EXHIBIT NO. T-___ (CEO-3)
DOCKET NO. TG-920234
WITNESS: CHARLES E. OLSON

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

COMPLAINANT

VS.

US ECOLOGY, INC.

RESPONDENT

REBUTTAL TESTIMONY 002940

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION
TG-920234 T-96

PREPARED REBUTTAL TESTIMONY OF
CHARLES E. OLSON

Q. Please state your name.

A. My name is Charles E. Olson.

Q. Are you the same Charles E. Olson who testified previously in this case?

A. Yes.

Q. Have you reviewed the Staff and intervenor testimony that was filed in this case?

A. Yes, I have. In addition, I was present during the cross-examination of their case.

Q. What return requirement does Mr. Nikula recommend in this case?

A. Mr. Nikula recommends a return requirement of approximately $54,000; this works out to about $6,500 per month. He derived his return requirement using the rate of return of 18.5 percent that I recommended in combination with a rate base of approximately $193,000. The $54,000 includes an allowance for income taxes.

Q. Would a pre-tax return requirement of $54,000 provide for a reasonable "end-result" as indicated by the U.S. Supreme Court in the <u>Hope</u> case?

A. No, it would not. Essentially what Mr. Nikula is proposing is that US Ecology provide a complex, high risk service for operating expenses only. What he has done is to apply my rate of return to a rate base that approximates zero and obtained a return that is less than two percent of US Ecology's expenses. Even the proposed expenses are understated. The result will not permit capital attraction on reasonable terms.

Q. What does the Hope case require?

A. My answer is not intended to be a legal opinion. As an economist, I read Hope to require a reasonable end-result for US Ecology's Richland site. This means that the revenues must be adequate to pay reasonable expenses and taxes as well as providing for a return that will permit capital attraction on reasonable terms. Neither Staff nor the intervenors have challenged my testimony regarding the high risk nature of the LLRW business. What has been ignored is the fact that high risk requires a high return and that return must be available in dollars, not percentages. Mr. Nikula's recommendation simply doesn't provide for a return requirement.

The return requirement must be adequate on a stand-alone basis to permit capital attraction on reasonable terms. This means that the rates should not be based on the premise that the Richland site is part of a corporation that has available capital and expertise to assist in financing and operating it. Instead the rates must be based on a revenue requirement that will permit the Richland site, operating alone to cover, expenses plus earn a return sufficient to attract capital.

Q. Why is the proposed return of $54,000 per year inadequate?

A. It is inadequate because it doesn't even provide US Ecology with a reasonable chance to stay in business, much less to attract capital. Staff and intervenors both have agreed that US Ecology's operation in Richland is essentially a fixed cost business. This means that the costs go on even if the revenues don't flow in. If volumes are overprojected as they appear to be, US Ecology's Richland site will be bankrupt in a month. This will occur even if the volumes are overestimated by only 300 cubic feet a month. Given that Staff is insisting on imputing volumes that cannot possibly materialize in early 1993, bankruptcy is inevitable under Staff's approach.

Q. Would US Ecology do any better under Mr. Drazen's return proposal?

A. Somewhat. However, in my view it is not enough. While $1.44 million is more than 15 times greater than the $0.054 million that Staff is proposing, it only amounts to $120,000 per month. Given the volumes and the rates his clients propose, a shortfall of a few thousand cubic feet per month would also put the Richland site out of business.

Q. But isn't Mr. Drazen proposing the same profit margin as your comparable companies earned during recent years?

A. In a sense, that is correct. What he has done is to use <u>Value Line</u> information to compute the average operating

002943

margin for the last 5 years. Apparently it was his view that if it was appropriate for me to use these companies to estimate a rate of return, then he could use them for purposes of computing an operating margin. But there are several reasons that the procedure he followed is inappropriate.

First, I estimated the return on equity for the 5 comparable companies and applied that return to a 100 percent common equity base because of US Ecology's risk and inability to obtain financing on a stand-alone basis. Mr. Drazen's use of an operating margin effectively reduces the return by including the substantial debt of these companies in the calculation. Second, the earned returns that are implicit in his operating margin calculation appears to average somewhat less than the 18.5 percent return that I recommended. To that extent the cost of capital is underestimated as well. For example, the average return for Chambers Development during the period he utilized was only 11.4 percent, well below my 18.5 percent figure.

Third, Mr. Drazen applied the operating margin approach in an unfair manner. He used actual operating margins for the comparable companies but then applied them to a stripped down level of expenses for US Ecology. In my view, this is unfair because it produces a meaningless comparison. Either he should have permitted US Ecology expenses that are similar to those of the comparables or he should have adjusted the operating margins of the comparables to reflect what their profits would have been with a level of expenses that had been determined to be reasonable under public utility regulation.

Q. In your view, what would an appropriate operating margin be for US Ecology?

A. If risk differences are considered, an appropriate operating margin would probably be between 50 and 60 percent.

Q. At page 15 of his direct testimony Mr. Drazen said that you didn't quantify the extent to which any particular level of return will produce financial integrity for US Ecology. He also says that it isn't clear why US Ecology would need to borrow money. Would you please response to that testimony?

A. Yes. Mr. Drazen's general problem seems to be that the standard of financial integrity is not particularly well defined in this case (page 17, ll.16-18). In my view, the financial integrity standard has always been quite clear: it means that the regulated entity has the ability to obtain capital on reasonable terms on a stand-alone basis under almost any market conditions. Now I would agree that it is difficult to determine exactly what the financial integrity of the Richland operation will be in two or three years following the implementation of rates in this case. But it seems quite obvious that an after-tax income flow of $2-3 million per year is necessary to develop a financial track record. Once such an earnings record is achieved it will be possible to assess the financial integrity of the Richland site.

