

Agenda Date: December 10, 2003, recessed to December 23, 2003  
Item Numbers: D4 and D5

**Dockets:** **TO-032023**, Current 35.3% General Rate Increase Filing  
**TO-031973**, Petition for Commission Order Accepting Settlement Agreement

Company Name: Olympic Pipe Line Company

Staff: Bob Colbo, Transportation Program Consultant  
Gene Eckhardt, Assistant Director, Water-Transportation

**Recommendation:**

Docket No. TO-032023: That the Commission take no action on the tariff filing , thereby the proposed rates will become effective as filed, by operation of law, on January 1, 2004.

Docket No. TO-031973: That the Commission issue an order approving the December 2, 2003, Settlement Agreement as in the public interest.

Discussion:

On December 12, 2003, Olympic Pipe Line Company (Olympic, or the Company) filed new WUTC Tariff No. 25, which was assigned Docket No. TO-032023. The new tariff would cancel existing WUTC Tariff 24 and reflects a 35.3 percent general increase to intrastate pipeline transportation rates. The new tariff's effective date is January 1, 2004. The annual impact of the proposed rate increase on Washington intrastate petroleum pipeline traffic is \$5,256,400 (35.3%). Olympic made a concurrent and identical filing with the Federal Energy Regulatory Commission (FERC) for interstate pipeline transportation terminating in Portland, Oregon. That filing, if approved, will generate \$8,008,100 (35.3%) annually.

The proposed intrastate tariff complies with the terms of an extensively negotiated Settlement Agreement (Agreement) between Olympic and Tesoro Refining and Marketing Company (Tesoro) and ConocoPhillips Company (ConocoPhillips). ConocoPhillips is the successor by merger to Tosco Corporation (Tosco). Olympic, Tesoro, and ConocoPhillips are collectively referred to in this memo as the "Parties."

Along with the proposed tariff, the Parties filed a Joint Petition, which was assigned Docket No. TO-031973, seeking Commission approval of the Agreement resolving various issues and pending cases between the parties. The parties filed a concurrent and identical petition with the FERC.

The proposed tariffs and the Agreement represent a "package deal," and are a key part of Olympic's business plan to emerge from Chapter 11 bankruptcy. The US Bankruptcy Court

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approved the Agreement on November 26, 2003. If FERC or the Commission change any of the terms of the Agreement, do not approve the Agreement, or the initial rates Olympic filed in compliance with the Agreement do not go into effect as proposed, the Agreement is void.

If approved, the Agreement would establish the “Olympic Settlement Methodology” (OSM) that the Parties agree Olympic will use to determine future rate changes that will be filed during the term of the Agreement.

#### Background:

Olympic is a corporation owned by ARCO Midcon LLC, (ARCO) a business unit of BP Pipelines (North America), Inc., and Shell Pipeline Company LLC, (Shell) formerly Equilon Pipeline Company LLC. Olympic’s pipeline transports petroleum products from the four refineries in Whatcom and Skagit Counties, along the eastern edge of Puget Sound, and continuing south to Portland, serving various end points along the way, including Sea-Tac Airport and other terminals. Olympic’s owners, ARCO and Shell, each own a refinery that is served by the pipeline. They are two of Olympic’s largest shippers. Tesoro and ConocoPhillips also own refineries served by the pipeline, and they are Olympic’s two largest non-affiliated shippers.

On October 21, 2001, Olympic filed a tariff with the Commission seeking to increase intrastate rates by 62%. The case was assigned Docket No. TO-011472. Tesoro and Tosco opposed the proposed increase and intervened. On January 31, 2002, the Commission granted an interim increase of 24.3%, subject to refund and further investigation and hearing. The contested issues in that docket included:

- rate-making methodology - FERC Trended Original Cost (TOC) or Depreciated Original Cost (DOC),
- anticipated throughput,
- rate base and the status of Bayview Terminal,
  
- capital structure and rate of return, and
- representative levels of proper operating expenses.

