BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant,

vs.

OLYMPIC PIPE LINE COMPANY, INC., Respondent.

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A hearing in the above matter was held on July 9, 2002, at 3:35 p.m., at 1300 South Evergreen Park Drive Southwest, Olympia, Washington, before Administrative Law Judge C. ROBERT WALLIS, Chairwoman MARILYN SHOWALTER, Commissioners WILLIAM HEMSTAD and PATRICK OSHIE.

The parties were present as follows:

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Kathryn T. Wilson, CCR, Court Reporter

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(The cross-examination of Mr. Fox continued
after afternoon recess.)

JUDGE WALLIS: We have asked the witness to mark the chart that he prepared as Exhibit 1708 for identification. He has done so, and the Company has agreed to have reduced-size copies made for our purposes of the record. Is there any objection to receipt of 1708? Let the record show there is no response, and that document is received in evidence. Mr. Brena, you indicated you had some questions?

MR. BRENA: Yes, thank you.

FURTHER CROSS-EXAMINATION

BY MR. BRENA:

Q. Good afternoon, again, Mr. Fox.

A. Good afternoon again.

Q. I was interested in your line of questions and answers with Commissioner Hemstad, and I think we might have found something we can agree on, and that is that the $66 million necessary to return the line to 100 percent for the safety and integrity improvements, that that $66 million is not in this rate case; is that correct?

A. It is not in the cost-of-service calculation that was presented by Olympic.

Q. Is it fair to say that as far as you are aware, Tesoro hasn't taken a position on the recovery or nonrecovery of those sums at this point?

A. When you use the name "Tesoro," I'm not sure personally whether your client Tesoro or you as Tesoro are claiming that, so not to be evasive. I can expand on that if you would like me to.

Q. We are agreeing, are we not, that the 66 million dollars is not in the cost of service that Olympic has requested that this Commission hold this hearing on?

A. It is not in the cost of service; that is correct.

Q. I'm not clear about your answer, so let me explore it a little bit, but if I were to represent that Tesoro's position is simple: Spend the money, and if it's prudently spent, add it to rate base and we will pay you back. Would you have any reason to disagree that that's been Tesoro's position with regard to whatever capital improvements may be necessary for the safety or integrity of this line?

A. I have yet to hear testimony from Tesoro, so I don't know if that's their opinion or not. I'm not sure -- I just don't know. I haven't heard anybody articulate the position, frankly.

Q. With Commissioner Oshie, you talked about when the audit would be done, and with Chairwoman Showalter as well. Is it fair to say that it will not be an unqualified auditor's letter if it only includes 2001 and doesn't go back from 1999 and go forward?

A. No, it's not fair to say.

Q. You are saying it may or not be an unqualified auditor's letter notwithstanding that the audit has not been included for prior years?

A. Correct.

Q. I'm interested in the colloquy with regard to whether or not there is something atypical about this rate proceeding. I think that you indicated that Olympic is in an unsteady state of operations, I believe, when you were speaking with Chairwoman Showalter; correct?

A. Correct.

Q. I guess it's true that if people are at steady state, they generally don't come in for rate increases. I would note for the record that the witness nodded. I'm struggling with the concept of trying to understand why Olympic thinks that its requested this Commission to be treated any differently than any other, so let me ask you with regard to

Commissioner Hemstad's question. If capital improvements need be done, isn't it fair to say those are typically done with equity or additional debt and then the capital improvements are done and put into the rate base and then recovered over time in rates?

A. Generally, that's true, yes.

Q. What in your mind makes Olympic unique from any public service company that chooses to come in and have a rate increase because they have capital improvements that are necessary to be done?

A. It won't be as short as you thought because we could talk a lot about the differences. This is, to my knowledge, the only oil pipeline in the State of Washington.

Q. Can we take them one at a time?

A. Sure.

Q. Let me ask it this way: So what? So what if this is an oil pipeline? It's a public service company and it's subject to rate regulation. Why does that make any difference to anybody?

A. I'll preface this by saying that I did not attest to being a rate-making expert, but my personal view is that I can't believe that a regulated company that serves other major oil companies should be regulated the same way as a regulated company that serves the general public. To me, that just seems to be a major difference.

Q. May I explore that?

A. Sure.

Q. Both have the regulatory standard that this proceeding is all about, that there be a just, fair, reasonable, and sufficient rate; correct?

A. Correct.

Q. So should you be able to charge more because the members of the public you serve are fewer in number?

A. I didn't say that.

Q. Well, I'm --

A. I didn't say that at all.

Q. But you are going to the characteristics of the customers in the public service company, and you are saying based on the characteristics of the customers, the ratepayers, there should be a different regulatory philosophy involved.

With utility rates, Alcoa Aluminum, for example, may be one of the largest industrial users of electric rates in the world, so why -- how is it, in your mind, that the characteristics of the ratepayer should determine what's a fair rate that they should be assessed?

A. And I understand your question, but the -- I think when you look at kind of a public interest angle, what's important for the public, I think it's been demonstrated by several witnesses that the end result for the average citizen of Washington is relatively small and that you've got a handful of shippers of which only two decided to protest this. I think that, to me, is odd in and of itself. You asked me what was atypical, so that was one, and I can go to number two, if you would like.

Q. I would like to explore number one before we get to number two.

A. Okay.

Q. Are you suggesting that the characteristics of the ratepayer should determine how cost-based regulation is applied?

A. I think that it's a different situation. I'm not sure that the actual algorithm that is used should change, but I think, for example, that a typical electrical user isn't sophisticated enough to know if the rates they are been charged are appropriate as opposed to very, very large oil companies that can afford very expensive legal consultants to defend themselves. That's all I was saying.

Q. But I'm trying to figure out how this should factor into what's a fair rate for Olympic. Let me give you a hypothetical. Let's say that the two refineries went out of business due to high transportation costs due to Olympic. There is only small ratepayers left on the line. Should the rate that Olympic receives in that situation be less?

A. I didn't say that.

Q. Well, if it shouldn't be less if they are smaller, then it shouldn't be more if they are bigger, should it?

A. You asked me about being atypical. You didn't ask me about what the outcome should be for ratepayers.

Q. What I'm really exploring for, are we talking about, and this is in your answers and in your testimony, do we apply rate concepts to Olympic, or is there an alternative rate-making device that we are going to compose because of the uniqueness of Olympic? So ultimately, my questions go to what is unique about the situation that should impact rates?

A. I think, and without getting drawn into a big discussion of things that were testified to by others, I think that unique historical sort of development of methodology is unique for the oil industry.

Q. You are speaking now about federal

regulation?

A. Federal regulation, yes. I think it's unique that --

Q. Can we take these one at a time?

A. Sure.

Q. Does this Commission, is its responsibility to determine rates under the Interstate Commerce Act?

A. I didn't say that.

Q. Well, that is what the federal obligation is.

A. I understand.

Q. Would you acknowledge that the federal statute is quite different than state statute?

A. But I would contrast that to -- and I may be wrong on this, but does Puget Sound Energy, for example, do they have interstate -- does their electrical lines run into Oregon, for example, where there is situations that they had one methodology, and then 30 years later, 20 years later, potentially have that methodology change? I think that's different. You were looking for contrast, and that's what I'm giving you.

Q. Let's discuss methodology. Do you believe that a public service company in Washington, or for that matter, any regulated rate base, has a vested interest in a particular methodology?

A. Could you restate your question?
Q. Are you familiar with the line of authority that states that a regulated entity does not have a vested interest in any particular rate-making methodology?
A. That all methodologies will get you the same answer?
Q. No. As I understood the distinction you were drawing, you were suggesting that there was something unique about Olympic with regard to methodology.
A. Let me rephrase my question to you. Are there other entities here in the state that have had a methodology, and maybe methodology under the auspices of some other federal agency or Commission like FERC, that had that methodology changed in this state because they were an interstate carrier. I don't know the answer to that, but I pose that question.
Q. Is it your testimony that there has ever been a methodology applied by this Commission and accepted for the purposes of rate-setting to Olympic?
A. Could you state that again?
Q. I said, are you suggesting that this Commission has ever considered and established a rate-making methodology for Olympic?
A. I think they've considered it, yes.

Q. When?

A. I believe it was 1983, but I don't know for sure.

Q. Are you talking about when rates were allowed to go into effect without suspension?

A. I believe that was the time.

Q. So to the degree that you are suggesting that a long-standing methodology in place may change and that may raise certain regulatory issues, isn't it true that that has no place in this hearing room because this Commission has never established a rate-making methodology for Olympic?

A. Well, you asked me atypical, and I'm giving you an atypical, and maybe I'm wrong. Maybe that happens all the time, but to me, that's atypical where you've got one regulatory scheme and it changes. To me, that's atypical.

Q. That's what I'm exploring. What do you mean by that something has changed? There hasn't been one established, and we are here establishing one. What is atypical about establishing a methodology for setting rates? They do it in every rate case.

A. And again, I'm not going to pretend I'm a regulatory expert to any degree, but it's my understanding that more of the FERC was in place from

1983 up through this proceeding, and the Staff's case was more of a change from trended original cost to depreciated original cost.

Q. Are you suggesting that -- does this go back into that this Commission should default to however federal regulators regulate under the Interstate Commerce Act? Is that what you are suggesting?

A. I didn't say that. You asked for things that are atypical, and I can give you a whole range. These are just a few things that to me are not things that happen to pipelines every year that are atypical, that are unusual, and to me, that's one of them.

Q. Is there something else that's --

A. Sure.

Q. Before we leave that, I don't mean to beat a dead horse, but I'm just trying to understand why federal methodology is in this hearing room. Why does Olympic feel that because they are regulated on a federal level, however they are regulated on a federal level, that any state should adopt that?

A. Let me give you an example, and hopefully, this will be a good example, but maybe not. Your client purchased a line from us in North Dakota. It's a pretty typical line. It has pretty steady state, pretty steady volume, pretty steady regulatory issues, virtually none, no issues with the shippers, and so they are never faced with will the State of North Dakota come in and potentially change their rates because of a change of methodology. To me, you asked for distinctions that made this atypical, and to me, that's one of them.

Q. Did the state change your rate?

A. I didn't say that. I was referring to the State of North Dakota, and it was the Staff that has made recommendations, not the State.

Q. Do you think that rate-making in the State of Washington should be an exercise in exploring how much money to give BP so that it invests in safety in Olympic?

A. Before I answer that question, could I finish with your other question on the atypical nature?

Q. Why don't you answer that one and then we will go back to it.

A. Then you will have to restate it.

Q. Do you think that rate-making in the State of Washington should be an exercise in searching for how much money to give BP in order to have it invest in safety for Olympic?

A. No.

Q. Now I would like to go back to the atypical.

Is there something else unusual about this rate case that should impact rates?

A. This pipeline, other than the very unfortunate accident at Whatcom Creek and the ERW weld seam failure, I think -- and I believe Mr. Talley testified in terms of how much of this pipeline went through high-consequence areas, a very, very large amount -- if you compare that to pipelines in West Texas, Tesoro's pipeline now in North Dakota, it's fractional, and to the extent that the intervenors are questioning the prudency of some of the spending with shippers that have no experience to speak of in transporting in high-consequence areas, that, I think, really brings up the whole issue about the fact that that's another sort of atypical operating environment.

Q. Let me explore that. With regard to the capital spending that's necessary to comply with the high-consequences-areas rulings, that's in the $66 million; correct?

