BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. OLYMPIC PIPE LINE COMPANY, INC., Respondent.	DOCKET NO. TO-011472 STAFF CASE SUMMARY AND PROPOSED OUTLINE

As requested in its Eleventh Supplemental Order in this docket, Commission Staff submits the following Summary of the case Staff will present at hearing. This Summary outlines the major issues facing the Commission in this case. Not all issues are covered.

An outline of topics for the post-hearing briefs is included at the end of this Summary.

I. Staff's Case in a Nutshell

Staff recommends a slight increase in rates for Olympic (0.54%). Staff used a traditional rate base, rate of return methodology. Staff's recommendation is based on a test year ending December 31, 2001, fully restated and preform, and a capital structure of 80% debt, 20% equity (until Olympic's owners provide a meaningful equity infusion). Olympic's overall return is 7.4%.

Staff's results of operations analysis includes every safety-related project Olympic is seeking to recover in rates in this case. To further accommodate Olympic's claims regarding its financial situation, Staff proposes exceptional measures: 1) Including significantly more equity in the capital structure than Olympic actually has on its balance sheet (Olympic's equity ratio is negative and Staff proposes a hypothetical equity ratio of 20% for rate making purposes) ; 2) A rate base determination that uses year-end amounts, instead of the traditional average of monthly average amounts; 3) Including in its calculation of rate base year Construction Work in Progress (CWIP) at year end amounts; 4) Permitting Bayview Terminal to accrue AFUDC while it is bypassed by the pipeline.

The status of Olympic's Bayview Terminal remains highly uncertain. It is currently bypassed by the pipeline, and Olympic does not plan to study how it might integrate Bayview into the system until after the pipeline is back to 100% pressure. Staff therefore recommends Bayview be removed from results of operations, but that AFUDC be accrued, pending a final decision by Olympic management. Once in service, it can be included in results of operations, and the accrued AFUDC can be included in rate base and amortized over the useful life of the project.

II. Witnesses Testifying for Commission Staff

Staff will present five witnesses in this case, in the following general areas:

- Mr. Maurice L. Twitchell (ratemaking methodology, AFUDC, rate base and taxes)
- Mr. Robert E. Colbo (other accounting issues, including regulatory treatment of Bayview Terminal, and throughput)
- Mr. Kenneth L. Elgin (issues raised in the Commission's Third Supplemental Order and response to claims made by Olympic witness Omohundro)
- Dr. John J. Wilson (cost of capital, capital structure, Company's case on alleged competition)
- Mr. Danny P. Kermode (consistency of Olympic's accounting practices with General Accepted Accounting Principles (GAAP))

III. Overview

Staff's analysis of Olympic's filing is now complete. Based on a thorough review of the documents available, Staff has determined that Olympic justified only a slight increase in rates. This result obtains even after Staff included extraordinary measures, such as end of period levels of rate base and CWIP, Bayview AFUDC, and a capital structure with significantly more equity than Olympic's actual capital structure contains. (Exhibit No. ___ (MLT-1T), pages 43-46 and 52-54)(Exhibit No. ___ (JWW-1T), pages 45-50).

Olympic and its owners have taken no discernable action to improve its financial situation since the Commission granted the 24.3% interim rate increase. Olympic remains financed exclusively with debt, and the amounts of debt on its books exceeds the expenditures Olympic has made to date for long-lived assets. Olympic remains without a long term financing plan. Olympic still has no target equity ratio. Olympic used a portion of the proceeds from its debt issuances to pay past operating expenses. The disconnection between Olympic's total debt and the net book value of Olympic's facilities that are serving the public remains large. And Olympic's parents have yet to infuse any equity capital into Olympic. (See Exhibit No. ___ (KLE-5T), pages 4-10, 14-15, and 16-19). In summary, Olympic's case rests on the theory that the Commission abandon its long-standing principle that rates and fair returns are on the basis of facilities (rate base) Olympic has dedicated to public service. Instead, Olympic's case rests upn the theory that rates should be based upon total Company expenditures irrespective of whether the expenditures were for necessary for Olympic to carry out its obligations as a public service company.

