Exhibit T- ______ (GRG-1T)
Docket No. TO-011472
Witness: George R. Ganz

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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

REBUTTAL TESTIMONY OF GEORGE R. GANZ

OLYMPIC PIPE LINE COMPANY

June 11, 2002

Exhibit No. ______ (GRG-1T)

OLYMPIC PIPE LINE COMPANY

REBUTTAL TESTIMONY OF GEORGE R. GANZ

Introduction and Qualifications

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

A. My name is George R. Ganz. My business address is 332 Pine Street, Suite 600, San Francisco, California 94104. I am a Principal in the consulting firm Regulatory Economics Group, LLC ("REG").

Q. Please describe your education and professional background.

A. I hold a B.S. degree in Business Administration from the University of California at Berkeley, with concentrations in Accounting and Finance. I have over 18 years of experience with providing consulting services to common carrier oil pipelines regulated by the Federal Energy Regulatory Commission (FERC). Most of my client engagements throughout my career have involved accounting and ratemaking matters.

Q. Have you participated in other oil pipeline tariff proceedings?

A. Yes. I testified of behalf of SFPP, L.P. (SFPP) in rate proceedings before the FERC, SFPP, L.P. (Docket Nos. OR96-2-000, *et al*.), SFPP, L.P. (Docket Nos. OR92-8-000, *et al*.), and I filed testimony on behalf of SFPP in SFPP, L.P. (Docket Nos. OR98-11-000, *et al*.). I also filed testimony in the Colonial

Pipeline Company (Docket No. OR99-16-000) and Koch Pipelines, Inc. (Docket No. IS93-32-000) tariff proceedings, and I testified in the Phillips Pipe Line Company (Docket Nos. IS94-1-000 and OR94-1-000), and Gaviota Terminal Company (Docket Nos. IS93-23-000 and OR94-5-000) tariff proceedings, all of which were before the FERC.

In my career, I have directed and served on project teams in several other oil pipeline proceedings before the FERC. Most of these proceedings have involved interpretation and application of the principles promulgated in FERC Opinion No. 154-B, 31 F.E.R.C. ¶ 61,377 (1985), as modified and clarified by subsequent opinions.

In addition to proceedings before the FERC, I have directed and served on project teams in proceedings before the Alaska Public Utilities Commission, the Wyoming Public Service Commission, and the California Public Utilities Commission. I also have assisted clients with pipeline transportation matters in United States District Court proceedings. My resume contains a more complete description of my background, and is attached as Exhibit No. _____ (GRG-2).

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

A. I am submitting testimony on behalf of Olympic Pipe Line Company ("Olympic") to respond to certain issues raised in the prepared testimonies filed before the Washington Utilities and Transportation Commission ("WUTC" or "Commission") by WUTC Staff ("Staff"). Specifically, I address several matters concerning regulatory accounting standards and application of the FERC's cost of service methodology for oil pipelines that are discussed in the testimonies of Staff witnesses Danny P. Kermode, Robert Colbo, and Maurice L. Twitchell. My testimony and the prepared rebuttal testimony of Mr. Leon P. Smith, also filed on behalf of Olympic, describe the FERC methodology that is reflected in the ratemaking presentation of Olympic witness Brett A. Collins. My testimony also discusses certain accounting matters in connection with the testimonies of Olympic witnesses, Mr. Collins and Ms. Cynthia A. Hammer.

Q. How is the remainder of your testimony organized?

A. It is organized into four sections. In the first section, I discuss the accounting regulations that apply to Olympic. In the second section, I respond to several issues raised by Staff in the context of the appropriate regulatory accounting standards. In the third section, I explain certain aspects of the FERC methodology in response to criticisms raised by Staff. Finally, in the fourth section I discuss several methodological and conceptual issues reflected in the Staff revenue requirement presentations.

I. ACCOUNTING REGULATIONS

Q. What agencies have responsibility for regulatory oversight of Olympic's rates?

A. Olympic provides both interstate and intrastate transportation service. As such, it is my understanding that Olympic's rates for interstate service are regulated by the FERC, and Olympic's rates for intrastate service are regulated by the WUTC.

Q. What are the accounting and financial reporting requirements for Olympic that are administered by the FERC?

A. The FERC requires each oil pipeline company with annual jurisdictional revenues of $500,000 or more for three consecutive years to file a Form No. 6 "Annual

Report of Oil Pipeline Companies" pursuant to 18 CFR § 357.2. The FERC's accounting regulations are contained in the Uniform Systems of Accounts Prescribed for Oil Pipeline Companies Subject to the Provisions of the Interstate Commerce Act, 18 CFR § 352 (hereafter referred to as "USOA").

Q. What are the accounting and financial reporting requirements for Olympic that are administered by the WUTC?

A. The WUTC has adopted the FERC Form No. 6 as its annual report for oil pipeline companies pursuant to WAC 480-75-010. As far as I am aware, the WUTC has not promulgated specific accounting regulations for oil pipelines. However, the instructions contained in the Form No. 6 indicate that it must be prepared in conformance with the USOA. Therefore, by adopting the FERC Form No. 6, the WUTC also has adopted the FERC USOA.

In the case of gas and electric utilities, the WUTC has adopted the corresponding uniform systems of accounts published by the FERC, pursuant to WAC 480-90-203 and WAC 480-100-203, respectively. To the extent that accounting regulations have been promulgated for industries that are subject to both FERC and WUTC jurisdictions, it appears that the WUTC has aligned its regulatory accounting standards with the federal standards.

