MR. HERTZ: Thank you Chairman Nober, Vice Chairman Buttrey, and Commissioner Mulvey, My name is Mitch Hertz. I'm counsel for CF Industries. We have resolved one important issue in this case. Kaneb paid too much. They now agree. And they paid too much because they ignored the volumes for 2001, the year before they bought the pipeline, and the volumes for 2002, where they had 10 months of data. And they projected accepting Koch's estimates at face value, that volumes would go up 50%. They were wrong. And they want CF to pay for it.

So the issue for the Board is who pays for Kaneb's mistake. Can Kaneb use it's market dominance to force its captive shippers to be an insurance policy for its bad decision making? The answer should be no. In Washington, we ask the question who pays quite a bit. And this Board has been very careful in answering the question who pays, to try to mimic what will happen in a competitive market. And as has been pointed out today, in competitive markets, if you overpay, the investor is the one who suffers. It would turn this Board's jurisprudence, and its policy decisions on its head to say we will mimic market activity by forcing captive customers to pay.

There's a bit of an irony in this case and I have to pause on it. CF is one of the largest shippers on this pipeline. Not surprisingly, when Koch went to sell it, one of the people it approached was CF. CF said no. CF said it won't pay that price for that pipeline. If the Board grants the relief that Kaneb requests, the result will be forcing CF to pay for a pipeline, to pay a price it wasn't willing to pay, in an arm's length transaction. And in response to something Mr. Tabor said, let's not feel too bad about this pipeline. The Board found that Koch recovered 100% of its costs and everything else was upside. It's entire investment was recovered, and if Kaneb had paid a reasonable price, it too would be revenue adequate, as we'll talk about here.

The Board's decision in the *Koch* case found two things, market dominance, which is not the subject of any evidence in this case right now, and revenue adequacy. It found that Koch was more than revenue adequate and to lift the rate prescription, Mr. Chairman, you pointed out, there has to be a finding that one of those two things has fundamentally changed. That there was an error. That there was a material change in circumstances.

Before I get there, let's talk quickly about what the significance is of rate - of lifting the rate prescription. Mr. Tabor says that that will level the playing field, and I will tell you every night I go to sleep hoping that I wake up as an unregulated monopolist. Because there is no level playing field between captive customers in a market dominant pipeline. So this is about have the facts changed such that you should lift the rate prescription.

Now the Board in *Arizona Public Service v. Brurlington Northern* laid out very compelling standards for how we should consider whether to lift a rate prescription. There was the *SAC* case that had been previously prevented, presented, excuse me. And as a result of the alleged changed circumstances, the carrier went back and said here are the things that have changed. I'm going to plug that into my *SAC* model and see if the result is any different. The Board finding that some of those things were different, was in a position to grant some relief. That's not what happened in this case. Kaneb did not come forward with compelling evidence using the model that the -- that the Board used in the CFV *Koch* case to demonstrate under the circumstances the results would be any different. All they did was provide a snapshot. They ignored the cyclical nature of the industry. They provided a one year snapshot, tied it to their excessive purchase price and said, look at us, we're bleeding. That is not the kind of evidence that the Board has relied on in lifting a rate prescription.

So the teaching of *Arizona Public Service* is you have to do something more than show that something changed. You have to show the significance of the change. Why it undermines the validity of the decision reached in the prior case. So let's look at what Kaneb said about the changes that have taken place.

Kaneb cites to a number of different changes and the most significant of which is their excessive purchase price. And I'd like to set that aside for a second so we can just dispose of the rest of it in response to the question about allocating the -- the under-recovery, if you will.

Kaneb points to a series of changes, other than its purchase price, and each of them suffers from two fatal flaws. First, Kaneb knew about the changes when it purchased the pipeline. They can't be heard to complain now, when they had the information then. For example, smart pigging, Mr. Graham cites the smart pigging and this new DOT obligation. What Kaneb said in response to discovery, this is a direct quote: "At the time of the purchase of the pipeline, Kaneb was aware that Koch had commenced to smart pigging program."