One of Staff's recommendations is for Olympic to have the ability to increase its preforma equity ratio, when and if Olympic's parent corporations decide to actually invest equity capital in the Company. (Exhibit No. ___ (JWW-1T), pages 45-50).

The Whatcom Creek explosion was instantaneous. But as Staff's case shows, the seeds of Olympic's current financial problems were sown by Olympic's conduct over the several years prior to that event. The solutions to Olympic's situation will not be instantaneous, either. Staff's case permits Olympic to build its equity (assuming the parent corporations will not infuse equity into the Company). Over time, Olympic will be able to return to financial viability.

IV. Issues Raised by the Commission in Paragraph 10 of its Third Supplemental Order

In Paragraph 10 of its Third Supplemental Order granting interim rate relief in this docket, the Commission set forth several issues it expected the parties to address in this docket. Staff witness Mr. Elgin addresses each issue. (See Exhibit No. ___ (KLE-5T), pages 3-20).

In his testimony, Mr. Elgin explains how the Company's past financial policies have affected its present ability to recover from the 1999 Whatcom Creek explosion. From 1990 to 1998, Olympic paid virtually all of its net income to its parents instead of retaining those earnings. Olympic invested large amounts of money into new facilities that failed to deliver new revenues (e.g. Bayview Terminal and the Cross Cascades Project). To fund the new facilities and to finance operations, Olympic issued new debt rather than equity. After the Whatcom Creek explosion, Olympic issued more debt in part to pay operating expenses. This further compounded the adverse effects of Olympic's prior financial policies, and led to a situation where the Company cannot produce a rational balance sheet. (*Id.*, pages 4-8, 10-12, and 16-19).

In sum, Olympic's past financial policies provided the Company no current financial flexibility to respond to a curtailed ability to move product, as happened when the Whatcom Creek explosion occurred.

Olympic, not its shippers, should bear responsibility for the Company's past aggressive financial policies. Shippers should not pay for lost financial flexibility or prior operating losses. Staff's recommendations will provide Olympic an incentive to move, over time, to a more sound financial footing. Rates should be set to allow the Company to earn a fair return on the facilities actually serving the public, at a cost that reflects Olympic's need to build equity.

Olympic's owners have yet to infuse equity capital into Olympic. Staff's recommended 20% equity, 80% debt capital structure, compared to Olympic's actual debt ratio, which contains debt exceeding the amount of long-lived assets, will permit Olympic to build an equity cushion to provide financial flexibility and growth in equity through retained earnings.

V. Staff's Proposed Resolution of Major Issues

A. Revenue Deficiency/Revenue Requirement

Olympic has a revenue deficiency of $78,614, based on an intrastate revenue requirement of $14,641,838. Olympic Pipe Line Company (Olympic) has justified a 0.54% general increase in Olympic's intrastate Washington rates. (Exhibit No. T-___ (RGC-4T), page 1).

B. Ratemaking Methodology

Staff recommends the Commission use its traditional rate base, rate of return methodology, valuing investment at its historical cost, less depreciation. Staff opposes Olympic's presentation of the FERC formula, because it is not an objective or rational ratemaking methodology.

Staff witness Mr. Elgin examined the four reasons Olympic advanced to support use of the FERC methodology. Mr. Elgin explains why the Company's reasons for abandoning the Commission's traditional ratemaking methodology are incorrect. Mr. Elgin explains that the Commission's methodology meets the capital attraction standard. He shows that Olympic is not fundamentally different from other regulated utilities, contrary to Olympic's belief. For example, Olympic argues that it has to compete for capital sources with alternative investments. But most public utilities must compete worldwide for capital. All investments must meet the capital attraction test (*i.e.* the expectation of a return on and a return of investment). Thus, Olympic has failed to explain how it is unique, and how any perceived uniqueness should affect the Commission's regulation of the Company. Finally, Olympic has failed to provide evidence that the Company actually relied upon a specific methodology when it invested in plant in Washington. (Exhibit No. ___ (KLE-5T), pages 20-29).

