Exhibit T ___ (KLE-5T)
Docket No. TO-011472
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Washington Utilities and Transportation Commission,	)	**DOCKET NO. TO-011472**
Complainant,	)	
v.	)	
Olympic Pipe Line Company, Inc.,	)	
Respondent	)	

TESTIMONY OF
KENNETH L. ELGIN

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

May 24, 2002

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Kenneth L. Elgin. My business address is Chandler Plaza Building, 1300 South Evergreen Park Drive SW, Olympia, Washington, 98504-7250.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. My employer is the Washington Utilities and Transportation Commission. I work in the Regulatory Services Division as the Case Strategist.

Q. DID YOU TESTIFY IN THE INTERIM RATE RELIEF PHASE OF THIS DOCKET?

A. Yes.

Q. DID YOU SUPPLY YOUR QUALIFICATIONS AT THAT TIME?

A. Yes. My qualifications are contained in Exhibit No. 131-T, pages 2-3, and Exhibit No. 132.

I. SCOPE OF TESTIMONY AND SUMMARY

Q. WHAT IS THE SCOPE OF YOUR TESTIMONY?

A. I review the information Olympic Pipe Line (Olympic or Company) has provided relating to certain issues set forth in paragraph 10 of the Commission's Third Supplemental Order "Granting Interim Relief, In Part" in this docket. I also address certain points made by Olympic regarding the Company's reasons for rejecting a historical cost less depreciation form of regulation.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The financial circumstances Olympic currently faces are the result of an extended period during which Olympic pursued aggressive financial policies that had the effect of maximizing Olympic's returns and cash flows from its oil transportation services. Between 1990 and the Whatcom Creek explosion in 1999, Olympic achieved extraordinary returns on its equity investment. Another effect was that Olympic had no financial flexibility in the event of a curtailed ability to move product on its system.

The Commission should hold Olympic accountable for the risks it accepted by pursuing such aggressive financial policies that led to these high returns. Shippers should not be required to pay for prior operating losses, nor should shippers be required to pay, during the period Olympic upgrades its facilities to return its operations to full capacity, for the financial flexibility lost as a result of these prior decisions. I recommend that the Commission provide an incentive to the Company to move, over time, to more sound financial footing.

I also address the reasons Olympic has advanced to justify rejection of the Commission's traditional form of regulating rates. Olympic asserts that it is distinguishable from other public service companies. However, when the distinctions Olympic offers are examined, they either are not distinctions at all, or they do not support a different form of regulation for Olympic.

Q. ARE YOU SPONSORING ANY EXHIBITS IN THIS PHASE OF THE PROCEEDING?

A. Yes. I am sponsoring Exhibit Nos. ____(KLE-6, KLE-7, KLE-8-C, KLE-9, KLE-10-C and KLE-11). The exhibits Olympic has designated confidential are provided under separate cover. My testimony regarding them is based on discussion in deposition testimony that has not been declared confidential by Olympic.

II. ISSUES IDENTIFIED BY THE COMMISSION IN PARAGRAPH 10 OF THE COMMISSION'S THIRD SUPPLEMENTAL ORDER

Q. PLEASE STATE THE ISSUES YOU WILL DISCUSS, WHICH THE COMMISSION IDENTIFIED IN PARAGRAPH 10 OF ITS THIRD SUPPLEMENTAL ORDER IN THIS DOCKET.

A. In paragraph 10 of its Order, the Commission identified eight issues that were areas of concern:

1. "How the Company came to this situation, what regulatory consequences should flow from the Company's actions, and what the Company should do in the future…"
2. "Questions exist with regard to the Company's financial structure, its plans for the future, and its ability to operate soundly."
3. "Questions exist with regard to the Company's cash flow, its lack of audited financial reports, its failure to notify the Commission of its debt financing, its ability to secure capital in a rational manner to assure its future operations, its ability to shed the ghosts of its past, its owners' willingness to support -- or share in the support of -- its long-term financial needs."

4. "Questions exist with regard to the status of its investments in the Bayview Terminal and the Cross-Cascade Pipeline."
5. "Whether a firm with a more traditional capital structure would have fared better than Olympic through its recent circumstances."
6. "How to gauge the effect of capital structure in determining long-term fair, just, and reasonable rates."
7. "The level of current management fees and whether the management contract may have required prior approval."
8. "How to account for the Bayview Terminal, the investment in the Cross-Cascade Pipeline, and the Whatcom Creek expenses for ratemaking purposes."