Property taxes, this is a great one because it's actually tied to the purchase price and actually led to higher property taxes because they paid so much. What Kaneb said on that changed circumstance, I quote: "At the time of the purchase of the pipeline, Kaneb was aware that property taxes would increase for the pipeline based on the purchase price." Same thing for volumes, Kaneb admits that at the time of the purchase of the pipeline it was aware of the closure of the Farmland plant, and it was aware of the idling of the Koch Sterlington plant. Kaneb knew about these things and they did not reflect them in the purchase price. And Kaneb cannot simply ignore them and try and pass them along to captive shippers. The second fundamental problem, and this really goes to the heart of the allocation question, is it doesn't change the outcome one bit. These changes don't affect whether the pipeline is revenue adequate. Koch was substantially in excess of revenue adequacy. There was a lot of room for volumes to go down and costs to go up, and the pipeline to still be revenue adequate. And the Board addressed that in the *Koch* decision. If you take everyone of these changes that Kaneb said, accept their presentation, at face value, this pipeline is still revenue adequate, putting aside the purchase price for a minute, which we'll get to.

Let me stop and talk about a procedural issue very quickly. The burden is on Kaneb to present the evidence that the rate prescription should be lifted. They failed. They didn't provide the analysis that's, I believe, required by the *Arizona Public Service* case. CF did. CF took what the Board did in the last case, plugged in the chain of circumstances and demonstrated that the pipeline would still be revenue adequate, but for the fact that Kaneb paid too much.

We put the purchase price aside, let's tackle it now. It seems like it's the heart of this case. Everyone acknowledges that the Board has used purchase price to evaluate revenue adequacy in the railroad context. But this case is not about the proper choice for the railroad industry. This case is about the proper choice for a pipeline where 90% of the markets are captive. The Board hasn't squarely faced this issue. It did not squarely face this issue in Koch. And here, I must correct Mr. Tabor. His own Brief explains that it was not the transfer price between an intermediary, it was the book cost of the predecessor. And it's at page 11, note 28 in the October 27th response to Dyno, Kaneb says that Koch explains the $77.2 million figure was not the true acquisition cost, but the previous owners, Gulf Central's depreciated, original cost.

So while the issue in the last case really did not focus on acquisition cost versus original because they were the same as Koch explained. The Board never had to confront the issue that we have in this case. The only other pipeline case that the Board or its predecessor has addressed, was *Ashley Creek*. In that case, once again, the Board did not use acquisition cost.

If the Board uses acquisition cost in this case, it's going to create rather perverse incentives. If carriers are going to believe that they're insulated from bad decision making, they'll have less incentive to be conservative in their analysis. And as I'll discuss later, that's exactly what happened in this case. Kaneb took the most aggressive analyses it could come up with to arrive at the highest purchase price so it would win an auction. Fine for Kaneb, not for its captive shippers.

But this as we discussed earlier, is also the result consistent with the competitive market. If you make a bad investment decision, the investor pays. You can't pass it along to others. And finally, going with the right rule, a rule that uses book cost for a revenue adequacy case, is consistent with the Board's precedent. And that's the key thing that this Board needs to understand as it goes through and decides this case. As was discussed earlier, the Board has flexibility. *Hope* provides that flexibility.

But the *Hope* case did set boundaries. And the *Hope* case identified a problem that an agency must take into account in setting rates, and it's the upward spiral problem. It's the reality, as Kaneb's own due diligence demonstrates, that this pipeline is only worth the revenues it's allowed to collect, which is the rates it's allowed to charge times the volumes. And the court, in *Hope*, when it was faced with the fair value or book cost question, required book value. Required book value because it was concerned about that escalation in rates.

Now this Board is bound by *Hope*. That was one of the questions that you asked in your Order setting this oral argument. But to say you are bound by *Hope* is simply to say every agency is bound by *Hope*. It's the law of the land. The Supreme Court said it. And the question this Board has to face is, are the facts of *Hope* relevant to this case. Because this Board has consistently dealt with *Hope*, and decided when it applies and when it doesn't, and the rail industry is the place that it has done that most often, so let's go there now.

Maybe the best way to explain why the Board is bound to assess Kaneb's revenue adequacy under the *Hope* standard is to look at why it didn't do that in the railroad industry. The ICC acknowledged that the use of acquisition cost would lead to write downs, as well as write ups. There's no dispute. It's in the

Order, the 1988 order. But you have to look at the context in which it arose. What the Board notes in that case is that most rail traffic is not subject to maximum rate regulation, it's negotiated between the parties. And as a result, the ICC distinguished *Hope* as more applicable to situations of traditional utility regulation, where there's a carrier with captive shippers.