Mr. Twitchell testifies on the specifics of Olympic's use of the FERC methodology. He testifies that Olympic provided no direct testimony supporting any elements of the version of the FERC methodology Olympic advances in this case. (Exhibit No. ___ (MLT-1T),page 19, lines 17-19 ; page 20, lines 18-19 ; page 22, lines 13-14 ; page 25, lines 16-18 ; page 28, lines 12-13).

In particular, the deferred return the Company included in rate base ($25,287,000 per Exhibit No. ___ (CAH-4), Schedule 5) is not an operating expense, a tax, or a return of or on investment used to provide service. Olympic's inclusion of these deferred return amounts is also inconsistent with the matching principle. Not only has Olympic failed to obtain a Commission accounting order authorizing Olympic to defer anything, the Company did not actually defer any return on its books. In any event, in every year 1984-1998, Olympic earned in excess of what it claims was its required return. (Exhibit No. ___ (MLT-1T), pages 18-20 and 28-34). So Olympic has already recovered any such "deferred" return.

The Company also computed AFUDC incorrectly. (*Id.* at page 20, 23-25). And Olympic's calculation of federal income taxes creates a large mismatch between revenues, expenses, taxes and rate base. (*Id.* at page 22).

The Company's case also includes "Starting Rate Base" in the amount of $8,347,000. (Exhibit No. ___ (CAH-4), Schedule 5). This Starting Rate Base should not be included, since it is not contained on Olympic's books, nor does it represent capital invested by investors, or anyone else. Including Starting Rate Base also violates the matching principle, and it is an irrational ratemaking method since it only allows recover on, but not of, the Starting Rate Base then is amortized. (*Id.* at 27-28).

The methodology Staff proposes grants Olympic an opportunity to earn a fair return on the property it has prudently incurred and employed to serve the public. Staff went further, by including year end values of rate base and CWIP, AFUDC on Bayview and 20% more equity that Olympic actually has.

C. Selection of Test Period / Restating and Preforma Adjustments Versus Budgeted Amounts

Staff's analysis is based on the test year ending December 31, 2001, fully restated and preform. There are numerous accounting adjustments addressed by Staff witnesses Mr. Colbo and Mr. Twitchell. The more significant adjustments are described below.

In contrast to Staff's preforma and restated actual results of operations, much of Olympic's case is based on budgeted results. (Exhibit No. ___ (MLT-1T), page 6). Olympic agrees that budgeted amounts are not known and measurable. *Id*. Staff cannot reasonably test budgeted figures. Olympic has not demonstrated why budgeted figures are better than actual results, restated and preform. These are just some reasons why Olympic's results of operations should not be accepted.

D. Major Revenue Issues – Throughput

Throughput recommendations in this case vary widely. Staff recommends a throughput level of 108,323,721 annual barrels be used to set rates. Tosco recommends the highest level of throughput: 130 million barrels. Staff's proposed throughput is based on an estimate of throughput under "normal" operations under the current 80% pressure restriction. (Exhibit No. ___ (RGC-1T), pages 26-31).

This estimate is difficult to make, since Olympic maintains no reliable annual downtime information. (*Id.* at page 32). The Company's failure to maintain adequate information should not permit the Company to complain about Staff's estimate.

To address the wide variety of proposals, and the likelihood Olympic could over earn if it moves to 100% pressure without a simultaneous change in rates, Staff recommends the Commission either have the rates resulting from this proceeding terminate at a date certain, or adopt a throughput tracking mechanism. (*Id.* at 28 and 30).

E. Major Operating Expenses Issues

The major operating expense issues include the proper treatment of $5.6 million in Outside Services for One-Time Maintenance (OTM), which the Company includes as the budgeted 2002 amount for such expenses. To begin with, 80 percent of this $5.6 million figure is from 2001, bringing into question whether that much will actually be spent in 2002. In any event, Staff analysis indicates that 40 percent of the $5.6 million should more properly be capitalized and depreciated using the company's overall depreciation expense rate of 2.45%, and 58 percent should be amortized over 5 years. Staff adjusted actual incurred 2001 OTM expenses using the above percentage amounts. (See Exhibit No. ___ (RGC-4T), pages 20 – 22).