Q. REGARDING THE FIRST ISSUE IDENTIFIED BY THE COMMISSION, HOW DID THE COMPANY COME TO ITS CURRENT FINANCIAL SITUATION?

A. The Company's current financial situation is the result of Company management's aggressive financial policies in its pursuit of high returns and cash flows. As shown in Exhibit____(KLE-6), throughout the 1990's and up until the Whatcom Creek explosion in 1999, the Company's dividend policy, its investment decisions, and its financing decisions were extremely aggressive.

A comparison of the data on the "Income" line and the "Dividends" line shows that Olympic implemented a dividend policy under which virtually all of its earnings were paid to its owners in the form of cash dividends. Overall, between 1990 and 1997, Olympic paid $51.5 Million in dividends to its owners. This figure is shown in the "Sum" column on the "Dividends" line.

Olympic also invested substantial sums in new facilities that failed to deliver any new revenues, primarily the Bayview Terminal ($20.5 million) and the Cross Cascades Project ($21.5 million). As my Exhibit No. ___ (KLE-6) shows, from 1990 to 1998, Olympic spent $65.5 million on new construction (sum of amounts on the "Construction" line for the years 1990 through 1998). The Company elected to finance its investments and operations with new debt, rather than equity. In 1990, the total debt for Olympic was approximately $27 Million ($25.066 million in "Long Term Debt" plus $1.896 million in "Short Term Debt"), which grew to $61.5 Million in 1998 ($17 million in "Long Term Debt" plus $44.484 million in "Short Term Debt"). Over that same time period, Olympic's equity grew from about $3.5 Million to $15.1 Million ("Equity" line amounts for 1990 and 1998).

Following the Whatcom Creek explosion, the Company issued additional debt to pay operating expenses, which compounded the effects of its prior aggressive financial policies. From 1998 to 2000, the Company's total short-term debt exploded from $2.1 Million to over $100 Million. ("Short Term Debt" line on Exhibit No. ___ (KLE-6) showing amounts for 1998 and 2000).

Basically, the Company has failed to pursue prudent financial policies. Indeed, it is arguable that the rates shippers paid were for a "quality" operation, which would have included fiscally prudent financial policies. Unfortunately, shippers did not get a company that was implementing financially prudent financial policies and are now faced with the prospect of responding to emergency conditions caused by these aggressive financial policies.

Q. WHAT IS THE SOURCE OF THE FIGURES SHOWN ON EXHIBIT_____(KLE-6)?

A. The Company's annual report on file with the Commission, FERC Form 6.

Q. WHAT REGULATORY CONSEQUENCES SHOULD FLOW FROM THE COMPANY'S PAST FINANCIAL POLICIES?

A. The rate setting process should set rates based upon sound financial and regulatory principles. In this case, the regulatory consequences that should flow from the Company's financial policies during the 1990's should be based on the principles designed to achieve financial stability over time.

The Commission should set rates that allow the Company to earn a fair return on the facilities actually serving the public, at a cost that reflects the Company's need to build its equity over time. Providing a return on the Company's facilities, with some degree of equity where none currently exists, will not only compensate the Company for the risk in continued maintenance and management of those facilities, it will provide a cushion to provide a modest amount of financial flexibility and growth in equity through retained earnings. In that regard, the Company's cost of service for its intra-state operations should be based on the cost rates and capital structure Mr. John Wilson describes in his testimony. Rate base is the original cost of the Company's investment in facilities less accumulated depreciation.

In essence, the rate setting process should recognize that, absent an equity investment by the owners, the Company will only be able to achieve sound financial footing over an extended period of time. Mr. Wilson's recommendation to adopt a hypothetical capital structure with 20 percent equity for general rates will provide sufficient revenues to support debt that is financing assets that are serving the public, and a cushion to provide an incentive for the Company to build its equity investment.

At some point, if Olympic's owners invest the necessary equity to achieve the capital structure deemed appropriate by Staff witness Mr. Wilson, then Olympic may file for new rates to produce the revenues necessary to provide it with the opportunity to earn a return on its actual equity investment, and pay the necessary taxes to support that level of earnings. If Olympic's owners fail to invest equity, Olympic may still file for an equity return as its level of retained earnings grows over time.