On September 27, 2002, the Commission issued its Final Order in Docket No. TO-011472, approving a 2.52% increase and requiring refunds, plus interest, for all over-collections during the period interim rates were in effect.

The similar tariff filing Olympic made at the FERC became effective July 1, 2001, also subject to refund and further investigation by the FERC. Tesoro and Tosco protested this filing as well. By order issued November 26, 2002, the FERC rejected Olympic’s interstate tariff and ordered Olympic to refund all increased revenues collected.

On March 31, 2003, Olympic filed a 54.5% rate increase with the FERC that became effective May 1, 2003, again subject to refund pending final determination. Tesoro and ConocoPhillips

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also protested this filing. On March 27, 2003, Olympic filed for reorganization under Chapter 11 of the United States Bankruptcy Code.

In June 2003, Olympic converted \$108 million in owner-held debt to equity. Staff believes this demonstrates good faith by Olympic's owners and significantly improves the financial health of the Company. Owner-held debt, Olympic's capital structure, and its effect on Olympic's operations were major issues in Docket No. TO-011472. By converting owner-held debt to equity, Olympic now has a capital structure that is 30% equity, 70% debt. Olympic has the potential to reach a 50% equity, 50% debt capital structure.

#### Rate Making Issues Addressed by the Agreement

The "Olympic Settlement Methodology" (OSM) includes valuing rate base at Depreciated Original Cost (DOC), and does not include deferred return and trended rate base (two elements of the FERC methodology that were litigated and rejected by the Commission in Docket No. TO-011472).

The annual revenue requirement reflected in the tariff filing in Docket No. TO-032023 is \$51 million (35.3% higher than current rates), consisting of the following elements:

- Actual Power and Drag Reducing Agent costs
- Actual Project Costs (referred to in Docket TO-011472 as One-Time/Major Maintenance)
- Other Operating Expenses – excludes all Whatcom Creek costs, fines and penalties, litigation, claims, etc., and capped at \$19.5 million the first year, plus an annual adjustment for inflation
- Amortization of Transition Costs related to Bankruptcy (amortized over 24 years ) and current Ratemaking/Regulatory costs (amortized over three years,) only to the extent that Other Operating Expenses are kept below the \$19.5 million as adjusted above
- Depreciation Expense (straight-line)
- Amortization of AFUDC
- 10.09% overall Return on the DOC Rate Base
  - 50% Equity at 12.38% - a real cost of 10.0% + Inflation Component (2.38% in the initial proposal)
  - 50% Debt at a cost of 7.8%
- Normalized Income Tax Allowance

Future filings will also include:

- Net Carryover/True Up – a deferred adjustment based on the difference between actual revenue requirement and historical revenue, plus interest. That is, at the end of the rate year, all expenses (pro forma and estimates / budgets) are tried up

to actual historical amounts, resulting in a revised revenue requirement, which is compared to actual revenue and over (under) collections are subtracted (added) to the next rate year revenue requirement.

- (The first Net Carryover/True Up will be for the 14-month period from May 1, 2003, (the effective date of present FERC rates) through June 30, 2004, (See Below); thereafter each Net Carryover will be for 12 calendar months, July to June.)

### General Framework and Other Terms of the Agreement

The general framework of the Agreement calls for:

- A five-year term, with renewal options.
- Annual tariff filings effective July 1, each year.
- Interim Quarterly tariff filings if actual 12 month rolling throughput exceeds established ranges; 2% increases or 15% decreases.
- Tesoro and ConocoPhillips will have access to all supporting information relied on by Olympic to prepare any filing 60 days prior to the filing date, including a review of cost inputs within a “regulatory” context.
- Tesoro and ConocoPhillips will not protest or contest any Olympic rate filing made under the provisions of the Agreement.
- Bayview must be placed into intended service by September 30, 2004, or removed from rate base and Olympic must file revised rates.