A. That's correct.

Q. So I'm looking for something that's atypical that should impact this rate proceeding --

A. It also is in the operating and maintenance expense as well. If there is anything that is in the major maintenance category that is the result of that, it would also be in there.

What we are really talking about -- and I forgot which witness it was you were questioning -- how do we know that their spending is reasonable in the cost side, and that's really what I was addressing.

Q. You agree, don't you, that with regard to the cost that you've included in this rate proceeding that Olympic has the burden to demonstrate those costs are recurring in nature and prudently incurred; correct? Do we agree on that beginning point?

A. Could you restate that?

Q. Would you agree that with regard to any costs that are included within this rate proceeding that Olympic has the burden to demonstrate that the recurring costs have been prudently incurred?

A. I am trying to figure out how to respond tactfully to that question, because what I'm hearing you say is, why should we trust Olympic, and really by definition, BP Pipelines, why should we trust them to determine what's reasonable for this pipeline, and I just find that a little bit strange from two shippers that are virtually -- have no experience in pipeline operation, expert witnesses that have virtually no oil pipeline experience, and you're questioning a company that operates over 20,000 miles of pipes throughout the United States that probably you use to get your gasoline, and nobody has any problems with the way they operate pipelines or what they think is necessary to spend to operate those pipelines.

Q. Is it your testimony that ratepayers should just pay based on trust because BP operates lots of lines?

A. No, but BP deserves a fair rate on what they think is prudently or needed to be spent on a prudent basis to operate the lines.

Q. Are you suggesting that just by the fact that BP files a rate case that that's sufficient to meet it's burden?

A. That's not what I meant.

Q. Let me explore the burden. Do you agree that one of the burdens that BP has to meet is to show that the costs that are incurred are recurring in nature?

A. Yes. I understand that from a regulatory standpoint.

Q. So to the agree that there is a disagreement with regard to whether a cost would be recurring or not in the future, it's BP's --

A. That's not what I was addressing. It was the interplay, and I can't remember who it was with, one of

Olympic's witnesses, where there was a discussion about, I believe it was salaries and management fees and things of that nature and whether those were reasonable costs to be included in the rate base, and I just found that odd that people basically with no experience that relied on BP's expertise when they bought a line from BP would question things like salaries and materials and supplies and things of that nature. I just found that odd.

Q. Is it your understanding that Tesoro disallowed any part of the salaries that BP proposed in its rate case?

A. I'm not aware of that. I don't know. They certainly disallowed a lot of the major maintenance costs.

Q. The one-time expenses?

A. The major maintenance costs.

Q. I'm taken by your suggestion that the ratepayer who is not in the business doesn't have the right to question the rates that they pay. Take the salaries, for example. In your direct case, do you know where the salary number came from?

A. In the direct case?

Q. Yes.

A. Generally, yes.

Q. It was 7.4 million dollars for 81 employees based on the budget that was prepared when time the management contract was entered into two years before. Did you understand that?

A. Considering I was the one that did the management contract, yes.

Q. So we are two years later, and BP puts 7.4 million dollars in for 81 employees but they only have 72. Now, you think there is something improper about Tesoro saying, "Why are we paying for nine more employees based on the two-year-old budget estimate than what you are actually using?

A. Can I respond to that question?

Q. Certainly.

A. First of all when that management contract was developed, it was 91 employees, so obviously, BP did something to reduce staffing levels, and it's obvious they are making due with less people because from what I understand, each employee is averaging about 30 hours of overtime per month. The salaries are in an acceptable range, and also, I believe, Mr. Brena, that in our rebuttal case -- I don't know the exact number that came in the rebuttal case, but I would expect it would be lower reflecting those lower salary levels. Is that true?

Q. You are asking me about your rebuttal case? Yes. As a matter of fact, you went to actuals in your rebuttal case and away from the budget. It was a good move.
A. So you can trust us that we will do the right thing.
Q. I can trust you that the case will change whenever -- never mind. Aside from trusting BP, that's something that -- I'm just wondering to what degree you are really advocating just throwing rate-making principles out the window and really making this proceeding about trying to figure out how much money it would take to get BP to invest in future investments that aren't even in the rate case?
JUDGE WALLIS: Mr. Brena, is this the second time around on that general inquiry?
MR. BRENA: I think it may be, yes.
Q. (By Mr. Brena) Is there anything else that we haven't talked about that you think makes Olympic unique to rate-making applied by this Commission?
A. I can't think of any right at this juncture. I take that back; one does come to mind. The financing, and again, as I answered earlier, I don't have a lot of knowledge about Puget Sound Energy or Bonneville -- I'm starting to learn some of the

utilities around here. That means I've been here too long. I think Avista is another one -- but I believe it's true that a lot of their debt is thirty-party debt as opposed to the oil industry that is often times loans from parents, so I think that may be something that's a little different as well, particularly when you are looking at capital structure.

Q. With regard to financing, isn't it fair to say that prior to Whatcom Creek that this was a line that was capable of obtaining third-party financing?

A. I would probably change that to say that prior to the ERW weld seam failure, that would be true, yes.

Q. If Olympic's parents were to invest equity rather than debt into this line, all the affiliated debt were actually equity instead of debt, don't you think that Olympic could continue to participate in the debt market today?

A. No, I don't. The letters will look at cash flow multiples, as I said earlier today. They don't care about the capital structure. They only look at the capital structure of the parents, and it's that simple.

Q. Do you know how many pipelines Tesoro operates or owns?

A. I don't know exactly, but I think less than three, and it may be one, and I think that one is up for sale.

Q. You are not aware of their Alaska lines?

A. Do they have one to the Cook Inlet Refinery?

Q. I was just wondering what the factual basis was for your assertions with regard to Tesoro's lack of experience in operation, if you were familiar with what pipelines they did own and operate.

A. I know several individuals that jumped from BP to Tesoro when they acquired our North Dakota properties.

MR. BRENA: I don't have anything further. Thank you.

JUDGE WALLIS: It's time for redirect.

REDIRECT EXAMINATION

BY MR. HARRIGAN:

Q. On the subject that you were just discussing of salaries, what would be the basis on which one could place any trust or confidence that BP's salary levels at Olympic were reasonable?

A. Taking a step backward from there, a little higher level, one thing I meant to say to Mr. Brena was

BP is a big company, and it's not just big because it drills a lot of wells and finds a lot of oil and gas. They also are very, very driven to reduce costs and constantly looking at ways to make operations more efficient. That's one of their cornerstones of the BP Corporation.

So if you look at something like salaries, we do market tests every year, market surveys. We have oil industry surveys that we utilize to make sure that our people are in reasonable ranges and quite a few other market areas.

Q. In terms of other elements that go into the operating and maintenance arena, what about outside contracting and materials and supplies, that sort of thing. What basis would there be for having confidence that BP's numbers in those areas was reasonable?

MR. BRENA: Objection, scope.

JUDGE WALLIS: The inquiries on cross were rather broad, and we'll allow some latitude.

THE WITNESS: First of all, and I'm not sure this was presented or requested and it probably was. Everything else was requested in the discovery process, but BP uses what is called the capital value process where it essentially does what's called "front-end loading" on projects. It looks at what it's going to cost, do we really want to do them, maybe we shouldn't do them, and how can we make them better economically, so we use the CVP process on all of our project spending.

Q. Does that apply to Olympic as well as other parts of the BP operation?

A. Absolutely, every part. We do a lot of competitive bid work. I understand from our procurement people that previously, we had singular vendors for a lot of the contractor services and have now brought in competitors to force the prior vendors, singular vendors to drop their rates. BP also works on national accounts and regional buying power to make sure that we get as low a price as we can on the stuff that we buy.

Q. With regard to the national accounts, does that apply to Olympic or just apply to BP nationally?

A. It applies to --

Q. For example, how does it work, in an example?

A. This probably isn't a good example because I hate to use a national brand name, but I'll just say Company X is a rental car agency. That's because we work exclusively with them. We get discounted rates with them. Although, I personally say we get terrible rental cars, but that's another story, but BP does get a pretty sizable discount by using that vendor on a national basis, and obviously, that applies to Olympic and any other pipeline that we own.

Q. Now, there are Olympic employees working at Olympic and also BP employees working at Olympic; correct?

A. No. They are all BP employees.

Q. Sorry, I forgot. It used to be the other way around. Some of those BP personnel that work on behalf of Olympic are covered by the management fee so there is no separate charge and others are charged separately; is that correct?

A. The management fee covers the support for Olympic provided generally from our Lisle, Illinois office and our Houston Eccenture contracted accountant office.

Q. What basis would there be for the Commission to have any confidence that the fee itself is reasonable?

MR. BRENA: Your Honor, I understand that the scope of the cross was quite broad, but it just simply didn't go into these areas.

JUDGE WALLIS: Mr. Harrigan?

MR. HARRIGAN: Your Honor, I think the scope of the cross was why should we have any trust and confidence in the numbers that have been presented here by Olympic, and the numbers consist, at least in the operations and maintenance area, it seems to me, of salaries, materials, contractors, and the support from BP, so this is the last piece.

MR. BRENA: That line of cross went to whether or not they had a burden to demonstrate those things within the context of a rate case and whether trust should be the basis for the acceptance of those numbers, and it did not go into these areas with regard to the reasonableness of the management fee at all.

JUDGE WALLIS: I think that the basic nature of the inquiry was into the reasons for trust and am inclined to overrule the objection and allow the question.

Q. (By Mr. Harrigan) Do you have the question in mind?

A. No.

Q. What basis, if any, would there be for the Commission to have confidence that the amount of the management fee that BP is charging for its support for Olympic is reasonable?

A. I hate to keep bringing up Tesoro, but I can tell you that the management fee that they agreed to pay BP when they purchased the North Dakota line dwarfs the management fee that Olympic pays to BP by a long shot, and it is a very simple, typical, easily-administered line that I spent zero of my time on as opposed to this pipeline which I spend, and this is an example, a lot of time on.

Q. How has the cost of servicing Olympic compared to the fee?

A. I was in charge of setting the management fee. If I had to do it all over again, I'm sure it would be much, much higher.

Q. Because...

A. This pipeline takes an inordinate amount of time and resources from our staff, our central staff.

Q. Take a look at Exhibit 1704 for a second, please. One of the differences that you mentioned earlier on cross related to the difference between, for example, the Staff figure for operating expenses less depreciation and the rebuttal number with that difference being around $6 million. What underlies the increase that is reflected in the rebuttal number in operating expenses? What are the underlying causes of that number being as high as it is?

A. The vast majority is major maintenance costs.

Q. Related to what?

A. A lot of it is mandated spending from various agencies, line lowering, right-of-way mowing, tank painting, pipe painting, etcetera, obvious recurring items.

Q. There was a question from Mr. Brena that appeared to suggest that major maintenance was synonymous with nonrecurring costs. Is that true?

A. No, it is not.

Q. Would you explain it?

A. This pipeline is constantly undergoing maintenance, and it might not be the same piece of pipe, but there is going to be maintenance on another piece of pipe a mile down the road. You are not going to paint the same piece of equipment each year, but you are going to paint a part of the pipeline each year, same with right-of-way mowing, etcetera. So it is definitely recurring, and to take up 98 percent is, in my judgment, not fair.

Q. You have indicated that the $66 million in projected capital expenditures is not part of the basis on which a rate increase is being sought here; in other words, that it is not an element of the rate case. What is the connection between the outcome of the rate case and whether that investment gets made?

