

I. INTRODUCTION

- 1 **Overview.** The goal in this case is to set fair, just, reasonable and sufficient rates for Olympic Pipe Line Company (Olympic or Company). The key issues are ratemaking methodology, capital structure and rate of return, throughput, and the proper treatment of the Bayview Terminal. Staff's analysis properly resolves these issues, and demonstrates that a rate increase of no more than 1.12% can be justified. This result reflects the basic principle that investors are entitled to a fair return on the plant a public service company has prudently devoted to public service.
- 2 Under sound financial and regulatory principles, rates are sufficient when they adequately fund long-lived assets, supported by balanced capital structures. A fair rate of return applied to a depreciated original cost rate base, coupled with recovery of reasonable and prudent operating expenses, satisfies capital attraction considerations. Staff's case is based on these principles.
- 3 Olympic's case is not based on these principles. Olympic is a highly leveraged company. Olympic enjoyed high returns and cash flows because of that. But when the Whatcom Creek explosion occurred, Olympic had no financial flexibility to respond. It was time for Olympic's owners to supply equity, but they did not. Instead, Olympic wants ratepayers to pay rates based on an 86.85% equity ratio, and associated income tax effects, when Olympic has zero equity.
- 4 Olympic also wants to recover a "deferred return," although Olympic did not defer a return and had no Commission order authorizing a deferral. Rather than deferring returns, Olympic earned handsome returns. Olympic also is seeking a return on plant it did not build (starting rate base) and that is not cost-effective under current usage (Bayview Terminal).

5 Olympic’s case produces excessive rates that are not cost-based. Regulation’s role is not to rescue a public service company from itself. The Commission should reject Olympic’s case, adopt Staff’s analysis, and approve a rate increase of no more than 1.12%.

6 **Olympic’s current situation, and its causes.**¹ Other than the \$11 million sale of Olympic’s SeaTac facilities, little has changed since the interim relief phase of this docket. Olympic remains financed exclusively with debt. (Elgin, Ex. 2101-T at 8:10-19). The covenant in Olympic’s note to Prudential still precludes Olympic from issuing additional debt. (Peck, Tr. 2788-89). Olympic’s owners still have provided no equity, and Olympic has yet to ask for any. (Peck, Tr. 2777:1-10). Olympic still has no written financial plan or target capital structure. (Elgin, Ex. 2103, last page, and Ex. 2101-T at 9:7-17).

7 The financial circumstances now facing Olympic are the direct result of the financial policies Olympic pursued in the past. Those policies maximized returns and cash flows, and created a highly leveraged company. This meant Olympic had “no financial flexibility in the event of a curtailed ability to move product on its system.” (Elgin, Ex. 2101-T at 2:3-8).

8 Exhibit 2102-R proves this. As of 1998 (the last full year of operations prior to the Whatcom Creek explosion), Olympic had booked \$87 million in carrier property (assets ostensibly providing service to the public), supported by \$76.6 million in liabilities and owners’ equity.² There was a rational connection between long-lived assets serving the public, and the permanent sources of capital funding those assets, albeit with little equity.

9 Everything changed in 1999, because of the Whatcom Creek explosion and Olympic’s response. Olympic’s carrier property increased only slightly, to almost \$88 million, but its liabilities and

¹ The Commission has identified several issues in this subject area. (3rd Supp. Order at ¶ 10). Staff’s response is in Mr. Elgin’s Ex. 2101-T and Ex. 2102-R through 2104-C.

² Ex. 2102-R, “98” column, \$17m (LTD) + \$44.484m (STD) + \$15.143m (Eq.) = \$76.627m.

owners' equity supporting these assets increased to \$98 million.³ This \$10 million gap between Olympic's carrier property and its permanent sources of capital represents an operating loss funded by debt. (Elgin, Ex. 2101-T at 5:15-16; Tr. 4940:3-12).

10 Olympic's financing of past losses continued. In 2000, property accounts became \$97.3 million, but Olympic's permanent sources of capital increased to \$119.1 million, including over \$100 million in short term debt.⁴ This \$21.8 million gap ($\$119.1\text{m} - \$97.3\text{m} = \21.8m) represents yet another operating loss. Because Olympic now carried a negative equity amount on its balance sheet, the Company's 2000 books show \$119.1 million of liabilities supporting only \$97.3 million in assets.

11 The gap is widening. Olympic now has about \$148 million in debt and accrued interest supporting only \$95.5 million in carrier property.⁵ (Fox, Tr. 4369:13-17). Olympic claims this \$52.5 million gap represents "capital at risk," provided by owners in the form of loans, for which they expect recovery. (Peck, Tr. 2778:11 to 2779:16). In fact, that \$52.5 million represents prior operating losses that Olympic is not entitled to recover through rates.

12 Olympic has not acted in a timely way to address its financial problems. Its owners have provided no equity, and Olympic took more than two years to file a rate case it would pursue. Although it is speculation what the result of a timely rate filing would have been, Olympic estimates its choice not to timely file cost it \$50 million. (Fox, Ex. 1701-T at 6:21 to 7:1). Olympic finally filed for rate relief in May 2001, but withdrew that filing, and did not re-file until October 31, 2001.

³ Ex. 2102-R, "99" column, $\$15.500\text{m (LTD)} + \$68.257\text{m (STD)} + \$14.261\text{m (Eq.)} = \98.018m .

⁴ Ex. 2102-R, "2000" column, $\$14\text{m (LTD)} + \$100.579\text{m (STD)} + \$4.545\text{m (Eq.)} = \$119.1\text{m}$. This figure assumes the negative \$4.545m in equity would be financed with debt.

⁵ This calculation includes Bayview, and removes the Cross-Cascades Project (\$21.5 million approx.).

13 **A proper response in these circumstances.** One result of Olympic's past policies and actions is that Olympic's balance sheet is not rational. (Elgin, Ex. 2101-T at 9:13-17). To move forward, Olympic must produce a balance sheet that shows that its assets (*i.e.*, Olympic's properties dedicated to public service) are in balance with its liabilities and owners equity (*i.e.*, Olympic's permanent sources of funding). To do so, Olympic's owners need to supply equity. Instead, Olympic promises to do needed construction only if ratepayers supply more revenues to meet new cash flow needs. That is not appropriate:

Going back 12 years there's not been a single instance in which any of the owners of Olympic Pipeline have infused any equity capital into the enterprise during a period of time in which they regularly received as dividends all of the earnings of the enterprise.

...

In this case, because the retained earnings have not been [accrued] over time, it would have been appropriate for there to be equity infusions by the parents to resolve these problems. That's not happened.

So you sort of can't have it both ways. You can either say capital structure doesn't make any difference. We can pay out all of our earnings, because the other pipeline companies do. We can maintain the type of equity ratios that the other pipeline companies do. But you can't turn around when the time for equity infusions comes about and say, well, we're going to provide safety investments only if rates increase to provide the cash flow that has been interrupted by virtue of these accidents.

(Wilson, Tr. 2539:8 to 2540:12).

14 The failure of Olympic's owners' to supply equity has caused both customers and the Commission to respond to a financial problem exacerbated by Olympic's own policies and actions. Olympic is still failing to pay for the risks it created. Olympic alone is responsible for the decisions it made by pursuing high returns and cash flows during the past decade. If the Commission adopts Olympic's version of the FERC methodology, that would mask Olympic's financial policies, and ratepayers would absorb the risk of those policies. That is not just or reasonable.

II. LEGAL STANDARDS AND GOVERNING PRINCIPLES

A. Burden of Proof

15 RCW 81.04.130 places the burden of proof on Olympic to show that its proposed tariffs are just and reasonable. Olympic's burden carries with it the responsibility to affirmatively prove every element of its case:

[The company] must make an affirmative showing of the reasonableness and prudence of the expenses under review. This is true even in the absence of a challenge by another party.

WUTC v. Puget Sound Power & Light Co., Docket No. UE-921262 (11th Supp. Order)(1993) at

19. Olympic has not borne its burden of proof in this case.

B. Fair, Just, Reasonable and Sufficient Rates

i. General considerations

16 RCW 81.04.250 authorizes the Commission to set "just and reasonable rates." In doing so, the Commission may use "any standard, formula, method, or theory of valuation reasonably calculated to arrive at the objective of prescribing and authorizing just and reasonable rates."

(*Id.*) RCW 81.04.250 prescribes a non-exclusive set of factors the Commission may consider.

They are: the effect of rates on traffic of Olympic, the public need for adequate service at the "lowest level of charges consistent with the provision, maintenance and renewal of the facilities, equipment and service," and Olympic's need for revenue at a level "under honest, efficient, and economical management is sufficient to cover the cost ... of providing adequate transportation service," plus a reasonable profit. RCW 81.04.250(1)-(3).

17 Other statutes require Olympic's rates to be "just, fair, reasonable and sufficient," RCW 81.28.010, or "just, reasonable or sufficient." RCW 81.28.230. As the Commission has stated, questions of fairness, justness, reasonableness and sufficiency are resolved "by establishing the

fair value of respondent's property in service, determining the proper rate of return permitted respondent on that property, and then ascertaining the appropriate spread of rates charged various customers to recover that return." *WUTC v. Puget Sound Power & Light Co.*, Docket No. UE-921262, *supra*, 11th Supp. Order at 4.

ii. End Result Test

18 The "end result test" is what courts use to evaluate a regulatory agency's rate order. *POWER v. UTC*, 104 Wn.2d 798, 811-13, 711 P.2d 319 (1985). The test includes a "zone of reasonableness" within which judicial intervention is unjustified. The court will not supplant the agency's balance of ratepayer and investor interests if the Commission "has given reasoned consideration to each of the pertinent factors." *Id.* at 811-12.⁶

19 Olympic has made the Commission's task difficult. Olympic has not stated the terms and conditions under which it will be able to finance. Olympic conceded it does not expect to receive all of the rate increase it seeks, but it will not say how much it expects. (Peck, Tr. 2830:1-2 and Fox, Tr. 4375:12-25). Olympic cannot attract new debt capital because a covenant in the Prudential note prevents that. (Elgin, Ex. 133)(Peck, Tr. 2789)(Fox, Tr. 4371:24 to 4372:3). \$20 million remains available to Olympic under the June 2001 ARCO note, but there are no objective criteria for accessing that capital. (Elgin, Ex. 2001-T at 14:19 to 15:4)(Peck, Tr. 2788-89). Likewise, Olympic has provided no objective criteria for obtaining additional equity capital from its owners. Olympic has made no request of its owners for additional equity capital. (Peck, Tr. 2777:1-10).

20 In the interim phase of this case, the Commission concluded that Staff's analysis "enables us to fulfill our obligation to consider the salient factors by providing an objective and rational methodology to measure the Company's interim need..." (3rd Supp. Order at 14, ¶ 52-53). In

the general case, Staff has also used a rational and objective methodology to analyze Olympic's cost of service. Staff's analysis reflects the principles that investors are only entitled to a return upon that portion of their investment that is devoted to public service, *Bluefield Water Works & Improvement Co. v. PSC*, 262 U.S. 629, 692, 43 S. Ct. 675, 67 L. Ed. 1176 (1923)(“*Bluefield*”); that an expense that provides no ratepayer benefit is not recoverable through rates, *US WEST v. UTC*, 134 Wn.2d 74, 126-27, 949 P.2d 1337 (1997); and that the value of investment or securities lost due to market forces is not recoverable through rates. *Market Street Ry. v. Railroad Comm'n*, 324 U.S. 548, 567, 65 S. Ct. 770, 89 L. Ed. 1171 (1945).

21 Olympic's case is inconsistent with these principles. Deferred return and starting rate base are not investments investors made in facilities Olympic uses to serve the public. Olympic has not shown its Bayview investment is prudent based on its current uses. And Olympic's past losses were funded with debt. Rates providing a return on or of these items are beyond what investors are entitled to expect.

22 In sum, Olympic's case cannot be justified when sound legal principles are applied.

iii. Public Interest Standard

23 The Legislature did not adopt an amorphous “public interest” standard to be invoked by a common carrier to justify the relief it is seeking. RCW 80.01.040 empowers the Commission to “regulate in the public interest, *as provided in the public service laws*, the rates, services, facilities, and practices” of public service companies. (Emphasis added).⁷

iv. Commission's Dual Role

24 The Commission has a “dual role” of regulating both the safety and rates of Olympic. That is not unusual. The Commission regulates both the safety and the rates of most common carriers

⁶ Quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92, 88 S. Ct. 1344, 20 L. Ed. 2d 312 (1968).

under its jurisdiction. For example, the Commission regulates both safety and rates for solid waste collection companies, auto transportation companies, household goods carriers, as well as petroleum pipeline companies.⁸

25 There is a public interest that common carriers operate safely. All common carriers have a statutory duty to provide facilities that are safe and to promote the safety of the public. RCW 81.28.010. All parties agree Olympic should operate safely.

C. Federal/State Jurisdictional Legal Issues

26 Olympic presented legal argument on Federal/State jurisdictional issues in its February 11, 2002, Motion for Reconsideration. The Commission correctly concluded “[t]he authorities the company cites simply do not support its contentions.” (3rd Supp. Order at 9, ¶ 36). In its Motion at 8, ¶ 20, Olympic stated that if this Commission did not grant the 62% increase placed into effect by FERC, then “*here, for the first time, the Commission’s rate increase will diverge from FERC’s interstate rate increase.*” (Emphasis added). Olympic’s statement is false. Olympic’s index-based FERC rate filings prove there has been “divergence” between state and federal rates since at least 1995. (Grasso, Ex. 2418). The legal problem Olympic told us we needed to avoid has existed for years because of Olympic’s actions.

27 The law also refutes Olympic’s theories. FERC and Commission ratemaking jurisdictions are exclusive within their respective spheres. RCW 81.28.230 limits the Commission’s rate jurisdiction to transportation “within this state.” 49 U.S.C. § 1(1)(b) applies the Interstate Commerce Act to transportation between states. Congress has “expressly provided that [the

⁷ This section applies to Title 81 per RCW 81.01.010. Oil pipelines are common carriers per RCW 81.88.030. Common carriers are public service companies per RCW 81.04.010, 2nd to last ¶.

⁸ E.g. Solid waste collection companies: Rates, RCW 81.77.030(1); Safety, RCW 81.77.030(4) and, e.g. WAC 480-70-310 – 335. Auto transportation companies: Rates, RCW 81.68.030(1); Safety, RCW 81.68.030(4) and, e.g. WAC 480-30-090 – 105. Household goods carriers: Rates, RCW 81.80.140; Safety, RCW 81.80.140 and, e.g. WAC 480-15-560 - 580. Petroleum pipelines: Rates: e.g. RCW 81.28.230; Safety, RCW 81.28.010, RCW 81.88 and WAC 480-75.

scope of federal regulation] was not to extend to purely intrastate traffic.” *Simpson v. Shepard*, 230 U.S. 352, 418, 33 S. Ct. 729, 57 L. Ed. 1511 (1913).

28 It is not unlawful to have intrastate and interstate rates set on a different basis, even if the result is lower intrastate rates. *Cook Inlet Pipe Line Co. v. Alaska PUC*, 836 P.2d 343, 352 (Alaska 1992). It is only when an intrastate rate is proven to prejudice or discriminate against interstate commerce that federal interests are unlawfully affected. FERC is the forum for deciding that issue, but only after “investigation” and “full hearing.” 49 U.S.C. § 13(4) and *North Carolina v. U.S.*, 325 U.S. 507, 511, 65 S. Ct. 1260, 89 L. Ed. 1760 (1945).

29 In short, if the Commission proceeds to set only intrastate rates, and if it sets rates on a cost of service basis, it will respect the jurisdictional division recognized by Congress and the courts.

D. Retroactive Ratemaking

30 “The retroactive ratemaking doctrine prohibits the Commission from authorizing or requiring a utility to adjust current rates to make up for past errors in projections.” *Town of Norwood v. FERC*, 53 F.3d 377, 381 (D.C. Cir. 1995). “If a utility includes an estimate of certain costs in its rates and subsequently finds out that the estimate was too low, it can not adjust *future* rates to recoup past losses.” *Id.* (emphasis in original)(citation omitted).

31 The retroactive ratemaking issue is presented in two contexts in this case. First, granting Olympic’s request to recover prior period equity returns that were not actually deferred, and for which Olympic had no order authorizing deferral, would constitute unlawful retroactive ratemaking. (See Section IV.B.iii.1, *infra* at ¶ 97).

32 Second, Olympic is seeking rates sufficient to enable it to recover the principal and interest payments on its outstanding debt that have been deferred and accumulated. (Peck, Tr. 2784:4-8). Olympic seeks to recover these past costs by artificial means: through a deferred return, which

was not deferred in fact; a starting rate base, which represents funds not actually invested by investors; a full return of and on its investment in Bayview, which is significantly underutilized; and an 86.85% equity ratio, when Olympic has no equity. That should not be permitted.