Q. WHAT ARE STAFF'S RECOMMENDATIONS WITH RESPECT TO WHAT THE COMPANY SHOULD DO IN THE FUTURE?

A. The Company should develop a financial plan to build equity in the Company through retaining its earnings and equity investments. According to Mr. Wilson, a reasonable equity ratio is approximately 50%. Furthermore, the short-term notes Olympic issued in part to cover operating losses should be disregarded and recognized as an equity infusion. This will require Olympic to carry a negative equity ratio for the time being. These short-term loans must be recognized for what they are funds provided by the owner to pay for operating expenses from prior periods. Simply put, no solvent firm can issue debt to support operating losses and issue financial statements that show debt exceeds the long-lived assets of the business.

Q. WHAT WAS THE SECOND ISSUE IDENTIFIED BY THE COMMISSION IN ITS ORDER?

A. "Questions exist with regard to the Company's financial structure, its plans for the future, and its ability to operate soundly."

Q. HOW WAS OLYMPIC FINANCED AT THE TIME OF THE INTERIM RATE RELIEF HEARINGS?

A. Olympic financed its facilities exclusively with debt.

Q. IS THE COMPANY STILL FINANCED EXCLUSIVELY WITH DEBT?

A. Yes. (Exhibit No.____(KLE-6), Batch Deposition at Tr. 16). Worse yet, Olympic's debt, totaling some $150 million, exceeds the amount Olympic has invested in facilities that are serving the public (approximately $98 million per Exhibit No. 134).

As I have already stated, to the extent these debts were used to pay expenses, they must be recognized for what they are: equity capital provided by Olympic's owners to pay ongoing operating expenses. The proper way to book such "loans" is as additional paid in capital.

Q. HAS OLYMPIC COMMITTED TO PREPARE A LONG-TERM FINANCIAL PLAN?

A. Yes. According to the Company's response to Staff Data Request No. 361, included in my Exhibit No.___(KLE-8-C), Olympic and its shareholders have committed to prepare a long-term financial plan.

Q. HAS OLYMPIC PREPARED A LONG-TERM FINANCIAL PLAN?

A. No. (Exhibit No.__(KLE-7), Batch Deposition at Tr. 43-44). It will be difficult for Olympic to develop a long-term financial plan until it is able to produce a rational set of financial statements. However, as Olympic continues to operate and generate revenues, it should be able produce both rational income statements and balance sheets. Only then it be able to produce a credible long-term financial plan. Rational financial statements are those that, at a minimum, establish a relationship between facilities serving the public and how these facilities are financed. A credible long-term financial plan should, at a minimum, demonstrate how the Company will extinguish the debt on the Company's books that does not support any investment in long-lived assets serving the public.

Q. DOES THE COMPANY HAVE A LONG TERM TARGET CAPITAL STRUCTURE?

A. No. Included in my Exhibit No.___(KLE-8-C) is the Company's response to Staff Data Request Nos. 362 and 363. In issuing those data requests, Staff offered the Company an opportunity to identify its target capital structure and to explain its plans for achieving that capital structure.

As the responses show, Olympic has no target capital structure and did not explain its plans for achieving a target capital structure.

Q. IS OLYMPIC ABLE TO OPERATE SOUNDLY?

A. First, I would qualify that my answer is related exclusively to Olympic's financial operations. As long as the pipeline is operational and moving products, Olympic will have the opportunity to pay its expenses and interest on the debt that is supporting its facilities that are serving the public. Although Olympic will be able to operate with a significant amount of financial leverage, it will not have the financial flexibility to weather any additional interruptions on its system. While an oil pipeline may operate with significant amounts of financial leverage, it does so at a price. The pipeline owners must recognize that a curtailment on the system would require an infusion of equity to support operations. In this regard, Olympic realized the benefits of its financial policies for several years, but it now is failing to pay the cost associated with those policies.

Q. WHAT IS THE THIRD ISSUE IDENTIFIED BY THE COMMISSION?

A. "Questions exist with regard to the Company's cash flow, its lack of audited financial reports, its failure to notify the Commission of its debt financing, its ability to secure capital in a rational manner to assure its future operations, its ability to shed the ghosts of its past, its owners' willingness to support -- or share in the support of -- its long-term financial needs."

