PREPARED DIRECT AND ANSWERING TESTIMONY OF GARY GRASSO

1. INTRODUCTION

Q. Please state your name, business address, and occupation.

A0 My name is Gary Grasso. My business address is 7201 Wisconsin Ave., Bethesda, Maryland 20814. I am a consultant with Benjamin Schlesinger and Associates, Inc., a management consulting firm practicing in the national and international energy markets. Our clients include major natural gas, oil, electric, and energy project development firms.

Q. Please state your personal qualifications.

A0 My resume is attached as Appendix A, which sets forth details of my experience. I have over 25 years of experience in the energy field, encompassing consulting in the natural gas, oil, and electric industries. I have considerable experience in the area of litigation support for oil and gas rate proceedings and have provided cost-of-service testimony and affidavits in oil pipeline rate proceedings. In addition to my quantitative work, I also have experience in the due diligence, market power, and policy analysis practice of Benjamin Schlesinger and Associates, Inc., having recently completed projects in all three areas.

I PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony in this proceeding?

A0 I have been retained by Tesoro Refining and Marketing Company (ATesoro@) to review Olympic=s financial data and information for the purposes of developing a Depreciated Original Cost (ADOC@) cost of service for Olympic Pipe Line Company=s (AOlympic@) based, in part, on the recommendations of Tesoro Witnesses Brown and Hanley. I have also been retained to compare and comment on the differences between the DOC cost of service I have developed and the FERC Opinion No. 154-B cost of service developed by Olympic Witness Collins.

II SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A0 The proper application of DOC methodology to the financial circumstances of Olympic results in a total cost of service as set forth in Exhibit No. ____ (GG-2C) of approximately $37.9 million. This total cost of service of $37.9 million includes $25.2 million in total operating costs net of depreciation which is an increase of $3.1 million or approximately 14% in total operating costs net of depreciation when compared with the $22.1 million in total operating costs net of depreciation which Olympic used when requesting an increase to its final rates only three years ago.

This total cost of service of $37.9 million is, however, significantly below the total cost of service of $60.1 as set forth in Exhibit No. ___ (CAH-4) and advanced by Olympic for setting rates in this proceeding. The major reasons for the significant differences between the calculations of the cost of service are: (1) Olympic has included $11.1 million in excess Operating Expenses (exclusive of depreciation) which do not meet the standards for inclusion in rates, due primarily to

including prior one-time nonrecurring costs in future rates, the miscalculation of its energy costs, the failure to amortize its regulatory costs, and the inclusion of transitional costs for a change of operators resulting from a change in majority ownership; (2) Olympic has included $6.2 million in excess Return based on very high equity and equity returns when it has no actual equity within its capital structure; (3) Olympic has included $4.9 million in excess Income Tax Allowance, due primarily to the overstatement of the equity portion of its Return; (4) Olympic has included $878,000 in Amortization of Deferred Return when it did not actually defer any of the underlying return; and (5) Olympic has included $70,000 in excess Depreciation due on the actual rather than estimated impact on Rate Base from the sale of the Sea-Tac facilities.

In addition to these major differences in the calculation of the total cost of service between Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4), the rates derived from these two approaches are quite different also because of differences in the assumed throughput during the period in which the future rates will be collected. Exhibit No. ___ (CAH-4) determines intrastate rates based upon continued constrained operating throughput of 105,897,000 barrels per year (ABPY@) while Exhibit No. ____ (GG-2C) calculates intrastate rates based upon normal operating throughput of 121,349,000 BPY. Specifically, Olympic=s constrained throughput calculation is an unsupported calculation which assumes that during the future period in which the rates at issue will be in effect the Bayview terminal will not be in operation and the safety requirements established by the Office of Pipeline Safety (AOPS@) will not be completed so the pipeline may operate at normal operating pressures. Tesoro=s normal operating throughput

calculation is the calculation of normal operating throughput based upon Olympic=s represented normal operating throughput underlying its rate filing in support of its current final rates three years ago.

Based upon the proper application of the DOC methodology, my recommendations are set forth in Exhibit No. ____ (GG-2C) and may be summarized as follows: (1) Olympic=s total cost of service be set at $37.8 million; (2) Olympic=s intrastate rate be set based on normal operating pressure of 121,349,000 BPY; and (3) an average rate be set at 31.20 cents per barrel.

2. OLYMPIC=S RATE FILINGS

Q. Please briefly review Olympic=s recent rate filings.

A. On May 30, 2001, Olympic filed a cost-of-service tariff seeking a 76% rate increase over current rates. This filing was protested and eventually rejected by the FERC as unsupported. The filing was also withdrawn from consideration at the WUTC by Olympic after the FERC=s rejection of the filing.

On July 30, 2001, two months later, the company filed another cost-of-service tariff seeking a 62% rate increase over existing rates. This filing was also protested, but the FERC accepted and suspended the rate increase on August 31, 2001, and set the matter for further proceedings. Later, the company filed the same case at the WUTC. When compared with its May 30, 2001, filing, its July 30, 2001, rate filing (1) reflected an increase in throughput which the company asserted was due, in part, to increased throughput since its Renton to Allen line was

restarted in June 2001; and (2) increased its cost of service by over $1 million from the filing submitted just two months earlier.

Q. Please explain whether Olympic=s direct case in this proceeding is consistent with either Olympic=s May 30, 2001, filing or its July 30, 2001, filing.