Q. Please describe the FERC USOA for oil pipelines.

A. Generally, the USOA is a system of accounts that has been established to promote uniform financial reporting among jurisdictional oil pipeline companies in providing information necessary for the FERC to exercise its statutory responsibilities. The USOA provides definitions and instructions for the chart of accounts that appear in the FERC Form No. 6. The accounting requirements in the USOA are consistent with Generally Accepted Accounting Principles (GAAP) in many respects, but key differences exist.

Q. Does the FERC allow oil pipelines to rely exclusively upon GAAP accounting standards to fulfill their accounting and financial reporting requirements?

A. No. In a recent rulemaking proceeding, the FERC updated the USOA to be more consistent with GAAP, but denied an oil pipeline industry initiative to shift to GAAP financial statements. Order No. 620, 93 F.E.R.C. ¶ 61,262 (2000).

II. REGULATORY ACCOUNTING STANDARDS

Q. What accounting standards have Staff witnesses applied to evaluate Olympic's accounting and financial data?

A. The Staff has placed exclusive reliance upon GAAP accounting standards. For example, in his testimony, Mr. Kermode stated that the purpose of his testimony was to focus "on the issue whether Olympic's accounting conformed with Generally Accepted Accounting Principles (GAAP)." Exhibit T___ (DPK-1T) at 3, lines 5-6.

Mr. Kermode identified several accounting standards specific to regulated industries on page 4 of his testimony, and he asserted that Olympic is subject to the requirements of Financial Accounting Standards Board Statement 71 ("FASB 71"), which is entitled "Accounting for the Effects of Certain Types of Regulation." In his testimony, Mr. Kermode acknowledged that Olympic must comply with the FERC USOA requirements, but he dismissed the degree and significance of any differences between the USOA and GAAP, noting that the

USOA refers to GAAP for guidance in several instances. Exhibit No. ___ (BPK-1T) at 6, line 3.

Q. Do you agree with Mr. Kermode's views regarding the standards that are applicable to Olympic's accounting and financial data?

A. No, I do not. The Staff's exclusive reliance upon GAAP accounting standards is at odds with the action taken by this Commission. The Commission has adopted the FERC Form No. 6 as the annual report for oil pipeline companies, but has not promulgated accounting system requirements that deviate from the federal standards contained in the USOA. While GAAP may provide guidance for interpreting the FERC's accounting rules, by no means does it supplant the USOA.

Q. Is Mr. Kermode correct in his assertion that FASB 71 applies to Olympic?

A. No. In fact, I doubt that FASB 71 applies to any oil pipeline that is subject to FERC regulation.

Q. Please explain.

A. As Mr. Kermode discussed in his testimony, paragraph 5 of FASB 71 sets forth three criteria, all of which must be met in order for FASB 71 to apply to a regulated company. The second criterion is that ". . . Rates are designed to recover the specific enterprise's costs of providing the regulated services or products." As Mr. Smith discusses in his testimony, the FERC's regulations provide four approaches under which oil pipelines may file rates as follows:

1. <u>Indexed Rates</u> – Allows rate changes that do not exceed indexed rate ceilings based upon the annual percentage change in the

Producer Price Index for Finished Goods less one percentage point;

2. Market-Based Rates – Allows rate changes based upon competitive factors;

3. Settlement Rates – Allows rate changes based upon agreement with shippers; and

4. Cost of Service Rates – Allows rate changes based upon the Opinion No. 154-B methodology.

Under the first three of these approaches, an oil pipeline's costs of providing regulated services is irrelevant to the rates that are filed. The required linkage between costs and rates is relevant only under the fourth rate filing approach. However, there are certain requirements that must be met each time a cost of service rate filing is made so that no oil pipeline is entitled to use the fourth approach by default. Thus, it is unlikely that the second criterion for applying FASB 71 is met, and since all three criteria must be met, FASB 71 generally does not apply to oil pipelines regulated by the FERC.

Q. What is the result of Staff's exclusive reliance upon GAAP instead of USOA accounting requirements?

A. The result is that the Staff witnesses have made several erroneous assertions regarding the accounting data reflected in Olympic's direct case. For example, Mr. Twitchell's testimony discussed the Staff's adjustment P-11, which was made to remove from rate base the costs associated with the Sea-Tac terminal facilities that Olympic sold recently to the Port of Seattle. Exhibit No. T ___

(MLT-1T) at 46-47. Mr. Twitchell took issue with the adjustment made by Olympic in its direct case to reflect the removal of plant costs and the treatment of proceeds from the sale of the Sea-Tac facilities. Id. at 47-48. Specifically, Mr. Twitchell asserted that Olympic's adjustment does not reflect correct accounting, and based upon his assertion, he recommended a different rate base adjustment for this transaction.

Q. Please elaborate.

A. I understand that the adjustment reflected in Olympic's direct case was based upon estimated values available to Mr. Collins in December 2001. I also understand that the sale of the Sea-Tac facilities was not completed until the first quarter of 2002. Accordingly, Mr. Collins has updated the ratemaking presentation in his rebuttal testimony to reflect the final values recorded in Olympic's financial records after the sales transaction had been completed. Exhibit No. ___ (BAC-6T). I understand that the final values Mr. Collins reflected in his rebuttal testimony vary slightly from the values used by Mr. Twitchell, but the differences do not appear to be material. Therefore, for the purpose of my present discussion I will use the values identified by Mr. Twitchell's testimony in order to align my discussion with his. Exhibit No. T ___ (MLT-1T) at 47, lines 1-3.