Q. WHAT IS YOUR PERSPECTIVE REGARDING THE COMPANY'S OPERATIONS AND THE THIRD ISSUE AREA IDENTIFIED BY THE COMMISSION?

A. These issues are related to my previous testimony regarding the Company's current financial statements. The short-term debt on Olympic's balance sheet, to the extent it was issued to fund prior period operating losses, should no longer be carried on Olympic's balance sheet. Over time, as the Company's cash flows improve with a return to normal operating pressure, the Company will be able to produce a credible financial plan and rational financial statements. Finally, an infusion of equity from Olympic's owners will accelerate the Company's prospects for returning to sound financial performance.

Q. DOES THE COMPANY HAVE UNQUALIFIED AUDITED FINANCIAL STATEMENTS?

A. No. The Company has not obtained unqualified audited financial statements for 1999, 2000, or 2001.

Q. WHEN WILL THE COMPANY HAVE UNQUALIFIED AUDITED FINANCIAL REPORTS?

A. The Company has made several different commitments regarding when it will have unqualified audited financial statements. At the January 24, 2001, hearing, the Company committed to having audited financial statements "in the next couple weeks, certainly before -- much before the end of the general rate case, before, I think, Commission Staff has to put on their rate case…" (Tr. 1304).

The Company now states it will have unqualified audited financial statements "by the end of this year, or perhaps the first quarter of 2003…" (Exhibit No.___(KLE-7), Batch Deposition at Tr. 14)

It is doubtful that the Company will be able to achieve this objective within the next two years unless it is able to address the issues surrounding its financial statements I have previously discussed.

Q. WHAT PROBLEMS MAY THE COMPANY FACE IN OBTAINING UNQUALIFIED AUDITED FINANCIAL STATEMENTS?

A. The Company will likely have difficulty obtaining unqualified audited financial statements until its balance sheet reflects liabilities that more closely match investments, and until prior operating losses are no longer financed with debt. Staff witness Mr. Danny Kermode addresses other issues related to the Company's accounting practices.

Q. DID THE COMPANY FAIL TO NOTIFY THE COMMISSION OF ITS DEBT FINANCINGS?

A. Yes. Olympic did not file financing applications or notices for all of the debt financings listed by Mr. Batch in Exhibit No. 3-T, page 3. My review of the documents the Company submitted in response to Staff Data Request Nos. 5 and 364 indicate that the only filings the Company made for any of the securities listed in Mr. Batch's testimony (Exhibit 2-T, page 3, lines 13-21) were for the Chase and Prudential notes.

RCW 81.08.040 requires Olympic to file with the Commission a notice of its intent to issue any new security. The statute states in pertinent part, "Any public service company that undertakes to issue…evidences of indebtedness shall file with the commission before such issuance: (1) A description of the purposes for which the issuance is made,…(2) A description of the proposed issuance including the terms of financing; and (3) A statement as to why the transaction is in the public interest.

Q. DID YOU MAKE ANY OTHER EFFORTS TO DETERMINE WHAT FILINGS THE COMPANY MADE IN ORDER TO COMPLY WITH CHAPTER 81.08 RCW?

A. Yes. In response to Staff Data Request No. 364 Olympic provided a draft letter from the Company's counsel to the Commission indicating the intent of Olympic to increase the amount of debt it will issue under a revolving line of credit with Texas Commerce Bank (now called Chase). In addition, Olympic provided a follow-up letter to Staff Counsel with a reference to Docket Nos. TO-941557 and TO-961214. I reviewed the official Commission files for theses dockets. Docket

No. TO-941557 is Olympic's formal filing to increase the line of credit with the Texas Commerce Bank (Chase) from $5 million to $10 million. Docket No. TO-961214 is Olympic's subsequent notice to the Commission in regarding an increase to the same line of credit from $10 million to $20 million. These two dockets appear to be related to the Chase note listed by Mr. Batch in his testimony, Exhibit No. 2-T.

Q. IS OLYMPIC ABLE TO ISSUE ADDITIONAL NEW SECURITIES AND OBTAIN CAPITAL IN A RATIONAL MANNER TO ASSURE ITS FUTURE OPERATIONS?

