compensatory, but the interstate is not just and reasonable. In addition, Anadarko/Tesoro argue that the disparity between the intrastate rate and the interstate rate has not resulted in any harm to interstate commerce. Finally, Anadarko/Tesoro assert that the Carriers' have failed to meet their burden and their claim should be rejected.

268. Staff states that following cost based regulatory principles will produce a just and reasonable interstate rate that should be very similar to the cost-based rate approved by the RCA and, as a result, there will be no basis for a claim of burden upon interstate commerce. The Carriers have failed to provide any cost of service to demonstrate, *inter alia*, that the intrastate rates are abnormally low or fail to

contribute a fair share towards the pipeline's needs. According to Staff, the Carriers have failed to meet the standards necessary to prove their claim under section 13(4) and the claim should be rejected.

269. Flint Hills argues that the Carriers' ICA section 13(4) claim should be denied because the Carriers have failed to meet their burden of proof with record evidence. Flint Hills also claims that the carriers have not proven, among other things, that the current intrastate rates result in any undue burden or unreasonable advantage, preference or prejudice between intrastate commerce and interstate commerce. Flint Hills states that the most compelling reason that the carriers 13(4) petition is baseless is demonstrated by the fact that not a single West Coast refiner has protested or complained about the lower intrastate rates.

270. Petro Star claims that the Carriers have produced no credible evidence that the rates prescribed by the RCA create an undue preference in favor of intrastate shippers or create an undue burden on interstate commerce. The Carriers have not shown that the disparity between TAPS intrastate and interstate rates is causing interstate shippers to bear a disproportionate share of the cost to operate TAPS. Thus, Petro Star states that the Carriers' claim should be rejected.

Discussion/Findings

271. In accordance with the discussion in the immediately preceding section, it is found that once the new rates are filed using the methodology and inputs contemplated in this initial decision, the difference between the interstate and intrastate rates will be minimal. With such a minimal difference between the RCA established rate and the rates required by this decision, the Carriers' ICA section 13(4) claim has been effectively rendered moot.

IV. CONCLUSIONS

272. The burden of proving the justness and reasonableness of the proposed rates and the TSA/TSM is on the Carriers. The justness and reasonableness of these rates has up to now, never been adjudicated. Just and reasonable rates should be cost based and in accord with *Farmers Union II* and Opinion 154-B. The Carriers did not prove that the TSA/TSM produces just and reasonable rates. Accordingly, just and reasonable rates are established in this decision.

273. In establishing cost based rates in this case, costs recovered in rates by virtue of the TSA/TSM must be considered. These costs are best reflected in the numerous annual rate filings (for rates under the TSM) made by the Carriers for almost three decades. The decision orders the Carriers to account for DR&R funds and establishes a reasonable return on these funds.

274. The appropriate capital structure is found to be 55 percent debt and 45 percent equity for 2005 and 58 percent debt and 42 percent equity for 2006. The ROE for 2005 is established at 12.16 percent (nominal) and 8.90 percent (real) and for 2006 it is 12.31 percent (nominal) and 8.89 percent (real). As a result, the weighted cost of capital is 7.20 percent in 2005 and 7.16 percent in 2006. Consequently, refunds are ordered based on the difference between the 2005 and 2006 proposed rates and the 2004 rates. Furthermore, it is concluded that there should be a uniform rate for TAPS. Additionally, the State's ICA § 2 and 3(1) protest and the Carriers' ICA § 13(4) petition are rendered moot by this decision.

V. ORDER

275. IT IS ORDERED, subject to review by the Commission on exceptions or on its own motion, as provided by the Commission's Rules of Practice and Procedure, that:

276. Within thirty days from the issuance of the final order of the Commission in this proceeding, the Carriers shall make a compliance filing establishing rates in conformance with this initial decision.

277. Within thirty days from the issuance of the final order of the Commission in this proceeding, the Carriers must prepare and file a refund report and refund shippers in accordance with this initial decision.

Carmen A. Cintron
Presiding Administrative Law Judge