BEFORE THE WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. OLYMPIC PIPELINE COMPANY, INC., Respondent.	Docket No. TO-011472 Volume XXXVIII Pages 4834 to 4984

A hearing in the above matter was held on July 11, 2002, at 9:30 a.m., at 1300 South Evergreen Park Drive Southwest, Room 206, Olympia, Washington, before Administrative Law Judge ROBERT WALLIS and Chairwoman MARILYN SHOWALTER and Commissioner RICHARD HEMSTAD and Commissioner PATRICK J. OSHIE.

The parties were present as follows:

THE COMMISSION, by DONALD T. TROTTER, Senior Assistant Attorney General, and by LISA WATSON, Assistant Attorney General, 1400 South Evergreen Park Drive Southwest, Olympia, Washington 98504-0128, Telephone (360) 664-1189, Fax (360) 586-5522, E-mail dtrotter@wutc.wa.gov.

Joan E. Kinn, CCR, RPR
Court Reporter

OLYMPIC PIPELINE COMPANY, INC., by STEVEN C. MARSHALL, Attorney at Law, Perkins Coie, 411 - 108th Avenue Northeast, Suite 1800, Bellevue, Washington 98004, Telephone (425) 453-7314, Fax (425) 453-7350, E-mail marss@perkinscoie.com, and by WILLIAM H. BEAVER, Attorney at Law, Karr Tuttle, 1201 Third Avenue, Suite 2900, Seattle, Washington 98101.

TESORO WEST COAST COMPANY, by ROBIN O. BRENA, Attorney at Law, Brena, Bell & Clarkson, 310 K Street, Suite 601, Anchorage, Alaska 99501, Telephone (907) 258-2000, Fax (907) 258-2001, E-mail rbrena@brenalaw.com.

TOSCO CORPORATION, by EDWARD A. FINKLEA, Attorney at Law, Energy Advocates, LLP, 526 Northwest 18th Avenue, Portland, Oregon 97209, Telephone (503) 721-9118, Fax (503) 721-9121, E-mail efinklea@energyadvocates.com.

INDEX OF EXAMINATION

INDEX OF EXHIBITS

EXHIBIT:	MARKED:	ADMITTED:
HOWARD B. FOX		
1708	4838	4838
KENNETH L. ELGIN		
2113		4839
2115		4895
2116		4895
2117		4895
2118		4895
JOHN F. BROWN		
2301-T		4958
2302	4948	4958
2303	4948	4958
2304	4949	4961
2305	4949	4958
2306	4949	4958
2307	4949	4958
2308	4949	4958
2309	4949	4958
2310	4949	4958
2311	4949	4958
1006		4961

P R O C E E D I N G S

JUDGE WALLIS: Let's be on the record, please, for our Thursday, July 11 session in the matter of Commission Docket TO-011472. I will acknowledge for the record receipt of reduced copies of Exhibit 1708, the chart, in conjunction with the testimony of Mr. Fox, and have noted receipt of that document.

When we concluded yesterday, we were engaged in the cross-examination of Staff witness, Mr. Elgin.

Mr. Beaver, are you ready to continue?

MR. BEAVER: I am.

JUDGE WALLIS: Please do.

MR. BEAVER: Initially in an effort to reduce the amount of time that I'm going to take, I thought that rather than go through some points in the deposition, which is Exhibit 2113, I would just at this point offer Exhibit 2113.

MR. BRENA: And, Your Honor, of course that is Tesoro's cross-examination exhibit. I have discussed this with Mr. Beaver and have no objection to him offering it.

JUDGE WALLIS: Is there any objection to receipt of the document?

MR. FINKLEA: No objection.

JUDGE WALLIS: Let the record show that there is no objection, and Exhibit 2113 is received.

Whereupon,

KENNETH L. ELGIN,

having been previously duly sworn, was called as a witness herein and was examined and testified as follows:

C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. Mr. Elgin, we left off last night, I think we agreed that from 1990 to 1998 Olympic paid out 76% of its net income to its owners in the form of dividends; is that correct? That's on Exhibit 2116.

A. Yes, I agreed that the math was correct.

Q. And from 1996 through 1998, they paid out approximately 44%; is that correct?

A. Yes, again the math is correct.

Q. And from 1996 through 1998 alone, that meant that Olympic retained $11 Million in earnings; is that correct?

A. I assume that that -- I will accept that number subject to check.

Q. Okay. And if I would have included 1999 in my calculation, the percent paid out actually would have been less, because Olympic actually had earnings in

1999, correct?

A. Yes, it had less earnings. At the same token though, that's -- would be again weighted by the fact that -- the calculated payout ratio would be weighted by the fact that the payout -- dividend payout ratio was zero for that year. It paid out no -- Olympic paid out no dividends.

Q. Correct. In other words, the earnings that it had in 1999 were retained?

A. Yes.

Q. Can you tell me what happened to this $11 Million in net earnings that Olympic retained as earnings, and essentially what I'm getting at is did that become equity?

A. Yes, it's -- it's retained earnings, and retained earnings is a component of shareholders' equity when you calculate book equity, so it's a component of equity. To the extent that there were no other -- if there was negative equity and you retain -- and then you all of a sudden had retained earnings, that would, you know, act to offset that. But in this circumstance in 1999, that would have added to equity.

Q. And the same is true with the retained earnings from 1996 through 1998, correct?

A. That's correct.

Q. And obviously the same would have been true for all the retained earnings since 1990, in other words, that would have been equity into Olympic?

A. Yes, that is what the dividend policy is all about. Once a company has earnings, the board of directors have two options. They can pay the earnings out in dividends, or they can elect to retain their earnings for investment in the future, whether it be buying another company, investing in new facilities, in new capital projects. It's retained earnings, and the board has elected to retain the money and invest it for the benefit of shareholders in lieu of giving it back to shareholders in the form of dividends, and then the shareholders then in turn reinvest that or do whatever they would like with those dividends.

Q. Now do you agree that the vast majority of the expenses that Olympic incurred with regard to Cross Cascades and Bayview were from 1996 through 1998?

A. I have not studied the specifics. I can't answer that.

Q. I take it you don't have any information suggesting that what I just said is incorrect?

A. No, I don't.

Q. And do you know whether the reason that the Olympic board decided to retain the $11 Million in earnings from 1996 to 1998 was because of the Bayview and Cross Cascades projects?

A. I think the best way to answer that would be to look at Exhibit 21 from the interim case. And it's my understanding that that is precisely why the company chose to retain the earnings was that one of the owner -- one of the owners at that time felt that it was no longer prudent to continue to pay out virtually all of the earnings in dividends due to the company's investment in Bayview and prospect for substantial investment in Cross Cascades.

Q. So in other words, those two projects, in fact, were not funded exclusively with debt?

A. Well, again, it -- you have to look at all the projects and all the sources of capital. But again, the choice was to retain some earnings, but at the same time the company did have to acknowledge that part of its capital expenditures that it foresaw in the next few years were for investments in Bayview and Cross Cascades and that they would need both equity and additional debt to finance those projects. And I believe it's consistent with the testimony that I have offered that a prudent financial policy would be to have both equity and debt supporting the new investments.

Q. And that apparently is exactly what happened, correct?

A. Well, it's a matter of degree.

Q. Do you know the purpose of the Chase loan?

A. Well, under the state's public -- I don't know the specific purpose. I can say that the Chase loan, there's three purposes for which under the state's public -- well, I will -- no, I don't know the specifics.

Q. And do you know the purpose of the Prudential loan that we have heard about?

A. The specific purpose, no.

Q. Do you know if either of those loans were designed to pay some of the expenses for either Cross Cascades or Bayview or both?

A. Well, again, the capital -- the capital budgeting process, you identify projects, and then the financing decision is independent of the projects. So the way -- the way capital budgeting works is you identify projects, and then the company goes and secures the capital in a balanced and reasonable manner that would minimize the cost of capital and maximize the value to the firm, and so the decisions are independent. You decide how you want to invest the money, and then you go and say how am I going to secure the money. So they -- to the extent that they -- there's a matching on the balance sheet, the capital budgeting process doesn't say I'm specifically going to identify projects and fund it exclusively with this security. That's my understanding of the process.

Q. Do you know how the 44% dividend payout that Olympic had from 1996 through 1998 compared to the industry norm, that is the pipeline industry norm, in this country?

A. Well, that -- Mr. -- I think I will correct you here -- that is a misnomer. I agreed with the math, but to say that the dividend payout ratio for that three year period is an incorrect statement. Your math is correct, that if you take the total earnings for those three periods and compare that to the total dividends paid in those three periods you get 44%.

Q. But --

A. But just -- I'm not finished. But to say that it is a 44% payout ratio, that is incorrect. The concept of payout ratio is related exclusively to the year in which earnings are identified and the board's decision to deal with earnings in that specific year. So that you can do the math the way you did, but you can not say that the company had a 44% payout ratio.

Q. Do you know what the industry norm as far as dividend payout ratios was in the pipeline industry from

1996 to 1998?

A. Again, the industry norm would be calculated on a yearly basis, and it would be my recollection is if -- if there were an industry norm, you would -- you would say we would look at those five limited partnerships, and the payout ratios for those companies would be I think we established that it was -- ranged from 70% to 105%. However, I also noted that those limited partnerships, the payout ratio was unique in the respect that it was not only a payout of earnings but also a return of capital.

Q. Mr. Elgin, do you know what the typical dividend payout rate is for utilities regulated by this Commission?

A. 60% to 70%, and again, that would be on an annual basis, the annual earnings. And then the board would pay generally 60% to 70% of those earnings out in dividends. That's the, for regulated utilities in the energy industry in particular since they're highly capital intensive, that would be kind of the industry norm.

Q. Do you still have Exhibit 2116 in front of you?

A. One moment, please.

Yes, I have that now.

Q. Would you agree that the equity ratio of Olympic from 1990 to 1998, the last full year before the 1999 accident, actually went from 9% in 1990 to essentially 20% in 1998?

A. Yes.

Q. And --

A. That is the way you have calculated on this exhibit.

Q. Well, do you have any reason to believe that that -- you have to understand, I did the calculation, and I'm not, you know, an accountant. I mean I was a biologist, now I'm a lawyer. But I mean to me it seemed like a pretty simple calculation, so do you have any reason to believe that that number is inaccurate?

A. Well, again, no, I don't, but I would note that I calculated it a little bit differently because I was looking at in my Exhibit 2102, 2102-R, is that it did increase from 1990 from about 8.4% to 16%, and I calculated that on the basis of the amount of book equity compared to the property in service. So there's probably a little difference, and it's the way it's calculated based on -- I would assume that this calculation, and to explain the difference, is this is based on the total debt and equity, and so this is equity to the sum of equity and debt, whereas my calculation in 2102 is the amount of equity as related to property. So there's a slight difference, but depends on how one wants to calculate equity ratio.

Q. And your 16.2% was actually the 1999 number; is that correct?

A. Yes.

Q. And do you know if that number was actually impacted by either the Whatcom Creek incident or the seam failure in September?

A. Well, that number -- in 1999, the company still had net income, so I would expect as I look at it that number changed primarily because of the -- I can't tell from looking at 2102 what caused that, but there -- all I can say is there was some equity, but that -- those two numbers are not materially different.

Q. Do you mean my number and your number?

A. No.

Q. Okay. Do you know how it is that the equity ratio from 1990 through 1998 essentially doubled?

A. That arithmetic would be correct, from roughly 9% to 18% is doubling.

Q. Right, but I'm wondering if you know how or why it doubled.

A. Yes, I can explain that from Exhibit 2102, and that's because in 1998 the company elected to retain its earnings and not pay a dividend. I should say the board elected, not the company.

Q. So in other words, it was because of retained earnings that the equity ratio went up?

A. Yes.

Q. I would like to explore a little bit with you what would have happened if Olympic during the 1990 through 1998 period would have paid out let's say 50% of its earnings in dividends and retained 50%, which as I understand from your testimony a minute ago would be actually more conservative than the typical entity that this Commission regulates, okay?

A. I have that assumption in mind.

Q. And if you look at 2116, what was the dollar amount that equated to the almost 20% equity? I think if you look it's about $15.1 Million.

A. In '98, correct.

Q. So is it --

A. That's what 2116 --

Q. Right.

A. Right.

Q. So I'm assuming that if you doubled the equity ratio to 40%, it would be, what, $30.2 Million; is that correct?

A. That math works, yes.

Q. So a difference of essentially $15.1 Million, that's what we're talking about?

A. Yes.

Q. Now if you also look at the earnings versus dividends from 1990 through 1998, if you change the payout rate for that entire period from 76%, which is what it was, to 50%, can you tell me what the difference in the retained earnings would have been? And I think if you do the math, it will come out to almost exactly $18 Million.

A. I will accept that subject to check, but that does -- that holds everything else constant, so you're looking at just the change in retention, but you have to look at it in combination of what was happening to the company at the time. And the company at the time through that period, you will see that there was a three fold increase in property in service. So I agree with your math that if you look at it with those narrow assumptions in mind, I will accept that math subject to check. But I would say that from a prudent financial policy, you also have to look at what was happening and what were the company's total needs for capital over the same time period, and you will see, as I said, there was over almost a tripling of the amount of property in service.

Q. And, Mr. Elgin, I'm simply trying to find out what would have happened if Olympic would have retained 50%, not 24%, of its earning from 1990 through 1998. And again, we're talking about an $18 Million difference; is that correct?

A. Under those -- under those narrow hypotheticals, I will accept your math.

Q. And if that $18 Million had been retained by Olympic during that period, its equity ratio would have been somewhere between 40% and 50%; is that correct?

A. No, it's not correct.

Q. Why is that not correct?

A. Because of the offsetting factors to the company's property accounts and the amount of debt that it issued at the time.

Q. Well, in 1998, if you would have added just $18 Million to its equity, we have already established that $15 Million would bring it up to 40%, so I'm assuming that 18% or $18 Million would bring it to some point above 40%.

A. No, if you look at 1998, look at -- look at -- do not look at 2116, because that does not have complete information. If you look at 2102, you will see that if you add $18 Million of equity under your hypothetical, you get --

CHAIRWOMAN SHOWALTER: Mr. Elgin, can you just work, I'm struggling very hard to follow this, can you point to what column, that is what year and what rows you are talking about. I know it's just second nature to you, but it really isn't to us.

THE WITNESS: I apologize, thank you for helping me with that.

A. If you look at the column that's on the top it says 98.

BY MR. BEAVER:

Q. And there's an equity line on that, right?

A. Yes, one thing at a time, please.

Q. Oh.

A. And if the -- in that column, the fourth number down is equity.

Q. Okay.

A. And that says $15 Million.

Q. Okay.

A. If you add $18 Million to that, you get $33 Million. Now the next two numbers above that equity number is the amount of short-term debt outstanding and the amount of long-term debt. And in 1998, there was approximately $61 Million in total debt. So if you add 18 and 15 you get 33, and 33 plus 60 is approximately 90, so 33 over 90 would be approximately a 30% equity ratio. Or I can do the specific maths, but it wouldn't -- it would be approximating 40, but moving towards 40.

Q. Okay. In other words, it would be close to 40%?

A. Yes.

Q. Okay. I hate to ask you this, but how did you calculate your equity ratio, the 17.40%, which I'm assuming is based upon the $15 Million in equity in 1998?

A. Yes, and divide that into the property, and you get 17.4%.

Q. Okay.

A. So the fourth number divided by the first number equals the very last percent number in that column.

Q. Okay. And apparently based upon the testimony you have given earlier, there are other ways to calculate equity ratios such as the way I did it on 2116, which provides a slightly different number. It's very close, but it's slightly different; is that correct?

A. That's correct.

Q. Okay. And depending upon which methodology you use, apparently adding this $18 Million gives you a number that's either close to 40 or a number that's going to be probably closer to 44%?

A. I don't know that. All I'm saying is that the reason why I calculated it this way was it's consistent with my testimony regarding the principle that I was trying to focus on, and that is the connection between the balance sheet and the capital on the liabilities, the equity and the debt, as it's related to useful property for service. In other words, there has to be a connection, and that was the principle I was trying to focus on, and that's why I calculated it this way. So that this is the number, this is the amount of equity as it relates to the book investment on the company's balance sheet and net carrier property, and that's why I did it that way.