A. No, not until the Company produces a rational set of financial statements. Its financial statements should reflect sound financial theory: at a minimum, they should show that Olympic's cash flows fund its ongoing operations and that it can meet other fixed-charge obligations. If Olympic's income statements continue to show that operating expenses are funded by debt, and if Olympic is unable to pay its fixed-charge obligations, the Company will never be able to show any potential provider of new capital that it has a sound business plan.

Q. HAVE THE COMPANY'S OWNERS SHOWN A WILLINGNESS TO SUPPORT -- OR SHARE IN THE SUPPORT OF – OLYMPIC'S LONG-TERM FINANCIAL NEEDS?

A. That is not clear. However, the evidence suggests that Olympic's owners will invest only if there is some guarantee of a return of interest and capital. For example, the notes that Olympic issued to its owners are relatively short term and for amounts far beyond the Company's ability to pay from ongoing operations. In addition, no owner has invested equity capital in Olympic, nor do I see any indication that the owners plan to invest equity.

Q. WHAT IS THE FOURTH ISSUE LISTED BY THE COMMISSION IN ITS THIRD SUPPLEMENTAL ORDER?

A. "Questions exist with regard to the status of [Olympic's] investments in the Bayview Terminal and the Cross-Cascade Pipeline."

Q. WHAT IS THE STATUS OF THE BAYVIEW TERMINAL AND THE CROSS-CASCADES PROJECT?

A. Staff witness Mr. Colbo addresses Bayview Terminal in detail. In short, the pipeline currently bypasses the Bayview Terminal. Bayview is not operating as intended and may not operate as intended for another year or more. Staff recommends Bayview be removed from results of operations, but that it be allowed to accrue AFUDC until it comes back on line.

The Cross-Cascades Project is not included by either Staff or Company in the calculation of rate. This project not providing service to the public. Olympic has not sought to include this project in rate base.

Q. WHAT IS THE FIFTH ISSUE IDENTIFIED BY THE COMMISSION?

A. "Whether a firm with a more traditional capital structure would have fared better than Olympic through its recent circumstances."

Q. WHAT WAS THE COMPANY'S EQUITY RATIO WHEN THE WHATCOM CREEK EXPLOSION OCCURRED?

A. At the time of the Whatcom Creek Explosion, Olympic's equity ratio was approximately 16%.

Q. HOW DID OLYMPIC FINANCE ITS OPERATIONS AFTER THE WHATCOM CREEK EXPLOSION?

A. Olympic financed its ongoing operations with additional debt.

Q. PLEASE EXPLAIN THE EFFECT OF COMPANY'S 100% DIVIDEND POLICY AND ITS FINANCING ITS OPERATIONS EXCLUSIVELY WITH DEBT.

A. As I explained earlier, and as shown in my Exhibit No. ___ (KLE-6), in the past the Company consistently pursued a dividend policy that paid virtually all of the Company's earnings to its owners as dividends. This amounted to approximately $51.5 million in dividends since 1990.

Olympic also invested significant amounts in new projects. From 1994 to 2000, Olympic's construction expenditures were $75.6 million (total of "Construction" line figures from 1994 through 2000). Of this $75.6 million for new projects, Olympic spent only $12 million in 2000, the year following the Whatcom Creek explosion.

Olympic financed both the $75.6 million in new projects and its operations after the Whatcom Creek explosion with new debt. Short-term debt grew from $2.1 million in 1990, to over $100 million in 2000. Long-term debt grew from $25 million in 1990, to $44.5 million in 1994. After 1994, long-term debt declined to $17 million in 2000. Total debt increased from $27 million in 1990, to $117 million in 2000.

Q. WHAT WERE THE CONSEQUENCES OF THE COMPANY'S DIVIDEND POLICIES AND CAPITAL STRUCTURE POLICIES DURING THE 1990's?

A. The Company was left without any financial flexibility. If any event disrupted operations curtailing its cash flow, the Company was financially unable to respond. Indeed, even a minor incident curtailing operations would have had a significant impact on Olympic's ability to pay operating expense and service the amount of debt on its books.

Q. IF OLYMPIC HAD AN EQUITY RATIO IN THE 40-50% RANGE, WOULD THE COMPANY HAVE FARED BETTER THAN IT DID THROUGH ITS RECENT CIRCUMSTANCES?