E. Other (N/A)

III. STATUS OF COMPANY BOOKS AND RECORDS

33 **Summary.** The ability of all parties to provide the Commission a defensible analysis of
Olympics' results of operations was severely hampered by the status of Olympic's books and
records because Olympic does not follow sound accounting practices.

34 Staff used calendar year 2001 actual operating results, restated and pro-formed. Staff could not
verify many of the figures on Olympic's balance sheets and income statements. (Twitchell, Tr.
4635:3-5). But after making the analysis and restating and pro-forma adjustments, Staff could
testify its overall recommendations were reasonable. (Colbo, Ex. 2001-T at 8:5 to 11:3)
(Twitchell, Tr. 4663:25 to 4665:4 and Tr. 4691:7-11).

35 Based on the status of Olympic's books, and Olympic's use of budgets and estimates in its
results of operations, the Commission should have no confidence in the Company's rate case
portrayals. (*E.g.* Twitchell, Tr. 4693:4 to 4698:13)(Brown, Ex. 2301-T at 37:11 to 40:30)(Grasso,
Ex. 2401-T at 7:10 to 8:2). Likewise, the Commission should not have confidence in Tesoro's or
Tosco's cases, which also use a non-calendar year base period.

36 **Accounting practices.** Olympic does not comply with FERC USoA and Generally Accepted
Accounting Principles (GAAP) because Olympic does not record its transactions monthly, on an
accrual basis. (USoA per Ex. 1105, items 1-3 and 1-4 and Kermode, Tr. 4547:16-21).⁹ Olympic

⁹ "Accrual accounting" means recording the transactions in the month the service is rendered, or as a practical matter, when the service is invoiced. A company has sixty days to book the transaction in the proper month. (*Id.* and Kermode, Tr. 4547:10 to 4548:16; Tr. 4554:19 to 4555:5). Olympic agreed that under the accrual method, expenses

accrues expenses, if at all, “mostly based on an annual basis versus a month-to-month.”

(Hammer, Ex. 802 at Tr. 102:22-25).¹⁰ This was confirmed when Staff examined all invoices Olympic booked in one ledger account for September 2001. Of the 148 transactions, only 23 had September invoice dates. (Kermode, Ex. 1801-T at 7:23-30 and 11:3-10). The same “dynamic” applied to other months and accounts. (Kermode, Tr. 4552:14-15).

37 In addition, Staff discovered lags as long as four or five months from the date an invoice is first received into Olympic’s accounting system, and the date Olympic pays the expense. (Colbo, Ex. 2001-T at 8:21 to 9:2; Kermode, Ex. 1801-T at 7:23 to 9:8). For example, Olympic records its Power and Outside Services expenses when the invoice is paid, not when the service is rendered. (Hammer, Ex. 802 at Tr. 103:1-8). This is cash-basis accounting, not accrual-basis accounting. (Colbo, Ex. 2001-T at 8:19 to 9:12; Tr. 8:21 to 9:2). This does not conform to the USoA (as discussed above), or GAAP. (Kermode, Ex. 1801-T at 9:22-30).¹¹

38 This is significant beyond simply violating the USoA and GAAP. Olympic used monthly income statements for its case. (Kermode, Ex. 1801-T at 9:10-18). Olympic is proposing base periods that are not calendar years. Olympic’s practice of “annual accruals” means that non-annual base periods produce unrepresentative levels of expenditures for that period. (Kermode, Tr. 4594:10 to 4597:18).

39 **Verification problems.** Staff was unable to fully verify and support all entries shown on the Company’s books and records. Most of the Company’s accounting records prior to July 2000 (when BP Pipe Lines became the operator) were simply unavailable. (Colbo, Ex. 2001-T at 7:3-11). BP then changed Olympic’s accounting system in May 2001, from an “ISP” system to a

are booked to reflect resources consumed as offsets against revenues for the same period. (Hammer Ex. 802 at Tr. 102:7-16).

¹⁰ Staff confirmed Olympic accrued revenues on a monthly basis as required. (Hammer, Ex. 802 at Tr. 104:17-22).

¹¹ Olympic also fails to accrue AFUDC on its books, in violation of GAAP. See Section VII.G, *infra* at ¶¶ 187-191.

“SAP” system. Basic inconsistencies between the two systems made it difficult, if not impossible, to analyze accounting information between July 2000 and May 2001 on a consistent basis. (Colbo, Ex. 2001-T at 7:12-18).¹² Moreover, the new SAP system did not consistently allow Staff to trace the entries back to their original source.¹³ (Colbo, Tr. 4712:8-10).

40 **Balance sheet problems.** Staff also discovered a number of problems with Olympic’s balance sheets. For example, for the first four months of 2001, Plant In Service was overstated and Construction Work in Progress (CWIP) was understated by \$25.4 million each. (Colbo, Ex. 2001-T at 8:11-17). There was also a correction in March 2001 for \$2.6 million that was incorrectly brought forward from Equilon, understating Plant In Service and overstating CWIP. (*Id.*). By not correcting the balance sheet for the month of the error, Olympic’s balance sheets between the date of the misstatement and March 2001 remain misstated.

41 In addition, Olympic’s accounting entries for the March 2002 sale of the SeaTac facilities were never correctly posted to the Accumulated Depreciation account. (Collins, Ex. 728-C at 7) (Twitchell, Tr. 4610:24 to 4611:1-4)(Grasso, Tr. 5084:16 to 5085:12).

42 Olympic’s December 2001 balance sheet incorrectly increased Plant In Service and decreased CWIP by the \$21.5 CWIP balance in the Cross Cascade project account. (Colbo, Ex. 2001-T at 8:11-17). Depreciation expense was overstated by \$365,650. (Colbo, Ex. 2003-C at 3, col. F, line 24, Restating Actual Adjustment RA-5). Olympic did not correct for these erroneous December 2001 entries until April 2002. (Twitchell, Tr. 4639:23 to 4640:6). By correcting an error applicable to December 2001 on the April balance sheet, the Company’s accounting statements for January through April 2002 remain misstated. (*Id.*).

¹² Tesoro had the same problems. (Brown, Ex. 2301-T at 37:11 to 40:30)(Grasso, Ex. 2401-T at 7:10 to 8:2).

¹³ Olympic testified that the SAP system was capable of electronically tracing an entry to its source. (Hammer, Ex. 801-T at 10:7-24). That testimony is inconsistent with Staff’s experience, and with Olympic’s representations to

43 **Conclusion.** Given the accounting difficulties the parties faced, using calendar year 2001 as the test year for ratemaking purposes is the only reasonable approach. Calendar year 2001 captures three additional months of total pipeline operations with the 80% pressure restriction, and Olympic’s annual accrual practice. With restating and pro-forma adjustments, Staff’s overall results and recommendations are reasonable. (Colbo, Ex. 2001-T at 11:1-3).

IV. RATEMAKING METHODOLOGY

44 **Summary.** The selection of the appropriate ratemaking methodology for Olympic is an issue of first impression. The Commission should set cost-based rates using its traditional rate base, rate of return methodology, valuing rate base at depreciated original cost (DOC). The Commission should reject Olympic’s version of the FERC methodology because the defects in that methodology are fundamental and abundant. Olympic’s proposed methodology develops rates that fail the fair, just, reasonable and sufficient standard.

A. Investor Expectations;¹⁴ Right to Methodology

45 **Investor Expectations.** There is no direct proof that Olympic or its investors had any specific expectations regarding the Commission’s use of any particular ratemaking methodology. For example, Mr. Smith, Olympic’s witness purporting to describe the FERC methodology, admitted having no actual “direct knowledge” of Olympic’s investor expectations. He offered only assumptions. (Smith, Tr. 4257:20 to 4258:5). Neither Mr. Batch nor Mr. Talley knew “the considerations or expectations Olympic actually had or applied before it elected to invest in ... the pipeline before July 2000 [when BP took over operation of the line].” (Batch, Ex. 603 at Tr. 29:4-8)(Talley, Ex. 1609 at Tr. 40:8-12).

Staff in Houston during the audit. (Colbo, Tr. 4712:8 to 4714:6). In Staff’s actual experience, the SAP system was like “running up against road blocks.” (Colbo, Tr. 4714:4-6).

¹⁴ A discussion of Olympic’s rate filing history is in Section IV.B.i, *infra* at ¶¶ 78-80.

46 With respect to the post-July 2000 period, Staff asked Olympic to produce representative documents that Olympic used to justify its capital additions. These types of documents “would cover all the considerations that Olympic would take into account” in making its investment decisions. (Talley, Ex. 1609 at Tr. 48:11-13). The sample documents Olympic provided include categories for Investor Required Return (IRR), Net Present Value over ten years in thousands ((NPV)(10)(\$K)), Discount Payback, Capital Efficiency (CE), and Projected Life. If Olympic had expectations regarding the methodology under which it would recover its investments in these projects, Olympic would have filled out these categories. Olympic did not do so. (*See, e.g.* Ex. 606-C at 53). None of the documents provided indicate Olympic considered any ratemaking method in making its capital budgeting decisions. (*Id.*).

47 **Right to Methodology.** Even if Olympic had proved it actually relied on a particular ratemaking methodology, such reliance would be unreasonable. RCW 81.04.250 notified Olympic that the Commission had authority to use “any standard, formula, method or theory of valuation reasonably calculated to arrive at the objective of prescribing and authorizing just and reasonable rates.” There is no vested right to a particular ratemaking methodology.¹⁵ *E.g., Farmers Union Exch. v. FERC*, 734 F.2d 1486, 1517-18 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984)(citations omitted)(“*Farmer’s Union II*”). *Accord: POWER v. UTC*, 104 Wn.2d 798, 812, 711 P.2d 319 (1985)(“within a fairly broad range, regulatory agencies exercise substantial discretion in selecting the appropriate ratemaking methodology.”).

48 Public service companies have a legitimate expectation that the rates set by the Commission will be fair, just, reasonable and sufficient. Staff’s case, based on the Commission’s traditional ratemaking methodology, meets that expectation.

¹⁵ Olympic conceded the point when its counsel stated at Tr. 3911:17-19: “we’re not trying to say that there’s a vested right somehow in one methodology ...”

B. FERC Methodology

49 **What is FERC methodology?** A threshold problem is to define FERC methodology. FERC uses four different methods. The “generally applicable” method is indexation. (Smith, Ex. 1201-T at 15:23-24). Olympic does not propose indexation. Olympic proposes only its version of the methodology FERC adopted in Order 154-B, *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985)(“Order 154-B”).

50 Olympic provided no direct testimony proving the propriety of any element of its proposed methodology. (Twitchell, Ex. 1901-T at 19:17-19; at 20:18-19; at 22:13-14; at 25:16-18; and at 28:12-13). This was a tactical decision: “the lawyers” decided Olympic would simply file its FERC testimony here. (Schink, Tr. 2261:23 to 2262:1). In rebuttal, Olympic offered Mr. Smith to explain the FERC methodology Olympic proposes. But he was a “conceptual expert,” not a “detail expert” on that methodology. (Smith, Tr. 4248:1-2). He was not espousing any theory to this Commission, and he was making no recommendation as to the proper methodology. (Smith, Tr. 4209:9-11, Tr. 4255:4-8). He made no study specific to Olympic’s situation. (Smith, Tr. 4266:25 to 4267:1-4).

51 The result is what one would expect: Confusion. Indeed, Olympic was unable to supply a consistent story describing basic applications of its proposed methodology.

52 On the issue of capital structure, Commissioner Hemstad asked Olympic a simple question: Would the FERC methodology use Microsoft’s capital structure if Microsoft purchased Olympic? Olympic’s answer is either No (Schink, Tr. 2456:24 to 2457:5), or Yes (Smith, Tr. 4262:5-18), depending on who you ask.

53 FERC’s answer is more complex. In Order 351, *ARCO Pipe Line Co.*, 52 FERC ¶ 61,055 (1990) at ¶ 61,243 (“Order 351”), FERC stated that it had a “general policy to use actual capital

structures for the purposes of developing weighted rates of return for gas and oil pipelines ...” FERC recognized an exception when equity ratios were above or below “generally accepted limits.” In that situation, FERC considers adjustments to either the equity ratio or the cost of equity. In Order 351, FERC used the parent’s capital structure, but adjusted for perceived differences between the pipeline’s risk and the parent’s risk. *Id.* at ¶ 61,243. No such analysis was offered by Olympic in this case.

54 On the issue of calculating AFUDC, Olympic changes the AFUDC rate applicable to prior periods whenever a rate case is filed. (Grasso, Ex. 2413; Tr. 5228-31; and Tr. 5070:15-19). According to FERC, the AFUDC rate for historical periods does not change: “The equity rate of return embedded in the AFUDC rate should be the equity rate of return *in effect at the time of the construction of the facilities.*” Order 351, *supra*, 52 FERC at ¶ 61,244 (emphasis supplied).

55 On the issue of using budgets to set rates, Olympic says budgets are appropriate under the FERC methodology. (Smith, Ex. 1201-T at 20:23 to 21:5). Yet FERC adopts the “known and measurable” standard for test period adjustments (*see* 18 CFR § 346.2(a)(ii)), and Olympic agrees budgets are not known and measurable. (Hammer, Ex. 802 at Tr. 25:16-19).

56 Olympic has explained none of these discrepancies. The result: Olympic has not met its burden to prove the FERC methodology is appropriate. Olympic tried to deflect attention from the deficiencies in its own case by claiming Staff mischaracterized the FERC methodology. (*E.g.* Ganz, Ex. 1101-T at 17:21-22). With no direct case from Olympic justifying its methodology, and no case at all explaining the details of that methodology, Staff analyzed the version of the FERC methodology Olympic has advanced. In doing so, Staff relied on what the Company said its proposed methodology was:

I’ve tried to understand the company’s case as they’ve presented it. They have not provided witnesses to support the method they’ve used. They supplied me with this

worksheet, which they said was the approach that they used. I reviewed that and found that I didn't feel it was appropriate for ratemaking purposes.

(Twitchell, Ex. 1917 at Tr. 43:23 to 44:4)(*See also* Twitchell, Ex. 1901-T at 15-16).

57 Staff is eminently correct: the Commission must address the methodology the Company advances, not the methodology it might have advanced. The methodology Olympic advances in this case is unacceptable, for all of the reasons stated in this brief.

i. Nature of Oil Pipelines and History of Regulation

Nature of Oil Pipelines

58 Oil pipelines are substantially similar to the public utilities the Commission regulates using the traditional Commission methodology. Olympic tried to distinguish itself from public utilities, in an effort to justify a methodology other than the traditional Commission methodology. That effort failed. The distinctions Olympic advances are not material, and provide no basis for using a different methodology.

59 **Olympic and most public utilities have characteristics of natural monopolies, and lack effective competition.** Olympic is similar to most capital-intensive public service companies, such as electric, natural gas, and water companies, for which the Commission applies its traditional ratemaking methodology. All share the characteristics of a natural monopoly: significant economies of scale, high fixed costs, low operating costs, significant barriers to entry, and usually no competition. Olympic exhibits “the traditional kind of classical public utility monopoly kind of industry organization.” (Elgin, Ex. 2113 at Tr. 11:6 to12:5).

60 If anything, Olympic is less risky than public utilities. Historically, Olympic has been immune from revenue volatility caused by economic cycles or competitive forces. Olympic has enjoyed stable throughput and the associated revenue stream that produces. Indeed, Olympic faces no actual competition from any other pipeline, and no prospects. (Peck, Tr. 2860:15-16). Any

potential competing pipeline would face a daunting task. It can take Olympic “years to complete” the permitting process for some of its construction projects. It took Olympic two years just to get a permit to bore under a single river. (Batch, Ex. 601-T at 8, last ¶, and Tr. 3086:25 to 3087:4). A new pipeline would have to hurdle these market barriers to entry, in addition to the EFSEC process, before it could compete with Olympic.

61 Olympic has not proven it has lost even one barrel of available pipeline capacity to other modes of transport. That is because waterborne transportation is “typically a lot more expensive” than pipeline transportation. (Peck, Tr. 2785:19 to 2786:7).¹⁶ Barge rates and tanker truck rates are over 172% and 360%, respectively, of Olympic’s proposed pipeline rates.¹⁷ The result is what one would expect: prior to the Whatcom Creek explosion, Olympic’s throughput increased with “monotonous regularity.” (Means, Ex. 2207 and Tr. 3709:22-24). Olympic’s pipeline capacity “is insufficient to meet demand.” (Batch, Ex. 610-T at 3:10). Olympic’s capacity has been prorated “for the last 10 to 15 years,” and “could have been prorated prior to that ...”. Olympic knows of no changes that will impair the demand for its services. (Batch, Ex. 603 at Tr. 8:1-3 and at Tr. 8:16-20)(*See also* Hanley, Ex. 420).¹⁸

¹⁶ This had a real impact on BP/ARCO. BP/ARCO was cut off from pipeline services after the Whatcom Creek explosion. When service was finally restored to 80% pressure, BP/ARCO enjoyed “substantially reduced [pipeline] transportation costs” compared to waterborne transportation. In BP/ARCO’s experience, pipeline transportation was “substantially cheaper” than alternatives. (Peck, Tr. 2786:15-18).

