I. Introduction

1. The Commission has already determined many of the key facts in its Interim Order: "First, it is clear that the Company is in dire financial straits, in large part due to the need for safety improvements."[1] "It has seen its throughput plummet because of mandated closure."[2] Its only means to acquire financing for its operations and needed capital projects are loans or capital investments from its owners or revenues from transportation rates."[3]

2. "Second, it is equally clear that safety must continue to be a top priority for this Company. Its is essential that the Company have the means to buttress its ability to operate safely, to support public confidence that it will operate safely, and to avoid the occurrence of a major event that could precipitate complete financial meltdown and deprive the shippers and the region of an efficient and cost-effective means of transportation."[4]

3. The key public interest factor the Commission should focus on in deciding this case is the safe and reliable operation of the pipeline at 100% operating pressure. The Commission's new dual public interest role in ensuring pipeline safety is centrally at issue.

4. Compared to the oil pipeline proxy companies, OPL is far smaller financially, has far fewer miles of pipeline, is less diverse, is in a seismically active area and is subject to a high level of regulatory scrutiny. The Commission has the discretion to adopt a capital structure and set an ROE that recognizes OPL's unique risks.

5. Use of the FERC approach comports with the WUTC's own general end result standard and best meets the financial and safety needs presented in this proceeding. It will also allow continued consistency with rates for interstate shippers. But the primary benefit is that it is a fair, just, reasonable

---

[1] WUTC v. Olympic Pipe Line Co., Docket No. TO-011472, Third Supplemental Order at 3, ¶8 ("Third Supplemental Order").

[2] Id.

[3] Id.

[4] Id. at ¶9.

and sufficient method at a time when OPL most needs the Commission to exercise its discretion in a manner that best buttresses OPL's ability to continue to invest in safety and reliability.

6. OPL's owners have been supportive. But for their loans of $94 million, OPL would be bankrupt now. OPL's new operator, BP Pipelines, has done its best "to support public confidence that the pipeline will operate safely."

7. This is a case about risk and safety. The Commission has the discretion to make the choices suggested by OPL in this brief that will attract the risk capital it needs to "operate safely, to support public confidence that it will operate safely and to avoid the occurrence to a major event that could precipitate complete financial meltdown and deprive the shippers and the region of an efficient and cost-effective means of transportation."[5]

II. Legal Standards and Governing Principles

A. Burden of Proof

8. A public service company proposing a rate increase bears the burden of proving, by a preponderance of evidence, that the requested rates are fair, just, reasonable, and sufficient.[6] A "preponderance of the evidence" is the amount of evidence needed to persuade the trier of fact that the existence of the contested fact is more probable than its non-existence.[7]

B. Fair, Just, Reasonable, and Sufficient Rates

i. General Considerations

9. Oil pipelines, such as OPL, are regulated as common carriers under Chapter 28 of Title 81, RCW.[8] Although a common carrier's rates must be just, fair, reasonable and sufficient, it is entitled to reasonable compensation for the service it provides.[9] A public service company is "entitled to the opportunity to earn a rate of return sufficient to maintain its financial integrity, attract capital on

---

[5] Id. at 3, ¶8.
[6] RCW § 81.04.130; WUTC v. Twin City Sanitary Serv., 1988 Wash. UTC LEXIS 118, at *12-13 (Sept. 7, 1988).
[7] See, e.g., Blue Chelan, Inc. v. Dep't. of Labor & Indus., 101 Wash. 2d 512 (1984).
[8] See RCW § 81.88.030.
[9] Puget Sound Traction Light & Power Co. v. Pub. Serv. Comm'n, 100 Wash. 329, 334 (1918).

reasonable terms, and receive a return comparable to other enterprises of corresponding risk."[10]

ii. End Result Test

10. "[T]he 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."[11] This authority parallels the U.S. Supreme Court's ruling in Federal Power Commmission v. Natural Gas Pipeline Co., subsequently reaffirmed in Federal Power Commmission v. Hope Natural Gas Co.:[12]

> [t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.

11. Unlike Staff's and Tesoro's proposed application of the depreciated original cost ("DOC") methodology, OPL's proposed methodology and risk-adjusted rate of return fully satisfy the end result test as they will enable OPL to attract capital necessary to achieve 100% operating pressure and make additional safety improvements and thereby also further the public's interest. Selection of the appropriate methodology is discussed in depth in Section IV.

iii. Public Interest Standard

12. Although "public interest" is not defined,[13] the legislature has in RCW 81.04.250 set

---

[10] WUTC v. Avista Corp., 2000 Wash. UTC LEXIS 558, at *152-53 (Sept. 29, 2000) (citing Duquesne Light Co. v. Barasch, 488 U.S. 299, 310, 312 (1989)). The Commission "must in each rate case endeavor to not only assure fair prices and service to customers, but also to assure that regulated utilities earn enough to remain in business--each of which functions is as important in the eyes of the law as the other. See also People's Org. for Wash. Energy Res. v. WUTC, 104 Wash. 2d 798, 808 (1985) ("POWER") (citing State ex rel. Puget Sound Power & Light Co. v. Dep't of Pub. Works, 179 Wash. 461, 466 (1934)). The "rate of return should be determined on a case-specific basis with reference to the particular pipeline's risks and its corresponding cost of capital." Williams Pipe Line Co., 31 F.E.R.C. ¶61,377, at 61,833 (1985) ("FERC Opinion 154-B").

[11] RCW § 81.04.250.

[12] 315 U.S. 575, 586 (1942). "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944); see also Duquesne Light Co., 488 U.S. at 314.

[13] In Permian Basin Area Rate Cases, the U.S. Supreme Court recognized the difficulty of providing a concrete definition to the concept of the "public interest":

> Social welfare and public interest standards have been described as "almost unique in the extreme vagueness of [their] ultimate verbal norm." . . . Similarly, it is said that no writer "whose views on public utility rates command respect purports to find a single yardstick by sole reference to which rates that are reasonable or socially desirable can

forth a non-exclusive list of "public interest" factors that may be considered in establishing rates for common carriers. In addition to those factors, the legislature recently mandated an additional specific public interest factor regarding the transport of hazardous materials by pipelines and placed responsibility for pipeline safety on the Commission.[14]

13. In general, these public interest factors can be evaluated by the proposed rate's impact on three groups: (a) the general public, (b) the ratepayers, and (c) the regulated company.

a. Effect of Rate on the General Public

14. Currently, there are four viable methods of transporting petroleum-related products: (1) by pipeline, (2) by barge, (3) by ship, and (4) by tanker truck. Transportation by oil pipelines is superior in efficiency and economy.[15] Tanker trucks are "statistically less safe by a three-to-one factor compared to pipeline transportation."[16] Barge and ship carriage entails the risk of oil spills in the environmentally fragile Puget Sound.[17]

15. If the Commission grants OPL's proposed 59% rate increase in full, the total cost of transporting gasoline on the pipeline would be about 1.3 cents per gallon,[18] of which 0.48 cents would arise from the requested increase.[19] Because the retail price of gasoline is driven by the highest--not the lowest--transportation cost, even this small marginal increase would not be passed on to the end consumer.[20]

b. Effect of Rate on Ratepayers

16. This case is unusual because the two protesting ratepayers, who together ship only 23% of the total pipeline volume,[21] are large corporations whose retail rates are unregulated at the wholesale or retail level. Because the total intrastate increase for all shippers is only about $8.47 million per year, the

---

be distinguished from rates that are unreasonable or adverse to the public interest." 390 U.S. 747, 791 n.59 (citations omitted).

[14] RCW § 81.04.250.

[15] See Ex. 1401T at 18, l. 13 through 19, l. l1; Third Supplemental Order at 3, ¶9.

[16] Id. at 18, ll. 14-16.

[17] Id.

[18] Tr. at 2412:14-25.

[19] Ex. 703C at 1 and 68.

[20] Tr. at 2419:19 through 2421:1; Ex. 223T at 19, l. 354 through 20, l. 373 ; id. at Appendix B at 10.

[21] Third Supplemental Order at 4, ¶16.

requested state rate increase for these shippers is approximately $2 million a year--a minute fraction of their total revenues. This is unlike setting rates for electricity, natural gas, or phones where the regulated rate generally is paid by the retail ratepayer. Moreover, the petroleum products shipped on OPL's pipeline are not transformed by the ratepayers here into entirely new products, such as the industrial users of electricity who transform power into other products. Further, the two shareholder owners of OPL, BP and Shell are also ratepayers, who together will pay 55% of the requested increase in state rates.[22]

c. Effect of Rate on the Regulated Company

17. OPL's current financial crisis is well-documented. This Commission's Third Supplemental Order in this proceeding recognized OPL's problems:

> [i]t is clear that the Company is in dire financial straits, in large part due to the need for safety improvements. Its case on this issue is compelling. It has no shareholder equity, as such. It owes substantially more money than the book value of its assets. It has seen its throughput plummet because of mandated closure. Its only means to acquire funding for its operations and needed capital projects are loans or capital investments from its owners, or revenues from transportation rates. The Company is not financially sound and it needs funds.[23]

The Commission also has recognized that safety must be a top priority and that OPL must have the resources to fulfill its safety goals:

> [I]t is equally clear that safety must continue to be a top priority for this Company. It is essential that the Company have the means to buttress its ability to operate safely, to support public confidence that it will operate safely, and to avoid the occurrence of a major event that could precipitate complete financial meltdown and deprive the shippers and the region of an efficient and cost-effective means of transportation.[24]

18. Without a significant tariff increase, there is little likelihood of attracting further capital to OPL, especially given the high risk of investing in OPL.[25] It is undisputed that OPL needs $66 million of new capital over the next three years in order to continue compliance with new federal pipeline regulations

---

[22] Tr. at 633 ll. 17-24.
[23] Third Supplemental Order at 3, ¶8.
[24] Id. at 3, ¶9.
[25] Ex. 501T at 4, ll. 7-15; Tr. at 2854:20 through 2855:20.

that implement HCA rules and Integrity Management Plans and to restore the pipeline system to 100% operating pressure, continue OPL's ongoing effort to make safety upgrades, and institute other capital improvements.

19. However, the Commission need not deviate from normal ratemaking principles to reach a result that achieves these vital goals. The Commission need only recognize that OPL is seeking a fair, risk-related return on its capital, and must reject the efforts that have been mounted, to mention a few of the unfair or arbitrary proposals put forward, to a) provide revenue that barely exceeds reasonable operating and maintenance costs when the industry standard is a ratio of two-to-one; b) disallow recurring major maintenance costs on the basis of testimony by witnesses who admit ignorance of the material underlying facts;[26] and c) switch from rates set under the TOC method to rates set under the DOC method without recognizing, and compensating for, the undisputed stranding of capital that will never earn a return without such recognition.

20. By approving an increase that provides a fair, risk-related return on OPL's carrier property through recognizing the real costs OPL must incur to achieve safe, full pressure operation, the Commission will provide the assurance investors require that the "regulatory compact" has meaning in the State of Washington.

iv. Commission's Dual Role

21. The legislature has required this Commission to administer and enforce all laws related to hazardous liquid pipeline safety.[27] As Chairwoman Showalter said, "pipeline safety [is] one of [the WUTC's] highest priorities."[28] The safety standards for intrastate pipelines are no less rigorous than federal safety standards for interstate pipelines.[29] The Commission should set rates that will permit OPL to fulfill its obligations to maintain and operate its pipeline in a manner that fully meets the safety

[26] Tr. at 4592:25 through 4595:13.
[27] RCW § 81.88.005.
[28] Ex. 1409 at 1.
[29] RCW § 81.88.050; WAC 480-75-005; 49 C.F.R., Parts 195 and 199; Ex. 1401T at 11. In June 2001, state law required enhanced training of pipeline personnel, new measure to identify and prevent pipeline corrosion, safety performance for the repair of corroded pipeline, and random drug testing. Ex. 601T at 8, ll. 1-23. Additional state regulations for hazardous products pipeline standards are set to be adopted before the rate year.

expectations and obligations of this Commission, the FERC, its shippers and the communities through which OPL's pipeline runs.

C. Federal/State Jurisdictional Legal Issues[30]

22. The same control rooms, communication systems, and most of the valves, pipes and other physical assets support OPL's intrastate and interstate shipments. Section 14(3) of the Interstate Commerce Act prohibits discrimination between inter- and intrastate shippers. OPL is urging the Commission to set rates in a fashion that is consistent with the federal approach to avoid potential problems of discrimination between inter- and intrastate transportation. OPL believes that a significant disparity between inter- and intra-state rates affecting compliance with federal oil pipeline safety regulations would not pass scrutiny under either the ICA or the Constitution's Commerce Clause.

23. OPL believes that an unecessary conflict (especially with a pipeline whose facilities cannot be segregated into intrastate and interstate portions) should be avoided if possible. Continued use in Washington State of the federal methodology to set general oil pipeline rates instead of a lower state rate method will (1) avoid an adverse impact on interstate commerce and shippers, (2) avoid an adverse impact on compliance with new federal safety standards, and (3) avoid unnecessary expense and confusion regarding how to finance OPL's system. There is no strong countervailing public interest to formally adopt for the first time since 1965 a separate state general oil pipeline methodology.

D. Retroactive Ratemaking

24. All parties agree that retroactive ratemaking is not appropriate and OPL's case does not advocate retroactive ratemaking.[31]

III. Status of Company Books and Records

25. The financial data supporting OPL's case must be "sufficiently reliable to enable [the Commission] to make an intelligent and informed judgment."[32] The challenges to OPL's financial

---

[30] See also Section IV.

[31] Tr. at 2247:15 through 2248:13; id. at 2483:16-21; Ex. 201T at 99, l. 9 through 102, l.3.; Ex. .1201T at 18, ll. 14-24.

[32] WUTC v. Wash. Water Power Co., 1981 Wash. UTC LEXIS 3, at *26-27 (Nov. 25, 1981); see also WAC 480-09-330.

record keeping over the past three years likely are unprecedented for any company regulated by this Commission. Those challenges included a devastating accident causing hundreds of millions of dollars in damages and economic losses, giving rise to over twenty separate lawsuits as well as several administrative and other governmental proceedings,[33] litigation between OPL and its shareholders over responsibility for the losses, which in turn may explain lack of full cooperation by the former operator in transferring financial records and data to OPL's new operator, and an outside independent auditor that was destroyed with the Enron collapse.

26. These challenges would be major ones for any company, but became all-consuming for a company operated by fewer than 100 individuals.[34] Yet despite the challenges OPL has faced, OPL's financial data is sufficiently reliable for the Commission to base a determination of the merits of an appropriate tariff increase for OPL on that data, as even Staff's witnesses have agreed.[35] Further, OPL recently received an "unqualified" independent auditor's opinion verifying its financial data.[36]

27. One of the major issues raised during the hearing concerning OPL's financial records was the lack of audited financial statements since 1998. Staff witness Kenneth Elgin represented that OPL would be unable to obtain an unqualified audited financial statement until about the first quarter of 2003, and not even then unless OPL first addressed various shortcomings he felt existed in its financial data and balance sheet.

28. OPL countered that staff and intervenors mischaracterized the condition of its records and that it would have audited financials by mid-August. OPL requested permission to submit the anticipated report until August 15. Staff did not oppose this request, although intervenors did. On August 12 OPL received from Ernst & Young a final unqualified audited financial report for years ending 2000 and 2001 which it immediately circulated to the Commission and the other parties. The report verifies what OPL

---

[33] Third Supplemental Order at 5-6, ¶22.

[34] Ex. 601T at 2-3.

[35] Ex. 2101T at 12, ll. 1-17.

[36] Tr. at 4588:24 through 4589:16. Staff and intervenors also were provided with OPL's general ledger detail to provide the backup information for all of the financial data that is the basis for OPL's case. Id. at 3857:14-16. WUTC staff reviewed this information in Houston, Texas with OPL/BP representatives and representatives of OPL's outside accountants, Accenture. Id. at 3859:14 through 3860:5.

maintained throughout this proceeding, namely that its financial records are sufficiently reliable for this Commission to make an intelligent and informed judgment regarding OPL's requested rate increase.[37] It also verifies that Staff and intervenors' representations concerning the state of OPL's financial records were not accurate.

29. Some of the confusion concerning OPL's data likely derives from the unique nature of the rules dictating how OPL's financial information is reported. OPL is obligated to follow FERC reporting guidelines. FERC guidelines require OPL to use the Uniform System of Accounts ("USOA") which provides definitions and instructions for the chart of accounts that appears in FERC Form 6 which this Commission also requires OPL to submit in this form (and thus in accordance with the same chart of accounts) annually.[38] Although the USOA is consistent with Generally Accepted Accounting Principles ("GAAP") in many areas, they are different in several key respects,[39] and proper application of USOA can potentially lead to materially different results from proper application of GAAP (and will almost invariably lead to some differences in result).[40]

30. The financial data relied on by OPL in its filing are the result of a detailed and multi-level process designed to ensure accuracy. Since May 2001, the entire BP pipeline system, including OPL, has used the SAP accounting process, which is an integrated system that uses various modules such as general ledgers, accounts payable, accounts receivable, and asset management. Every entry made into an SAP module has an electronic audit trail that allows the entry to be traced to its original source.[41] The SAP system of accounts is one of the most popular and widely used accounting programs in the world, and BP's use and implementation of the program has been audited numerous times by BP's internal and external auditors with no financial control issues found.[42]

---

[37] Some of the data in the audit are slightly different than the data used in Olympic's case. However, adjusting Olympic's case to reflect the data in the audit would benefit Olympic. For example, the 2001 net book value, which flows through to rate base, would increase approximately $5 million, which would result in a larger return on rate base and larger tax allowance.

[38] Ex. 1101T at 4.

[39] See Id. at 4-6.

[40] Tr. at 3533:7 through 3544:19; id. at 3616:13 through 3622:10.

[41] Ex. 801T at 9, l. 15 through 10, l. 6; see also Tr. at 3801:3 through 3802:17.

[42] Ex. 801T at 9, ll. 15-22.