Q. And, Mr. Elgin, I think on page 17, lines 19 through 22 of your testimony, you were suggesting --

A. One moment, please, may I get there.

Q. Sorry about that.

CHAIRWOMAN SHOWALTER: What page?

Q. It's page 17, lines 19 through 22.

A. Yes.

Q. You apparently are suggesting that your recommendation would have been that Olympic have an equity ratio of somewhere between 40% and 50%, is that correct, prior to June 10, 1999?

A. Yes.

Q. Do you know how much money Olympic has had to borrow since 1998?

A. Yes, it's $53 Million to $54 Million is the number, I believe.

Q. So substantially above whatever number would have been required to get Olympic's equity ratio from the approximately 20% it was in 1998 to 40%, correct?

A. Well, that math works, but again I would refer you to Exhibit 2102, and had the company put in equity, and again equity can come from retained earnings or additional moneys supplied by the owners, if you look -- turn to 2102 and you look at the sum figure in 2000, so the $53 Million represents the amount of money borrowed, if you look at the property number, the very top number in the column labeled 2000, you will see $97 Million. And so had there been approximately 50% equity, there would have been, oh, about $44 Million, $43 1/2 Million in book equity on the balance sheet. So my point is that it would have provided the necessary cushion and -- but that's not to say that investors given the circumstances of the Whatcom Creek incident would have not had to provide even additional equity to maintain a balanced capital structure.

Q. I think I was trying to find out just what --

how much more money Olympic had to borrow than this additional equity to get the equity ratio to 40%, and as I understand it, it would be substantially above that number under either your calculation or mine?

MR. TROTTER: Can we have the question read back, I think he said amounts of money Olympic would have to borrow to have equity ratio, and that didn't make sense to me. Could we have the question read back.

A. Yeah, that's what confused me as well.

Q. Sure. I'm asking you to assume that Olympic had an equity ratio of 40% in 1998, not the approximately 20% that it had.

A. I have that assumption in mind.

Q. And I'm trying to find out from you how much more money than that, that additional equity, that it would have had to have had to get up to 40%, it had to borrow after 1998?

A. Well, again, that's why I'm having trouble. If you -- you don't borrow equity.

Q. I understand that. I'm asking you to assume that it had an additional amount of equity to get the company from its 20% equity ratio to 40% in 1998, which under either your calculation or mine is either going to be somewhere around $15 Million or $20 Million.

A. Well, let's do it this way. 40% of $87

Million is $34.8 Million, and the company had equity of $15 Million, $15.1 Million.

Q. So my guess of 20 was close?

A. $20 Million, yes.

Q. And how much more than $20 Million has Olympic borrowed since 1998?

A. Well, it's 53 minus 20 is $33 Million.

Q. Right.

A. I think that's the math you wanted me to do.

MR. BEAVER: Thank you.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. I just can't resist a follow-up question at this point, because I'm just wondering if everybody is on the same page. But if you begin at a certain point, let's say 40% equity, and then you borrow another $50 Million, don't you immediately at that point change your equity ratio?

A. Yes.

Q. In other words, in order to maintain the same equity ratio, you couldn't simply borrow, you would have to also put in some more equity if you wanted to maintain the same ratio?

A. Correct. That -- I'm answering his

hypotheticals in the narrow sense that he's posing those questions, Madam Chairwoman, and you are correct that that is one of the financing decisions. You have the money that you need, and now you choose, and if you choose to finance with debt, that reduces equity ratio, all else being equal.

CHAIRWOMAN SHOWALTER: Okay.

C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. Mr. Elgin, could you turn to page 5, lines 3 through 5 of your testimony.

A. One moment, please.

I have that.

Q. And I'm trying to figure out from your testimony, are you suggesting that Olympic should not have invested in Bayview or Cross Cascades?

A. No. Again, that question is just a statement of fact. There's nothing to say that -- nothing about whether they should or should not have. It's just merely to say what the company did.

Q. I understand that. Just so I understand your testimony, you are not suggesting that it was somehow imprudent for Olympic to invest in either project when --

A. No.

Q. -- those decisions were made; is that correct?

A. I'm sorry to interrupt your question. The answer is no.

Q. Do you believe that a public service entity ever has an obligation to expand its service to meet the growing demands of its customers?

A. Yeah, I believe they do have that obligation.

Q. Do you know if that potential obligation was considered by Staff with regard to its recommendation to the Commission here in this matter?

A. Well, it was considered in the sense that nobody made any representations in any of the meetings that we would take on the question of prudence with respect to the company's investments in facilities, so it was an implied kind of assumption that we all were working on that the question of prudence was not to be raised.

Q. Do you know if the refining capacity of the four refineries that are served by Olympic's pipeline has actually increased since 1990?

A. I don't know.

Q. Is that an issue that in your mind is at all relevant?

A. Well, again, it would be relevant in the sense that to the extent that the company made investments to expand the capacity and hence increase the throughput because of expanded capacity at the refineries, that would be an issue as to whether or not -- I mean that would be a factor to evaluate regarding the prudence of investments I think is the best way to answer your question.

Q. And do you know if the demand for petroleum products in Western Washington has actually increased since 1990?

A. I don't -- based on the growth in Washington in terms of general freeways and what knowledge, anecdotal knowledge, I would assume that there would be a connection and a correlation between growth in Washington and the demand for petroleum products.

Q. And that again also might be an important issue when determining whether an entity like Olympic should try to expand its service?

A. Correct.

Q. And what about the demand for petroleum products in Eastern Washington, do you know if that has increased since 1990?

A. I would give you the same answer as I did before.

Q. Do you know the percent of the production of the four refineries served by Olympic's pipeline that was transported by Olympic prior to June 10, 1999?

A. I don't know.

Q. Is that an important consideration at all in evaluating Olympic's investment decisions?

A. Yes.

Q. You would agree, wouldn't you, that a substantial percent of the production of the four refineries served by Olympic are actually or is actually transported by barge and tanker truck?

A. I don't know.

Q. Assuming that it is, do you believe there's a benefit to the state of Washington to actually increase the capacity of Olympic's system to reduce transportation by barge and tanker truck?

A. You asked me yesterday evening about my general research in pipeline industry, and I -- my opinion is that transporting products via a pipeline is the preferable method based on many factors. But as I -- the research I did led me to believe that in general transportation through pipelines is the preferable method.

Q. And we're in 100% agreement there.

As far as safety goes, from what you read, you would agree that transporting by pipeline is generally the safest way to transport product?

A. Absolutely.

Q. Do you know if the shippers supported Cross Cascades?

A. I don't know.

Q. Do you know --

A. I have heard representations that the shippers have supported Cross Cascades, but I have not done an independent study with respect to that issue.

Q. Do you know if the shippers supported Bayview?

MR. BRENA: At this point, I think I will object. The witness indicated that this is, well, that this is beyond the scope of his testimony.

MR. TROTTER: Your Honor, I was about to step in here, this does seem to be beyond the scope, but if counsel can show us contrary, then I'm -- I'm open minded on the subject.

MR. BRENA: And just to supplement that objection slightly, he's indicated that Staff didn't take a position with regard to prudence on these investments. His testimony goes to the way that they chose to finance. So we're going through an entire prudence line of cross when he has already stated more than five minutes ago that Staff is not taking a position on it, and neither did he.

JUDGE WALLIS: Mr. Beaver.

MR. BEAVER: Well, on page 5, I mean there's a substantial amount of testimony about Bayview and Cross Cascades with representation that, at least as I interpreted this, that these were -- substantial sums were invested in these facilities that failed to deliver any revenues. Of course, Cross Cascades has been eliminated from this case, and Staff is attempting to dramatically essentially adversely impact Olympic by treating the Bayview investment differently than we feel it should be treated. And I think it's appropriate for me to explore a little bit about Staff's knowledge of the facts surrounding Olympic's decision to build Bayview.

MR. TROTTER: Your Honor, I think the witness for that is Mr. Colbo, he's the one that sponsored the Staff treatment of this. All Mr. Elgin is doing in his testimony is pointing out that part of the, in response to, of course, the Commission's order in interim relief, where it addressed several -- raised several issues, what are the causes of -- some of the causes of Olympic's current financial position, and he's just talking about here the Bayview terminal was bypassed, they invested a lot of money in it, and it's not producing revenues right now, and that's contributing to their financial problems. I mean that's the scope, as I understand it, of his testimony.

MR. BRENA: And I agree with that, and I would add that the basis for Staff's recommendation has nothing to do with the line of questions that he's asking. It's either used or useful, and it's available for service or it's not. That's the reason that Staff is recommending the shift that it did. It has nothing to do with prudency. It's either in use or it's not.

MR. BEAVER: Could I respond just briefly. I think we're getting to a legal issue. I'm trying to get into the record certain facts that allow us to argue the case as we want to argue it. And we have actually spent more time discussing this than my two questions were going to take up.

JUDGE WALLIS: So with that representation, we will overrule the objections and allow him the questions.

BY MR. BEAVER:

Q. And, Mr. Elgin, I think my question was simply whether you know if Olympic shippers supported Bayview.

A. I don't know. I have heard representations to that effect.

Q. Do you know when the final hearing on the approval of the Cross Cascades pipeline was set to begin?

A. I can't -- I did know, I can't remember it right now.

Q. Subject to check, will you accept June 11, 1999, as that date?

A. Yes.

Q. Do you have any reason to believe that it was not a prudent decision by Olympic given what happened on June 10, 1999, and what happened in September 1999 to postpone the Cross Cascades project?

MR. TROTTER: Your Honor, I guess I will object. This is beyond the scope or lacks foundation. I don't know if he has an opinion one way or the other, and just to ask one side of that question is unfair. So I will object on the basis of lack of foundation since Staff is not examining or taking a stance on the position of prudence of Cross Cascades. It's not relevant.

MR. BRENA: I would like to also join in the objection, but for different reasons. I didn't object to the first 10 or 15 questions on this line, and I thought he had 1 or 2 more, and now he's up to 4 or 5 and with no end in sight. So he's perfectly willing to explore whatever facts he thinks explore -- supports his case so long as it's within the scope of this witness's testimony, and this has not been for some time.

MR. BEAVER: Could I respond. When we just had this discussion about the last objection, I said I had two questions, this is actually the second question, this is my last question, and this actually is a question that I think relates to a comment that Mr. Elgin made last night about his belief that it is imprudent to write off Cross Cascades. I'm trying to find out what information he actually knows about the Cross Cascades project, and I am actually going to be asking later on some questions that relate to that comment that he made last night. And to me at least, this information is important.

JUDGE WALLIS: The objection is overruled.

A. Would you please repeat the question, so I make sure I have it in mind.

BY MR. BEAVER:

Q. Do you have any reason to believe that it was not a prudent decision on the part of Olympic to postpone the Cross Cascades project after what happened on June 10, 1999, again given that the hearing was to begin the next day, and also what happened in September of 1999?

A. I have no opinion about that. However, I do have a comment as to tie this back to my testimony is that given what happened in 1999, from a financing perspective, what would have been prudent would have been for the company to put in equity to represent its investment in the Cross Cascades pipeline, in other words, not to issue additional debt. That's the import of my testimony. It's got nothing to do -- the investment decision and the financing decisions are independent, and my testimony is related to how they chose to finance, not whether they those to invest.

MR. BEAVER: Your Honor, I don't believe that has anything to do with the question that I actually asked, and I would move to strike it as nonresponsive.

JUDGE WALLIS: Well, I think it does relate to the question, and the motion to strike is denied.

BY MR. BEAVER:

Q. Mr. Elgin, I'm assuming that you're suggesting that by the company you mean somebody other than Olympic?

A. Olympic's board.

Q. Olympic's board was to put in more equity?

A. Olympic's board should have taken what actions necessary to finance its operations in a reasonable manner. And once the events of Whatcom Creek occurred and it was looking at the need to restore the pipeline in light of the prior investment decisions, it needed to at that point make a determination that the proper way to finance this company would be to invest equity and to build up the equity ratio on the balance sheet in order to restore the operations of the pipeline after the explosion. That's my testimony.

Q. Mr. Elgin, the board of Olympic obviously doesn't have any equity, correct? I assume you're talking about somebody else outside the company investing equity in this company?

A. Well, yeah, the owners, but the -- Olympic's board is responsible for taking the recommendation to the owners and saying we need equity in this company. That's the way I understand how the financing decisions and the -- are made with respect to this company.

Q. And if the owners say, well, we don't think that's a great idea from our standpoint, but we'll loan you a heck of a lot of money and not make you pay any interest or principal, what's the company supposed to do?

MR. BRENA: Objection.

MR. BEAVER: I will withdraw the question.

BY MR. BEAVER:

Q. Mr. Elgin, I want you to assume that a company has on its books an asset, and it's evaluated what is on its books as far as the value of the asset, and it has concluded that that value is not accurate and that --

A. I have that --

Q. -- and that in reality the value is a heck of a lot less.

A. I have that in mind.

Q. What in your mind is the company supposed to do?

A. At that point, it has two options. It can choose to determine what would be necessary to make the asset valuable, in other words what additional investment. It's a sunk cost, but at that point the capital budgeting decision is what incremental investment is necessary, and what would be the internal rate of return or the net present value of that investment. And if it turns out that that does not meet the hurdle rate, then the company in my estimation should dispose of the asset.

Q. Actually, I probably misstated my question. I'm trying to find out from an accounting standpoint. Let's say you're somebody who is looking at the books, and you see a number for an asset, and you don't believe it's accurate. Just from an accounting standpoint, I'm not asking from a management standpoint. Because as I understand it, you have never managed a pipeline, you have never been involved in pipeline operations, correct?

A. No, but I am an expert in capital budgeting.

Q. So what I'm trying to find out is if you have an opinion or if you know just from an accounting standpoint, you know, what should a company do with regard to the number on its books if it concludes that it's got an asset whose number is grossly inflated?

A. And the accounting entry is derived from the management decision regarding the economic value of the asset, so that the accounting merely records the decisions of the management with respect to that asset. So accounting follows what specific management decisions were made with respect to that asset, and that is all tied to the capital budgeting process.

Q. And if management says there's no way that we're going to be able to get the kind of value out of this asset that's on our books, I mean what is the company supposed to do with regard to the number on the books?

A. The number on the books reflects the decision making of the management. If the management chooses to sell the asset and it sells the asset, it gets the cash, and now the accounting follows -- the accounting describes the action of the company. That's what accounting is. It's a description of the actions of the management of the company.

Q. So if we assume that we have an asset let's say that's $10 Million on the books, and management says it's worthless, we can't even sell it, and we can't use it, and it tells its accountants that, what are the accountants supposed to do with that number, that $10 Million number?

A. The accountants are supposed to remove it from the balance sheet, and that removal will reflect that period's earnings, and there's the -- that's the connection between the income statement and the balance sheet. So when the decision is made to remove the asset, that $10 Million goes to the company's earnings in that year. So to the extent that the company had $20 Million of earnings and it wrote off a $10 Million asset, so now the asset side of the balance sheet is reduced by $10 Million, you also through the income statement, because the income goes to retained earnings, you have to now remove the $10 Million from that year's earnings. And if there isn't $10 Million in earnings that year, now that $10 Million reduces the owners' equity investment.

That's the accounting, and that's the connection between the accounting transactions and the disclosure of the financial statements on -- for public account -- either whether it's public accounting purposes or for this company FERC Form 6. That is the accounting description of the actions of the management and the impact on the owners of the company.

Q. Okay. Have you reviewed all the materials that Olympic provided in response to discovery concerning the Bayview terminal?

A. I'm hesitant to say all the materials. I have reviewed some materials.

Q. Have you reviewed enough materials to know that the purpose of building the Bayview terminal was to improve the utilization of Olympic's main line and achieve greater total annual throughput?

A. That's my understanding of the purpose.

Q. And would you agree that the Whatcom Creek incident and the September 1999 hyper test failure where an ERW seam failed continued -- and as a result our pressure was limited to 80% on the entire system, has delayed Olympic's ability to fully accomplish its original objective with the Bayview terminal?

A. I don't have that understanding. I can't speak to that. I wish I could, but I have not done a study to speak to it fully.

Q. So you don't know one way or the other?

A. I have some understanding but not to the extent that I would be able to testify today.

Q. Were you here when Mr. Talley testified as to all the uses that the Bayview terminal is currently being used for?

A. Yes.

Q. Could you turn to page 5 of your testimony, lines 15 through 18.

A. Yes, I have that.

Q. And you state the company, excuse me:

Following the Whatcom Creek explosion, the company issued additional debt to pay operating expenses.