A. Olympic=s direct case is not consistent with either Olympic=s May 30, 2001, filing for a 76% rate increase or its July 30, 2001, filing for a 62% rate increase. The differences among Olympic=s two filings and its direct case in this proceeding are summarized in the following illustration:

Illustration No. 1

Description	May 30, 2001 Filing Test Period	July 31, 2001 Filing Test Period	December 13, 2002 Case 2 Test Period
1 Total Allowed Return	$ 12,585	$ 12,368	$ 13,268
2 Income Tax Allowance	$ 6,964	$ 7,026	$ 7,438
3 Operating Expenses Excluding Depreciation	$ 34,799	$ 36,261	$ 36,256
4 Depreciation Expense	$ 3,157	$ 3,157	$ 2,945
5 Amortization of AFUDC	$ 351	$ 381	$ 204
6 Amortization of Deferred Return	$ 877	$ 868	$ 878
7 Test Period Cost of Service	$ 58,733	$ 60,061	$ 60,989
8 Throughput (000)	96,888	105,897	105,897
9 Composite Rate	$0.6062	$0.5672	$0.5759

As may be seen by the illustration above, Olympic=s rate filings and direct case are all quite different from each other. Of particular note, Olympic=s total cost of service was $58.7 million on 96.8 million BPY in its May 2001 filing for a 76% increase in rates, $60.1 million on 105.9 million BPY in its July 2001 filing for a 62% increase in rates, and $61 million on 105.9 million BPY in its direct case in support of its 62% increase in rates. Stated differently, as

Olympic has been forced to recognize the reality of higher throughput from its May 30, 2001, filing, it has simply offset this increase in throughput by also increasing its test period operating costs in its subsequent July 31, 2001, filing and increased its operating costs again in its direct case.

This is particularly a concern given Olympic=s refusal to file a direct case which supports the cost of service set forth in either of its last two underlying rate filings. Absent a protest and the outright rejection of its May 30, 2001, filing, Olympic=s 76% rate increase would have been in effect now based on the cost-of-service support Olympic filed at the time. Similarly, absent a suspension and investigation of Olympic=s July 30, 2001, filing, Olympic=s 62% rate increase would have been in effect based on the cost-of-service support Olympic filed in support of that filing. One would think that a cost of service which Olympic advanced as a basis to collect a 76% increase or a subsequent 62% increase from its shippers would have accurately stated the financial position of Olympic for rate setting purposes.

Moreover, the variations in its cost-of-service support between its July 30, 2001, filing and its direct case are particularly disquieting. Olympic did not file its cost-of-service supporting workpapers for its July 30, 2001, filing until October 9, 2001. Olympic had over two months to prepare those workpapers and was intimately familiar with and informed of its shippers= concerns well prior to filing its cost-of-service support on October 9, 2001. There seems no excuse for Olympic to continue to shift its cost-of-service support after having five months from its original rejected filing of May 30, 2001, to consider its shippers and the

Commission=s concerns with its filings. I note that the above discussion focuses on the filings made at the FERC. The filing and testimony of Olympic now before the WUTC are the same as filed with FERC.

Finally, on December 13, 2001, the company filed testimony in this docket. Rather than support the cost-of-service information provided in support of its July 30, 2001, filing, the company developed not one but two whole new costs of service, designated as Case 1 and Case 2. To date, Olympic has now filed four different costs of service with this Commission in support of its intended rate increases. Such apparently arbitrary changes over such a short time frame in its cost-of-service support bring into question the credibility of Olympic=s cost-of-service analysis.

Q. Please explain whether Olympic=s lack of providing audited financial information in support of its rate filings also causes you concern.

A. Yes, it does. Absent an unqualified auditor=s letter, Olympic cannot verify that the financial information it has advanced accurately and fully represents its actual financial position. In the last two years, Olympic has changed operators, changed auditors, and changed complete accounting systems three separate times. There is little to no cooperation between Olympic=s former operator and its current operator or between Olympic=s two owners. In fact, there are outstanding accounting disputes in litigation between Olympic and one of its owners. Olympic has been unable to get an audit completed of its 1999, 2000, or 2001 financial books and records. Its auditors have indicated an unwillingness to provide an unqualified audit letter

verifying its financial books and records accurately represent its actual financial position. When one also considers its shifting cost-of-service support for its rate filings, I have very little comfort that Olympic=s financial books and records accurately reflect its actual financial position.

III. OLYMPIC=S COST OF SERVICE

Q. Please explain how you developed your cost of service for Olympic.

A. I applied DOC to develop Olympic=s cost of service and to establish just and reasonable rates. To have a common presentation baseline with Olympic, I used the cost-of-service model forwarded by Olympic Witness Collins and used in his cost-of-service Exhibit No. ___(CAH-4). This is the model and inputs used for Olympic=s Case 2, which is the cost of service Olympic has adopted for this rate proceeding. In using this basic cost-of-service model, however, I made three modifications to the model. First, I corrected the Interest Expense calculation to conform to the Commission=s directive issued in Opinion No. 435-A. Second, I amortized the AFUDC balance over the remaining life calculation, rather than the useful life calculation used by Olympic Witness Collins. Third, I converted the Opinion No. 154-B model to a DOC model. The result of the first adjustment is to properly allocate more dollars to the Interest Expense, thereby reducing the Income Tax Allowance. The result of the second adjustment is to align more closely the amortization of AFUDC with the currently authorized depreciable life of the facilities. The result of the third adjustment is to eliminate from rate base the calculation of Deferred Earnings and the Starting Rate Base Write-Up provided for under Opinion No. 154-B and to convert the calculation of the return on equity back to the use of a nominal rate of return in conformance with the DOC methodology.

A. OVERVIEW OF DOC METHODOLOGY

Q. Please explain how just and reasonable rates are derived under DOC.

A. In general, under DOC, an annual revenue requirement is first established, which is based on the test period costs of providing service and a reasonable return on the remaining investment in facilities based on an appropriate capital structure and rates of return.[1] Next, the revenue requirement is allocated among the various services, and then rates for those services are determined based on an appropriate rate design.

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[1] As is well established, the rate base under the traditional DOC differs from that calculated pursuant to FERC Opinion No. 154-B, which follows a Trended Original Cost (ATOC@) methodology, as modified by the inclusion of a Starting Rate Base Write-Up, or Transition Rate Base, if applicable.