31. To be entered into OPL's accounting system, any invoice must be sent to OPL's outside accountant, Accenture, at its Houston office where the invoice is electronically scanned into the accounts payable system.[43] The financial data scanned into the system by Accenture is reviewed at several levels to ensure reliability. Initially, the scanned invoice information is electronically mailed to the OPL/BP individual responsible for the work reflected in the vendor invoice who then reviews the information for accuracy.[44] This information also is reviewed by the BP controllers group, OPL management, including Bobby Talley and Ms. Hammer.[45] In addition, actual spending levels are regularly compared to budgeted amounts to ensure that the actual spending data is reasonable.[46]

32. OPL's budgetary process also is quite detailed with various levels of review and approval to ensure that estimates of future spending are reasonably reliable. OPL prepares budgets on a calendar year basis.[47] OPL's various operating and administrative groups develop the estimates for the coming year's spending requirements and the proposed budgets are reviewed, revised and ultimately approved by OPL's Board of Directors.[48] Bobby Talley described this budgetary process in detail in his deposition, admitted as Exhibit 1609.[49]

33. When BP became OPL's operator it implemented its "capital value process" used to develop budgets and manage capital projects.[50] Each capital project has a project manager and each project goes through five separate approval stages before ultimately becoming part of an approved budget.[51] At the end of the process the project's estimated cost is expected to be within 10% of what the project's final cost will be.[52]

34. Proposed budgets containing the projects supported by management are then presented to OPL's Board of Directors for review and approval. Typically, Bobby Talley reviews with the Board

---

[43] Id. at 10; Tr. at 3811:1 through 3813:16; id. at 3819:17 through 3820:25.
[44] Id. at 3864:18 through 3866:8.
[45] Id. at 3823:2-13; id. at 3844:2-18; id. at 3850:6 through 3851:18; id. at 3862:19 through 3865:21.
[46] Id. at 3844:2-11.
[47] Id. at 3407:10 through 3408:3.
[48] Ex. 801T at 2, ll. 4-10.
[49] Ex. 1609 at 40, l. 13 through 54, l. 3; id. at 58, l. 2 through 61, l. 25.
[50] Id. at 41, ll. 17-25.
[51] Id. at 41, l. 17 through 43, l. 4.
[52] Id. at 42, ll. 17-24.

the various budget items and responds to the Board's questions regarding particular projects.[53] All projects exceeding $100,000 must be specifically approved by the OPL Board and actual spending for a project cannot exceed 10 percent of the approved budget without further Board review and approval.[54]

35. Once approved, bid packages are prepared and distributed to potential vendors in an effort to obtain the most cost-effective project implementation.[55] Bids received also are compared to BP corporate master service agreements with various vendors to determine whether OPL would obtain better value under the terms of such an agreement.[56] Once projects are under way, in addition to the project manager, Bobby Talley, Cindy Hammer and BP's internal controllers group regularly monitor actual spending by comparing it to the approved budget.[57] As reflected by Exhibit 865, actual total operating expenses run within 90% of the total operating expense budget.[58]

36. Many questions were raised, primarily of Cindy Hammer, regarding the accuracy of the balances brought forward from Equilon when BP became OPL's operator on July 1, 2000. Ms. Hammer explained more than once that because she did not work with OPL prior to November 2000 she was not directly involved with bringing the Equilon data into the BP system.[59] Regardless, questions raised by Staff and intervenors concerning the reliability of the Equilon data should not be a major concern to the Commission in evaluating OPL's filing.

37. First, this issue has little bearing on the accuracy of the data utilized in OPL's case. Nearly all of the data used in OPL's "case 2," as modified by its rebuttal case to substitute budgeted amounts with actual expenditures incurred after OPL's tariff filing, were generated after BP became OPL's operator.[60] Second, Ms. Hammer explained that at the time of the transition between Equilon and BP, a team of accountants from Accenture and BP, including Howard Fox, were involved in transitioning

---

[53] Id. at 40, l. 23 through 41, l. 16.
[54] Id. at 41, ll. 9-16 and 52, l. 7-18.
[55] Id. at 43, l. 5 through 44, l. 25.
[56] Id. at 43, l. 23 through 45, l. 3.
[57] Tr. at 3823:2-13; id. at 3844:2-11; id. at 3850:6 through 3851:18.
[58] See also id. at 3861:3 through 3862:13.
[59] Id. at 3794:6 through 3808:23.
[60] See Ex. 817T at 10, ll. 13-18.

OPL's financial information from the Equilon system into the BP system.[61] Mr. Fox testified that based upon the work of Accenture and BP during the transition, he was generally satisfied with the reliability of the financial information brought forward into the BP system.[62]

IV. Ratemaking Methodology

A. Investor Expectations; Right to Methodology

38. The contention has been made by both Staff and Intervenors that OPL could not *reasonably* have relied upon the federal methodologies--either the earlier valuation methodology or the current trended original cost ("TOC") methodology prescribed in Opinion No. 154-B--because the Commission never formally adopted those methodologies. Even if in some strictly formal sense this is correct, it by no means compels the conclusion that OPL (and its investors) did not *reasonably* rely on the federal methodologies. It is well-established under both the Washington Transportation Act and the ICA that tariffs are in the first instance "carrier made"--i.e., that when a carrier files and publishes tariff schedules in proper form and upon proper notice and the relevant regulatory authority takes no action, the tariffs become effective.[63] The reality is, however, that from 1983 until the filings giving rise to the present case, the Commission did not "do nothing" and simply allow the tariffs to become effective without affirmative Commission scrutiny and action.[64] Rather, with regard to every OPL tariff filing during that period, all these filings were allowed to go into effect after the Commission received the analyses and recommendations of Staff.

39. The FERC adopted TOC in "fairness" to oil pipeline investors who, in the FERC's view, relied "on a rate base which has been adjusted for inflation."[65] The FERC's concern with fairness also had a

---

[61] Tr. at 3794:6 through 3795:10; id. at 3808:4-8.

[62] Id. at 4474:2 through 4476:3.

[63] RCW § 81.01.01 et seq.; 49 U.S.C. § 10101 et seq.

[64] Mr. Colbo of the Commission's Staff submitted a memorandum to the Commission regarding Olympic's WUTC Tariff No. 16 scheduled to become effective July 1, 1983. In that memorandum, Staff took the position that the proposed increase, supported by computations made under the then-applicable FERC methodology, should be allowed to become effective as scheduled depending upon "whether or not the Commission is willing to adopt current FERC guidelines, or rely on the more traditional pro forma restated year with original cost, depreciated rate base." To aid the Commission's resolution of this matter, the Staff's memorandum attached a summary of the FERC's rationale for the FERC's then-current regulatory methodology. In response, the Commission allowed WUTC Tariff No. 16 to become effective on the proposed effective date. Ex. 1918 at 4-6.

[65] FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,836.

public interest component because an uncompensated switch from the traditional valuation methodology to the new trended original cost methodology would have chilled future investment in oil pipeline assets.[66]

40. The uncompensated switch from TOC to DOC advocated by Staff and Intervenors raises the same "fairness" concerns. Over the life of an asset, TOC and DOC methodologies produce the same return.[67] However, a mid-life uncompensated switch from TOC to DOC would result in the asset owner earning less than a fair return, thereby effectively "stranding" capital. As demonstrated below, one can easily calculate the appropriate compensation for a TOC to DOC switch, but such a switch is unnecessary and is more complicated than simply continuing to allow OPL to use the FERC's TOC-based methodology.

41. In its tariff filing with the WUTC, OPL did rely on the Commission continuing to evaluate its request for a tariff rate increase based on the FERC's TOC-based methodology. Abruptly changing course at this stage as proposed by Staff and Intervenors--neither of which proposes any device for compensating for the unfair results arising from the change itself--would result in an unfair rate and would undermine the confidence OPL's investors have reasonably placed in a consistent pattern of parallel methods in setting intrastate and interstate rates.

B. FERC Methodology

42. In arguing for a change to a DOC methodology, Staff and Intervenors have failed to address the merits of the FERC methodology that they seek to jettison and have in fact affirmatively shown a lack of understanding of the analytical and historical underpinnings of the current FERC approach.

i. Nature of Oil Pipelines and History of Regulation

43. Oil pipelines first became subject to regulation at the federal level under the Interstate Commerce Act ("ICA") upon the enactment of the Hepburn Amendment of 1906.[68] The ICA, as it was thus amended, declared oil pipelines to be common carriers. In addition, the amended ICA

---

[66] Ex. 1201T at 12, ll. 10-17.

[67] FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,834-35.

[68] The Hepburn Amendment of 1906, ch. 3591, § 2, 34 Stat. 587, to the Elkins Act of 1903, ch. 708, § 1, 32 Stat. 847 (codified as amended at 34 Stat. 587, 49 U.S.C. §§ 41-43 (repealed 1978)).

required that oil pipelines' rates be just and reasonable and prohibited certain forms of discrimination. However, Congress chose not to regulate oil pipelines as pervasively as it had other carriers subject to the ICA. Most importantly, Congress chose not to regulate oil pipeline market entry (i.e., construction or acquisition) or exit (i.e., abandonment). In this respect, the federal regulatory framework was and is fundamentally different from most regulatory regimes at the state and federal levels. Because these "special obligations" under the ICA were not applicable to oil pipelines, a federal court of appeals found "a congressional intent to allow a freer play of competitive forces among oil pipeline companies," and determined that we should be "especially loath uncritically to import public utilities notions into this area without taking note of the degree of regulation and of the nature of the regulated business."[69]

44. Unlike natural gas pipelines and electric utilities, oil pipelines compete with one another and with other modes of transportation--motor carriers, railroads and, most importantly, water carriers; virtually everyone that has studied oil pipeline competition has recognized that transportation of petroleum products by water is a potent source of such competition.[70] Oil pipeline regulators typically have no ability to protect oil pipelines from such intermodal competition.

45. Until 1977, when jurisdiction over oil pipelines was transferred to the FERC under the Department of Energy Organization Act, interstate oil pipelines were regulated by the Interstate Commerce Commission ("ICC") on the basis of a valuation methodology.[71] After much litigation, the D.C. Circuit Court of Appeals required that the FERC adopt an amended approach which, ultimately, led to the FERC's adoption of its Opinion No. 154-B.

ii. Rationale for FERC Methodology

46. The methodology adopted in Opinion No. 154-B, in contrast to the valuation methodology, is rigorously cost-based but nonetheless attempts to take into account the unique nature of the oil pipeline industry, most importantly its competitive nature.[72] Two aspects of the Opinion No. 154-B analysis

[69] Farmers Union Cent. Exch. v. FERC, 584 F.2d 408, 413 (D.C. Cir. 1978) ("Farmers Union I").

[70] See e.g., Williams Pipe Line Co., 71 F.E.R.C. ¶61,291, at 62,138 (1995); Department of Justice, *Oil Pipeline Deregulation* at 36 and 64 n. 75.

[71] FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,832.

[72] FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,834-35.

deserve particular emphasis. First, all that differs between the trended original cost methodology of Opinion No. 154-B and more conventional depreciated original cost methodologies is the time pattern of capital recovery. As the FERC emphasized in Opinion No. 154-B, in theory, trended original cost and depreciated original cost produce the same earnings (on a discounted present value basis) over the regulated asset's life.[73] Second, the Opinion No. 154-B methodology is not restricted in its application depending upon the degree of competition faced by the pipeline. Thus, for example, in Lakehead Pipe Line Company,[74] the FERC explained that it "adopted [trended original cost] to stimulate future competition. It did not adopt [trended original cost] only for competitive markets."[75]

1. Potential for Underinvestment

47. The adoption of TOC by the FERC to reduce the potential for under-investment in oil pipelines is discussed above in Section IV.A.

iii. Elements of FERC Methodology

1. Trended Original Cost

48. Deferred returns are an inherent feature of TOC and are discussed in this section. The TOC methodology only allows the real equity return on the rate base to be recovered in the year it is earned, and the inflation component associated with the nominal equity return on the rate base is recovered in future periods.[76] As Mr. Smith testified, the inflation component of the equity return on the rate base is not recovered in the current year, but deferred to future periods and recovered over the pipeline's life.[77] The rationale behind allowing this deferred return does not depend upon whether there is accounting evidence of an actual past earnings "deferral" or under-recovery,[78] but instead is a policy-based approach designed to encourage future investment. An example will highlight the distinction between the timing of receipt of returns under the DOC and TOC methods. If inflation is 3% and the real equity return is 12%, then the nominal equity return is 15%. Under TOC, the pipeline will receive today only

[73] Id.
[74] Lakehead Pipe Line Co., 71 F.E.R.C. ¶61,338.
[75] Id. at 62,307.
[76] Ex. 1201T at 10, l. 25 through 11, l. 9; see also FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,834.
[77] Ex. 1201T at 10, ll. 25 through 12, l. 4.
[78] Id. at 17, l. 18 through 19, l. 10.

the real equity return of 12% with the 3% inflation component being deferred to future periods. Under DOC, the pipeline will receive today the entire nominal equity return of 15%.[79] However, the present value of the earnings received over the life of the property are the same under TOC and DOC.[80]

49. The Staff/Intervenor critique of TOC misses two basic points. First, it assumes that OPL records must reflect an earnings deferral[81] when the applicable FERC standards contain no such requirement since the analytical basis for TOC has nothing to do with an individual pipeline's historical earnings.[82] Second, they overlook the unfair result of an uncompensated change from TOC to DOC. Once the nominal portion of the return is deferred (3% in the above example) with TOC, an uncompensated deferred return switch to DOC results in its never being recovered. However, TOC is consistently followed over time, therefore it would be recovered.[83]

50. A methodology change should not occur without a transition mechanism compensating for the accumulated deferred return balance. Dr. Schink has demonstrated how such a transition mechanism could be implemented.[84] However, OPL believes it would be best for the Commission to allow it to continue to use the FERC's TOC-based methodology.

---

[79] Ex. 201T at 16, l. 6 through 19, l. 3.

[80] As stated in FERC Opinion 154-B, "But, and this is crucial, as Justice admits, '[t]heoretically, TOC results in the same discounted value of the earnings stream for the investor as does 'untrended' original cost.'" FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,834. Dr. Schink demonstrated this fact with an example in his rebuttal testimony. Ex. 201T at 15, l. 19 through 19, l. 3. Under the TOC approach earnings from transportation services are spread more uniformly over the life of the assets used to provide these services. Ex. 201T at 15, l. 21 through 16, l. 5.

[81] Ex. 2301T at 25, l. 1 through 27, l. 11.

[82] In Lakehead, the FERC stated that the use of the TOC-based methodology and the calculation of deferred earnings is not based on an analysis of past earnings, nor is it appropriate to perform such an analysis to correctly apply the TOC-based methodology. Furthermore, the FERC in its clarification of the Lakehead decision (FERC Opinion 397-A) further amplified that the use of the TOC-based methodology was appropriate, that the TOC-based methodology was to be applied to all pipelines, and that Lakehead Pipe Line was entitled to use the TOC-based methodology and have a deferred return since 1983 even though it made its first cost-based TOC tariff filing in 1992. Lakehead Pipe Line Co., 71 F.E.R.C. ¶61,338, at 62,307-08 and 62,590-01.

[83] An uncompensated mid-stream switch from TOC to DOC strands the deferred earnings component of its earnings under TOC, thereby denying OPL the opportunity to earn a fair return on its rate base over the lives of the assets that are in the rate base. Ex. 201T at 13-23. Staff and Tesoro are proposing that OPL be subjected to this uncompensated switch. Ex. 1901T at 11, ll. 14-19; id. at 18, ll. 6-15; id. at 25, l. 20 through 26, l. 6.

[84] Ex. 201T at 20, l. 1 through 24, l. 11; Ex. 202; Ex. 203; Ex. 204. The transition mechanism proposed by Dr. Schink involves recovering OPL's deferred return balance over five years which would require a surcharge of about 11 cents per barrel to the average tariff rate per barrel over the next five years. This surcharge would be added to the average tariff rate determined using DOC, and an upper limit would be imposed on revenues generated to ensure there would be no over-collections. Ex. 201T at 23, l. 3 through 24, l. 11.

2. Starting Rate Base

51. The starting rate base is a transition device designed to avoid unfairness arising from the change from the ICC valuation method to the FERC TOC method.[85] If this Commission were to switch to a DOC methodology, OPL should be permitted to recover the remaining earnings from the starting rate base write-up.[86] However, OPL believes such a switch is unnecessary and inappropriate.

3. Deferred Return

52. See subsection 1 above.

4. Parents' Capital Structure

53. The FERC has expressed in Opinion No. 154-B a preference to use the actual capital structure of either the pipeline or its owners (i.e., its "parents").[87] If an oil pipeline company issues no long-term debt, issues long-term debt to its owners, or issues long-term to outside investors which has the repayment guaranteed by the pipeline owners, then the owners' capital structure should be used for rate making purposes.[88] If an owner has guaranteed the long-term debt of the pipeline, the investors of the long-term debt can look to the owner for debt repayment. This means the pipeline is using the creditworthiness and hence the capital structure of the owner to secure financing.[89]

5. Cost of Equity

54. The FERC has devoted substantial efforts to evaluating alternative methodologies for determining an oil pipeline's cost of equity capital, in the context of the SFPP, L.P., oil pipeline

---

[85] Ex. 201T at 24, l. 15 through 25, l. 4; Ex. 1201T at 11, l. 23 through 12, l. 10. "Because the Commission is switching oil pipelines from a valuation rate base to a TOC rate base, it *must adopt* a starting or transition rate base in dollars for existing plant." FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,835 (emphasis added and citations omitted). FERC also noted: "However, the Commission is concerned about the *long reliance of pipeline investors on the previous rate base method* and, as a result, has sought a middle ground that is *fair in light of investor expectations* but without perpetuating the serious flaws of the previous method." Id. at 61,836 (emphasis added). The only basis on which a pipeline would not be entitled to a starting rate base is that it had earnings in years before 1985 higher than those allowed under the valuation method. Id. at 61,377. There is no evidence that this exception applies to OPL.