In his testimony, Mr. Twitchell described the adjustment that Olympic reflected in its direct case, which involved two steps as follows:

> Step One – The plant in service account and the accumulated depreciation account each were reduced by $3,645,000, an estimate that is analogous to the $6,814,365 value identified by Mr. Twitchell.

Step Two – The accumulated depreciation account was increased by $10,000,000, an estimate that is analogous to the $11,000,000 value identified by Mr. Twitchell.

Exhibit No. T ___ (MLT-1T) at 47, lines 18-23. Mr. Twitchell stated that the net effect of these two steps, as reflected in Olympic's direct case, was to reduce rate base by $10,000,000, which would be $11,000,000 using Mr. Twitchell's values. Mr. Twitchell asserted that the adjustment described in step one above does not reflect correct accounting because the resulting plant balance is overstated and the accumulated depreciation balance is understated, though he acknowledged that the net book value would be correct once the proceeds from the sale are reflected. Exhibit No. T ___ (MLT-1T) at 48, lines 1-6.

Q. What are the accounting requirements for recording the sale of the Sea-Tac facilities under the USOA?

A. When pipeline facilities are sold, the transaction is recorded using accounting entries to retire the property from service. To record the property retirement, USOA Instruction for Carrier Property Accounts 3-7 (b) (1) states in relevant part "The book cost . . . shall be written out of the property account as of date of retirement, and the service value shall be charged to account 31, Accrued Depreciation–Carrier Property." In the USOA List of Instructions and Accounts, Definition 28 states "*Service value* means the book cost less the actual or estimated net salvage value of property." Definition 20 states "*Net salvage value* means salvage value of property retired less the cost of removal." Definition 26 states "*Salvage value* means the amount received or estimated to be received for property retired less any expenses incurred in connection with the sale or preparing the property for sale; or, if retained, the value at which the recovered material is chargeable to the material and supplies account or other appropriate account."

Based upon Mr. Twitchell's values associated with this transaction, the book cost of the Sea-Tac facilities is $6,814,365. The sales price Mr. Twitchell identified is $11,000,000, so that is the salvage value, and the net salvage value. The service value is $(4,185,635), which reflects the book cost of $6,814,365 less the net salvage value of $11,000,000.

The result of writing the book cost out of the property account is that the account would be reduced by $6,814,365. The result of charging the service value to account 31, Accrued Depreciation--Carrier Property is that the account would be increased by $4,185,635. I note that these results are consistent with the results that would be produced using the approach that Olympic applied in its direct case to reflect the sale of the Sea-Tac facilities, which Mr. Twitchell asserted does not reflect correct accounting. I also note that these are the same results that are produced by Mr. Twitchell's recommended adjustment, as he discussed in his testimony. Exhibit No. T___ (MLT-1T) at 47, lines 13-14; id. at 49, lines 4-5.

Q. If the results are the same, what is wrong with Mr. Twitchell's recommendation?

A. The adjustment that Mr. Twitchell recommended does not conform to the USOA accounting requirements. His recommended adjustment involved two steps as follows:

> Step One – The plant in service account was reduced by $6,814,365, and the accumulated depreciation account was reduced by $2,617,774, to remove the net book value of $4,196,591 from rate base.

Step Two – The accumulated depreciation account was increased by $6,803,408, to pass the gain to ratepayers, reflecting the $11,000,000 sales price less the net book value of $4,196,591.

The USOA makes no reference to removing the net book value from the books to record an asset retirement. Furthermore, there is no need under the USOA to calculate the gain or loss from the sale of property to record an asset retirement.

Q. What do you conclude about the Staff's adjustment P-11?

A. I conclude that Mr. Twitchell was incorrect in his assertion that Olympic's adjustment for the sale of the Sea-Tac facilities does not reflect correct accounting and that Mr. Twitchell's adjustment does not conform to the USOA accounting requirements. Mr. Twitchell's discussion of the Staff's adjustment P-11 erroneously casts doubt upon the accounting data on the basis of an adjustment that was correctly reflected in Olympic's direct case in conformance with the USOA.

Q. Did Staff make other allegations of improper accounting by Olympic?

A. Yes. In Mr. Kermode's testimony, he discussed a line lowering project, and he asserted that Olympic did not account properly for the $455,000 cost. Exhibit T ___ (DPK-1T) at 11-12. Olympic recorded the cost as an expense, but Mr. Kermode claimed that this does not conform to GAAP, and that Olympic should have capitalized the cost because it provides a benefit beyond one year.

Q. Is Mr. Kermode correct regarding the appropriate treatment of line lower costs?

A. No. Mr. Kermode's rationale, that Olympic's line lowering cost provides a benefit beyond one year, proves too much. On that basis, the cost of routine maintenance activities, such as tank painting, also should be capitalized because the cost provides a benefit beyond one year. However, that is not the controlling factor for the proper accounting treatment for these costs.

Mr. Kermode also asserted that line lowering improves the safety over the remaining life of the asset, but that mischaracterizes the nature of the activity for which the costs were incurred. I understand that the costs Mr. Kermode identified were incurred to lower the pipeline because it had been exposed as a result of storm water runoff. In that context, the line lowering activity merely restored the pipeline to the operating condition it was in previously, which represents a repair, not an improvement of the asset.

Q. What are the relevant USOA accounting requirements for this line lowering cost?

A. The USOA Instruction for Operating Revenues and Expenses 4-4 (a) states:

> *Operations and maintenance expense.* This group of accounts includes all costs directly associated with the operation, repairs and maintenance of property devoted to pipeline operations including scheduling, dispatching, movement, and delivery of crude oil, oil products and other commodities.

Based upon this instruction, it is appropriate to record costs for repairs as expense.