The Company has also included $455,000 in ownership transition costs Olympic incurred when BP Pipelines began operating Olympic in July 2000. This figure represents a 20% amortization amount. Transition costs are non-recurring costs, and are not related to improved service. They are the responsibility of stockholders, not ratepayers. (See Exhibit No. ___ (RGC-4T), page 20). Such amounts represent additional costs of acquisition, not ongoing operating expenses.

The Company also included a $1.194 million amount for 2001 of the $6.452 million budgeted December 2000, environmental accrual in One-Time Maintenance. The Company was unable to confirm how much for any of the projects has actually been spent. Moreover, this $1.194 million amount included $644,000 of amounts relating to the Whatcom Creek explosion and the Sea-Tac terminal that the Company recently sold. This $644,000 is therefore unjustified. (See Exhibit No. ___ (RGC-6C), page 14).

Finally, in its direct case the Company updated its power expense based on the per barrel cost incurred in August 2001, plus the estimated impact of a Puget Sound Energy 18 percent rate increase request currently pending before this Commission. To date, there has been no final determination by the Commission of what future permanent rate levels will be. So, this increase is not known and measurable. In addition, as Mr. Colbo explains, it would be improper to update power expense on a per barrel basis without giving recognition to the fact that 24 percent of power expenses are fixed, and are therefore not incurred on a per barrel basis. (Exhibit No. ___ (RGC-4T), page 37).

F. Major Rate Base Issues

Apart from the selection of a ratemaking methodology, the primary rate base issues turn on the problem of whether to include CWIP and whether to value plant account balances at the average, or year end levels.

1. Average Rate Base vs. Year End Rate Base; CWIP Issues

Staff witness Mr. Twitchell acknowledges the Commission's preferred method for valuing rate base is using an average of monthly averages approach. However, given Olympic's alleged adverse circumstances, Staff recommends the use of end of period rate base, and end of period CWIP. (Exhibit No. ___ (MLT-1), pages 43-46 and 52-54).

2. Bayview Terminal and the Cross Cascades Project

Olympic's Bayview Terminal remains bypassed by the pipeline. Olympic will determine when and how it will be returned to service in a study Olympic will do after the pipeline is restored to 100% pressure. Its current use is for office space, storage of diesel fuel for PIG runs, and water storage for one or two hydro tests. Staff proposes to remove Bayview Terminal from results of operations, but permit Olympic to accrue AFUDC until such time as it returns to a used and useful status consistent with prudently incurred investment levels. (See Exhibit ___ (RGC-1T), pages 32-33).

It would not be appropriate to include Bayview in results of operations based on the fact it is used for something. Olympic has not proven it was prudent to spend over $23 million on the Bayview Terminal for these limited purposes. In the words of Olympic: "I'm sure you'd have a hard time justifying that if that was your only intent." Deposition of Mr. Talley at Tr. 26, lines 12-13, contained in Exhibit No. ___, (to be offered by Staff at hearing). It would not be prudent for Olympic to pay $23 million for a facility to use it to store water, diesel and provide some limited office space.

Staff's recommendation to remove Bayview from results of operations and permit it to accrue AFUDC until it is used for its intended purposes, is well supported by case law. A public service company is entitled to earn a return on the property it has dedicated to the public, and which is used and useful for service. *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 629, 692, 43 S. Ct. 675, 67 L. Ed. 1176 (1923). *See also Washington Util. & Transp. Comm'n v. American Water Resources, Inc.*, Docket No. UW-980265 (Fifth Supp. Order)(1998)(*affirmed* by Sixth Supp. Order)(1999).

It is equally well settled that imprudently incurred costs or costs that provide no ratepayer benefit are not recoverable. *US WEST Communications, Inc. v. Utilities & Transp. Comm'n*, 134 Wn.2d 74, 126-27, 949 P.2d 1337 (1997).

In *San Diego Land & Town Co. v. Jasper*, 189 U.S. 439, 446, 23 S. Ct. 571, 47 L. Ed. 892 (1903), the Court stated: "If a plant is built, as probably this was, for a larger area than it finds itself able to supply, or apart from that, if it does not, as yet, have the customers contemplated, neither justice nor the Constitution requires that, say, two thirds of the contemplated number should pay a full return." To avoid the smaller number of customers from paying a full return, the court stated that it should "assume that only a proportionate part of the system was actually used and useful." *Id.* at 447.