Do you see that?

A. Yes.

Q. Now all of the loans that Olympic obtained did not go to simply pay operating expenses, did they?

A. No, but --

Q. Did you -- oh, I'm sorry.

A. Yeah, so -- I'm sorry, go ahead.

Q. Do you know how much of those loans was actually used to pay capital expenses?

A. Yeah, I could probably figure that out for you if you would like. Give me one second, please.

Q. I think I have heard testimony it was like $36 Million.

A. That number is about right, yes. For purposes of this cross, I think we can use that number.

Q. Okay.

A. And that's not just in one year, that's over a period of time. That's between the point of the explosion and I guess the end of 2000 I think was what that number represented.

Q. Okay. And you indicate that:

Issuing this additional debt compounded the effects of its prior aggressive financial policies.

And I'm assuming based on your testimony that what you're referring to as far as financial policies related to the funding of the Cross Cascades and Bayview projects and this dividend payout that you have been talking about?

A. I was going to refer, if you will give me a moment, I will refer you to a specific citation place in my testimony. It would be on page 4, line 19. It's a combination of three factors, the dividend policy, its investment decisions, and its decisions with respect to financing.

Q. And those investment decisions I assume are Bayview and Cross Cascades. I mean isn't that what you have been talking about?

A. Well, those are the two major components. In the next page, page 5, line 6, I note that the total expenditures were $65 1/2 Million on new construction, so there was an additional $20 Million for other projects, but those were part of the expenditures, the capital projects, and they needed to be financed.

Q. And that's going all the way back to 1990?

A. That's correct.

Q. Okay. And you also indicate at lines 17 through 18 that the company's total short term debt went from $2.1 Million to over $100 Million; is that correct?

A. Yes.

Q. Do you know what Olympic's long-term debt was at the end of 1998?

A. $17 Million.

Q. Do you have Exhibit 2115 handy? That's Olympic's 1997 FERC Form 6.

A. One moment, please. 1997 or --

Q. 1997. Unfortunately, 1998 is not an exhibit as far as I know.

A. I have your 1997 Form 6 in front of me now.

Q. Okay. And this is, of course, a document that Olympic filed with this Commission; is that correct?

A. Yes.

Q. As it's obligated to do by regulation?

A. Yes.

Q. Could you look at page I think it's 225, line 30, excuse me, it's page 227, line 30.

A. Yes.

Q. And what was Olympic's long-term debt?

A. $44.5 Million and $1 1/2 Million payable within one year.

Q. Do you know where you came up with the $17 Million figure for the end of 1998?

A. Yes, I do know. Give me a second, and I will find it.

Please look at exhibit -- what has been marked for identification as Exhibit 2117. At page 113, column -- this is the 1999 FERC Form 6, and if you look at the balance at the end of the previous year in dollars, column D, line 57, it says long-term debt payable after one year $17 Million. That's where I got that figure.

Q. Okay.

MR. TROTTER: Excuse me, Your Honor, could we just ask the witness, I don't think he read that column exactly as it's stated, if it could be read into the record.

THE WITNESS: It says, balance at end of previous year.

MR. TROTTER: Thank you.

A. So since 1998 FERC Form 6 isn't in an exhibit, this one is, so the FERC Form 6's have the existing year and the prior year, and so that's where I got that figure. But I pulled that figure directly from the 1998 FERC Form 6 that was submitted by Equilon, the former owner.

BY MR. BEAVER:

Q. Okay. The short-term debt that you indicated went from $2.1 Million to over $100 Million from 1998 to 2000 on page 5, lines 17 and 18. Who loaned that additional $98 Million in short-term debt?

A. The specifics are in the record in Mr. Batch's Exhibit 2-T from the interim case. There's a table and the -- it's on page 3, Exhibit 2-T, and the -- there's Prudential, Texas Commerce which is now Chase, Equilon which is an owner, and ARCO or BP ARCO.

Q. How much of the short-term debt that you're referring to was loaned by Olympic's parents from 1998 to 2000?

A. Well, let's -- it depends on how you want to calculate and look -- what we actually mean by loaned to and how you want to calculate, but we have a number of $53 Million, and then there's approximately $43 Million that represents the loan from Equilon, so the sum of those two figures is $96 Million.

Q. And that was from 1998 to 2000?

A. Well, I just -- again, the best evidence of those amounts are Exhibit 2-T on page 3, and that's where we're at. That's the numbers to look at.

Q. And again, I'm -- the number that you just gave for both Equilon and BP, those were amounts loaned to Olympic after 1998; is that correct?

A. Yes. Again, I did not reconcile Mr. Batch's column with the amounts that are outstanding on the FERC Form 6. I just reported what's on the FERC Form 6. If you want to know who is holding the notes and the amounts, Exhibit 2-T is the place in the record to see that.

Q. And the reason I'm asking actually is I'm trying to reconcile that number, which I believe is accurate, with the number you gave earlier when I asked you how much money Olympic had to borrow since 1998, and I believe you said something like $56 or $58 Million?

A. Well, if you look at Mr. Batch's exhibit, it's, you know, since 1998, the number -- I will give you a number. We have $30 Million in the Chase, excuse me, $43 Million from Equilon plus another $2 Million so approximately $45 Million from Equilon and approximately $50 Million from BP ARCO. And I took those numbers from Mr. Batch's 2-T, so those would be the owners' loans to Olympic since 1998.

Q. Okay. Now has Olympic paid any interest on any of those loans?

A. No.

Q. Has it paid any principal on any of those loans?

A. No.

Q. So from a cash flow standpoint, as far as Olympic is concerned, those loans are no different than if they had been called equity? And again I'm asking about a cash flow standpoint for Olympic.

A. In other words --

Q. Well, maybe I can ask it a different way. If that money had been called equity, Olympic wouldn't have paid any interest or principal on it, correct?

A. Correct.

Q. And --

A. So to the extent that it's not paid any principal or interest on the loans, it's similar. I would agree with that.

Q. Well, as far as the amount of money that Olympic has had to pay, it's been the same, correct? I mean it's not just similar, it's the same?

A. I'm having trouble with your question. Maybe you could try to rephrase it.

Q. That's okay, I think the point has been made.

I would like to go back in time to late 1999, and what I would like to do is run through the scenario that Olympic was in at the time. And after September of 1999, you agree that Olympic's entire 16 inch main line pipeline was shut down; is that correct?

A. That's my understanding.

Q. And that was by order of the Federal Office of Pipeline Safety, correct?

A. That's, again, I have heard representations to that. I have no independent -- I mean that's what I have heard and understand, come to understand.

Q. And it also just had an ERW seam fail during a hyper test; is that correct, in September?

A. Again, that's my understanding.

Q. And do you know where Olympic has the same type of pipe in its system, in other words, the same type of pipe that failed in that hyper test?

MR. BRENA: Your Honor, at this point, I

think I would object as beyond the scope of this witness's testimony. Most of this is in the record already. It's been testified by people who do have knowledge of it. Mr. Talley has testified, there's been extensive testimony on it.

I would also like to point out we're supposed to be in the last day of hearing. Their estimate for how long they had to cross this witness was an hour and a half. We have been over that now for a while, and I don't see an end in sight. So I guess I would like to know where we're going and how we're going to get there at some point. If we're going to sit here and just -- if we're going to exceed the scope and if we're going to ask this witness engineering questions. I mean I'm trying to go home.

MR. BEAVER: Can I respond?

MR. TROTTER: Your Honor.

JUDGE WALLIS: Mr. Trotter.

MR. TROTTER: Just to the extent that we're not holding Mr. Elgin out as a pipeline engineer or an expert on ERW pipe, so it is getting pretty far afield as far as I can tell.

MR. BEAVER: Actually, it's not at all. My question at the end of these assumptions is going to ask Mr. Elgin what lender, what commercial lender out there would have loaned Olympic in late 1999, in fact any time since 1999, over $90 Million at 7% interest and then forgive the interest and principal payments. And I think this is -- goes to the very core of his testimony. This is very important, and I think it's very important for everybody to understand the situation that Olympic was facing in late 1999, and I can only ask him the ultimate question after going through these situations that Olympic was in.

JUDGE WALLIS: The objections are overruled.

The second question relating to the examination is how we're doing.

MR. BEAVER: Not as fast as I had hoped, but I'm definitely going to try to be done at 11:00 if that's --

MR. BRENA: Well, Your Honor, I have, after Mr. Elgin, I have our entire case to put on, and one of my concerns throughout has been that people stay with their timelines so that our case isn't squeezed out at the end, so I just -- I'm not suggesting that will or won't happen, I just want to express my concern.

JUDGE WALLIS: Your concern is noted, Mr. Brena, and we have talked about scheduling options and believe that we do have the opportunity in the remaining time in this hearing to allow you to present your case.

MR. BRENA: Well, and if I may, you know, it would be my clear preference to have all three commissioners present during the presentation of my case so that Commissioner Hemstad, who is not available tomorrow, has an opportunity to ask questions. I understand that he will read the transcript, but it's different whether you're here or not here and whether you can ask questions or not ask questions. So I'm not just asking for the time, I'm asking for the right time, the right spot.

JUDGE WALLIS: We understand your concerns.

BY MR. BEAVER:

Q. Mr. Elgin, you also understand that shortly after, like three days after the seam failure, the Office of Pipeline Safety put the entire rest of the Olympic system on an 80% pressure restriction?

A. I will accept that.

Q. And you understood that the throughput and thus revenue for Olympic at the time was down by over 40%?

A. I will accept that.

Q. And, in fact, Olympic's operating expenses actually went up, not down, at this point; isn't that correct?

A. Well, what they were recording as operating expenses I will accept. In '99, I think the major change in operation and maintenance was in 2000. I would have to check Mr. Twitchell's exhibit. He has that, I don't have that in front of me.

Q. Would you accept that they certainly didn't go down at least?

A. No.

Q. You would not --

A. They did not go down. I would not expect that.

Q. And also at the time there was no way to reasonably predict when, if ever, Olympic's system would be allowed to be back into normal operation?

A. I would accept that.

Q. And also are you aware that an oil pipeline that actually has a release regardless of fault is strictly liable for various damages resulting from that release?

A. I don't know.

Q. Would you just accept that for the purposes of my question?

A. Yes.

Q. Now I also want you to assume that Olympic had an equity ratio prior to this accident of 40% to

50%, as you have indicated in your testimony you think would have been prudent, and had followed the financing policy that you believe it should have. And what I'm trying to find out is if you can tell me the name of any outside commercial lender that would have loaned Olympic over $90 Million at 7% interest and then not required Olympic to pay that interest or any principal?

A. I have answered that question on, to some extent, not specifics, on page 17.

Q. I couldn't find the name of a commercial lender in your testimony, and I'm trying to find the name of a commercial lender that would have done what I just mentioned with the circumstances facing Olympic in late 1999.

A. I believe that had the company had a 50% equity ratio and at the time of the accident recognized that Bayview and Cross Cascades could not be used as intended, that with an equity investment and at that time had 40% to 50% equity ratio, when the revenues dropped and the company needed to borrow more money, had there been equity in the company, the company could have financed and gone out and -- I don't have a specific lender in mind, but it's my estimation that the company make those in equity investments, and with the new level of revenues it was experiencing, with equity cushion, they could have financed. I don't have a specific lender in mind.

Q. Have you ever been a commercial loan officer?

A. No.

Q. And have you ever talked to any commercial lenders about whether under these circumstances they would have loaned Olympic over $90 Million at 7% interest and then not required the company to pay the interest or the principal?

A. No, I have not. But I can tell you that if I would have been working for the company, I would have -- and in the finance department, I would have developed some kind of financial plan, and part of that financial plan would have included equity investment. It was -- it's -- it would have been critical and that the -- the important piece is to recognize the fact that particularly that the principal two assets, Bayview and Cross Cascades, needed to have equity support. That's what I would have recommended to the management and shepherded that through to the best of my ability is what I would have done.

Q. And this equity investment, you're talking about trying to convince outside entities to invest equity in the company?

A. No, it's the owners, the owners would have made the equity investment.

Q. Apparently in addition to the $93 Million they loaned?

A. No, you're mixing apples and oranges. The $93 Million was the choice that the owners made in lieu of equity, and that was what is producing in my testimony what I believe is irrational balance sheets that prohibit the company from developing a credible long-term financial plan to get out of this predicament.

Q. Mr. Elgin, this equity cushion that you're mentioning, isn't it in essence a risk management issue?

A. Yes, it's a financing decision which is related to the amount of leverage, and we have heard testimony what financial leverage is when we talk about financial risk. That's what financial risk means, how we choose to finance, we meaning the management, and how in light of their business what risks they accept in the consequences of their decision to finance the operations of this company.

Q. Mr. Elgin, are you aware of how the pipeline industry in the United States manages risk?

A. No.

Q. Mr. Elgin, what is the basic purpose of insurance?

A. To offset risks.

Q. So in other words --
A. That would otherwise be too costly to self insure.
Q. Have you studied Olympic's insurance coverage?
A. No, I have not.
Q. Would you agree that the more insurance that you have and the more risks that are covered by insurance, then at least in your mind you would need less of an equity cushion to handle those risks?
A. Again, it depends on which types of risks you are insuring, but no. One of the basic principles of finance is that the company needs to have a balanced capital structure given the business it's in, and it needs to minimize its cost of capital, and it needs to have prudent financial policies in respect to the business that it's in.
Q. Okay. Mr. Elgin, could you turn to page 20, lines 1 and 2 of your testimony.
A. Yes, I have that.
Q. And I believe you are suggesting that a management contract of a pipeline should be submitted to the Commission prior to its effective date; is that correct?
A. That's my interpretation of what the statute

requires.

Q. You're not suggesting that this agency has any ability to approve or disapprove a contract to manage an interstate pipeline, are you?

A. No, all I'm saying is that the contract, the management contract, should have been, at least my interpretation of the affiliated interest statute, requires a filing of the contract.

Q. Do you know when the Commission was first aware that BP had been selected as the new operator of Olympic?

A. I don't know.

Q. Do you know if the Commission ever asked to see a copy of the contract?

MR. TROTTER: I will object, that question is shifting the burdon of compliance to the Commission, not to the company where it belongs, and I will object to that question.

MR. BEAVER: I'm just asking if he knows if they asked for it.

MR. TROTTER: And there is absolutely no obligation to ask for it, and he's just -- he's attempting to shift the burdon to the Commission, and I'm just going to object to that.

JUDGE WALLIS: We will sustain the objection.

BY MR. BEAVER:

Q. Mr. Elgin, on page 12, lines 1 and 2 of your testimony, do you have that?

A. Yes.

Q. You indicate that the company has made several different commitments regarding when it will have unqualified audited financial statements; is that correct?

A. Yes.

Q. Obviously the auditor is the entity that is primarily responsible for determining when that will be completed; is that correct?

A. Well, the auditor and the company.

Q. Well, the auditor has something to say about it, correct?

A. It's a joint effort. The auditor -- what the auditor does is certify that the books and records are an accurate representation of the financial condition of the company and conform to generally accepted accounting principles. I'm not a CPA, but that's my understanding of what auditors do.

Q. Okay. And you're aware that Olympic is currently being audited by Ernst & Young, correct?

A. I heard Mr. Fox testify to that fact.

Q. And are you aware that Olympic has been told that it will have an audited financial statement for the year 2001 this summer?

A. I'm not aware. I heard Mr. Fox testify to that fact.

Q. And do you have any information suggesting that that's incorrect?

A. No, I do not.

Q. Okay. Could you turn again to Exhibit 215, which I believe is the 1997 FERC Form 6.

CHAIRWOMAN SHOWALTER: 2115.

MR. BEAVER: I'm sorry, you're right.

A. Yes.

BY MR. BEAVER:

Q. And I will represent that this actually is a copy that we obtained from this Commission.

A. Okay.

Q. And if you, for example, look on page 113, and actually there's several places in here, there's handwriting that is on the document.

A. Yes.

Q. Do you know whose handwriting that is?

A. I believe I recognize who makes those numbers like that, but I can't say for sure.

Q. Who do you believe does?

A. I believe those were Mr. Colbo's.

Q. So apparently these FERC Form 6's are supposed to be reviewed by somebody when Olympic files them, as it's obligated to do by regulation?