[86] According to Dr. Schink, this would require a separate surcharge of about one cent per barrel above the average tariff rate determined using DOC for the next five ears. Ex. 201T at 26, ll. 6-16. Also, an upper limit would be placed on the revenues generated to ensure there is no over-recovery. Id. at 24, ll. 1-11; id. at 26, ll. 9-16.

[87] Id. at 12, l. 11 through 13, l. 2; FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,836.

[88] FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,836.

[89] Ex. 1201T at 13, ll. 9-13; Ex. 201T at 34, ll. 6-12.

proceedings which began in 1992 and continue today.[90] As a result of this process, the FERC has selected a detailed, specific single-stage DCF approach that it expects to be applied to the five companies in its oil pipeline proxy group in calculating the cost of common equity capital for an oil pipeline.[91]

55. In calculating the expected cost of common equity for an oil pipeline company based on the five proxy group companies, the FERC analyzes the dividends, share prices, analysts' predictions of long term dividend growth, and predictions of long-term nominal GDP growth (the latter compensating for the relatively short five-year horizon of analysts' predictions).[92] This results in a range of costs of equity that defines a zone of reasonableness for oil pipeline companies. The appropriate cost of common equity for a given company depends upon perceived similarities between it and the companies with costs of common equity in the upper and lower ends of this range.[93]

56. The FERC discounted cash flow ("DCF") methodology, including the use of the five-company oil pipeline proxy group, conforms to WUTC's standards for an acceptable DCF-based analysis with the possible exception that the WUTC has relied solely upon analysts'projections of dividend growth.[94] The FERC view that factoring in projected GDP increases accounts for an expected convergence of costs of equity has support in the financial literature.[95] The WUTC, in its prior decisions, has determined that the five-year analysts' forecasts are sufficiently long-run in nature to qualify them as appropriate estimates of long-run expected dividend growth.[96]

---

[90] The FERC decision in this case dealt in detail with the determination of the cost of common equity capital for an oil pipeline. SFPP, L.P., 86 F.E.R.C. ¶61,022 (1999) ("FERC Opinion 435"). FERC Opinion 435 affirms, without discussion, some of the decisions reached by Administrative Law Judge as set forth in SFPP, L.P., 80 F.E.R.C. ¶63,014 (1997). The litigation led to evaluation of numerous options before the current method was adopted. Ex. 221 at 39, l. 1 through 42, l. 21.

[91] Ex. 221 at 39, l. 1 through 42, l. 21.

[92] Panhandle Eastern Pipeline Co., 71 F.E.R.C. ¶61,109, at 61,362-63 (1996); FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,100. See also National Fuel Gas Supply Corp., 51 F.E.R.C. ¶61,122, at 61,337 n.68 (1990) (detailing the formula used to perform this calculation).

[93] FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,101; Transcontinental Gas Pipe Line Corp., 84 F.E.R.C. ¶61,084, at 61,427 (1998) (applying the same principles to a wholly-owned natural gas pipeline relying on its parent for financing).

[94] Avista Corp., 2000 Wash. UTC LEXIS at *157-58 and *163.

[95] Ex. 221 at 49 n.10.

[96] Ex. 201T at 45, ll. 5-20 and 47, ll. 3-6; WUTC v. Wash. Water Power Co., 1978 Wash. UTC LEXIS 3, at *47-48 (Mar. 24, 1978).

iv. Commission Discretion in Choosing Methodology

57. See discussion in Section II.B.

1. Consistency with Interstate Rates

58. The public interest is best served by consistent interstate and intrastate rate making methodologies. Regardless of whether adopting different methods violates Section 13(4) of the ICA, the costs and burdens of ratemaking will be minimized by consistency in methodology.[97]

2. Past Practices

59. Since OPL started operations in 1965, the Commission and its predecessor have not adopted a separate general rate methodology for oil pipelines.[98] Thus, the general federal oil pipeline regulatory framework has been relied upon by OPL to set its general intrastate rates, with minimal burden and, until now, no complaints. Moreover, this long-standing reliance is consistent with guidance from our legislature and courts. The Washington Transportation Act is largely identical to the ICA, and our state courts often look to interpretations of the ICA in construing the Washington statute.[99] The Commission has known since 1983 that the TOC methodology resulted in a higher rate.

C. DOC Methodology

60. See discussion in Section IV.B above.

V. Test Year and Jurisdictional Separations

A. Definition of "Test Year"

61. When determining the appropriate "test year," it is important to understand the differences in nomenclature used by this Commission and the FERC. This Commission defines a "test year" as "the most recent 12-month period for which income statements and balance sheets are available."[100] "The purpose of a test year is to develop a normal level of expenses that is expected to match the company's expenses in the rate year."[101] To better predict what the regulated company can expect its operations

---

[97] See Section II.C.
[98] See Sections II.C and IV. A.
[99] See, e.g., Inland Empire v. WUTC, 112 Wash. 2d 278, 283 (1989).
[100] Avista Corp., 2000 Wash. UTC LEXIS 558, at *8.
[101] WUTC v. Bremerton-Kitsap Airporter, Inc., 2002 Wash. UTC LEXIS 61, at *26 (Apr. 15, 2002).

to cost in the rate year, test year results are adjusted for (i) unusual events that occurred during the test year and (ii) known and measurable events.[102]

62. FERC regulations state that a "base period" must consist of "12 consecutive months of actual experience. The 12 months of experience must be adjusted to eliminate nonrecurring items (except minor accounts). The filing carrier may include appropriate normalizing adjustments in lieu of nonrecurring items."[103] Thus, the FERC's definition of "base period" is consistent with this Commission's definition of "test year."

63. However, FERC defines "test period" as "a base period adjusted for changes in revenues and costs which are known and are measurable with reasonable accuracy at the time of filing and which will become effective within nine months after the last month of available actual experience utilized in the filing."[104] The FERC's "test period," therefore, is analogous to this Commission's concept of a "rate year." The only difference between the two concepts is time. Before this Commission, adjustments are made for known and measurable events that will occur during the twelve-month period after the issuance of a final order (the "rate year"), whereas the FERC allows adjustments for known and measurable events that will occur within nine months after the FERC's "base period."

B. Test Year in this Proceeding

64. OPL, Tesoro, and Tosco all propose a test year of October 2000 through September 2001.[105] Commission Staff uses calendar year ending December 31, 2001, as their test year.[106] Staff Witness Colbo admitted that Staff's deviation from OPL's test year was unusual but not unprecedented.[107]

65. OPL's selection of an October 2000 through September 2001 test year (FERC base period)

---

[102] Mr. Colbo, Staff witness, defined "rate year" as the twelve months immediately after the final order in a rate case. See Tr. at 4719:8-12. His definition is consistent with the Commission's past applications of the concept in its decisions. See, e.g., Avista Corp., 2000 Wash. UTC LEXIS 558; Bremerton-Kitsap Airporter, 2002 Wash. UTC LEXIS 61.

[103] 18 C.F.R. § 346.2(a)(1)(i).

[104] Id. at § 346.2(a)(1)(ii).

[105] See Ex. 2301T at 13, l. 5 through 14, l. 2.

[106] Ex. 2001T at 10, l. 3 through 11, l. 19. Staff's revised test year added three additional months of actual throughput (October through December 2001), thereby allowing Staff to make its recommendations using six months of actual throughput information.

[107] See id.

was based in part on a desire to use the same time periods for both the FERC and WUTC rate filings to avoid what certainly would have been significant confusion. Further, and more importantly, OPL's test year contained the most current information available to OPL when it filed its case and it met this Commission's definition of "test year" found in ~~Avista Corp.~~[108] Further, OPL's rebuttal case substituted actual data generated after it filed its direct case for the period October 2001 through April 2002, which both improved the reliability of the rate year data and was consistent with the Commission's "known and measurable" standard.[109]

C. Jurisdictional Separations

66. Because OPL carries both intrastate and interstate shipments, there is an issue of how to separate costs between intrastate and interstate service. Dr. Schink testified that there are no economically meaningful methods to allocate costs between interstate and intrastate tariff routes and he explained why cost allocation methods cannot properly allocate joint costs and common costs.[110] Mr. Collins echoed the same theme.[111] Staff witness Mr. Twitchell recommended use of a jurisdictional separation,[112] while Tesoro witness Mr. Grasso recommended use of a FAC (fully allocated cost).[113] Tosco witness Dr. Means expresses no opinion on the topic of jurisdictional separation.[114]

VI. Operating Expenses

A. Results Per Books

67. OPL's financial statements for 2001 and 2000 have now received an "unqualified" opinion from Ernst & Young. Staff's challenges to OPL's data, which of course predated the completion of the

---

[108] ~~Avista Corp.~~, 2000 Wash. UTC LEXIS 558.

[109] As an example, Staff amended its testimony and used the most current prices from PSE for power even though that rate was not set until after Staff filed its direct case testimony in May. (Staff had used PSE's past rates and opposed use of OPL's power rates based on PSE's filings). It became known and measurable only after an agreement was reached that set rates starting on July 1, 2002--but would extend into the rate year. The purpose of making adjustments to cost data based on known and measurable data is to have the best data available for what will be experienced in the rate year. Mr. Colbo has defined known and measurable as "verifiable, quantifiable, objective," which is met by use of actuals instead of projections. Ex. 2008 at 30, ll. 2-17. Olympic's cost adjustments to actuals had the result of reducing its rate requests in most areas.

[110] Ex. 223 at 59, ll. 1081-1097; ~~Id.~~ at Appendix D at 1-3 (Section B); ~~Id.~~ at 55, l. 1010 through 56, l. 1033.

[111] Ex. 713 at 3, ll. 5-12; Ex. 701T at 2, l. 19 through 3, l. 6.

[112] Ex. 1901T at 37, l. 4 through 38, l. 17; Ex. 1903; Ex. 2401T at 34, l. 6 through 35, l. 13.

[113] Ex. 2402 at Schedules 25, 26, and 27.

[114] Ex. 2201T at 2, l. 1 through 4, l. 23.

audit, are addressed below.

B. Whatcom Creek Expenses

68. All direct costs incurred to remediate damages from the Whatcom Creek accident were excluded from OPL's Rate Year cost of service calculations.[115] OPL has tracked Whatcom Creek as a separate project with invoices relating to Whatcom Creek sent to the project manager of the remediation project, in part to facilitate presenting invoices to insurers.[116] This segregation enabled OPL to exclude these remediation costs from the expenses included in the Rate Year cost of service calculations prepared by Mr. Collins.[117]

69. By not requesting the direct costs of Whatcom Creek in this proceeding, OPL does not concede that those costs would not be recoverable in rates. The cost of accidents is a cost of doing business and OPL could have requested them ere. The "*costs associated with catastrophic losses due to accident*, equipment failure, or third party damage" comprised the type of costs that would "*justif[y] use of cost-of-service* methodology."[118] This general principle has been upheld in the courts.[119]

C. Restating and Pro forma Adjustments

70. Staff proposed certain restating and pro forma adjustments, using different periods[120] for Test Year (calendar 2001) and Rate Year ("known and measurable" changes to 2001 results than did

---

[115] Ex. 801T at 13, ll. 1-6.

[116] Ex. 1609 at 14:17-20.

[117] Ex. 801T at 6, ll. 13-17; id at 13, ll. 14-22.

[118] Revisions to Oil Pipeline Regulations Pursuant to Energy Policy Act of 1992, 59 F.R. 40,243, 40,253 (1994) (emphasis added); see also SEPP, 91 F.E.R.C. ¶61,135, at 61,513 (2000); SEPP, 96 F.E.R.C. ¶61,281, at 62,069-71 (2001); see also Iroquois Gas Transmission Syst., L.P. v. FERC, 145 F.3d 398, 400-02 (D.C. Circuit 1998) (recognizing that even costs stemming from unlawful activities that benefit ratepayers might be recoverable through rates if incurred in the interest of ratepayers), citing Mountain States Tel. & Tel. Co. v. FCC, 939 F.2d 1021, 1035 (D.C. Cir. 1991); cf. Lakehead Pipe Line Co., 65 F.E.R.C. ¶63,021, at 65,124, 65,139-40 (1993) (costs of hydrotesting necessitated by pipeline spills recoverable through rates).

[119] See, e.g., New Orleans Pub. Serv., Inc. v. United Gas Pipe Line Co., 732 F.2d 452, 470 (5th Cir. 1984) (electric utility has right to recover through rates costs "arising from liability to third parties for personal injury or property damage in *accidents*, insurance costs . . . ." (emphasis added)); Stibitz v. Gen. Pub. Utilities Corp., 746 F.2d 993, 995 (3d Cir. 1984) (increased utility rates pass on at least part of the cost of Three Mile Island accident to ratepayers).

[120] Ex. 2001T at 10, ll. 4-5; Ex. 1901T at 10, ll. 4-12.

OPL).[121] Both OPL and Tesoro[122] used a Test Year of October 2000 through September 2001 and a Rate Year of October 2001 through September 2002. Dr. Means relies on a five-year period for determining his forward lookingrates.[123] Due to these differences, it is not possible to compare Staff's adjustment amounts to the record amounts proposed by OPL and the other parties. However, the substance of the proposed adjustments by Staff and others is discussed below.

i. WUTC Staff Adjustments

71. Staff's adjustments are summarized in Mr. Colbo's Ex. 2001T which sets forth"Restating Adjustments" and "Pro Forma Adjustments." Restating adjustments make adjustments to amounts extracted from the test period accounting records (Staff's test period of calendar 2001) that reflect Staff's interpretation of accounting treatment appropriate for rate making. Pro forma adjustments reflect the effects of different assumptions concerning the assets that should be included in the rate year rate base and the level of throughput. OPL disagrees with the assumptions for Staff's pro forma adjustments and several of the proposed "Restating Adjustments" as follows:

a. **Interpretation of Accounting Standards for Capitalization**

72. Staff uses an extremely broad definition of capitalization that treats any expenditure for maintenance with effects extending beyond one year as a capital expense.[124] Staff has restated Outside Services to reclassify certain expenses relating to maintenance as capital investment rather than expenses. Staff has not proposed such adjustments under standards conforming to the requirements of the uniform system of accounts ("USOA"), yet Staff agrees that OPL is bound to follow USOA under FERC and submit this financial information to the WUTC on Form 6.[125] Mr. Ganz points out that the USOA provides for recording maintenance of plant and equipment as an expense.[126] Further, OPL has adopted "units of property" as a basis for differentiating expensed and capital costs, but Staff's critique

[121] Ex. 713 at 16, ll. 5-9.
[122] Ex. 2301T at 13, ll. 12-17.
[123] Ex. 2201T, at 4 ll. 17-18.
[124] Ex. 2001T at 20, ll. 21-23.
[125] WAC 480-75-010.
[126] Ex. 1101T at 13, ll. 8-17. Ms. Hammer has explained that it is OPL practice to maintain the records from which these amounts have been extracted in conformance with the USOA. Ex. 801T at 9, ll 13-14.

does not address this system, and Staff's assertions are at odds with the results of its application.[127] Mr. Colbo indicated that he is not acquainted with the Form 6, or the USOA, and has not applied these standards when making his re-classification.[128] Accordingly, his arbitrary and unsupported re-categorization of various maintenance expenses must be rejected.[129]

b. **Non-Recurring Expenses**

73. Staff concludes that certain expenses are non-recurring.[130] Two alternatives are prescribed for expense items that Staff placed in the non-recurring category. They are either amortized over five years, or disallowed.[131]

74. While adjustments via normalization are proper where costs are non-recurring,[132] Staff erroneously reclassifies OPL costs as non-recurring. For example, Mr. Colbo has not addressed the effect of HCA regulations on OPL even though over 75% of its line passes through such areas, periodic reassessments are required, urbanization on the pipeline corridor has increased significantly, and the current compliance effort will last well into 2004.[133] Because these costs will be at or above the 2001

---

[127] Tr. at 3605:13 through 3608:24; Ex. 1609 at 9, ll. 13-18. A much discussed example is the "line-lowering" at East Creek. Although Staff contended that this line-lowering should not be expensed on the basis that it constituted an improvement with a benefit beyond one year (Tr. at 4586:3-19) and was non-recurring, it became apparent that the basis for this assertion was flawed in that Mr. Kermode did not know (a) why the line had to be lowered, (b) how long the section was that was lowered, (c) how frequently similar events occur, and (d) whether the length of affected pipe was within the "units of property" used by Olympic (as required by FERC) to differentiate expensed items of work from capitalized items of work. Id. at 4592:25 through 4595:13. Mr. Kermode based his criticism of Olympic's accounting in part on the expensing of this line-lowering, but did so in apparent ignorance of the very facts that would be relevant even if GAAP applied and in disregard of the applicable units of property standard. Whether the Commission chooses to require amortization of this cost over time as a matter of rate-making is a separate question not addressed by Staff, which instead used this example to criticize OPL's accounting practices. However, even from a rate-making standpoint, Staff has supplied no information about the line-lowering event that would afford a basis for amortizing the cost. Olympic, by contrast, has supplied direct testimony that the work simply restored the line to its prior condition: i.e., brought it back into compliance with regulatory requirements for minimum cover. Ex. 1101T at 13, ll. 18-24; Tr. at 3550:11 through 3554:16; id. at 3615:18 through 3616:12. Although the FERC's requirement that pipelines follow FERC's prescribed units of property system is no longer in effect, FERC does require that pipelines maintain units of property system of their own and notify FERC of any changes. Mr. Talley has testified without contradiction that OPL has continued to use the units of property system previously imposed by FERC under which, for example, replacement of up to 1,000 feet up line would be expensed.

[128] Tr. at 4727:2-21.

[129] Mr. Kermode expressed the view that line-lowering was less routine than pipe replacement but lacked any factual foundation for this opinion. See previous footnote.

[130] Ex. 2001T at 20, ll. 1-5.

[131] Id. at 21, ll. 4-10.

[132] 18 C.F.R. § 346.2(a)(i).

[133] Ex. 601T at 6-9; id. at 22-24.

level for the foreseeable future, there is no basis for the adjustments proposed by Mr. Colbo.