A. The only connection is that we are looking for a fair rate as an outcome of this proceeding. I think that if that rate is appropriate, there will be enough cash flow to make those expenditures, but they are not really related. The rate that we are looking for is based on the investment that already exists.

Q. In terms of a fair outcome, what is the -- you referred earlier to the coverage provided under the Staff-proposed rate increase for operations and maintenance expenses. What is the ratio of coverage, as you referred to it, if the Staff recommendation were adopted?

A. Bear in mind that the Staff recommendation was $6 million lower than Olympic's recommendation. Revenue would cover operating and maintenance 1.07 versus --

Q. Before you go on, what do you mean? What is 1.07?

A. That's how much the revenue exceeds the operating and maintenance expenses.

Q. In other words, they are practically the same?

A. Practically the same.

Q. What effect does that have on the pipeline's ability to make capital expenditures or do anything else that's not within the operations and maintenance category?

A. It's not there to spend.

Q. Does that refer to all of the revenues of the pipeline that would be received in the event that the Staff recommendation were adopted that produces that ratio?

A. Yes.

Q. What is the normal ratio, if there is such a thing?

A. It's been my experience for the 40-some odd pipelines we are involved in, it's somewhere in the range of 1.75 to 2.25, in that range.

Q. You indicated that there was an issue in your mind with regard to the fairness of switching rate bases within the State of Washington from what had previously been the manner in which they were set. What is the problem there?

A. Simply, it hurts Olympic.

Q. How?

A. It will result in a lower tariff if that's approved.

Q. You also referred to the difference between depreciated original cost and trended original cost. Which is the method that Olympic has used prior in its historical rate filings, as you understand it?

A. Trended original cost.

Q. Why does it use that method?
A. Because that's the method that FERC adopted.
Q. Have the rates that Olympic has received using that method been applicable on the intrastate part of the business?
A. Intra?
Q. Intra.
A. I believe so.
Q. Is there an economic effect on Olympic if the method is switched in this particular year from trended original costs to depreciated original costs?
MR. TROTTER: I'm going to object to the question. He's made a leap from what Olympic filed, or at least what this witness believes Olympic filed, and how the rates were actually set, and there is a legal distinction between the two, so we will object that there has been a switch. We've objected consistently throughout this hearing and will object now.
JUDGE WALLIS: We understand there is a difference in theory. Would you be willing to rephrase the question to avoid that issue, Mr. Harrigan?
MR. HARRIGAN: I think I can, Your Honor.
Q. (By Mr. Harrigan) If rates are set from here on out based on depreciated original costs for the intrastate part of the line, will that have a financial

impact on Olympic?

A. Yes, it will.

Q. What is the nature of that impact? You don't have to give it to us in numbers, but what is the nature of it?

A. The lower revenue for Olympic.

Q. You were asked a question with regard to Olympic's having earned 100 percent on its book equity. I believe you said that was accounting versus economics. What is the significance under the circumstances of this case of earning 100 percent on book equity?

A. Obviously, when your equity, which is the denominator, is very low as it is with a lot of oil pipelines and the numerators of that income, the return is going to be enormous. It really should be compared to something that's a little more normalized, such as capital employed, or generally, we will look at capitalized costs, net plant.

Q. You were asked whether it would be possible for Olympic to access third-party sources of loans as opposed to parent sources of loans even though it was 100 percent debt financed. Under what circumstances could Olympic access such third-party sources even though it was 100 percent debt financed?

MR. BRENA: Objection. I don't mind the line of questions, but it was whether or not if they converted the debt to equity whether or not they would be able to participate in the debt marketplace, so it mischaracterizes what the cumulative was.

MR. TROTTER: I took the question differently. I thought he was referring to the Chase note, and I don't think there was any evidence that they were 100 percent debt financed when that note, so I'll object on lack of foundation.

JUDGE WALLIS: Mr. Harrigan, do you want to try that again?

Q. (By Mr. Harrigan) What are the circumstances under which Olympic would be able to get access to third-party lending that is nonparental lending even though it was 100 percent debt financed, and I'm not speaking about some historical event. I'm asking what are the general conditions under which that could occur?

A. The only conditions in which that can occur is if the cash flow was such that it could support it.

Q. When you say "cash flow," are you speaking about EBITDA?

A. About EBITDA specifically.

Q. In basic numbers, if the Staff approach to the tariff setting is taken, what would EBITDA be?

MR. TROTTER: I'm going to object. If this was an important issue, they should have brought it up in direct. Based on an exhibit that we got today, we are now getting supplemental direct, and I'm going to object.

MR. BRENA: It's beyond the scope of the cross.

JUDGE WALLIS: I do sense, Mr. Harrigan, that we are just the other side of that line with this.

MR. HARRIGAN: All right.

Q. (By Mr. Harrigan) EBITDA is "earnings before interest, taxes, depreciation, and amortization"; correct?

A. Correct.

Q. It's not "earnings before operations and maintenance," is it?

A. No.

Q. How much is left over after operations and maintenance under the Staff approach to the tariff?

A. Virtually none.

Q. You were asked a question about the tax liability column on Exhibit 1704, and the gist of the question was, wouldn't Olympic have an amount of extra cash equal to the projected number if, in fact, it ended up not having to pay that much income tax. What is the answer to that question?

A. Well, if it didn't make enough money, obviously, it wouldn't have to -- it just wouldn't be able to pay it. I'm not sure I understood the question.

Q. If the income isn't there to pay the taxes, does that mean Olympic has more money?

A. No, it doesn't.

Q. You were asked about BP's purchase of the GATX shares, and I believe Mr. Brena suggested to you that Olympic had paid $34.5 million for its entire percentage interest in Olympic between GATX and the Arco acquisition.

With regard to the Arco acquisition, you were explaining earlier to Commissioner Oshie about the distinction between what happened at the time of the Arco acquisition versus the later due diligence at the time that Olympic took over as operator. Can you put those two events in time? When was the Arco acquisition?

A. The Arco acquisition, I believe, was finally approved in April of 2000.

Q. Olympic took over as operator when?

A. July 1st, 2000.

Q. When were the processes that went on that culminated in the actual closing of the Arco acquisition? Over what period of time did they take place?

A. The company Arco?

Q. I'm talking about the processes that BP went through in order to acquire Arco. How long did that go on before the actual closing in April?

A. I believe it was over a year. The due-diligence process was probably much shorter than that because you can't really do the due diligence until you get approval from the FCC, so I believe that you have sort of a period where you really can't talk. I would say it was less than a couple of months, actually.

Q. Then when BP found that it had become the owner of Arco's piece of Olympic, what was the decision-making process that led to the GATX acquisition?

A. Frankly, I wasn't that involved in it but -- could you rephrase your question?

Q. Let me just ask you this: When did the GATX acquisition take place?

A. I believe it closed in September of 2000.

Q. In between those two dates, BP became the operator.

A. Correct.

Q. If, in fact, it's Mr. Brena's representation was correct that the purchase price for the total of the GATX shares and the Arco piece of Olympic was $34.5 million, what is BP's current total sum invested in Olympic?

A. Just a little short of 90 million, I would guess.

Q. The rest of it being what?

A. 52 million in loans to Olympic.

Q. What portion of that was spent on capital projects?

A. Probably 80 percent.

MR. HARRIGAN: I have no other questions.

JUDGE WALLIS: Chairwoman Showalter?

FURTHER CROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. You just testified about a ratio that you found was common in the industry from 1.75 to 2.25. Was that the range that you mentioned?

A. Yes. I think that's what I said.

Q. What was the ratio, of what to what?

A. Revenue to operating and maintenance expense, essentially the coverage of those expenses.

CHAIRWOMAN SHOWALTER: Thank you.

JUDGE WALLIS: Anything further? Let the record show that there is no response, and Mr. Fox, thank you very much for appearing with us today. You are excused from the stand at this time. Let's be off the record for a procedural discussion.

(Recess.)

JUDGE WALLIS: Mr. Danny P. Kermode has taken the stand. Mr. Kermode, would you please stand and raise your right hand?

(Witness sworn.)

JUDGE WALLIS: In conjunction with Mr. Kermode's testimony, the Commission staff has predistributed documents entitled testimony and others to which numbers have been assigned, 1801-T through 1806, as recorded in the transcript of the June 13 prehearing conference.

In addition, yesterday and today, copies of additional documents were presented by Olympic for possible use on cross-examination. We've marked as Exhibit 1807 for identification a document entitled "FASB 71," and we've marked as 1808 for identification an excerpt from Wiley, Generally Accepted Accounting

Principles, or GAAP 2002, the cover, and Pages 61 through 69. With that, Mr. Trotter?

DIRECT EXAMINATION

BY MR. TROTTER:

Q. Mr. Kermode, would you please state your name and spell your last name for the record?

A. My name is Danny Kermode, K-e-r-m-o-d-e.

Q. You are employed by the WUTC as a regulatory analyst; is that correct?

A. That's correct.

Q. In the course of your duties as a regulatory analyst, did you have cause to prepare testimony and exhibits in this case?

A. Yes, I did.

Q. Is Exhibit 1801-T your direct testimony?

A. Yes, it is.

Q. If I asked you the questions that appear there orally, would you give the answers that appear there?

A. Yes.

Q. In the course of that testimony, you refer to Exhibits 1802 through 1806; is that right?

A. That's correct.

Q. Are those exhibits true and correct to the best of your knowledge?
A. Yes, they are.
MR. TROTTER: I move the admission of Exhibits of 1801-T through 1806.
JUDGE WALLIS: Is there objection? Let the record show there is none, and 1801-T through 1806 are received in evidence.
MR. TROTTER: In accordance with the arrangement for permitting additional direct or surrebuttal, I have a few questions of Mr. Kermode.
JUDGE WALLIS: Please proceed.
Q. (By Mr. Trotter) Mr. Kermode, as a general matter, could you describe the differences, if any, between regulatory reporting and financial reporting for public service companies?
A. Regulatory reporting is mainly for the regulatory body. Regulatory accounting is used to produce data in which regulatory bodies can use to make decisions. Financial reporting uses financial accounting, and its mainly designed for investors, lenders, people that are investing in the company itself.
Q. Does the FERC Uniform System of Accounts, or USOA, apply to regulatory reporting or financial

reporting for oil pipelines?
A. Regulatory.
Q. Do you recall that Mr. Ganz for Olympic testified that the FERC USOA required oil pipelines to accrue interest during construction, or IDC, and not AFUDC.
A. That's correct.
Q. Is he correct on that point?
A. No. The USOA itself states that a company use the IDC. However, in my research, it's my opinion that the FERC policy allows either IDC or AFUDC.
Q. Did Ms. Hammer testify that various pipelines upon which she worked in the past had factored for AFUDC?
A. Yes.
Q. Does Olympic accrue IDC?
A. No. I don't see anywhere where they do that.
Q. Does Olympic accrue AFUDC?
A. On their books, no.
Q. Does the fact that the FERC USOA refers to accrual of IDC change your opinion on whether GAAP requires Olympic to accrue AFUDC on its financial statements?
A. No. It's my opinion that under GAAP, Olympic would accrue AFUDC.

