BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION Complainant, v. OLYMPIC PIPE LINE COMPANY, INC., Respondent.	DOCKET NO. TO-011472

REPLY BRIEF ON
BEHALF OF COMMISSION STAFF

August 28, 2002

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I. INTRODUCTION[1]

1 Olympic is entitled to recover a reasonable level of operating expenses, plus a fair return on its prudent, used and useful investments that are devoted to public service. (Staff Br. at ¶¶ 16-20). Staff's case reflects this fundamental principle, which is in the public interest. (Wilson, Tr. 4918:2 to 1919:5).

2 This case is not about safety. Staff proposes recovery of all safety expenditures identified and quantified by Olympic. (Staff Br. at ¶ 149-152). Staff also proposes extraordinary adjustments for end-of period rate base, and end-of period CWIP, assuring more timely recovery of Olympic's prudent expenditures in serving the public. (*Id.* at ¶¶ 183-186).

3 This case is about who will pay for the financial policies and actions of Olympic. Olympic spent almost $45 million on unproductive or under-performing assets. (Bayview-$23.2 million; Cross Cascades-$21 million). Olympic says it lost $50 million more by not filing a rate case sooner. (Fox, Ex. 1701-T at 6:21 to 7:1). And Olympic financed its post-Whatcom Creek losses with debt. (Staff Br. at ¶ 6-11). Shippers are not responsible for those costs.

4 The shippers should pay for costs Olympic prudently incurs to operate its system and comply with applicable safety rules. Olympic cannot expect shippers to pay for future investments in current rates. A responsible public service company must first make the necessary investments, then file for a rate increase if one is necessary. Olympic should do no less.

[1] Staff has no confidence in the citations contained in Olympic's Opening Brief. Time and resources have not permitted Staff to thoroughly review all citations of other parties. The limited review Staff has made shows Olympic's brief contains improper or insufficient citations. Examples are provided *infra* at footnotes 3, 22, and 28, and ¶¶ 35 and 60.

5 Olympic says it only needs to recover the "real costs" it incurs to provide a safe pipeline (OPL Br. at ¶ 20). However, Olympic's case shows it wants much more. An equity ratio of 86.85%, deferred equity return, starting rate base write-up, and full recovery of its Bayview investment with no associated increases in throughput, are not "real costs" prudently incurred by Olympic to operate its system. Rather, these are devices to implement a methodology unjustified by the record or the law, that would improperly reward Olympic for its prior financial policies.

6 Before Whatcom Creek, Olympic was able to: 1) finance at reasonable rates, without parent guarantees (*see* Ex. 2421, Tabs 12 and 13: "Chase" note documents); 2) increase its throughput with "monotonous regularity" (Staff Br. at ¶ 61); 3) enjoy assured throughput via consistently overnominated capacity (*Id.*); and 4) earn robust returns on equity. (Ex. 2102R).

7 After Whatcom Creek, Olympic chose to defer filing a rate case and to finance its losses with an ever-increasing burden of new debt. Its owners chose to supply no cash in the form of equity. The result: Olympic has a financial problem it wants the Commission to solve by approving rates that are excessive by any traditional measure. (*See* Staff Br. at ¶¶ 6-14). That is unjust and unreasonable.

8 This is not a game of "chicken," as Olympic represents. (OPL Br. at ¶ 125). If Olympic makes prudent investments, it will recover them. (Elgin, Tr. 4917:20 to 4918:1). Staff's case is sound ratemaking, supported by law, and based on cost and the record. It should be accepted.

II. LEGAL ISSUES

9 **Olympic's Reliance on the Interim Order.** Olympic persists in relying on the Commission's order on interim relief in this case. (OPL Br. at ¶¶ 1, 2, 7, 17, 159, 178). However, the interim phase of this case was quickly resolved and "pose[d] more questions than it

answer[ed].” (*See* 3rd Supp. Order at 2 and 3, ¶¶ 7 and 10). The record now proves Olympic’s financial problems are largely of its own making, and the solution should not reward Olympic with excessive rates that are not cost-based. (Staff Br. at ¶¶ 6-14).

10 **Federal/State Jurisdictional Issues.** Olympic wants the Commission to adopt the FERC methodology to “avoid potential problems of discrimination between inter- and intrastate transportation.” Olympic says it fears a “separate methodology” will exist between state and federal jurisdictions. (OPL Br. at ¶¶ 22-23). However, Olympic’s fear lacks a legal basis (Staff Br. at ¶¶ 27-29)(Tosco Br. at ¶¶ 27-29), and its argument lacks credibility: Olympic created the separate methodology situation by filing index-based rates at FERC, and proposing no indexation methodology in this case. (Staff Br. at ¶ 26).