75. The Staff treatment of legal expenses also is flawed. Mr. Colbo incorrectly assumes that the entire $1,004,000 recorded under "Legal and Other Professional Services" relates to rate litigation. However, as demonstrated in Ex. 801T at 14, ll. 3-8, this category includes costs for recurring expenses, including audit fees, security, and safety related services. Only $440,000 of the total is legal costs that include both rate litigation and normal legal expenses.[134]

76. While the portion of legal expenses that do relate to rate proceedings are normally treated as non-recurring items since they are not certain to recur at predictable intervals, they are normally recognized as a cost of doing business and as such are usually normalized over a three- to five-year period in rate proceedings, not eliminated as Mr. Colbo has done.[135] There is no basis for not according this treatment to the ratemaking legal costs OPL has presented. In addition to these costs, Mr. Collins has provided an estimate for the legal and consulting expenses relating to the current rate dispute before the FERC and this Commission of approximately $2.6 million.[136]

c. Disallowance of Expense

77. Staff's proposal to disallow a significant portion of operating expenses is unsupportable for the following reasons:

78. **Relocation Expense**: Mr. Colbo proposes to disallow relocation expenses, stating that: "These expenses are not normal, ongoing expenses related to providing regular service."[137] Relocation of employees needed to operate a pipeline is periodically necessary and is a normal cost of doing business. Absent some showing that OPL's costs are beyond those normally incurred (and there has been no attempt to make such a showing), the suggested disallowance does not meet any of the regulatory criteria enumerated above nor is it consistent with this Commission's treatment of relocation expenses in other proceedings.[138]

---

[134] Tr. at 3267:1-9.
[135] FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,106.
[136] Ex. 701T at 8, ll. 9-13.
[137] Ex. 2001T at 20, ll. 1-5.
[138] Avista Corp., 2000 Wash. UTC LEXIS 558, *128-29.

79. **Dan Cummings:** Mr. Cummings is a Director of West Coast Public Affairs for BP America, Inc. for OPL.[139] Mr. Colbo proposes disallowing 65 percent of Mr. Cummings salary for the Rate Year claiming that this part of his work in the test period was related to Whatcom Creek. However, Mr. Cummings testified,[140] that the majority of his duties are related to meeting the requirements of federal and Washington laws for providing information about OPL to the surrounding communities. There also is no basis for expecting that his activity will be related in any direct manner to Whatcom Creek in the future.

80. **Bayview**: Staff's proposed exclusion of Bayview operating expenses (an issue distinct from including in the rate base the cost of installing Bayview) also is unsupported. Bayview is currently being used for a number of purposes. These functions will continue until the line is restored to 100 percent operating pressure and Bayview is fully integrated into pipeline operations.[141] There is no basis for excluding the actual cost of these functions from operating expenses.

ii. Intervenors's Adjustments

81. With the exception of adjustments to fuel and power costs, Tosco did not challenge OPL's proposed operating expenses.[142] However, Tesoro witness Brown, who admittedly has no pipeline operational experience, proposes to disallow a significant portion of OPL's rate year operating expenses.[143] One reason offered is OPL's reliance on budgeted amounts.

82. The use of budgets for projecting and controlling expenses is the prevailing practice throughout regulated industry and with this Commission. This Commission's regulations require that "public service companies with annual gross operating revenues exceeding two hundred and fifty thousand dollars" must file their budgets with the Commission.[144] The Commission requires that these companies show "amounts needed for construction, operation and maintenance during the ensuing year.[145] Although

---

[139] Ex. 1401T at 1, ll. 8-10.
[140] Ex. 1401T at 3, l. 20 through 4, l. 26.
[141] Ex. 1601T at 13, ll. 3-14.
[142] Ex. 2201T at 4, ll. 8-11.
[143] Tr. at 5029:2-22.
[144] WAC 480-140-020.
[145] WAC 480-140-040.

OPL is exempt from these legal requirements, OPL management prepares an annual budget that includes these items. Accordingly, the OPL budget is an important source of the information relied on for the OPL-31 filing. The budget data reflect OPL's plans for operations and has been approved by management only after a rigorous and detailed process to ensure accuracy.[146] This process is addressed in Section III. The budget is the basis by which OPL management controls and appraises the level of expenditures throughout the year.[147] Further, OPL's rebuttal case updates budget data to reflect the actual expenditures for the period October 2001 through April 2002 and revised projections for the remainder of the period.[148] The updated operating expenses are approximately $2.8 million less than originally projected for budget purposes. This variance is primarily due to fuel and power cost differences caused by delays in the Commission's approval of a Puget Sound Energy rate increase and slightly lower than projected throughput.[149] But for these issues, the revised operating expenses relied on by Mr. Collins are remarkably close to the projections originally relied on for OPL-31.[150]

83. Tesoro makes totally unsupported adjustments to test period data. The most significant effect of these adjustments is to arbitrarily reduce Outside Services (USOA Accounts 320 and 520) for the rate year by approximately $11.9 million as compared to the operating expenses used by Mr. Collins for his rebuttal testimony. This reduction arises from two sources: approximately $3.9 million resulted from Mr. Brown's failure to account for future "known and measurable" changes to outside services during the rate year, and the remaining $8 million is due to the unsupported exclusion of four amounts within Outside Services. First, Tesoro does not provide any reasoned analysis of the likely requirements of outside services for the ~~rate year~~, which results in its arbitrary reduction of $3.9 million. Rather, it relies on ~~test year~~ expenses of approximately $9 million.[151] The correct amount of ~~rate year~~[152]

[146] Ex. 801T at 2, ll. 5-8.
[147] Id. at 2, ll. 8-10.
[148] Id. at 4, l. 17 through 5, l. 1.
[149] Id. at 5, l. 21 through 6, l 1.
[150] Ex. 701T, at 7, Table 1.
[151] Ex. 2402 at Schedule 21.5, l. 7.
[152] The exhibits prepared by Mr. Collins uses the FERC terminology of "Test Period" rather than this Commissions term of "Rate Year" to designate the forward-looking period estimates relied on for determining rates.

Outside Services is approximately $13 million.[153] The $13 million figure was based on a combination of actual results for the period October 2001 through April 2002 and revised budget projections. These represent the "known and measurable" changes for the rate year.

84. Mr. Grasso compounds this error by adjusting the "test period" to account for Mr. Brown's recommendations that various amounts included in the Outside Services Category in the OPL-31 rate filing be disallowed. The amounts removed by Mr. Grasso are the forward looking estimates relied on for OPL-31. Thus, Mr. Grasso takes the amount of Outside Services incurred in the period October 2000 through September 2001 (corresponding to this Commission's "test period" and the FERC's " base period") and reduces various items included in the forward looking estimates for the rate period (October 2001 through September 2002) included in OPL-31. Clearly, the quantity Mr. Grasso adjusts, the actual amounts for October 2000 through September 2001, do not have the forward looking estimates for October 2001 through 2001 in them. Accordingly, even accepting that the disallowances are warranted, which is not the case, applying them to a prior time period is illogical and unsupportable.

85. Mr. Grasso also erroneously relies on Mr. Brown's flawed recommendations that approximately $8 million included in the Outside Services category be disallowed. Specifically, Mr. Brown recommends the following items be either disallowed or substantially reduced.

86. **"One Time Maintenance Costs" ($5.6 Million).** Mr. Brown recommends no allowance of maintenance expenses. He speculates that these costs are unlikely to recur in the future and recommends that they be rejected.[154] He also speculates that a portion of these expenses should be capitalized.[155] Mr. Talley testified that he anticipates that the level of maintenance expense to increase for the next several years.[156] Mr. Ganz affirmed that the maintenance expenditures such as those included in this category are properly recorded as expenses under the Uniform System of Accounts ("USOA"), the accounting standard under which the Form 6 Report filed with this Commission is

---

[153] Ex. 703C at Schedule 21.5, l. 8.
[154] Ex. 2301T at 43, l. 3 through 44, l. 2.
[155] Id.
[156] Ex. 1601T at 23, ll. 5-23.

prepared.[157] Accordingly, Mr. Brown's speculation that the expenditures in this category are not recurring or that they are more properly categorized as capital is incorrect. The amount of these rate year expenses in the OPL-31 filing were approximately $5.6 million and the amount included in Mr. Collins' rebuttal testimony is approximately $5.0 million.[158]

87. **"Remediation Costs" ($1.2 Million).** Mr. Brown recommends no allowance for remediation costs. Mr. Brown speculates that OPL may not spend the amount, that the amounts may improperly include Sea Tac and Whatcom Creek and that these amounts may not be reoccurring.[159] He provides no factual basis for any of these conclusions. The amounts included in this category related to the ongoing expenses for remediation that OPL has projected to span the next several years.[160] The amounts exclude Whatcom Creek[161] but include obligations relating to the SeaTac fuel handling facilities which remainded with OPL even though the facility was sold.[162] The amount of these rate year expenses was approximately $1.2 million and the amount included in Mr. Collins rebuttal testimony is approximately $0.7 million.[163]

88. **Legal and Regulatory Expenses (($0.8 million).** Mr. Brown recommends normalization of legal expenses related to rate litigation over a five-year period.[164] Accordingly, Mr. Grasso removes the entire $1 million and replaces it with a normalized amount of approximately $200,000, a reduction of $800,000.[165] However, Mr. Brown's assumption concerning the composition of the $1 million is wrong. Mr. Collins has demonstrated that of the approximately $1 million, only $440,000 is related to legal expense; including expense related to rate litigation.[166] For the purpose of his rebuttal testimony Mr. Collins prepared an estimate of the total rate litigation costs for the rate year, which he projects to

[157] Ex. 1101T at 13, ll. 8-17.
[158] Ex. 728C at Workpaper 2, l. 5.
[159] Ex. 2301T at 44, l. 3 through 45, l. 2.
[160] Ex. 1601T at 23, ll. 5-23.
[161] Ex. 801T at 13, ll. 4-6.
[162] Id. at 13, ll. 7-9.
[163] Ex. 728-C at Workpaper 2, l. 24.
[164] Ex. 2301T at 45, ll. 3-13.
[165] Ex. 2401T at 13, l. 10 through 14, l. 11; Ex. 2402 at Schedule 21.5, ll. 11.
[166] Ex. 728-C, Workpaper 9-C.

be approximately $2.6 million.[167] Mr. Collins has recommended normalization of these expenses over five years, which is common practice for rate litigation expense.[168] Accordingly the amount of rate litigation expense that is appropriate for inclusion in the rate year is 20% of the total cost, or approximately $525,000, which is the amount included in Mr. Collins rebuttal testimony.[169]

89. **Transition Costs ($455,000).** Mr. Brown recommends that this cost be disallowed claiming that the change in operators was the result of influence by the majority owner and provides no benefit to shippers.[170] The inclusion of a normalized amount for transition costs is appropriate. OPL's Board selected BP Pipelines as the operator after a competitive bidding process at the expiration of the prior operating agreement and prior to when BP became the majority owner.[171] In the Board's, the change in operator necessarily provided a cost-effective alternative to continuation with the prior operator. Accordingly, this change is in the interest of all parties and the associated costs are a normal business expense that may occur from time to time, but with no predictable interval between occurrences, similar to a non-recurring cost. Accordingly, normalization over a five-year schedule is a reasonable approach for rate making.

D. One Time Maintenance Costs

90. The primary issue relating to "One Time Maintenance Costs" arises from efforts by Staff and Intervenors to reclassify recurring major maintenance into either (a) carrier property (capital costs) or (b) non-recurring costs to be amortized over five years.[172] OPL believes these costs are not "One Time" costs and it presents its position in the next section relating to recurring Major Maintenance costs.

91. The ongoing costs for activities to maintain plant and equipment are recorded in the Operations

---

[167] Ex. 701T at 8, ll. 8-13.
[168] FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,106.
[169] Ex. 701T at 8, ll. 8-13.
[170] Ex. 2301T at 45, ll. 14-21.
[171] Tr. at 2893:5 through 2894:11.
[172] A semantic quibble may arise from terminology used by BP. Maintenance projects that have been planned and approved by management under a work order system have been termed One Time Maintenance projects in the past by BP. However, this term relates only to the fact that BP has called such expenses "one time maintenance expenses" because the identical project is unlikely to be repeated in the future. Ex. 815 at. 175, ll. 9-18. Whether an expense is "recurring" for rate purposes is a function of whether a similar expense will occur as the same maintenance work is performed on different sections of the pipeline facilities.

and General expense categories in conformance with the standards of the Uniform System of Accounts.[173] The USOA accounting standard for the Form 6 submitted annually to this Commission states:

> 4-4 *Expense classification*. The primary expense accounts are to be reported under the following classification:
>
> (a) *Operations and maintenance expense*. This group of accounts includes all costs directly associated with the operation, repairs and maintenance of property devoted to pipeline operations….[174]

92. The reclassification of amounts correctly recorded as expenses by OPL[175] to either carrier property or amortization "over a 5 year period" would violate these instructions. However, the fundamental flaw in the proposed disallowance of these operating expenses by both Staff and Tesoro is that they are recurring as explained in Section VI.E.

E. Major Maintenance Costs

93. The magnitude of major maintenance costs will be determined in large part by the increased inspection and repair requirements recently promulgated by the Office of Pipeline Safety (OPS). The OPS has promulgated HCA (High Consequence Area) regulations effective January 16, 2002.[176] These rules apply to OPL and[177] well over seventy-five percent of OPL's pipeline facilities are located in HCA's.[178]

94. The HCA regulations require a program of detailed assessment of the condition of pipeline facilities and is consistent with the program implemented by BP to restore the pipeline to 100% maximum operating pressure.[179] The assessments include internal line inspection to look for third-party damage, corrosion problems, or potential seam defects, and similar instances of deterioration in the integrity of the line.[180]

---

[173] Ex. 1101T at 13, ll. 8-17.
[174] 18 C.F.R. § 352, Instruction 4-4 (a) (emphasis added).
[175] Ex. 2001T at 21, ll. 4-10.
[176] Ex. 1501T at 3, l. 20 through 4, l. 11.
[177] Id. at 5.
[178] Tr. at 4029:1-7; Ex. 1601T at 2, ll. 18-19.
[179] Ex. 1601T at 6-9; Tr. at 4152:3-22; id. at 4169:5 through 4170:14.
[180] Id. at 6-9; id. at 6-10; id. at 23-24; Tr. at 4037:25 through 4039:23; id. at 4103:13 through 4106:11.

95. The effect of the OPS regulations has been, and will in the future be, to increase recurring major maintenance costs well beyond the previous industry norm and OPL's own historic experience for several related reasons. HCA criteria for excavating to inspect the line in response to reported anomalies are more conservative than previous industry standards, and the circumstances under which the line must be shut down or operated at reduced pressure pending repairs have become more stringent.[181] The costs of these actions are further increased by other more stringent environmental, regulatory and permit requirements that apply to the repair and excavation work.[182]

96. It also is inherent in the HCA requirements that these maintenance costs are recurring. The current HCA program on OPL entailing excavation, inspection and repair work is still going on and will not be completed before at least 2004.[183] Further, the operator anticipates the continuing requirements relating to OPS regulations will entail consistently higher maintenance expenses in the future than have been typical in the past.[184]

F. Regulatory Costs

97. There is no provision in the USOA for recording "Regulatory Costs." Accordingly, apart from the costs of the ongoing rate litigation before this Commission and the FERC, that Mr. Collins accounts for, there is no mechanism for identifying the additional costs that OPL incurs due to the multiple levels of regulation. As explained above, regulatory oversight has increased in intensity and breadth and there is no sign of abatement. To the contrary, there is pending legislation at the federal level that will likely add requirements, and costs, to ensure pipeline integrity.[185] Overlying this is the economic regulation by the FERC and this Commission. OPL must devote time and money to comply with regulatory requirements to inform the general public, liaison with public safety and emergency agencies and protect the integrity of its facilities in each of the communities in which it operates.[186]

G. Transitional Costs

---

[181] Ex. 1501T at 4-6; Tr. at 4027:21.
[182] Tr. at 4110:4 through 4111:18.
[183] Ex. 1601T at 4, ll. 6-9.
[184] Tr. at 4041:19 through 4043:24; Ex. 1601T at 69 to 71; id. at 6-9; id. at 23-24.
[185] Ex. 1401T at 16, ll. 21-22.
[186] Id. at 4, ll. 22-26.

98. The change in operator in July 2000[187] occasioned approximately $2.3 million in non-recurring costs. OPL normalized these costs using a five-year schedule. The amount of expense included in the Rate Year is $455,000.[188]

H. Fuel and Power Costs

99. This category includes the cost for electric energy and drag reduction agent ("DRA"). OPL and Staff have arrived at similar projected costs in this category. However, both Tosco's[189] and Tesoro's[190] calculations for fuel and power expenses are marred by the use of electric rates that are substantially lower than the rates paid by OPL during the rate year and because of differences in the parties' proposed throughput levels.

I. Federal Income Taxes

100. Income taxes are included in the Commission's definition of operating expenses.[191] Mr. Collins followed the "normalization" convention, whereby the income tax allowance included in cost of service is determined by applying the prevailing income tax rates to the taxable items included the cost of service calculations. Differences between the tax treatment of items in the cost of service calculations and the tax treatment elsewhere is accounted for in the accumulated deferred income tax ("ADIT") balance.[192] Regulators have deemed that the pre-paid amounts represented by ADIT should be viewed as a source of financing to the company and deducted from rate base.[193] This is the approach that has been followed by all parties in this case.