Q. Is that because, in your opinion, FASB 71 applies?
A. That's correct.
Q. Can AFUDC be accrued even if the regulatory body has not established a fair rate of return for Olympic?
A. Yes, they can. They can do what I would call a good-faith effort. There is enough theory. There is enough information out there where a company can do that. In fact, looking at the Form 6 of Olympic Pipe Line, they apparently have done that since on Page 700, they show an amortization of AFUDC, and obviously, to do that, they would have to derive it somewhere.
Q. Page 700 is not the books of account. Isn't that a special page that FERC requires be produced?
A. Yes, sir.
Q. Do you recall that Mr. Ganz for Olympic focused on the second of three criteria for applicability of FASB 71, and that was quote, The regulated rates are designed to recover the specific enterprises costs of providing the regulated services or products.
A. That is correct. He focused on that.
Q. Did you review Olympic's rate filing history at FERC?

A. Yes, I did.
Q. Did you find any evidence that FERC has established rates for Olympic using indexing?
A. I saw nothing in the dockets or any of the records of FERC where they did that.
Q. Mr. Ganz also testified that the index prescribed by FERC is decreased at least as often as it's increased. Were you able to confirm that?
A. I checked the actual index years, and out of the nine index years, the index decreased three times.
Q. Mr. Ganz testified that when the index is reduced, FERC goes out and pursues rate filings by oil companies. To your knowledge, has Olympic ever filed a rate reduction related to the index?
A. No. In this Commission, I see no filing where they've reduced their rate based on index.
Q. What about FERC?
A. I saw no evidence there either.
Q. To your knowledge, has Olympic always used a cost-of-service approach in establishing rates before FERC?
A. That's my understanding.
Q. Do you recall Mr. Ganz referring to Footnote 37 in FERC Order 561 where FERC stated, quote, Indexing fosters efficiency by severing the linkage under

traditional cost-of-service rate making between a pipeline's rate changes and changes in its current operating and investment costs, unquote. Do you recall that?

A. I recall that.

Q. Do you have a response to that testimony?

A. Yes. If you actually read the Order itself, Order No. 561, the footnote stands out in contrast to the rest of the Order, and I found a lot of quotes, but the right one right above Footnote 37, I think, handles it pretty nicely.

CHAIRWOMAN SHOWALTER: Are you reading anything that might be in front of us that we could look along with?

THE WITNESS: It's Order 561.

CHAIRWOMAN SHOWALTER: This is not an exhibit?

MR. TROTTER: I don't recall if it is. It may be through Mr. Ganz. I can check, but the quote the fairly short. Perhaps Mr. Harrigan can help us.

MR. HARRIGAN: I would be guessing. I'm not sure.

MR. TROTTER: If we can take the quote, and then we can supply the order to the Bench.

THE WITNESS: Right above the footnote, it states, "Under indexing, pipelines adjust rates to just and reasonable levels for inflation-driven cost changes." To me, it's very explicit that there is a link between, obviously, the rates, the revenue, and the inflation-driven cost, and like I said, through the rest of the Order, they've referred to it time and time again of that link.

Q. (By Mr. Trotter) Would you refer to Exhibit 1807 for identification, which is FASB 71 and turn to Paragraph 65, which is on the second-to-the-last page. Do you recall Mr. Ganz referred to Paragraph 65 as a place where FASB 71, in his opinion, addressed the subject of the application of FASB 71 to index rates?

A. Yes, I recall that.

Q. In your opinion, does Paragraph 65 address index rates?

A. No. I was surprised they picked that paragraph. When I was teaching at NARUC (phonetic), I actually used this paragraph, so it came out pretty convenient. In rate-making, you either set rates by specific costs to a company, or what used to be very common in transportation, trucking industry, household goods, they set it by an aggregate cost.

And what they do and what this Commission did was they would go out and take a sample of many companies spread across the state. They would bring the costs together, and you would make what is basically an average surrogate company. From that average surrogate company, they would set rates. That's what this paragraph is talking about. It's talking about the grouping of rates, and I will show you how this works, and under that perspective, you will see what I mean.

I believe the second sentence that goes, "If rates are based on industry costs or some other major not directly related to the specific enterprises costs, there is no cause-and-effect relationship between the enterprises cost and revenues. In that case, costs would not be expected to result in revenues approximately equal to the cost. Thus, the basis for accounting specified in this statement is not present." And that's what Mr. Ganz was pointing to.

"That criteria is intended to be applied with substance of the regulation rather its form." Here's where it highlights the fact that this is the type. The group-costing regulation is what this paragraph is talking about. "If an enterprise's regulated rates where based on the cost of the group of companies and the enterprise is so large in relation to that group of companies that its costs are, in essence, the group's costs, the regulation would meet the second criteria for that enterprise."

That's precisely what happened. You will get a group of companies in a sample, and if that sample company is so large that it overpowers the sample, then, in effect, you are setting rates for that specific company, but as far as indexing and using an inflation factor to adjust rates of a cost or rates set by a cost methodology for a specific company, this paragraph is not relevant.

Q. In your opinion, do rates set under the indexation formula at FERC for oil pipelines meet the cost-of-service criteria under FASB 71?

A. Yes, it does.

Q. Mr. Ganz also testified regarding the accounting for the sale of SeaTac facilities, and he compared what he called the proper accounting for the gain of that sale under the USOA versus GAAP. Do you recall that?

A. Yes, I do.

Q. Is he correct?

A. Mr. Ganz was pointing out that he felt that under GAAP, the sale would be recognized as gain and would flow through the income statement as income. Whereas under regulatory accounting, it's just offset to the accumulated depreciation.

He's incorrect. If you look at any intermediate accounting book, that standard accounting for group asset accounting, GAAP recognizes that it's a group asset, so under GAAP, it would also be offset to the accumulated depreciation.

Q. Mr. Ganz also discussed the painting of storage tanks in his testimony as an example of an activity that extends the life of an asset but is expensed. Do you recall that?

A. Yes, I do.

Q. How do you respond to that testimony?

A. Again, I think he misunderstood the dynamic. In this case, I guess, the oil pipeline is closer to a water utility than any other utility. It's standard in a water utility that has many tank farms that they have -- hypothetically when you paint a tank, it lasts three years. What they will do is they will take one-third of the tanks, and they will paint a third of the tanks every year, so at the end of the life of the tanks, they will be starting to repaint the next tank.

Now theoretically, everytime they paint a tank, it should be capitalized one after another and then you would start depreciation. But as for administrative convenience, you get the same result by expensing a third of the expense, or I'm sorry. Your expensing the cost of painting a third of the tanks is equal to depreciation that would be produced if you capitalized one after the other. So it's basically an administrative convenience and you get the same amount.

Now, in the same basis, if there is a small water company that might have one tank farm and they paint that tank farm, we would depreciate it over three years. It would be capitalized and depreciated. So it's not an example of a maintenance cost that extends the life and it's not capitalized. In fact, it would be capitalized.

MR. TROTTER: Your Honor, those are all my additional questions. Mr. Kermode is available for cross-examination.

JUDGE WALLIS: Mr. Harrigan?

CROSS-EXAMINATION

BY MR. HARRIGAN:

Q. Would you take a look at Page 5 of your testimony?

MR. TROTTER: Excuse me. I forgot. We did issue an errata for Mr. Kermode, which I apparently don't have with me. I did circulate it to the parties yesterday and to the Commission, so perhaps if the witness -- there are two corrections if he could go through them on the record and we can accommodate that. I apologize. Mr. Kermode, can you refer us to the changes?

THE WITNESS: Yes. On Page 10 starting at Line 6, second sentence, starting "the." It's the last word --

MR. TROTTER: That would be the third sentence?

THE WITNESS: Yes. I'm striking, "the issues that I address such as the use of modified cash basis and recording of AFUDC are the same between the two systems."

Q. So strike the "the" on Line 6, 7 and 8?

A. Yes.

Q. The second set of changes?

JUDGE WALLIS: Is this a correction that might be made after the evening break?

THE WITNESS: It's a short strike.

MR. TROTTER: We circulated this, and hopefully, the parties have it. I'm happy to do whatever you think is appropriate at this time.

JUDGE WALLIS: Unless it's likely to be a matter of substance, why don't we catch that after the break. Now, Mr. Harrigan?

Q. (By Mr. Harrigan) I was asking you to take a look at Page 5.

A. I'm there.

Q. Line 26, you say, "In Title 18 CFR Part 352, Chapter 1, Paragraph 1 to 2, FERC requires all carriers to keep their accounts and records in accordance with FERC Uniform System of Accounts;" correct?

A. Correct.

Q. And that applies to Olympic.

A. Correct.

Q. Now, in your testimony at Page 7, you indicate down at the bottom of that page that you made an examination of a certain month, September. What year was that?

A. It was the test year.

Q. 2001?

A. Yes.

Q. You examined that single month for what?

A. I was looking for anything unusual, so I wasn't specifically looking for a thing. I was just checking for anything that might catch my attention.

Q. Does your testimony contain the unusual thing that you found?

A. Yes, it does.

Q. Did you look at any other months in the test year for this purpose?
A. Yes, I did.
Q. What you are discussing here are invoices that were recorded, correct, invoices that were contained in the September ledger account.
A. It appears what I'm looking at more fully was the cash payment of invoices, yes.
Q. But what you started with, you said, "I found that Olympic recorded 148 transactions in its September ledger account for other specialized services;" right?
A. Correct.
Q. What did you then learn about those 148 transactions that were recorded during September?
A. That only 23 were actually dated or had document dates related to September.
Q. What was unusual about that?
A. Being an accrual basis -- I initially looked at this when I started looking at the ledger. I went on the basis that the Company was on a full accrual method of accounting, so by looking at those -- ask me the question again.
Q. You said only 23 had September invoice dates; right?
A. Yes.

Q. What was unusual about that?
A. Because being on an accrual basis, I would expect all of them to have September dates.
Q. So you would expect them to be recorded in the month that the invoice was received?
A. Yes.
Q. What you found, in fact, was that, according to your testimony, 73 were from the previous month, August. This is out of 148; right?
A. Yes.
Q. 31 were from two months earlier, July?
A. Correct.
Q. Then there were 15 from June, and then that leaves six unaccounted for; right? That is, six that are not within the period June, July, August or September.
A. Correct.
Q. You found that of those six, three were in May, two were from March, none from April, and one from February; right?
A. Correct.
Q. What does the USOA say about the requirement for recording such costs?
A. It says expense shall be consistently applied.

Q. Let me refer you to USOA General Instruction 1-3(A) which you paraphrase in your testimony, and in your testimony, you say on the same page right above this paragraph which we were just talking about, you say, "The FERC USOA requires that all transactions be entered not later than 60 days after the last day of the period ended," and then you cite 18 CFR. Do you see that in your testimony?

A. Yes.

Q. If you will bear with me, I would like to read to you the precise language you are referring to, and this is found in Exhibit 1105, which does not have page numbers for some reason, but Exhibit 1105 is the USOA 18 CFR 352, and I'm going to read the section, and if you would like to check it, I've got a copy for you.

And specifically it says: "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." Under that standard, how long after September 30th would Olympic have to record invoices received during the month of September?

A. Let's be clear here on that question. Are we talking about recording the invoice into the proper month, or are we talking about recording the invoice in a month that it's not related to? I'm asking you.

Q. My question to you is, with respect to invoices which are received in September, how long would Olympic have after September 30th under this standard to -- let's say, just for example, Olympic receives 20 invoices with September dates on them, which is what you are talking about here, right, is that it had 23 September invoices with September document dates. How long would Olympic have to enter those invoices into its accounts under this USOA standard?

A. It has 60 days to enter the invoices and to close that month, so those invoices would go into the September ledger, and they have 60 days to go into the September ledger.