Q. Please explain the cost and return elements included in the calculation.

A. The cost elements in the DOC revenue requirements consist of annual operating and maintenance expenses (AO&M@), administrative and general costs (AG&A@), depreciation and amortization expenses, other tax expense, a return allowance, and income taxes related to the return allowance. Normally, in presenting the cost of service, various items are grouped together in a summary schedule. For example, Operating Expenses would include O&M, G&A and Other Tax Expense. Other items such as Depreciation and Amortization Expenses are shown in their component parts, those being Depreciation and the Amortization of AFUDC.[2]

[2] Under the TOC, an allowance for the Amortization of Deferred Earnings is included in the revenue requirement.

As will be explained in more detail later, the return allowance is determined by applying a composite rate of return to the pipeline=s average DOC Rate Base, as defined above.[3] Under DOC, the nominal rate of return on equity is applied to the average rate base, so that the company=s full return for the test period is provided for in the cost of service.

B. CALCULATION OF OLYMPIC=S COST OF SERVICE

Q. Please illustrate the total cost of service and the composite tariff rate for Olympic under DOC.

A. Exhibit No. ____ (GG-2C) contains the complete DOC cost-of-service calculation of Olympic=s properly calculated rates. The total cost of service and Olympic=s composite rate are summarized in the following illustration:

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[3] As a side note, under TOC, the expected inflation rate component of the nominal return on equity is capitalized into rate base and recovered through amortization, and the remainder, or real rate of return of equity, is used in the rate of return on equity calculation under TOC. Hence, under TOC a company collects its return on equity in the Cost of Service in two parts, i.e., the Real Return on Equity contained in the Overall Return allowance and the capitalized inflation amount based on an amortization factor.

Illustration No. 2

DOC Total Cost of Service	Composite Rate
$37,859,814	$0.3120

Q. Please provide an illustration of the individual cost and return elements used in your calculation of the cost of service as shown in Exhibit No. ____ (GG-2C).

A. Following is an illustration of the cost-of-service elements used in the calculation of the total cost of service. Following the illustration, line-by-line comments are provided which illustrate how the DOC methodology was applied to establish the cost of service. Please note that I include a line item for Deferred Return merely as a marker to compare the DOC Methodology to Olympic=s TOC methodology that it advocates in this proceeding.

Illustration No. 3

Ex. No. ____ (GG-2C), Sched. 1, Column 2 (Cost of Service Test Period)
Total Cost of Service
($000's)

1	Allowed Total Return	$7,080
2	Income Tax Allowance	$2,499
3	Operating Expenses Excluding Depreciation	$25,182
4	Depreciation Expense	$2,875
5	Amortization of AFUDC	$224
6	Amortization of Deferred Return	$0
7	Total Cost of Service	$37,860
8	Operating Revenues 1/	$42,257
9	Headroom	($4,397)

* Olympic Case 2 - October 1, 2000 to September 30, 2001.
1/ Based on tariff rates prior to rate increase.

Q. Please comment on the line items in the illustration.

A. Line 1 of Illustration No. 3 is Olympic=s total return on rate base of $7.1 million for the test period. Determination of this amount begins with Olympic=s average DOC Rate Base of $70.28 million for the test period. As previously explained, the DOC Rate Base is equal to its Net Depreciable Property in Service plus capitalized working capital, less Accumulated Deferred Income Taxes.[4] The DOC rate base calculation is Exhibit No. ____ (GG-2C), Schedule 5.

Once the rate base is determined, an appropriate capital structure is utilized to separate the rate base between equity and debt investments and then an appropriate return on equity and cost of debt are applied to determine the overall return on rate base. Based on Tesoro Witness Hanley=s recommendation which assumes Olympic is properly recapitalized, I used a capital structure of 46.40% equity and 53.60% debt, a nominal return on equity of 13.0%, and a cost of debt of 7.54% supplied by Tesoro Witness Hanley, for the test period. I arrived at an overall weighted cost of capital of 10.07% when applying the above debt cost and the nominal rate of return to the capital structure percentages recommended by Mr. Hanley. The capital

[4] Under TOC, which is Olympic=s position, the FERC allows a transitional adjustment if applicable (the SRB) and the unamortized balance of equity return capitalized in rate base, commonly known as net deferred earnings.

structures, nominal return on equity, and cost of debt used to determine overall return on rate base is shown in Exhibit No. ____ (GG-2C), Schedule 3.

Line 2 of Illustration No. 3 is Olympic=s Income Tax Allowance of $2.499 million for the test period. This allowance provides Olympic an after-tax return on equity consistent with the returns on equity recommended by Tesoro Witness Hanley. The cost of debt, of course, is not subject to income taxes. Instead, it is a tax deductible item. Hence, in determining the Income Tax Allowance, the applicable cost of debt is deducted from the Return Allowances, which cost of debt is determined by applying the weighted debt cost portion in the overall rate of return to the average DOC rate base for each year, as noted above. I then added an amount for the AFUDC amortization recalculated as set forth below and in Exhibit No. ____ (GG-2C), Schedule 7, and an adjustment for amortization of amounts related to FASB 96/109 pronouncements. After determining the amount on which income taxes are to be calculated, I applied the same income tax factors and methodology used by Olympic to derive the Income

Tax Allowance.[5] The calculation of the Income Tax Allowance for each of the years at issue is set forth in Exhibit No. ____ (GG-2C), Schedule 4.