¹⁷ One set of barge rates provided by Olympic was \$.84/bbl. and trucking rates \$1.47/bbl. from Northwest refineries to Seattle. (Batch, Ex. 3T at 14:10-15). Olympic also offered a rate quote of \$.70/bbl to Seattle. (Cummings, Tr. 3993:12). The pipeline transportation rates in Olympic’s existing tariff show the pipeline rate from Ferndale to Seattle is \$.247/bbl. and the rate from Cherry Point to Seattle is \$.256. The average of these two rates is .2515/bbl. So a barge rate \$.84/bbl. is 334% of the pipeline rate (.84/.2515 = 334%), and the trucking rate is 584% of the pipeline rate (1.47/.2515). A barge rate of \$.70/bbl is 278% of the existing pipeline rate.

Olympic’s proposed rate from Ferndale to Seattle is \$.4001, and from Cherry Point to Seattle it is \$.4147. The average of these two rates is \$.4074. So the barge rate is between 172% and 206% of the proposed pipeline rate (.70/.4074 and .84/.4074) and the trucking rate is 361% of the proposed pipeline rate (1.47/.4074).

¹⁸ Olympic does not fear competition. Dr. Schink asked for any market research Olympic had, but Olympic was unable to find any. (Schink, Tr. 2239:25 to 2240:15). The forms Olympic uses to justify its investment decisions contain a box for “competitive risk,” but no such box was checked on the representative samples provided in discovery. (*See, e.g.* Ex. 606-C at 55, item 17, sixth box).

62 Non-price factors also make pipeline transportation the heavy favorite of shippers. According to Olympic, pipeline transportation is “a superior way to transport.” (Cummings, Tr. 3952:8). Shippers prefer pipeline transportation because it is safer, does not promote traffic congestion, and meets shipper’s advance scheduling needs. (Cummings, Tr. 3951:19-25). Inadequate dock facilities give Olympic a further competitive edge. This problem forced the BP/ARCO refinery to reduce output when the line was shut down. (Peck, Tr. 2901:1-8). Olympic has captive customers: “there is a very real question of how jet fuel would get to SeaTac Airport, which currently [is] served only by pipeline.” (Cummings, Ex. 1401-T at 18:11-12).

63 Against the weight of these facts, Olympic offers Dr. Schink’s analysis that waterborne transportation was able to respond to the shut down of Olympic’s line and that retail gasoline prices returned to “normal” during this period. (*E.g.* Schink, Ex. 221-T at 13-16).

64 Dr. Schink’s analysis fails to prove Olympic faces effective competition. First, examining retail prices is not direct evidence of the transportation component of the wholesale price. Absent proof the transportation cost was actually passed on to consumers, Dr. Schink’s analysis lacks a critical factual foundation.¹⁹ Dr. Schink offers no proof that petroleum transportation costs were in fact passed through to retail rates.

65 Second, none of Dr. Schink’s statistical formulae rebut the basic fact that Olympic has always had more demand than it has had capacity to serve:

The fact that barge/tanker capacity is available, and yet Olympic, when operating, approaches its capacity constraint limit, is powerful evidence that Dr. Schink’s competitive risk theory lacks merit.

(Wilson, Ex. 301-T at 52:20-22).

¹⁹ Mr. Smith, also representing Olympic, testified that there is no assurance that pipeline rate increases are passed through to retail customers. (Tr. 4208:20 to 4209:2). By the same reasoning, there is also no assurance waterborne transportation costs incurred in the aftermath of Whatcom Creek were passed through to retail customers.

66 Finally, Dr. Schink wanted barge transportation prices and asked Olympic for that information. Olympic decided not to ask BP/ARCO or Equilon for barge prices because that would not be “appropriate.” (Schink, Tr. 2298-2299). The Commission should not reward Olympic’s failure to ask its parent companies for information required by its consultant.

67 **Olympic and most public utilities in this state lack exclusive franchises.** Like Olympic, all public utilities in this state (except natural gas distribution companies) lack exclusive franchises, nor do they need a certificate of convenience and necessity before extending service.²⁰ Olympic therefore fails to distinguish oil pipelines from public utilities in this respect. (*See* Smith, Ex. 1201-T at 7:2-4).²¹ Mr. Smith did not analyze specific Washington statutes in his testimony on this issue.

68 **Olympic and public utilities in this state must have fair, just, reasonable and sufficient rates and must avoid unreasonable preferences and discrimination.** Both oil pipelines and public utilities in this state are subject to the same requirements for fair, just, reasonable and

²⁰ Under the public service laws of this state, there are no legal bars to entry for public utilities or oil pipelines. The only exception is natural gas distribution companies, who are granted a territorial certificate of convenience and necessity in order to operate. Overlapping certificates cannot be granted unless the incumbent provides unsatisfactory service. RCW 80.28.190. A natural gas distribution company would have to get an extension on its certificate if it sought to extend a line outside its previously certificated area, but not within it. RCW 80.28.190.

No similar condition applies to public utilities in the electric, water or telecommunications industries. *See also In re Electric Lightwave, Inc.*, 123 Wn.2d 530, 538, 869 P.2d 1045 (1994)(Commission may not grant exclusive territory absent express statutory authority. Such authority did not exist for telecommunications companies). Accordingly, the distinction Olympic offered that only oil pipelines lack exclusive franchises does not apply here. (Smith, Ex. 1201-T at 6:9-14 and Tr. 4211:6-15). Olympic’s methodology witness did not know what public utilities had exclusive certificates in this state. And the knowledge he did have (that natural gas distribution companies do not have exclusive certificated territories) was wrong. (Smith, Tr. 4212:21 to 4214:2). Natural gas distribution companies do have a form of exclusive territory. RCW 80.28.190.

²¹ Olympic also addresses the issue of abandonment of service at this point in Mr. Smith’s testimony. It is by no means clear what the legal restrictions are in this state on a public utility or an oil pipeline, if either decides to abandon service. Both public utilities and oil pipelines have substantially the same duty to serve, and the Commission has substantially the same right to order improved service for such companies. *See* RCW 80.28.010(2), .030, .040 and .130; and RCW 81.28.010, .020 and .240.

In any event, in Order 154, FERC attempted to use its own lack of abandonment control to justify departing from a cost-based rate methodology. *See* Order 154, *infra*, 21 FERC at ¶ 61,690 n. 217, and related text. The court rejected that attempt, stating FERC “overstated the significance of its lack of abandonment authority.” The court noted “The extremely high sunk costs involved with initiating oil pipeline service render a decision to abandon that

sufficient rates, and for avoiding unreasonable preferences and discrimination. (RCW 80.28.010, .090 and .100; RCW 80.36.080, .170 and .180)(RCW 81.28.010, .180 and .190). According to Olympic, these are the “two most important requirements” of the federal statutes governing oil pipelines. (Smith, Ex. 1201-T at 6:17-21). If so, they do not distinguish Olympic from public utilities in this state.

69 **Olympic’s status as a common carrier does not make Olympic unique.** Olympic seeks to distinguish oil pipelines as common carriers, from gas pipelines as contract carriers. According to Olympic, “at some level,” this difference becomes a “structural difference” that is “significant from a regulatory perspective.” (Smith, Ex. 1201-T at 8:20-25). Olympic’s point is that a contract carrier “will have more certainty with regard to future throughput than common carriers, who may experience sharp fluctuations in their throughput.” (*Id.* at 9:1-10).

70 Assuming the difference between common and contract carriage becomes a structural difference “at some level,” that level has not been reached in this state. Olympic has actually enjoyed certainty of throughput, just as a contract carrier might. Olympic’s capacity has been prorated for years. Olympic’s throughput (before Whatcom Creek) increased with “monotonous regularity.” (Means, Tr. 3709:23-24).²² Olympic’s methodology witness did not consider this evidence. (Smith, Tr. 4222:2-21).

71 **Oil pipeline rates and public utility rates may have a small impact on retail consumer prices, but that is not a relevant factor in setting rates.** Another distinction offered by Olympic throughout this case is that oil pipeline transportation rates have a small impact on the

service a weighty one indeed.” *Farmers Union II, supra*, 734 F.2d at 1509, n. 51. That analysis applies to Olympic as well.

²² Olympic’s historical immunity from loss of throughput to competitors is described in more detail in Section IV.B.i, *supra* at ¶¶ 59-66.

ultimate consumer.²³ This is not a relevant consideration. The Commission does not consider the impact of rates on retail consumer products. (Elgin, Ex. 2113 at Tr. 156:24 to Tr. 157:1). FERC learned that lesson the hard way. It based its decision to continue the valuation methodology in part because of the minimal impact of pipeline rates on consumers. Order 154, *Williams Pipe Line Co.*, 21 FERC ¶ 61,260 (1983) at ¶ 61,601 (“Order 154”). The court held against FERC, stating the minimal impact on retail consumers “does not excuse deviation from the just and reasonable standard, for not even ‘a little unlawfulness is permitted.’” *Farmer’s Union II*, *supra*, 734 F.2d at 1508 (citation omitted).

72 In sum, Olympic has not materially distinguished itself from public utilities. Olympic has not justified a departure from the Commission’s traditional ratemaking methodology.

History of Oil Pipeline Regulation

73 **Statutory history.** The history of economic regulation of oil pipelines in this state fully justifies use of the traditional Commission rate methodology. State regulation of oil pipelines began in 1915, when pipeline companies were declared to be common carriers subject to commission regulation, and granted the power of eminent domain. (Laws of 1915, ch. 132, §§ 1, 2). As common carriers, oil pipelines were subject to the same securities, transfers of property and affiliated interest requirements as other common carriers and public utilities. (RCW 81.08, 81.12 and 81.16; RCW 80.08, 80.12 and 80.16).

74 By contrast, federal oil pipeline economic regulation began earlier, in 1906, through amendments to the Interstate Commerce Act. (49 U.S.C. § 1 (34 Stat. 584 (1906)) often called the “Hepburn

²³ *E.g.*, Petition by Olympic Pipe Line Company for a Policy Statement and Order Clarifying Oil Pipeline Rate Methodology (October 31, 2002) at 9, ¶ 19, and Smith, Ex. 1201 at 26:13-23.

Act” or the “Hepburn Amendment”). Oil pipelines were not subject to federal common carrier laws regarding securities, property transfers and affiliate transactions.²⁴

75 **History of Using Valuation Rate Base.** Olympic erroneously claimed that since 1906, oil pipelines were “obliged” to use a valuation methodology, while public utilities were “obliged” to use a depreciated original cost methodology. (Smith, Ex. 1201-T at 9:17-22 and Tr. 4218:14-22). In fact, for decades, public utilities and oil pipelines were commonly regulated on a valuation methodology. It simply took longer before a court ruled the valuation methodology unlawful for oil pipelines. In 1944, in a case involving a public utility, the Court held that valuation rate base methodology was improper:

The heart of the matter is that rates cannot be made to depend upon “fair value” when the value of the going enterprise depends on earnings under whatever rates may be anticipated.

FPC v. Hope Natural Gas Co., 320 U.S. 591, 601, 64 S. Ct. 281, 88 L. Ed. 333, (1944)(“*Hope*”).

76 Nonetheless, the ICC and FERC continued the valuation methodology for oil pipelines until 1984, when FERC was finally reversed in *Farmer’s Union II*, *supra*, 734 F.2d 1486 (D.C. Cir. 1984).²⁵ On remand, FERC issued Order 154-B. In that Order, FERC did not try to justify the valuation method under the applicable “just and reasonable” ratemaking standard.

²⁴ In *Farmer’s Union Central Exchange v. FERC*, 584 F.2d 408, 413 (D.C. Cir. 1978)(“*Farmer’s Union I*”), the court surveyed the relevant statutes and noted that pipelines were not subject to ICA requirements for “acquisitions, mergers, corporate affiliates, uniform cost and revenue accounting, issuance of securities and corporate or financial reorganizations.”

²⁵ The order on review was Order 154. In that Order, FERC decided to continue the valuation methodology, based on the idea that FERC’s regulatory role was to prevent only “egregious exploitation and gross abuse,” and to restrain only “gross overreaching and unconscionable gouging.” Order 154, *supra*, 21 FERC at ¶¶ 61, 649 and 61,597. FERC noted the valuation formula it adopted would produce “creamy returns on book equity.” *Id.* at ¶ 61,650.

The court disagreed with FERC’s view of its regulatory role. The court held that shippers were entitled to a “just and reasonable rate.” According to the court, FERC “abdicated its statutory responsibilities...” FERC “...did not offer a reasoned explanation for adhering to an admittedly antiquated and inaccurate formula, but rather a host of unconvincing excuses that fail to add up to a rational choice.” *Farmer’s Union II*, *supra*, 734 F.2d at 1504, and at 1518 (citing *Consumers Federation of America*, 515 F.2d at 358, n. 64, quoting *FPC v. Texaco, Inc.*, 417 U.S. 380, 399, 94 S. Ct. 2315, 41 L. Ed. 2d 141 (1974)).

77 That the ICC and FERC elected to perpetuate an improper ratemaking methodology in the past,
does not justify Olympic’s proposed methodology for oil pipelines now.

78 **Olympic’s rate-filing history.** Other than the Commission’s suspension of Olympic’s tariff
filing in this docket, and in Docket No. TO-010792 in May 2001, Olympic’s rate filings have
gone into effect by operation of law. (*See* Ex. 2421, a compilation of the rate filings Olympic has
made, for which Commission records exist).²⁶

79 In Docket No. TO-010792, Olympic’s filing for a 76% increase in rates was suspended, then
withdrawn on motion of Olympic. Olympic believes the Commission’s suspension of that tariff
was an “apparent rejection” of the FERC methodology...” (*See* Olympic’s July 3, 2001, Motion
to Withdraw at 2:26-28, in Ex. 2421, under Tab 9).²⁷

80 Olympic has not filed rate changes before this Commission using a consistent rate
methodology.²⁸ Since 1978, Olympic has made seven rate filings that went into effect by
operation of law. One filing was not based on any form of FERC methodology.²⁹ One reflected
a rate less than what Olympic’s version of the FERC methodology at that time would justify.³⁰

81 **Olympic’s history of regulatory compliance.** Olympic has repeatedly failed to comply with
state regulatory requirements. In addition to repeated discovery rule violations in this case,
Olympic has yet to file for approval of its current management contract as required. And

²⁶ Cause No. TP-1437 (included in Ex. 2421 under Tab 1) was a 1981 Olympic tariff filing designed to address the nominations process. That filing was also suspended, but it did not directly affect a specific rate.

²⁷ In that Motion to Withdraw, Olympic asked for time to prepare a filing that “fully complies with the WUTC’s methodology and requirements.” (*Id.* at 3:1-3). Olympic has yet to make such a filing.

²⁸ The legal aspects of this history of rate filings are discussed in Section IV.B.iv.2, *infra* at ¶¶ 117-121.

²⁹ In Docket No. TO-961053, Olympic’s SeaTac surcharge filing, the proposed rate for shipper use of Olympic’s SeaTac facilities was based on a return on Olympic’s investment in SeaTac facilities: no “deferred return” or “starting rate base” calculation was identified. (*See* Ex. 2421, under Tab 5, September 19, 1996 letter from Olympic to the Commission). Olympic agreed the FERC methodology was not used in this filing. (Collins, Tr. 3117:11-19).

³⁰ In Docket No. TO-961518, a 4.5% general rate increase, Olympic filed a rate less than what its version of the FERC methodology would have justified. (Ex. 2421, under Tab 6, December 30, 1996 Staff memo 2nd ¶ of “Discussion”).

Olympic has yet to file the required financing applications or notices for the several notes Olympic issued to ARCO. (Elgin, Ex. 2101-T at 19:20 to 20:2, and at 12:21 to 14:7).

Conclusions

82 In this state, while the nature of oil pipelines and their legal history are not identical in all respects to public utilities, the similarities far outweigh the differences. Both are subject to the same rate standards and other regulatory requirements. Both enjoy significant economies of scale, with high fixed costs, low operating costs, significant barriers to entry, and in this state at least, no effective competition. Olympic has provided no substantial reason why the history or nature of Olympic justifies a different ratemaking methodology.

ii. Rationale for FERC Methodology

83 **Summary.** In broad form, the FERC methodology includes a “trended original cost (TOC)” rate base element and a “starting rate base (SRB)” element. The reasons underlying TOC and SRB have no application here, lack an evidentiary basis, or at most, provide only weak justification for applying that methodology to Olympic.