Other key elements of the Agreement are:

- Olympic is committed to achieve Maximum Allowable Operating Pressure (MAOP) by January 1, 2007. If not, the Parties will enter a Dispute Resolution process, potentially leading to termination of the Agreement.
- FERC and WUTC Refunds on all shipments made prior to May 1, 2003, will be paid no later than October 1, 2006, plus interest.
- FERC Refunds on all shipments made after May 1, 2003, will be paid no later than May 1, 2006, plus interest, and will be based on the difference between the May 1, 2003, FERC 54.3% increase and the instant 35.3% amount.
- **“No provision of the Agreement is intended to nor shall be interpreted to limit the regulatory jurisdiction or authority of the FERC or WUTC in any regard.” Agreement 40, §4.5(d).**
- The Agreement sets forth a number of termination/dispute resolution/binding arbitration provisions on specific issues for shippers and Olympic.

In addition, the Parties specifically state that the OSM is not intended to be precedential in any future rate filings. See Item (g) below. In their Prayer for Relief at paragraph 27 on page 10 of the Joint Petition (Docket TO-031973), the Parties respectfully request that the Commission issue an order [quoting]:

- (a) Approving the Agreement as being in the public interest
- (b) Allowing the Initial Tariff Rates for intrastate shipments as defined in the Agreement to go into effect on January 1, 2004, without suspension and by operation of law
- (c) Approving the methodology for preparing future rate filings under the Agreement
- (d) Approving the Total Revenue Requirement “true-up” elements as defined in Sections 3.3 through 3.12 of the Agreement
- (e) Approving the refund schedule in the Agreements as satisfying the requirement in paragraph 349 of the Final Order [Docket TO-011472]

[¶ 349: “Olympic must file, at the time that it files a tariff to implement the rate increase that we here authorize, a tariff rider that provides for the return of excess tariff collections by means of a discount, over a two-year period or its equivalent in estimated throughput, including interest at the overall rate of return authorized herein. Olympic must provide work papers that demonstrate the accuracy and effectiveness of its refund, and must submit the refund tariff rider on the same schedule as the Company is required to file tariff implementing the rates authorized herein.”]

- (f) Approving this Petition and the associated rate filing as satisfying the requirement in paragraphs 256-258 of the Final Order (requiring Olympic to make a new rate filing between July 1 and October 1, 2004),

[¶ 256 – 258: “The Commission appreciates the creative suggestions. An adjustment mechanism, however, would be one-dimensional in its application, while the Company’s areas of concern are multifaceted. Consequently, we think that the better approach is to direct the Company to file a general rate case between July 1 and October 1, 2004.

While the information of record is sufficient to set rates (given its limitations and the recent exigent circumstances affecting the Company), the lack of some data and the remaining questions about Olympic’s operations call for the opportunity for an additional review with better information.

By directing that Olympic file two years from now, we provide a full opportunity for Olympic to resolve remaining issues with Bayview and with throughput. The two-year period also provides an incentive for early performance: if Olympic exceeds its estimates and resolves those matters earlier, the timing will allow

collection of additional revenues from increased throughput that can be used for such things as improvement of Olympic's capital structure,"] and

- (g) Stating that the Agreement and the Commission's approval of the Agreement and any subsequent rate filings made pursuant to the Agreement shall have no precedential effect in any future rate proceeding regarding rates in effect beyond the term of the Agreement. [A similar expression appears in the Agreement at 40, §4.5(d). See above.]

#### Staff Analysis:

In its analysis of the filing, Staff determined that the components comprising the final revenue requirement under OSM are identical, with one exception, to those in a traditional, utility rate of return on a depreciated, original-cost rate base. The sole exception is the deferred Net Carryover provision. The review of Olympic's current and deferred cost inputs by Staff, Tesoro and ConocoPhillips prior to each filing will help ensure that only appropriate expenses normally included in rates will be allowed in this true-up process.