A. Well, no, Mr. Colbo testified that the first thing they do is they come into the business office, and then the business office verifies that the regulatory fee that's being paid is consistent with the statute or what the Commission has. And then the FERC Form 6's and all the annual reports go to the records center. I can tell you that over the years the analysis of both the annual reports and the budgets in terms of Staff effort towards analyzing and looking at them and doing something with them has changed over time, and our emphasis is no longer to really devote any resources to that effort.

Q. So is that why the 1997 FERC Form 6 has a lot of handwriting on it, but the later ones don't? In other words, somebody actually evaluated 1997, but they did not evaluate, for example, 1999?

MR. BRENA: Objection, scope.

MR. TROTTER: Well, I will object also, Your Honor. I don't see a lot of handwriting, and there's no evidence as to when this handwriting was placed on this document, so any answer would call for pure speculation.

MR. BRENA: If you can tie it back to the testimony, that would be helpful to me.

MR. BEAVER: I'm just asking him if he knows.

MR. FINKLEA: Well, then, Your Honor, Tosco will join. Just the fact that there aren't marginal notes doesn't mean somebody didn't carefully review the numbers.

JUDGE WALLIS: Mr. Beaver, I am concerned that from what the witness has said so far, going any further would involve speculation. If you desire to pursue this line, I think you need to reword the question.

MR. BEAVER: Sure, will do.

BY MR. BEAVER:

Q. Mr. Elgin, do you know if, in fact, Mr. Colbo reviewed the 1997 FERC Form 6 that was submitted to this Commission pursuant to its regulation?

A. No, I don't.

Q. You would agree having yourself reviewed these FERC Form 6's, which you have indicated were the source of your Exhibit 2102, that they contain a substantial amount of financial information concerning Olympic Pipeline, correct?

A. It contains a substantial amount of summary information.

Q. It will, for example, indicate what any

affiliated debt is; isn't that correct?
A. Yes, it does. There's a specific page for the company to identify that.
Q. And in order to save time, I'm not going to go through all of the various line items, but, for example, Exhibit 2117, which is the 1999 FERC Form 6, on page -- oh, I'm sorry.
A. Oh, yes, on page?
Q. 225.
A. Yes.
Q. Actually shows the obligations of Olympic that were paid by Equilon to the tune of $38 plus Million, correct?
A. Not page 2, this shows --
Q. Paid on behalf of?
A. Correct.
Q. And if we looked at the 2000 FERC Form 6, again page 225.
A. Yes.
Q. We would see the notes, payable to Equilon and to ARCO?
A. Yes, you would. And again for 2001, you would see the same thing on page 225.
Q. Right. Have you evaluated what you believe would have happened to Olympic Pipeline if its owners

had not loaned Olympic over $90 Million since 1998 and not required that it pay interest or principal?

A. I expect that it would have been likely that Olympic would have gone into receivership and that an owner would have come along and done what was necessary to restore the operations. But in my estimation, it's a critical essential facility in the state of Washington, and somebody would have come along and operated and made the necessary investments and returned the pipeline to the state it probably is today. That's my estimation. I have not done an independent study, but that's my feeling of what would have happened.

Q. Have you determined whether there is, in fact, any owner or operator out there that, in fact, would have come in and bought this pipeline and done what BP has done?

A. Well, clearly a different operator owner would not have done what BP has done, but it would have done something different, but the road map would have been different to the same end result, and that's returning the pipeline to operation and moving petroleum products in the state of Washington.

MR. BEAVER: That's all I have.

Before I end, I do want to offer the exhibits that I have discussed, which I believe are 215 through --

THE WITNESS: 2115.

MR. BEAVER: I mean, excuse me, 2115 through 2118 in addition to the 2113.

JUDGE WALLIS: 2113 has been received.

Is there objection to 2115 through 2118?

Let the record show that there is no response, and those documents are received in evidence.

JUDGE WALLIS: Let's be in recess for 15 minutes, please.

(Recess taken.)

JUDGE WALLIS: Let's be back on the record, please.

Mr. Finklea, you have volunteered to take up the baton for cross-examination; is that correct?

MR. FINKLEA: That's correct, Your Honor.

C R O S S - E X A M I N A T I O N

BY MR. FINKLEA:

Q. Good morning, Mr. Elgin.

A. Good morning.

Q. In your testimony, you look back at the situation that Olympic is in, and I take it that a lot of your looking back was prompted by the questions from the interim order; is that correct?

A. Not precisely from those eight questions that the Commission raised in that order.

Q. And in an interim proceeding, one of the inquiries is whether the company is in a financial emergency, correct?

A. Correct.

Q. But in a normal rate proceeding, the question that we're trying to answer through this proceeding is what rates to set prospectively that would be just and reasonable; is that correct?

A. Yes.

Q. So in some sense, how the company got here, does it matter or not for this proceeding?

A. Well, I think it does because of the way the company has presented its case. And why I say that is the company is saying that they need a substantial increase in rates in order to attract capital on reasonable terms. Unfortunately, the record that they have presented in terms of their case is we don't know what that means. There's nothing to find. It's just we're going to -- we're going to get additional money from the owners because the Commission is going to grant a rate increase. We don't have a specific financing plan, we don't have specific terms and conditions, we don't know how much equity they're going to issue in the future. That's what's so troubling from my perspective. And so to the extent that we got to this point -- and it's also related to the Whatcom Creek explosion. I think it was important to look at historically how we got to the position that we are and then what would be an appropriate response.

And my testimony is or recommendation in response to one of the Commission's questions is that if the company does not issue additional equity and support this company, the only way we're going to get there is over a period of time and provide a small increment of equity, a small equity cushion, and then therefore over time, and I can't say how long that that will take, but over time the company will get there.

The other part of the Staff recommendation is that part of going to that end state over time is subsequent rate filings so that we know the company has over a three year period approximately $20 Million of further capital additions. That will add to rate base, and that's -- we also know that over time when they make those capital additions that they will likely improve throughput. So that we will have a series of slowly building their earnings, slowly filing for new rates to capture those investments, and then a slow buildup of equity.

Now the other part of the Staff recommendation is that if the company chooses to invest equity and go to what Mr. Wilson recommends is an appropriate capital structure, 50% equity, then they can also file and will provide the return on equity and associated income taxes once they make that equity contribution. So I think it's important in this case because of the circumstances, and we had to look at how we got there in order to make a recommendation of what's a fair, just, and reasonable rate and how we proceed in the future.

Q. For purposes of establishing rates, the Commission has to adopt some type of a capital structure, correct?

A. That's correct.

Q. But the Commission doesn't ultimately control what capital structure the company chooses to have?

A. No, that's a management decision.

Q. So --

A. Or excuse me, a board decision. When I use management in that context, I mean the board.

Q. So when you have opinions about how the company might have structured itself different than how it has, that in some sense goes to what's the proper capital structure going forward; is that correct?

A. I'm not sure I understand your question, if you could maybe rephrase it or --

Q. Is your analysis of where the company is today and how it got there relevant to Dr. Wilson's recommendation on capital structure?

A. Yes.

Q. But if the Commission adopts either Dr. Wilson's or Dr. Means' approach to capital structure, we as shippers, we don't have any guarantee that that's the capital structure that the company will choose?

A. That's correct.

Q. And in subsequent rate cases, whether the company has chosen any particular capital structure, the Commission will still have to make a decision as to what's a reasonable capital structure for purposes of establishing rates, correct?

A. Yes.

MR. FINKLEA: I have no further questions.

JUDGE WALLIS: Mr. Brena.

MR. BRENA: I have just one follow-up.

C R O S S - E X A M I N A T I O N

BY MR. BRENA:

Q. Following up on Mr. Finklea's questions, would it be reasonable for this Commission to encourage equity infusions through rewarding equity?

MR. BEAVER: I'm going to object, it's clearly friendly cross, and as such, the question is leading.

MR. TROTTER: I'm going to object on the basis he just answered that question in terms of recommendation of Dr. Wilson.

MR. BRENA: Let's see, taking the friendly cross, you know, Staff and Tesoro are at different places with regard to these matters, and I'm just exploring -- to me it's a logical follow-up from Mr. Finklea's question, which is asking him, you know, what steps can this Commission take to encourage real equity in this public service company.

JUDGE WALLIS: The question is allowed.

BY MR. BRENA:

Q. Is one step that the Commission could take to encourage real equity to give equity returns when equity is invested?

A. Yes, and that is the basis of the Staff recommendation on the 20% equity, 80% debt capital structure recommendation of Mr. Wilson is that to provide some equity where none exists and to provide the incentive to say -- and it's kind of consistent with the

Commission's order in the American Waterworks, there is no equity, we need you to move there, here's additional equity. And it's not unprecedented, there have been prior utility cases where the Commission has done the same thing. It has provided in rates equity where there is none to encourage the company to build the retained earnings in order to build up its equity so it has a balanced capital structure.

Q. To the degree that Olympic is a company whose owners are unwilling to invest their equity in the company, doesn't that make the question of capital structure even more important to the public interest?

A. Well, if the Commission were to make a finding and felt that on the basis of this record that the company wasn't willing to invest equity and wanted to do something different, it has that discretion.

Q. I understand, but to the degree that that is a risk that's been introduced into this, I mean isn't the -- isn't a proper regulatory response to that risk is to try to ensure that the public service company has even greater equity if it's going to be -- if there -- if the parents aren't going to stand behind it?

A. Well, the Commission would need to exercise its judgment and determine what would be the way it wanted to respond in light of the evidence in the record in front of it. But yes, that would be something for it to consider, I think, as I understand your question.

MR. BRENA: I have nothing further.

JUDGE WALLIS: Commissioner questions.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Mr. Elgin, I'm mindful of the time pressures, and I have what I consider to be a set of short answer questions and then maybe a few essay questions after that.

A. All right.

Q. But my first set of questions really has to do with my lack of understanding of certain accounting and financing issues, and so they're asked more in an abstract way than for this particular company.

If you were a prospective third party lender and you were looking at one company with a 50% equity ratio actual and another company with 100% debt but all of the debt was guaranteed by the owners, would you as a third party lender look at those two companies differently in terms of attractiveness of lending?

A. Yes.

Q. And why?

A. Because even though the debt is guaranteed by the parents, there's always the prospect of default. And so if -- the hypothetical, let's just say you have $100 of assets and you finance it with 100% debt and you default, all the owners of debt have similar claims on those assets, so in bankruptcy you sell the assets and then the proceeds are distributed. And whereas when you have 50% equity, you only have $50 of debt, and so in the event of default, the likelihood of your getting your money back is enhanced by the fact that only half of the investment or half of the assets that are there that could be sold have a claim in terms of the dissolution of the disbursement of the assets through a sale, and so that's the difference.

Q. All right. This is about this case. Have the lenders in this case, that is the owner lenders, forgiven the principal or interest on their loans as far as you know?

A. No, they have not, and in fact --

Q. Do they remain on the books?

A. Yes. Would you like me to show you where it's at on the books?

Q. No, you don't need to.

A. They are on the books, both the principal and the accrued interest.

Q. All right. I think I deferred this question to you, or maybe Mr. Colbo did. If a company has negative equity and a lot of debt obviously and the interest on the debt is forgiven, does that create equity?

A. No.

Q. And so is the interest, is it just less debt but no more equity?

A. Yes.

Q. All right.

A. If you look at their balance sheet, you can see it. If you look at Exhibit 2118, look at the balance sheet, you will see it. And if they forgive -- if they forgive the interest payment, all that does is take off the balance sheet accrued interest, so that's no longer a liability.

Q. All right.

A. It does not create any equity. Because the equity has already been reduced by the loss in the year that the loss was incurred when the company could not service debt.

Q. All right, and that question was about interest. Now if the loan is "converted" to equity, and I take it that means the principal is not -- neither the principal nor the debt would be owed, does that create equity?

A. Yes.
Q. And why is that?
A. Because again it's a balance sheet item. The principal of finance is that assets equal liabilities. And so on the liabilities side of the balance sheet let's say for argument purposes there's two sources of capital, debt and equity. If it's all debt, then that should equal the assets. But if you convert it to equity, now you have a balance sheet that reflects equity and debt. And so the first thing that has to happen is that as the equity is infused, you basically -- the account is, my best understanding, would go to additional paid in capital, and all of a sudden now that additional paid in capital amount grows, the debt is taken off the books, and you now have created equity. Because equity is the par value or the common stock, the additional paid in capital, which in this company's specific circumstances would be the equity infusion. In a publicly traded company, it's the difference between the par value of the stock and what they actually received when they sold the stock to the public and retained earnings.
Q. So but when you say the word equity infusion, you include in that concept converting debt to equity and no more, not actual dollars plunked into the bank?

A. Well, it could be both. But in this circumstance, the first step is the -- clearly the transaction of taking the debt and converting it so that it goes to the additional paid in capital. And then the next thing would be the actual cash, that would be additional paid in capital, which would now provide the cash to fund the operations.

Q. And what cash are you talking about?

A. A check.

Q. Right, but that's a different -- that's new money, I will call that new equity from my point of view.

A. That's right.

Q. As distinct from converting debt to equity.

A. That's a good way to look at it.

Q. But in both cases you would call that an infusion of capital?

A. Right, but the old -- the old debt that we're converting was also cash. It was a check. The cash came in, it was represented by a -- you got a -- now on the balance sheet you have cash, now the liability is $10 Million of loans.

Q. Right, and I think that's why I'm having a problem since that cash that really existed was provided say three years ago, and now we're going to instead of calling that debt we're going to call it equity. The cash may not be there any more.

A. That's right.

Q. And yet you're saying from a financial stability point of view and a balance sheet point of view, the company does have equity that it didn't used to have?

A. That's right, because the liability has been converted from debt to equity through the transfer of that amount to the additional paid in capital account.

Q. All right. Here's another accounting 101 question. There was discussion about retained earnings as being part of equity. This is similar to the previous question. If you start with 100% debt, no equity, and then retain some of the earnings, is that retained earnings now equity?

A. Yes.

Q. Okay. Another elementary question, are retained earnings calculated before or after payment of expenses for things like maintenance?

A. They're after payment of all expenses, maintenance, interest, taxes.

Q. So if you have company A that say is doing a very good job every year of expending money for maintenance versus company B who hasn't done that for several years, if they both pay out, if they both have the same equity ratio I think was the term.

A. Mm-hm.

Q. Are those companies the same in terms of I guess I will say fiscal responsibility?

A. No.

Q. All right. And --

A. I can explain why.

Q. Okay. Yes, do.

A. Because prudent management would not defer the O&M. What you're doing is robbing Peter to pay Paul. And so if you rob Peter to pay Paul, you have less O&M, and so you increase earnings, all else being equal. And so by increasing earnings, now you have earnings, retained earnings, one or two things, you can invest in new facilities, or you can pay it out. So if you keep the equity ratio constant over time, the company that maintains its facilities is in a better position, because it doesn't have deferred maintenance. And at some point, the company that robbed Peter to pay Paul will have to pay the piper, and that's why they're not the same.

Q. And so if we're asked to compare equity ratios of one company to its industry or one company to another company or another industry, isn't it only meaningful if you also look at that other side of the equation, that is, what happened before you got to those earnings?

A. Yes.

Q. All right. You had discussion which I more or less followed on the $10 Million asset and what would happen if it were decided -- if the management decided it was worthless, and you went through some consequences on the balance sheet.

A. Mm-hm.

Q. I had the sense that you were talking about something in this case, and if you could just tell me what that discussion was relevant to, I would appreciate it.

A. It's related to Mr. Peck's testimony when we heard for the first time that one of the elements to get unqualified financial statements would be to write off Cross Cascades. So let's just assume for hypothetical purposes it's not $10 Million but it's about $20 Million. When the management determines that an asset that it has on its books, $20 Million, is worthless, it has to now charge that to earnings, and there is a connection between income statements and a balance sheet. The balance sheet is -- says at this point in time for this 12 month period, here is the assets and liabilities, here is the firm. The income statement is a 12 month period that says, over this 12 month period, this is how revenues, expenses, and income, and then, you know, what we choose to do with the income.

So when there's -- lets assume there's no dividend payout, so we have earnings. The earnings in retained earnings now reflect owners' equity, because it's on the balance sheet. It gets transferred from the income statement as retained earnings onto the balance sheet, and you have value. You increase the value of the company by that amount of earnings.