In *Midwestern Gas Transmission Co. v. Federal Power Commission*, 292 F.2d 119, 121 (1961), the Fifth Circuit stated that the company was "not entitled to the return for the lesser volume of business during the development years that it will become entitled to receive during the post-development period from the larger volume." The court stated that this rule is applicable when the plant facilities are operating at less than capacity. *Id.* at 122.

Staff's recommendation for Bayview is consistent with these principles. Bayview is not fully serving shippers, by a wide margin. Staff's proposal is more generous than if the $23 million Olympic invested in Bayview was reduced to reflect the investment cost associated with Bayview's current uses.

In *State ex rel. Utilities Commission v. Public Staff – North Carolina Utilities Commission*, 424 S.E.2d 133, 139 (1993), the court stated that although substantial latitude is given to utilities to determine what property is needed to meet service demands in the immediate future, "present ratepayers may not be required to pay excessive rates for service to provide a return on property which will not be needed in providing utility service within the reasonable future." Staff's recommendation is consistent with this principle.

In 1992, the Florida Public Service Commission dealt with a situation similar to Olympic's Bayview situation. *Re Florida Power Corporation*, 138 PUR4th 472 (1992). In a previous rate case, 17 units were placed in extended shutdown. *Id.* at 486. In an earlier 1992 rate case, only one of the 17 units remained in extended shutdown. *Id.* The Florida Commission excluded the unit from rate base, but allowed it to accrue a charge equivalent to the AFUDC rate until such time as the unit is returned to commercial use or the lease became operational. *Id.* at

487. Once the unit was returned to commercial use or the lease became operational, the unit was allowed to be recorded in plant-in-service and revenues would be recorded above the line. *Id.* Staff's recommended treatment for Bayview is consistent with this approach.

As to the Cross-Cascades Project, Staff does not include this project in results of operations, consistent with the Company's case. (Exhibit No. ___ (KLE-5T), page 15).

G. Rate of Return and Capital Structure

Dr. Wilson presents the case for Staff on rate of return and capital structure. Olympic's fair rate of return is 7.4%. Olympic's cost of equity is 9.0%; its cost of debt is 7.0%. The appropriate capital structure for purposes of setting rates in this case is 80% debt and 20% equity. (Exhibit No. ___ (JWW-1T), page 5 and Exhibit No. ___ (JWW-9)).

A 50% debt/50% equity capital structure might otherwise be appropriate. However, since Olympic's facilities serving the public are in fact financed exclusively with debt, Staff recommends rates be set using a capital structure of 80% debt and 20% equity, unless Olympic's owners infuse equity into the Company. Staff's recommendation here is flexible: Olympic can achieve a higher preforma equity ratio if its owners infuse additional equity capital into the business. They have not done so. Staff's recommendation is consistent with the Commission's policy applied in Docket No. UW-980076, *WUTC v. American Water Resources, Inc.*, Sixth Supplemental Order (January 21, 1999)(See Exhibit No. ___ (JWW-T), pages 45-50).

Dr. Wilson's return on equity analysis is based on a thorough and well defended application of the discounted cash flow method (DCF), Capital Asset Pricing Model (CAPM) and comparable earnings method. (Exhibit No. ___ (JWW-1T), pages 7-44).

In his analysis, Dr. Wilson critiques Olympic's witness Dr. Schink's cost of capital analysis. He demonstrates why Olympic's use of stock analysts' forecasts of earnings are inherently unreliable. Dr. Wilson also explains why Olympic fails to present a correct calculation of these analysts' estimates in any event. (Exhibit No. ___ (JWW-1T), pages 17-24). He also shows why Dr. Schink's use of gross domestic product projections is flawed. (*Id.* pages 24-27).

Dr. Wilson also analyzed Olympic's recommended capital structure of 82.92% equity and 17.08% debt. He explains that Olympic's proposal is arbitrary since it reflects Olympic's owner's capital structures. For example, when Olympic changed owners, its equity ratio (measured as Mr. Schink proposes) jumped 25%. Yet there was no change in risk. Dr. Wilson also shows that Olympic's proposed capital structure is uneconomical. (Exhibit No. ___ (JWW-T), pages 46-49).