So in the rail context, the decision simply meant that using acquisition cost would not impact the rates for most shippers. And the Rail Accounting Board helped the Board analyze whether *Hope* applies to the industry in that 1988 decision. In cases of write downs, the -- the Rail Accounting Board said that railroads would not be impacted by the rate regulation, because it didn't govern most movements. Then it contrasted that to public utilities. It said write downs could result in a spiral downward, and of course the converse is also true. They can result in a spiral upward. But the Rail Accounting Board said no, not this case, not the rail industry. So it doesn't matter.

Now the Board, the ICC recognized that it needed flexibility in the event it was faced with a circumstance like *Hope*, where you could face a spiral up. And in that instance, it reserved for itself the flexibility to use something other than acquisition cost. And it did so in the 1988 Order, saying that the decision will be driven by the accurate and reasonable valuation in each particular case. Thus the ICC's decision was tied to the competitive facts in the rail industry. That using acquisition cost would not be the governing factor on rates, because rates were negotiated. And the DC circuit relied on that in approving the Board's -- the ICC's decision when it noted that railroads, that most rail rates are not subject to maximum regulation and that the Board was -- the ICC was willing to make exceptions.

Now the Board confronted this issue even more squarely in *Conrail*. And *Conrail* I think, is a key case in understanding why Kaneb should not be successful here. In that case, carriers paid significantly above book cost. They paid a significant premium, and the Board found that because relatively few shippers were captive, even before the transaction, a strategy of making up the revenue shortfall, making up the difference between book and the acquisition cost would never work. There weren't enough shippers who were captive to force that on. And they actually rejected as not credible arguments that that's exactly what the carriers would do. Given the fact that very few rail shippers are captive, whose rates ever require regulatory intervention, paying too much for a property in hopes of extracting increased rents would be a self-defeating strategy in the rail industry.

That's what the Board had to say. And the Board make’s the crucial distinction for this case. *Hope* is different. It cited *Hope* for the circularity problem. It sited *Hope* for the fact that when there are captive customers, the spiraling up problem could exist. And that's our case. That's Kaneb. Kaneb is like *Hope*. Kaneb is not like *Conrail*.

Let me just point out one other important distinction with the *Conrail* case. The *Conrail* case spends a lot of time talking about the benefits that shippers will experience as a result of the merger. There was a preapproval process, where the Board could consider the possible impact on rates while considering the other benefits of the merger. There was no such opportunity in this case. Kaneb and Koch did a deal outside the site of the Board, shippers had no say, other than the smart decision not to do it themselves, and now Kaneb is coming to this Board and asking that shippers be forced to pay.

So the circularity problem. That's what *Hope* is concerned about and that's what the Board said it would be concerned about when faced with a *Hope* like situation. A situation like ours where 19 of 21 markets are captive to the pipeline. A look at how Kaneb handled its due diligence is quite interesting. Kaneb created a chart. First of all the chart it used for the actual purchase price it proposed, accepted Koch's volume estimates at face value, no discounting whatsoever.

Koch is a little biased in those estimates, but they accepted them nonetheless. And they took those volumes and the revenues that would come with it, and they said how much of a return do we want to earn. We can earn 15%, then we'll only pay maybe $100,000,000.00. We can earn 12%, then we'll pay $120,000,000.00. We can earn 10%, pretty close to the revenue adequacy level, and we'll pay $140,000,000.00. The decision making Kaneb used was exactly the concern that the court in *Hope* was addressing its
hat carriers could simply do the math, say that if we can raise rates, we can pay more. Kaneb, as I said, ultimately chose the highest volume assumptions. It left very little margin for error. If volumes dropped, Kaneb was not going to earn its revenue adequate return for that year using its acquisition cost. It was very simple. They were as aggressive as they could possibly be. There was no discipline that the market actually would provide for someone who couldn't come to this Board and ask for relief.