Q. So --

A. Okay. So now in the hypothetical that Cross Cascades is worthless, $20 Million, the first thing you have to do is charge that to current earnings. It's exactly what's been going on with all of this accounting is they're saying these assets that we have put on our books are no -- they're impaired, and we have to now -- when you hear the phrase they're taking a charge, that's exactly what they're doing. They're saying this asset is impaired, it no longer has the value, we made an investment, we thought we would have a certain kind of revenue stream, we're no longer -- we have made a decision that it no longer has that value, we have to charge it to earnings. And that's exactly what's related to this case so that -- and if there are no earnings, now the loss has to go to prior earnings. And if there's not enough prior earnings, now it goes to additional paid in capital. And if there's not enough there, now all of a sudden you have negative equity.

But it has to flow from the income statement to the balance sheet, and that's financial accounting. That's the fundamental principle of reporting earnings and reflecting credible information to investors about the status and the nature of this firm as an ongoing economic entity.

Q. Okay, thank you. There was another question deferred to you, and it had to do with the ratio, and you're going to have to fill in of what to what, but do you remember of 1.75 to 2.25 that Mr. Fox found -- said was the norm among the oil pipeline industry?

A. Yes, I remember that testimony.

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

MR. TROTTER: Can I just interject, I think his testimony was it was the ratio of BP Pipelines, but the record will speak for itself on that.

CHAIRWOMAN SHOWALTER: Okay.

MR. TROTTER: But I just wanted to make sure -- it may not be quite exactly as you indicated.

CHAIRWOMAN SHOWALTER: All right.

BY CHAIRWOMAN SHOWALTER:

Q. I'm really just trying to get at your evaluation of that range of ratios, if you are able to give any opinion on it.

A. Well, the -- I can.

Q. First of all, can you just remind me --

A. What was the ratio?

Q. Yes.

A. The ratio was total revenues to operation and maintenance expense.

Q. Right.

A. And the Commission uses that as a measure for rate of return in transportation. It's another way to evaluate rate of return. It's called the operating ratio. And we use it because there are a lot of transportation companies that don't have a lot of rate base. And so when we regulate them on operating ratio, if you take that 1.75 and just take the inverse of it, in other words divide it into 1, that is operating ratio. And when we say we regulate companies and we provide a 90% operating ratio or whatever we -- the standard that we have adopted for this particular carrier, it's just another way to measure rate of return.

But the reason why it works for those

companies is the fact that they don't have a rate base. They turn over -- they have -- they need lots of revenue, they need higher rates of return because they turn over. A good example is like a grocery store. They turn over their inventory a lot. They have quick turn over. They have higher operating but low amounts of assets. Their inventory gets turned over.

A company like Olympic or an electric utility or even to some extent a gas company, they have more rate base. It turns over less. And so that's why in preference of operating ratio we use rate of return regulation.

Q. All right. Last night there was some discussion about cost allocation among jurisdictions. Do you agree that Puget, for example, has transmission lines that are used to serve both its retail function regulated by this State as well as its wholesale function regulated by FERC?

A. Yes.

Q. And do you agree that when you use a telephone to make either a long distance interstate call versus an instate call, you're using the same telephone and telephone wires?

A. Yes, and for telephones it's even more complicated, because the same copper pair gives you interstate, intrastate services, competitive services, discretionary services, a whole myriad of services through that dual copper pair into your home.

Q. And are those functions regulated by both or different functions regulated by the State in the case of intrastate and by the FCC in the case of interstate?

A. Correct.

Q. And does there need to be allocations of cost among those different functions and jurisdictions?

A. Yes, and my understanding is there's very prescriptive rules for those types of cost allocations. Those are the part X regulations under the FCC, and we -- you have a separate jurisdiction -- even though it's the same copper pair, the FCC has jurisdiction over the interstate piece and how -- and we have to allocate costs of that copper pair in the central office to the interstate, and they determine what their cost is under their jurisdiction, and the Commission has its way of determining costs for its intrastate piece.

Q. Okay.

A. They're separate even though it's the same copper pair.

Q. Okay.

A. And this pipeline is the same way.

Q. And likewise, take the case of Pacificor, do

you agree that it's regulated by six different states as well as the FERC for wholesale operations?
A. Yes.
Q. And in all of those cases, aren't there different methodologies by either our state versus FERC or FCC or our state versus other states --
A. Yes.
Q. -- for determining the appropriate regulation for the component under that jurisdiction?
A. Yes. And, in fact, it's different, and each state is allowed to exercise its discretion in terms of how it chooses to regulate and determine costs for its jurisdiction, for its piece, its -- the part that it regulates.
Q. Now do you agree that there is a tension that develops because of the different jurisdictions with their different methodologies?
A. Yes, it's called the regulatory gap or I have heard it called the black hole or -- but yes.
Q. Well, then in that respect, if you determined that the FERC methodology was reasonable but different, would you agree that we should seriously consider for consistency's sake deferring to a different methodology if we found it to be reasonable?
A. That's your discretion.

Q. But to the extent that we find that it is not a reasonable form of regulation, does that offset the value for simplicity of consistent regulation from one jurisdiction to another?

A. No. And, in fact, in telephones and in states, it's -- this -- this is part of being a regulated company, things -- that's what you have to deal with. I can tell you during nuclear construction and the big power plant constructions for states like Pacificor, they had each state had its own different way. The states have their own rate making policies, FERC has its own rate making policies, you know, in many different things.

The important thing is to, based on what you feel is the right way to regulate, it's you make that decision, and the companies deal with it. And it's not -- I don't think it's saying that, well, one is paying more of their fair share of costs than another. It's this is a reasonable rate based on your regulatory principles and policies in determining what's a fair rate.

Q. Are there some companies such as Verizon that operate in 50 states with 50 state regulations as well as the FCC?

A. Yes.

Q. I want to get at the question of whether the Staff recommendation will or won't induce BP to continue to invest in order to get up to 100%. You have heard Mr. Fox and others say fairly flatly, if it's the Staff's recommendation, there's no way that London is going to agree to give them money. And I am wondering what you think of that consequence, if that is the consequence?

A. Well, if -- I think the consequence is that there's still the public service company, and under your authority, you have, if you feel that this record is adequate enough that investing the $66 Million over three years to get the company up to full operating pressure and to fully integrate Bayview again into the operations of the company so that it's a fully used and useful facility as originally intended, you can order them to do that, and then it would be incumbent upon them to make those investments and get the pipeline up to full operating pressure and then come in and seek appropriate rate recovery. It's, in my mind, this is almost like a game of chicken, but they're a regulated company, and I believe they have an obligation to build and maintain adequate facilities and make the necessary investments to get this line up to operating pressure. And once they make those investments, they can come in and get a fair rate.

Q. Well, I agree, that's the vision of the Staff's proposal and that the Staff would propose a certain rate now, and as I read the Staff's recommendation, you would like us to more or less lay out a road map in our order giving some comfort to BP or Olympic that should it invest more, it stands a good chance of getting it recovered. Is that more or less the concept?

A. Well, but I don't think it's really the road map you have to lay out in your order. It is I wouldn't use the term regulatory compact, but you heard the testimony of Dr. Means in that regard, and that's the regulatory paradigm that I think is in the public interest. You provide a fair rate now based on the record that's in front of you. If they choose not to make the investments, if you feel that they're in the public interest, you have the authority to order those improvements. And then if they still choose not to, then they're in violation of the Commission's order. You have sanctions under the statute.

And then at some point if they choose to say we don't want to be an operator, they can now choose to sell or whatever, get a different operator, but that is the kernel of the Staff recommendation. And this is --

the existing regulatory paradigm in Washington provides for fair compensation on facilities that are serving the public, and the compact is that you make the investments, you do the upgrades, and you're entitled to a fair rate once you make those investments.

Q. So what I'm interested in is kind of when push comes to shove if people are just not seeing eye to eye, you are saying that if we adopt the Staff recommendation, ultimately if Olympic or its owners just don't see it the way we see it, that ultimately we could require the company to invest, and if they didn't, we have the ability ultimately to find a new operator. Is that more or less what you're saying?

A. Yes, what I'm saying is that they're the regulated company, and you're the regulator. And under my reading of the statutes are that you can tell them -- you can look at them and stare them down and say, this is a fair rate. And if they choose on the basis of that not to invest, you can order them to make the investments. And then if they choose to ignore that order, you have sanctions. And it's my -- the Staff recommendation is to use your authority under the State's public service laws to provide a fair rate and make these investments happen and get this pipeline back up to full operating pressure. What I hear the company doing is they're forcing you to stare them down, and the Staff recommendation is that --

Q. Stare them down?

A. -- you have to stare them down.

CHAIRWOMAN SHOWALTER: All right, thank you. I have no further questions.

E X A M I N A T I O N

BY COMMISSIONER HEMSTAD:

Q. I have only one, and I have asked this before. In light of the references to other states, do you have any knowledge about how other states respond to the issue of adopting FERC regulation or using alternative methodologies?

A. I don't have any now, but I could -- I believe NARUC publishes that information, and I think we could find it fairly readily if you would like it. But as I sit here now, I don't have the specifics. My general understanding is that depreciated original cost is the preferred method for the reasons that I have stated in previous testimony, but I don't have any specific knowledge right today.

COMMISSIONER HEMSTAD: Thank you.

COMMISSIONER OSHIE: I have no questions.

C R O S S - E X A M I N A T I O N

BY MR. BRENA:

Q. I have one perhaps series, but Chairwoman Showalter and you just had a very interesting conversation about who is the regulator and who is the regulated and how that paradigm should be treated. Do you have those questions and answers in mind?

A. Yes, I do.

Q. Okay. I want to reverse this. Let's say that the regulator blinks. Do you think it's in the public interest for the regulator to blink and set higher than a just and reasonable rate because an owner balks and they withhold investment; do you think that's a signal that should be sent through the state of Washington?

A. No, that's why I answered the question to her the way I did.

Q. So if we're going to leave cost based regulation because an owner may withhold investment, then are we in a better place that's in the public interest or a worse place?

A. Well, we're in the worse place, and, in fact, I don't think, I mean this is again I'm not a lawyer, but I think that legislature was very specific in its direction to the Commission. It's saying -- I look at the public service laws and say that is not the way we want you to act and execute those public service laws.

MR. BRENA: Thank you.

JUDGE WALLIS: Are there follow-up questions?

MR. BEAVER: There are.

C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. Mr. Elgin, did I hear you correctly a minute ago in response to the Chairwoman's questions to say that you believe this agency has the authority to order Olympic to invest $66 Million to get its interstate pipeline up to 100% pressure?

A. I didn't say that. I said that the Commission has the authority to order the company to make whatever investments it feels are necessary to adequately provide service in the state of Washington, whether that be up to 100% or whatever, but it does have the authority. And how it chooses to exercise and what are the circumstances that it would exercise that authority, I did not specify.

Q. Do you know what agency actually has the regulatory authority over 80 some percent of Olympic's pipeline system?

A. I don't know. I don't -- I don't know.

Q. Was the assumption that this agency in fact has the ability to order Olympic to invest a basis for or in any way a basis for the Staff's recommendation?

A. I don't understand your question. Maybe if you could rephrase it and try it again.

Q. All right. The response that you gave to the Chairwoman's question a minute ago about your belief concerning this agency's authority to order investment, was that assumption in any way a basis for the Staff's recommendation?

A. No.

Q. Is BP regulated by this agency?

A. No, Olympic Pipeline is.

Q. So is it your belief that this agency has the authority to order BP to invest money in Olympic?

A. No, it has the authority to order the regulated public service company.

Q. Okay. And I want to ask you some follow-up questions about some of the other questions that the Chairwoman asked you. She asked you a question about a company that had 50% debt and 50% equity versus a company that was 100% debt, but that debt was guaranteed by the parents, and whether there would be a preference in your mind to lending money to one of those two entities. Do you remember that question?

A. Yes, I do.

Q. I want you to make another assumption, and that assumption is that with regard to this company that is 100% debt that you actually get, you as the new lender, a priority security interest ahead of all of the parent debt and all of the parent guaranteed debt.

A. Okay.

Q. In other words, you are first in line.

A. I understand your assumption.

Q. In fact, wouldn't that entity be the entity that as a lender you would be more interested in lending money to with all else being equal?

A. Always if you're first in line, yes.

Q. I want you to assume another situation. Again we have this 50/50 debt equity company versus 100% debt, and that debt is made by the parents or guaranteed by the parents. And you as the new lender are offered by two entities with a combined equity of over $117 Billion a guarantee for that new loan. Again, wouldn't that be the entity that you would be more likely to invest money in?

A. Well, again, you would have to evaluate the circumstances of the loan, but if the company had that kind of equity and was standing behind it, you would have different assurances. Yes, I would agree with your hypothetical.

Q. Okay. You were asked questions I think again by the Chairwoman about this ratio between total revenues to operating and maintenance expenses; do you remember that?

A. Yes.

Q. Are you aware that the WUTC tariffs that have been allowed to go into effect for Olympic previously have provided a ratio of 1.9 that is revenue to operation and maintenance expenses?

A. I don't know that.

Q. Would you accept that subject to check?

A. Well, the problem I have with accepting that is that if you're saying that when the company filed that it provided evidence that showed that its O&M was X and the revenues were 1.9 times that; is that what your question is?

Q. Yes.

A. And for which filing so I can check that, for which?

Q. It would be the most recent.

A. Which is?

Q. '98.

A. I'm looking to the back of the room to see if I can -- we can check that.

Q. Thank you. I'm almost done.
Mr. Finklea asked you some questions that prompted you to talk about this equity cushion concept.
A. Yes.
Q. And I think you were suggesting that a 50% equity cushion would be kind of a good idea to maintain; did I get that correct?
A. Yes.
Q. Now obviously Olympic prior to the 1999 year had equity, either as you calculated it I think it was close to 18%, or as I calculated about 20%, correct?
A. Yes, about 20% equity.
Q. And that equity disappeared, correct?
A. Yes.
Q. Well, let's assume that it was either 20% or 50%, either one, you know, is it your testimony that you believe the owners have an obligation to maintain that equity ratio if some disaster happens that wipes it out?
A. Well, in that circumstances, if the -- would be -- if they choose not to make the equity investment, the other option is receivership. So you make judgments about the circumstances that give rise to the erosion of revenues, and when those revenues are insufficient to meet debt service and pay O&M and are continuing to eat into earnings, then -- and then at some point when the

debt can't be serviced, then the decision has to be made as to whether or not additional equity will be provided or the business no longer operates.

Q. Well --

A. That's the essence of American enterprise.

Q. Olympic is still operating, correct?

A. That's correct.

Q. And it apparently didn't do either one of those things, did it?

A. No.

MR. BEAVER: Okay. I have no other questions.

CHAIRWOMAN SHOWALTER: I have a follow-up.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Well, I have a follow-up to Mr. Beaver's hypothetical that was a variation of my hypothetical, the third party lender. And we have seen in the last year several multi tens of billion dollar companies go from those kinds of values to virtually nothing, so I will ask the question again but using his hypothetical. If you had two companies, one has a 50/50 actual equity, and the other has 100% debt, and they're both owned by multi multi billion dollar companies, and now the third party lender can loan to the first company, which has the equity, or the second company but have its loan come first in line. So all I'm trying to test for is the value of equity, all other things being equal, but this time let's say the loans are guaranteed. Are those two, does the third party lender look at the company with equity more favorably than the one without even though the loan is backed by the owner?

A. Well, the way I answered his question was the hypothetical had the condition of you get to be first.

Q. Right.

A. And but lots of times when there's already debt outstanding, for example, there's restrictions, they don't allow you to do that. So I answered it in the narrow sense of his hypothetical, but in reality there are covenants in existing debt instruments that prohibit somebody -- the company from doing just that, so.

Q. Okay. But I guess the question I'm trying to get at is even if let's say you're first in line, there's really nobody else around. But on the one hand, the third party loan has equity to look to should things go wrong. On the other hand, in the other case it doesn't have any equity to look to, but it does have the guarantee of a big other company, but you don't know what's going to happen to that big other company.

A. You don't.

Q. That is had the other company been Enron or been Qwest or been WorldCom, the third party lender wouldn't be very happy right now.