101. However, the approach taken for implementation of the other aspects of income tax normalization by Staff is not logically consistent. First, Mr. Twitchell[194] uses OPL total tax depreciation for determination of income taxes without adjusting for Cross Cascades, which both Staff and OPL

---

[187] Ex. 1601T at 3, ll. 1-2.
[188] Ex. 703-C at Schedule 21.5, ll. 9-11.
[189] Ex. 2212.
[190] Ex. 2402 at Schedule 22.7, ll. 16.
[191] Ex. 1901T at 12 l. 17.
[192] Williams Pipe Line Co., 21 F.E.R.C. ¶61,260, at 61,656 (1982)
[193] ARCO Pipeline Co., 52 F.E.R.C. ¶61,055, at 61,238 (1990).
[194] Ex. 1904 at 2, l. 11.

remove from the rate base.[195] Including assets for tax depreciation that are not included in the rate base is contrary to well established regulatory principles.[196] The result is an understatement of income taxes, which in turn understates the revenue increase.[197] This problem is aggravated by Mr. Twitchell's erroneous conclusion that FERC 154-B methodology requires the use of "actual interest" when in fact the governing pronouncement requires a determination based on rate base balances.[198] This error results in further understatement of taxes and thus in understatement of the revenue increase calculated by Staff. [199]

J. Other

i. Depreciation

102. OPL claimed $2.798 million as its rate year depreciation expense. Interveners do not take issue with this expense.[200] Staff includes $2.276 million for its rate year depreciation expense. Staff's amount differs from OPL for two reasons: (1) it excludes approximately $0.3 million in depreciation associated with Bayview; and (2) it is based on property in-service for calendar year 2001 and does not take into account approximately $0.3 million in depreciation for forward looking rate year changes in depreciation expense to additions in CPIS during the rate year.

ii. Summary of OPL's Operating Expenses

103. The following table summarizes OPL's operating expenses for the test year and the rate year upon which Mr. Collins' rebuttal cost of service presentation is based:

OPL's Operating Expenses: Exhibit 703-C at Schedule 2

Line	Description	Test Year	Rate Year
			[a]
	OPERATIONS AND MAINTENANCE		
1	Salaries and Wages (300)	$5,885	$5,102
2	Materials and Supplies (310)	$370	$231

[195] Tr. at 4640:9-20.
[196] FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,103-04.
[197] Ex. 1907.
[198] Williams Pipe Line Co., 33 F.E.R.C. ¶61,327, at 61,640 (1985).
[199] Ex. 1907.
[200] Ex. 2412; Ex. 2212.

3	Outside Services (320)	$11,017	$5,322
4	Operating Fuel and Power (330)	$6,185	$8,886
5	Oil Losses and Shortages (340)	$2,642	$7
6	Rentals (350)	$0	$0
7	Other Expenses (390)	$2,308	$668
8	**Total Operations and Maintenance Expenses**	$28,407	$20,216
	GENERAL		
9	Salaries and Wages (500)	$1,616	$1,401
10	Materials and Supplies (510)	$901	$562
11	Outside Services (520)	$6,703	$7,816
12	Rentals (530)	$540	$822
13	Depreciation and Amortization (540)	$2,599	$2,798
14	Employee Benefits (550)	$0	$0
15	Insurance (560)	$600	$909
16	Casualty and Other Losses (570)	$2,711	$0
17	Pipeline Taxes (580)	$1,771	$1,717
18	Other Expenses (590)	$13	$4
19	**Total General Expenses**	$17,454	$16,028
20	**Total Operating Expenses**	$45,861	$36,244

VII. Rate Base

A. Rate Base Methodology

104. Under the FERC Trended Original Cost ("TOC") methodology, as specified in FERC Opinion 154-B, the rate base has three components:1) net depreciated original cost ("DOC") rate base, 2) the starting rate base write-up, and 3) deferred return. The DOC component is the sum of working capital, the original cost of the property, and the gross allowance for funds used during construction (AFUDC) less the sum of the accumulated depreciation, accumulated amortization of AFUDC, and accumulated deferred income taxes.[201]

105. Under FERC methodology, the return is determined with reference to the rate base. OPL has presented its case under this methodology and is seeking a return only on its rate base, determined by the TOC method.[202] Any suggestion that OPL is seeking a return on invested capital is simply wrong, nor does it matter in determining OPL's return whether its debt exceeds its invested capital.[203] Even if this Commission adopted a DOC method, OPL would still be seeking a return only on its rate base (though any such change would unfairly undercompensate OPL on its rate base).[204]

B. Starting Rate Base Calculation[205]

106. The purpose of the starting rate base is to allow the company to earn a return on this portion of its carrier property, but not to allow the company to recover the amount of the write-up itself. The starting rate base write-up to the equity portion of the rate base is the difference between the starting rate base and the net depreciated original cost.[206] It consists of the sum of the net depreciated original cost times the pipeline debt ratio, and the current cost of building the pipeline depreciated by the same percentage as the book original cost rate base has been depreciated times the equity ratio.[207] The debt

---

[201] Ex. 713 at 5, l. 1 through 11, l. 20.

[202] Ex. 703C, Schedule 1 at 1, and Schedule 3 at 3.

[203] Staff appears to be concerned that OPL is seeking a return based on invested capital, but the use of the FERC methodology assures that this is not the case. Tr. at 4808:14 through 4809:7.

[204] See Ex. 706C, Schedule 1 at 1, and Schedule 3 at 3.

[205] The history and purpose of the Starting Rate Base have already been explored in Section IV.

[206] ARCO Pipeline Co., 52 F.E.R.C. ¶61,055, at 61,236.

[207] Ex. 703C, Schedule 10 at 16-17; FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,836; ARCO Pipeline Co., 52 F.E.R.C. ¶61,055, at 61,236.

ratio and equity ratio used in the calculation are based on the capital structure as of June 28, 1985, because the purpose is to avoid the unfairness that would otherwise arise from the change to the TOC method effected by FERC Opinion No. 154-B issued on that date.[208] The effect of the Starting Rate Base is to provide a return on the starting rate base write-up, but not to include this so-called "rate base" in carrier property that is itself recovered in rates.[209] The amortization time period for the starting rate base is the remaining useful life of the pipeline assets as of December 31, 1983.[210] There is no apparent difference of view regarding this method of calculation.[211]

C. Deferred Return (Calculation)

107. The purpose and background of the deferred return, which is the central feature of the TOC method, is discussed in Sec. IV. The trending base is computed as the sum of the net depreciated original cost rate base which has been funded by equity, the unamortized starting rate base write-up, and the accumulated net deferred returns.[212] Annual deferred returns are calculated by multiplying the trending base by the inflation rate.[213] There is no apparent issue regarding the method of calculation.[214]

D. Bayview

108. Staff, Tesoro, Tosco and OPL each have different viewpoints on the treatment of the Bayview Terminal for cost of service purposes. Tosco witness Dr. Means does not explicitly express an opinion on whether Bayview should be part of carrier property in service or treated in some other manner,[215]

---

[208] Ex. 703C, Schedule 10 at 16, l. 22; FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,087; FERC Opinion No. 154-B, 31 F.E.R.C. ¶61,377, at 61,839 n.43. See Sec. IV.

[209] Ex. 703C, Schedule 1 at 1, Schedule 3 at 3, and Schedule 5, at 5-6; ARCO Pipeline Co., 52 F.E.R.C. ¶61,055, at 61,236-37.

[210] Ex. 703C, Schedule 10 at 16, l. 24 and Schedule 11 at 18, l. 12; FERC Opinion 435, 86 F.E.R.C. ¶61,022, at 61,090.

[211] Since Tesoro witness Mr. Brown (Ex. 2301T at 29, ll. 11-15) and Staff witness Mr. Twitchell (Ex. 1901T at 25, l. 20 through 26, l. 4) reject the use of a starting rate base, there is not a starting rate base calculation method to describe for Tesoro and Staff. Tosco witness Dr. Means expresses no opinion on starting rate base, but he also uses a rate base-The rate base employed by OPL. Ex. 2201T at 2, l. 1 through 4, l. 23. The absence of any basis for their rejection of the use of starting rate base is explained in Sec. IV.

[212] Ex. 703C, Schedule 9 at 14-15; FERC Opinion No. 435, 86 F.E.R.C. ¶61,022, at 61,090-92.

[213] Ex. 703C, Schedule 9 at 14-15; FERC Opinion No. 435, 86 F.E.R.C. ¶61,022, at 61,090-92.

[214] Since Tesoro witness Mr. Brown (Ex. 2301T at 26, ll. 3-18) and Staff witness Mr. Twitchell (Ex. 1901T at 28, l. 19) reject deferred returns, there is not a deferred returns calculation method to describe for those witnesses. Tosco witness Dr. Means expresses no opinion on this topic (Ex. 2201T at 2, l. 1 through 4, l. 23), but he also uses a rate base--the rate base employed by OPL.

[215] Ex. 2201T at 2, l. 1 through 4, l. 23.

but he includes it in his rate base. Tesoro witness Mr. Brown recommends that the Bayview Terminal be considered as being in service if the additional volume associated with Bayview is included in the calculation of tariff rates.[216] Staff witnesses Mr. Elgin[217] and Mr. Colbo[218] recommend removing Bayview from the rate base, but allowing AFUDC on the Bayview investment until it is ready for its intended use. OPL witness Mr. Talley stated that Bayview Terminal is currently used and useful[219] implying it should be in the rate base.

109. OPL's Bayview tank facility will enhance throughput, which occurs in two main ways: 1) minimizing the effect of maintenance shutdowns and delayed shipments of throughput[220] and 2) maximizing efficiency by creating larger batches of compatible product.[221] The first contribution occurs when the northern line section is closed for maintenance or line inspection or a shipper fails to deliver product on schedule.[222] In both cases, the operator can ship product stored at Bayview and maintain throughput in the southern line section. The second contribution occurs when product can be sent in large batches so that it is possible for a single product run to meet the demands of several locations using lines branching off the main lines. Use of branch lines increases the overall flow rate through the main line above what is possible where only the main line operates. Bayview enables adding stored compatible product to a scheduled run which increases the compatible batch size and enhances the strips made, thereby increasing the flow rate.[223]

110. Bayview was operational only for a short time before the June 10, 1999 accident. Since it takes time for shippers and OPL to learn to maximize the benefits of batching product, there is no data from actual experience with maximum utilization of Bayview.[224] The projected improvement in throughput of 4.375 million barrels per year ("BPY"), is based on compairing the throughput projection

---

[216] Ex. 2301T at 34, l. 10 through 35, l. 9,
[217] Ex. 2101T at 15, ll. 20.
[218] Ex. 2001T at 32, l. 16 through 33, l. 16.
[219] Ex. 1601T at 3, ll. 11-21; id. at 10, l. 6 through 15, l. 22; id. at 18, ll. 5-9.
[220] Ex. 1601T at 10, l. 20 through p. 11, l. 7; Tr. at 4077:23 through 4078:9.
[221] Ex. 1601T at 10, l. 15 through 11, l. 7; Tr. at 4078:17-25.
[222] Ex. 1601T at 10, l. 20 through 11, l. 3; Tr. at 4077:23 through 4078:9.
[223] Ex. 1601T at 10, 15-20; Tr. at 4078:17-25; Ex. 1609 at 15:7 through 21:2.
[224] Ex. 1601T at 11, ll. 9-10; Ex. 1609 at 15:21; Id. at 20:5-7 ("I don't think any of the shippers had adjusted their operations to take advantage of Bayview").

in OPL's tariff filing No. 19, of 116,974,000 BPY, with the next filing in 1998, of 121,349,000 BPY, where Bayview was the only line change between the two filings affecting throughput.[225] OPL has found no basis for the prior operator's statement in the 1998 filing that Bayview will contribute 30-35,000 barrels per day ("BPD") in enhanced "capacity," an error of academic interest only since"capacity" is the theoretical maximum flow for the line.[226] Throughput is a determination of the flow actually achievable in the real world of pipeline operations, and is affected by daily events.

111. Bayview's current status does not suggest the investment was imprudent nor is it any less "useful" than other pipeline parts. Bayview enhances efficiency and safety currently by providing three functions. First, Bayview provides overpressure protection by providing tanks into which relief valves connected to the main line from Anacortes can discharge product in case of a pressure surge.[227] Second, Bayview is the headquarters for the northern area maintenance team, including warehousing for cathodic protection equipment, manifolds, pumps, smart pig supplies, spare parts and other material, vehicle housing and office space, all of which speeded OPL's compliance with the requirements for returning the northern section of the line to operation, and in satisfying the subsequent regulatory requirements for 100% MAOP.[228] Third, Bayview provides facilities for maintenance of cathodic protection and other equipment used in the maintenance and monitoring of the northern section of the pipeline facility, diesel storage for smart pig runs and water for hydrostatic testing (avoiding the need to locate a source and providing a storage location for the contaminated water after testing).[229]

E. Average v. End-of-Period

112. OPL and the Intervenors rely on the average of the beginning and end of period balances for determination of rate base.[230] Staff, citing magnitude of capital investments recently made by OPL,[231] relies on this Commission's practice of relying on end of rate period balances in such circumstances and

---

[225] Ex. 1601T at 17, ll. 9-18.
[226] Ex. 1601T at 16, l. 2 through 17, l. 18.
[227] Ex. 1601T at 11, ll. 4-5; id. at 12, ll. 13-24.
[228] Id. at 13, ll. 3-14; Tr. at 4146:6-12.
[229] Ex. 1601T at 13, ll. 3-14.
[230] Ex. 709C 22:1-4.
[231] Ex. 1901T at 53, ll. 7-9.

includes end of period construction work in progress in rate base. OPL agrees that given OPL's current circumstances Mr. Twitchell's reliance on this Commission's precedent is appropriate.[232]

F. CWIP

113. CWIP is Construction Work in Progress. CWIP is the capital spent on projects in progress which have not yet been completed. Once the projects are completed and put into service, they are reclassified as carrier property in service. A return is allowed on CWIP which is recovered over time after the project is completed and becomes carrier property in service.[233] The allowed return on CWIP is called AFUDC which is defined in subsection G below.

G. AFUDC

114. AFUDC is Allowance for Funds Used During Construction. AFUDC is earned on the CWIP balance. In other words, AFUDC represents the return on money spent on a project while it is being constructed. AFUDC is not recovered immediately when the project is completed and is put into service. Instead, AFUDC is recovered over time in increments like depreciation of carrier property.[234]

VIII. Capital Structure

A. Actual Capital Structure

115. No party has argued that OPL's actual capital structure of 100% debt should be used for ratemaking purposes. The issue is what hypothetical structure to use and whether OPL's 100% debt structure should affect the result. OPL is wholly-owned by two large integrated oil companies (BP and Shell) which supply OPL's financing by infusions of cash or by guaranteeing loans by third parties,[235] who in turn measure OPL's creditworthiness based on its cash flow[236] and its parents' equity, not OPL's equity.[237] OPL's equity ratio is irrelevant from the standpoint of OPL's potential sources of financing.

---

[232] Wash. Water Power Co., Docket No. U-80-13 and U-80-14, Third Supplemental Order, at 6 (Jan. 26, 1981); Wash. Natural Gas Co., Docket No U-80-111, Third Supplemental Order, at 6 (Sept. 24, 1981)

[233] Ex. 713 at 5, l. 17 through 6, l. 2; FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,839 n.38.

[234] Ex. 713 at 5, l. 17 through 6, l. 2; FERC Opinion 154-B, 31 F.E.R.C. ¶61,377, at 61,839 n.38.

[235] Ex. 1701T at 23, ll. 17-18.

[236] Tr. at 4395:21 through 4396:5.

[237] Ex. 201T at 93, ll. 10-17.

116. This Commission has expressed concern over OPL's lack of equity,[238] and Tesoro and/or Staff have advanced the following propositions relating to OPL's 100% debt capital structure:

a. The Commission should require OPL's parents to increase equity and penalize OPL by applying a debt cost rate to most,[239] or all,[240] of OPL's rate base[241] until this occurs. The Commission should do so[242] in part because the cash infusion of $97 million from OPL's parents' has been in the form of loans and should have included equity,[243] and in part because OPL needs approximately 40% to 50% equity to provide a cushion for financial setbacks,[244] and to enable OPL to borrow without parent guarantees.[245] It is urged that, if OPL had had such an equity position before both the Whatcom Creek accident and the regulatory response to the ERW seam failure, it would not have needed the cash infusions that its parents actually made to address these problems.[246]

b. OPL should have paid out less in dividends in the period 1990-97.[247]

c. OPL's debt of nearly $150 million exceeds its carrier property in service of approximately $98 million,[248] and OPL may be presenting its case based on what is needed to retire the debt.[249]

For the following reasons, these views are either in error or not relevant:

117. Equity is not cash. It is a claim on assets in favor of shareholders. If, for example, the shareholders elected today to convert half the loans on OPL's books to equity, no change in OPL's available cash would occur.[250] Therefore, the percentage of equity that existed as of 1998 is irrelevant to OPL's cash needs[251]--those needs are simply a function of what portion of OPL's assets are in cash. Even if OPL had had 50% equity at the end of 1998, the incremental equity would have represented a

---

[238] Tr. at 2436:23 through 2437:17; id. at 2442:7-15.

[239] Staff witness Dr. Wilson recommends an 80% debt capital structure. Ex. 301T at 49, ll. 8-10. This recommendation is supported by Staff witness Mr. Elgin. Ex. 2101T at 7, ll. 1-14.

[240] Tesoro witness Mr. Hanley recommends a 100% debt capital structure. Ex. 401T at 22, l. 14 through 23, l. 2.

[241] Ex. 401T at 21, l. 13 through 22, 1. 6; Ex. 2301T, at 36, l. 15 through 37, l. 2.

[242] Tosco makes no such recommendation but suggests that an equity cushion might be beneficial. Ex. 2201T at 21, l. 1-16.

[243] Tr. at 876:2-12; Ex. 401T at 15, ll. 6-10; Ex. 2101T at 15, ll. 1-4.

[244] Ex. 2101T at 17, l. 19 through 18, l. 8.

[245] Id.; Tr. at 2603:18 through 2604:16.

[246] Ex. 2101T at 17, l. 19 through 18, l. 8.

[247] Id. at 4, l. 13 through 6, l. 2.

[248] Id. at 8, ll. 16-19.

[249] Tr. at 4378:19-21.

[250] Id. at 4456:20 through 4457: 6.