So while Kaneb makes much of the fact that it was an arm’s length transaction, arm’s length does not mean that this Board should go ahead and approve the request to lift the prescription. So who's responsible? In the rail context, if a carrier overpays, the rail carrier is the one who takes the hit because they're the ones who still have to go back and negotiate with shippers who have alternatives. In contrast, in this case, the entire outcome is dependent upon whether or not you allow the use acquisition cost, because Kaneb has made it clear, they intend to increase rates. That's how this case started. They did it twice before the Board issued the first Order in this case, so we know rates are going up to reflect their decision to pay $140,000,000.00 for the pipeline.

I just want to note one other thing, Mr. Tabor cites to the independent appraisal coming at $150,000,000.00. There is no questioning in that appraisal of the revenue and volume data in Koch's offering memorandum. It accepts it at face value just like Kaneb did. So while it was a separate analysis, I think we can hardly call it an independent confirmation that the purchase price was reasonable.

I just want to finish up with one point that Mr. Tabor made in response to a question from you, Mr. Chairman. That shippers would somehow be protected because they could always file a *SAC* case. What that means -- what that means is that the gap between the rates this Board prescribed, and the stand alone cost of constructing a new pipeline, is free to the pipeline. The revenue adequacy finding in the last case becomes eviscerated if the pipeline just makes a bad enough decision in its purchase price, and suddenly our cost immediately go up to the *SAC level*. That is not the kind of protection, and the kind of balancing the statute requires, and the Board should reject Kaneb's request to lift the rate prescription.

CHAIR NOBER: Okay. Commissioner Mulvey

COMMISSIONER MULVEY: Now this Board is in responsible for ensuring that rates to shippers are fair and reasonable, but it's also charged with the carriers earning revenues that meet all of their cost, including the return on invested capital, high enough to replace. capital as it wears out, and high enough to attract investors. If we do not vacate the prescribed rate, wouldn't that cause Kaneb to continue to "bleed money," and after all, like it or not, Kaneb did incur the $140,000,000.00 obligation. And if it did so in good faith, it doesn’t it need to pay the cost of the acquisition?

MR. HERTZ: Well I have several points in response. First, Kaneb is not losing money. They’re earning a positive return. It may not be what they want, it may not be the revenue adequate level, but it's not like they are actually losing money. They show that they're making an affirmative profit.

COMMISSIONER MULVEY: An accounting profit, but an economic loss. In the sense, you're not making a fair return.

MR. HERTZ: Fair point. So then we have to ask the question, who bears the risk. This is a balancing, regulation is balancing. And when a captive shipper is incapable of protecting itself against a bad business decision, this Board should rule in favor of the captive shipper. The shipper had no control. Kaneb is the one who agreed to overpay, not CF. CF made exactly the opposite decision. And *Hope* does not say that you are guaranteed a particular return. You're simply given the opportunity, and as I lay it out, and the Board's very jurisprudence on this question, a pipeline should have known that it can't simply pay any price and get away with it. What if they paid a billion dollars? What if they paid $2 billion? It's true, they would actually be earning a negative return. They would be bleeding money. Should the Board lift the rate prescription? I think not.

COMMISSIONER MULVEY: Well taking into account that they did pay the $140 million, do you know what they -- and let's assume for the moment that paying back that debt that they acquired to purchase Koch, what return are they getting right now? Do you know?

MR. HERTZ: They say that they are getting between 3 and 4% in the most recent data that they submitted. I would note that it's not clear that they actually incurred that to buy this pipeline.

COMMISSIONER MULVEY: Okay. but they're not losing money. They're not about to go bankrupt on this?

MR. HERTZ: That's exactly right.

COMMISSIONER MULVEY: Okay. If their other costs were to continue to increase, is it potentially possible that they could go bankrupt and file Chapter 7 or 11 to reorganize or to sell the pipeline?

MR. HERTZ: There's no reason to believe this pipeline will be in that situation based on the history of the pipeline and the cyclical nature of the industry. The pipeline is earning positive returns now, not withstanding paying three times book. The costs they've admitted that -- some of the changes that they cite that I didn't discuss, for example some of the Cap ex is done. They've already made that Cap. Ex investment and they don't claim to have anymore coming down the pike. They've debottle necked the southern end of their system, for example, and they claim there will be no further expenditures in that regard. Therefore, there's no reason to believe that that will happen.