A. Right.

Q. Looking at some equity in the company.

A. Right.

Q. That's what I would have thought, but that's what I want your opinion on.

A. Yes, and that is -- that is fundamentally -- your hypothetical -- I mean when you're on the stand and you get these hypotheticals, the question is how -- at what point then does the hypothetical approach what really happens, okay.

Q. Okay.

A. So your hypothetical is in my mind more based in terms of what would likely happen. If you have a firm that's lending money and it has some equity, if I'm a potential lender, I look at the equity, and I also look at the assets and to the extent what are the assets on the balance sheet, and I will evaluate the likelihood of the impairment, in other words what can those assets produce, and also where I will be in the context of the loan. And if you have equity, you already have a 50%

cushion, you already have half of it, so that if in the likelihood that the assets are only worth half, you are still going to get your money, your principal back.

Q. I mean I would think another way to put it is that all other things being equal, and I mean all other things, so the guarantees, whatever the situation is, all other things being equal, a third party, a prospective third party lender would rather see equity there than not.

A. Right. And in the hypothetical that Mr. Beaver presented me, if you go first in line, you know, you're now a bond holder, and I answered, I said, yeah, now I'm better than any other bond holder. And then to the extent that there is a parent guarantee, I would still need to look at the underlying economics of that parent who is guaranteeing the loan and the assets supporting that guarantee. But all else being equal, if you have some equity and I'm choosing to invest, I mean that's exactly when you look at these bond covenants.

If you recall when we went through the thing about Avista and you recall those covenants and those -- the testimony and exhibits regarding coverages and debt and equity ratio, those are all things designed to protect investors, third party providers of capital and debt, additional debt. And that's why equity is there, all else being equal, and you will see income, and it's traditionally a restriction on the amount of total debt that you can issue.

CHAIRWOMAN SHOWALTER: Okay, thank you.

MR. BEAVER: One follow-up.

JUDGE WALLIS: Mr. Beaver.

C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. Maybe we should have brought a loan officer in here, but you made a comment about what you would look to, which confused me actually quite a bit, in your response, and you indicated that you would look at the assets and the equity. What about the liabilities, would you look at the liabilities of this entity that you were thinking about loaning to?

A. That's what equity is, it's a liability, it's a liability to the owners.

Q. I understand that. But, for example, if this entity was involved in a myriad of lawsuits with all kinds of claims against it, I mean is that something that you would think about?

A. Yes.

MR. BEAVER: I have no other questions.

MR. BRENA: I have one.

C R O S S - E X A M I N A T I O N

BY MR. BRENA:

Q. Mr. Elgin, have you ever tried to collect on a multimillion dollar guarantee?

A. No.

Q. Do you think that would be an easy process?

MR. BEAVER: I'm going to object. Obviously he just said he hasn't, so this clearly calls for speculation.

MR. BRENA: Well, and I am exploring the value of having something, equity, versus a guarantee and what the relative benefits of those are. It goes directly to the Chairwoman's line of questioning, and so I would like to be able to --

JUDGE WALLIS: The witness may respond to the extent of his knowledge.

A. I would think that the larger the amount in terms of a guarantee, the more likely there would be some issue regarding recoverability, but I think as I understand what your hypothetical question was.

BY MR. BRENA:

Q. I mean --

A. It's different than equity still.

Q. The way the real world works is the guarantor really doesn't think it's his debt because it's primarily due by the principal, correct?

MR. BEAVER: I'm going to object. First of all, it's clearly speculative, it's also leading, this is friendly cross.

MR. BRENA: Which one shall I respond to first. I'm just exploring the Chairwoman's hypothetical between the difference between equity and a guarantee in the hypothetical. I don't see that it's friendly or not friendly.

JUDGE WALLIS: We will allow this question, but we think you're getting pretty close to the line here, Mr. Brena.

MR. BRENA: All right.

BY MR. BRENA:

Q. Well, I'm just trying to reduce this down to the real world, and that's what you were trying to do. In the real world, would you agree that it's not real easy to go out and get someone to write a multimillion dollar check to honor their guarantee of some third party debt?

A. That would be an issue. I would agree with that.

Q. I mean you're buying a lawsuit, aren't you?

A. I can't answer that.

MR. BEAVER: Objection, speculative.
MR. BRENA: I'm done.
MR. TROTTER: Your Honor, I recommend we take our lunch break. That will help us streamline our redirect, and I promise there will be no questions about work papers supporting the company's cross exhibits. But I think we have had now over three hours of cross-examination, and we would like to be able to focus it, and I think we will be able to do that.
MR. BEAVER: I will give you my work papers if you want.
JUDGE WALLIS: Very well, let's take our noon recess now, and we will be back at 1:30.
(Luncheon recess taken at 12:15 p.m.)

A F T E R N O O N S E S S I O N
(1:30 p.m.)

JUDGE WALLIS: Let's be back on the record, please, for our afternoon session.
Mr. Trotter, I believe at the point we broke you were prepared to proceed with redirect.
MR. TROTTER: Yes, Your Honor.

R E D I R E C T   E X A M I N A T I O N
BY MR. TROTTER:
Q. Mr. Elgin, during the lunch break, were you able to confirm whether or not NARUC reports state regulatory practices with respect to oil pipelines?
A. It does not.
Q. Also I think you said just before the break that equity is a liability; can you clarify what you meant?
A. Yes, I am sorry for that confusion there. I meant it's on the liability side of the balance sheet.
Q. You were also asked some questions or gave some testimony regarding this Commission's authority to order Olympic to invest or BP to invest and so on. Do you recall that line of questioning?
A. Yes.
Q. And you're not a lawyer, so your testimony is based on your understanding of the state statutes; is that right?
A. That's correct.
Q. Did you have the statute in front of you when you gave that testimony?
A. No, I did not.
Q. Just referring you to 81.28.240, does that statute speak in terms of the Commission ordering a

public service company to provide among other things sufficient facilities to be furnished?

A. Yes.

Q. Does it speak in terms of investing money specifically?

A. No.

Q. You were asked a question by Mr. Beaver comparing equity to debt in an instance where the lender permits the principal and interest payments on the debt to be deferred; do you recall that?

A. Yes.

Q. Is equity the same as debt in that context?

A. No, it's not.

Q. What are the distinctions that immediately come to mind?

A. The biggest distinction is the fact that debt is a contractual obligation between two parties to make principal and interest payments in some kind of fashion, and to the extent that debt is a contractual obligation to pay, if the company does not pay, it then puts the deferred payment on its balance sheet in the liability side as accrued interest and is under a contractual obligation to pay it at some point in time. Whereas if it were equity, there is no contractual obligation. Equity owners are only entitled to the residual earnings of the firm, and they're -- so to the extent that there are no earnings, there is no obligation to receive any return or principal repayment. So that is a major distinction.

Q. Would the debt in that hypothetical be carried on the books as equity?

A. No.

Q. Would it be carried on the books as debt?

A. Yes, it would be.

Q. You were also asked some questions whether Olympic could have financed under certain circumstances, and in the context of one of your answers, you said if you were at Olympic at that time, you would have prepared a financial plan; do you recall that?

A. Yes.

Q. Would a component of an appropriate financial plan be a decision to promptly file for rate relief?

MR. BEAVER: Objection, the question is leading.

JUDGE WALLIS: The question is permissible.

A. Yes, in it would be a credible financial plan would include what specific actions would be necessary to enhance the revenues of the company.

BY MR. TROTTER:

Q. Are financial plans also important in terms of managing the risk of a company?

A. Yes.

Q. You were asked some questions about payout ratios for other public service companies in this state being in the 60% to 70% range; do you recall that?

A. Yes.

Q. Do other public service companies in this state have substantial equity ratios?

A. Yes, to the extent that there is an average payout ratio of companies in the 60% to 70% range, it's not unusual for also to see those companies have equity ratios in the 40% to 50% range as well.

Q. I would like you to turn your attention to Exhibit 2102-R, and you were asked a number of questions from Mr. Beaver regarding the timing of loans from Olympic's parents and the amount of earnings Olympic retained over various periods of time. I think he used 1998 forward and 2000 forward. I would like you to use this exhibit to explain -- explain how this exhibit describes Olympic's equity ratio in light of the money the owners loaned in the 1998 to 2000 time frame and what happened to the proceeds.

A. Yes, if you look at the 1998 column, you will see that under the seventh line or the --

CHAIRWOMAN SHOWALTER: Mr. Elgin, can you just tell us what row, the title of the row.

THE WITNESS: Yes, it's the title of the row is '98.

CHAIRWOMAN SHOWALTER: No, the column is '98 and the row is?

THE WITNESS: The row is construction.

CHAIRWOMAN SHOWALTER: Thank you.

THE WITNESS: Okay.

A. You will see in 1998 the companies used $25 1/2 Million for construction. Also in 1998 you will see on the long-term debt column that the company have $44 1/2 Million of long-term debt which now was reduced to $17 Million of long-term debt, so that change of approximately $27 Million and -- there's a delta there. In the next row, you will see short-term debt, and you will see short-term debt went from $2 Million to $44 1/2 Million.

BY MR. TROTTER:

Q. That's between 1997 and 1998?

A. '98, that's correct. So the company invested in new facilities of about $25 1/2 Million, which corresponds to the property line. And then you can see that in 1998 where the $25 Million is in construction, the company at that point had issued $42 Million in new short-term debt, of which it appears that $27 Million of that was for -- to take down -- to pay off some long-term debt.

Then in the next year you will see the company only spent $4 Million in new construction so -- and only -- there was very little change in net property. So it appears that in 1999, most of the company's needs for construction, cash for construction, was provided by depreciation. Now you see that the short-term debt column increased by another $24 Million. So what has happened between '98 and '99, there was $24 Million that was issued, and the cash came into the company, and it's ostensibly for a loss.

Now we go from '99 to 2000, and we see that the property figure went from 87 to 97, so approximately $10 Million, and we see that there's a correlation between that and the construction expenditure of $12 Million. So there's a -- of about that. Some of that was provided through cash flow through depreciation, but the remainder was needed to be financed somewhere, so we looked where did the money come from. So we go up and we see that $1 1/2 Million was used for long-term -- to -- the principal repayment under the -- one of the long-term notes, but the short-term debt went from $68 Million to $100 Million, so it's a delta of $32 Million. So $32 Million minus the $12 Million in construction leaves about another $20 Million.

So what this is saying is between '99 and 2000, there was approximately $45 Million to $50 Million that was loaned, cash came into the company, and it went to fund the operations, and it was a loss. And so what this exhibit shows is how the company used the cash from the loans from the parent, where it spent that on facilities, and then where -- which to support my testimony is the debt was issued to support prior operating losses, and this supports that testimony, and it's approximately $45 Million to $50 Million.

MR. TROTTER: Those are all my questions, thank you.

JUDGE WALLIS: Is there anything further of the witness?

MR. BEAVER: Yes.

JUDGE WALLIS: Mr. Beaver.

R E C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. Mr. Elgin, do you still have Exhibit 2102 in front of you?

A. Yes.

Q. It says that the source of this information is the FERC Form 6's; is that correct?

A. That's correct.
Q. Is that where all of this information came from that is on this exhibit?
A. Yes.
Q. Except obviously for the calculations that you did, I mean but the calculations were based on information from the FERC Form 6's?
A. Yeah, these are -- these numbers are exclusively from the summary lines on the balance sheet and income statements and the statement of cash flows that are in the Form 6.
Q. Could you turn to Exhibit 2118, which is the 2000 FERC Form 6, and I'm not going to go through all of these numbers, I'm just going to go through one.
A. Okay.
CHAIRWOMAN SHOWALTER: What page?
Q. And if you could turn to page 113.
A. Yes.
MR. TROTTER: Counsel, my page numbers are kind of blocked off, can you tell us what -- describe it?
MR. BEAVER: At the top it says comparative balance sheet statement continued.
MR. TROTTER: Okay, thank you.
BY MR. BEAVER:

Q. And I'm looking at line, this particular one is line 47 where it says notes payable right under the current liabilities.

A. Yes.

Q. You were aware that Olympic took out $30 Million in long-term debt from Chase; is that correct?

A. Yes.

Q. And we have on this line $30 Million; do you see that?

A. Yes.

Q. Now can you tell me where that $30 Million is on your exhibit?

A. It's embedded in the short-term debt column. You will see that line number 47 and 48 are notes payable and payables to affiliated companies, and $30 million plus $70,579,000 equals $100,579,000, which is the amount of short-term debt for the year 2000. So that's the way -- it's a note payable, and I added those two together to get that figure.

Q. And do you know why you added the long-term Chase debt of $30 Million to -- under the short-term debt line?

A. Because it's under the column current liabilities, and so it's due within -- under current liabilities, that means it's due within a year, so it's short-term debt.

Q. You understand that Olympic still owes that money?

A. Yes.

Q. So it obviously didn't --

A. Well, it owed it -- it reported it at the end of December 31st, 2000, so between -- I guess I misunderstood your question. When it published this number, it owed it. But the question is, does it still owe it now. I believe the -- there's been some change in that. The $30 Million now between end of 2000, 2001, if it's due in a year, it would have been paid off, and so it would need some additional source of funds, so I -- I'm just reporting this with respect to the FERC Form 6, and you asked me where I got the number.

Q. You're aware that Olympic actually produced for the Commission the actual Chase notes?

A. Yes.

Q. Have you reviewed those notes?

A. Not since the interim case. For purposes of this testimony and this exhibit, I didn't do that. I didn't go back and review the notes.

Q. But you understood from reviewing those notes when you reviewed them that those were actually long-term debt, in other words payable after one year?

A. The Chase note was, yes.

MR. BEAVER: Okay, I have no other questions.

CHAIRWOMAN SHOWALTER: I have a follow-up to that.

E X A M I N A T I O N

BY CHAIRWOMAN SHOWALTER:

Q. Looking at the FERC Form 6, it appears to me that all you can tell from line 47 is that there is an entry under current liabilities, that you could infer from that that it should be a short-term debt, but you can't tell, can you, just from it's being listed in this slot that it is or isn't a long or short-term debt? It's supposed to be a short-term debt, is that --

A. Yes.

Q. Okay.

A. Yes, by definition current liabilities mean something due within the year.

Q. All right. But that means if the form is filled out properly, it is a short-term debt?

A. That's correct.

Q. All right. And what the agreement actually says isn't revealed on this particular form?

A. No, it's not, ma'am.

Q. All right. So I just saw some raised

eyebrows, and so I take it that either it was a short-term debt and properly put here, or it wasn't and it was improperly put here?

A. That's correct.

CHAIRWOMAN SHOWALTER: All right.

R E D I R E C T E X A M I N A T I O N

BY MR. TROTTER:

Q. Just as long as we're with that page, Mr. Elgin, if you could turn to still on page 113, line 58.

A. Yes.

Q. Is that where long-term debt would be reported if it was long-term debt?

A. Yes.

Q. Okay.

A. And that is -- represents the $14 Million figure that's right above the $100 Million figure.

Q. And with respect to your answer to my question in which you raised these figures and brought these figures to the Commission's attention, does it really matter whether the $100 Million was short-term or long-term, it was still debt; is that right? Did it matter to your conclusions whether it was short-term or long-term?

A. No.

MR. TROTTER: Thank you.

R E C R O S S - E X A M I N A T I O N

BY MR. BEAVER:

Q. I hate to ask one, and this is solely for clarification, and I don't know if it matters, but the line 58 entry that counsel just asked you about, do you understand that that is actually the Prudential loan?

A. Yes.

MR. BEAVER: That's all I have.

JUDGE WALLIS: Nothing further for the witness?

Mr. Elgin, thank you for appearing, you are excused from the stand.

THE WITNESS: You're welcome.

JUDGE WALLIS: We will be off the record while Mr. Brown prepares to step forward. And during our break, we will get sorted out the exhibits for Mr. Brown.

(Recess taken.)

JUDGE WALLIS: Let's be back on the record, please. Tesoro has called to the stand at this time its witness John F. Brown.

Mr. Brown, is my recollection correct that you have previously testified in this docket?

THE WITNESS: Yes, sir.

JUDGE WALLIS: I will merely remind you that you have been sworn under oath.

And, Mr. Brena, the witness is available.