Q. So how long did Olympic have to enter the invoices that were received in July?

A. Into the July books or into the September books?

Q. Into any books.

A. You have to give me a point in time here.

Q. Let me ask you a slightly different question. In your paraphrase of this provision in your testimony, you don't make a reference to the phrase "as nearly as may be ascertained," which is contained here.

Take, for example, the invoice from February, the one in February that was not entered in the books until September, what was the nature of that invoice?

A. I don't know.

Q. What was the amount?

A. Don't know.

Q. What was the work that was done?

A. Irrelevant, don't know.

Q. Was there a dispute with regard to the amount that was owed?

A. Doesn't matter, don't know.

Q. So is it your testimony that one should enter the expense in the books of account even when there is a dispute regarding the amount and you don't know what the check is going to be written for yet?

A. Absolutely, absolutely. You either estimate it. You put it into a liability account, put it in a clearing account. I've done that before. If there is a dispute and it's a February invoice, it goes into the February general ledger, and when a manager reads it, they know right there that there is an invoice that's been received for $20,000, and if it's in a clearing account, the manager is going to say, "Why is it in there?" If it's not in the clearing account and it's not recorded, the manager is going to have no idea it's even out there.

Q. The USOA standard that we are looking at here which says that the transaction shall be entered as nearly as may be ascertained, do you regard that as not referring in any way to uncertainty with regard to the proper amount to enter?

A. And I guess that's the question. If one person has a -- that the vendor fills its 20,000 and the company believes its 10,000, and the invoice is for 20,000, if I was the controller, I would book 10,000 to the expense and 10,000 to the clearing account.

Q. However, you are not telling us that you can authoritatively state that that is what this standard under USOA requires, are you?

A. It means to make a good-faith effort and estimate as to what that liability is or that invoice is --

Q. Excuse me, but what it says is that you shall as nearly as may be ascertained enter the amount -- excuse me -- enter the amount in the accounts not later than 60 days, etcetera. Is that correct?

A. I'm sorry. Restate that.

Q. Let me refer you specifically to the language that says, "shall be entered in the accounts not later than 60 days after the last day of the period for which the accounts are stated." In this case, the period for which the accounts was stated was September; correct?

A. Correct.

Q. Is it correct that you do not know the actual nature of the work performed with respect to any of the five invoices that were actually tendered prior to June?

A. That would be my testimony. It's irrelevant.

Q. You don't know whether there were any disputes with regard to any of those invoices?

MR. TROTTER: I'm going to object. This has been asked and answered, and the witness has fully explained how the appropriate booking should be obtained.

MR. HARRIGAN: I don't believe I asked about anything except February, and I just want to clarify.

Q. (By Mr. Harrigan) Is it correct that you do not know the nature of the work, the amounts, or whether there were disputes with respect to any of the 148 invoices?

A. As to the thrust of my testimony, I didn't need to.

Q. Is it your testimony that, in fact, you did not have that information and do not have that information?

A. I didn't pursue it and I didn't need it.

Q. Do you have any information with regard to the invoices that were recorded for the months of June, July, or August, the invoices that were recorded in the accounts in those months?

A. The information I have is that they were recorded late, but that's all the information.

Q. Do you have any quantification of you that they were recorded late?

A. I don't understand the question.

Q. Do you have a similar statistical survey for any other month?

A. No. Though I did scan some other months, and they had the same dynamics.

Q. What is your understanding of the term "transaction" in USOA General Instruction 1-3?

A. I would say it's a business transaction.

Q. If you are the company that's operating the backhoe, have you had a business transaction until you've been paid?

A. If I have a backhoe and I go and dig a trench in September, when I'm done with that trench, I've had a business transaction. I now can invoice you. You now owe me money.

Q. So you are interpreting the term "transaction," and let's review this one more time. What is supposed to be entered in the accounts is all transactions; correct?

A. All transactions, correct.

Q. It is simply your view that this transaction is complete when the work is done before the person performing the work has been paid or even the invoice approved for payment.

A. Say it again.

Q. You are basically interpreting this general instruction, the term "transaction" in this general instruction, to mean that the transaction is completed when work has been performed even though no invoice has been paid or even approved for payment.

A. No. Now the "completed" came in there. You asked when a transaction happened. That's when a transaction. The transaction is completed when payment is made.

Q. Doesn't Olympic record its payments and its costs at the time that the invoices are approved for payment?

A. My understanding is they recorded the transaction when they pay it, not approve for payment.

Q. I believe Ms. Hammer said it was, in fact, when they were approved for payment.

A. It may be a subtly. I'm sure the difference between when its approved and when it pays is not material to her.

Q. So really, the question whether Olympic is complying with the standard or not depends on your definition of "transaction," doesn't it?

A. No, not at all. It says here, "...shall keep all books on a monthly basis so all transactions..." It does not say "all completed transactions." It says "all transactions as nearly as can be ascertained." So when somebody sends you an invoice or does a job, that's a transaction.

Q. Which one? When they do a job or send the invoice?

A. It's part of the process. The actual transaction, I would say, is when they dig the trench and you at that moment owe them money.

Q. So actually, what should happen is Olympic should record the backhoe work when its done even though they don't have the invoice yet.

A. From pure accounting, an accountant would love that. I think that's precisely what should, in the theoretical sense, happen, but obviously in the real world, you can't do that, and that's where we use invoices, and invoices do a good job as far as tracking it, but you are right, the liability in the pure sense, and like I said, the accounting world would love to be able to record a transaction at that moment in time, but in reality, you can't.

Q. And basically, you are confirming, I believe, that to the best of your knowledge, all 148 of these invoices that were recorded in the month of September were not approved for payment prior to the month of September; correct?

A. I have no idea.

Q. In other words, as far as you know, they were all approved for payment in September and paid in September and recorded in September; right?

A. No. I have no idea when they were approved for payment. The one in February could have been approved, sitting on somebody's desk and never made it, so no, I can't testify to that.

Q. What you are saying is you have no idea of whether they were approved or not for payment in September. Therefore, as far as you know, they may all have been.

MR. TROTTER: I'll object to the question. He's testified he didn't know when they were approved for payment, so that was also a compound question.

MR. HARRIGAN: I'll withdraw that question. I think it's probably clear enough what the witness does and does not know about that.

Q. (By Mr. Harrigan) I would be interested in finding out about the change that you have identified on Page 10. The question that you were asked on Page 10 at Line 5 is whether the FERC Uniform System of Accounts is considered an "other comprehensive basis of accounting," right, otherwise known as an OCBOA.

Then after confirming that it is considered one of those, you said that the difference between FERC and GAAP are few and specific, and then what you struck was the issues that I addressed, such as the use of the modified cash basis and the recording of AFUDC are the same between the two systems. Isn't it, in fact, the case that they are not the same between the two systems?

A. What I did was put in modified cash basis. That's a basis of accounting with itself, so I was comparing FERC and GAAP and saying that the modified cash basis is the same between them. Well, it can't. It's a separate type of accounting basis, so it was an invalid comparison.

Q. At the time that you prepared your testimony, were you familiar with the fact that the pipeline industry and FERC in its regulation of the pipeline industry had employed the concept of units of property in differentiating between capitalized costs and expensed costs?

MR. TROTTER: I'll object to the question. It assumes a fact not in evidence.

JUDGE WALLIS: The witness may respond if the witness knows the answer.

THE WITNESS: Could you repeat it?

Q. (By Mr. Harrigan) Were you here during Mr. Talley's testimony?

A. No, I was not.

Q. When you prepared your testimony, were you aware that the pipeline industry as regulated by FERC and pursuant to FERC regulations had employed a concept known as "units of property" in differentiating between what types of expenses should be capitalized and which should be expensed?

A. Actually, that's a two-part question for me. First is did I know that the industry employs the unit methodology. I read about the industry using that methodology. When I prepared my testimony, I saw no evidence that Olympic Pipe Line used it.

Q. Did you look for any?

A. Again, I was examining documents looking for evidence of how the Company handled its accounting, so I did not specifically go in there looking for retirement units, minor units. In fact, I found none. If I would have seen them, I would have recognized them.

Q. Did you look for them?

A. I was examining the records to find out what kind of accounting they used. I was not examining the records to -- I did not make a list of accounting and go look for those accounting principles or accounting techniques. Instead, I was reading the information I got to understand the accounting methodologies and techniques that were used.

Q. Do you know what the unit of property that FERC approved in the past was for a pipeline, the pipeline itself, the physical object, the pipeline?

A. Before they repealed it?

Q. Right.

A. No.

Q. Would the number 1,000 feet surprise you?

A. Doesn't surprise me; doesn't do anything. It's interesting.

Q. Is it your understanding what that meant was that even if you replaced 800 feet of pipeline that you would expense it, and that you would only capitalize a replacement if it exceeded 1,000 feet?

MR. BRENA: I have an objection, and it's based on relevancy. I think that we are exploring the unit of throughput mechanism that FERC used to employ at some historic point in the past, and I suppose if the relevancy to this proceeding could be addressed.

JUDGE WALLIS: Mr. Harrigan?

MR. HARRIGAN: I'm going to connect this to the present momentarily. I just wanted to clarify what the actual concept of unit of property implied first. I will represent to you that Mr. Talley testified that although FERC no longer has its own requirements of units of property, it requires the pipeline companies to maintain units of property. Olympic does maintain units of property, and it still uses the same ones that FERC used to require.

MR. BRENA: I withdraw my objection.

MR. TROTTER: I'll object after the fact that I don't think Mr. Talley said all of that.

JUDGE WALLIS: Mr. Talley's testimony will be available for review, and we will allow this line of questioning.

Q. (By Mr. Harrigan) Is it your understanding that, assuming with me for the moment that the unit of property for the pipeline itself was 1,000 feet, that under the FERC methodology that applied when it had its own such requirements, if you replace 900 feet, you would expense it. If you replaced 1,100 feet, you would capitalize it.

A. That's correct.

Q. Do you have any knowledge as to whether Olympic, in fact, still maintains essentially the same units of property and uses essentially the same differentiation method between capital and expense as applied when FERC required specific units of property?

A. I saw no evidence of that.

Q. My question is whether you have any knowledge to the contrary as to whether Olympic, in fact, is following that system today?

A. I guess I was surprised at Ms. Hammer's deposition when asked about replacement. She didn't refer to units of property. What she referred to is -- I'm paraphrasing -- we put it back the way it was. Even Mr. Ganz's testimony says, It's back to the way it was. That's why it's maintenance.

So everything that I had looked at appears to be contrary to the unit-of-property methodology. I would expect Ms. Hammer to say, Well, because that's a minor unit of property, we expensed it.

Q. Can you testify to this Commission under oath that you've determined that Olympic, in fact, is not using the unit-of-property system as I've generally described it?

A. No. All I can testify to is I've seen no explicit -- anything I reviewed did not show a solid reliance on units-of-property approach to expensing and capitalization.

Q. Does the USOA require Olympic to record AFUDC on its books and records as opposed to making a calculation of it and submitting it at the time that it submits Form No. 6?

MR. TROTTER: I will object. That's a compound question, and I don't think USOA requires FERC Form 6, so I'll object to lack of foundation to the second question.

JUDGE WALLIS: Mr. Harrigan, do you want to split it up?