- Power and Drag Reducing Agent (DRA) costs will be allowed as usual.
- Project/One-Time Maintenance costs will be passed through directly in rates. In Docket No. TO-011472, significant portions of these costs were either deferred and amortized over 5 years, or capitalized and depreciated over their useful lives. The inclusion of these costs as normal operating expenses is accepted industry practice, and this treatment will provide an incentive for Olympic to continue to make operational and safety improvements to the pipeline.
- All other operating expenses will be subject to a \$19.5 million price cap (as adjusted by inflation), which will serve as an incentive for Olympic to hold down expenses, if it intends to amortize bankruptcy and rate case transition costs into rates. Such amortization costs are often found to be recoverable in rates at prudent levels. Price caps on operating expenses are not normally included as

ratemaking adjustments, although expenses are reviewed for their reasonableness and prudence.

- Depreciation expense will be normal, straight-line depreciation based on plant that is actually in service, plus Bayview, which the Commission included in rate base in Docket No. TO-011472.
- Remaining expenses include normalized Income Taxes and the amortization of the Allowance for Funds Used During Construction (AFUDC). The latter is calculated based on Construction Work in Progress (CWIP) balances using capital structure and cost rates consistent with the overall return amounts.
- Rate Base is traditional, depreciated original cost of plant in service including a provision for Working Capital and net AFUDC and less Accumulated Deferred Income Taxes.
- The 50/50 hypothetical capital structure in the OSM is different than the current 70/30 structure of Olympic resulting from the conversion of \$108 million owner-held debt to

equity. It is also different than the 80% debt 20% equity ratio used by the Commission to set rates in Docket No. TO-011472. As Olympic emerges from bankruptcy, Company officials believe the 50/50 capital ratio is achievable.

- The cost of debt is stipulated at 7.8 percent, compared with 7.0 percent used by the Commission in Docket No. TO-011472.
- The cost of equity used to determine the overall 10.09 percent return on investment is a generous 10 percent “real” return, plus an additional 2.38 percent inflation factor. The 10 percent amount is stipulated; each year’s inflation component will be the December-to-December change in the CPI-U, seasonally unadjusted index published by the United States Bureau of Labor Statistics. The inflationary additives will be separately determined each year and will not accumulate. Given the current unique financial condition of Olympic, Staff feels the amount is reasonable.

Staff believes that, overall, and in view of all the unique factors associated with this matter, the proposed methodology is reasonable.

### **Conclusions and Recommendations**

Staff has reviewed the Joint Petition, the Settlement Agreement, the Definition of Terms Glossary, the Technical Appendix ( OSM Excel Model), and additional information supplied by Olympic and Tesoro representatives. Standing alone, the OSM contains many unusual provisions, such as the incentive to hold down operating expenses, the

deferred true-up, the pass-through of Project costs, the hypothetical capital structure, the generous equity return with an inflation adjustment, plus incentives to utilize Bayview as intended and achieve MAOP. However, the OSM is only one piece of the overall agreement, which must be considered in its entirety as a “package deal.”

While Staff was not a party to the settlement negotiations that resulted in the Agreement, Staff was kept abreast of the discussions and we are confident the process was vigorous. The resulting Agreement will help Olympic emerge from bankruptcy and attract financing on reasonable terms. It will substantially resolve years of contentious litigation among the Parties at the Commission, FERC, and the courts, including the United States Bankruptcy Court, but excluding an ongoing business interruption lawsuit against Olympic is not affected by the Agreement.

The Agreement will establish a consistent, rational framework for the Parties to work cooperatively into the future, at proposed rate levels still significantly below any other alternative price of transportation. It provides a quick response to changes in project costs, investment, and operating pressure and throughput, thereby encouraging the continued safe, environmentally sound operation of the pipeline and reliable delivery of petroleum products throughout western Washington.

Overall, Staff believes the Agreement, the OSM Methodology, and the proposed rates together strike a fair balance between the Parties and the shipping public, and the results are fair, just, reasonable, and sufficient.

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Staff therefore recommends in Docket No. TO-032023: That the Commission take no action on the tariff filing, thereby the proposed rates will become effective as filed, by operation of law, on January 1, 2004, and in Docket No. TO-031973: That the Commission issue an order approving the December 2, 2003, Settlement Agreement as in the public interest.

Attachment: A one page Financial Exhibit summarizing the effect of Docket TO-032023.