Q. What do you conclude about Mr. Kermode's assertion that Olympic has not accounted properly for line lowering costs?

A. I conclude that Olympic's line lowering cost was accounted for properly as expense based upon the USOA and that Mr. Kermode's assertion to the contrary has no merit. Even a proper application of GAAP does not support capitalizing line lowering costs. An error was alleged to exist on Olympic's books based upon Mr. Kermode's mischaracterization of these costs.

Q. Has Staff mischaracterized other aspects of Olympic's books and records?

A. Yes. Staff witnesses identify several items that are reflected in Olympic's direct case that are not recorded on Olympic's books and records, which they mischaracterize as a failure to conform to GAAP. Staff asserts that it is appropriate to remove these items from consideration in determining Olympic's revenue requirement on the basis, in part, of their determination that Olympic has not conformed to GAAP with respect to these items.

Q. What are the items that Staff suggests should be recorded on Olympic's books and records to conform to GAAP?

A. Mr. Kermode and Mr. Twitchell observed that Olympic does not record an Allowance for Funds Used During Construction ("AFUDC") on its books and records. Exhibit T ___ (DPK-1T) at 13, lines 14-19; Exhibit No. T ___ (MLT-1T) at 4-5, 23.

Mr. Twitchell noted in his testimony that Olympic does not record deferred return on its books and records. Exhibit No. T ___ (MLT-1T) at 4-5, 20, 32, 33.

Mr. Twitchell also noted in his testimony that Olympic does not record the net write-up of starting rate base on its books and records. Exhibit No. T ___ (MLT-1T) at 4-5, 27.

Q. Is Staff correct in observing that Olympic does not record AFUDC, deferred return, or the net write-up of starting rate base on its books and records?

A. Yes. However, they mischaracterize the nature of these items and the purpose for which they have been reflected in Olympic's direct case by evaluating their observations in the context of GAAP accounting requirements. I will discuss these items further in the third section of my testimony. For now, I simply note that these items are not recognized under the USOA and it would be improper for Olympic to record any of them on its books and records. The Staff's observation that these items are not recorded on Olympic's books and records indicates nothing useful or relevant regarding conformance to GAAP and provides no valid basis for removing them from consideration in determining Olympic's revenue requirement.

Q. Do you have any other comments regarding Staff's reliance upon accounting standards?

A. Yes. I believe that the Staff has portrayed accounting standards inappropriately as rigid absolutes, which has led them to reach certain conclusions that do not appear to be well-founded. For example, Mr. Kermode noted in his testimony that for certain transactions there had been an apparent lag between the period when costs were recorded and the dates on underlying invoices. Exhibit T ___ (DPK-1T) at 7. He suggested that GAAP requires invoices to be processed more promptly, and he asserted that the USOA requires all transactions to be recorded within 60 days after the end of an accounting period. Then, Mr. Kermode suggested that accounting delays cause wide variations in Olympic's monthly expenses, which has diminished the accuracy and reliability of its accounting and financial data. Id. at 9. In sum, Mr. Kermode concluded that Olympic's accounting and financial data are not accurate or reliable because monthly costs reflect wide variations caused by accounting delays that violate the USOA and GAAP requirements. I do not believe his premises have been established, which undercuts his conclusion.

The USOA does not act as a rigid cut-off that prohibits any transactions from being recorded more than 60 days beyond the end of an accounting period. General Instruction 1-3 (a) states in relevant part "Each carrier shall keep its books on a monthly basis so that all transactions, as nearly as may be ascertained, shall be entered in the accounts not later than 60 days after the last day of the period for which the accounts are stated . . . ." (Emphasis added.) Furthermore, there are provisions in the USOA to deal with accounting delays within the same year and between years. Thus, the USOA places no absolute prohibition on accounting delays in the manner Mr. Kermode suggested.

As far as monthly variations in costs, I note that a company's monthly expenses may experience wide variations in the absence of accounting delays. I do not believe that the accuracy and reliability of accounting and financial data would be diminished by such variations in that situation. The presence of monthly variations in costs is not a sufficient indicator of the accuracy and reliability of accounting and financial data, which Mr. Kermode suggests.

Based upon my reading of Mr. Kermode's testimony, it is unclear what the degree and impact of accounting delays might be. In his testimony, Mr. Kermode stated that he examined Olympic's ability to promptly record expenditures, yet his review appears to have been limited to examining invoice dates for one month of historical transactions for one expense account. I do not believe that Mr. Kermode has adequately explained how his limited review of historical transactions allowed him to make any determination regarding Olympic's ability to promptly record expenditures; nor has he adequately supported his conclusion regarding the accuracy and reliability of Olympic's accounting data.

Q. Please summarize your findings with respect to the accounting standards applied to Olympic by the Staff.

A. Based upon the foregoing, I conclude that the Staff improperly placed exclusive reliance upon GAAP accounting standards in evaluating the accounting and financial data reflected in Olympic's direct case. Staff has largely ignored the USOA accounting requirements that apply to Olympic. In fact, several of Staff's recommendations violate USOA accounting requirements.

The Staff acknowledged that nonconformance with GAAP would not preclude the preparation of appropriate financial statements. Yet they have concluded, nevertheless, that the Commission can not rely upon the accounting and financial data reflected in Olympic's direct case. This conclusion has not been adequately supported--yet it provides the foundation for subsequent Staff recommendations concerning Olympic's revenue requirement, which I will address in the fourth section of my testimony.