11 **Retroactive** Ratemaking**.** Olympic agrees retroactive ratemaking is illegal, but says its case “does not advocate retroactive ratemaking.” (OPL Br. at ¶ 24). Olympic is wrong. It is retroactive ratemaking to grant deferred prior period equity returns that were not in fact deferred, and for which there was no authority to defer. (Staff Br. at ¶¶ 30-31, 97)(Tesoro Br. at 38). On this issue, Olympic cites only FERC orders, not the law. (OPL Br. at ¶ 48-49).

III. STATUS OF COMPANY BOOKS AND RECORDS

12 Olympic defends the inadequacies of its record keeping by describing the data entry process for its SAP accounting system. (OPL Br. at ¶¶ 30-37). However, describing how a system is *supposed* to work does not change how it *did* work. Olympic’s accounting system did not permit Staff to access underlying data consistently or confirm the accuracy of Olympic’s

books and records. (Staff Br. at ¶ 39).[2] The bottom line is that the Commission can have no confidence in any test period other than calendar year 2001. (Staff Br. at ¶¶ 33-43, 127-138).[3]

13 Olympic also says it is "generally satisfied" with the accounting reports it got from Equilon. (Olympic Br. at ¶ 37). This purely self-serving statement passes no test of credibility. Olympic had no accounting records to support those reports. (Staff Br. at ¶ 39).[4]

IV. METHODOLOGY ISSUES

14 **Overview.** Staff evaluated Olympic's case under state law and the record, and proved FERC methodology and its underlying assumptions have no application to Olympic in this state. (Staff Br. at ¶¶ 58-121). On the key issues, Olympic mostly cites FERC policies and statements which are not justified by the record. The Commission cannot delegate its fact-finding or policy making to FERC.[5] Olympic's case defies this principle.

15 **Investor "Reliance."** No facts or law support Olympic's idea that "investor reliance" requires the **Commission** to adopt FERC methodology instead of the traditional Commission methodology, or pay Olympic the difference. (Staff Br. at ¶¶ 45-48, 78-80, 117-121). Instead of proving Olympic's investors actually relied on FERC methodology in this state, Olympic cites FERC orders and makes general assumptions. (OPL Br. at ¶ 38-39).

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[2] Given Mr. Colbo and Mr. Twitchell's combined 60 years audit experience, their inability to confirm the accuracy of Olympic's books and records connotes a significant problem with those books and records.

[3] Olympic erroneously states that Staff witnesses have agreed that Olympic's "…financial data is sufficiently reliable for the Commission to base a determination of the merits of an appropriate tariff increase…." (OPL Br. at ¶¶ 30-31). The record Olympic cites for this point (in OPL's footnote 35) is unrelated to the point Olympic attempts to make. If Olympic had correctly cited the record, it would have cited Staff testimony that, based on everything Staff did, only calendar year 2001 results were reasonable. (*E.g.,* Colbo, Ex. 2001-T at 10:4-12 and 11:1-3).

[4] Olympic also cites its recent outside audit report to defend its own record keeping. (OPL Br. at ¶ 28, 67). That evidence is not in the record and cannot be relied on. (19th Supp. Order at 1, ¶ 4)(RCW 34.05.461(4)). If the Commission does not disregard Olympic's references to the Ernst & Young reports, it should know that Ernst & Young found the same accounting problems Staff did. ("Ernst & Young, 2001 Audit Results, Summary of Required Communications." Area: "Material Weaknesses in Internal Control," first 3 bulleted points).

[5] *E.g.,* RCW 34.05.461(4)("Findings of fact shall be based exclusively on the evidence of record" and on "matters officially noticed"); *Diversified Inv. Partnership v. DSHS*, 113 Wn.2d 19, 28, 775 P.2d 947 (1989) and *State ex rel. Kirschener v. Urquhart*, 50 Wn.2d 131, 135, 310 P.2d 261 (1957)(legislative power is non-delegable).

16 Like FERC,[6] Olympic cites no case law that investor reliance requires adoption of FERC methodology, or that use of the traditional Commission methodology requires compensation to Olympic. (OPL Brief at ¶ 39). This dooms Olympic's reliance argument, even before applying the rule that investors have no vested right in any methodology.[7]

17 Olympic is left to argue it would be "unfair" for the Commission to "switch" methodologies. (OPL Brief at ¶¶ 38 and 59).[8] Once again, Olympic's argument is based on a FERC policy that does not apply in this state. (*Id.*). Olympic did not prove it filed tariffs with the Commission that consistently reflected FERC methodology.[9] And Olympic's argument presupposes the Commission actually adopted FERC methodology. It did not.