A. Yes. First, Olympic would have had an equity cushion to absorb operating losses while the operations were shut down. If Olympic had equity on its books, it could issue new debt to fund both its curtailed operations and the necessary capital projects to restore operations. It would have been necessary to recognize the losses when incurred, reducing its equity investment, but Olympic would have continued to have rational financial statements that lenders could rely upon in assessing the future performance of the Company. Indeed, Olympic would have been able to produce a sound financial plan in order to restore operations, and it would have been able to provide assurances to lenders that it had the ability to pay off the new debt once operations were restored.

Q. WHAT IS THE SIXTH ISSUE LISTED BY THE COMMISSION IN ITS THIRD SUPPLEMENTAL ORDER?

A. "How to gauge the effect of capital structure in determining long-term fair, just, and reasonable rates."

Q. HOW SHOULD THE COMMISSION RESPOND TO THE ISSUE OF CAPITAL STRUCTURE IN THIS CASE TO DETERMINE LONG-TERM RATES THAT ARE FAIR, JUST, REASONABLE, AND SUFFICIENT?

A. Staff recommends the Commission adopt the approach recommended by Mr. Wilson, to provide a small equity cushion as an incentive to the owners to restore the equity in the Company.

Basing long-term rates on phantom equity investment (i.e., the consolidated equity ratio of the parent as proposed by the Company), is unreasonable. Since 1990, the Company has demonstrated that it will not maintain a reasonable amount of equity in its capital structure.

If Olympic's owners provide an equity infusion, Olympic may then file for rates to support a return on a reasonable level of equity investment and associated income taxes. The failure of Olympic's owners to infuse equity into the operations requires the Commission to take an approach that provides the Company the opportunity to build equity over time, as Olympic's equity grows by retaining its earnings.

Q. WHAT IS THE SEVENTH ISSUE LISTED BY THE COMMISSION?

A. "The level of current management fees and whether the management contract required prior Commission approval."

Q. WHAT IS THE CURRENT LEVEL OF MANAGEMENT FEES OLYMPIC PAYS TO BP PIPELINES FOR THE SERVICES BP PIPELINES PROVIDES TO OLYMPIC?

A. Staff witness Mr. Bob Colbo provides that amount and Staff's recommendation on this issue.

Q. DID THE MANAGEMENT CONTRACT REQUIRE WUTC APPROVAL?

A. Yes. RCW 81.16.020 states, "Every public service company shall file with the commission a verified copy…of a contact or arrangement providing for the furnishing of management…or similar services…. The filing must be made prior to the effective date of the contract or arrangement."

Q. WHAT IS THE LAST ISSUE LISTED BY THE COMMISSION IN PARAGRAPH 10 OF ITS THIRD SUPPLEMENTAL ORDER?

A. "How to account for the Bayview Terminal, the investment in the Cross-Cascade Pipeline, and the Whatcom Creek expenses for ratemaking purposes."

Q. DID YOU ALREADY SUMMARIZE HOW STAFF PROPOSES TO TREAT THE BAYVIEW TERMINAL AND THE CROSS CASCADES PIPELINE PROJECT?

A. Yes.

Q. HOW DOES STAFF PROPOSE TO TREAT THE WHATCOM CREEK EXPENSES?

A. Staff witness Mr. Colbo testifies on this issue. Staff concurs with the Company's proposed treatment that costs associated with the Whatcom Creek explosion be excluded for ratemaking purposes.

III. OLYMPIC'S PROPOSAL FOR DETERMINING AN APPROPRIATE RATEMAKING METHODOLOGY

Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF OLYMPIC'S WITNESS MS. OMOHUNDRO REGARDING THE ISSUE OF

DETERMINING THE APPROPRIATE RATEMAKING METHODOLOGY?

A. Yes. In Exhibit No.___(CAO-3), Olympic lists four factors the Company believes the Commission should consider in determining the appropriate ratemaking methodology for Olympic. I have reviewed those four factors.

Q. MY FOLLOWING QUESTIONS ON THE FOUR FACTORS ASK YOU TO ASSUME THE FOUR FACTORS LISTED BY OLYMPIC ARE RELEVANT. WHAT IS THE FIRST FACTOR OLYMPIC LISTS AS JUSTIFICATION FOR REJECTING THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. According to Olympic, "The Commission should set rates at a level sufficient to attract capital on reasonable terms, which in turn depends on the nature and circumstances of the company and the context." Exhibit No. ___ (CAO-3), page 4.