[251] Id.

total value (not a cash asset) of only $28 million,[252] a far cry from the $97 million that had to be infused to keep OPL operating safely and in compliance with regulatory requirements, not counting the current need for $20 million.[253]

118. Further, requiring OPL today to have a 40-50% equity share of capital would not affect OPL's access to cash either from its parents or from third parties, especially under OPL's current circumstances. With cash on hand of about $10 million, all of which is committed to imminent operations,[254] OPL could not respond to a future emergency or to the increased requirements regulators have imposed without either relying entirely on its parents' backing to obtain cash in the form of loans or relying partially on cash flow from operations to secure such loans from third parties, or both. Neither the parents nor a third party lender would care what percentage of equity OPL had in deciding whether to furnish cash since the source of repayment to which they would look would be the parents' guaranty and/or actual earnings multiples,[255] not the prospect of owning part of a pipeline facing the problems OPL has (which is all that equity would provide). Under the Staff and Intervenor proposals, cash from operations will barely cover Operations and Maintenance expenses when a normal ratio is close to two times such expenses.[256] This outcome would preclude third party borrowing and would provide no basis for a parent equity infusion either[257]--a problem that would be unaltered if the parents decided tomorrow to convert half the balances on their existing loans to equity.[258]

119. OPL's ability to "weather the storm" of the Whatcom Creek accident, ERW seam failure, and increased regulatory requirements would not have been enhanced had its equity ratio on June 10, 1999,

---

[252] Ex. 2102R. The amount of $28 million is computed from figures on Ex. 2102R. $15,143 thousand in equity for 1998 divided by $87,052 thousand in property for 1998 equals a 17.40% equity ratio in 1998. Thus, to achieve a 50% equity ratio in 1998 based on 1998 carrier property of $87,052 thousand would result in equity for 1998 of $43,526 thousand (0.5 times $87,052 thousand). The difference between $43,526 thousand and $15,143 thousand is $28,383 thousand.

[253] Id. at 4371:11-15.

[254] Tr. at 4376:17-20; Ex. 1601T at 5 (Approximately $66 million required to achieve 100% MAOP, comply with regulatory requirements and for other safety-related capital spending).

[255] Tr. at 4397:1-17; id. at 4514:14-23; id. at 4526:12-21.

[256] Id. at 4522: 5 through 4523: 11; id. at 4527:19-21.

[257] Ex. 501T at 3, ll. 4-19.

[258] Tr. at 4454:8-16.

been 50% rather than what it was, approximately 20%.[259] The difference in equity would have been equal to only a value of about $28 million.[260] Nor would a higher equity percentage allow OPL to borrow or spend without parent approval as Staff suggest[261] since BP Pipelines and its executives who act as OPL's operator must secure Board (composed of parent designees) approval for any significant borrowings or expenditures either through the annual budget process or through approval of actions outside that budget.[262] Even if equity were cash (which it is not) and even if OPL had ample cash on hand (which conversion of debt to equity would not provide), any outlay not covered by the budget would require approval by the Board consisting of parent representatives.

120. Over the period 1990-98, OPL paid dividends to its parents totaling $51.550 million,[263] or about 77% of its income, and from 1996 to 1999 the dividend payout was only 45%.[264] Since 1996, OPL's parents retained within OPL about $11 million in earnings and they injected an additional $97 million of cash into OPL,[265] making their net investment since 1990 $56.45 million. The have not received a dividend since 1997. No witness has testified that, had the parents left more money in OPL, they would have been willing to infuse a greater net amount over this period, or that they would be more willing to do so in the immediate future. The unalterable fact is that OPL's ability to meet financial burdens depends on a) the sums its parents provide and b) its earnings, which in turn are directly related to the former. While borrowings normally give rise to an obligation to pay interest, equity also has associated costs since no rational investor infuses cash as equity without a reason to anticipate a fair return.[266] OPL's parents have not received interest payments on loans for over two years and do not anticipate receiving any in the near term,[267] so, from a cost standpoint, it has not made and will not make

---

[259] Id. at 4846.

[260] See above in this section.

[261] Ex. 2101T at 17, l. 19 through 18, l. 8.

[262] The budget provides operational latitude to Olympic's operator, but, any significant activity not covered by the budget must be approved by BP and Shell.

[263] Ex. 2102R.

[264] Id.; Ex. 2116; Tr. at 4832:1 through 4833:5; Id. at 4839: 10 through 4840: 10. Also, Mr. Elgin admitted that OPL's dividend payout rate from 1990-98 was more conservative than the oil pipeline company proxy group and many of the entities regulated by this Commission. Id. at 4827:3 through 4833: 5.

[265] Tr. at 2782:21 through 2783:5; Ex. 501T at 4, l. 17.

[266] Tr. 4514:14-23; Ex. 501T at 2, ll. 18-24.

[267] Ex. 501T, p. 4, ll. 16-20; Tr. at 4436, ll. 1-8. Olympic's owners might possibly recover the principal on their

a difference to OPL whether cash is infused as a loan or as equity.[268]

121. The ratio of OPL's debt to carrier property has no bearing on the return OPL should earn on the latter or on the calculation of OPL's cost of service. OPL's return on rate base, which is part of the cost of service, is calculated using a hypothetical capital structure, an embedded cost of debt, a cost of equity, and OPL's carrier property in service, which is $92.7 million based on OPL's rebuttal testimony.[269] The amount of OPL's actual debt is not relevant to these calculations.

B. Hypothetical Capital Structure

i. Historical Capital Structure

122. All parties have proposed hypothetical capital structures for OPL. Mainly because OPL depends entirely on its parents for funding (whether via cash contributed as equity or cash from foregone dividends--which are equivalent--or cash loans or guarantees of third party loans), the proper hypothetical equity ratio for OPL is one that mirrors their equity ratio, or 86.85% at the end of 2001.[270]

123. Staff and Intervenors take a variety of approaches in opposing use of the parents' equity ratio. Some look to the equity ratios of the five oil pipeline companies in the oil pipeline proxy group,[271] which have an average equity ratio from 1996-2001 of 49.28%, a ratio of 49.43% in 2001,[272] an average low equity share in 1996-2001 of 40.96%, an average high of 61.35%,[273] and a median over the six years

---

loans with a 20% tariff increase, but this is not expected to occur until after 2011. Ex. 1701T at 3, ll. 8-9.

[268] Tr. at 4377:13 through 4378:16. The suggestion by Hanley that OPL's parents have treated OPL in a manner akin to the American Water Resources Inc. (AWRI) case is far wide of the mark. AWRI was a small water company owned by an individual who assembled small water systems into a large one to provide high-quality and reliable service. Service actually fell far short of this standard, and the individual was taking money out of the system at the expense of even adequate operation (AWRI ALJ Order at 4-6) with resources "stretched increasingly thin to the point that it has reduced staff, eliminated routine communication with customers, eliminated convenient means by which customers can contact the company, and has put on hold all repairs not necessary to simply 'keep the water flowing.'" AWRI ALJ Order at 18. The owner was extracting funds for unrelated purposes at the expense of providing even basic service vs. a net investment by OPL's owners to enhance safety and performance since 1990 of $56.45 million.

[269] Ex. 703C, Schedule 3 at 3, l. 1.

[270] Ex. 201T at 6, l. 10.

[271] The five companies in the oil pipeline proxy group are: (1) Buckeye Partners, L.P.; (2) Enbridge Energy Partners, L.P.; (3) Kaneb Pipe Line Partners, L.P.; (4) Kinder Morgan Energy Partners, L.P.; and (5) TEPPCO Partners, L.P. Ex. 220; SEC 10-K filings for proper company name.

[272] Ex. 220.

[273] Id.

of 47.4%.[274] Dr. Means recommends using the median of 47.4%.[275] Mr. Hanley recommends the average for 2000 (46.4%)[276] but only if OPL's parents actually create such a ratio with the equity percentage otherwise deemed to be zero.[277] Dr. Wilson proposes an equity share of 20% if OPL's owners are unwilling to commit to infuse substantial equity as the mechanism for providing the cash required to restore 100% operating pressure and compliance with new regulatory requirements.[278] If they do so, he recommends use of an equity share up to 50%.[279] Mr. Elgin recommends using an equity share of 20% with OPL filing for new rates if a higher equity ratio is created.[280]

ii. Use of Parents' Capital Structure (Excluding FERC Rationale)

124. As previously outlined, the financial strength of OPL is the financial strength of its parents coupled with their willingness to lend that financial strength to OPL, which in turn is a function of OPL's earnings. Regardless of whether cash infusions take the form of a claim on assets with an expected return (equity), a third party loan guaranteed by the parents (obtainable with a reasonable level of earnings) or a direct parent loan, OPL cannot meet its capital spending objectives except via cash or cash equivalents from its parents. This situation would not differ if OPL had higher "equity," such as via a conversion of current debt to equity.

125. OPL's rate case reflects the assets already created with a substantial part of the $97 million of cash the parents have infused into OPL recently.[281] A fair return predicated on that rate base (which necessarily will include coverage for operations and maintenance expenses approaching the normal industry ratio of 2, not the proposed Staff ratio of 1), will provide the basis for further infusions up to the $66 million required to achieve capital spending goals and thereby ensure the long-run safety and

---

[274] Id.

[275] Ex. 2201T at 2, ll. 15-17.

[276] Ex. 401T at 2, 1.19 through 3, l. 1.

[277] Id. at l, l. 17 through 5, l. 5.

[278] Dr. Wilson cites the AWRI matter discussed above as a precedent for his 20% lower bound on Olympic's equity share. Ex. 301T at 49, l. 16 through 50, l. 2.

[279] Id. at 49, ll. 5-13.

[280] Ex. 2101T at 7, ll. 1-14.

[281] See, e.g., Tr. at 2932:14 through 2933:1 (of $53 million infused by ARCO, $36 million was spent on capital projects and the balance on major maintenance and safety items).

reliability of the system at 100% allowable operating pressure.[282] OPL's parents have done their part of the "regulatory compact." The Staff and Intervenors' approach to setting capital ratios, combined with their approach to disallowing proper operating expenses to the point where no revenue remains after normal operations and maintenance activities, would penalize the parents for responsible behavior in the past and discourage them from making the future investment OPL requires to provide safe, reliable and full service. Staff's approach appears to be summed up in Mr. Elgin's testimony when in response to Chairwoman Showalter he admitted that Staff's position was essentially a case of playing "chicken" with OPL's owners in an effort to force them to provide yet more funding to OPL or to force OPL into bankruptcy.[283]

126. In earlier decisions, the Commission stated that a regulated entity's risk determines its appropriate equity share of capital. The Commission's criterion reflects what the market requires: the higher the business risk faced by a regulated entity, the higher equity ratio the market place requires.[284] As the Commission has noted, it "does not set the cost of equity, but rather it determines what the market requires."[285] The same concept applies to capital structure.[286]

127. The choice of the appropriate share of equity for OPL rests on an assessment of OPL's risk. For two reasons, OPL's risk should be equated to that of its parents in making this assessment. First, viewed as a stand-alone enterprise, OPL faces a combination of operating and competitive risks that support an equity ratio in that range. Second, OPL is a financial creature of its parents, so its financial risks are theirs. In fact, Dr. Wilson described OPL as being an integral part of BP and Shell's refinery operations which, he asserted, made OPL less risky.[287] He thus concedes the equivalency of OPL's risk profile to that of its parents.

128. Even if the Commission focuses on the oil pipeline proxy group, there is every reason to choose

---

[282] Ex. 1601T at 2, ll. 2-4.
[283] Tr. at 4917:20 through 4918:21.
[284] WUTC v. GTE Northwest Inc., 1994 Wash. UTC LEXIS 92, at *6-9 (Dec. 21, 1994); Ex. 223 at 54, ll. 992-994.
[285] GTE Northwest Inc., 1994 Wash. UTC LEXIS 92, at *10.
[286] Ex. 223 at 54, l. 995 through 55, l. 1009.
[287] Tr. at 2521:14-19.

an equity ratio for OPL above the highest levels of those companies because of OPL's competitive, operational and financial risk profile, even if viewed entirely independently of its parents' risk profile.

129. Staff and Intervenor witnesses admitted that OPL is much smaller financially, and in terms of miles of pipeline, far less diverse and geographically riskier than any of the five proxy companies.[288] Further, Dr. Wilson agrees that OPL's pipeline is more than 80 or 90% located in High Consequence Areas (HCA) as defined by the federal government and is in a seismically active geographic area.[289] These elements create much higher operating risks for OPL than the proxy group experiences, as Dr. Wilson conceded.[290] The efforts of Staff and Intervenor witnesses to refute this proposition were shown on cross-examination to lack both foundation in fact and foundation in expertise.[291] For example, Mr. Hanley does not "hold himself out to be an expert in oil pipeline operational risks" because, in his words, "I try to maintain my expertise within the area of finance and cost of capital."[292]

130. OPL's higher operating risks include: (1) OPL's pipeline is almost uniformly located in high-consequence and an environmentally sensitive areas with high seismic activity; (2) it runs over difficult terrain with significant elevation changes; (3) it has many water crossings whose maintenance is costly; (4) it is subject to disruption by landslides arising from tectonic activity; (5) much of the line is situated on steep slopes making maintenance difficult and costly; and (6) it has a high percentage of pipe with potential ERW seam failure issues.[293] None of the oil pipelines in the proxy group faces this broad an

---

[288] Drs. Means and Wilson agreed that all five members of the oil proxy group are much larger, financially, than Olympic. Id. at 3705: 21 through 3706:9; id. at 2504:6-9. Dr. Wilson stated that Olympic is "a lot smaller than Kinder Morgan, a lot smaller than Colonial. A lot smaller than a lot of these companies." Id. at 2504:6-9. Drs. Means and Wilson agreed that all are much larger than Olympic in terms of miles of pipeline. Id. at 3706:10-23; id. at 2503:20 through 2505:17. Dr. Wilson states that Kinder Morgan, for example, has 10,000 miles of natural gas pipeline and about the same miles of oil pipeline. Id. at 2505:14-16. Drs. Means and Wilson agree that all are much more geographically diverse than Olympic. Id. at 3706:20-23; id. at 2504:17 through 2506:24.

[289] Id. at 2511:20 through 2512:13.

[290] Id. at 2523:15-20.

[291] Ex. 201T at 5, ll. 3-20. These witnesses were shown to have almost no knowledge of the operational issues facing Olympic, the oil pipelines in the oil pipeline proxy group, or other oil pipelines. Tr. at 2654:14 through 2659:12, id. at 5029:2-16, id. at 5034:13-25, id. at 5037:22 through 5040:11, id. at 3710:21 through 3711:21, id. at 2511:9 through 2515:10.

[292] Tr. at 2661:15-18.

[293] Ex. 1601T at 2, l. 1 through 3, l. 10, id. at 4, l. 22 through 5, l. 11; Ex. 601T at 5 through 6; Ex. 1401T at 8, l. 1 through 10, l. 8; Ex. 1501T at 4, l. 12 through 6, l. 22.

array of operational risks.[294] Nor have Staff and Intervenor witnesses credibly refuted OPL's evidence of its operating risks. These witnesses had no pipeline operational experience and were generally unfamiliar with the new federal regulations on oil pipelines. The only testimony on operational risks and costs from knowledgeable experts was from OPL.[295]

131. OPL faces far greater financial risk than any of the proxy group companies, unless, of course, one posits that OPL is the financial creature of its parents, a proposition which leads straight to use of the parents' equity ratio. The alternate proposition is that OPL should be viewed as a stand-alone business with its own financial risk profile. There is no comparison between OPL's financial vulnerability and that of the proxy group companies. The average capitalization for the proxy group companies is $1.5 billion compared to OPL's less than $100 million.[296] Dr. Wilson states that all have product diversification, such as natural gas and carbon dioxide, which OPL does not.[297] OPL also has suffered severe financial setbacks and, but for the willingness of its parents to inject large amounts of cash, OPL would be bankrupt.[298] None of the oil pipeline proxy group companies are in such dire financial straits.[299] OPL's operating risks aggravate its financial risk by making OPL much more vulnerable than the proxy group to unpredictable future costs such as the cost of meeting regulatory requirements (e.g., because of the increasing percentage of the line in HCA's and other factors),[300] of finding and repairing third-party damage of the kind that precipitated the Whatcom Creek rupture (because of urbanization in HCA's, requiring, e.g., new water lines in areas near the pipeline), of an

---

[294] Tr. at 2424:2-13, id. at 2657:14 through 2658:19, id. at 3710:21 through 3711:21, id. at 2510:17 through 2515:10.

[295] Ex. 1601T at 2, l. 1 through 2, l. 10, id. at 4, l. 22 through 5, l. 11; Ex. 601T at 5 through 6; Ex. 1701T at ll. 5-20; Ex. 501T at 1, l. 18 through 3, l. 4, id. at 4, ll. 5-15; Ex. 1401T at 8, l. 1 through 10, l. 8; Ex. 1501T at 4, l. 12 through 6, l. 22.

[296] Tr. at 2652:21 through 2653:37.

[297] Id. at 2505:24 through 2506:24.

[298] Id. at 3663:22-25.

[299] Ex. 201T at 59, l. 22 through 60, l. 4.

[300] As Dr. Means states, "[c]learly, Olympic has taken a major hit because of the Whatcom Creek incident, and that's true whether you think it was their fault or wasn't their fault." Tr. at 3709:15-18. Increased future risk of another "major hit" is an unavoidable indirect result of Whatcom Creek that objective investors will not ignore. As Dr. Means said, "[t]he expectations of investors in such a company will be determined by the business prospects of the company. But, assuming it has good business prospects, will be, to large extent determined by their expectations regarding the regulatory treatment." Id. at 3684:15-20. Regulatory treatment should not be limited to just rate regulation, but should extend to safety and environmental regulation as well.

actual rupture and interruption of operations because of such damage,[301] of needing to address potentially faulty weld seams in a significant portion of its system, and of needing to repair/lower line sections because of earthquake and other earth movement events such as erosion in or near the numerous watercourses in Western Washington.