III. FERC METHODOLOGY

Q. What is the purpose of this section of your testimony?

A. The purpose of this section of my testimony is to describe certain aspects of the FERC cost of service methodology for oil pipelines. Mr. Twitchell purported to describe the FERC methodology and the differences from the approach the has applied historically for utility ratemaking purposes. I find that Mr. Twitchell has mischaracterized the FERC's approach and the underlying rationale for their oil pipeline cost of service methodology. To the extent that the Commission desires an understanding of the FERC methodology, further explanation is in order.

Q. What was Mr. Twitchell's approach for describing the FERC methodology?

A. Mr. Twitchell's discussion begins on page 15 of his testimony, and it continues through page 36. Exhibit No. T ___ (MLT-1T) at 15-36. He started with an overview of the FERC methodology in which he set forth a list of the rulings in Opinion No. 154-B, which he attributed to Olympic. Next he introduced Exhibit No. ___ (MLT-2), which purports to compare the FERC and approaches using information contained in Olympic's direct case presentation of base year cost of service, reflecting the 12-month period ending September 30, 2001. Then, starting with the information from Olympic's direct case presented on the basis of the FERC methodology, in the remainder of his discussion, Mr. Twitchell made various adjustments and, ultimately, he recast the information and results into the methodology. Mr. Twitchell attempted to link his explanation of each adjustment to the list of Opinion No. 154-B rulings and to the accounting issues I discussed earlier in my testimony.

Mr. Twitchell's explanations amount to a collateral attack on all aspects of the FERC methodology that differ from the methodology. His discussion includes a number of mischaracterizations of the FERC methodology and contradicts several rulings in FERC Opinions issued subsequent to Opinion No. 154-B.

Mr. Twitchell's discussion indicates to me that he is not familiar with the FERC methodology. This is evident, for example, in that the list of Opinion No. 154-B rulings that Mr. Twitchell attributed to Olympic reflects the FERC's summary that appears in Opinion No. 154-C, 33 F.E.R.C. ¶ 61,327 (1985), its Order on rehearing of Opinion No. 154-B. Therefore, in conjunction with Mr. Smith's testimony, I will address the misconceptions that Mr. Twitchell has introduced regarding the FERC methodology.

Q. What aspects of the FERC methodology do you believe require clarification based upon Mr. Twitchell's discussion?

A. I believe that clarification is required in regard to the treatment of AFUDC, deferred return, the starting rate base write-up, and income taxes under the FERC methodology.

A. AFUDC

Q. Please describe the treatment of AFUDC under the FERC methodology.

A. In Opinion No. 154-B, the FERC determined that AFUDC, computed using a nominal overall cost of capital, is an appropriate component to include in rate base under Trended Original Cost ("TOC"), as Mr. Smith discusses in his testimony. Exhibit No. ___ (LPS-1T). Prior to the issuance of Opinion No. 154-B, oil pipelines were regulated using a valuation rate base that did not include a component for AFUDC. Therefore, AFUDC first became relevant for computing rate base for oil pipelines when Opinion No. 154-B was issued in June 1985. Subsequently, in Opinion No. 351, 52 F.E.R.C. ¶ 61,055 (1990) ("Opinion No. 351"), the FERC affirmed its intent to allow oil pipelines to recognize AFUDC as a component of construction costs, but clarified that oil pipelines are not entitled to include in rate base AFUDC associated with construction that occurred during periods prior to 1984.

USOA Instruction for Carrier Property Accounts 3-3 (11) (i) provides specifically for oil pipelines to capitalize interest during construction. The debt portion of AFUDC is similar conceptually to interest during construction. However, there is no similar provision in the USOA for oil pipelines to capitalize the equity portion of AFUDC. The FERC has made several modifications to the USOA but has made no provision for oil pipelines to record the equity portion of AFUDC on their books and records. Therefore, oil pipelines must prepare a side calculation of AFUDC for ratemaking purposes, as Mr. Smith affirms in his testimony. Exhibit No. ___ (LPS-1T).

Q. What did Mr. Twitchell discuss regarding AFUDC, and how do you respond?

A. Mr. Twitchell addressed several issues regarding AFUDC in his discussion of the FERC methodology that I believe are without merit. For example, Mr. Twitchell asserted that Olympic does not record AFUDC on its books but it would be appropriate to do so. Exhibit No. T ___ (MLT-1T) at 23. As I have just explained, Olympic does not record AFUDC on its books because there is no provision for it in the USOA. Therefore, it would not be appropriate to do so. Furthermore, assuming that is was appropriate for Olympic to record AFUDC on its books and records, as far as I am aware, there has been no formal determination by the FERC or the regarding an authorized rate of return for Olympic, which would be necessary for calculating AFUDC.

Mr. Twitchell asserted that the AFUDC that is reflected in Olympic's direct case is overstated because it reflects the equity rate of return and capital structure of BP rather than Olympic. Id. at 23-24. In Opinion No. 154-B, and in many other rulings, the FERC stated its preference for using the actual capital structure of the pipeline or the parent company, depending upon which entity controls the financing of the pipeline. As discussed in the testimony of Olympic witness Dr. George R. Schink, Olympic's capital structure, which was used to calculate the AFUDC, reflects an ownership weighted average parent company capital structure. Exhibit No. ___ (GRS-4T). This is consistent with the approach required by the FERC. Dr. Schink's recommendation of an equity rate of return was based, in part, upon consideration of specific risks faced by Olympic. Olympic's direct case does not reflect either the capital structure or the equity rate of return of BP, and Mr. Twitchell is simply incorrect with respect to the basis for Olympic's capital structure and rate of return.