As a theoretical matter, of course it can happen. If their costs go through the roof, it's conceivable that they will not be able to cover their costs at existing rates, but there's no reason to believe that's the real world example.

COMMISSIONER MULVEY: You mentioned that the independent assessor and Kaneb accepted Koch's projections and revenues and volumes. Is that correct?

MR. HERTZ: That's correct.

COMMISSIONER MULVEY: But were, were there obvious reasons why they should not have accepted those?

MR. HERTZ: Absolutely. The two largest shippers on the pipeline -- two of the three largest shippers, other than CF,–were Farmland and Koch. Farmland had shut its plant, it was on its way to bankruptcy and all the public data made clear that it was not going to reopen, and Kaneb admits it knew that. Koch had shut down one of its lines at the Sterlington plant, which was another major injection point. Kaneb admits it knew that there were problems and that it would not be opening -- reopening. Kaneb was oddly questioning some of the volume assumptions and some of its due diligence. It actually has a memo included that -- that we've attached that -- that says we don't -- we can't square what Koch is saying with the reality, and in fact, noted that 2002 was coming in way under what Koch had projected. And not withstanding that, they still decided to bid as if Koch's projections of return to the 2000 and 1999 levels would come true.

COMMISSIONER MULVEY: Thank you.

CHAIR NOBER: Vice Chairman Buttrey.

VICE CHAIRMAN BUTTREY: Who are your customers?

MR. HERTZ: CF is a farmers cooperative, owned by 1,000,000 farmers.

VICE CHAIRMAN BUTTREY: So –

MR. HERTZ: They are the customers.

VICE CHAIRMAN BUTTREY: You sell to distributors.

MR. HERTZ: Well the -- there are a series of regional co-ops that own the CF national co-op, and then there are local farmers that own the regional co-ops. So we are selling, essentially, to our owners along the way, and it's not a profit maximizing venture.

VICE CHAIRMAN BUTTREY: You produce the product then you sell it to distributors?

MR. HERTZ: We produce it and we sell it to intermediaries who then sell it to farmers.

VICE CHAIRMAN BUTTREY: And who pays for the storage of that -- at the terminus of the movement?

MR. HERTZ: CF owns many of the storage tanks that it uses and it sells at a stated price, posted for the particular terminal.

VICE CHAIRMAN BUTTREY: And do you do that by contracts to provide this at a certain price for a certain length of time? Is that correct?

MR. HERTZ: I -- I don't know all of the details. I apologize. But our mission is to supply our owners, our farmer owners, with product and we don't really do it in an attempt to -- to generate returns for shareholders. So it's really a cost based arrangement that comes through the ownership and they structure the co-op.

VICE CHAIRMAN BUTTREY: My understanding is that those prices go up and down every year.

MR. HERTZ: They do.

MR. HERTZ: They do. As I said, we're passing through our costs to our owners, essentially. So it will reflect the volatility in -- in the inputs, for example, as you alluded to earlier.

VICE CHAIRMAN BUTTREY: Right. And your product is superior, basically, to any other similar type product?

MR. HERTZ: Well there are different ways that you can get nitrogen to plants. The highest amount of nitrogen that you can deliver, sort of the highest bang for your buck, if you will, is ammonia.

VICE CHAIRMAN BUTTREY: Like 80%?

MR. HERTZ: It's an extremely high amount –

VICE CHAIRMAN BUTTREY: Right.

MR. HERTZ: -- of -- of nitrogen what you get. Yes.

VICE CHAIRMAN BUTTREY: Yes. Let's say you were a regulated seller, and you were entering into these contracts with your distributors, what would be the maximum length of time that you'd think you'd be willing to go with a contract to a distributor somewhere in the country? Given the volatility, say for instance, of the natural gas market, and given the volatility of agri-business in general, and the volatility of other prices that might impact on your production cost, and so forth; what do you think the length of time would be that you'd be willing to go on a contract like that to your distributors to provide a certain product, at a certain price?