84 **Rationale for TOC.** Olympic says “one of the primary reasons that the traditional public utility model is not applicable to pipelines” is the existence of competition. (Smith, Ex. 1201-T at 6:9-14). Indeed, FERC’s primary rationale for TOC was that it “will help newer pipelines with higher rate bases to compete with older pipelines with lower rate bases and will help them compete with other modes of oil transport and so will tend to foster competition generally.” Order 154-B, *supra*, 31 FERC at ¶ 61,377. According to FERC, a “front-end load” problem exists under DOC because rate base declines over time. So under DOC, a new pipeline may not be able to compete with an older pipeline due to this “bunched income” effect. (*Id.* at ¶¶ 61,834 and 61,835).

85 FERC’s primary rationale for TOC does not apply in this state. As Olympic conceded: “Front-end loading when you don’t have competition doesn’t matter.” (Smith, Tr. 4269:10-11).³¹ In fact, Olympic faces no competition from other pipelines. (Olympic agreed any concerns about competing pipelines “would probably not be applicable in this case.” (Smith, Tr. 4273:21 to 4274:2)). And there is no effective inter-modal competition, either,³² assuming the Commission can consider that.³³ (See Section IV.B.i, *supra* at ¶¶ 59-66).

86 On the record before it, FERC also found that TOC promotes “intergenerational equity,” and “comes closer to duplicating pricing in unregulated enterprises.” Order 154-B, *supra* at ¶ 61,835 and ¶ 61,839 n. 30 (citing the record support). The instant record does not support these reasons, either. Olympic has failed to supply any evidence specific to Olympic that proves “intergenerational equity” is an issue. And there is nothing in the record that suggests unregulated firms price according to TOC. The record shows that for corporations generally, investment is indeed “bunched,” or “lumpy.” (Elgin, Tr. 4811:9-16).

87 Finally, Olympic (though apparently not FERC) thinks the absence of exclusive franchises is a factor that favors TOC. But Olympic conceded that in this state, the lack of exclusive franchises “is another ... rationale for TOC, that doesn’t exist here...” (Smith, Tr. 4272:13-16).

88 In sum, Olympic has not proven that the rationale that led FERC to select TOC have any application in this state.

³¹ See also Brown, Ex. 2301-T at 28:1-10.

³² Some competition exists between public utilities, but that has not justified a departure for the Commission’s traditional rate methodology. Natural gas competes against electricity and oil for some applications, and electric utilities compete with self-generation by large customers. The issue is whether effective competition exists. Mr. Smith did no study of competition in the oil transportation markets in Western Washington to support his testimony. (Smith, Tr. 4211:2-5).

³³ Unlike other statutes the Commission administers (*e.g.* RCW 80.36.300 - .370), there is no clear statutory basis for considering “fostering competition” among pipelines, and it is uncertain whether the Commission has authority at all to foster competition by unregulated modes of transportation. In *Cole v. WUTC*, 79 Wn.2d 302, 306, 485 P.2d 71 (1971), the court held the Commission “correctly determined that it had no authority to consider the effect of a regulated utility upon an unregulated business.”

89 **Rationale for SRB.** FERC was concerned that there was “long reliance of pipeline investors on the previous rate base method...” FERC adopted SRB because FERC thought this was “fair in light of investor expectations but without perpetuating the serious flaws of the previous [valuation] method...”³⁴ FERC cited no legal authority justifying this conclusion.

90 These reasons for SRB find no support in the record or the law. Olympic provided no direct evidence it relied on any particular rate methodology when it invested in plant in this state. (See Section IV.A, *supra* at ¶¶ 45-48). And no investor is entitled to rely on a particular methodology (*id.*), let alone an improper one:

We believe FERC’s principal duty under the statute is to ensure “just and reasonable” rates. Accordingly, the frustration of the [investor] expectation that this excessively “permissive” and “indulgent” methodology would continue in force is a “factor[] which Congress has not intended [FERC] to consider.” We therefore do not condone FERC’s reliance on these expectations.

Farmers Union II, supra, 734 F.2d at 1518, n. 65. No court has ruled on FERC’s decision to allow SRB. The Commission should heed the federal court’s warnings about alleged investor reliance, and reject SRB.

1. Potential for Underinvestment

91 This issue is related to Olympic’s claim that it needs a 62% increase or else it will not be able to fund its \$66 million construction program. (*E.g.* Fox, Ex. 1701-T at 2:8-10). The relationship of this claim to the choice of ratemaking methodology was made clear by Olympic’s testimony that “one of the other thoughts behind the 154-B methodology” is that investors were relying on the “creamy returns” provided by the valuation methodology: “The 154-B methodology was part of that thought process, the result of that thought process, to take -- to partially take care of that problem.” (Smith, Tr. 4335:3-22).

³⁴ FERC permits parties to “raise this issue and attempt to prove that a particular company is not entitled to the instant starting rate base.” (Order 154-B, *supra*, 31 FERC at ¶ 61,836).

92 This rationale lacks both a legal and factual foundation. We just explained that no investor is entitled to rely on any methodology. In addition:

So long as the pipeline receives a just and reasonable rate for its service, it will be afforded an opportunity to derive a fair profit. Even if the oil pipelines do not receive everything they would like – even if they do not make “creamy returns” on their investment - they are unlikely to “abandon service whenever they find the regulators’ decisions unpalatable,” especially considering FERC’s view that oil pipeline capacity is needed to serve the oil companies which, in turn, own many of the pipelines.

Farmers Union II, supra, 734 F.2d at 1509, n. 51. Again, there is no direct evidence Olympic relied on FERC methodology, or any methodology, when making investment decisions. (*See* Section IV.A, *supra* at ¶¶ 45-48).

93 Investors are entitled an opportunity to a fair return on the assets they have devoted to public service. That is the essence of the capital attraction standard. (Elgin, Tr. 4808:8-21). Olympic justifies SRB as necessary to satisfy investors’ appetites for excessive returns. That rationale justifies rejection of SRB, not its acceptance.

iii. Elements of FERC Methodology

94 In this section, we analyze the technical details underlying key elements of the FERC methodology, and provide further reasons why the WUTC should not adopt that methodology.

1. Trended Original Cost (TOC)

95 The TOC methodology applies a “real” (*i.e.* net of inflation) rate of return on equity to the rate base. The inflation component of the rate of return on equity is applied to the trended rate base to calculate a “deferred return.” This deferred return is added to rate base and amortized. (Order 154-B, *supra*, 31 FERC at ¶ 61,833-35).³⁵ FERC noted that “theoretically, TOC results in the same discounted value of the earning stream for the investor as does ‘untrended’ original cost.”

³⁵ TOC is also explained by various witnesses in this case, *e.g.*, Staff: Twitchell, Ex. 1701-T at 29:11-22; Olympic: Smith, Ex. 1201-T at 11:1-9; and Tesoro: Brown, Ex. 2301-T at 20:7-13.

(*Id.* at ¶ 61,834, quoting a Department of Justice exhibit in the record). This theory is shown graphically in Exhibit 1218.

96 TOC is flawed in theory and practice. First, the theoretical matching of return under TOC and DOC shown in Exhibit 1218 assumes a constant rate of return, constant rate of inflation, constant depreciation rates, and no changes to investment over time. (Elgin, Tr. 4810:3-11). These “steady state” assumptions underlying TOC are unrealistic, because changes occur in investment, asset lives, depreciation reserves, and salvage values. TOC’s assumptions also do “not take into account the dynamic changes in the economy and the underlying cost of capital [that changes] over time.” (Elgin, Tr. 4811:1-8).

97 There is no evidence in this record that corporations finance based on the levelized payment stream assumed by TOC. “Investments are lumpy, and capital additions are lumpy, and the rate-setting process recognizes that with the [DOC] methodology.” (Elgin, Tr. 4811:16-19). On the practical side, because the Commission never approved TOC for Olympic, there was no basis for Olympic to defer equity returns from prior periods. In any event, Olympic failed in fact to defer the return on its books for which it now seeks unlawful retroactive recovery. (Twitchell, Ex. 1901-T at 33:21-22). Olympic requires an accounting order from this Commission if it intends to defer any amount for later recovery. *E.g., Re Puget Sound Power & Light Co.*, Docket Nos. UE-920433, 920499 and 921262 (11th Supp. Order)(1993) at 53 (rejecting deferred accounting of costs without a Commission order approving same) and *Re Pacific Power & Light Co.*, Cause Nos. U-82-12 and U-82-35 (4th Supp. Order)(1983) at 23-24 (rejecting deferred accounting of expenses into capital accounts to the extent the company failed to achieve its authorized return). Olympic has no such order.

98 Finally, even assuming Olympic's choice of a nominal rate of return was actually approved by the Commission, Olympic earned substantially in excess of that return over the 1984-1999 period. (Twitchell, Ex. 1910). Indeed, from 1990-1995, Olympic's cash flows effectively returned to owners Olympic's entire investment in facilities serving the public at that time. (Elgin, Tr. 4806:10 to 4807:15). This proves Olympic has not foregone any "deferred return." To permit Olympic to amortize any "deferred" return now would amount to double recovery. (Twitchell, Ex. 1901-T at 30:18 to 32:10)(Brown, Ex. 2301-T at 25).

99 For each of these reasons, TOC should not be permitted. Ultimately, use of TOC does not produce a fair, just, reasonable and sufficient intrastate rate.

2. Starting Rate Base ("SRB")

100 FERC allows oil pipelines to earn a return on what is called "starting rate base (SRB)." FERC adopted SRB as a "transition" mechanism between the valuation methodology and the TOC methodology. SRB is calculated by applying the rate of return on equity to the valuation rate base as of 1983. FERC permits an equity return on, but not of, this transition rate base. Order 154-B, *supra*, 31 FERC at ¶ 61,835-36.³⁶ As we noted above, FERC cited no legal authority to justify this transition mechanism.

101 There is no reason for the Commission to adopt SRB. The Commission has never adopted a ratemaking methodology for Olympic, so there is no "transition" from one methodology to another. Even assuming the Commission had adopted a different methodology, there is no legal reason why a "transition" is necessary.³⁷

102 SRB is "merely an artificial construct derived by a one-time formula to bridge the transition from valuation to TOC." Order 351-A, *Arco Pipeline Co.*, 53 FERC ¶ 61,398 (1990) at ¶ 61,389.

³⁶ SRB is also explained by various witnesses in this case, *e.g.*, Staff: Twitchell, Ex. 1901-T at 26-28; Olympic: Smith, Ex. 1201-T at 12:5-17; Tesoro: Brown, Ex. 2301-T at 20:14 to 21:3.

SRB was not supplied by investor funds (Collins, Ex. 709 at Tr. 27:18-23), so it improperly provides Olympic a return on investment it did not make. (Twitchell, Ex. 1901-T at 27:15-21)(Brown, Ex. 2301-T at 29:20-21). There is no need for such an artificial construct in this state.

103 For each of these reasons, SRB should not be permitted. Ultimately, use of SRB does not produce a fair, just, reasonable and sufficient intrastate rate.

3. Deferred Return (*See* Section IV.B.iii.1, *supra* at ¶¶ 95-99)

4. Parents' Capital Structure

104 As discussed earlier, much confusion has been generated by Olympic regarding FERC methodology on appropriate capital structure. (*See* Section V.B, *supra* at ¶¶ 50-53). What is certain is that Olympic mechanically applies its parents' capital structure for ratemaking purposes. Indeed, Olympic "updated" its recommended equity ratio from 82.92% to 86.85%, based solely on new information on Olympic's parents' equity ratios. Olympic made no independent analysis of any change in its specific business risk to justify this change. (Schink, Ex. 201-T at 92:2-8, Ex. 219 and Tr. 2221:5-15).

105 It is not rational to use Olympic's parents' capital structure for purposes of setting rates in this case. First, when BP/ARCO purchased Olympic from GATX, the parents' capital structure "jump[ed] 25 percentage points. This, of course, has nothing to do with any changes in Olympic's operations or risks." (Wilson, Ex. 301-T at 47:1-4). Increasing an equity ratio by 25 percentage points for ratemaking purposes because of such a change in ownership makes no sense from a cost-of-service perspective.

106 Second, under Olympic's theory, by guaranteeing Olympic's debt, Olympic's owners can convert a company with an actual 100% debt ratio, into a company with an 86.85% equity ratio

³⁷ *See* argument in Section IV.A., *supra* at ¶¶ 45-48, and Section IV.B.ii, *supra*, at ¶¶ 89-90.

for ratemaking purposes. That produces a greatly disproportionate revenue impact. As the Commission has acknowledged, on a pre-tax basis, equity capital is about twice as expensive as debt. *UTC v. Avista Corp.*, Docket Nos. UE-991606 & UG-991607 (3d Supp. Order)(2000) at 99, ¶ 375. That is borne out in this case.³⁸

107 Finally, using the capital structure of BP and Shell is improper since the risks of those firms bear little resemblance to the risks of Olympic, a public service company with natural monopoly characteristics and assured throughput. (*See* Section IV.B.i, *supra* at ¶¶ 59-66).

5. Cost of Equity

108 FERC uses a multi-stage Discounted Cash Flow (DCF) methodology to estimate return on equity (ROE). FERC uses stock analysts' growth in earnings estimates reported by IBES to estimate near-term dividend growth. Gross Domestic Product (GDP) is used to estimate long-term dividend growth. FERC relies upon a five company "Proxy Group," which, according to FERC, represents a proxy measuring the business risk of owning and operating an oil pipeline.³⁹

109 In short, FERC's method is a mechanical calculation that uses limited and faulty data to produce an unreliable measure of ROE.

110 Using stock analyst earnings forecasts is improper because a stock analyst's expectations for a firm's growth in earnings differ from an investors' expectations for growth in dividends.

Moreover, stock analysts' forecasts are inherently unreliable. When stock analysts overrate stocks, investors discount what those analysts have to say. Investors are wary of the bullish

³⁸ If Olympic is 100% debt financed, assuming a pre-tax cost of debt of 7% and rate base of \$60 million, the total return requirement is \$4.2 million. ($.07 \times \$60 \text{ million} = \4.2m). If the parents now guarantee the loans, and the equity ratio moves to 85%, the rate of return becomes 12.45% and the return requirement balloons to \$7.47 million. [Calculation: Using a cost of equity of 9% and the same 7% cost of debt, and a 35% tax rate, the pre-tax weighted cost of capital is 12.45% ($.07 \times .15 \times .65 + [(.09 \times .85) \div .65] = 12.45\%$). $.1245 \times \$60\text{m} = \7.47m]. Using the larger rate base and higher ROE estimates proposed by Olympic magnifies this impact.

³⁹ The FERC method for ROE described herein is discussed in Order 435, *SFFP, L.P.*, 86 FERC ¶ 61,022 (1999), cited and applied by Dr. Schink. (*See, e.g.* Ex. 201-T at 39, n. 7).

expectations of earnings analysts.⁴⁰ (Wilson, Ex. 301-T at 19:5-9). “For this reason, analyst forecasts are, at best, an overstated proxy for investors’ long-term expectations.” (*Id.* at 20:1-2).⁴¹

111 The use of GDP to estimate long-term growth in dividends is seriously flawed since the use of any long-term total growth measure will not provide a proxy for *per share* growth in dividends. (Wilson, Ex. 301-T at 26:20-22).

112 The use of a five company Proxy Group is also problematic since it represents “a small and limited universe.” (Wilson, Tr. 2569:9-13). The companies in the group are limited partnerships that often pay out dividends that constitute a return of capital, which makes the group unrepresentative. (Wilson, Tr. 2568:23 to 2569:8).

113 In sum, the “FERC method” for computing ROE is a mechanical application of a multi-stage DCF methodology using improper limiting and flawed assumptions. It is a “generic approach” that “doesn’t work very well. And it’s a mistake that FERC has made.” (Wilson, Tr. 2570: 2-6). The Commission should not make the same mistake. It should reject the FERC method for estimating cost of equity.

iv. Commission Discretion in Choosing Methodology

114 The Commission has discretion to choose among methodologies “to arrive at the objective of prescribing and authorizing just and reasonable rates.” RCW 81.04.250. No investor has a vested right in any one methodology. (*See* Section II.B, *supra* at ¶¶ 16-22 and IV.A, *supra* at ¶¶ 45-48). “Past practices” or “consistency with interstate rates” do not justify Olympic’s methodology, either.

⁴⁰ Clearly, recent events regarding bullish expectations have cast considerable doubt on the reliability of sell-side analysts’ expectations for earnings growth.

1. Consistency With Interstate Rates

115 Consistency with interstate rates is not an achievable goal in fact, nor is it required by law.

There has not been consistency between Olympic's intrastate and interstate rates for several years. Olympic has had indexed interstate rates with FERC, but not the WUTC, since 1995. (Grasso, Ex. 2418)(*See also* Section II. C, *supra* at ¶¶ 26-29).

116 Even if consistency in rates was achievable, it is not required by law so long as the intrastate rates are cost-based. (*See* Section II.C, *supra* at ¶¶ 26-29). The Commission should proceed to set cost-based intrastate rates, and let FERC do as it wishes in the federal jurisdiction.