Line 3 of Illustration No. 3 is Olympic=s operating expenses excluding depreciation of $2.875 million for the test period. This amount reflects Olympic=s actual base period operating expenses of $43.3 million as adjusted in Exhibit No. ____ (GG-2C), Schedule 21. These adjustments were as follows: (1) As set forth in Schedule 21.5 therein, Outside Services from $8.99 million to $1.25 million to reflect, among other things, the elimination of $5.615 million in one-time maintenance costs, $1.194 million in budgeted but unspent remediation, an accrual of $455 thousand relating to Operator Transition Costs of $2.28 million, Legal and Consulting Expenses of $1.0 million, amortized over 5 years; (2) Other Expenses from $2.3 million to $1.822 million, reflecting the elimination of expenses associated with the sale of the Sea-Tac

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[5] As a side note, Olympic Witness Collins= interest expense calculation ignored the FERC=s directive in Opinion No. 435-A, resulting in a disproportionate amount of return to be associated with the equity return that results in an improper income tax allowance included in the cost of service. Let me further note that while Opinion No. 435-A was issued in May 2000, Olympic=s July 2001 filing used the same methodology as in its direct case, resulting in an overstatement of the return on equity and associated income tax allowance now currently being collected in rates since September 2001 under the FERC tariffs.

facilities; (3) Salaries and Wages from $7.5 million to the company-proposed level of $7.38 million; (4) Fuel and Power from $6.18 million to $9.43 million; (5) Insurance from $600 thousand to $1.1 million, accepting the company=s proposed level; and (6) Pipeline Taxes from $1.77 million to $1.9 million, accepting the company=s proposed level. As discussed by Tesoro Witness Brown, other test year adjustments proposed by Olympic were considered improper, and Base Year amounts were used as representative levels in lieu thereof. The operating expenses and the adjustments from the base period are set forth in Exhibit No. ____ (GG-2C), Schedule 21.

Line 4 of Illustration No. 3 is Olympic=s depreciation expense of $2.875 million for the test period. This line reflects the actual depreciation expense (less the Sea-Tac adjustment) which Olympic has included in its annual rate filings to this Commission. The calculation of depreciation expense is set forth in Exhibit No. ____ (GG-2C), Schedule 23.

Line 5 of Illustration No. 3 is Olympic=s amortization of AFUDC of $224,000 for the test period. This line reflects adjustments that I made to the company=s calculation of AFUDC in its direct case. I accepted the elimination of construction work in progress (ACWIP@) amounts related to the Cross Cascades Project, noting that the filed rates improperly contain those amounts. The company=s changes to various items in the calculation of AFUDC

and its amortization in the company=s Direct Case from that filed in July 2001 that were not supported by the company=s testimony were not used in the calculation. These items include an increase of the real rate of return by 150 basis points from 1983 through 1999 in the direct case, the cost of debt in certain of the years 1983-1987, and the CWIP in-service ratio from 50% to 100%. The changes contained in the direct testimony to the AFUDC calculation tend to offset the elimination of the Cross Cascades project from CWIP. I also changed the amortization of AFUDC from a useful life method to a remaining life method. The calculation of AFUDC is set forth in Exhibit No. ____ (GG-2C), Schedule 7.

Line 6 of Illustration No. 3 is Olympic=s amortization of deferred return of $0 for the test period. This line reflects the amount of deferred earnings capitalized into rate base to be collected in the test year. As explained earlier, I have included this item as a marker to allow a side-by-side comparison with Olympic=s TOC Cost of Service.

Line 7 of Illustration No. 3 is Olympic=s total cost of service of $37,860,000 for the test period which is the sum of all the previous items in the column. The calculation of the total cost of service and associated rates is set forth in Exhibit No. ____ (GG-2C), Schedules 1 through 27.

Line 8 of Illustration No. 3 is Olympic=s operating revenues of $42,257,000 for the test period. The operating revenue is derived by multiplying the test year throughput by the underlying current rates in place since 1999 as adjusted for indexing. The result is then compared to the proposed test year cost of service to examine the impact on collections. Stated differently, Olympic=s expected revenues based on its prior rates result in overcollections of its total cost of service for the test period.

Line 9 of Illustration No. 3 is Olympic=s headroom of negative ($4,397,000) for the test period. The headroom is derived by subtracting the total revenues from the total cost of service. A negative headroom is the amount Olympic=s operating revenues overcollect its total cost of service under its prior rates. In other words, Olympic will overcollect its total cost of service by $4,397,000 if its prior rates remain in effect.

Q. Does the application of the DOC methodology as you have illustrated above result in just and reasonable rates for Olympic?

A. Yes. The DOC cost-of-service calculation illustrated above results in rates which are just and reasonable under the traditional methodology employed by this Commission. Through the collection of the $37.9 million total cost of service, Olympic would generate sufficient revenues

to recover its actual prudently incurred costs (including depreciation) plus a reasonable return on its remaining investment. This amount is all that Olympic is entitled to recover through its rates. The intrastate rates under the DOC calculation illustrated above are set forth in Exhibit No. ____ (GG-2C), Schedule 22.

C. BENCHMARKS FOR OPERATING COSTS

Q. Do you have some general benchmarks that you used to roughly evaluate the calculations for Olympic=s general level of operating expenses set forth in Exhibit No. ____ (GG-2C)?

A. Yes. The overall level of Olympic=s operating expenses set forth in Exhibit No. ____ (GG-2C) seems reasonable when measured against Olympic=s historic levels of operating costs. In fact, the recommended level of operating costs set forth in Exhibit No. ____ (GG-2C) represents an increase of approximately $3.1 million or 14% above Olympic=s operating costs for 1998--the last full year of operating expenses prior to the Whatcom Creek incident. The Whatcom Creek incident and the regulatory investigations resulting from it have significantly spiked Olympic=s one-time costs, but had a far lesser impact on Olympic=s recurring costs. Since Olympic=s recurring costs are the costs relevant when setting future rates, I used Olympic=s 1998 operating costs as a benchmark. Olympic=s 1998 operating costs form the best available benchmark from which to judge recurring cost levels because they represent the most recent year of normalized and recurring cost levels for Olympic. Following is an illustration which compares Olympic=s 1998 operating costs with the recommended operating costs set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4).