Mr. Twitchell stated that Olympic has not provided testimony to support that AFUDC is an appropriate adjustment for ratemaking under either the FERC or methodologies. Exhibit No. T ___ (MLT-1T) at 20, 25. I have explained the basis for including AFUDC in Olympic's cost of service under the FERC methodology and I believe it is appropriate to reflect AFUDC under the methodology for the same reasons. This does not appear to be a serious point of contention, as Mr. Twitchell himself included AFUDC in rate base and explained why it is appropriate to do so in his testimony. Id.

B. Deferred Return

Q. How is deferred return treated under the FERC methodology?

A. Deferred return is a component of rate base under TOC, which the FERC established as the oil pipeline cost of service approach in Opinion No. 154-B. Mr. Smith discusses deferred return in detail in his testimony. Exhibit No. ___ (LPS-1T).

Q. What did Mr. Twitchell discuss regarding deferred return and how do you respond?

A. Mr. Twitchell made a number of assertions regarding deferred return, most of which represent complete mischaracterizations. Mr. Smith responds to most of these issues in his testimony to clarify the FERC's methodological perspective regarding deferred return. My discussion is limited to the issues Mr. Twitchell raised from an accounting perspective.

Mr. Twitchell asserted that deferred return was not justified on the basis of accounting requirements. In his testimony, he suggested that the matching principle requires that revenues should be collected in the same time frame as the expenses, taxes, and rate base that provided the service. Exhibit No. T ___ (MLT-1T) at 19. It is not clear from Mr. Twitchell's testimony how this suggestion has any bearing on deferred return. Mr. Twitchell also noted that he was not aware of any accounting order issued by the that permits Olympic to defer a portion of its return. As Mr. Smith discusses, TOC is a methodology that provides a benchmark for evaluating an oil pipeline's cost of service, or revenue requirement. Exhibit No. ___ (LPS-1T). I do not believe there is anything about the TOC methodology that implies the need for Olympic to obtain an accounting order from the Commission. I submit that if it was necessary for oil pipelines to defer a portion of return on their books and records, it is reasonable to assume that the FERC would have modified the USOA for that purpose subsequent to issuing Opinion No. 154-B in 1985.

C. Starting Rate Base ("SRB") Write-Up

Q. How is the SRB write-up treated under the FERC methodology?

A. The SRB write-up is a component of rate base under Opinion No. 154-B. Mr. Smith also discusses the SRB write-up in his testimony.

Q. What did Mr. Twitchell discuss regarding the SRB write-up and how do you respond?

A. Mr. Twitchell raised two primary objections regarding the SRB write-up. First, he stated that Olympic does not record the SRB on its books. Exhibit No. T ___ (MLT-1T) at 27. This is a matter I have already explained in my discussion of the USOA. Second, Mr. Twitchell stated that Olympic has not provided testimony to support that the SRB write-up is an appropriate adjustment for ratemaking under either the FERC or methodologies. Id. at 28. Mr. Smith addresses this point in his rebuttal testimony.

D. Income Taxes

Q. Please describe the treatment of income taxes under the FERC methodology.

A. In Opinion No. 154-B, the FERC addressed two income tax issues. First, they addressed determination of the interest expense deduction to be used in calculating an oil pipeline's income tax allowance. The FERC determined that oil pipelines should use their actual interest expense for this purpose, rather than using a traditional approach that would synchronize interest expense with rate base. Second the FERC reaffirmed its prior decision that oil pipelines should reflect tax normalization instead of flow-through for ratemaking purposes.

The FERC subsequently reconsidered its ruling regarding determination of the interest expense deduction to be used in calculating an oil pipeline's income tax allowance. In Opinion No. 154-C, the FERC reversed its decision and ruled that oil pipelines should synchronize interest expense with rate base, which required multiplying a weighted cost of debt times a Depreciated Original Cost ("DOC") rate base. This approach was reaffirmed in Opinion No. 351. In Opinion No. 435-A, 91 F.E.R.C. ¶ 61,135 (2000), the FERC implemented a modification to synchronize interest expense with the TOC rate base, instead of the DOC rate base.

Q. What did Mr. Twitchell discuss regarding income taxes, and how do you respond?

A. Mr. Twitchell asserted that the FERC methodology uses actual interest expense to calculate income taxes. Exhibit No. T ___ (MLT-1T) at 21. As I just discussed, the FERC reversed its decision in Opinion No. 154-B and, since the issuance of Opinion No. 154-C in December 1985, it has required oil pipelines to synchronize interest expense with rate base.

Mr. Twitchell took issue with Olympic's calculation of synchronized interest expense as reflected in its direct case. Id. at 22. Setting aside his erroneous assertion regarding the use of actual interest expense for the income tax calculation, I note that Mr. Twitchell calculated synchronized interest expense for the Staff's revenue requirement adjustment P-12. Id. at 51. Therefore, it appears that Mr. Twitchell's disagreement with Olympic's calculation of synchronized interest expense is based upon the capital structure reflected in that calculation. I have explained previously the basis underlying the capital structure that Olympic has reflected in its direct case.

What remains to be addressed is Mr. Twitchell's claim that Olympic's calculation is inconsistent with accounting theory because income taxes are determined using interest expense that is based upon a different amount of debt than was used to purchase and construct Olympic's facilities. I believe that this claim condemns most ratemaking presentations that attempt to synchronize interest expense with rate base, as this would not likely achieve the matching Mr. Twitchell suggests is required by accounting theory. In addition, I note that Mr. Twitchell has calculated synchronized interest expense using a capital structure of 100 percent debt in Exhibit No. ____ (MLT-2), but he used a capital structure of 80 percent debt for the synchronized interest expense calculation in adjustment P-12, which suggests that at least one of these calculations, if not both of them, suffer from the same inconsistency with accounting theory. Finally, to the extent that Mr. Twitchell's accounting theory is valid, it does not appear to address a difference between the FERC methodology and the methodology, which, after all, was his stated purpose for Exhibit No. ____ (MLT-2).