2. Past Practices

117 As we described in Section IV.B.i, *supra* at ¶¶ 78-80, Olympic's rate filings have become effective by operation of law (other than Olympic's filing in May 2001, and the instant case, both of which were suspended by the Commission). As we explained, some of Olympic's rate filings were based on Olympic's version of FERC methodology at the time. However, one rate filing was not based on FERC methodology, and one rate filing was at a level less than what the FERC methodology would have produced. Therefore, the "practice" has not been for Olympic to file rates that have always reflected its version of FERC methodology.

118 Moreover, there is certainly no "past practice" in this state regarding what ratemaking methodology is appropriate for Olympic. That issue has yet to be decided. Rates filed by a public service company that are allowed to go into effect by not suspending the operation of the tariff are not commission-prescribed rates. *Bison Steamship Corp. v. U.S.*, 182 F. Supp. 63, 66 (N.D. Ohio, 1960).

⁴¹ Moreover, what Dr. Schink considered to be the "consensus" of analysts estimates is really no consensus at all. In fact, the range of forecasts for earnings reveals significant divergence of opinion, and there is significant disagreement among analysts and their expectations for future growth in earnings. (Wilson, Ex. 301-T at 22:16-19).

119 Even if Olympic could prove it actually relied on Commission “past practices” in an attempt to bind the Commission to select Olympic’s version of a FERC methodology, such reliance would not have been reasonable. In the past, if Olympic wanted to obtain a Commission pronouncement on appropriate methodology, it could and should have pursued a petition for declaratory relief or for a policy statement on rate methodology issues, much like it attempted to do at the outset of this docket.

120 Olympic now advances an argument that if the Commission “switches” methodologies, ratepayers must make five years of “transition payments” for “stranded investment” to compensate Olympic for the “switch.” (Schink, Ex. 201-T at 19-24). Olympic’s argument cannot be sustained. First, since the Commission never adopted a ratemaking methodology for Olympic, there is no “switch” to be concerned about. Second, public service companies are not entitled to a specific ratemaking methodology. Third, Olympic is tacitly arguing that the rates it filed were not just and reasonable rates. If so, that is Olympic’s problem, not the ratepayers’. If equities are to be considered, the Commission should consider that Olympic substantially over earned during the 1989-1997 period. (E.g., Elgin, Ex. 2102).

121 Finally, if Olympic’s entitlement to “stranded investment” recovery was somehow implicit in its past rate filings, it had an obligation to explicitly inform the Commission of that. Olympic’s failure to do so is no basis to hold the Commission captive to Olympic’s “transition payment” theory now.

C. DOC Methodology

122 The Commission should apply its traditional methodology in this case. Both Staff and Tesoro recommend this methodology. (E.g. Twitchell, Ex. 1901-T at 8-13)(Brown, Ex. 2301-T at 19:1-14 and at 21:4 to 24:5)(Grasso, Ex. 2401-T at 9:9 to 10:5). The Commission should do so not

just because Olympic has failed to support its version of FERC methodology, but also because the traditional Commission methodology is appropriate and meets legal standards.

123 A regulated company is entitled to charge prices that provide it an opportunity to earn a fair return *of* and *on* its investment used and useful to provide service to the public, plus recover its normal, prudently incurred costs of providing service. Return *of* investment is accomplished through depreciation and amortization. Return *on* investment is accomplished by allowing a dollar return calculated by multiplying the fair rate of return times the rate base. (Twitchell, Ex. 1901-T at 8-13).⁴²

124 This traditional Commission methodology is implemented by selecting a 12-month test period, and determining a results of operations for the test period. Restating actual adjustments are made to adjust the test period recorded results to reflect transactions applicable to the test period. Pro-forma adjustments are also made to account for known and measurable changes that have occurred, to the extent these changes are not offset by other factors. (Twitchell, Ex. 1901-T at 9-11). Rate base is developed using the book value of used and useful plant in service, less depreciation. This is also known as depreciated original cost, or DOC. The fair rate of return is applied to the rate base to develop the fair return. If the rate of return the company achieves on a pro-forma and restated basis is below the fair rate of return, a rate increase is warranted. If the rate of return the company achieves on a pro-forma and restated basis is above the fair rate of return, a rate decrease is warranted. (*Id.*).

125 The traditional Commission methodology (including DOC) has been used consistently by the Commission when it has set rates for capital-intensive public service companies like Olympic.

⁴² Olympic acknowledged these essential features of the traditional ratemaking methodology. (Collins, Ex. 713-T at 3:17 to 6:14).

The traditional Commission methodology “is the one commonly accepted and used.” *POWER v. UTC, supra*, 104 Wn.2d at 808-09)(citations omitted) .

126 The traditional Commission methodology is also consistent with how American businesses are financed, and it satisfies the capital attraction standard:

[T]he test in terms of attracting capital is truly met by the Commission's adoption of its traditional rate-of-return methodology for rates. Applying a fair market rate of return to the Company's investment and long-lived assets meets that capital attraction test.

It's the basic premise that virtually every regulatory Commission operates under. It is truly the language, the historical language of American finance. This is how investors make capital available. They make an investment. They expect a return on that investment, and all accounting standards and measurements of that investment is on the basis of invested capital, the book investment.

(Elgin, Tr. 4808:8-21). Accordingly, the Commission should adopt the traditional WUTC ratemaking methodology in this case, including DOC.

V. TEST YEAR AND JURISDICTIONAL SEPARATIONS

Test Year

127 **Summary.** The Commission should adopt the year ended December 31, 2001, as the test year in this case. It is the only test year in which the Commission should have any confidence. The Company's rebuttal case uses a combination of new actual results, plus new budgeted figures and estimates that violate the “known and measurable” concept of ratemaking. Moreover, Olympic's rebuttal case has not been audited or analyzed in detail by Staff or other parties. It should not be accepted. Tesoro and Tosco both use fiscal year test periods that do not capture Olympic's annual accrual practice and, on that basis alone, the Commission should not use those results.

128 **Terminology.** Terms used during the proceeding varied, due to the terms used by the FERC and WUTC. The traditional Commission methodology uses a “test year” of 12 months actual data.

Restating actual adjustments and pro-forma adjustments are made to the test year data, resulting in pro-forma and restated results of operations. (See Section IV.C, *supra* at ¶¶ 122-124).

129 The FERC methodology uses a “base period” of 12 months of actual data (See 18 CFR § 346.2(a)(i)), which is comparable to the Commission’s test year. FERC’s base period is also to include adjustments for nonrecurring items or “normalizing” adjustments. (*Id.*). This is comparable to the test year with restating adjustments, under the traditional Commission methodology. FERC then requires adjustments for changes that are “known and . . . measurable with reasonable accuracy at the time of filing and which will become effective within nine months” of the end of the base period, to arrive at what FERC calls the “test period.” (See 18 CFR § 346.2(a)(ii)). FERC’s “test period” is comparable to the test year results of operations, restated and pro-formed, under the traditional Commission methodology (absent the nine month restriction in FERC rules).

130 **Positions of the Parties.** Staff proposes calendar year 2001 as the test year (12 months of actual data), restated and pro-formed. Olympic proposes a base period of 12 months ended September 30, 2001. This is also the base period used by Tesoro, though that is where the similarity between Tesoro and the Company ends. Tesoro’s test period analysis is more like the traditional Commission methodology. (Brown, Ex. 2301-T at 41:6 to 48:5). Tosco also uses a base period ended September 30, 2001. (Means, Tr. 3726:5-20).

131 In its direct case, Olympic’s “known and measurable” test period adjustments were mostly budget year 2002 estimates. (Hammer, Ex. 817 at 12:15-18; Ex. 819, Sch. 21). In its rebuttal case, Olympic purports to use the same base period used in its direct case: 12 months ending September 2001. For test period adjustments, Olympic shows figures through the 12 months ended September 2002. To get there, Olympic uses the sum of actual data for the 7 months

ended April 2002, 2 months of budgeted data (for May and June 2002), and an average of the combined sum of the 9 months ended June 2002 for the remaining 3 months (July through September 2002). (Collins, Ex. 703-C, Sch. 21, Tr. 3108:9-12)(Hammer, Ex. 859 at Tr. 47:6 to 48:5). We will call this Olympic's "7-2-3 Method" herein.

132 **Argument.** The Commission should accept the Staff's test year and accompanying analysis. That test year is more representative because it contains 3 more months of actual operating data under the 80% pressure condition than the Company's base period. (Colbo, Ex. 2001-T at 11:7-9). Moreover, only an annual test year captures Olympic's year-end accounting adjustments relating to the previous 12 months. (*Id.* at 10:8-11).

133 There are several other reasons for rejecting Olympic's base period and test period results. First and foremost, it would be unfair and improper to use the numbers in Olympic's rebuttal case, because they have not been tested by detailed review or audit. (Colbo, Tr. 4716:10-24)(Brown, Tr. 4979:24 to 4981:1).

134 Second, because of irregularities in Olympic's accounting practices, use of a base period that is not an annual period produces unreliable results. (*See* Section III, *supra* at ¶¶ 33-43). For this reason alone, Tesoro and Tosco's base period ending September 2001 is also unreliable.

135 Third, Olympic's use of budget estimates to develop test period results is improper. Olympic admitted budget amounts are not known and measurable:

Q: Is it your testimony that an increase in operating expenses is known and measurable if the next year's budget reports an increase?

A: No.

(Hammer, Ex. 802 at Tr. 25:16-19). Olympic's use of budget estimates is inconsistent with the known and measurable concept. Olympic simply replaced the base period with budget or

estimated data. (*E.g., see* Collins, Ex. 728-C at 5 and 15, and Ex. 725 at Tr. 36:11-20).⁴³

“Known and measurable” means adjusting historical results for known changes, not “substituting one set of numbers [base period] with another set of numbers [test period].” (Colbo, Tr. 4717:25 to 4718:7).⁴⁴

136 Olympic’s budget estimates are also unreliable. By definition, budgets are estimates of future activity. It is impossible to audit a company’s projections until after the activity has occurred.⁴⁵

When a comparison between Olympic’s budget data and actual data was made, major inaccuracies were exposed. For example, Olympic’s budgeted expenses were almost 12% over actuals for a recent 4 month period. Olympic also under-budgeted property taxes by 33% during that same period. (Hammer, Ex. 865 and Tr. 3403:24 to 3405:14).

137 The contrast between Staff and Company cases could not be more apparent. Staff started with the calendar year test year, then applied restating and pro-forma adjustments. The result is fully restated, pro-formed results of operations that are “forward-looking [but] still firmly rooted in actual operating expenses.” (Colbo, Tr. 4716:3-5). For the most part, Olympic’s “7-2-3 Method” substitutes base period figures with 7 months of “actuals,” 2 months of budgeted amounts and 3 months of estimates, none of which have been reviewed in any detail. What limited review has been done proves Olympic’s figures are unreliable.

138 The Commission should adopt calendar year 2001 as the test year and reject the Company’s, Tesoro’s and Tosco’s base and test period analysis in this case.

⁴³ Olympic described its rebuttal test year calculations in contradictory terms. In his deposition, Mr. Collins testifies that Olympic’s test year adjustments were developed “based on the difference between projected test period levels of cost and the actual base period of costs.” (Collins, Ex. 725 at Tr. 36:17-19). During cross examination, Mr. Collins described the adjusted amounts as being “added to the base period to get to the test period.” (Collins, Tr. 3112: 11-13). When asked about his prior characterization that “The test period less the base period equals test period adjustments” (Ex. 703 at Tr. 52: 1-3), Mr. Collins stated that his prior characterization was true for some, but not all adjustments. (Tr. 3113:5-7).

⁴⁴ Tesoro is in accord. (Brown, Ex. 2301-T at 12:1-3 and Tr. 4965:3 to 4967:7).

⁴⁵ Olympic agreed that budgeted numbers are not normally subject to audit. (Hammer, Ex. 802 at 16:12-15).

Jurisdictional Separations

139 Staff recommends the Commission set rates based on Washington intrastate results of operations. Staff prepared its case on that basis. (Twitchell, Ex. 1901-T at 37:4 to 38:5 and Ex. 1903). Setting rates based on intrastate results of operations is a proper way to distinguish the federal and state jurisdictions. *Louisiana PSC v. FCC*, 476 U.S. 355, 375, 106 S. Ct. 1890, 90 L. Ed. 2d 369 (1986). The separations factors used in Staff's case and Olympic's direct case are the best available from the record. (Twitchell, Tr. 4618:20 to 4619:2). Olympic agreed these factors are "a reasonable way" to separate results by jurisdiction. (Collins, Ex. 709 at Tr. 8:17-21).

VI. OPERATING EXPENSES

A. Results per Books

140 Exhibit 1904, p. 1 and 2, col. (B), and Ex. 2003-C, p. 1 show Olympic's per books actual operating results for calendar year 2001. (*See also* Attachment Table 1).

B. Whatcom Creek Expenses

141 All parties agree the costs associated with the Whatcom Creek explosion should be excluded from consideration in this docket. The direct costs, as reflected on Olympic's books and records, have been removed by each party. The issue remains about possible indirect costs that may be included in test year expenses or rate base. Such costs are largely unknown.

142 Tesoro claims that one result of Whatcom Creek is the 80% pressure restriction currently imposed by the federal Office of Pipeline Safety (OPS). This issue is addressed in Section X.B, *infra* at ¶¶ 229.

C. Restating and Pro-forma Adjustments (N/A)⁴⁶

⁴⁶ See Section V, *supra* at ¶¶ 127-138, for a discussion of restating and pro-forma adjustments in the context of the analysis of the appropriate test year. See Section VI.J, *infra* at ¶¶ 163-165, for discussion of adjustments other than those specifically listed on the required outline.

D/E. One-Time Maintenance Costs – Major Maintenance Costs

143 Many of Olympic’s expenses for what it calls “One Time Maintenance (OTM)” and/or “Major Maintenance” (collectively called “OTM costs” herein) do not fit within the context of normal or routine maintenance expense that should be included in permanent rates. OTM projects are usually large, atypical projects that have lasting value extending into future operating cycles. (Colbo, Ex. 2003-C at 10-11). Olympic’s Board must approve OTM projects before they are undertaken, and then monitors their progress. (*E.g.* Batch, Ex. 35-C). While OTM costs recur annually in some fashion, individual projects vary in type from year to year. (Hammer, Tr. 3304:14 to 3305:1).

144 Staff recommends normalizing OTM costs to a “more reasonable level for rate setting.” (Colbo, Ex. 2001 at 20:9 to 21:21 and Tr. 4784:15-19). Tesoro recommends excluding OTM costs as non-recurring items. (Brown, Ex. 2301-T at 41:10-11 and at 42:11-13). Olympic believes these costs were properly expensed and recoverable in rates without adjustment. (Hammer, Ex. 801-T at 12: 3-11).

145 Normalizing the OTM costs is appropriate because it is not reasonable to disallow the costs if they are prudent and properly relate to providing regulated service. Normalizing OTM costs does not eliminate them. Rather, the timing of their recognition is adjusted to more accurately match the expenses with their derived benefits. To disallow such costs would deprive the Company of reimbursement for legitimately incurred costs and would penalize the Company for undertaking necessary improvements.

146 Because Staff had no detail on 2001 OTM expenditures, Staff reviewed and analyzed 2002 budget information on OTM items that Olympic provided in response to Staff Data Request 307. Based on that information, only two percent of the budget OTM costs would be properly

expensed. (Colbo, Ex. 2003-C at 11). Of the remaining amounts, 40% should be capitalized and 58% should be amortized over five years. (*Id.*). Staff applied these percentages to the \$3,295,502 of OTM costs Olympic incurred in 2001 to derive the adjusted OTM amount, offset in part by the increases to rate base and depreciation expenses for the amounts capitalized. (Colbo, Ex. 2003-C at 9:11-27).

147 Certain items are not included in the 2002 OTM budget review and 2001 OTM adjustment by Staff. For example, because there were no line replacements in the 2002 OTM budget, none were included in the adjustment. The issue whether line replacements are capital or expense items is not presented in this case. (Colbo, Ex. 2003-C at 10-11 and Tr. 4789:6-9).

148 Staff's OTM adjustment excludes the Company's proposed \$1,085,000 amortization of a \$6.5 million accrual for environmental remediation costs, including amounts associated with Whatcom Creek and Olympic's former SeaTac property. Olympic has provided no support for these estimated amounts. (Colbo, Ex. 2003-C at 14). Nor has Olympic calculated any offset for insurance reimbursements. (*See* Peck, Tr. 2888:18-21 and Colbo, Tr. 4792:3-23). Excluding remediation costs is appropriate on this record.

F. Regulatory Costs

149 Changes in federal and state safety regulations have been ongoing for the last several years. In its direct case, Olympic made little or no mention of the impact of such regulations on its results of operations. On rebuttal, Olympic made this issue a major theme of its case, offering detailed testimony about alleged impacts of new regulations. (*E.g.* Wicklund, Ex. 1501-T; Cummings, Ex. 1401-T at 8-15)(Talley, Ex. 1601-T at 22-24). In doing so, Olympic charged that Staff and Intervenors did not "address" these alleged increased costs. (Cummings, Ex. 1401-T at 15 :13-20). Olympic also warned that it would be inappropriate to deny recovery of increased

compliance costs “simply on the basis that they are higher than past spending levels.” (Smith, Ex. 1201-T at 21 :16-19).