Illustration No. 4

Tesoro Refining and Marketing Co. - OPL COS Exhibit No. ___ (GG-6) Schedule 1

Comparison of 1998 Expenses to Test Year
($000's)

Line No.	Description	1998 Expenses	Tesoro Expenses	Olympic Expenses
1	Operating Fuel and Power	$9,430	$9,368	$10,678
2	Outside Services	$5,690	$1,249	$9,317
3	Salaries and Wages	$3,492	$7,380	$7,380
4	Other Expenses	$0	$1,822	$2,727
5	Pipeline Taxes	$1,176	$1,900	$1,900
6	Supplies and Expenses	$1,944	$1,272	$1,889
7	Insurance	$270	$1,102	$1,102
8	Rentals	$637	$540	$712
9	Pensions and Benefits	-$576	$0	$0
10	Casualty and Other Losses	$36	$0	$0
11	Maintenance Materials	$28	$0	$0
12	Oil Losses and Shortages	$83	$550	$550
13	Total Expenses	$22,211	$25,182	$36,256

As may be seen in Illustration No. 4, the total operating costs of $25.2 million set forth in Exhibit No. ____ (GG-2C) are significantly higher than the total operating expenses of $22.2 million for 1998--the most recent normalized year. This comparison of total expense is a good albeit rough benchmark which indicates what one would reasonably expect to find. That is, that Olympic=s total operating costs have increased approximately 14% since its last rate increase only three years ago. Please note these costs are exclusive of depreciation.

One comment is in order as to the variability between the benchmark and the recommended operating costs set forth in Exhibit No. ____ (GG-2C) with regard to Salaries

and Wages and Outside Services. The prior operator, Equilon, charged most of the operational employees to the Outside Services account while the current operator, BP Pipelines, charges all of the operational employees to the Salaries and Wages account. Accordingly, with the change in operators and the way they each account for the operational employees, one would expect to see the Outside Services amount be reduced and the Salaries and Wages amount be increased. This is, in fact, what the illustration reflects.

Q. Did you also use additional benchmarks to roughly evaluate the calculations for Olympic=s general level of operating expenses set forth in Exhibit No. ____ (GG-2C)?

A. Yes. As a further benchmark of comparison, I have created Exhibit No. ___ (GG-10), Schedules 1 and 2, which shows the company=s operating expense levels contained in the FERC Form 6 Annual Report of Oil Pipelines for the years 1982-2000. I list them first by FERC account number and then by aggregation of expense categories. This type of comparison demonstrates the spikes in expenses that have occurred since 1996 over historical trends, as the company increased spending due to Cross Cascades, Bayview, and the Whatcom Creek incident. As a general benchmark, this exhibit illustrates that Olympic=s historic levels of operating costs have been rising at a consistent pace for many years prior to the recent spike in one-time extraordinary expenses. This strongly suggests that Olympic=s test year level of operating expenses includes historically high levels of one-time nonrecurring expenses and would not be representative of future levels of recurring expenses.

Please note that the expense numbers contained in the FERC Form 6 relate to actual expenditures and accruals of a company, regardless of whether a particular expense item would be part of the company=s allowed regulatory cost of service. That is to say, all of Olympic=s expenses are included regardless of whether or not they are properly included for ratemaking purposes. Many of the direct expenses associated with the Whatcom Creek incident, for example, are included with the expenses set forth in this exhibit. Further, I have not made any adjustment to the expense numbers for 1982-2000 to allow for the collection of the full amount of expenses in my illustrative historical costs of service under each scenario.

Following is an illustration which graphically demonstrates the dollar level for each year from 1982 through 2000 for the major categories of Salaries, Outside Services, Materials and Supplies, Maintenance Materials, and Other Expenses as set forth in Exhibit No. ____ (GG-11).

Illustration No. 5

As seems obvious in Illustration No. 5 above, the major expense categories at issue in this proceeding have been spiking above recurring levels due to the failed Cross Cascades project, the Bayview terminal, and the Whatcom Creek incident. While I realize this illustration only uses a historical perspective, it is instructive when evaluating the extremely high levels of operating costs Olympic has proposed without adequate support for its test period costs.

IV. COMPARISON OF DOC COST-OF-SERVICE CALCULATIONS

Q. Have you reviewed and compared your DOC cost-of-service calculation with the one advanced by Olympic in its direct case?

A. Yes, I have. Following is a comparison, with my comments, between the approach set forth in Exhibit No. ____ (GG-2C) and the approach Olympic set forth in Exhibit No. ___ (CAH-4) which is Olympic=s Case 2.

A. IDENTIFICATION OF MAJOR DIFFERENCES

Q. Have you prepared an illustration showing a comparison of the total revenues and composite rates under each approach?

A. Yes, I have. Following is an illustration of side-by-side comparisons of the total cost of service and the composite rates under (1) existing rates using Olympic=s test period throughput of 105,897,000 BPY, (2) the approach set forth in Exhibit No. ____ (GG-2C) using the test period throughput of 121,349,000 BPY, and (3) the approach set forth in Exhibit No. ____ (CAH-4) using Olympic=s test period throughput of 105,897,000.

Illustration No. 6

		OPL at Current Rates	Tesoro Test Year	Olympic Test Year
1	Revenue	$36,876	$37,860	$60,989
2	Throughput	105,897	121,349	105,897
3	Composite Rate	$0.3482	$0.3120	$0.5759
4	Change over Current Rates		-10.41%	65.39%

In general, Olympic=s revenue would increase from $36.9 million per year under existing rates to $61 million per year given under Olympic=s proposed throughput and rates. This represents a $24.1 million per year or 65.3% increase in revenues over existing rates. Again, as previously shown, however, the company is requesting only a 62% increase in rates.