Whereupon,

JOHN F. BROWN,

having been previously duly sworn, was called as a witness herein and was examined and testified as follows:

D I R E C T   E X A M I N A T I O N

BY MR. BRENA:

Q. Good afternoon, Mr. Brown.

A. Good afternoon, Mr. Brena.

Q. I have a few questions for you.

A. I would say, don't we cover the errata first or last.

JUDGE WALLIS: Let's note for the record that Exhibit 2301-T has previously been identified and that a number of additional documents have been distributed for use with Mr. Brown. These consist of the following: 2302, which is an alert notice ALN8801; 2303 which is 49 CFR Part 195 from the Federal Register of November 4, 1998; 2304 is pressure restriction exhibits; 2305 is one time expenses exhibits; 2306 is CIPL Supreme Court decision; 2307 is an order P85(16) for CIPL; 2308 is an order P82-6(25); 2309 is order P91-2(11); 2310 is a decision involving Amoco Pipeline Company; and 2311 is comparative rebuttal information.

MR. BRENA: Thank you, Your Honor.

BY MR. BRENA:

Q. Are you sponsoring 2301 through 2311, Mr. Brown?

A. Yes, I am.

Q. Do you have an errata for 2301-T?

A. Yes. On page 3, line 5, it currently reads, Pipeline Safety's (OPS) and Department of Environmental Conservations. That should be Department of Ecology, and just to be on the safe side, change the designation to DOE. I'm not sure if it's used anywhere else in the testimony, but change it to DOE.

And then on line 6, the first word is safety, and after that first word add and environmental.

Q. Are you also sponsoring an exhibit that was previously prepared for Mr. Beaver, Exhibit 1006?

A. Yes, I am. I thought that was on this list of -- but maybe it's not. In any event, yes.

Q. Yeah, it is on the list of 2304, but it was not sponsored because Mr. Beaver did not appear.

With that errata, do you accept the testimony in its current form?

A. Yes, I do.

MR. BRENA: I would move for the introduction of the marked exhibits.

MR. MARSHALL: Your Honor, the testimony was subject to a motion to strike two phrases, which was granted by Your Honor on June 13th. Those are still in the testimony. If you recall, the motion dealt with the unproven criminal allegations, and they still appear here. And for the same reasons, we have an objection to those exhibits that were marked for Mr. Beaver's examination as well. Those are unproven allegations, and there's no foundation for this witness either to prove any of those unfounded allegations.

JUDGE WALLIS: What document or documents are you referring to in your letter?

MR. MARSHALL: The letter, what I have right here is the motion to strike, which again, Your Honor granted. Lines 16, 8 to 9 of the testimony, and page 52, lines 18 to 20, which again was granted on June 13th.

MR. BRENA: Would you go back to that, please.

MR. MARSHALL: Sure.

CHAIRWOMAN SHOWALTER: What was the page?

MR. MARSHALL: Page 16 is the first place where that appears.

MR. BRENA: We do not oppose that correction.

THE WITNESS: Would you give me the --

MR. MARSHALL: Certainly.

THE WITNESS: Thanks.

MR. MARSHALL: After we repeat it long enough, we probably shouldn't even strike it. That's one of those issues where ignore that.

JUDGE WALLIS: Could, Mr. Brena, seeing as how you won the, or I'm sorry, Mr. Marshall, seeing as how you won the motion on this, could you provide corrected copies or pages with that material excised.

MR. MARSHALL: Certainly, that would be good, we'll do that.

THE WITNESS: Can you tell me what lines were stricken, I don't know.

JUDGE WALLIS: Let's be off the record.

(Discussion off the record.)

JUDGE WALLIS: Mr. Marshall, you are going to provide corrected copies of the testimony for the record; is that correct?

MR. MARSHALL: Yes, excising those portions relating to the motion.

JUDGE WALLIS: Very well. And you're objecting to reference in Mr. Brown's Exhibit for identification 2304 to a document proposed for presentation through Mr. Beaver. As we recall, Mr. Beaver declined to testify following a ruling about his eligibility to testify earlier in the proceeding, so that document was never offered to the record.

Now just as a procedural matter, I take it, do I, Mr. Brena, from this reference that Mr. Brown seeks to sponsor Exhibit 1006?

MR. BRENA: Yes, Your Honor.

JUDGE WALLIS: And should we consider that a part of the 2304 exhibit?

MR. BRENA: Yes, Your Honor.

JUDGE WALLIS: Now, Mr. Marshall, your objection to that document is?

MR. MARSHALL: The objection to the document is these were cross-examination exhibits proposed by Tesoro for use with Mr. Beaver, and they consist of the first three items of six as complaints and notices, all of which remain unproven and which are beyond the knowledge of the witness, the last three of which are either press releases or Seattle Times articles. Again, those are hearsay containing unproven allegations again beyond the knowledge of this witness. He would not be able to authenticate or speak with any personal knowledge about these articles.

JUDGE WALLIS: Mr. Brena, what's the purpose for which this exhibit is being offered?

MR. BRENA: The issue is whether or not the financial consequences associated with the pressure restriction should be borne by the rate payers of Olympic. Previously it had been argued successfully that a reference to criminal allegations was not appropriate. This is the other side of the story that they have told with regard to Whatcom Creek. They have had a parade of witnesses put in their side of the story. Mr. Talley has, Mr. Batch has. This is -- this balances the record with regard to the events.

It is our position in this proceeding that this pressure restriction arises from the imprudent operation of the operator and that this Commission should not use the restricted throughput as a basis for rate setting. Consistent with that theory, we're in a position of having to advance facts and evidence. This witness has reviewed all of these documents, is familiar with them, has sat through the entire hearing listening to the testimony of Olympic's witnesses, and is -- and under the best evidence rule, this is proper to come in.

JUDGE WALLIS: Are you offering these documents for the proof of the information contained therein?

MR. BRENA: I'm offering these documents under the best evidence rule to demonstrate in part operator imprudence.

CHAIRWOMAN SHOWALTER: Mr. Brena, I just have a question on these six documents here. The first three are, you know, a notice or a complaint, but the second three are reports of an agency action and fine.

MR. BRENA: Mm-hm.

CHAIRWOMAN SHOWALTER: Is there a distinction between the two in that the latter three are reporting a finding or resolution by an administrative body, but the first three are not?

MR. BRENA: We have throughout this proceeding -- well, yes, of course, there is. I think that there is a distinction there, but I don't think that the distinction should go to the admissibility of any of the documents. We have cross-examined extensively on the corrective action order, on notice of violation, on the notice with regard to the ERW pipe. We have throughout this proceeding used these types of materials as a basis to advance our case, and there is nothing in substance or style or procedure different from these documents than the ones that have already been admitted into the record. They just allow us to present our side of the record.

JUDGE WALLIS: Do other counsel wish to comment first before we go back to Mr. Marshall?

MR. TROTTER: Well, I think it is crucial to understand the purpose for which they are offered, because allegations in a complaint are just allegations, they're not proof of facts. I do see the distinction the Chair pointed out with respect to a formal agency action of whatever nature. And it wasn't clear to me for what purpose allegations in a complaint would serve, but certainly if Mr. Brena can identify that, that might move us along. But it does seem to me the agency actions are appropriate to be admitted to show what the agencies have done within the scope of their authority. With respect to the other complaints, I think that's a little more tenuous.

MR. BRENA: Well, Your Honor, the --

JUDGE WALLIS: Excuse me, specifically which documents do you put in which classification?

MR. TROTTER: The notices of penalty I would classify as agency action. The complaint, which is, you know, in a form of an action by the government, but I would nonetheless put it in a different category. If the purpose of the complaint is to show that there are complaints, that's one thing. If that's the purpose, then the issue is whether that advances the issues in the case or not. But I do think that the DOE penalties are the result of agency action and investigation after investigation, and then it ought to be -- those appear to be much more probative.

JUDGE WALLIS: Mr. Marshall.

MR. MARSHALL: Yes, with regard to the first item of the six, the complaint, that was objected to in the interim case. Your Honor may remember that he denied the admissibility of that complaint already. That was the foundation for our motion to strike the same unproven criminal allegations in the testimony. So I disagree with Mr. Brena's characterization that these are the same in substance, style, and procedure as to what we have been doing. Just to the contrary, we have already had a ruling on this exhibit once, and it has been objected to and ruled on and kept out.

With regard to notice of penalties, those are notices only. Those penalties have not been paid, they are being contested. It's not a resolution, it is a step in a process, and it doesn't have anything to do with pressure restrictions. Mr. Brena is trying to link it up to some pressure restriction, it has nothing to do with pressure restrictions.

With regard to the Seattle Times article on the $75 Million settlement, that again has nothing to do with pressure restrictions. And, in fact, this witness won't have any knowledge of it, but I would ask him if it came in if he knows anything about who paid for those settlements, were they insurance companies. If he's trying to link it to the financial condition of the company, of Olympic, that $75 Million settlement, this witness will not be able to link in the least to the financial condition because of the presence of insurance.

And the same thing with all of these, they're all not capable of being testified to by this witness. If Tesoro wanted to ask questions of Mr. Batch, Mr. Talley, and others about these things, they should have been marked as cross-examination exhibits then. To do it now where we can't respond in detail through a witness that will have absolutely no factual background one way or the other about any of these items is just nothing more than trying to use the witness as a vehicle to get in hearsay testimony about things that are still pending and have no link to the pressure restrictions.

JUDGE WALLIS: Do you have any objections to the other proposed exhibits?

MR. MARSHALL: Well, again, I don't see how a notice of penalty --

JUDGE WALLIS: No, I'm talking about 2301-T through 2311 other than 2304 and the documents in --

MR. MARSHALL: No, I do not except as to basic foundation on alert notices on ERW, but I can ask that of the witness.

JUDGE WALLIS: Very well. For administrative purposes, I'm going to admit 2301-T through 2311 except for 2304, and we will deliberate on that now.

MR. BRENA: I would like to respond since I get the last -- since these are my exhibits. A couple of things.

First of all, the complaint is not the complaint that was ruled on in the interim proceeding. Let's start there. That was factually wrong. The complaint that was ruled on in the interim proceeding was the criminal complaint. This is not a criminal complaint. It is a civil complaint, and it's been recently filed, so it has not been ruled on.

Secondly, hearsay, this is an expert witness, and he's perfectly entitled to rely upon his review of public records as a basis for forming his opinions and has been able to do that.

Third, I would point out that if, you know, that these arguments really go to weight and not admissibility. If they feel that, for example, under witness Beaver, they had sponsored under witness Beaver their answer to a notice of complaint, and I didn't oppose that on admissibility grounds. I said, well, if you're going to put in that document, then you should put in the other side of the document as well. So the record can not be allowed to exist where everything that tells their side of the story with regard to the operator imprudence that led to the pressure restriction is allowed in the record and without -- any such rulings other than the ruling with regard to the criminality charge, everything has been in, the notice of ERW pipe, the notice of the corrective action order. There's another notice of violation that's already been admitted I believe. These are not in form or substance different at all. The only difference is we're trying to tell our side of the story through available information.

We understand that it may or may not be persuasive to the Commission that an allegation is contained within a complaint, but this is a complaint by the United States government against this pipeline going to the way that it operated this line. This is properly before this Commission, it properly forms the basis in part for an expert witness to use in the formation of his opinion as to whether or not there has been operator imprudence.

With regard to their side of the story, we have heard a parade of witnesses comment on it, and this witness has sat in here and listened to those as well. But the fact is notwithstanding that parade, there is considerable factual basis out there for people to be suing this company, levying fines against this company, and taking agency actions against this company because they don't agree with that. That's fair, that's fair to come in.

MR. MARSHALL: One last comment on the comment about Mr. Beaver's exhibit, which by the way was withdrawn. His response was a response by Shell. I see here that there is a notice regarding Shell. I don't know where Shell fits into this. They're not Olympic, they're a separate entity.

I also have serious reservations about any of this material for authentication. This witness can not authenticate any of these.

I did jump to the conclusion that the complaint was the criminal complaint that we dealt with earlier in the interim case, and I stand corrected on that. But still and all, it's a complaint with unproven allegations, and that was the basis for stating that we have a record of objecting to having any unproven allegations in.

MR. BRENA: I would like to address the authentication issue specifically. That issue has come up and been ruled on within the course of this proceeding already. The fact that an expert witness can or can not authenticate a document, I mean these are reliable sources of information that experts routinely rely upon to form the basis for their opinions.

(Discussion on the Bench.)

JUDGE WALLIS: The objection is overruled, and the document 2304, along with it the document earlier marked as Exhibit 1006 for identification that would have been sponsored by Mr. Beaver is received in evidence. The items in 1006 are admissible for the purpose of showing context, the basis of the expert's opinion, and will be received.

MR. BRENA: With all that, I think that I'm ready to ask my witness some questions if you're ready to hear.

JUDGE WALLIS: Please proceed.

BY MR. BRENA:

Q. Good afternoon again, Mr. Brown.

A. Good afternoon.

Q. There has been some questions raised with regard to your operating experience and your experience in general to pro offer the opinions that you have offered in this proceeding. Will you please for the benefit of this Commission summarize the background that you think is relevant to the opinions and policies that you have advanced?

A. Yes. 1957, I started working in rate matters. That was the first rate case that I worked on, and I have worked on a number of rate cases since then both as an employee of two natural gas pipeline companies and also in the consulting field. In addition to that, when I was with a pipeline company in Saint Louis, I was directly involved in the operation of a small subsidiary company that was ultimately formed into the larger pipeline company. In 1978, I became president of United Gas Pipeline, which is a major interstate pipeline company having some 10,000 miles of pipe in the ground, and I was directly involved in the operation of that pipeline. I had operating people reporting to me. One of the first chores that I undertook when I became president was to sit with the gas controllers to find out how they operated the pipeline on a day-to-day basis and listened to the decisions that were made and, in fact, participated in some of the decisions that were made with regard to operating the pipeline.

COMMISSIONER HEMSTAD: Mr. Brena, I'm sorry, but I believe this kind of material was in the witness's written testimony. I think we're all concerned about time here, and I would have thought his response here would now be directed to an oral rebuttal where we have the rebuttal case, oral surrebuttal of the rebuttal case.

MR. BRENA: Your Honor, I mean Commissioner, the issues with regard to his experience and whether or not he had or lacked operational experience were raised in the rebuttal case as well as by Mr. Fox on the stand where he indicated most recently, the most recent time on the stand, is he indicated that he's got a couple of witnesses who don't know anything about pipelines that are up here offering opinions.

COMMISSIONER HEMSTAD: Very well.

MR. BRENA: And I can assure you that it's my intention just to use my hour and not more.

BY MR. BRENA:

Q. When were you first named the head of regulatory and rate making for a pipeline company?

A. In 1960, and then when I joined United Gas Pipeline, I was senior vice president of rates and regulatory affairs. That was in 1976, and then I became president in 1978.

Q. Do you consider yourself an expert in regulatory policy rate making?

A. Yes, I do.

Q. Do you consider yourself an expert on rate making methodologies?

A. Yes.

Q. Do you include the rate making methodologies for gas crude oil products lines including FERC and state regulation?

A. Yes.

Q. Can you in a sentence or two tell me what regulatory standards this Commission should apply to this case?

A. Yes, the regulatory standards should be to set just and reasonable rates. And in doing so, they should provide a means by which the pipeline company has the opportunity to recover its prudently incurred costs, its return on its investment, and a reasonable return on, I'm sorry, return of its investment and a reasonable return on its investment.

Q. Have you heard during the course of this proceeding anything that would cause you to believe that this Commission should deviate from standard and sound cost based regulatory principles in setting rates for

Olympic?

A. Not at all.

Q. There has been considerable testimony with regard to how to put rate cases together and how not to put rate cases together. How do you put rate cases together?

A. You start with the actual costs, and I know that there's been concern about base period, test period, and what the test period is here, but basically we're talking about the same thing. Base period is a period of actual costs or is a period for which actual costs are known, and then adjustments must be made to those actual costs to remove nonrecurring costs. And then adjustments can be made to take into consideration normalization of costs, for example a payroll increase that incurred during the period that wasn't covered for the full period, and things like that. Those are the items that form the basis for the development of the costs for service to establish the rates.

Q. Have you ever in your experience taken numbers without looking behind them off of a financial statement and plugged them into a rate setting context?

A. Not at all.

Q. What do you do in order to confirm that the numbers on the financial statements are proper for rate purposes?

A. Well, you, I have heard the term, I don't think I have heard it before, but drill down to look at the elements of the costs that are included in the actual costs, and see whether they're reasonable, see whether there are nonrecurring items that are included. And that's the basis on which you start putting a rate case together.