150 There are two reasons why Olympic’s late emphasis on safety regulations is not helpful in establishing rates in this case. First, Olympic offered no adjustment quantifying any such alleged cost impacts. Moreover, Olympic agreed no party was recommending denial of compliance costs on the basis that they are higher than past spending levels:

Q: Are you aware of any adjustment that any party other than Olympic has proposed in this case that would deny Olympic recovery of cost of compliance on the basis that they are higher than past spending levels?

A: No, sir.

(Smith, Tr. 4243:3-7). If Olympic had actually sponsored an adjustment, the parties could address the issue in a cost of service context. Without an adjustment, we have only speculation.

151 Second, the record shows that Olympic was already in compliance with many new regulations well before they went into effect. When BP took an ownership interest in Olympic Pipe Line “it was already at that time implementing some of the provisions that would later become codified in the HCA [High Consequence Area] rules.” (Wicklund, Tr. 4024:12-17). The inspections Olympic has already conducted in its effort to restore the line to 100% pressure “can be considered within the HCA rule.” (Wicklund, Tr. 4025:3). The HCA rules require a baseline safety assessment of the pipeline and follow-up assessments at least every five years. (Wicklund, Ex. 1501-T at 6:12). But Olympic already follows this standard:

Q: So [Olympic] would have had a five-year interval prior to the HCA being implemented anyway?

A: Yes.

(Wicklund, Tr. 4027:22-24). In short, beginning in 2000, Olympic was already meeting standards that did not go into effect until 2002. (Wicklund, Tr. 4026:11-14).

152 Olympic has committed that since BP took over operations, the pipeline has been operated safely, exceeding industry standards. (Peck, Tr. 2793:1-15). The related costs are embedded in test year expense and investment levels. Until Olympic proposes an adjustment for additional compliance costs, if any, Olympic's presentation does not help to set cost-based rates.

G. Transitional Costs

153 Olympic sought to include \$455,000 amortization of transition costs incurred when BP took over as operator of Olympic's pipeline. (Colbo, Ex. 2001-T at 22:18). Olympic included these costs in its calculation of Outside Services expenses. (*Id.*). Transition costs are associated with "the change in operatorship of Olympic." (Hammer, Ex. 859 at Tr. 64:22-23). Accordingly, Staff excluded these transition costs that have no recurring effect on the petroleum transportation services provided to shippers. These costs are properly borne by shareholders. (Colbo, Ex. 2001-T at 20-22 and Tr. 4773:16-25). These costs are not acquisition costs per se, but they are analogous to acquisition costs, and should not be included in pro-forma results of operations for much the same reasons. (Colbo, Tr. 4779:11 to 4780:2).

H. Fuel & Power Costs

154 Staff's Fuel and Power expense calculation is provided in Exhibit 2010-R. It is the only calculation that is objective, verifiable, and based on the re-priceout of actual consumed KWHs by Olympic. Staff contacted all electric suppliers of Olympic, to reflect the most current rate levels, including Puget Sound Energy's recent rate increase in Docket UE-011570. This recent rate increase has a significant impact on Olympic. Puget supplies almost two-thirds of Olympic's power (Colbo Ex. 2003-C at 29), and is the only utility that has experienced a recent change in rates.

155 Olympic used a cost per barrel approach to calculating power costs. (*E.g.* Collins, Ex. 703-C, Schedule 22.6, line 30). A cost per barrel calculation is improper because Olympic’s power costs include demand charges, which do not vary based on barrels of throughput. (Colbo, Ex. 2001-T at 37:13-14). Apart from the impact of each party’s assumed throughput level, no party has challenged Staff’s calculation of gross pro-forma power expense developed in Ex. 2003-C at 29 or Ex. 2010-R.⁴⁷ Staff’s is the only adjustment that correctly separates the fixed demand and facility charges from the variable KWH usage component. It provides the only accurate method to pro-form power expenses. It should be accepted.

I. Federal Income Taxes (“FIT”)

156 There are three issues affecting the proper calculation of Federal Income Taxes: (1) pro-forma interest expense, (2) Schedule “M” adds and deductions, and (3) Tax depreciation. Staff’s FIT calculation is shown in Exhibit 1903, 1904 and 1905.

157 **Pro-forma interest expense.** Because interest is tax deductible, the level of pro-forma interest will affect FIT expense. The proper pro-forma interest amount turns on the weighted cost of debt (hence it depends on the capital structure proposed by each party), and whether CWIP and Bayview are included in the calculation.

158 Staff’s pro-forma interest calculation is in Exhibit 1911, and is summarized in Exhibit 1906 at 3, PF Adj. 12. The base for Staff’s calculation includes Staff’s proposed rate base plus Bayview. (Ex. 1911, ln. 1-2). This base represents Olympic’s investor supplied capital. Staff’s cost of

⁴⁷ Staff’s Pro-forma Power Adjustment is portrayed in a manner that can be used to adjust fuel and power costs to whatever throughput level the Commission decides is appropriate in this case (Colbo, Ex. 2001-T at 38:22-23), and regardless of the test year. Based on the Puget settlement rates that became effective on July 1, 2002, Ex. 2010-R updates those amounts to current rates as well as the impact of converting Bayview to Schedule 31. (Colbo, Tr. 4710:8-10). In addition, the pro-forma fuel and power cost amounts for Bayview (Colbo, Ex. 2010-R, line 8) and SeaTac (line 13), in the far right column, are the revised amounts that should be used in Colbo Pro-forma Adjustments 2 “Remove Bayview” and 11 “Remove SeaTac.”

debt (7%) and the debt ratio (80%) were supplied by Dr. Wilson. This provided pro-forma interest of the test period of \$4,594,423 (\$1,665,019 intrastate). (*Id.* col. B, ln. 7).

159 Olympic claimed it was improper for Staff to include Bayview because Bayview was excluded from Staff's proposed rate base. (Ganz, Ex. 1101-T at 30). However, because both CWIP and Bayview represent investment supported by debt and equity, they should be included. Otherwise, FIT will be overstated, and the revenue requirement will be higher than it should be. (Twitchell, Tr. 4613:11 to 4614:7).

160 In addition to using an improper weighted cost of debt derived from an excessive equity ratio, Olympic's adjustment improperly excludes CWIP for the reasons just stated. But Olympic's adjustment does prove the huge impact of its proposed 86.85% equity ratio. If Olympic's capital structure proposal is approved, Olympic will enjoy a tax deduction of \$8,642,656, but for ratemaking purposes, Olympic will reflect only a \$447,000 deduction. (Olympic's actual 2001 interest expense was \$8,642,656 (Twitchell, Ex. 1911, col. B, l. 8), while application of Olympic's proposed capital structure reduces this to \$477,000. (Collins, Ex. 703-C, Sch. 4, l. 5)). At a 35% tax rate, that is an unearned benefit to Olympic of \$2,857,979.⁴⁸ There is no reason for Olympic to get such a windfall.

161 **Schedule "M" adds and deductions.** Schedule "M" is a schedule that reconciles Olympic's books to its tax returns. Staff used Schedule "M" adds of \$6,820,303 and deducts of \$7,887,574, which were figures supplied by Olympic. (Twitchell, Ex. 1903, at 2:9 and 13 and Ex. 1901-T at 54:21 to 55:6). Olympic's rebuttal calculation of FIT used Schedule "M" adds of \$1,072,000 and deducts of \$53,000. (Collins, Ex. 703-C at Sch. 4, test year lines 2+3 (adds) and 4 (deducts)). Olympic provided no testimony to support these figures, and they cannot be reconciled with

⁴⁸ $\$8,642,656 \times .35 = \$3,024,929$. $\$447,000 \times .35 = \$166,950$. $\$3,024,929 - \$166,950 = \$2,857,979$.

what Olympic provided Staff in discovery. (Twitchell, Ex. 1901-T at 54). The Company's FIT calculation should be rejected.

162 **Tax depreciation** is accelerated depreciation used to calculate FIT. Staff's FIT calculation includes tax depreciation of \$7,063,201, based on figures supplied by Olympic. (Twitchell, Ex. 1903, p. 2, l. 11 and Ex. 1901-T at 55:7-11). Olympic's exhibits provide tax depreciation of \$4,663,000. (Collins, Ex. 703-C, Sch. 16, 2 :11). This figure was not used in the calculation of FIT. Olympic provided no testimony supporting this figure. It should be rejected.

J. Other

163 **Litigation expenses.** Olympic increased its tariff litigation expense from \$0.4 million (direct case) to \$2.6 million (rebuttal), with no showing that increase is appropriate. (Collins, Ex. 701-T at 8:9-13). To calculate the litigation costs, Olympic used a combination of actual and estimated data. (Collins, Ex. 728 at 17:24 and Ex. 725 at 19:20-21). Olympic also provided no detail of interstate (FERC) and intrastate (WUTC) costs. Accordingly, Olympic has failed to show that the \$2.6 million in litigation expense meets the fair, just and reasonable standard.

164 **Uncontested Operating Expense Adjustments.** The following Staff adjustments are uncontested. They should be accepted for the reasons stated by Staff: RA-1: Reclassifications and Removal of Issuance Expense (Colbo, Ex. 2001-T at 17:2-13); RA-2: Remove Non-Operating Rate Base (*Id.* at 18:2-8);⁴⁹ RA-3: Remove Casualty Loss (*Id.* at 18:11-16); RA-4: Reclassify Capitalized Construction Payroll (*Id.* at 18:18 to 19:9); RA-5: Correct December [2001] Depreciation and Rate Base (*Id.* at 19:11-20); RA-6: Remove Employee Relocation Expenses (*Id.* at 19:22 to 20:5); RA-9: Amortize Employee Long Term Disability Buy Outs (*Id.*

⁴⁹ There was some initial confusion regarding whether the same adjustment should have been made by Olympic. The starting point for Staff's proposed rate base was total plant (including non-operating plant) as contained within the Company's response to Staff Data Request No. 303. Olympic's proposed rate base shown in Ex. 703-C at 5 and

at 24:8-15); RA-10: Remove D. Cummings Whatcom Creek Payroll (*Id.* at 24:17 to 25:4); RA-11: Remove Advertising, Charity, and Lobbying (*Id.* at 25:6-18);⁵⁰ PF-3: Remove [FERC] Interim and SeaTac [Terminal] Rates (*Id.* at 31:21 to 32:2); PF-5: Oregon Income Tax (*Id.* at 40:21 to 41:2); PF-6: Management Fee (*Id.* at 41:4-14); PF-7: Normalize Oil Loss (*Id.* at 41:16 to 42:15);⁵¹ and PF-10: Insurance (*Id.* at 43:2-14).

165 **Contested Expense Adjustments Addressed Elsewhere in this Brief.** Staff Adjustment RA-8: AFUDC, is addressed in Section VII.G, *infra* at ¶¶ 187-192. The expense portion of Adjustment PF-2: Bayview, is addressed in Section VII.D, *infra* at ¶¶ 169-182. Staff Adjustment PF-11: SeaTac & Related removes operating expenses incurred at Olympic's SeaTac terminal that has now been sold. All parties agree the gain on sale should be passed on to ratepayers. The contested piece relates to Olympic's accrual of environmental remediation costs, which was addressed in Section VI.D/E, *supra* at ¶¶ 143-148.

VII. RATE BASE

166 **Summary.** Staff proposes a rate base of \$61,510,551. (Twitchell, Ex. 1904, Col. (h), l. 38)(*See also* Attachment Table 1). The principal differences between Staff and Tesoro is that Staff excludes Bayview Terminal, but includes plant balances, ADIT and CWIP at end of period levels, not average levels. Comparing Staff and Company rate bases, these same differences exist, plus Olympic includes deferred return and starting rate base, while Staff does not. Tosco made no recommendation on rate base.

A. Rate Base Methodology

6 began with Plant in Service, which already excluded non-operating plant. So Olympic did not need to make the adjustment, as explained by Mr. Colbo at Tr. 4734:8-19.

⁵⁰ On materiality grounds alone, Staff will accede to Olympic's claim that \$19,636 of this adjustment was for providing information to the public consistent with federal rules. (Cummings, Tr. 3937:13-23).

⁵¹ The Company accepted Staff's Oil Loss adjustment. (Hammer, Ex. 801-T at 6:5-12).

167 For the reasons stated in Section IV, *supra* at ¶¶ 44-126, the Commission should value rate base using the DOC method. To address issues of regulatory lag, Staff recommends plant balances be measured at an end of period level, with end of period CWIP. These issues, and the other rate base adjustments proposed by Staff, are discussed below.

B/C. Starting Rate Base (“SRB”)(Calculation) and Deferred Return (Calculation)

168 For the reasons stated in Section IV.B, *supra* at ¶¶ 83, 89-90, and 100-103, the Commission should not include in rate base SRB or Deferred Return.⁵² If the Commission concludes otherwise, it should prohibit Olympic from changing SRB for historical periods, and require a reasonable estimate of the return applicable for each prior year. (*Id.*) The proper deferred return amount should be zero. Olympic did not forego any return, because Olympic did not actually defer any return, it lacked the required approvals to defer, and it earned handsome returns without deferrals. (*See* Section IV.B.iii.1, *supra* at ¶¶ 97-98).

D. Bayview

169 **Nature of Bayview Terminal and Its Uses.** Bayview Terminal is an Olympic facility located five miles from Anacortes. It was built at a cost of \$23.2 million. (Colbo, Ex. 2003-C at 28). It has six storage tanks with a total capacity of 500,000 bbls of petroleum products. (Talley, Tr. 4164). Bayview began full operation in April 1999, two months before the Whatcom Creek explosion. (Talley, Ex. 1601-T at 10:8-10).

170 Bayview Terminal was built to permit different shipments of the same products to be “batched” (*i.e.* transported at the same time), substantially increasing efficiency. Olympic built Bayview to increase system capacity by 35,000 to 40,000 bbls/day, shorten delivery transportation time,

⁵² Mr. Twitchell’s Ex. 1902, a comparison of FERC methodology and the Commission’s traditional ratemaking methodology, was offered for illustrative purposes only.

“debottleneck” the system, and provide emergency sourcing of product. (Colbo, Ex. 2003-C at 24)(Talley, Ex. 1609 at Tr. 14:21 to 19:22).

171 Bayview has served none of these purposes since June 10, 1999, when the Whatcom Creek explosion occurred. Products are diverted around the facility. Bayview is used only for emergency pressure relief, office space, staging construction projects in the Northern area, for monitoring the line, and for storage related to hydro testing and PIG runs. (Talley, Ex. 1601-T at 3; Tr. 4070:1-8; and Ex. 1609 at Tr. 20:21 to 21:21).⁵³

172 Bayview’s current uses are minimal from a cost of service perspective. Storage of diesel for PIG runs is no longer necessary. (Talley, Tr. 4081:20-22). Olympic has no plans for more hydro testing. (Batch, Tr. 2960:17-18). Pressure relief facilities would cost roughly \$1 to \$2 million, and would use only 30,000 bbls, a mere 6% of Bayview’s 500,000 bbl tank capacity. (Talley, Tr. 4159:10-15 and Tr. 4164:16-19). Commercial storage facilities are available in the market for “staging” construction work. (Talley, Tr. 4077:3-10).

173 Bayview’s future status is uncertain. OPS requires Olympic to prepare a study to determine the future use of Bayview, and any necessary design changes. That study has not been done. A study may take 2-3 months to complete, with an additional 3 months to a year to implement, depending on the results. At best, Bayview may be operational in 2004. (Talley, Tr. 4159:2-3 and Ex. 1609 at Tr. 22-24).

174 Olympic tried to defend including Bayview investment in rate base by noting that it incurred around \$.5 million in operating costs in the test year. (Talley, Ex. 1601-T at 15:12-15). That proves Bayview’s use is minimal. Over half that \$.5 million was for power supply, of which less

⁵³ Olympic earlier said the current uses of Bayview were limited to storing water for hydro testing and diesel for PIG runs, and to store some petroleum products. (Talley Ex. 1629, Supp. Memo at 2). These limited uses were later confirmed in sworn deposition testimony. (Talley, Ex. 1609 at Tr. 21:22 to 22:5). When specifically asked if there

than \$7,000 was for kilowatt hours consumed. (Talley, Tr. 4082-83). \$.5 million is only around 11% of the approximately \$4.5 million Olympic assumed Bayview would normally require. (Fox Ex. 1705-C at 9 of 28, delta between the dashed line and the dotted line).⁵⁴

175 **Positions of the Parties.** Staff recommends Bayview be removed from results of operations and AFUDC be accrued until it is returned to service. (Colbo, Ex. 2203-C at 32-33). Olympic seeks full inclusion of Bayview investment and operating expenses because Bayview was “used and useful” for certain limited purposes. (*E.g.* Talley, Ex. 1601-T at 13). Tesoro supports either excluding Bayview from results of operations, or inclusion of Bayview in results of operations so long as the revenues from throughput associated with an operational Bayview facility is included. Tesoro chose the latter treatment, using the throughput figure Olympic used in its Bayview-related 1998 rate filing. (Brown, Ex. 3401-T at 34-35 and 57-60). Tosco includes Bayview with 37,500 bbls/day of additional throughput. (Means, Ex. 2201-T at 28-30).