Q. Please summarize your findings with regard to Mr. Twitchell's discussion of the differences between the FERC methodology and the methodology.

A. Based upon the items I discussed in this section of my testimony, I find that Mr. Twitchell has mischaracterized a number of aspects of the FERC methodology, which makes his discussion of the differences with the methodology misleading.

IV. COMMENTS ON STAFF PRESENTATIONS

Q. What issues will you address in this section of your testimony?

A. In this section of my testimony, I discuss several methodological and conceptual issues reflected in the Staff revenue requirement presentations. First I discuss the Staff proposal for the test period. Next, I discuss several inconsistencies in the Staff's use of data. Finally, I discuss the Staff's improper treatment of certain costs.

A. Staff Proposal for Test Period

Q. What is the WUTC's approach for determination of an appropriate test period?

A. It is my understanding that the Commission defines an appropriate test period as the most recent 12-month period for which income statements and balance sheets are available. WUTC v. Avista Corp., 2000 Wash. UTC LEXIS 558, at 8-9 (2000). In addition, the test period should be established as of a date that is relatively contemporaneous with the filing of rates. WUTC v. American Water Resources, Inc., 1999 Wash. UTC LEXIS 63, at 22-23 (1999). Accounting and financial data associated with the test period must be adjusted for unusual events that have occurred during the test period, and for known and measurable events that are not offset by other factors so that the data will better reflect a company's results of operations during the rate year. Avista, 2000 Wash. UTC LEXIS 558, at 11-12. Pro forma adjustments should reflect known and measurable events at the time rates are filed. Finally, once established, a test period should not be changed absent compelling reasons. AWRI, 1999 Wash. UTC LEXIS 63, at 23.

I note that the FERC uses different terminology in discussing test periods, but the concepts are consistent. The ratemaking presentation contained in Olympic's direct case more closely reflects the FERC terminology, which describes a base year consistent with this Commission's definition of a test period. In addition, the FERC describes a test period consistent with this Commission's definition of a rate year.

Q. Based upon this Commission's terminology, how did Olympic prepare its direct case?

A. Olympic filed WUTC Tariff No. 23 in October 2001. Consistent with this Commission's approach, Olympic's direct case was prepared using a test period defined as the 12-month period ending September 30, 2001, with adjustments to the accounting and financial data for known and measurable changes that Olympic believes will better reflect the results of operations anticipated for the rate year.

Q. How did the Staff prepare its ratemaking presentation?

A. As discussed in Mr. Colbo's testimony, the Staff's presentation of Olympic's revenue requirement reflects a test period defined as the 12-month calendar year 2001, with adjustments to the accounting and financial data for known and measurable changes that the Staff believes will better reflect the results of operations Olympic anticipated for the rate year. Exhibit No. ___ (RGC-4T) at 10.

Q. On what basis did Staff propose changing the test period?

A. As mentioned in Mr. Colbo's testimony, the Staff proposed to use calendar year 2001 as the test period on the basis of their conclusion that the Commission could not rely upon the accounting data reflected in Olympic's direct case. Id. at 9-10.

Q. Is the Staff's proposal to move to a different test period than Olympic reflected in its direct case warranted?

A. No. As I discussed previously in my testimony, the Staff placed exclusive reliance upon GAAP accounting standards in reviewing and evaluating Olympic's accounting data instead of applying the accounting standards that Olympic is subject to, which are contained in the FERC USOA. I also explained that certain of the Staff's recommendations do not conform to the USOA and that conclusions reached with regard to the reliability of Olympic's accounting data have not been adequately supported in the testimony of Staff witnesses. Moreover, Mr. Colbo acknowledges that using calendar year 2001 as the test period does not correct the alleged problems the Staff encountered. Id. at 10.

Therefore, I do not believe that the Staff has presented a compelling reason to reject the test period that Olympic reflected in their direct case. I note that as a consequence of the Staff's proposal to move to a different test period, it is difficult, if not impossible, to make meaningful comparisons of Olympic's and the Staff's ratemaking presentations and results.

B. Staff's Inconsistent Use of Data

Q. Please identify the inconsistencies you will address concerning the Staff's use of data.

A. My discussion of the Staff's inconsistent use of data will address the adjustments made for costs associated with the Bayview facilities, the convention used for the balances reflected in rate base, and capital structure.

1. Bayview Facilities

Q. What does the Staff propose to do with costs associated with Olympic's Bayview terminal facilities?

A. In his testimony, Mr. Colbo discussed adjustment PF-2, which was made to exclude the costs associated with Olympic's Bayview terminal facilities from the Staff's ratemaking presentation. Id. at 32-33. Mr. Talley's testimony discusses the fact that Bayview is used and useful. Thus, it would not be excluded. The purpose of my discussion here is to address the adjustments made by the Staff in removing the Bayview terminal costs from Olympic's revenue requirement.

Q. What types of costs did the Staff remove from Olympic's revenue requirement?

A. The Staff removed net plant and expenses associated with the Bayview terminal facilities from Olympic's rate base and revenue requirement. However, the Staff did not include the balance of Accumulated Deferred Income Taxes ("ADIT") associated with the Bayview facilities in adjustment PF-2. This represents an inconsistent use of data and an error.