Q. (By Mr. Harrigan) Does Olympic compute and record AFUDC on its Form 6, the ones that you reviewed?

A. On Page 700?

Q. Anywhere.

A. I believe on Page 700 they do, yes.

Q. Does USOA, the Uniform System of Accounts that FERC requires Olympic to follow according to Page 5 of your testimony, require Olympic to record

AFUDC on its books as opposed to calculating it and putting it on Form No. 6?

A. It does not prohibit.

Q. Does it require it?

A. No, it does not.

Q. Do you have any disagreement that AFUDC is properly allowed as part of the rate-making process in this proceeding as under FERC? I'm not asking whether you agree on the number, but do you agree it's an appropriate element?

A. Yes, it is.

Q. It's appropriate whether or not Olympic records it on its books, isn't it?

A. Not relying on the number, but yes, that's correct.

Q. You talked in your supplemental direct just a minute ago about the recording of the gain on the SeaTac sale. Is there any difference of opinion between you and Olympic's rate case regarding the calculation of the amount of the gain and its effect in this proceeding, or are you in agreement on the outcome?

A. I agree with Staff's methodology, if that's what you are asking.

Q. No. I'm asking you whether there is any disagreement between you or anyone else on the staff and Olympic's rate case in terms of the result; that is, the effect, the financial or monetary effect of the gain on this proceeding?

A. No.

MR. HARRIGAN: That's all I have. Sorry, I forgot one whole segment.

Q. I did want to ask you about the paragraph in FASB 71 that you talked about. Would you be kind enough to read Footnote No. 37 aloud that you referred to in Order No. 561?

A. Again, I want to highlight this in contrast to the rest of the Order. "Indexing fosters efficiency by severing the linkage between traditional cost of service, rate-making between a pipeline's rate changes, and the changes in its current operating and investment costs. This provides the pipeline with the incentive to cut costs aggressively since it is assured it may retain a portion of the savings it generates."

Q. The relationship that's being severed there is, according to that footnote, at any rate, the relationship between the specific enterprises costs and the rate as opposed to the indexed costs.

A. Again, I disagree, but what's that the footnote says.

Q. Looking at the paragraph from FASB 71, which is Paragraph 65, and that has now been marked, but I don't have the number written on it.

MR. TROTTER: 1807.

Q. What Paragraph 65 talks about is whether the second criterion for applying FASB 71 is met; right?

A. That's correct.

Q. If that second criterion is not met in a particular instance, then FASB 71 does not apply in that instance.

A. I'm sorry. You are asking me if this was the criteria as to if it was met. It is not the criteria. It's one of the tests as to if it's not met.

Q. In other words, as I understand it, there are three bases on which it can be determined that FASB 71 does not apply, and this second one is one of those.

A. That's correct.

Q. What this paragraph is talking about is one aspect of applying the second criterion.

A. Correct.

Q. And it says, "If rates are based on industry costs or some other measure that is not directly related to the specific enterprises costs, there is no cause-and-effect relationship between the enterprises costs and its revenues." And essentially, it goes on to say that where that is true, FASB 71 doesn't apply; right?

A. Correct.

Q. What the footnote that you just read is saying is that when rates are based on indexing, the relationship to the specific enterprises costs is severed; right?

A. Again, the footnote is in conflict with the rest of 561 and 561-A. If you read either of those, you will see that actually there is a direct link between the two.

Q. When you say, "the footnote is in conflict with 561," the footnote is in 561, is it not?

A. The body of 561.

Q. The footnote is in 561, is it not?

A. I'm differentiating between the actual Order itself and the footnotes. Yes, it is in 561, but it is in conflict with the rest of 561.

Q. Do you have any knowledge as to whether Olympic's rates have been the result of indexing?

A. My research shows that it has not been.

Q. Does your research exclude -- did your research extend to the cases in which the rates went up, or was it limited to the three where they went down?

A. I did an entire search of the entire docket at FERC, and I did not open every case, but I also searched companies that had index changes, and the description was explicit that there is index change. Back to 1982, I saw no description that described index filing.

Q. Do you agree that there is a potential for Olympic's rates to result from indexing at any point in time?

MR. TROTTER: I'll object --

Q. In other words, is Olympic potentially subject to index rates?

MR. BRENA: Could I ask for clarification, if we are talking about federal indexing?

MR. HARRIGAN: We are.

MR. BRENA: Then I will object based on relevance. There isn't an indexing system in this state.

JUDGE WALLIS: The topic has been explored. I believe that this question is within the topic, and I will allow it.

THE WITNESS: Could you ask the question again?

Q. (By Mr. Harrigan) Is Olympic potentially subject to FERC index indexed rates?

A. Yes, they are.
Q. In the circumstances of a company with a single pipeline operation, does FASB 71 provide for a situation where you would apply it to the intrastate rate-setting process and not to the interstate?
A. Yes.
Q. Doesn't the situation of differentiating apply only where there are multiple operations?
A. No. They are talking about jurisdiction. If in one jurisdiction the criteria is met and in another jurisdiction, the criteria is not met, the jurisdiction in which it is not met, FASB 71 will be discontinued, and the one that is met obviously continues.
Q. You are suggesting that that is independent of whether you can segregate the operation of the business when it has a single operation like a pipeline where the same material is flowing through the same line that goes to the intrastate destinations as to the interstate destinations?
A. One is interstate. One is intrastate. We do separations all the time. I believe your auditor should be able to do that, but he wouldn't have to because indexing falls under FASB 71.
Q. According to your interpretation of Footnote 37 and the balance of 561.

A. Actually, the FASB released -- off the top of my head, I can remember too there is a FASB 33 that has been superceded. FASB 89, both of them deal with price changes due to inflation, and what they do is they take the financial statement and they adjust -- it was an experiment during the periods of hyperinflation.

They adjusted financial statements for the effects of inflation, and they used basically the same approach. They used, I think, the CPI instead, and they would adjust the assets up to the current cost. I think FASB would have a hard time with somebody saying that by adjusting those financials under 33 and 89 that those financials for that specific company is no longer cost-based. Of course they are cost-based. They are cost-based adjusted for inflation.

Q. Has this Commission entered an order creating a system of accounting that it has directed Olympic Pipe Line to follow and is filing it for its rate increases?

A. No, I believe not.

Q. Has this Commission accepted filings from Olympic for years that were based on the FERC system of accounting?

MR. TROTTER: I'll object to the question. The word "acceptance" is a legal term, or it's a confusing term.

MR. HARRIGAN: I'll change the question.

Q. Has this Commission acted upon and issued rates based on filings by Olympic under the USOA and FERC-based accounting systems for many years?

MR. TROTTER: I'm going to object to the same question. "Acted upon," again, from what I understand, the Commission did not act upon. They let the rates go into effect by operation of law. I don't want to be hung up on semantics here, but --

JUDGE WALLIS: We understand the difference in perspective, and rather than resolve that here, Mr. Harrigan, if you want to try to rephrase the question.

Q. (By Mr. Harrigan) Are you aware that this Commission has in any previous year objected to Olympic's filing it for rate increases based upon the submission of a Form 6 and otherwise complying with the FERC and USOA requirements?

A. It's my understanding they've allowed -- the Commission has allowed the rates to go in through the operation of law.

Q. Based upon filings that were prepared in accordance with the FERC and USOA requirements; right?

MR. TROTTER: I'll object at this point. I think this is beyond the scope of this witness's testimony. If he has personal knowledge, that's fine. I don't think he does.

JUDGE WALLIS: The witness may respond, if he knows.

THE WITNESS: I would rather not answer. I believe it would be more of a guess.

MR. HARRIGAN: I have no other questions.

JUDGE WALLIS: Let's take our break now. We'll return at 7:15.

(Dinner recess taken at 5:45 p.m.)

EVENING SESSION

(7:20 p.m.)

JUDGE WALLIS: As a preliminary matter, Mr. Trotter has provided copies of errata to the testimony of Danny P. Kermode consisting of one page plus cover sheet and certificate of service. I'm marking that as Exhibit 1809 for identification. Is there any objection to its receipt in evidence? Let the record show there is no response, and 1809 is received. Commissioner questions?

CROSS-EXAMINATION

BY CHAIRWOMAN SHOWALTER:

Q. If you could turn to Exhibit 1105, and in particular, it seems to be Section 1-3.

A. I'm there.

Q. I would like to try to understand this a little better, and I would like to look at 1-3 and 1-4, but I'm hoping to go only one sentence at a time. So focusing on the first sentence, which begins, "Each carrier shall...", it seems to me to state that as near as may be ascertained that you enter the transactions into the account not 60 days after the last day of the period -- and here's what I want to concentrate on --

the period for which the accounts are stated. So doesn't that mean if you are entering something for the month of September, you should accomplish it within 60 days after the last day of September?

A. Yes. Usually, we call it a closing period. We have 60 days to close that month's books.

Q. But this sentence alone doesn't tell me what should go into September. So far, all it says is for things that are going into September, get it done by 60 days after the last day of September, this sentence alone.

A. Correct.

Q. So now I'm asking, the next question is, well, what should go in the month of September, and that wasn't the question to you. I read to 1-4, which is the accounting method, and it says, "This system of accounts shall be kept by the accrual method," and that led me to speculate, well, maybe that will tell us what's supposed to go into September as opposed to things that don't.

Now, the next sentence simply says, "The basis for accruing shall be consistently applied." So to me, that sentence also isn't actually telling me what goes into the month of September. It just says, whatever you do do, do it consistently. Do you agree with that?

A. I think accounting, per se, no matter what basis of accounting you have -- you have regulatory accounting, financial accounting -- they all have at their root a basic understanding, if you will, of when a transaction is incurred, and so I believe when they say the basis used for accruing income or expense items for each month shall be consistently applied, that basis is when that transaction is incurred, and I think that applies to at least the forms we are talking about, the regulatory form and the GAAP form, so I think that when that transaction is incurred, that's when it should be recorded, and it should be recorded on a consistent basis.

Q. Well, I understand the consistent part, but it seems to me that without reverting to something else, perhaps a common understanding of what accrual method means, I don't know, but the only thing I'm getting out of these sentences, per se, is do it within 60 days and be consistent.

But as to the third piece, which I think was your piece, was saying, And furthermore, you must account for the transaction in the month in which, well, in which, what, in which its billed to you or theoretically the month that the liability arose, but for that third piece, in your view, is it stated right here, or do you have to know from elsewhere what the accrual method is?

A. I believe you have to know from elsewhere, and I believe that's something that I refer to in my testimony that the FERC USOA is really a road map, a general road map, but you have to go deeper. You have to go into that general accounting literature, which is basically GAAP, and the FERC USOA relies heavily on GAAP.

Q. So when the sentence says, "This system of accounts shall be kept by the accrual method of accounting," it's alluding to something called the accrual method of accounting, which it's presuming readers, or at least experts, will know what it means.

A. And it has a defined term. It's when expenses incurred or revenues earned. That's a nice broad Accounting 101 cut at it.

Q. Of course, I never took Accounting 101, which is one of the problems here, but it's not a defined term, actually, in this document. I looked that up, and it's not there, so we have to look elsewhere for what the accrual method means.

A. And I believe that accounting literature, per se, discusses that concept deeper.

Q. So is it correct to say that given your understanding of what the accrual method means to begin with, then when you combine that understanding with these sentences here, it means, to you, that transactions for which one receives a bill in the month of September should be accounted for in September and should be booked within 60 days of the end of September?