176 **Argument.** A public service company is entitled to earn a return on the property it has dedicated to the public, and which is used and useful for service. *Bluefield, supra*, 262 U.S. at 692. *See also, UTC v. American Water Resources, Inc.*, Docket No. UW-980265 (5th Supp. Order) (1998) (*affirmed* by 6th Supp. Order)(1999). Imprudently incurred costs or costs that provide no ratepayer benefit are not recoverable. *US WEST Communications, Inc. v. UTC, supra*, 134 Wn.2d at 126-27.

177 Staff’s proposed treatment of Bayview satisfies these principles; Olympic’s proposed treatment does not. Olympic conceded it would “have a hard time justifying” Bayview based on its current limited uses. (Talley, Ex. 1609 at Tr. 26:7-13). Olympic has made no attempt to prove that its

were any other uses for Bayview, Olympic’s response was an unqualified “No.” (*Id.*) Olympic agreed with this deposition testimony at hearing. (Talley, Tr. 4071:10-21). On rebuttal, the list expanded.

⁵⁴ Note also that the \$.5 million in operating costs referred to by Mr. Talley in his rebuttal testimony does not include \$852,240 in depreciation expense, which is clearly excessive given the minimal current uses of Bayview.

\$23.2 million Bayview investment is the prudent amount to support current uses. Also, the results of the required design study for Bayview are uncertain.

178 There is no legal support for Olympic’s position that Bayview’s current uses make it fully includable in rate base. For example, in *San Diego Land & Town Co. v. Jasper*, 189 U.S. 439, 446, 23 S. Ct. 571, 47 L. Ed. 892 (1903), the company built a facility large enough to serve future customers, but sought to recover its full investment from current customers. The Court rejected the company’s approach:

If a plant is built, as probably this was, for a larger area than it finds itself able to supply, or apart from that, if it does not, as yet, have the customers contemplated, neither justice nor the Constitution requires that, say, two thirds of the contemplated number should pay a full return.

179 To avoid the smaller number of customers from paying a full return, one should “assume that only a proportionate part of the system was actually used and useful.” *Id.* at 447.

180 In *Midwestern Gas Trans. Co. v. FPC*, 292 F.2d 119, 121 (5th Cir. 1961), the company sought full recovery for plant in service that was underutilized under current conditions. The Fifth Circuit stated that the company was “not entitled to the return for the lesser volume of business during the development years that it will become entitled to receive during the post-development period from the larger volume.” The court stated that this rule is applicable when the plant facilities are operating at less than full capacity. *Id.* at 122.

181 Staff’s recommendation for Bayview is consistent with these decisions. Bayview is not fully serving shippers, by a wide margin. Olympic has not demonstrated the prudent level of Bayview investment related to current uses. Accordingly, Bayview should be removed from results of operations, but accrue AFUDC. When Bayview is returned to service, Olympic can seek recovery in rates, including the accrued AFUDC.

182 Tesoro's and Tosco's position is that if Bayview costs are in the results of operations, so should the throughput. That has some appeal. Olympic testified this approach was appropriate.⁵⁵ Nonetheless, because the required study of Bayview has yet to be completed, there is no certainty when Bayview will be in service, what services it will provide if it does return to service, and what level of throughput it will provide. These uncertainties dictate removal of Bayview from rate base, and Staff's proposal should be accepted.

E. Average vs. End of Period

183 The other parties have calculated rate base using a beginning and end of period average. Staff agrees an average approach most properly matches revenues, expenses, taxes, and rate base. But if an average is computed, the method should be an average of monthly averages, not a simple average. (Twitchell, Ex. 1901-T at 13:17 to 14:7). However, in this case, Staff recommends an end of period rate base be used. Staff's adjustment increases plant by \$8,197,866, Accumulated Depreciation by \$1,438,523 and Depreciation Expense by \$185,617. (*Id.* at 44:1-6).

184 The Commission has used end of period rate base when addressing concerns about regulatory lag. (*E.g.*, *UTC v. Washington Natural Gas Co.*, Cause No. U-80-111 (3rd Supp. Order)(1981) at 6; *UTC v. Washington Water Power Co.*, Cause No. U-77-53 (3rd Supp. Order)(1978) at 9; and *UTC v. Washington Water Power Co.*, Cause No. U-79-10 (3rd Supp. Order)(1978) at 6. Olympic plans to add over \$20 million in plant annually over the next three years (Talley, Ex. 1603 at 3), so regulatory lag is a legitimate concern. To reduce regulatory lag, Staff recommends rate base, including CWIP, be calculated at an end of period level. (Twitchell, Ex. 1901-T at 44-

⁵⁵ Q: ... Do you and I agree that the cost and throughput [of Bayview] should either be out or in [results of operations]?

A: I like to see both. I agree.

Q: You agree with that statement?

A: Yes.

(Talley, Tr. 4165:13-17).

46 and Tr. 4669:20 to 4671:4). Including these end of period amounts in the rate base allows Olympic a return of and on this plant now.

F. CWIP

185 For the same reasons Staff is recommending end of period rate base, Staff recommends adding CWIP to the rate base, and at an end of period level. (Twitchell, Ex. 1901-T at 52-53). The Commission recognizes CWIP is a regulatory tool to use in cases such as this. *E.g.*, *UTC v. Washington Water Power Co.*, Cause No. U-80-13 and 14 (3rd Supp. Order)(1981) at 6.⁵⁶ Staff's adjustment increases plant by \$23,550,326, Accumulated Depreciation by \$533,229 and Depreciation Expense by \$533,229. (*Id.* at 52:19-20).

186 Olympic falsely charged that Staff's analysis constituted "mechanical application" of the traditional WUTC methodology that "penalize[s] Olympic on virtually every issue ..." (Fox, Ex. 1701-T at 16:9-10). End of period rate base and CWIP add well over \$30 million to rate base.

G. AFUDC

187 Olympic does not accrue AFUDC, nor does it maintain any contemporaneous records of AFUDC amounts for past periods. (Collins, Ex. 709 at Tr. 68:14-19). The result is that AFUDC must be calculated for prior periods, well after the fact.

188 Olympic should have accrued AFUDC because ¶ 15 of FASB 71 requires it, and Olympic satisfies all three criteria for application of FASB 71. (Kermode, Ex. 1801-T at 4:20-29, at 14:7-18, and Ex. 1807 at 12). If necessary, Olympic should estimate its cost of capital applicable to

⁵⁶ In *POWER v. UTC*, 101 Wn.2d 425, 430, 679 P.2d 922 (1984), the court reversed the Commission's inclusion of CWIP in rate base under a former version of RCW 80.04.250, interpreting "used and useful for service" language in that section to mean capable of actually providing service. No such language is contained in Title 81. The Commission has discretion to include CWIP in rate base in this case.

prior periods. (Kermode, Tr. 4535:4-15).⁵⁷ Absent such data, the return recommended by Dr. Wilson should be used. (Twitchell, Ex. 1901-T at 42-43).

189 The debate at hearing centered on whether FERC index-based rates met the third criterion of FASB 71: that the rates are set to “recover the specific enterprise’s costs...” In Order 561, *Revisions to Oil Pipeline Regulations Pursuant to EPA Act of 1992*, FERC Statutes and Regs ¶ 30,985 (1993) at ¶¶ 30,949 and 30,948 (“Order 561”), FERC stated that “the indexing methodology selected by the Commission ... is cost-based...” and “[u]nder indexing, pipelines adjust rates to just and reasonable levels for inflation-driven cost changes...”⁵⁸

190 Even if the Commission concludes FASB 71 does not apply, Olympic should still be ordered to accrue AFUDC. Olympic initially took the position at hearing that since AFUDC is not specifically described in the USoA, it would be “improper” for Olympic to accrue AFUDC. (Ganz, Ex. 1101-T at 15:2-4). Later, Olympic conceded USoA does not prohibit it from accruing AFUDC. (Ganz, Tr. 3555:20-22). FERC agrees with Olympic’s concession. In *Kuparuk Transportation Co.*, 55 FERC ¶ 61,122 (1991) at ¶ 61,372, FERC stated:

In Opinion No. 351 ... the Commission’s intent was to put oil pipelines on the same basis as gas pipelines and electric utilities where AFUDC is recognized as a component of the construction cost. AFUDC is permitted for the period of construction. It *may be capitalized* from the date that construction costs are continually incurred on a planned progressive basis.... *The Commission therefore will permit AFUDC to be accrued commencing with the date construction costs are continuously incurred.*

(emphasis added). This obviously refers to the pipeline’s books, not just ratemaking.⁵⁹

⁵⁷ Part of Olympic’s justification for not accruing AFUDC was that it had no authorized return. (Ganz, Tr. 3636:20-21). Part of Olympic’s justification for interim rate relief is that it was under earning its “allowed return” of 10.4%. (See Olympic’s January 11, 2002 Prehearing Brief regarding interim rate relief at page 15). Olympic should not be allowed to have it both ways.

⁵⁸ Order 561 contains a footnote that indicates that indexing “sever[s] the linkage under traditional cost of service ratemaking between a pipeline’s rate changes and changes in its current operating and investment costs.” Order 561, *supra*, at ¶ 30,948-49, n. 31. However, that does not mean index rates are not set to “recover the enterprise’s costs,” which is the FASB 71 criteria at issue. Indexing is simply another method to permit recovery of those costs.

⁵⁹ Therefore, Olympic was wrong to state that Order 351 “...was addressing a rate making presentation, it was not addressing an accounting requirement.” (Ganz, Tr. 3637:9-17).

191 If the Commission concludes accrual of AFUDC is not mandatory, Olympic should be ordered to maintain a contemporaneous record of AFUDC as a side record that is available for review and audit by Staff and interested parties. That way, AFUDC may be considered for ratemaking purposes as any other asset included in rate base. Indeed, Olympic would be on the same footing as any other public service company requesting inclusion of AFUDC in its rate base regulated by this Commission.⁶⁰

192 Tesoro contends that AFUDC should be amortized using the remaining life methodology because Olympic changed its methodology from remaining life to useful life in its 1996 rate filing. (Grasso, Ex. 2401-T at 14-15). Staff agrees with Olympic that “[t]he amortization of AFUDC ... should rely on useful life to be consistent with depreciation of carrier property because AFUDC is considered a cost of construction...” (Collins, Ex. 701-T at 12:4-6).

H. Other (N/A)

VIII. CAPITAL STRUCTURE

- A. Actual Capital Structure (N/A)
- B. Hypothetical Capital Structure (N/A)
 - i. Historical Capital Structure (N/A)
 - ii. Use of Parents’ Capital Structure (excluding FERC rationale) (N/A)
 - iii. Other

193 The determination of a reasonable capital structure for rate purposes is critical, and perhaps the single most important issue in this case.

194 Different sources of capital, whether debt or equity, have associated risks and returns. In a competitive market, the capital structure of a firm is market determined. A firm minimizes its cost of capital through obtaining an optimum level of debt (financial risk) given the business risk of the enterprise. A regulated enterprise operating in a monopoly environment usually does not

⁶⁰ An example of the Commission ordering an AFUDC side record is the Order Granting Application in *Re GTE Northwest, Inc.*, Docket No. UT-951072 (1988).

have these market forces to balance its use of debt and equity. The Commission has recognized this feature of public service companies, and it has consistently held that appropriate capital structures are necessary to balance the competing interests of economy and safety. *E.g.*, *UTC v. Avista Corp.*, Docket No. UE-991606/UG-991607 (3rd Supp. Order) (2000) at 99, ¶ 374.⁶¹

195 When a regulated firm capitalizes itself in an inappropriate manner, the burden of the inefficiency falls on the customer, and the Commission has a responsibility to protect consumer interests in determining the allowed rate of return for a regulated enterprise.

196 A hypothetical capital structure for ratemaking purposes is an adjustment like any other; it is used to calculate a fair rate of return in order to ensure that consumers are not burdened with excessive costs. This does not dictate to management a particular capital structure that must be achieved. As with other ratemaking adjustments, management can still incur the actual costs associated with the capital structure it chooses, but regulators have no obligation to permit them to earn a fair rate of return on that capital structure. Determining an appropriate capital structure ensures that equity costs above a reasonable level will not be used to set rates.

197 In this case, Olympic recommends establishing a rate of return based on a hypothetical capital structure comprised of the weighted average amount of Olympic's parents' consolidated equity ratio. The result would provide an equity return as if 86.85% of Olympic's assets were financed with equity. (Schink, Ex. 201-T at 6:10). Olympic implicitly acknowledges this unreasonable result. On rebuttal, Dr. Schink suggested a minimum 60% equity ratio, which is the upper-end of the range of equity ratios for the FERC Proxy Group, or an equity ratio of 73%, calculated by averaging Olympic's parents' equity ratios of approximately 86% and the 60%. (Ex. 201-T at 7:10-17). These suggestions are mostly veiled attempts to provide excessive returns to Olympic

⁶¹ Typically, the Commission is faced with capital structure decisions where the public service company has too much equity, and the adjustment is to remove equity for ratemaking purposes. In this instance, Olympic has no

by providing equity returns and associated higher income tax expense, where no such costs in fact exist. (*See* Section VI.I, *supra* at ¶ 160).

198 The 86.85% equity ratio Olympic recommends is largely arbitrary, since it reflects the average capital structure of Olympic's oil industry owners. For example, before ARCO was acquired by BP, the parents' consolidated average equity ratio was less than 60% (and even lower with other owners a few years ago). Because BP's consolidated equity ratio is exceptionally high, ostensibly to match the business risk of the parent, the acquisition of ARCO by BP caused the average parent equity ratio to jump by 25 percentage points. This had nothing to do with changes in Olympic's operations or risks. (Wilson, Ex. 301-T at 47).

199 Moreover, the book value capital structure of Olympic's parents has far more to do with accounting practices than with market forces. (Wilson, Tr. 2536-37).

200 In contrast to Olympic's capital structure proposal, Dr. Wilson recommended that the Commission find a reasonable capital structure for ratemaking purposes contain no more than 50% equity. Olympic's actions to date drive the appropriate level of equity. As Exhibit 2102-R shows, for years, Olympic's parents have withdrawn all, or nearly all, of the Company's earnings on an annual basis and retained little or no equity cushion for financial contingencies. (*See also* the discussion in Section I, *supra* at ¶¶ 6-14, regarding Olympic's actions and policies that led to the current situation). If Olympic and its owners choose to maintain the highly leveraged debt capitalization that exists presently, a 20% equity ratio is all that is appropriate. On the other hand, if a new major infusion of equity capital is forthcoming to finance the capital projects planned during the next three years, a higher equity ratio (up to 50 %) would be appropriate. Future equity infusions may justify new rates to support up to a 50% equity ratio. (Wilson, Ex. 301-T at 49).

equity, and seeks to establish rates on the basis of equity that does not exist.

201 Tesoro also recognizes the impact of these financial policies on the company and its customers. Tesoro's recommendation is simple: use Olympic's actual capital structure and provide no compensation for equity until such time as Olympic's owners make an equity investment. Because Olympic is financed exclusively with debt, rates should be made on the basis of 100% debt ratio. (Hanley, Ex. 401-T at 5:3-5). Staff's approach is slightly different, and provides an incentive to Olympic's owners to retain earnings and grow equity over time.

202 In summary, the Commission's determination of an appropriate capital structure for ratemaking purposes will have the greatest impact of any adjustment in this case. The Company's proposal does not meet any test of reasonableness. Rather, it seeks rates that provide an equity return where the owners have made no such investment.

203 Without any commitment on behalf of Olympic's owners to provide new equity, Staff's recommendation for a ratemaking equity ratio containing 20% equity will provide the proper incentive to management to make the equity investment necessary to restore the financial integrity of the pipeline. If management fails to make any new equity investment, Staff's recommendation for an appropriate equity ratio will provide Olympic with retained earnings, enabling it to replenish its equity over time.

IX. RATE OF RETURN

A. Cost of Debt

204 In this case, the cost of debt is a relatively minor consideration, given the overall impact of other issues surrounding rate of return. Staff recommends a cost of debt for Olympic of 7.0%, based upon Dr. Wilson's evaluation of the current cost of long-term debt for high quality corporate bonds. It is slightly less than the cost of debt for Olympic's owners as integrated petroleum

companies. (Ex. 301-T at 50:16-21).⁶² Tesoro recommends a debt cost of 7.54%, based upon the embedded cost rates for the Proxy Group Tesoro used to estimate return on equity. (Hanley, Ex. 401-T at 23:21). Olympic recommends a debt cost of 5.26%, based upon the actual weighted cost of debt for Olympic. (Schink, Ex. 201-T at 90:11).