Q. IS THIS A SUFFICIENT REASON TO REJECT THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. No.

Q. WHY NOT?

A. The traditional Commission ratemaking methodology, which applies a market rate of return to a company's rate base valued at historical cost less depreciation, meets the capital attraction standard. In fact, the Commission has consistently adopted the capital attraction standard in setting rates for public service companies in Washington. In every rate order I have reviewed in my experience with the Commission, the Commission has consistently recognized this long-standing ratemaking principle from the U.S. Supreme Court *Hope* and *Bluefield* cases.

From reading Ms. Omohundro's testimony, it is unclear exactly what Olympic means about how the capital attraction standard should be changed in differing circumstances and how "context" affects application of the standard. It is incumbent upon Olympic to provide a clear and supported argument why the Commission should abandon its traditional principles for determining rate base in this case for Olympic. In my opinion, Ms. Omohundro's direct testimony fails to provide any supportable evidence why the Commission's use of a rate base based on historical cost less depreciation should be rejected.

Q. WHAT IS THE SECOND FACTOR OLYMPIC LISTS AS JUSTIFICATION FOR REJECTING THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. According to Olympic, “An oil pipeline is fundamentally different from a public utility that provides an essential service, such as electricity or water, and which has a duty to expand service to meet new customer demand.” Exhibit No. ___ (CAO-3), page 4.

Q. IS THIS STATEMENT A SUFFICIENT REASON TO REJECT THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. No.

Q. WHY NOT?

A. First, Olympic is not fundamentally different from other public service companies. Olympic, like other companies subject to the Commission’s jurisdiction, is a monopoly controlling essential facilities built to serve the public. Mr. Wilson testifies to competitive issues for Staff, but I would note that Olympic has no competition from other pipelines. There are significant barriers facing potential any new pipeline entrant. In my opinion Olympic has not presented a case demonstrating alternatives to its service provide effective competition. I would note that if any of the alternative services truly amounted to effective competition, these alternative services should drive down the price of transportation service on the pipeline, forcing Olympic to lower its prices. Olympic’s request for a 62% increase amply supports the notion that Olympic is a monopoly with significant pricing power.

Second, Olympic's arguments suggest that any "non-essential" service subject to the Commission's jurisdiction be priced irrespective of cost. That is not reasonable. The critical point is not whether any service is essential or not. The defining factor is whether the firm meets the definition of a public service company and is subject to the Commission's jurisdiction. The legislature is very specific in its direction to regulate the rates of a common carrier. RCW 81.28.010 states, "All charges for any service rendered…by any common carrier…shall be fair, just, reasonable and sufficient." I cannot find any reference in the statute for the Commission to consider whether a service provided by a common carrier is "non-essential."

Finally, it is not apparent that oil pipeline companies lack a duty to expand service. To the extent the duty to expand service is a legal question, I cannot respond. But, it is my understanding that common carriers such as Olympic have a duty to construct adequate service facilities to transport property offered to it. It is also my understanding that the Commission has the authority, after hearing, to determine that such facilities be constructed.

Q. WHAT IS THE THIRD FACTOR OLYMPIC LISTS AS JUSTIFICATION FOR REJECTING THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. According to Olympic, "Capital potentially available for oil pipeline investments must compete for capital sources with other alternative investments." Exhibit No. ___ (CAO-3), page 4.

Q. IS THIS A SUFFICIENT REASON TO REJECT THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. No.

Q. WHY NOT?

A. This factor, like the others Olympic has listed, does not distinguish Olympic from other utilities that are regulated using the WUTC's traditional ratemaking methodology. That is because most public utilities compete worldwide for capital. Puget Sound Energy, PacifiCorp and Avista are companies that provide electricity, which Olympic considers an "essential service." Each of these companies compete for capital, and the investors providing that capital have alternative investment choices worldwide. Olympic Pipe Line, and oil pipelines generally, are not unique in that respect.