MR. HERTZ: I would not be so presumptuous as to speak for CF. I'm not a marketing person for CF. I'm outside counsel. I can observe the following, that the electric industry is an extremely volatile -- volatile industry. Not withstanding that, people do daily contracts and 20 year contracts. And they engage in various hedging activities as they go out with longer contracts. So I don't know that there is a simple answer, because I think it will depend upon your ability to hedge the inputs.

VICE CHAIRMAN BUTTREY: Thank you. Can I have another round?

CHAIR NOBER: Sure. You still have more time if you have more questions.

VICE CHAIRMAN BUTTREY: Not at the moment.

CHAIR NOBER: Okay. Let me go back to, and again having written the statute I would start with reading it and trying to figure out what constitutes substantially changed circumstances, because it strikes me that that's really the issue here. I Just what is a changed circumstance, which is what the statutory standard is for vacating a prescription. Mr. Tabor asserted, as you heard, that, you know I think, I don't want to put words in his mouth, but I think I understood him to say if we find that the decision that was made by Kaneb was prudent at the time they made it, that that would constitute a fair market transaction, which would be a materially -- a substantially changed circumstance. And, therefore, we should vacate the rate based upon that -- that action. Do you agree or disagree with that?

MR. HERTZ: I disagree. I think that while the statute does not specifically address that very question, of course.

CHAIRMAN NOBER: That would be what we are here to decide. What constitutes that?

MR. HERTZ: Yes. The -- exactly. We have to distinguish between two sets of circumstances. There are things that are outside the control of a pipeline, and there are things that are entirely within its control. The decision that the Board makes in this case must be guided by the jurisprudence dealing with rate setting and protection of consumers. And the spiral up cases tell us that when a carrier simply has the ability to pass along costs because their shippers are captive, as this Board's juris- prudence addresses, that we have to protect the consumers in that instance. And that we don't simply allow them to use acquisition cost. That is entirely within the control of the carrier and I would not use that as the basis to lift the prescription.

CHAIR NOBER: Now what though would you allow us to use as the basis for lifting a prescription?

MR. HERTZ: If the pipeline were to come in and demonstrate that its efficient operating costs have increased over time, such that it is no longer revenue adequate, as a result of things generally beyond its control, that would be a reasonable basis on which to lift the rate prescription.

CHAIRMAN NOBER: Well I hate getting into what ifs, but here you're saying that there were, I used the word rosy, they took issue with that, but the projections that were made in the offering were optimistic, as it turned -- as hindsight has shown, and that, you know you feel they've paid an inflated purchase price. A price you yourselves weren't willing to pay. What if they just -- what if they just had assumed a flat no increase in growth, but some large shippers had closed up and the volumes were cut in half; would that be a changed circumstance?

MR. HERTZ: Well it's an interesting question because the -- the Koch situation was such that they were already over earning, there were not rates set at revenue adequate levels, but -- so let me break it into two pieces. Let's say that Kaneb had done the prudent thing that Koch did, which was paid book.

CHAIR NOBER: Yes.

MR. HERTZ: Then let's just say volume was cut in half. And volume was cut in half, this pipeline would still be revenue adequate.

CHAIRMAN NOBER: So that wouldn't be a changed circumstance?

MR. HERTZ: I think that is a much tougher case. I think that should not be a changed circumstance, if they were at the revenue adequate level. But when they're not at the revenue -- when they were above revenue adequacy, what our data in this case demonstrates is that volumes could be cut in half and this pipeline is still revenue adequate, but for the purchase price. So if they'd paid book, there might be a change, but the change wouldn't affect the revenue adequacy determination that the Board reached in the last case. And I think that's the case.

CHAIRMAN NOBER: If volume was cut in half it would.

MR. HERTZ: I'm sorry. Here volume was cut in third. If it was cut in half, then yes, that would be the kind of thing that would drive even a purchaser at book below revenue adequacy.

CHAIR NOBER: I mean you may feel Mr. Tabor's, you know standard is unfair, but at least it's one that the Board could easily implement. Right? I mean we'd just have to make a finding that it was a reasonable transaction and that would be changed circumstance. Now I'm trying to figure out, how would we implement your -- your all's view of what changed circumstances are? How would we know it when we saw it, other than redoing the case?

MR. HERTZ: Well I think it's simple. It's exactly what happened in the *Arizona Public Service* case. You take the prior case –

CHAIR NOBER: Is that the one the court remanded back to us?