Comparing either of these total revenue calculations to the revenue derived is somewhat complicated by the different assumptions as to throughput. In general, however, Olympic=s revenue would also increase from $36.9 million per year under existing rates to $37.9 million per year under the recommended throughput and rates set forth in Exhibit No. ____ (GG-2C). If rates were set based on Olympic=s throughput assumptions, but Olympic achieved the throughput recommended in Exhibit No. ____ (GG-2C), then Olympic would substantially overcollect its total cost of service. This issue is discussed in more detail below.

Q. Please also illustrate the differences in the total cost of service under each approach based on the total dollar impact of those differences in this proceeding.

A. Illustrated below in total dollars is a side-by-side comparison of the total cost of service using the approach I have recommended, as set forth in Exhibit No. ____ (GG-2C), and the approach Olympic has recommended, as set forth in Exhibit No. ___ (CAH-4). This comparison is set forth with supporting schedules in Exhibit No. ____ (GG-3), and the following illustration is Exhibit No. ____ (GG-3), Schedule 1.

Illustration No. 7

Tesoro Refining and Marketing Co. - OPL COS Exhibit No. ____ (GG-3) Schedule 1
Total Cost of Service
($000's)

Description	Source	Tesoro Test Period	Olympic Test Period	Difference
Allowed Total Return	Schedule 3, Line 16	$7,080	$13,268	($6,188)
Income Tax Allowance	Schedule 4, Line 11	$2,499	$7,438	($4,939)
Operating Expenses Excluding Depreciation	Schedule 2, Line (20 - 13)	$25,182	$36,256	($11,074)
Depreciation Expense	Schedule 14, Ln 15	$2,875	$2,945	($70)
Amortization of AFUDC	Schedule 8 Line (5 + 12)	$224	$204	$20
Amortization of Deferred Return	Schedule 6, Line 17	$0	$878	($878)
Total Cost of Service	Sum Lines (1 through 6)	$37,860	$60,989	($23,129)
Test Year Throughput (000)		121,349	105,897	
Composite Rate		$0.3120	$0.5759	

Q. Please comment on the major difference between the two approaches that are illustrated in Illustration No. 7 above.

A. As may be seen, the major differences listed in the order in which they most impact rates between the approach set forth in Exhibit No. ____ (GG-2C) and the approach set forth in Exhibit No. ___ (CAH-4) are as follows: (1) Operating Expenses (excluding depreciation)—$11,074,000; (2) Allowed Total Return—$6,188,000; (3) Income Tax Allowance—$4,939,000; (4) Amortization of Deferred Return—$878,000; and (5) Depreciation—$70,000.

Q. Please comment on the major reasons why Olympic=s approach results in such a dramatically higher total cost of service than the total cost-of-service approach you have recommended.

A. As is largely illustrated above, there are six major reasons why Olympic=s approach results in such dramatically higher revenue requirements than those achieved under the approach I have recommended: (1) Olympic=s approach uses much higher Operating Expenses (exclusive of depreciation); (2) Olympic=s approach uses a much higher Return Allowance; (3) Olympic=s approach uses a higher Income Tax Allowance; (4) Olympic=s approach uses a component for the Amortization of Deferred Return; (5) Olympic=s approach uses higher Depreciation; and (6) Olympic=s approach uses a much lower throughput. Each of these major reasons are separately discussed below.

B. OPERATING EXPENSES (EXCLUSIVE OF DEPRECIATION)

Q. The first major reason for the differences between the two approaches was the level of the Operating Expenses. Please explain further.

A. There is a $11.1 million difference in the Operating Expenses (net of depreciation) between the total cost of service set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4). This difference is generally explained by Olympic basically taking an extraordinary time period when expenses are up and throughput is down to raise its rates by an extraordinary amount of 62%. In essence, the company claims that its Test Year level of expenses at over $36 million will be representative of its operations in future years. If allowed, Olympic=s total cost of service will result in Awindfalls@ for Olympic as it returns to normally operating the pipeline.

More specifically, slightly over $1.3 million of this difference is attributable to the calculated level of power costs. The remainder results in the inappropriate inclusion of amounts by Olympic that are either not supported by its filed material or not reflective of the proper method of determining test year level of expenses, as discussed by Tesoro Witness Brown.

Within these unsupported costs, Olympic would like to collect <u>on an ongoing basis</u> $5.6 million in one-time project expenses, the vast bulk of which relate to a carryover of budgeted amounts not actually spent in the year 2001. For reasons stated by Tesoro Witness Brown, this would be inappropriate to include.

Olympic also has included remediation expenses of $1.2 million as an ongoing

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Next, Olympic includes the costs associated with the transition of operators of Olympic from Equilon to BP Pipelines. Again, Olympic includes an amortized amount in the cost of service of $455,000 relating to expenses of over $2 million for these costs. Apart from the inappropriateness of the charge, as developed by Tesoro Witness Brown, this amortization may continue within rates indefinitely even though the amortization period has passed. Therefore, this expense is improper to include.

Olympic also includes over $1million related to Legal and Consulting Fees. The company is attempting to recover a one-year expense level associated with an extraordinary year of regulatory costs, rather than constructing a typical regulatory expense level in the cost of service. Therefore, it is only proper to allow an amortization of that amount as a representative level of recurring expenses.

Lastly, certain test year expenses are merely restatements of amounts derived by a rough budget set forth in the BP Pipelines July 2000 operating agreement. Again, BP Pipelines took over operation at a time when it knew that the operations were not representative of future operations. Its AFixed Bid@ amounts from that document are representative of costs associated with the level of operations it inherited and problems it had to address. Those expenses, estimated in 2000 and placed in the current Test Year, have not been appropriately constructed

with the regulatory framework for rate making in mind. Those amounts most likely contain extraordinary expenses as discussed above and would not be representative of future operations. Hence, such Test Year adjustments are improper to include, and the Base Year amounts are substituted in their place. These categories include Supplies and Expenses, Other Expenses, and Rentals, as well as Outside Services amounts discussed above. Therefore, the level of Operating Expenses set forth in Exhibit No. ____ (GG-2C) is intended to be more representative of Olympic=s future operations than has been advanced by Olympic.