A. That's a valid statement.

Q. Next I want to turn to the discussion of does or doesn't FASB apply, and I think I want to focus on Mr. Ganz's testimony, which is Exhibit 1101-T on Page 7. At least that's a good place to start. One of my problems with trying to understand this is that there seems to be exceptions to exceptions or multiple criteria. By the time you get finished, I forget where I am. So can we begin in the most elementary way so I'm not going the wrong way? To begin with, is it your view that FASB 71 does apply?

A. FASB 71 does apply, yes.

Q. Then do you agree that in order for FASB 71 to apply, three criteria must be met?

A. Yes.

Q. Now looking at Mr. Ganz's testimony on Page 7, he's focusing on the second criterion. The

first point is that all three criteria must be present in order for FASB 71 to apply; is that correct?
A. Yes. If one fails, it does not apply.
Q. But now that we are just focused on the second one, he has four elements, and am I right that if any of the four is applicable, then does the second criterion apply, or must all four of these apply?
A. Those four, Line 8 through 16 are rate-making methodologies that the FERC uses so --
Q. But they are in the alternative, aren't they?
A. I believe the indexed rates on Line 8 is the primary, what FERC considers the primary rate-making methodology. The other two, market-based rates, settlement rates, and cost-of-service rates, are secondary.
Q. All right, but let me ask this question. The criterion is up at Line 4, and it's that rates are designed to recover the specific enterprises costs, so that's the criterion. So now we have to decide, or this line of thinking is trying to decide, whether rates are designed to cover the specific enterprises costs.
A. Correct, through the FERC methodology.
Q. The first thing on the second criterion -- it's not all laid out here, but is the criterion that

rates are designed to recover the specific enterprises costs, or is it that rates are designed to recover the specific enterprises costs under FERC methodology?

A. No. Whatever methodology, the methodology is wide open as long as the rates are designed to recover that specific enterprises costs.

Q. So in general, if rates are cost-based, then the criterion will be met; is that correct, in your opinion?

A. I believe that's true, yes.

Q. We might have some arguments about what is or isn't cost-based.

A. That's correct.

Q. But whatever it is, it need not be FERC's cost-based.

A. That's correct.

Q. In fact, is this criterion limited to the jurisdiction at issue?

A. No. It's any regulatory body as long as those rates of that regulated entity are set to recover its costs.

Q. But let's suppose in this state, we have cost-based rates and that at FERC, they don't have cost-based rates. What does that mean for the second criterion?

A. There is a provision in FASB 71 that says if in one jurisdiction, the criteria does not meet, and in another jurisdiction, it does meet, the jurisdiction of which it does not meet, FASB 71 will not be applied, and the jurisdiction it does will be applied, so you could have --

FASB 71 says AFUDC is allowed for regulated entities, not for regular entities, so they would literally have the AFUDC from the jurisdiction that the criteria applies to on the books. The other part of the operations of the same company that the criteria did not apply to would not be allowed to approve AFUDC for financial reporting purposes.

Q. For our purposes here in this Commission, aren't we trying to decide whether we either have or will have -- let's not splice that one -- rates designed to recover this specific company's costs?

A. I believe even if -- again, just esoterically -- if the Commission took the FERC approach or maintained the regular depreciated original cost approach, both of those methods are designed to recover Olympic's costs, and therefore, FASB 71 would apply.

Q. That wasn't my question. My question is regardless of where we get our own rates from, isn't the question for us whether our rates, however derived, are designed to recover costs for purposes of our applying FASB 71 or not? Supposing we decide not to have a cost-based rate but FERC does. Would the second criterion be met for this jurisdiction?

A. No.

Q. So isn't the only question that we need to answer is whether this Commission's rates have been/are/will be designed to cover costs?

A. Yes.

Q. Then the next question is, well, what are our rates designed to do, and one of the proposals in front of us is to use the FERC methodology.

A. Correct.

Q. So now where you were leading, so if we adopt the company's proposal to use the FERC methodology, then we get into the question of whether the FERC methodology, or not the FERC methodology, but the company's rates are designed to recover costs under FERC methodology.

A. Yes.

Q. Then that brings us over to this Footnote 37, I think, in the Order, so maybe we can turn to that, but I'm going to come back to those other points under Mr. Ganz's testimony.

I'm now looking at this Order 561, and the pages on the cover, Footnote 37, and I did have time to look at this a little bit. This Order may be out of date, but let's stick with this Order for the time being. On Page 30947, which is the page before the footnote, I see that it says, "The indexing system is a methodology for changing rates. Generally, the initial rate will be established by a cost-of-service showing," and that would be my first clue that index rates are designed to recover costs because they start with, generally, by establishing the costs and then ratcheting up or down.

A. Correct.

Q. And then I also noticed on the next page, on Page 30949, the bottom of the first column, it says, "First, the indexing methodology selected by the Commission in this final rule is cost-based. That's further discussed below," and it goes on.

I guess what I'm wondering about is the interplay of this language and the footnote, and would this interpretation be correct, indexing begins with costs and is a cost-based methodology, but once the costs are established, the rates go up and down according to an index, not, per se, the costs of the company, but that the index itself is designed to roughly correlate with the costs once they are established.

A. I would consider the indexing is a surrogate for the actual costs.

Q. So it's a matter, I suppose, of interpretation in the end whether we on this Commission would, should we use the FERC methodology beside that the indexing method, if the company uses it, is cost-based or not?

A. One reason I guess I spend some time looking at this is that Olympic Pipe Line will be getting a financial audit, and the prior auditors apparently did not think, Arthur Anderson did not think that FASB 71 applied.

As pointed out, the AFUDC is obviously an integral part of their rate case. By having FASB 71 apply, the company's auditors would review the AFUDC calculation annually, and if it's probable that the recovery will happen, then they will put it on the books, and I think for this Commission, it gives some level of assurance that that AFUDC number is not only being recorded contemporaneously with the rest of the financials but it has been reviewed by an independent party.

Q. Back on Mr. Ganz's testimony, 1101-T, Page 7, he lists between Lines 8 and 16 these four possibilities. If we are down at Line 16, cost-of-service rates, rates based on 154-B methodology, if that is the case, is the second criterion clearly met?

A. Yes, it is.

Q. My last area of inquiry is on the painting of the pipelines.

A. The tanks.

Q. Now I'm mixed up already. Remind me what was the operation that had to do with the length of the pipelines?

A. That was replacement of pipe.

Q. In your view, how should replacement pipe be accounted if it's less than 1,000 feet?

A. Using the units-of-property theory, it should be expensed. And what happens, and you see this when you have a multiple-year history, using units of property, those costs will reoccur. They will come and reoccur and reoccur, and it's proper. That works. It's when regulated companies --

The New York Times had the article about companies that tend to overcapitalize to increase the bottom line. Regulated companies have the tendency to undercapitalize to decrease the bottom line. I think the problem that I'm approaching in my testimony is the major maintenance expenses that are being expensed that are not reoccurring.

Now, rates can be set to recover a previously incurred cost, and I think you mentioned at one time about earthquake damage. That damage can be recovered over a three-year period. That's an incurred cost that's allowed for regulatory purposes to be recovered over a period of time. That's a previously incurred cost.

Then you have a cost that you expect to reoccur, so the rates are being put in place not because of that expense but because we expect similar expenses to come in the future. The line lowering and some of the other major maintenance issues, I don't think, do not appear to be recurring in nature.

Q. But my question was more about pipe replacement.

A. Pipe replacement, I think in a solid compliance with the units-of-property approach with realistic standards, and they mention they maintain the FERC standard, I think should be expensed.

Q. Is that what the Staff proposal contains?

A. I believe, and I guess that's why I digressed. I believe that Staff's proposal is removing the major maintenance expenses as being not reoccurring and not based on a unit-of-property concept.

Q. Is pipe replacement in the Staff's view today, your view today, considered to be a reoccurring expensed cost or not?

A. I will have to defer that to Mr. Colbo. I don't know. I just know that it seems like an oxymoron to me when we talk about minor units being replaced under major maintenance one-time expenses. It doesn't seem to make sense to me.

Q. What I'm trying to do is get away from a label called "major maintenance" and trying to determine, is it something that should be called an expense or is it something that's capital, and what actually is it? What's happening on the ground and how should we treat that, because in the end, don't we have to make that kind of judgment. That is, it's not a matter of labels. It's a matter of judgment as to what label to give it?

A. That's correct.

Q. So you think Mr. Colbo is the better person to ask that particular question?

A. I believe he looked closer at those specific transactions better than I did.

Q. What about painting the tanks? Is he the more appropriate person to ask that question?

A. I addressed it just because Mr. Ganz addressed it. As far as the actual expenses being claimed by the Company, Mr. Colbo would be the one. Mr. Ganz refers to it as, like I said before, that this is a maintenance item that increases life over one year. However, it's a maintenance item that's expensed, and that's why I discussed it. As far as that it's more of an administrative convenience that's done that way than actual compliance with any type of theory.

Q. As far as line lowering, why the line is being lowered and what the effect of it is on the line, is Mr. Colbo better for me to ask that question or you?

A. Let me try.

Q. All right. First of all, am I correct that in Staff's case, that's considered to be a capital expenditure?

A. That's correct.

Q. So the question is why? Is it because it's one time or because it has some life-extending property about it or both?

A. I would say both, and that it's -- I believe the Company is trying to somehow bring the 1,000 feet of pipe replacement to a line lowering. In my mind, I can see a crew going out and pulling 100 feet of line and replacing it.

To me, there is no comparison between stopping a river, digging a trench, reengineering, lowering it down. There is no comparison, so I think that not only is it extending life, the question of the reengineering, everything involved, and frankly, I think the size of the expense -- I think regulatory theory allows, like you said on the earthquake damage, if this thing is truly -- I believe it was 400,000 -- if this is extraordinary, then it either should be removed as one time or as a matter of fairness, recovered over an extended amount of time, and that's just giving the benefit of doubt that it should not be capitalized, but to run it through the income statement for recovery and rates in one year without any type of track record that this line lowering happens every year, I think Staff would be very hard put to recommend that.

Q. If you had a section of pipe of the same length, but somewhere else, some nondescript farmland, but something had happened to it causing the Company to have to dig it up and replace it, for a normal type cost to dig such a pipe up and replace it, would you categorize such an expense differently from the line

lowering in this instance?
A. Yes, I would, because I believe it's routine, and that's probably something that happens every month of the year, probably multiple times. Especially since Olympic is spending an awful lot of time breaking on things, obviously, it's going to happen a lot. I guess the only caveat is that this routine expense in this case higher than normal because of their program is so strong, but in general in the theoretical sense, yeah, I believe that would be a maintenance expense.
Q. For the line lowering cost, if it were amortized over some period of years, then some of the costs would be recognized in expense items for the test year; is that correct?
A. Correct, depending on the length that you were amortizing it. The theoretical recommendation would be that that improvement would be amortized or depreciated over the life of the remaining section that it was added to, assuming that that whole section would be replaced.
And I frankly don't know engineering, but let's say that section is the last 10 years and it's now three years old, I would depreciate that line lowering over seven years so that it would synchronize with the rest of that pipe, but again, that's a

theoretical approach, but they would recover it.

CHAIRWOMAN SHOWALTER: I think that's all the questions I have. Thank you.