CHAIR NOBER: NO That was -- we have a different one that we did then. We just got -- we just found changed circumstance and vacated a rate and it was remanded back by the D.C. Circuit, so this was sensitive on that subject, trying to figure out exactly what --

MR. HERTZ: I apologize for pushing a button.

CHAIR NOBER: No, no, no. It's all right, but we do have to -- we do have to figure that out.

MR. HERTZ: Sure. This was a decision in late 2004. The -- what the carrier did in that case, is it took -- it took the –

CHAIR NOBER: That one's of appeal. I'm sorry it was a different one that was -- they remanded.

MR. HERTZ: Okay. It -- it took the *SAC* model from the prior case, you would do the same in this case. You'd take the revenue adequacy model, from the last case, you would plug in the changed circumstances that the Board said it would consider. Volumes are down, revenues are down, costs are up. Okay. In that case, it was changing some of the sourcing and the assorted other factors, inflation, cost of capital, and then you'd see what the result is. But you don't have to allow them to just plug in a number, that by definition, and within their control, dictates the outcome.

CHAIR NOBER: Okay. Commissioner -- I'll follow up on that in a minute. Commissioner Mulvey?

COMMISSIONER MULVEY: Well I'll follow up on that a little bit. I mean it seems like the issue of changed circumstances, and what those circumstances have changed that are beyond their control, and those circumstances that a prudent manager would have -- foreseen. Is that the distinction that you're making?

MR. HERTZ: Yes. I don't know that you need to go all the way to prudence. I think that we should adopt a standard here that revenue adequacy for a carrier with captive shippers is going to be based upon book costs, then we don't have to worry about whether or not they paid a reasonable price. The market will discipline them, as this Board's policies have repeatedly dictated. That they want the market to discipline. Those things that are outside the carrier's control, this is not an issue of market discipline. It's not an issue of bad decision making, the reality is that there is a smart pigging program, they should have reflected it in their purchase price. We'll deal with the purchase price issue separately. Okay?

COMMISSIONER MULVEY: Yes.

MR. HERTZ: But the smart pigging cost we don't contest should be included. We're just saying it should have affected how much they paid. Property taxes has a certain circularity. Property taxes are up because they paid too much.

COMMISSIONER MULVEY: As homeowners around here are finding out.

MR. HERTZ: Exactly.

COMMISSIONER MULVEY: Let me ask you though, in terms of book value, book value can include a lot of things, include a lot of historic value, which may very well understate the value of the firm. It seems to me that there's some sort of blending between book value, fair market value, and acquisition cost, no?

MR. HERTZ: The -- the Board addressed that in the Coal Rate Guidelines when it set alternative caps. And this was actually -- that's -- that was what Koch's argument was in the last case. These things are undervalued, and in the rail industry, understand that, make sense, use *Sapp* because they're not revenue adequate. Here the pipeline is earning plenty of money. We should not feel bad for a pipeline that's earning 20%, even if it's 20% based on an investment it made a while ago. And that's the difference here, captive customers, revenue adequate, in that circumstance, we use book cost.

COMMISSIONER MULVEY: Kaneb points out that your rates haven't gone up in 18 years, and I pointed out that, well railroad rates have even gone down during those 18 years. But if you look to the railroads, you can see important productivity gains, including reduced crew sizes, larger cars etc., which are responsible for the for those rates coming down. Are there productivity gains in the pipeline industry that could be responsible for falling rates?

MR. HERTZ: There are productivity gains. I cannot speak to the specifics of this pipeline, but –

COMMISSIONER MULVEY: The biggest productivity gain in a pipeline is building a larger pipeline. I mean the cost per unit of throughput goes down geometrically with the diameter of the pipeline. Are these anhydrous ammonia pipelines, getting larger? Are we replacing smaller diameter ones with larger diameter ones?

MR. HERTZ: This pipeline has not, but there are other efficiency gains that have arrived in the pipeline industry such as, remote monitoring of the system through cathodic protection, and -- and reducing the amount of time you need to spend actually walking lines, pumps are more efficient, using less fuel, so there are a number of things that have happened. Are they as significant as going from a 12 inch line to a 20 inch line? No they're not, of course not.