Q. At page 19, Mr. Drazen says that US Ecology's parent, American Ecology, has been able to obtain debt financing. Does that have any relevance for purposes of this case?

A. There is some relevance. As a starting point, however, US Ecology's Richland site is at issue here, not American Ecology. Under the guidelines laid down in the Hope case, US Ecology must have financial integrity on a stand-alone basis. American Ecology's ability to attract capital is of no relevance. Beyond that, however, I disagree that the convertible debentures referred to are debt. From an economic perspective those debentures were equity capital. In addition, their debt capital had been converted to equity capital in 1991.

Regarding the five-year bank loan secured by equipment, that is clearly not an indication of financial integrity. Any company, even one in bankruptcy, can obtain secured financing. Financial integrity means much more than being able to finance part of the cost of a bulldozer at a fairly high rate of interest. In my view, American Ecology's financial statements suggest that US Ecology's parent is not at all financially strong.

Q. At page 18 of his direct testimony Mr. Drazen says that there is no yardstick to determine marginal cost in this case nor to assess whether the charges are equal to marginal cost. Do you agree?

A. No. In my opinion the marginal cost evidence that was presented for the Needles, California site was adequate. The intervenors and Staff had the opportunity to review that study and make any adjustments they felt to be reasonable. Instead, they chose to ignore the concept and the data. Marginal cost studies are never as precise as historical cost studies because of their forward-looking nature. But that doesn't invalidate such studies. As things now stand, US Ecology has the only marginal cost evidence in the record. That evidence should be used as a basis for setting rates in this case.

As far as the issue Mr. Drazen raises relative to state charges and taxes, there is little to be said. All states place a variety of charges and taxes on regulated operations. Marginal cost pricing should not be criticized because state authorities decide to assess taxes for certain services. In the case of LLRW site, the charges may well be for the purpose of internalizing certain costs that would otherwise be externalities.

In my view, Mr. Drazen should have presented his own marginal cost study. It is unfair of him to criticize mine and then make the claim that marginal cost is irrelevant. I frankly can't think of a case in which it is more important. There is little doubt in my mind that the right price in a situation like this is one that reflects full marginal cost. Arguments against marginal costs are often voiced by polluters but they should clearly be ignored.

Q. Staff witness Parker said during cross-examination that if volumes are overestimated that there are safeguards built into the ratemaking approach in Washington. Is that correct?

A. I assume that she was referring to the volume adjustment mechanism. While that mechanism permits adjustment for year-to-year changes, it would not keep US Ecology out of bankruptcy under the Staff and intervenor cases. There simply wouldn't be time for the mechanism to even operate.

Q. During cross-examination Mr. Nikula said that he didn't include a working capital adjustment because American Ecology's balance sheet did not indicate that there was such a requirement. Do you agree?

A. No. At December 31, 1990, December 31, 1991, and March 31, 1992, current assets exceeded current liabilities by some $12-13 million. Based on the Aemrican Ecology information, there is clearly a working capital need.

Q. During his cross-examination Mr. Nikula said that the return on equity is a measure of the end-result. Do you agree?

A. No. The ability to attract capital on reasonable terms is the measure of the end-result. A high return doesn't indicate anything, especially in a case in which it is applied to a de minimus rate base.

Q. During cross-examination (Tr. 523) Mr. Nikula said that the rate base he was proposing was the original cost of the Richland site for ratemaking purposes. Do you agree that his figure of $193,465.29 is the original cost?

A. No, I do not. Original cost is the cost to the first person to devote the property to public service. In that US Ecology has never been regulated, the property has never been devoted to public service. It is both unrealistic and unfair of Mr. Nikula to use the depreciated accounting costs of facilities that were used in an unregulated business as a proxy for original cost. US Ecology had no knowledge of the possibility of regulation when accounting and depreciation decisions were made. Not only that, any early losses were surely considered as an investment that would later be recouped with a return. A proper original cost could be obtained in one of two ways. First, my estimate of long-run marginal cost is a reasonable figure to use for original cost because of the comparability of the Richland and Needles sites. Second, an attempt could be made to use the market price of American Ecology's common stock to determine the value of the Richland site.

In any event, Mr. Nikula's rate base is not original cost. It is simply an estimate of accounting cost less depreciation taken in the past. There is no basis in accounting, economics or regulation to use the $193,000 figure for rate base.

Q. During cross-examination Mr. Wilson said that there was no evidence that US Ecology practiced perfect price discrimination. If that is true, does it suggest that US Ecology has a monopoly in the LLRW market?

A. No. If US Ecology is a monopolist, perfect price discrimination would be relatively easy to practice. The use of price sheets in combination with annual prices increases is indicative of a competitive market, not monopoly.

Q. At page 25 of his direct testimony Mr. Young suggests that an appropriate pricing framework for irradiated hardware would be cost plus a mark-up of 41 percent. Would that be appropriate?

A. No. His approach amounts to short-run marginal cost pricing plus a mark-up. As shown in US Ecology's direct case, the LLRW business is characterized by a high percentage of fixed costs. Mr. Young's methodology would ignore those costs and focus on short-run variable costs. In my view, that is inappropriate and would penalize other users. Irradiated hardware must be priced in a way that will recover all of the costs associated with its disposal, not just short-run marginal costs plus a markup.

Q. Does this conclude your prepared rebuttal testimony?

A. Yes, it does.