CROSS-EXAMINATION

BY COMMISSIONER HEMSTAD:

Q. Mr. Kermode, I'm interested in your summary on Page 3 at Line 9 through 12 in which you say in your professional opinion, the accounting policies, practices, and procedures of Olympic Pipe Line cannot be reasonably expected to produce financial data that conforms to GAAP on a consistent and comprehensive basis, and then in your conclusion on Page 15, you take a paragraph to say it more elaborately, and your last sentence is, at 9/11, "Reliance on the financial data for the test year that Olympic has produced based on its accounting system is limited due to the weaknesses in that accounting system that I have discovered."

All well and good, so what do we conclude from your conclusion? I assume what you are saying is that the Company's financial statements cannot be relied upon?

A. I'm not saying they can't be relied on. I believe it's in a gray area there. It's not that they are totally worthless, but I believe that a close eye has to be put on the accounting of Olympic Pipe Line. They are going through the audit. I guess I'm concerned that in the future or as they go forward that they have to get their books in a better position.

I know our auditors have spent a lot of time working with the numbers and have tried in all fairness to put together the best case they can, so I believe you can rely on -- I'll leave it at that. I believe the auditors have tried the best to put together the fairest case they can.

Q. You are saying the Staff witnesses that worked the issue did the best they could to come up with what they think are the best numbers for the purposes of this case.

A. Yes, sir.

Q. I take it from your testimony it's as much about the future and admonitions about how the Company should function in the future.

A. Yes, sir.

COMMISSIONER HEMSTAD: That's all I have. Thank you.

CROSS-EXAMINATION

BY COMMISSIONER OSHIE:

Q. Mr. Kermode, were you in the hearing room during Mr. Fox's testimony when he testified as to the audited financial statements that were being completed by Ernst and Young for 2001?

A. Yes, I was.

Q. Is it unusual for a company to audit the books of the most recent past year without having audited the books of prior years?

A. Yes. When I heard that, I was kind of confused. I've seen audits of income statement only, and that relied on just that current year, that there was no opinion given for the balance sheet, because obviously, the balance sheet is a cumulative type of thing.

One of the concerns of any auditor is not only are things -- they fear that things may be misstated, but they fear that things may be omitted intentionally or just by mistake. By auditing the balance sheet from the last audit, the auditor -- as a matter of fact, there is auditing standards -- the auditor that is currently auditing the balance sheets must make explicit reference in his work papers that he is relying on a predecessor's audit for his balance sheets for the purposes, so to -- frankly, I don't know how they are going to produce an audited balance sheet that says it is not misstated in any material terms without having an audit for the prior balance sheets.

Q. In your opinion, would this result in a qualified opinion after the completion of the audit?

A. It can be a qualified. It could be a clean opinion on the income statement with qualified on the balance sheet.

COMMISSIONER OSHIE: Thank you. No further questions.

CHAIRWOMAN SHOWALTER: I have one more question just in case you are the right witness, but if you aren't, let me know. Mr. Fox testified that a normal ratio of revenue to O&M for a pipeline company is in the range of 1.75 to 2.25. Do you have any opinion not on what is normal but what is justified, or is another witness for the Staff a better person to ask that question?

THE WITNESS: I have no opinion of it, and I'm not sure if another witness does, to tell you the truth.

CHAIRWOMAN SHOWALTER: Thank you.

JUDGE WALLIS: Follow-up questions?

FURTHER CROSS-EXAMINATION

BY MR. HARRIGAN:

Q. Is replacement of 500 feet of pipe major maintenance?

A. Well, I think it's precisely what the Chair says. You start putting labels on things because of a certain criteria. If that 900 feet of pipe happens to be under bedrock in which a mountain had just slid over the top of, I would say that's major, but if that same bit of pipe is actually held up by cement posts that they can get to in a Jeep trail, I would probably say no, but I don't think, at least in pure accounting terminology, major maintenance, I don't think that's defined anywhere.

Q. You've excluded all major maintenance expenses that are included in the Olympic O&M category; right?

A. I have not. Maybe Staff, yes.

Q. That's without regard to whether those are, in fact, repeated operations over a period of years and different areas of the facility; right?

MR. TROTTER: I'm going to object to the question as being beyond the scope of this witness's testimony. He's not sponsoring the adjustment.

Q. Do you know how many line lowering operations

Olympic has to engage in each year?

A. No.

Q. Do you know how long the section of line was that was lowered in the case that you refer to in your testimony?

A. No.

Q. Do you know why it had to be lowered?

A. I forget. I contacted the County. The County said there was actually three projects that Olympic Pipe Line was doing at the time. Two were --

Q. Do you know why it had to be lowered?

A. I'm getting there. Two, I think, were completed, and they were minor projects, and the one that they discussed was a pipe that was being exposed because of runoff and that they were doing some type of bridge building, but that had not occurred yet, so what I'm saying is, I tried to find out, but the County seemed not to know anything about it, so I don't know.

Q. If the line was being lowered simply because there had been erosion of the surface above it so that it no longer met the minimum depth requirements, do you know how frequently that sort of problem occurs?

A. No.

Q. Do you know what it would cost to replace 900 feet of pipe that was buried at the normal elevation of most of Olympic's line in not particularly extraordinary conditions?

A. No.

Q. Is it possible it would cost more than $400,000?

A. As a hypothetical?

Q. Yes.

A. I'm sure.

Q. But it would still be appropriately expensed because it occurs frequently; right, as long as it's under 1,000 feet?

A. And I think that goes to --

Q. Is that correct?

A. Yes, it would be for financial accounting purposes or for FERC purposes. However, the Commission would have the ability to take that expense and remove it for rate-making purposes, and like I was saying before, amortize that period over, that expense over a reasonable amount of time.

Q. But the criticism in your testimony relates to how Olympic accounted for it, doesn't it? It doesn't relate to what the Commission might do with it later.

A. Yes.

Q. Do you know Olympic is running smart PIG's through its line to detect anomalies that may require attention?

A. Yes.

Q. Do you know how many occasions Olympic has to excavate lines that are in water ways or other locations like that because it plans anomalies and needs to figure out what's going on?

A. The Company did not provide any of that information, no.

Q. Did you ask them for it?

A. Again, I was examining the records. I would assume that the Company would have provided it, so no, I didn't ask for it.

MR. HARRIGAN: I have no other questions.

REDIRECT EXAMINATION

BY MR. TROTTER:

Q. Turn to Page 7 of your Exhibit 1801-T. On the last paragraph, you were asked several questions about the 148 transactions in the Company's September 2001 ledger.

A. Yes.

Q. I think the Chairwoman focused you in on this, but for the invoices that were dated July and

August and May and March and February that were booked in September under the 60-day rule in the Uniform System Accounts, in what months should those invoices have been booked under the accrual method of accounting?

A. July expenses would be booked in July, August expenses in August, May in May.

Q. And so on?

A. And so on.

Q. When did Olympic, in fact, book them?

A. September.

Q. I want you to assume that September was the first month of a test period for rate-making purposes. Do you have that assumption in mind?

A. Yes, sir.

Q. In order for September to be representative, would you have to remove the transactions with invoice dates in the prior months?

MR. HARRIGAN: Objection for lack of foundation since it depends on what happened the other months.

MR. TROTTER: I can respond if you want.

JUDGE WALLIS: Very well.

MR. TROTTER: The question was asked from the Bench about representativeness of the Company's books of accounts, and now I'm translating the representativeness of the books of accounts into the rate-making context. I think it's pretty obvious if there is transactions in September that were incurred in prior months, you would need to remove them for rate-making purposes, and that's the point I'm trying to make.

JUDGE WALLIS: I don't believe that there are any assumptions necessary as a foundation for the question. I believe the question is proper.

THE WITNESS: Without removing them, it would give the appearance of September had a level of expenses that in fact it did not have.

Q. (By Mr. Trotter) Likewise, if the test period from 2001 only included the month of January and February but a February invoice was recorded in September, would February be representative?

A. No, it would not.

MR. TROTTER: Those are all my questions. Thank you.

JUDGE WALLIS: Is there anything further of the witness? There is no response, and Mr. Kermode, you may step down. Let's be off the record for a moment.

(Discussion off the record.)

JUDGE WALLIS: Let's take up tomorrow with Mr. Twitchell. We've made inquiries about the expected length of the open meeting for tomorrow and understand that it is expected to be short. Now, sometimes our expectations are not met, but that's the best we have to go on. So we are looking forward to starting at 11 o'clock. If the unexpected happens and the meeting runs long --

(Discussion off the record.)

JUDGE WALLIS: We are continuing this evening's session for the purpose of preparing Mr. Twitchell for his examination tomorrow. Maurice L. Twitchell has been called by Commission staff to appear at this time. Mr. Twitchell, will you please stand and raise your right hand?

(Witness sworn.)

JUDGE WALLIS: In conjunction with Mr. Twitchell's appearance, the Commission staff has prefiled a number of documents. These documents have been marked for identification at the June 13 administrative conference as Exhibit Nos. 1901-T through 1915. The description of those documents is on the record of that proceeding and need not be repeated here.

In addition, Tesoro has presented two

documents for possible use on cross-examination of this witness. Those are the joint declaration of Robert Colbo and Maurice Twitchell in support of Staff's motion to dismiss dated March 27, 2002, which is marked as Exhibit 1916 for identification, and the deposition transcript of Maurice L. Twitchell, dated June 5, 2002. That document is marked as Exhibit 1917 for identification. Mr. Trotter, do you wish to qualify Mr. Twitchell at this time and deal with errata?

MR. TROTTER: Sure.

DIRECT EXAMINATION

BY MR. TROTTER:

Q. Mr. Twitchell, please state you name and spell your last name for the record.

A. My name is Maurice Twitchell, T-w-i-t-c-h-e-l-l.

Q. You're employed by the WUTC as a regulatory consultant?

A. That is correct.

Q. In the course of your duties as a regulatory consultant, did you have cause to prepare testimony and exhibits in this proceeding?

A. Yes, I did.

Q. Subject to some corrections, is Exhibit 1901-T your direct testimony?

A. Yes, it is.

Q. Can you proceed to make the corrections that you have?

A. Yes. First of all, I would like to turn to Page 2, Line 19. The sentence reads, "Collect total revenues of..." and it reads 14,641,838. It should read 14,724,886. On Line 20, it reads, "permanent rates of $78,614." It should read, $161,662, and then it goes on and says, "...or 0.54 percent." 0.54 should be changed to 1.12.

On Page 10, Line 9, it reads, "Operations for known and reasonably measurable charges to the extent that charges are..." Both "charges" should read "changes."

Q. With those corrections, if I asked you the questions that appeared in 1901-T, would you give the answers that appear there?

A. Yes, I would.

Q. In the course of that testimony, you sponsor Exhibits 1902 through 1915; is that right?

A. That's correct.

Q. Are those exhibits true and correct to the best of your knowledge or accurately portray what they

purport to portray?
A. They portray everything except for the changes we've made because of the change in the power supply.
Q. I'm sorry. So the change you made on Page 2 did reflect the power supply adjustment?
A. That's what it reflected.
Q. But your exhibits that you sponsor do not reflect that at this time?
A. Not these exhibits, no, they do not.
MR. TROTTER: Those are all the questions I have, and I would offer the exhibits.
JUDGE WALLIS: Is there objection to the exhibits?
MR. MARSHALL: The only objection we would have would go to weight.
JUDGE WALLIS: You are free to argue that on brief, and the Exhibits 1901-T through 1915 are received in evidence. The witness is available for cross-examination. Because of the hour, the cross-examination of this witness is deferred until tomorrows session which we expect to begin at 11 o'clock. Thank you all very much.
(Hearing recessed at 8:25 p.m.)