COMMISSIONER MULVEY: Okay.

MR. HERTZ: But there are efficiency gains.

COMMISSIONER MULVEY: Thank you.

CHAIR NOBER: Vice chairman?

VICE CHAIRMAN BUTTREY: Not at the moment.

CHAIR NOBER: Under what -- as Commissioner Mulvey pointed out, there hasn't been a rate increase in 18 years. In your view, when should there be a rate increase? If it's not based on the -- on the changed purchased price, when would a rate increase ever be appropriate?

MR. HERTZ: When the pipeline is not revenue adequate. So for example, to use --

CHAIR NOBER: Based on –

MR. HERTZ: -- what you said.

CHAIR NOBER: They're not revenue adequate now, but you're saying not revenue adequate based upon their purchase price, is that –

MR. HERTZ: No. I -- first of all, I disagree with that. They are revenue adequate now. If -- if we use the right standard of book cost.

CHAIR NOBER: Okay.

MR. HERTZ: I agree at purchase price, they are not revenue adequate. But they have also been inefficient, which is another part of constrained market pricing that we'll have to deal with if we get to a rate case, in paying that much inefficiency or imprudence. But putting that aside, you gave an example earlier, that if instead of dropping volumes by a third, it had dropped by 50%, while I haven't done the math, my sense is that this pipeline would not be revenue adequate right now. But this Board was very clear in the *Koch* case; it's not about this year. It's not about one year. It's about over time. The Board said no snapshots, and we'll need to look at a pipeline that has been historically very successful. And if Koch's still on the pipeline, even with a revenue inadequate year sprinkled in here and there, the Board will -- would have already concluded you've recovered all of your costs, this is all upside at this point in time.

CHAIR NOBER: The prescription in this case, as I believe, has no termination, right? It's permanent.

MR. HERTZ: The prescription is permanent, and to address a question that came up that there was no answer for earlier, it is a maximum rate prescription. It says you will not charge any more than the prescribed rates. So there is rate decrease flexibility built into the very language of the Koch order.

CHAIR NOBER: So you're saying that into the future, until they can -- they -- they can't rate -- we couldn't vacate the rate, and they couldn't raise the rate until they are revenue inadequate, based on the book value?

MR. HERTZ: One of two things. There were two findings that the Board made in the last case, market dominance and revenue adequacy.

CHAIR NOBER: Okay.

MR. HERTZ: And they could demonstrate that either one of those has changed, at which point the rate prescription would be lifted.

CHAIR NOBER: Mr. Tabor said that the *Hope* case gave us a great deal of flexibility to interpret whether or not purchase price was -- was available here, and I think -- and you pointed out in your presentation that we have looked at this extensively and found that in the railroad context it's not, because railroads are -- we use the term lightly regulated internally, but you know they're not heavily regulated industries. Now would you -- you assert that pipelines are heavily regulated?

MR. HERTZ: Well I think when we talk about light or heavy, the issue is not, for example, do you have to file reports. The issue is railroads are lightly regulated because most of the traffic does not move subject to maximum rate regulation. In that sense, this pipeline is heavily regulated because 19 out of 21 markets are captive to the pipeline and subject to a rate prescription.

CHAIR NOBER: In a sack case, let me go back, I'm going to jump around a little bit, the prescriptions are generally 20 year prescriptions, not permanent. So even if we get it wrong, you know you only have to live with it for 20 years. Here they appear to have to live with it forever. Is that fair?

MR. HERTZ: Yes, because I -- it's my view that there's a self-help remedy.

CHAIR NOBER: In the extent, that there's a difference between 20 years and forever.

MR. HERTZ: That's right. There is a self-help remedy available to a carrier. Just like railroads can come in, even with a rate prescription and argue that they're have been changed circumstances, so can this pipeline. And if there are not changed circumstances, the fact that it goes on forever, means it's got a depreciating asset with rates that are staying constant, which means it's over-earning more each and every year, exactly like Koch did.

CHAIR NOBER: Okay. Vice Chairman Buttrey do you have any further questions?

VICE CHAIRMAN BUTTREY: No. Not at the moment.

CHAIR NOBER: Okay.

COMMISSIONER MULVEY: No more, thank you.