Q. What is the impact of this inconsistency?

A. Rate base generally reflects the balance of net carrier property in service, reduced by the balance of ADIT. The impact of this inconsistency is that the rate base Staff has used to determine Olympic's revenue requirement reflects net carrier property in service excluding Bayview, reduced by the balance of ADIT including Bayview. As a result, Staff's rate base and revenue requirement for Olympic are understated.

Q. Are there any other instances of inconsistent use of data associated with Bayview in the Staff's presentation?

A. Yes. In his testimony, Mr. Twitchell discussed Staff adjustment P-12, which reflects pro forma synchronized interest expense and the associated income tax effect. Exhibit No. T___ (MLT-1T) at 50-52. As I discussed earlier in my testimony, synchronized interest expense is calculated by multiplying a weighted cost of debt times a rate base. For the purpose of this calculation, Mr. Twitchell took the balance of net carrier property associated with the Bayview facilities and added the costs back into rate base before he applied the weighted cost of debt. This represents another inconsistent use of data and also is an error.

Q. What is the impact of this inconsistency?

A. The impact of this inconsistency ripples through the Staff's revenue requirement calculations in several ways. First, as a result of adding the net carrier property associated with the Bayview facilities to rate base, the synchronized interest expense is overstated. Then, because interest expense is deducted to derive taxable income, both taxable income and income tax expense are understated. By understating income tax expense, the Staff has overstated net operating income, which, in turn overstates the achieved rate of return. Finally, the bottom line result is that by overstating the achieved rate of return, the Staff has understated Olympic's pro forma year revenue deficiency, which understates the rate increase they have recommended for Olympic.

Each of these two instances of the Staff's inconsistent use of data associated with the Bayview terminal facilities cause Olympic's revenue requirement to be understated.

2. Rate Base Convention

Q. What does the term "rate base convention" mean?

A. I use the term "rate base convention" to describe the accounting balances that are reflected in rate base. For example, if rate base has been developed using average accounting balances for a test period, that would be an average rate base convention. Similarly, if the accounting balances are measured as of the end of the test period, that would be an end of year rate base convention.

Q. What rate base convention did Olympic use in its direct case?

A. Olympic used an average rate base convention in its direct case, which reflected an average of the beginning and end of year balances.

Q. How did Staff develop rate base?

A. In his testimony, Mr. Twitchell described the Staff approach for developing rate base. Exhibit No. T ___ (MLT-1T) at 13-14. The Staff used average balances in developing rate base for all components except for ADIT, which they reflected based upon an end of test period amount.

Q. How would you describe the rate base convention that the Staff reflected?

A. This appears to be a hybrid approach that reflects inconsistent use of data. If it is important to use average monthly averages for each account in rate base to match it with the revenues expense and taxes, as Mr. Twitchell stated, that objective should be applied consistently when it comes to the ADIT balance as well or a mismatch will be introduced into the rate base.

Q. What is the impact of this inconsistency?

A. The impact of deducting an end of test period ADIT balance from a rate base that otherwise reflects average balances is that rate base has been reduced, as compared to the rate base that would result from using an average ADIT balance. The result of understating rate base is that Olympic's revenue requirement also is reduced. Mr. Twitchell has offered no valid basis to place greater emphasis on representing ratepayer-provided funds, as he describes ADIT, to the detriment of investors in the rate base calculation. His hybrid rate base convention does not achieve a consistent and proper matching of the accounting data.

3. Capital Structure

Q. What capital structure has the Staff applied in its revenue requirement calculations?

A. Staff witness John W. Wilson has recommended a capital structure of 80 percent debt and 20 percent equity for Olympic. Exhibit No. ___ (JWW-1T) at 49, lines 3-13. Accordingly, in his testimony, Mr. Colbo stated that the Staff's case is based upon Mr. Wilson's recommendation. Exhibit No. ___ (RGC-1T) at 2, lines 12-13. In contrast, Mr. Twitchell stated that, in preparing his Exhibit

No. ____ (MLT-2), he used a capital structure of 100 percent debt to calculate interest expense and AFUDC, respectively. Exhibit No. T ___ (MLT-1T) at 22, 25. Mr. Twitchell has not supported his departure from Mr. Wilson's recommended capital structure, which represents an inconsistency in the Staff's ratemaking presentation.

C. Staff's Improper Treatment of Costs

Q. Please identify the improper treatment of costs you will address concerning the Staff's revenue requirement calculations.

A. My discussion of the Staff's improper treatment of costs will address the environmental remediation costs associated with the Sea-Tac facilities.

Q. How does the Staff propose to treat the environmental remediation costs associated with Sea-Tac facilities?

A. In his testimony, Mr. Colbo described his adjustment RA-7, in which he normalized certain of Olympic's costs. Exhibit No. ___ (RGC-4T) at 23. With respect to the environmental remediation costs associated with the Sea-Tac facilities that Olympic sold to the Port of Seattle, Mr. Colbo proposed to eliminate the costs from Olympic's revenue requirement. The basis for Mr. Colbo's treatment of these costs appears to be that Olympic no longer owns the Sea-Tac facilities.

Q. Do you agree with Mr. Colbo's treatment of these costs?

A. No. To the extent that Olympic is incurring environmental remediation costs associated with the Sea-Tac facilities that were sold, these costs relate to prior operations while Olympic owned the facilities. Ratepayers benefited from the service provided in the past; therefore, it is appropriate for them to bear these costs because they relate to the service provided in the past. It is appropriate to include such costs in Olympic's revenue requirement regardless of the current ownership of the Sea-Tac facilities. To the extent that these costs have been excluded, Olympic's revenue requirement has been understated.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

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