Dr. Wilson explains why Dr. Schink's proposed "risk premium adder" inappropriately increases Olympic's cost of capital to compensate for alleged competition that does not exist in fact. As Dr. Wilson points out, even with barge and tanker capacity available, Olympic remains capacity constrained, *i.e.* it serves all traffic tendered to it. This shows Olympic's competitive risk theory is not sound. (*Id.* at pages 51-53). Dr. Wilson's analysis of beta coefficients of oil pipelines shows that this industry is subject to significantly less financial volatility than the market as a whole. (*Id.* at pages 54-55). Accordingly, Olympic has provided no defensible basis for its contention that Olympic is subject to effective competition.

Olympic's argument that it needs a higher rate of return (and hence higher rates) because of competition should be denied.

H. Audit and Accounting Problems

Staff's testimony itemizes the many problems Staff faced when attempting to perform its accounting analysis in this case. (Exhibit No. ___ (MLT-1T), pages 4-8; Exhibit No. ___ (RGC-1T), pages 6-11; Exhibit No. ___ (DPK-1T), pages 6-14). In addition to the lack of adequate company records, and the lack of confidence Staff has in the Company's booked results (occasioned in part by the Company's lack of audited financial statements), Staff also had concerns that Olympic's books did not conform to Generally Accepted Accounting Practices (GAAP).

Staff witness Mr. Kermode focuses his review on Olympic's ability to promptly record expenditures and Olympic's treatment of Allowance for Funds Used During Construction (AFUDC). Mr. Kermode found that Olympic did not record expenditures in a timely manner, resulting in an extraordinarily large expense being recorded in one month, and an extraordinarily low expense being recorded in another month. Additionally, Olympic uses a "modified cash basis" method of accounting, which is a hybrid accounting model using accounting principles from both cash basis and accrual accounting methods. A modified cash basis method does not conform with GAAP. Exhibit No. ___ (DPK-1T), pages 9-10).

Mr. Kermode explains the consequences of Olympic's failure to conform with GAAP. Because Olympic's books do not conform with GAAP, neither Staff, nor the Commission is able to discern whether Olympic's transactions are properly recorded. Therefore, the Company's accounting records are suspect, and unreliable. (*Id*. page 12).

VI. Refunds

In its Third Supplemental Order in this docket, at page 19, ¶ 86, the Commission conditioned interim rate relief on refunds "based on the level of permanent rates found to be appropriate..." Staff's analysis shows virtually no change in permanent rates has been justified. Accordingly, revenues produced by the interim rates should be refunded to shippers, over the same number of months they were collected. (Exhibit No. ___ (RGC-1T), pages 45-46).

VII. Proposed Outline of Issues for Post-Hearing Brief

Staff proposes the following outline of issues for the parties to use in preparation of post-hearing briefs:

I. Introduction/Overview

II. Legal Issues

A. Burden of Proof

B. Nature of Oil Pipelines and History of Regulation

C. Federal/State Jurisdictional Issues

III. Ratemaking Methodology Issues

A. FERC Methodology vs. Traditional Methodology

1. Starting Rate Base

2. Deferred Return

3. Competition

4. Other

IV. Results of Operations

A. Test Year

B. Revenues

1. Throughput

2. Other

C. Rate Base

1. Bayview Terminal

2. Cross-Cascades Project

3. End of Period vs. Average

4. CWIP

5. Other

D. Operating Expenses, Including Taxes

1. Whatcom Creek Costs

2. One-Time Maintenance Costs

3. FIT

4. Budgets vs. Actual, Preform and Restated Expenses

5. Other

E. Rate of Return

1. Methodologies

2. Summary of Witnesses' Proposals

3. Cost of Equity

4. Cost of Debt

5. Capital Structure

6. Other financial issues

F. Revenue Requirement Calculation

DATED this 13th day of June, 2002.

CHRISTINE O. GREGOIRE
Attorney General

____
Donald T. Trotter
Senior Counsel
Attorney for Commission Staff
(360) 664-1189