132. OPL also faces genuine competitive risk despite the fact that it runs at maximum achievable throughput because of demand. The demand is high because OPL's prices are lower than those charged by the competition, which is primarily water-borne transportation. The fact that OPL experiences high demand by competitively pricing its services means that it has competition and is meeting it. As Dr. Schink testified in response to a question by Chairwoman Showalter, "[t]he fact that they [OPL] are able to be full doesn't mean there isn't competition. All you have to do to stay full is to charge less than your competitors."[302]

133. The FERC has evaluated the extent of competition and thereby business risk faced by oil pipelines, as has the U.S. Department of Justice, and both have concluded that waterborne transportation is a strong competitors.[303] OPL faces greater competition from waterborne transportation than the oil pipeline proxy group companies.[304]

134. The two main paths taken by the parties in seeking an appropriate hypothetical equity ratio do not, when properly followed, lead to dramatically different results. If OPL is regarded as a stand-alone company, then the protection afforded by its parents must be disregarded, and its risk profile is far higher than that of the proxy group companies. The proper conclusion from making this comparison is an equity ratio significantly higher than the high end of those companies. If OPL is regarded as a

---

[301] Mr. Wilson said, "I think that a major risk that Olympic faces is the type of interruption that has occurred, which is the essence of its cash flow problem." Id. at 2509:7-9. He also stated that "[t]he risk of not being able to operate is the biggest risk that any type of business faces, and there are a variety of things that can lead to that." Id. at 2510:6-8. Mr. Wilson agreed that "interruption can occur for any number of reasons on Olympic's system including earthquakes, third-party damage, sabotage, poorly manufactured pipe, regulatory decisions of safety, regulatory decisions on environment, accidents." Id. at 2510:10-16.

[302] Id. at 2467:7-10. As confirmed by Dr. Means in his testimony, the fact that Olympic has been fully utilized does not mean that it does not face competition. Ex. 2201T at 17, ll. 9-14.

[303] See Williams Pipe Line Co., 71 F.E.R.C. ¶61,291, at 62,138; Department of Justice, *Oil Pipeline Deregulation* at 36 and 64 n. 75.

[304] Ex. 201T at 59, l. 21 through 60, l. 7.

convenience for its refinery-owning parents that they operate as essentially a financial division, then the equity ratio should be that of the parents.[305] In truth, OPL is not at either of these extremes. It is a separate company; its parents do not treat it as a division but in fact often have conflicting views regarding its direction. But, from a financial standpoint, OPL is entirely dependent upon its parents for its future capital needs. And the parents, like any lender or investor, must consider the operational and competitive risk factors that OPL faces in determining the level of return they require as an inducement to make further investments.

135. The upper end of the equity share range for the oil pipeline proxy group companies over the past five years has averaged 61.35%.[306] Because OPL has a higher risk profile than any of those companies, the market will demand a higher equity share for OPL than 61.35%.

136. If the Commission assigns an equity share of capital to OPL that is less than the market requires, potential investors in OPL will be unwilling to continue to invest in OPL.[307] An allowed equity share of capital which is too low has the same effect on the behavior of potential investors as an allowed return on equity capital which is too low.[308] These potential investors will invest elsewhere thereby denying OPL access to the funding it needs to restore 100% operating pressure and to ensure the long-run reliability and safety of the pipeline system.[309] The fact that these potential investors are OPL's parents does not affect this outcome because BP and Shell, as major international integrated oil companies, will invest their funds where they can obtain appropriate market returns. If an appropriate market return is not available from OPL, these funds will be invested elsewhere.[310]

IX. Rate of Return

A. Cost of Debt

---

[305] As noted above, Dr. Wilson described Olympic as being an integral part of BP and Shell's refinery operations which, he asserted, made Olympic less risky. If Olympic is an integral part of BP's and Shell's operations in the Northwest, and Staff witness Dr. Wilson is correct in this regard, then, Olympic's parents' risks also are Olympic's risks and vice versa. As a consequence, using Olympic's parents' capital structure is what the market would demand.

[306] Ex. 220.

[307] Ex. 223 at 21, l. 406 through 22, l. 408; id. at 54, ll. 995-1001.

[308] Id. 223 at 54, ll. 995-1001.

[309] Id.

[310] Ex. 501T at 3, l. 14 through 4, l. 4; Ex. 1701T at 17, ll. 19-21.

137. The appropriate cost of debt necessarily is dependent on the capital structure this Commission adopts for OPL. Because OPL proposes that its parents' capital structure is the most appropriate to be used (see discussion at Section VIII), OPL recommends that its parents' 2001 embedded cost of debt of 5.26% be used.[311] The logic behind using the parents' embedded cost of debt is that the parents, in fact, raise the capital for OPL, so the cost of OPL's debt is in fact their cost. OPL's debt is either guaranteed by its parents[312] or issued by its parents.[313] The same logic supports the use of the parents' capital structure for OPL.

138. Dr. Means agreed that the debt cost of OPL's parents should be used as OPL's debt cost and he accepted 5.26% as that cost.[314] However, the flaw in Dr. Means's analysis is that he also proposes using (under certain conditions discussed in Sec. 8) the capital structure of the oil pipeline company proxy group which maintains substantially more debt than OPL's parents. A greater debt share in the capital structure implies a higher debt cost rate, all else being equal.[315] Therefore, if Dr. Means' proposed capital structure were adopted, it would be more appropriate to use the higher average debt cost for the same oil pipeline proxy group which Mr. Hanley calculates as 7.54%.[316]

139. Without a significant equity infusion from OPL's parents, Mr. Hanley recommends a 100% debt capital structure for OPL and a 6.74% cost of debt, which is OPL's parents' embedded cost of debt for 2000.[317] Dr. Wilson recommends an 80% capital structure with a 7% cost of debt that he claims is the approximate current cost of high quality long-term corporate bonds.[318] However, the predicate for not using OPL's parents' capital structure is the false hypothesis that OPL is financially independent. If this hypothesis were accepted, consistency would compel that the much higher debt cost of a stand-alone company with little or no equity be used. The reason this hypothesis is false, of course, is that

---

[311] Ex. 201T at 90, ll. 6-11.

[312] The throughput and deficiency agreement for the $12 million Prudential loan is backed just by OPL's owners and not by any third-party shippers. Tr. at 2910:10 through 2911:2.

[313] Ex. 201T at 89, l. 18 through 90, l. 3.

[314] Ex. 2212 at 1; Tr. at 3711:22 through 3712:9; id. at 3712:10-23.

[315] Tr. at 3712:4 through 3715:14; see also Brealey, Richard A. and Stewart C. Myers, *Principles of Corporate Finance*, at 481-82 (6th ed. 2000).

[316] Ex. 401T at 2, l. 19 through 3, l. 1.

[317] Ex. 401T at 24, ll. 7-8.

[318] Ex. 301T at 5, ll. 12-14; id. at 50, ll. 16-19.

without OPL's parents' guaranties it could not borrow at any price under current circumstances, including current revenue levels, since lenders look to earnings for repayment.[319]

140. Dr. Means admitted that OPL, as a stand-alone with such high debt shares would have a "junk bond rate of interest"[320] that would be "obviously much higher than seven percent."[321] Goldman Sachs publishes yield indexes for three junk bonds grades. As of the close of business on August 7, 2002, the index yields were: (1) 10.19% for BB-rated bonds; (2) 13.41% for B-rated bonds; and (3) 22.66% for CCC-rated bonds.[322] On the same date, the average yield for investment-grade corporate bonds, as measured by the Dow Jones Corporate Bond Index, was 6.88%.[323] The Williams Companies, which is currently B-rated by Standard & Poor's, has a current (as of August 7, 2002) yield on its bonds of 14.845%.[324] If the Commission adopts a capital structure for OPL that does not reflect the financial reality that it is financially dependent upon its parents, as proposed by either Staff or intervenors, the cost of debt must be equally divorced from reality and reflect the cost OPL would incur if borrowing on its own (making the false assumption that it could do so in its current financial condition).

B. Return on Equity

i. General Principles

141. The landmark Bluefield and Hope cases[325] established several tests that must be satisfied to demonstrate the fairness of the rate of return. These tests include a determination of whether the rate of return is: (1) similar to that of other financially sound businesses having similar or comparable risks; (2) sufficient to ensure confidence in the financial integrity of the regulated company; and (3) adequate to

---

[319] Tr. at 4514:8-23.

[320] Id. at 3713:20. Junk bonds are those with ratings by the major bond rating firms (e.g., Moody's Investor's Services or "Moody's" and Standard & Poor's Corporation or "Standard & Poor's") that are below investment-grade (e.g., a rating by Standard & Poor's of BB, B, and CCC). Frank J. Fabozzi, Bond Markets, Analysts, and Strategies, Prentice Hall, Inc., 1996, pages 142-3.

[321] Id. at 3715:6-8.

[322] The data source for Goldman Sachs' index values is Bloomberg. Specific examples from Bloomberg of the yields on the junk bonds of specific companies on August 7, 2002 are as follows: (1) Western Energy, Inc.; S&B bond rating of BB, and a yield of 10.015%; (2) Williams Companies, S&P bond rating of B, and a yield of 14.845%; and (3) United Airlines, S&P bond rating of CCC, and a yield of 32.754%.

[323] Wall Street Journal, August 8, 2002, Section C, page 1.

[324] Bloomberg.

[325] Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n. of W. Va., 262 U.S. 679 (1923) and Hope Natural Gas Co., 320 U.S. 591.

maintain and support its credit, thereby enabling it to attract, on a reasonable cost basis, the funds necessary to satisfy its capital requirements so that it can provide adequate and reliable service to its shippers. Collectively, the above standards are generally known as the comparable-earnings and capital-attraction standards.

142. In setting the rate of return on equity (ROE), the Commission must balance the potentially competing interests of both reasonable prices and safe and reliable service. The process must allow a rate of return to the regulated company commensurate with the risk to which the invested capital is exposed. Risk includes financial risks such as business failure and bankruptcy, and the directly related operational, regulatory, and legal risks.[326]

143. The rate of return required by investors is directly linked to the perceived level of total risk. The greater the risk to an investment, the higher the rate of return that is required to compensate for that risk.[327] Since investors seek the highest rate of return available for a given total risk, the rate of return must at least equal the investor-required market-determined cost of capital for investments of conmparable risk if regulated companies are to attract the necessary investment capital on reasonable terms. If future investors are to have the necessary confidence that their capital will continue to experience an appropriate rate return over the years, the rate of return set in each tariff proceeding must be fair to existing investors as well as adequate to attract new capital.[328]

144. OPL has demonstrated that it faces much higher risks than a typical oil pipeline.[329] The Commission must take proper account of these risks in setting OPL's ROE. In the absence of an opportunity to earn a fair ROE that properly reflects its risks, OPL will be unable to attract the capital required to continue providing the safe and reliable service needed by the shippers, this Commission and

---

[326] Olympic is at financial risk in the event of any future accident even if it occurs as the result of events totally outside Olympic's control such as an earthquake. Olympic is subject to environmental regulations that provide for fines and other consequences regardless of fault. Moreover, Olympic may also be strictly liable under similar principles for the unexpected release of product from the pipeline, regardless of the cause or fault. See Siegler v. Kuhlman, 81 Wash. 2d 448 (1972) (transportation over public thoroughfares of gasoline an abnormally dangerous activity).

[327] WUTC v. U.S. West Comms., Inc., 1996 Wash. UTC LEXIS 7, at*164-166 (Apr. 11, 1996).

[328] Hope Natural Gas Co., 320 U.S. 591.

[329] See discussion in Section VIII.B Hypothetical Capital Structure.

the public.[330]

145. The Commission relies on a forward-looking single-stage discounted cash flow (DCF) analysis to determine the ROE for a regulated company:[331]

> The Commission will continue to rely on the discounted cash flow analysis as the most satisfactory method of measuring investor expectation. The various other methods employed by the parties, including CAPM, Risk Premium, Earning/Price Ratio, and Market to Book Ratio, are useful as a check. The results of all the other methods are interesting for the Commission to see as points of comparison. However, those methods are not relied upon in this order to reach a decision on a rate of return. The Commission thus continues to discourage the approach of averaging DCF with other methods.

146. The Commission also has noted the shortcomings of the non-DCF methods used by Tesoro and Staff. The Commission has commented that "the CAPM methodology is flawed and of extremely limited usefulness in this analysis"[332] and "[w]e have previously rejected the comparable earnings analysis as a sole basis for determining a utility's cost of equity."[333] Finally, the Commission has declined to use a multi-stage DCF model of the type used by Tesoro witness Mr. Hanley.[334]

147. Dr. Schink employed the FERC's DCF methodology. This methodology uses a single-stage forward-looking DCF model thereby measuring investor expectations regarding equity return. The DCF model is applied to the FERC-defined five-company oil pipeline proxy group.[335] The FERC's DCF methodology, including its use of the five-company oil pipeline proxy group, should qualify as a "standard DCF study" as defined by the Commission.[336]

ii. Application of DCF Methodology

148. Dr. Schink recommends a risk adjusted 15.65% ROE for OPL using a modified FERC DCF approach.[337] This recommendation is based on a nominal cost of equity capital for a typical oil pipeline

---

[330] POWER, 104 Wash. 2d 798.

[331] GTE Northwest, Inc., 1994 Wash. UTC LEXIS 92, at *14-15; see also Avista Corp., 2000 Wash. UTC LEXIS 558, at *154-66; Ex. 201T at 44, l. 2 through 46, l. 14.

[332] Wash. Natural Gas Co., 1993 Wash. UTC LEXIS 87, at *51.

[333] Wash. Water Power Co., 1978 Wash. UTC LEXIS 3, at *47-48.

[334] Avista Corp., 2000 Wash. UTC LEXIS 558, at *163-64.

[335] See discussion in Section IV.B.3.

[336] Ex. 201T at 47, l. 9 through 48, l. 16; Tr. at 2497:7-21.

[337] Ex. 201T at 3, l. 12 through 4, l. 7. The corresponding unmodified FERC DCF approach result of 15.55% is lower by only 10 basis points. Dr. Means said that "I believe that Dr. Schink's calculations are a correct application

of 14.70% which, given OPL's high risk, is increased by a risk-adder of 0.95%.[338] OPL's recommended cost of equity, including a risk-adder, falls well within the FERC's ROE zone of reasonableness of 10.81% to 17.54% for an oil pipeline company.[339]

149. The reasonableness of the OPL risk adder is documented by the fact that OPL is much riskier than the companies in the oil pipeline proxy group.[340] As Dr. Schink noted, "an investment in OPL is obviously much riskier than investment in any one of the companies in the oil pipeline proxy group."[341] Tosco witness Dr. Means notes that one of the oil pipeline proxy group companies, Kinder Morgan, has a ROE of 17.94% despite having an equity share of capital of 58.6% implying that it faces much higher risk than the other oil pipeline companies in the proxy group.[342] Dr. Means opines that a reason for Kinder Morgan's higher risk is that Kinder Morgan is "involved in a lengthy FERC proceeding [in] which a lot of money is at stake."[343] OPL, in addition to its numerous other risks, also is involved in a rate case where an unfavorable outcome could push it into bankruptcy.[344] Therefore, a ROE of at least 15.65% is well justified.

150. Dr. Schink provides a detailed comparison of the competing ROE analyses presented by the parties at Ex. 201 T, pages 31-85. Dr. Schink's ROE results are based on the FERC's single-stage DCF model where the growth rates component, "g", is the weighted average of the IBES 5-year expected growth rate for earnings (with a 2/3 weight) and the long-run expected growth rate for nominal GDP (with a 1/3 weight).

151. Tesoro witness Mr. Hanley averages the results produced by four different methods: (1) DCF;[345] (2) Risk Premium Method; (3) Capital Asset Pricing Model (CAPM), and (4) Comparable

---

of the [unmodified] FERC methodology." Tr. at 3698:10-11. Mr. Means accepted and used Dr. Schink's application of the FERC DCF approach, but he only used one of Dr. Schink's modifications. Id. at 3698:21 through 3701:11.

[338] Ex. 201T at 64, l. 1 through 65, l. 1.

[339] Ex. 213. OPL's recommended ROE of 15.65% also falls within the FERC's zone of reasonableness of 10.72% to 17.34% established using the unmodified FERC DCF method. Ex. 210.

[340] See discussion in Section VIII.B.

[341] Ex. 201T at 11, ll. 17-19.

[342] Tr. at 3702:5 through 3704:5.

[343] Id. at 3704:9-11.

[344] Ex. 201T at 4, ll. 1-2; id. at 11, l. 16 through 12, l. 12; id. at 30, l. 19 through 33, l. 7; id. at 59, l. 21 through 60, l. 7; Tr. at 2277:2-22.

[345] Mr. Hanley applies three versions of the DCF Model: One single-stage version and two multiple-stage

Earnings to produce a 13.00% nominal return on equity.[346]

152. Dr. Wilson employs two variations of the DCF, the CAPM, and the Comparable Earnings methods to produce his recommended cost of equity. In addition, he has three proxy groups: the oil pipeline proxy group used by the other witnesses, a natural gas pipeline proxy group, and an integrated petroleum company proxy group which includes BP and Shell.[347] Averaging over his multiple methods and multiple proxy groups, Dr. Wilson produces his recommended nominal cost of equity of 9.00%.[348]

153. While the Tesoro and Staff witnesses recommend averaging the WUTC's preferred single-stage DCF method with other methods, they also provide in their exhibits the results of applying the single stage DCF model to the oil pipeline proxy group companies. Mr. Hanley confirmed that his application of a single-stage growth version of DCF and the five-year IBES growth expectations produces a mean ROE estimate of 15.8%.[349] Dr. Wilson confirmed that using the single-stage DCF method generates a ROE range of 13.3% to 17.2%.[350] The midpoint of this range is 15.25%. Both Tesoro's and Staff's single-stage DCF results are consistent with and support Dr. Schink's recommended 15.65% cost of equity capital for OPL.