Q. And how do you do that?

A. Well, you look at a period of, talking in terms of the Washington Commission, they use a test period, which is a year of actual costs. The Staff has looked at the year 2001 as the test period, and then they have made pro forma adjustments in the FERC methodology. The pro forma adjustments they have made I think are very much the same as elimination of nonrecurring items and normalization.

Q. Have you, in that process, when you have put rate cases together, do you sit down with company people who are familiar with the specific costs so that you can categorize them properly for rate making purposes?

A. Personally when I was involved with both Mississippi River Transmission, with United Gas as I -- when I was in charge of the rate areas, I looked at all of the figures to be sure that they were appropriate to be included. Even when I was president of the company, I looked at and I had the senior VP of rates and regulatory affairs reporting to me so I knew what was in those figures.

Q. In your judgment, is that the way Olympic put its rate case together?

A. No, it's not.

Q. There's been considerable testimony on how rate base should be established. Do you have -- could you offer your opinion on that, please?

A. Yes, I think that in establishing just and reasonable rates, this Commission should use the method that they have used traditionally, which is the depreciated original cost methodology. Take the original cost of the property that has been invested to provide the service to the shippers, and deduct from that the accrued depreciation. You add an allowance for working capital and deduct deferred income tax reserves to arrive at a rate base.

Q. Should the rate base be written up based on deferred earnings from prior periods in this case?

A. No, sir.

Q. Why not?

A. There is no basis for the deferred earnings. There was never any deferral of earnings. Mr. Grasso put together exhibits that showed really that there have been overcollections when you look at either the 154-B methodology or the 154 methodology. The revenues that they received during those prior periods far exceeded the DOC methodology revenues and far exceeded even the 154-B methodology. There's no basis, and no one has refuted the calculations that were made showing these overcollections.

Q. So far as you're aware, has any state allowed the writeup of rate base based on such a deferred earnings calculation?

A. So far as I know, they have not. In fact, there are the cases that are included in whatever one of the exhibits is, well, these beginning at 2306 and going through 2310, those cases specifically did not allow the inclusion of deferred earnings.

Q. Do you believe that under the circumstances of this case even FERC would have allowed the deferred earnings to be included in rate base?

A. I don't think that they would, because again the 154-B does contain several places indicating that the application of 154-B is to be viewed on a case-by-case basis, and there has been no showing at all that there has been a deferral of earnings.

Q. Should this Commission write up the rate base based on a transitionary rate base or just --

A. Again, that's an item that has been addressed in the cases that I mentioned. It's an item that is a non-cost based item. There's no basis for it to be included in the rate base. It's not an investment cost. It's not a piece of pipe in the ground. It's a calculated cost, and there's no basis for it to be included. It's been rejected by these various cases. And in addition, Williams I and Williams II specifically indicated that there was not to be a -- it was their recommendation, this was the D.C. Court of Appeals recommendation, that a starting rate base was outmoded and shouldn't be included.

Q. And just so that we don't confuse it, did you mean Williams I and II or Farmers Union I and II?

A. I'm sorry, Farmers Union I and II.

Q. Okay. Do you think it's in the public interest for this Commission to give equity returns when there is not equity invested?

A. I don't.

Q. Why not?

A. There's no basis for it. It's a very extreme cost to the shippers when you simply substitute an equity amount when there is no equity. The cost is very large, because not only is the cost of the return on equity high, but then you have the income tax allowance to take into consideration. And in this instance, there's no equity in this company.

Q. Now before we turn from rate base and return matters to operating costs, where is the money at in this case?

A. Breaking it down, I would say that -- maybe I can give an example. Let me first say that Exhibit 2311 is the exhibit that I want to refer to, and that is an illustrative exhibit. It is not the exhibit on which Tesoro's direct case was put together.

But when you look at that exhibit, if you look on line 7, total cost of service, under the Tesoro column there's $38.6 Million. Under the Olympic column there's $56.5 Million. Difference of roughly $18 Million. $11 Million of that is found in the first two categories. There's $6 Million difference in the allowed total return, and there's $4.8 Million, $4.9 Million roughly, of income tax allowance. And then in addition to that, you have the amortization of the deferred return, that's another $1 Million roughly. So you've got, if my arithmetic is correct, there's 6, 4.8, and 8, 5, about $11 1/2 Million of the $18 Million is just in the return and related taxes. There's a difference again of some $6 Million that's in the operating expenses. So those are the areas that account for the difference.

Q. And in terms of priority then, return on tax allowance would be one, throughput would be two, and operating expenses would be last in terms of what's at issue in this proceeding?

A. Yes.

Q. Okay. Turning to operating costs, would you please explain to the Commission which of their operating costs that Tesoro accepted and which they took issue with?

A. Well, I guess I need to start with Tesoro indicated in and I indicated in my testimony that Olympic had put together three different separate costs of service. One was the cost of service that was made at the time of the filing, one was the case 1 cost of service, one was the case 2 cost of service. They all had different base period test periods that were utilized. But for convenience, we said we would go along with the case 2 presentation. That case was on the basis of a base period of October 2000 through September of 2001 with adjustments made to that. However, the adjustments that were made were basically to substitute the 2002 budget for the base period costs.

Having said all of that now, the items that

we did not take exception to included the salaries that were included in the presentation, insurance, taxes. Those are the three items that in particular that come to mind that we did not take exception to.
Q. And again, just so the record is clear, what we're discussing is the operating costs that were contained in their direct case, case 2?
A. Yes.
Q. Okay. Did we accept the management fee?
A. Yes, we did.
Q. Did we accept their characterization of oil losses?
A. Yes, we did.
Q. Did we accept but normalize regulatory expense?
A. Yes.
Q. What cost categories did we take issue with? What was the largest cost category that we took an issue with?
A. The largest category was the $5.6 Million that was reported in outside services as a one time expense.
Q. And if I could direct your attention to 2305, in you could explain why we took an issue with that, and also put it within the context of this exhibit, please.

A. Yes. In the first place, we had to hunt to find the one time expenses. In the case 2 presentation, there was some $9 Million, $9.3 Million I think it was that was shown as outside services. And I think the Washington Commission Staff asked for details, they drilled down into what was contained in the outside services, and it was found that $5.6 Million was included. There was no justification, no support for that figure, it was just included. It was classed as a one time expense.

When you look at this schedule, the 2305 exhibit, I went through and looked at the various exhibits that contained reference to one time expenses. And in Exhibit 860, the first line on this Exhibit 2305 shows prior years spending of $1.6 Million, the targeted 2002 spending level is $5.6 Million, and the 2002 forecasted spending is $9.4 Million. Big variation in those figures. And you can go down the list, and you can see all of the different figures that have been reported for one time maintenance costs.

There's on 845, yeah, I'm sorry, 845-C, it shows 2001 expected spending of $2.3 Million. That's basically during the test period. The 846 shows 2001 actual spending, $3.1 Million. 623 shows 2001 forecasted spending, $2.3 Million. I mean there were just all sorts of figures around. There's no support for any of those figures, and certainly one time maintenance costs don't have any place in the cost of service for recurring expenses on a continuing basis.

Q. Is the nonrecurring nature one of the primary reasons why you disallowed them in the calculation?

A. Well, that plus in my view there are included even -- even when you get into the individual costs, there are costs that are very likely capital costs and should have been capitalized rather than to be put in a one time expense. And let me give you an example. In 1996, Olympic came in to this Commission and presented a schedule that said that they had a total extraordinary cost of $5.6 Million. The net amount that was shown in that was $5.3 Million, and they asked for an amortization of those costs because they were extraordinary expenses of 1 1/2 cents per barrel. They began collecting that 1 1/2 cents per barrel in 1997, January 1st, 1997. They're still collecting that 1 1/2 cents her barrel. They have overcollected that figure that they said was a nonrecurring item that they were amortizing over a three year period. That's the type concern that you have -- that you should have with regard to including nonrecurring costs or costs that should be normalized over some future period.

Q. When you say that they didn't support this, did you sit in on Mrs. Hammer's deposition or review her transcript?

A. Yes, I did, I reviewed the transcript. I don't think I sat in on the deposition.

Q. How would you characterize their ability to explain the nature of these projects and how they should be properly categorized?

A. There was absolutely no support. In reviewing the transcript, you asked her about each one of the items making up the $5.6 Million, and her response was she didn't know anything about the projects. She didn't know the basis other than that managers had presented these projects to be included in the one time maintenance category.

Q. Did you also suggest modifications to operating fuel and power as was advanced in their direct case?

A. Yes. In the operating fuel and power that was in the direct case, the cost was adjusted upward to reflect a unit cost for power in the highest month of the experience. And we took exception too that Mr. Grasso made a calculation of what the appropriate unit rate should be for determining the fuel and power costs and related that to the quantity, the throughput quantity that Tesoro is recommending in this case. So yes, we did take exception to the fuel and power.

Q. Setting aside the details, has Olympic essentially adopted a more realistic approach in their rebuttal case to fuel and power?

A. Yes, they have.

Q. And is it consistent with what you recommended with regard to our answering case to their direct case?

A. I believe it is.

Q. Did you also suggest that adjustments be made to the supply and expense category of expenses in their direct case?

A. Yes, I did.

Q. Would you explain what you proposed and why?

A. Well, as I indicated earlier, on supplies and expenses, miscellaneous expense I think is another category, there was no support for the figures that were included in Olympic's direct case. They simply took their budget for 2002 as the figure to be included. And it did -- it resulted in an upward adjustment to costs that we didn't think were appropriate.

Q. Did you also suggest changes in other expenses?

A. Yes, on the same basis.

Q. Okay. How did you treat transitionary costs from one operator to the other?

A. It is my view that there should not be a transition cost. The transition occurred July 1st of 2000, and the costs that were associated with the transition amounted to something like $2.3 Million. That's the amount that is claimed by Olympic, and what they're suggesting doing is amortizing that. In my view, the change in shipper or in the operator wasn't something that the shippers should pay for, and so I recommended that we take that out of the, that amortization which I think is $450,000, out of the costs.

Q. Would you please also address your proposed treatment of regulatory expenses that they proposed in their direct case?

A. Yes, there was a schedule in I think it was in the outside services category of a little over $1 Million, and in my view the amount, and I included this in my testimony, that that should be amortized over a five year period so that you would have $200,000, which would be more representative of actual operations.

Q. Now I would like to ask you some questions, I would like to leave the proposed adjustments to the direct case, and I would like to address the proposed adjustments to the rebuttal case. But before we talk about the rebuttal case, I would like you to characterize your ability to understand what those numbers -- to look behind the financial numbers that were proposed in their rebuttal case as a basis for rate making.

A. No ability whatsoever to look behind the figures there. They were presented, stated as being taken off of the financial statements, but when you examine those figures --

Q. Are you looking at Exhibit 860?

A. No.

Q. Okay.

A. Maybe I should be, but no, I'm looking for 728. I think that's the right one.

Q. The additional work papers for Mr. Collins?

A. Yes.

Q. Okay.

A. I'm not sure now that I say that. Well, I think I can -- yes, this is the one.

Q. Mr. Brown, would you give the Commissioners an opportunity to get Exhibit 728 out if they choose.

A. Yes.

Q. And what page of the exhibit do you intend to comment on?

A. Well, my copy has handwritten page numbers, and I presume that's on all of the -- and so it would be page 4.

MR. BRENA: If you would just pause for just a minute, please, until the Commission indicates that they're ready to proceed.

THE WITNESS: Is the time clock stopped?

MR. BRENA: We're way ahead of schedule.

JUDGE WALLIS: Please proceed.

MR. BRENA: I anticipated friendly cross objections.

A. Let me give you an example of the concerns. This is the October through -- October 2000 through September 2001. And take outside services, there's, in November 2000, there's $1 Million. In December, there's $9.5 Million. If you look at the individual figures across the row and then you get to May, there's $1,140,000. I mean the figures fluctuate and vary so much that in my view they're just unreliable.

Let's go to the next page. I see I have two page 4's.

BY MR. BRENA:

Q. Actually, so do I.

A. Yeah, someone lost count. This is work paper 2. The outside services, again going across the line,

$323,000, $546,000, $650,000. You get over to March there's $1,133,000, April $1,210,000. Then $83,000 is the budget for May and June. How can you rely on those figures.

Q.   Have you had any opportunity to look into or determine what these extreme amounts were spent on or for?

A.   No.

Q.   In your judgment, should the Commission use the numbers contained in Olympic's rebuttal case for the purposes of rate making?

A.   No, and there are I think a couple of reasons for that. One is simply that no one has had the ability to drill down into these costs and find out what is really included. And the second is that it's a moving target. This is the fourth set of figures that's been put together, and it's supposedly on the basis of actual costs. Actual costs, well, I think Mr. Twitchell said yesterday that it's got to stop somewhere, and I think that simply because these are reported as actual costs doesn't mean that they're known and measurable costs.

Q.   Does it mean that they are recurring costs?

A.   No, it doesn't.

Q.   Does it mean that they have been normalized properly?

A. No.

Q. Notwithstanding the inability to look behind those numbers, did you try to do your best to figure out what a cost of service ought to be based on those numbers?

A. Yes, and that is reflected on page 2 of Exhibit 2311.

Q. And before we get into the exhibit, would you please tell me in broad terms how their case changed from their direct case to their rebuttal case in terms of where the money was?

A. I'm not sure I understand as to where the money is. Are you talking now about just the operating costs?

Q. Yes.

A. Okay. As I indicated earlier, their case 2 presentation was the actual costs that they reported for the period from October 2000 through September 30, 2001. But then in many of the categories, and I say many, I can't say all, but it's certainly in the major categories of costs like labor, they used their budget for the year 2002. That budget figure was a figure that was established in the year 2000 when the operating agreement was signed, and yet it was reflected in the -- as the test period labor cost. There are other examples like that that I could point out, but that's basically what they did in the case 2.

In the rebuttal case, they have simply taken the seven months, put in a two months again from the 2002 budget, taken a nine month figure, averaged that, and added three more months to derive the costs for the what they say is the test period. And incidentally, that test period that they show on their schedule takes you down through, and this is looking at work paper 2, takes you down through September of 2002.

Q. Is in real terms one of the major impacts from the direct to the rebuttal case that they have added $5 Million in unexplained outside services?

A. It's pretty close to $5 Million, but yes.

Q. Okay. Now before we go through this exhibit, I would like you to be clear, is it your intention that the Commission should use their rebuttal case or this exhibit for the purposes of rate making?

A. No, it's not my intent.

Q. You mentioned that this exhibit was for illustrative purposes?

A. That's correct.

Q. Would you please explain to me before we go through it what point you're trying to illustrate?

A. From the standpoint of the exhibit, page 1 of the exhibit is, of course, the total cost of service. And as I pointed out a while ago, the $38.6 Million versus the 56.5, overall cost of service, the difference in the throughput, and then the areas where there are differences in the operating costs that are shown on page 2.

Q. Now as a preliminary matter, if there is cross-examination on this exhibit, your contribution to the preparation of this was to work through the operating expense on line 3, and how you did that is indicated on page 2. And then Mr. Grasso put that operating expense number within the context of Tesoro's model to see what the total cost of service would be; is that correct?

A. That's correct.

Q. Okay. Would you please explain to me what expense adjustments you made to the rebuttal case and why.

A. Well, again, I guess it's easiest to explain by reference to work paper 2, but I had -- that's in Exhibit 728, line 9, miscellaneous expense. You look across the line and you see that the figures are from $11,300 in March to $69,000 in February, and then you have $1,324,000 in December and a negative $1,226,000 in January. What Olympic did --

COMMISSIONER HEMSTAD: I'm sorry, where are we, what page?

A. This is on page 4, well, 4 1/2 or something like that, Exhibit 728-C.

JUDGE WALLIS: We have interrupted Mr. Brown, and I want to let him finish, but we do need to let you know that we do need to take a break. So as soon as Mr. Brown is finished with --

A. I will give you one example.

CHAIRWOMAN SHOWALTER: The other thing is on that two pages 4, I only have one page 4, and so I think another reason we might be lost is that we don't have that second page 4.

JUDGE WALLIS: Let's be off the record.

(Discussion off the record.)

(Recess taken at 3:20 p.m.)