C. RETURN ALLOWANCE

Q. The second major reason for the differences between the two approaches was the level of the Return Allowance. Please explain further.

A. There is a $6.2 million difference in the Return between the total cost of service set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4). This difference is generally explained by the use of different rate base methodologies and by Olympic=s use of a nonrepresentative and very high level of equity within its capital structure and a very high return on equity capital. In addition, however, Olympic failed to institute the FERC=s directive in Opinion No. 435-A that the proper method for calculating the interest expense is to apply the adjusted weighted cost of debt to the entire Opinion No. 154-B rate base, rather than solely to the Net Depreciated Original Cost rate base. Again, failure to make this correction by Olympic results in the proper mechanical overall return allowance, but an understatement of the regulatory interest expense allowed. In essence, as shown in Exhibit No. ____ (GG-3),

Schedule 3, Olympic=s method results in an improper increase in its requested real rate of return, from 13.23% to 13.55%.

The importance of the capital structure in determining the total cost of service may not be overstated. As may be seen in Exhibit No. ____ (GG-5), Schedule 1, when Olympic=s actual capital structure is substituted for the conditional capital structure set forth in Exhibit No. ____ (GG-2C), the cost-of-service impact is $4.6 million. However, as may also be seen in Exhibit No. ____ (GG-5), Schedule 1, when Olympic=s actual capital structure is substituted for the capital structure set forth in Exhibit No. ___ (CAH-4), the cost-of-service impact is $12.8 million. Thus, $12.8 million of Olympic=s total cost of service is associated with its attempt to be compensated for equity absent from its actual capital structure.

D. INCOME TAX ALLOWANCE

Q. The third major reason for the differences between the two approaches was the level of the Income Tax Allowance. Please explain further.

A. There is a $4.9 million difference in the Income Tax Allowance between the total cost of service set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4). This difference is generally explained by the different rate base methodologies and by Olympic=s use of a higher Return. The Income Tax Allowance is a calculation driven by the equity portion of the Return. Accordingly, the Income Tax Allowance will be overstated to the degree the equity portion of the Return is similarly overstated. As shown in Exhibit No. ____ (GG-3), Schedule 3, Tesoro=s return on equity is $4.2 million while the company=s requested level is $12.6 million.

This is the primary reason that the Income Tax Allowance set forth in Exhibit No. ____ (GG-2C) is $2.5 million, while the Income Tax Allowance set forth in Exhibit No. ___ (CAH-4) is $7.4 million.

E. AMORTIZATION OF DEFERRED RETURN

Q. The fourth major reason for the differences between the two approaches was the level of the Amortization of Deferred Return. Please explain further.

A. There is an $878,000 difference in the Amortization of Deferred Return in the total cost of service set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ___ (CAH-4). This difference is generally explained by Olympic=s inclusion in its cost of service of a hypothetical calculation of deferred returns from prior periods when, in fact, Olympic overcollected its return.

Exhibit No. ___ (GG-7) compares the revenues collected during this prior period with the total cost of service under a DOC methodology. This illustrative exhibit demonstrates that the company overcollected its cost of service from 1984-1999 by over $116 million. Exhibit No. ___ (GG-9) graphically demonstrates this comparison.

Similarly, Exhibit No. ____ (GG-4) compares the revenue collected during this prior period with the total cost of service under Olympic=s version of the FERC=s 154-B methodology. This illustrative exhibit demonstrates that the company also overcollected its cost of service from 1984-1999 even under Olympic=s version of the FERC=s 154-B methodology. Exhibit No. ___ (GG-8) graphically demonstrates this comparison.

In reviewing these exhibits illustrating Olympic=s overcollections from prior periods, it must be borne in mind that they assume that every cost reported on FERC Form No. 6 should be included in the calculation whether or not those costs are proper to consider for ratemaking purposes. For example, many of the Whatcom Creek direct expenses, which no party contests should not be considered when setting rates, are included within the costs reported on FERC Form No. 6 and reduce the amount of overcollections calculated. In addition, it must be borne in mind that the calculation assumes Olympic=s capital structure, returns, and version of FERC=s 154-B methodology are all correct. Stated differently, under virtually any calculation, Olympic continues to have overcollections above its full nondeferred return. Olympic has no deferred returns from these prior periods, and a hypothetical calculation of deferred returns which ignores these overcollections should not be considered in setting rates.

F. DEPRECIATION

Q. The fifth major reason for the differences between the two approaches was the level of the Depreciation. Please explain further.

A. There is a $70,000 difference in the Depreciation set forth in Exhibit No. ____ (GG-2C) and Exhibit No. ____ (CAH-4). This difference is generally explained as resulting from Olympic=s estimated calculation of the impact of the sale of the Sea-Tac Facilities. Exhibit No. ____ (GG-2C) assumes Olympic=s Test Year level of net plant in service is correct, but updates it to reflect the new information provided on the actual rather than estimate purchase price and costs of the Sea-Tac Facilities.

G. THROUGHPUT

Q. The sixth and final major reason for the differences between the two approaches was the level of the throughput. Please explain further.

A. The cost-of-service recommendations set forth in Exhibit No. ____ (GG-2C) have been translated into intrastate rates based upon Olympic=s normal operating throughput of 121,349,000 BPY. The cost-of-service recommendations set forth in Exhibit No. ___(CAH-4) have been translated into intrastate rates based upon a calculation of Olympic=s constrained operating throughput of 105,897,000 BPY. While the throughput assumption used only marginally impacts the total cost of service (through the Fuel and Power operating expense), its does have a direct and material impact on the rates and a likelihood of overcollections in future years based on those rates.