154. Dr. Means' updated ROE analysis[351] implies a 13.00% real cost of equity capital,[352] which is equivalent to a 14.51% nominal cost of equity capital.[353] If the OPL risk-adder of 0.95% is applied to Dr. Means' nominal cost of equity, the result is a ROE for OPL of 15.46% which also is consistent with Dr. Schink's recommended ROE for OPL.

C. Overall Cost of Capital

155. OPL's recommended after-tax overall cost of capital is 14.28% and its before-tax overall cost of capital is 21.60%. These rates are based on an 86.85% equity share, 13.15% debt share, 15.65%

---

versions. Ex. 408.

[346] Ex. 401T at 24, l. 17 through 25, l. 6; id. at 53, l. 15 through 54, l. 15; Ex. 402 at 2; Ex. 417 at 1.

[347] Ex. 301T at 27, l. 20 through 29, l. 16.

[348] Id. at 5, ll. 9-12.

[349] Tr. at 2680:7-15; Ex. 408, line 1, 3rd and 4th column.

[350] Tr. at 2531:19-25; Ex. 304 at 1.

[351] Ex. 2212.

[352] Id.

[353] This is based on a 1.515% inflation rate. Ex. 201T at 63, ll. 21-23.

nominal cost of equity, 5.26% cost of debt, and a tax rate of 35%.[354]

X. Revenues

A. Test Year Revenues

156. Test year revenues at the rates before the proposed increase are $35.457 million.[355] The revenues justified by OPL's cost of service are $56.535.[356]

B. Throughput

i. Role of Throughput in Determining Revenues

157. Setting throughput at a level likely to be representative of the rate year period is "crucial" to determining appropriate rates because the "revenue requirement divided by the throughput gives the rate."[357] Because oil pipelines have high fixed costs, a decrease in throughput necessarily means that the fixed costs must be paid for by higher rates on fewer barrels.[358] OPL suggests that throughput be based on levels it experienced under conditions similar to those that will exist during the rate year. Staff and Intervenors disagree and recommend throughput levels that are speculative, have not been achieved under similar conditions in the past and most likely will not be achieved during the rate year. Accepting Staff's or intervenors' suggestions would result in a windfall for OPL's shippers and a revenue shortfall for OPL.[359]

ii. Calculation of Appropriate Throughput for Ratemaking Purposes

158. By annualizing the most recent ten months of actual throughput data.[360] OPL has calculated an

---

[354] Ex. 201T at 96, ll. 11-15.

[355] Ex. 703C, Schedule 1.

[356] Id.

[357] Ex. 2001T at.29, l. 5; see also Tr. at 1722:6-11.

[358] See Tr. at 4722:6 through 4723:10.

[359] The relationship of throughput to rates is demonstrated by what happened to OPL after the ERW seam failure in September 1999. Howard Fox calculated that the decrease in throughput from the September 1999 80% pressure restriction to December 31, 2001, cost OPL over $50 million in lost revenues. Ex. 1701T at 6, ll. 9-12; id. at 15, ll. 5-8. Chairwoman Showalter asked why OPL did not come in earlier for an increase in rates due to decreased throughput. Tr. at 2841:11 through 2842:25. The fact is OPL should have come in earlier for rates. However, OPL is not now asking for past revenue losses due to past throughput decreases (which benefited the shippers in the amount of $50 million). OPL is merely asking for fair treatment of the reduced throughput levels for the rate year that are known and measurable.

[360] The ten months represented all of the throughput data available since OPL's entire system became operational in June 2001.

adjustment to test year throughput volumes of 103.2 million barrels.[361] Using the most recent ten months of actual throughput data provides the most accurate basis for predicting likely volumes during the rate year.[362] It is undisputed that OPL's system will not be able to operate at more than the current restricted 80% pressure during the rate year, and that significant testing, permitting, repairs and pipe replacements will continue through the rate year further negatively impacting throughput.

159. For the interim case, Staff used the last six months of actual throughput data for 2001 (when the OPL system was fully operational at the restricted 80% pressure) and annualized it for a throughput number of 103 million barrels, [363] essentially the same number OPL obtained using the most recent ten months of data. The 103 million throughput figure necessarily formed the basis for the Commission's interim order.[364] However, Staff now has abandoned this approach and adjusted 1998 throughput data based on a ratio of the highest throughput months OPL experienced in 1998 (August) and 2001 (July) to come up with a proposed throughput number of 108 million barrels.[365]

160. Staff's methodology does not produce the most accurate estimate of actual throughput for the rate year. First, July 2001 was the first month in over two years that OPL's entire system was operational and no work or repairs were scheduled for that month to ensure that there was no interruption in service.[366] As the Commission is aware, substantial work on the system is ongoing that regularly results in monthly slowdowns in service and thus decreased throughput.[367] Second, the regulatory requirements and maintenance and repair obligations under which OPL operates are vastly different today than they were in 1998. Necessarily, the new more stringent inspection, maintenance and repair obligations have and will continue to

---

[361] Ex. 801T at 8, ll. 1-4; see also Ex. 859 at 53-55; Ex. 864; Tr. at 3413:1-25; id. at 3436:22 through 3438:7. OPL updated its throughput adjustment to reflect actual volumes for the period July 2001 through April 2002 and updated the volume forecasts for May 2002 and June 2002 by annualizing these months using the ten months of actuals. Ex. 801T at 8, ll. 1-4. Throughout this proceeding, OPL has provided updated throughput information to Staff and Intervenors as it became available. Ex. 1601T at 19, ll. 11-25; Ex. 1608C.

[362] Ex. 1601T at 21, ll. 18-20; Staff has defined the rate year as the twelve months following the issuance of a rate order. Tr. at 4719:8-12.

[363] Tr. at 4740:12 through 4741:19.

[364] Third Supplemental Order at 14, ¶52.

[365] Tr. at 4745:2 through 4749:20.

[366] Ex. 2109 at 12, ll. 23-25.

[367] Ex. 1601T at 7, l. 21 through 10, l. 5.

cause more slowdowns in service impacting throughput. While staff's methodology may account for the fact that OPL is now limited to 80% pressure, its use of the one month in 2001 during which there was no maintenance and repair work and thus no down time will not accurately predict the impact of such work on throughput during the rate year.

161. However, the conditions under which OPL will operate in the rate year are expected to be essentially the same as it experienced during the ten months of actual throughput data used by OPL in its case. Of course, the use of actual throughput data necessarily takes into account downtime and other operational factors experienced during the period. Thus the issue is whether the level of downtime that was experienced by OPL from July 2001 through April 2002 is reasonably expected to continue during the rate year and the undisputed testimony is that it is.[368] OPL's proposed use of the ten months of actual throughput data preceding the filing of its rebuttal case is the most accurate predictor of throughput during the rate year and should be adopted by the Commission.

162. Based on the mistaken assumption that OPL can achieve 100% maximum operating pressure during the rate year, Tosco adjusts the test year volumes to 130 million barrels per year and Tesoro to 121 million barrels per year.[369] However, neither Staff nor Intervenors contradicted OPL's testimony that maximum operating pressure will continue to be restricted at 80% during the rate year which is from October 2002 to October 2003. The "earliest anybody has indicated . . . that pressure could go up to 100 percent, assuming everything goes correctly, is after that period of time."[370] The use of estimates beyond the rate year would "get beyond known and measurable and into the realm of speculation."[371] Tosco impliedly admitted that its throughput determination is not based on known and measurable standards, but reflects "uncertainty."[372]

iii. Adjustment Mechanism Based on Throughput

163. OPL agrees with Staff that a throughput "tracking adjustment mechanism would seem to resolve

---

[368] Tr. at 4748:8-19.

[369] Ex. 2301T at 50, ll. 11-13 (Tesoro's adjusted throughput); Ex. 2201T at 3, ll. 14-15 (Tosco's adjusted throughput).

[370] Tr. at 4753:12-15.

[371] Id.. at 4744:23-24.

[372] Tr. at 3667:3-11.

a very contentious issue in a way that would protect both OPL and its customers"[373] and OPL believes this can be accomplished collaboratively.

XI. Calculation of Revenue Deficiency or Surplus

A. Explanation of Phrase "Revenue Deficiency"

164. The amount of any revenue deficiency (or surplus) for the rate year is equal to the rate year cost of service less rate year revenues prior to a rate increase. The purpose of computing a revenue deficiency (or surplus) is to determine whether a rate change is necessary to eliminate the shortfall or surplus. Following is an outline of OPL's expected rate year cost of service and revenue without a rate increase together with a calculation of both OPL's revenue deficiency and the rate increase warranted by that deficiency. OPL does not attempt to segregate its facilities and costs between intrastate and interstate transportation and thus its analysis is based on OPL's total company cost of service and revenues.

B. Summary of OPL Rate Year Cost of Service

165. The total company cost of service recommended by OPL is $56.535 million.[374] This amount is composed of the following elements:

	$000's
Allowed Total Return	$12,313
Income Tax Allowance	$6,864
Operating Expenses Excluding Depreciation	$33,446
Depreciation Expense	$2,798
Amortization of AFUDC	$255
Amortization of Deferred Return	$859
Total Cost of Service	$56,535

166. This cost of service is made up of the following six components: *Allowed Total Return* -this is the return on investment for OPL's rate base, see section VII.A for further discussion; *Income Tax Allowance*--this is an allowance for OPL's income taxes, see section VI.I for further discussion; *Operating Expenses - Excluding Depreciation*--these are the operating expense adjusted for the rate

[373] Ex. 2001T at 30, ll. 5-7; Tr. at 4759:1-11; Ex. 1601T at 22, ll. 3-14.

[374] Exhibit 703C, Schedule 1 at 1, l. 7. Note that the Exhibits cited in this section use FERC ratemaking terminology. For example, the term "headroom" corresponds to the term "revenue deficiency" as used by this Commission and the term "test period" corresponds to this Commission's use of the term "rate year."

year, see Section VI for further discussion; *Depreciation Expense*--this is for recovery of capital investment in OPL, see Section VI.J for further discussion; *Amortization of AFUDC*--this is for recovery of AFUDC, see Section VII.G for further discussion; and *Deferred Return*--this is the recovery of the deferred portion of OPL's allowed return on equity, see Section VII.C for further discussion.

C. Summary of OPL Rate Year Revenues

167. Without a rate increase and assuming OPL's rate year throughput of 103.165 million barrels, OPL's revenue during the rate year would be $35.457 million.[375]

D. Calculation of Revenue Deficiency and Corresponding Rate Increase

168. Based on the $56.535 million in cost of service projected for the rate year and $35.457 million in projected revenue without a rate increase, OPL would have a total revenue deficiency of $21.078 million.[376] Dividing this revenue deficiency by OPL's revenues shows that OPL would need a 59% rate increase to avoid a revenue shortfall. OPL is recommending that the Commission grant OPL this increase.

[375] See Ex. 703C, Schedule 22.2 at 64, l. 31.
[376] Ex. 703C, Schedule 1 at 1, l. 9.

169. Using OPL's rate year throughput level of 103.165 million barrels, OPL would generate the following rate year revenue under the recommendations of the intervenors and Staff:

	OPL	Tosco	Staff	Tesoro
Proposed Rate Increase	59.4%[377]	19%[378]	0.5%[379]	-15.9%[380]
Rate Year Revenues ($ Millions)	$56.535	$42.193	$35.647	$29.820

XII. Refunds, if the revenue deficiency fails to require a rate increase of at least the level of interim rates

A. Broad Discretion of the Commission

170. The Commission has broad discretion to set fair, just, reasonable and sufficient rates. The Third Supplemental Order states that the interim rates, which took effect on February 2, 2002, are subject to refund, and Commission retains the discretion *in this proceeding* to determine if and to what extent any refund is appropriate.

171. As held in a recent case involving Avista Corporation, "the Commission's authority to authorize immediate rate relief, subject to refund or other conditions, is a power necessarily incident to the exercise of the Commission's express statutory authority to regulate the rates of jurisdictional utilities."[381] In exercising ratemaking authority, the Commission is granted broad discretion:

> The Commission has been given broad discretion in the determination of just, fair, reasonable, and sufficient rates, charges, regulations, practices or contracts…. It is essential in the sound regulation of public utilities that this Commission possess the flexibility to develop policies for consistent application which recognize the real world in which the utilities operate and the existing circumstances which bear upon their ability to provide service.[382]

---

[377] Ex. 701T at 1, l. 16.

[378] Based on the percentage difference between Olympic Average Rate Per Barrel Under Prior Permanent Rates and Cost of Service Rate Per Barrel by Dr. Means (Ex. 2212) plus the surcharge of 6.7% (Ex. 2201T at 4, l. 19). [($0.387 - $0.344)/$0.344 + 6.7%].

[379] Ex. 2001T at 1, l. 22.

[380] Tr. at 5166:18-21.

[381] WUTC v. Avista Corp., 2001 Wash. UTC LEXIS 337, at *15 (Sept. 24, 2001) (citing State ex rel. Puget Sound Navigation Co. v. DOT, 33 Wash. 2d 448 (1949)).

[382] See WUTC v. Pac. Power & Light Co., 1983 Wash. UTC LEXIS 65 (Feb. 1, 1983).

The Commission is also authorized to alter, amend or change any order or rule made by it, with reasonable notice to the parties.[383]

172. Staff witness Twitchell acknowledged in response to questioning by Chairwoman Showalter the breadth of the Commission's discretion to consider the refund question on the basis of the complete record that is now presented to the Commission.[384]

B. Refund Of Interim Rates Is Not Appropriate

173. The relief provided by the Commission was ordered in response to dire financial conditions that supported interim relief under the Pacific Northwest Bell decision.[385] No evidence is presented in this proceeding that would suggest that OPL received relief in an amount that exceeded the minimum amount necessary and appropriate for the period in question. Rather, the full amount of interim relief awarded was warranted in consideration of the PNB criteria that the Commission considers in determining the public interest.

174. Moreover, given OPL's financial condition, any refund would reduce revenues prospectively and also would render permanent rates insufficient and confiscatory. The Commission is charged to set rates that are fair, just, reasonable and sufficient, while balancing the interests of the public, the utility and the ratepayers. Such a balance of interest must consider the financially stability of a utility and its ability to safely and reliably discharge its public service obligation at a reasonable cost to customers.[386]

175. OPL is still facing dire financial circumstances.[387] OPL must have ample revenues from sufficient rates so that it can attract capital it needs to operate and maintain the pipeline.[388] The

---

[383] See RCW § 81.04.210.

[384] Tr. at 4668:21 through 4669:14.

[385] See WUTC v. Pac. Northwest Bell Tel. Co., Cause No. U-72-30 (Oct. 1972).

[386] See Stone v. Farmers' Loan & Trust Co., 116 U.S. 307, 331 (1886) (the power to regulate is not a power to destroy).

[387] OPL's financial condition is especially difficult due to the recent FERC order dismissing the FERC general rate proceeding and possible refund of the federal rates. See FERC v. Olympic Pipe Line Co., Docket No. IS01-441-003, Initial Decision, dated July 19, 2002.

[388] See Tr. at 2825:3-12 (OPL witness Peck states that "the situation of the company itself is just very dire"); id. at 2854:20 through 2856:12 (OPL witness Peck discusses limited alternatives if a sufficient rate is not granted); Ex. 601T at 5, ll. 5-16 (OPL witness Batch discusses the financial consequences of adopting recommendations of Staff or Intervenor rates); Ex. 611 at 6, ll. 3-5 (OPL witness Batch discusses the plunge of OPL's profitability due to substantial safety related investments); Tr. at 4125:4-19 (OPL witness Talley explains that OPL needs rate revenue to attract capital investment in the company); Ex. 1701T at 2, ll. 5-10 (OPL witness Fox states that without increase in

Commission must set rates that are fair, just, reasonable and sufficient.[389] In addressing sufficient rates, the Commission in the POWER Case provided that "*The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. . . .*"[390]

176. OPL's revenues are limited due to decreased throughput from the federally mandated pressure restrictions. The company faces increased costs of operating the pipeline. OPL must be in a financial position that will enable it to comply with the recently enhanced federal and state pipeline safety regulations. The financial condition of OPL has not improved during the pendency of this rate case. It would be contrary to the public interest to require OPL to refund any portion of its interim relief. Washington law provides that the Commission must "[r]egulate in the public interest."[391] The Commission must set a rate that will allow OPL to earn an adequate rate of return in order to operate the pipeline in a safe and efficient manner. A refund of the funds collected from the interim rate relief would thwart the original intended purposes of that order and would deprive OPL of the financial integrity it needs to operate the pipeline in a safe and efficient manner.

XIII. Other

177. OPL requests a uniform percentage increase to all tariff rates which is consistent with the uniform percentage increase to all rates for the surcharge granted by the Commission in the interim case.[392]

XIV. Conclusion

178. Olympic urges the Commission to exercise its discretion to make the choices suggested by OPL in this brief that will attract the risk capital it needs to, in the words of the interim order: "operate safely, to support public confidence that it will operate safely and to avoid the occurrence to a major event that

---

tariff, there is little hope of additional loans or capital); Ex. 1701T at 16, ll. 15-22 (OPL witness Fox states that the current interim rate of 24.3% will still not be enough to produce sufficient cash flow to attract capital).

[389] POWER, 104 Wash. 2d at 805.

[390] Id. at 813 (quoting Bluefield Water Works, 262 U.S. at 693).

[391] RCW § 80.01.040(2) and (3).

[392] Third Supplemental Order, at 18, ¶72.

could precipitate complete financial meltdown and deprive the shippers and the region of an efficient and cost-effective means of transportation."[393]

DATED this ____ day of August, 2002.

Respectfully submitted,

PERKINS COIE LLP

By _____

Steven C. Marshall, WSBA #5272
Perkins Coie LLP
One Bellevue Center, Suite 1800
411 – 108th Avenue N.E.
Bellevue, WA 98004
(425) 453-7380

KARR TUTTLE CAMPBELL

By _____

William H. Beaver, Jr., WSBA #9205
Karr Tuttle Campbell
1201 Third Avenue, Ste. 2900
Seattle, WA 98101
(206) 224-8054

[393] Id. at 3, ¶9.