There is a related point for the Commission to consider at this time. It involves both the second and third factors Olympic lists for the Commission's consideration in its determination of an appropriate ratemaking methodology for Olympic. All investments, whether for "essential public services" or not, must meet the capital attraction test. Investors will make funds available if they expect to recover a return on (fair return on the actual investment) and of (depreciation) their investment. It is precisely because this standard is applied to all investments in a market driven economy, that it is almost universally used by regulatory bodies for purposes of rate regulation.

Q. WHAT IS THE FOURTH FACTOR OLYMPIC LISTS AS JUSTIFICATION FOR REJECTING THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. According to Olympic, "The Commission has used the federal oil pipeline methodology to establish rates for Olympic since 1983, creating a history of investment backed expectations." Exhibit No. ___ (CAO-3), page 4.

Q. IS THIS STATEMENT A SUFFICIENT REASON TO REJECT THE RATEMAKING METHODOLOGY TRADITIONALLY USED BY THE COMMISSION TO SET RATES FOR PUBLIC UTILITIES?

A. No.

Q. WHY NOT?

A. To what extent a regulated entity can legally require a regulatory commission to use a particular method indefinitely is a legal question to which I cannot testify. But Olympic has provided no evidence that the Company actually relied on a specific ratemaking methodology when it invested in plant in this state.

Olympic's witness on this issue, Ms. Omohundro, testified she had no knowledge on this issue. As she testified in her deposition: "I was generally aware, you know, of the history with Olympic, because I was involved in the discovery process early on. I am not the expert, nor did I study necessarily how Olympic made decisions on how to make its capital investments in this state." (Exhibit No.___ (KLE-9), Ms. Omohundro Deposition at Tr. 16).

Q. WITH RESPECT TO THE PERIOD *BEFORE* JULY 2000, WHEN BP PIPELINES AGREED TO BE THE PIPELINE OPERATOR, DID OLYMPIC PRODUCE ANY EVIDENCE THAT OLYMPIC ACTUALLY BASED ITS INVESTMENT DECISIONS ON THE RATEMAKING METHODOLOGY USED?

A. No. Olympic's witness Ms. Omohundro testified that she would defer to Mr. Batch and Mr. Talley's knowledge in this area. (Exhibit No.___(KLE-9), Omohundro Deposition at Tr. 16).

Olympic's witness Mr. Batch was asked, "Do you know what considerations or expectations Olympic actually had or applied before it elected to invest in the pipeline before that date?" He answered, "No." (Exhibit No.___ (KLE-7), Deposition of Mr. Batch at Tr. 29).

Olympic's witness Mr. Talley was asked, "So you simply don't know the considerations or expectations Olympic actually had or applied before it elected to invest capital in the pipeline before July 2000?" He answered, "I do not." (Exhibit No.___ (KLE-11), Deposition of Mr. Talley at Tr. 40).

Q. WITH RESPECT TO THE PERIOD *AFTER* JULY 2000, DURING WHICH TIME BP PIPELINES AGREED TO BE THE PIPELINE OPERATOR, DID OLYMPIC PRODUCE ANY EVIDENCE THAT OLYMPIC ACTUALLY BASED INVESTMENT DECISIONS ON THE EXISTENCE OF ANY SPECIFIC RATEMAKING METHODOLOGY?

A. No. Staff asked Olympic to produce documents which Olympic used to justify its capital additions. See Exhibit No. ___ (KLE-10-C), Olympic's response to Staff Data Request Nos. 323, 324 and 325 (the exhibit excludes certain attachments). The Company has declared these responses "confidential," but my testimony relies on deposition testimony, which was not confidential.

In depositions, Staff asked Olympic whether these documents "would cover all the considerations that Olympic would take into account?" Olympic answered, "Yes." (Exhibit No.___ (KLE-11), Deposition of Mr. Talley at Tr. 48). I examined each of the sample documents provided. These documents reflect Olympic's current use of a "capital value process." None of the documents Olympic provided referred to any ratemaking method as a consideration that Olympic actually used in its capital budgeting decisions.

The sample forms included entries for Investor Required Return (IRR), Net Present Value over ten years in thousands (NPV)(10)($K)), Discount Payback, Capital Efficiency (CE), and Projected Life. None of these categories were completed on the forms for the sample projects Olympic supplied. See

Exhibit No. ___ (KLE-10-CF), which includes Olympic's Response to Staff Data Request No. 323, *e.g.* at p. 53).

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.