Olympic=s Exhibit No. ___ (CAH-4) assumes constrained throughput during the future periods in which the rates at issue will be in effect. Specifically, Exhibit No. ___ (CAH-4) does not take into account either the enhanced throughput caused by the operation of the Bayview terminal nor the enhanced throughput caused by operating at normal operating pressures.

Prior to the Whatcom Creek incident, Olympic=s normal operations included operating the entire pipeline system (including the Bayview terminal) at normal operating pressures. For the reasons set forth by Tesoro Witness Brown, rates should be set based on normal operations. The 121,349,000 BPY used in Exhibit No. ____ (GG-2C) is Olympic=s calculation

of its throughput under normal operations which was used to support Olympic=s current final rate in its 1998 rate filing.

Q. Please explain why you are concerned with setting rates for future period assuming Olympic=s throughput will continue to remain constrained throughout the entire period the rates at issue are in effect.

A. If Olympic is allowed to establish rates based on constrained throughput, then it will receive a windfall and unjustified returns upon returning to normal operations. Given the reasons set forth by Tesoro Witness Brown, it would be unreasonable to allow Olympic to set rates based on the assumption that the pipeline with not operate under normal conditions.

Below, I have illustrated the impact of the throughput issue based on existing rates, the rates established under Exhibit No. ____ (GG-2C), and the rates established under Exhibit No. ___ (CAH-4).

Illustration No. 8

		105,000	110,000	115,000	120,000	125,000	130,000	135,000	140,000
Tesoro COS	$0.3120	$32,759	$34,319	$35,879	$37,439	$38,999	$40,559	$42,119	$43,679
Current Rates	$0.3482	$36,564	$38,305	$40,046	$41,788	$43,529	$45,270	$47,011	$48,752
CAH-4 COS	$0.5759	$60,472	$63,352	$66,231	$69,111	$71,990	$74,870	$77,750	$80,629

As is apparent in Illustration No. 8, Olympic will overcollect its total cost of service by at least $10 million each year when it returns to normal operations if its rates are set under the constrained throughput assumption set forth in Exhibit No. ___ (CAH-4). There is no justifiable basis to allow such overcollections based on constraints Olympic has had imposed upon it years before due to its imprudent operation of the pipeline. Moreover, allowing Olympic to collect its total revenue requirement based on throughput under normal operating conditions will provide a strong incentive to Olympic to comply with OPS=s safety requirements and return to normal operations as soon as possible.

V. RATE DESIGN

Q. Please discuss the applicable rate design that you are recommending to be used to design intrastate transportation rates.

A. Using the cost of service and throughput figures set forth in Exhibit No. ____ (GG-2C), there is a rate design study for the development of intrastate transportation rates based on the Fully Allocated Cost methodology employed by Olympic Witness Collins in Exhibit No. ___(CAH-4). While the methodology is set forth, he does not use the rates derived from the methodology. The Fully Allocated Cost methodology is a more proper and more defensible methodology than applying a straight percentage rate to increase (or decrease) rates as is done in Exhibit No. ___ (CAH-4). Such a methodology is employed generally in lieu of auditing the entire system of Olympic to study intrastate and intrastate flows for the purpose of segregating and assigning costs. While certain facilities may be used solely for intrastate shipments, on the whole, the system appears to be more fully integrated for intrastate and intrastate shipments. Therefore, the Fully Allocated Cost methodology set forth in Exhibit No. ___ (CAH-4) and used in Exhibit No. ____ (GG-2C) should be used to set rates.

Q. What are the results based on your Fully Allocated Cost study?

A. Based on the Fully Allocated Cost methodology, $23.688 million is allocated to intrastate service. Exhibit No. ____ (GG-2C), Schedule 25, demonstrates the BB/mile methodology employed. Exhibit No. ____ (GG-2C), Schedule 26, demonstrates the dollars assigned to the intrastate service at issue. Exhibit No. ____ (GG-2C), Schedule 27 shows the development of rates for the intrastate service. As a basis for comparison, Exhibit No. (GG-3), Schedule 6, compares the proposed rates to the existing rates. Exhibit No. ____ (GG-2C), Schedule 1, shows the resulting revenue achieved through the application of rates to Test-Year volumes.

Q. Are you recommending any level of rates for intrastate service?

A. Yes I am. Based on the fully allocated cost study that I performed, based on the company=s methodology, rates based on Exhibit No. ____ (GG-2C) are set forth in Exhibit No. ____ (GG-2C), Schedule 27.

VI. CONCLUSION

Q. Would you summarize your conclusions?

A. Yes. Based on the recommendations of Tesoro Witness Hanley concerning Capital Structure and the Cost of Capital, and Tesoro Witness Brown concerning the proper level and composition of costs for expense and rate base purposes and the implementation of the recommendations as set forth in Exhibit No. ____ (GG-2C), the proposed rate increase of 62% that is proposed by Olympic should not be accepted. The WUTC should adopt the cost-of-service approach set forth in Exhibit No. ____ (GG-2C), set just and reasonable rates, and order immediate refunds to be paid to the intrastate shippers.

Q. Does this conclude your testimony?

A. Yes it does.

CERTIFICATE OF SERVICE

I hereby certify that on May 13, 2002, a true and correct copy of the foregoing document was hand delivered to the following at the settlement proceedings at the WUTC:

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Exhibit No. ____ (GG-1T)
Docket No. TO-011472
Witness: Gary Grasso

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION	)	
	)	**DOCKET NO. TO-011472**
Complainant,	)	
v.	)	
OLYMPIC PIPE LINE COMPANY, INC.)	)	
Respondent.	)	

GENERAL RATE CASE

Prepared Direct and Answering Testimony of

GARY GRASSO
Benjamin, Schlesinger and Associates, Inc.

on Behalf of Intervenor
Tesoro Refining and Marketing Company

May 13, 2002

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TO
PREPARED DIRECT AND ANSWERING
TESTIMONY OF GARY GRASSO