B. Return on Equity (“ROE”)

i. General Principles

205 A fair rate of return provides a return to equity investors commensurate with investments of similar risk. That is the principle of the seminal cases of *Hope* and *Bluefield*, *supra*. The application of this principle is open to significant controversy. Dr. Wilson has presented a comprehensive study to account for the unique characteristics of Olympic, rather than blindly following FERC’s mechanistic formula.

ii. Analysis, Including Review of Testimony if Desired

206 **Dr. Wilson for Staff.** The Commission has a long-standing policy of using DCF to estimate ROE. In this case, Dr. Wilson used a series of studies to determine ROE, using DCF and other methods. That is justified because the number of publicly traded oil pipeline companies is extremely limited: only five such companies exist, and constitute FERC’s Proxy Group. Relying solely upon a DCF result for such a narrow group yields unreliable results. As Dr. Wilson testified:

[A] proper determination on the rate of return in this or any [other] proceeding, must necessarily involve the exercise of good judgment, common sense, and discretion on the part of the Commission. There is no magic bullet in terms of formula or methodology...’

⁶² The Company may argue that the Commission should use a proxy cost of debt similar to “junk” bonds. This argument is misplaced. As we described in Section I, *supra* at ¶¶ 1-14, Olympic is responsible for its current financial situation and its inability to obtain new funds from external sources. Ratepayers should not be responsible for Olympic’s parent companies’ failure to provide the necessary equity to restore the pipeline’s integrity and ability to reach full capacity. Nor should ratepayers be responsible for management’s failure to develop a credible long-term financial plan showing the Commission how this management will restore the long-term financial integrity of the pipeline. (Elgin, Ex 2101-T at 6:9-15, at 9:10-12, and at 11:7-14).

(Wilson, Tr. 2569:20-25). Furthermore, Dr. Wilson noted that the limited partnerships in FERC's Proxy Group are not an exceptionally good fit to an individual oil pipeline. This is because they pay dividends representing a return of capital. (Wilson, Tr. 2568-69). In addition, a group of only 5 companies provides too limited a data set to be reliable. (Wilson, Tr. 2569:9-13).

207 Accordingly, the Commission should apply good judgment, rather than a fixed formula. It should consider the evidence from other samples of companies and other models in estimating a fair return on equity for Olympic.

208 Dr. Wilson's traditional DCF analysis focused on publicly held enterprises in three comparable industries: (1) the same Proxy Group of five oil pipeline limited partnerships used by Dr. Schink and Mr. Hanley,⁶³ (2) a group of seven natural gas pipelines, and (3) fifteen integrated petroleum companies, including the owners of Olympic. These enterprises represent all major U.S. companies in each respective industry for which data is regularly published in the *Value Line Investment Survey*, and whose stock is traded on the New York Stock Exchange.

209 For each firm, Dr. Wilson examined historic and projected growth rates over various periods. Dr. Wilson weighted historic and projected growth equally for all three comparable industry groups, and found an overall average DCF ROE estimate of 9.4%. (Wilson, Ex. 304).

210 Although 9.4% represents a reasonable estimate of the ROE for Olympic, Dr. Wilson concluded that the wide range of cost estimates his traditional DCF analysis produced (5.4% to 17.2%) required further information in estimating ROE. (Wilson, Ex. 301-T at 31:19-23). Therefore, he produced a "fundamental" DCF estimate using retained earnings as the measure of expected growth. The results of Dr. Wilson's fundamental DCF analysis were presented in Exhibit 305: The average ROE for the three industry groups in this study is 11.8%.

⁶³ Dr. Means also uses this group but only provides adjustments to Dr. Schink's data. (E.g. Ex. 2201 at 2:12-14).

211 Dr. Wilson's DCF studies produced a wide range of results, and in some instances there were limited data points, *e.g.* only five oil pipeline limited partnerships. Dr. Wilson determined that it was reasonable to use the capital asset pricing model (CAPM) as another tool to estimate the fair rate of return for Olympic. CAPM estimates the cost of equity for each company's stock by combining the "riskless rate" plus an increment equal to the amount of non-diversifiable risk with that investment. Based on his CAPM analysis, Dr. Wilson concluded that his CAPM analysis could support an equity return range of 6.0 to 10.0 %. (Wilson, Ex. 301-T at 37).

212 Finally, Dr. Wilson provided an analysis based upon comparable earnings. Comparable rates of return from alternative investment opportunities estimate the return level that investors can expect to obtain in competitive capital markets at any time. The range of comparable earnings estimates for ROE's for the three comparable industry groups is between 6.04% and 9.53%. (Wilson, Ex. 307). Dr. Wilson observed that Olympic is less risky than the comparable companies in the five limited partnerships in FERC's Proxy Group. In particular, the Proxy Group does not have the protective advantages of vertical integration. The vertically integrated nature of Olympic, with its parents' refinery and marketing operations, shows Olympic is less risky than an independent products pipeline. (Wilson, Tr. 2503:8-19).

213 Based on Dr. Wilson's analyses, a reasonable range of ROE's for Olympic is 8.0 to 10.0%. Dr. Wilson recommends that a fair rate of return on equity for Olympic is the mid-point of that range: 9.0%.

214 **Dr. Schink for Olympic.** Olympic's ROE estimate is 15.65%, which includes a 0.75% risk premium "adder." Dr. Schink performed his ROE analysis "according to the FERC's specifications." (Ex. 201-T, at 40:14-15).⁶⁴ As we explained earlier in this section and in Section

⁶⁴ Dr. Schink actually offered two changes to the FERC method. He calculated current dividend yield differently and he used the mean rather than the median ROE of the Proxy Group. (Tr. 2267:2-22).

IV.B.iii.5, *supra* at ¶¶ 108-113, the FERC methodology for cost of equity is a mechanical formula that uses unrealistic and unreliable assumptions. The Commission should not adopt it.

215 If the Commission adopts the FERC method, it should reject any equity return “adder” for added risk. Olympic faces neither competitive risk (*see* Section IV.B.i, *supra* at ¶¶ 59-66), nor unique business risk. (Wilson, Ex. 301-T at 52:22-23)(Hanley, Tr. 2605:18 to 2607:7).

216 **Mr. Hanley for Tesoro.** Tesoro also provides an estimate of Olympic’s ROE using multiple studies. Mr. Hanley argues that the efficient market hypothesis and common sense mandate the use of multiple models. He recommends an ROE of 13.00%, giving equal weight to the result of all four studies he presents. (Ex. 401-T at 54). Notwithstanding this estimate, Tesoro agreed that Staff’s overall capital structure and cost of capital presentation was a reasonable solution given the facts of this case. (Hanley, Tr. 2634:7-14; 2636:14-22, and 5260:20 to 5261:23).

217 Tesoro’s cost of equity estimate (13%) is unreliable because, like Olympic, Tesoro principally analyzed the firms in the FERC Proxy Group, and used analysts’ forecasts and GDP growth. (*See e.g.* Hanley, Ex. 405-414). Using this data yields unreliable results for the same reasons stated earlier. Moreover, Mr. Hanley’s risk premium analysis used long term debt costs rather than the short-term risk-free rate. (Ex. 401-T at 47). The result is an ROE estimate skewed to the top end of the broader range of results presented by Dr. Wilson. While a higher equity return might be appropriate for a highly leveraged company, it is not justified here, because it would unduly reward Olympic for the payout and other financial policies Olympic pursued.

218 **Dr. Means for Tosco.** Tosco essentially adopts the work of Dr. Schink, with two modifications: 1) Tosco uses the median return of FERC’s Proxy Group; and 2) Tosco proposes no equity risk “adder.” As a result of these two adjustments to Dr. Schink’s FERC study, Tosco recommends a ROE of 11.28%. (Means, Ex. 2201-T at 9:5).

219 Because Dr. Means does not challenge the FERC methodology, his study presents the same methodological flaws as Dr. Schink's study. It should be rejected for the same reasons. But if the FERC method of computing ROE is to be used, Tosco's calculation more accurately reflects that method than Olympic's.

iii. Summary and Conclusions

220 Given Staff's generous recommendations for end of period rate base and CWIP, an equity return of 9% is eminently fair. Staff witness Dr. Wilson performed the most extensive analysis of cost of capital models and based his recommendation on the breadth of results those analysis produced. By contrast, the FERC methodology is a mechanical formula featuring unreliable inputs. It should not be accepted.

C. Overall Cost of Capital

221 The Commission should find the fair rate of return is 7.4%, based on Dr. Wilson analysis. He recommends a cost of equity of 9.0%, a cost of debt of 7.0%, and an appropriate capital structure of 20% equity and 80% debt. (Wilson, Ex. 301-T at 5:8-17).

X. REVENUES

A. Test Year Revenues

222 Olympic records revenues on an accrual basis. (Hammer, Ex. 802 at Tr. 104:17-22). Accordingly, the only (and uncontested) revenue adjustments Staff needed to make were to remove the impacts of the FERC 62% interim increase (effective September 1, 2001) and the \$0.20 per barrel SeaTac Terminal Charge (no longer effective).⁶⁵ The resulting permanent level of revenues of \$38,069,493 is the proper level upon which the Commission should judge the merits of the instant filing.

B. Throughput

i. Role of Throughput in Determining Revenues.

223 Like any capital-intensive public service company, most of Olympic's costs are fixed (*i.e.* do not vary with throughput). Accordingly, throughput is critical to Olympic's ability to cover its fixed costs.

ii. Calculation of Appropriate Throughput for Ratemaking Purposes

224 There are two basic issues to be resolved: 1) Should throughput be calculated based on an 80% pressure condition or a 100% pressure condition?; and 2) Whichever pressure condition is selected, how should the throughput figure be measured? Staff and Olympic use throughput at 80% pressure: Staff - 108,323,720 bbls/yr; Olympic - 103,165,081 bbls/yr; Tesoro and Tosco use throughput at 100% pressure: Tesoro: 121,349,000 bbls/yr., Tosco - 130,000,000 bbls/yr.

225 All throughput estimates in this case suffer from the same fault: none are based on a detailed evaluation of downtime or the impact of new batching procedures and other systems designed to enhance throughput. These are relevant factors. For example, if a pipeline was down for three months during a base period, and that downtime was atypical, the actual throughput for that base period would not be used to set rates. (*See* Talley, Tr. 4067:5-11).

226 Staff proposes that throughput be calculated based on 80% pressure; the current operating condition. (Colbo, Ex. 2001-T at 27:18-20). It is likely to be the operating condition until late 2003 at the earliest. (Talley, Ex. 1619-T at 9:8-10).⁶⁵ Because 80% pressure is the prospective operating condition of the line, it is appropriate.

⁶⁵ These two uncontested adjustments are in Colbo Pro-forma Adjustment No. 3 in Exhibit 2003-C at 21 and 27. No adjustment is necessary to the test year for the 24.3% increase the Commission granted on an interim basis. That increase did not become effective until February 2, 2002, after the end of the Staff's calendar year 2001 test year.

⁶⁶ If Olympic achieves 100% pressure before that time, it could over earn substantially. Any approved tariff changes should bear an expiration date of December 31, 2003, to address that issue. (Colbo, Ex. 2001-T at 15-17).

227 If the 80% pressure condition is used for throughput, Staff's calculation of 108,323,721 bbls/yr. should be used. In its calculation, Staff compared the only available months of demonstrably comparable throughput data. Staff measured the relationship between throughput for July 2001 and August 1998. These months shared the same characteristic of high throughput, but August 1998 was at 100% pressure and July 2001 was at 80% pressure. This permitted a direct, objective comparison between the two operating conditions. The resulting 93.17% ratio was multiplied by 1998 total throughput to arrive at a reasonable estimate of what throughput would be at 80%, pressure.⁶⁷ The result was 108,323,721 bbls/yr. (Colbo, Ex. 2001-T at 30-32; Ex. 2003-C at 21).

228 Olympic's calculation uses 10 months of actual throughput and 2 months of estimates. (Hammer, Tr. 3413:9-12; Ex. 801-T at 8:1-4; and Ex. 859 at 34:23 to 35:19). According to Olympic, its throughput figure is "known and measurable." (Hammer, Ex. 801-T at 4:16 to 5:8). That is wrong because Olympic's figure includes estimated numbers. Moreover, without an objective analysis of downtime, simply using actual throughput data fails to prove a defensible level of throughput. Olympic has not shown that using 10 months of actual data and two months of estimated data results produces a representative throughput level. Gas and electric rates are not based on actual weather. Analysis is required. The same is true of throughput for oil pipeline companies.

229 Tesoro and Tosco argue for throughput based on 100% pressure. Tesoro argues that the 80% throughput condition is a result of imprudent operation, and Olympic has not been prudent in restoring the line to 100% pressure by now. (Brown, Ex. 2301-T at 51-56). These claims are troublesome, but also difficult to sustain. The 80% pressure restriction was first imposed on

⁶⁷ 1998 was the last year of "normal operations" for Olympic. Therefore, the level of downtime that occurred in 1998 is representative of the normal level.

certain line segments as a result of the Whatcom Creek explosion. (Batch, Ex. 615, 6/99 Corrective Action Order at 4, Item 7). Standing alone, that could justify a finding of imprudence.⁶⁸ But the 80% restriction was imposed for the entire system in September 1999 due to the ERW pipe seam failure during a hydro test. (Batch, Ex. 617, 9/99 OPS Corrective Action Order, 2d Amendment, at 4). Staff believes it is difficult to fault Olympic on the ERW issue, because the Alert Notice (Batch, Ex. 667) is not particularly prescriptive, and Olympic had hydro tested the line when it went into service. (Batch, Tr. 3018:7-8). Accordingly, at this point, Staff is comfortable recommending throughput based on 80% pressure.

230 Tesoro uses the same throughput level Olympic estimated it would have once Bayview was in service. (Brown, Ex. 2301-T at 59). Tosco's figure adds 37,500 bbls/day of throughput for Bayview (Means, Ex. 2201-T at 29:8), which appears to be an unconfirmed capacity figure, not a throughput figure. (Colbo, Ex. 2003-C at 24)(Talley, Tr. 4068:13-18). If the Commission accepts the 100% throughput condition for setting rates, Tesoro's figure is more reliable.

iii. Adjustment Mechanism Based on Throughput

231 Staff supports a throughput tracker in concept (Colbo, Ex. 2001-T at 30:1-7), but the record does not contain an appropriate tracker proposal for consideration. Tosco's tracker and surcharge proposals impose adverse economic consequences if the line is not up to 100% pressure by a date certain. (Means, Ex. 2201-T at 31-34). Because Olympic does not control the permitting and pressure authorization process, such a penalty is not warranted.

XI. CALCULATION OF REVENUE DEFICIENCY OR SURPLUS

⁶⁸ There is evidence that a) in 1994, Olympic knew excavation was occurring at the site of the later explosion; b) in 1996, Olympic learned of an anomaly at the location of the explosion; c) Olympic did not shut down the line upon notification of a significant pressure loss; and d) Olympic was aware of pressure relief valve problems. The evidence suggests in none of these cases did Olympic timely address the problem. (Batch, Ex. 654, 6/00 OPS Notice at 2-4 and 8-10).

232 Attachment Table 1 presents Staff's comparison of the cases presented by Olympic, Staff,
Tesoro and Tosco. Attachment Table 2 shows Olympic has an intrastate revenue deficiency of
\$161,662. Olympic requires no more than a 1.12% increase.

XII. REFUNDS, IF THE REVENUE DEFICIENCY FAILS TO REQUIRE A RATE INCREASE OF AT LEAST THE LEVEL OF INTERIM RATES

A.-D. Should Refunds be Required? If So, By What Method, Over What Period, and Under What Conditions?

233 Refunds should be required. Little has changed since the interim phase of this case. The
Commission conditioned interim charges on refunds calculated based on the permanent rates
found in this case. (3rd Supp. Order at 19-20, ¶ 86).

234 Refunds should be customer-specific, based on a comparison of interim rates to permanent rates.
Credits to each customer's bill should be made over the same time period the rates were
collected. Interest should be computed monthly. The interest rate should be the overall return
found by the Commission. If any customer does not achieve a full refund over that time period,
a flat payment should be made at the end of the period.

XIII. OTHER – CONCLUSION

235 Staff's case is based on sound financial and regulatory principles that results in rates that are
cost-based and provides investors a fair return on property prudently devoted to public service.
The methodology Olympic advances produces excessive rates that are not cost-based and
rewards Olympic for its financial policies by shifting the risk of those policies onto the

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ratepayers. The Commission should grant Olympic a rate increase of no more than 1.12%,
subject to an expiration date of December 31, 2003.

DATED this 21st day of August 2002.

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