18 Note that Olympic is quick to observe that FERC methodology was "effected by FERC Opinion No. 154-B…" (OPL Br. at ¶ 107), but Olympic cites no order in which this Commission took similar action. The contrast is obvious: FERC took action, and actually adopted a methodology. The Commission took *no* action and actually did not adopt a methodology.[10]

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[6] *See* OPL Br. at ¶51, n. 85. There, Olympic quotes FERC's statement in Order 154-B that it "must" adopt SRB. FERC cited no legal authority whatsoever for that statement. Olympic does not either.

[7] That principle independently defeats Olympic's theory. (Staff Br. at ¶¶ 45-48).

[8] Olympic repeatedly and incorrectly refers to the Commission's use of its traditional methodology as a "change" or a "switch" in methodologies. (OPL Br. at ¶¶ 19, 39, 40, 41, 42, 49, 50, 51, 105). In the absence of an approved methodology, there can be no "change" or "switch." Olympic cites no Commission order in which a methodology was approved for Olympic.

[9] What Olympic says is a "consistent pattern of parallel methods" (OPL Br. at ¶ 41) is refuted by Olympic's actual tariff filings. As Tesoro showed, the rates Olympic filed that purported to use FERC methodology did not use the same version of FERC methodology, or even a correct version of FERC methodology. (Tesoro Br. at ¶ 96). Moreover, in Docket No. TO-961053, Olympic filed a rate that was not based on FERC methodology at all. (Staff Br. at ¶ 80). In Docket No. TO-961518, the Staff memo stated that the rate increase was justified by increased costs, despite Staff's concerns about rate methodology. In that case, Olympic did not file the full increase FERC methodology justified. (*Id.*).

[10] Olympic concedes its tariffs went into effect by operation of law, but wrongly suggests that the existence of Staff memos presented at an open meeting means the Commission somehow implicitly approved these tariffs and the methodology underlying them. (OPL Br. at ¶ 38). As Tosco correctly points out, Staff memos do not constitute Commission action. (Tosco Br. at ¶¶ 56-59). Note, however, that Tosco is incorrect in stating that tariffs that go into effect by operation of law are "approved by operation of law." (Tosco Br. at ¶ 58). Tariffs that go into effect by operation of law are not "approved" in any legal sense of that term. (Staff Br. at ¶¶ 117-118).

19 In the end, Olympic concedes that tariffs that go into effect by operation of law are "carrier-made rates" (OPL Br. at ¶ 38), which are not Commission-made rates. Because all of Olympic's tariffs filed in this state since 1983 went into effect by operation of law, they were carrier-made rates, and no Commission policy was created. (Staff Br. at ¶¶ 78-80, 117-121).

20 In sum, there is no legal or factual basis for Olympic's reliance theory.

21 **Nature of Oil Pipelines**. Olympic concedes that compared to other modes, pipeline transportation services are "superior in efficiency and economy," are substantially safer, and do not "entail[] the risk of oil spills in the environmentally fragile Puget Sound." (OPL Br. at ¶ 14). Olympic also concedes its proposed 62% increase would not be passed on to the consumer because gasoline prices are driven by the "highest … transportation cost" (which apparently is not Olympic's rate). (OPL Br. at ¶ 15).

22 These concessions alone are enough for the Commission to find Olympic faces no effective competition in this state. This means Olympic has failed to justify using FERC methodology because that methodology is premised on competitive concerns. The record shows Olympic reflects the classic public utility structure that supports use of the traditional Commission methodology: significant economies of scale, high fixed costs, low operating costs, significant barriers to entry, and no effective competition. (Staff Br. at ¶¶ 58-66, 84-85).[11]

23 **History of Regulation.** There is nothing unique about Olympic's history that justifies a methodology different than the traditional Commission methodology. (Staff Br. at ¶¶ 58-82).

24 Because Olympic consistently relies on federal laws and policies, Olympic discusses only federal regulatory history. (OPL Br. at ¶¶ 43-45). Olympic then goes on to focus on several requirements of the Interstate Commerce Act (ICA) that do not apply to interstate oil pipelines.

[11] On the issue of lack of competition, *see also* Tesoro Br. at ¶¶ 61, 88-90 and Tosco Br. at ¶¶ 49, 118-121.

Olympic argues the similarities between the ICA and Title 81 justify similar interpretations. (OPL Br. at ¶ 59). In fact, there is little similarity between the ICA and Title 81. Those common carrier requirements that do not apply to *inter*state oil pipelines subject to the ICA apply to all *intra*state oil pipelines and public utilities subject to Titles 80 and 81 RCW. (Staff Br. at ¶ 73-74)(Tesoro Br. at ¶ 33-36, 94). Thus, Olympic's argument supports use of the traditional Commission methodology, not the FERC methodology.

25 **Rationale for FERC methodology.** Olympic agrees the most important rationale for the FERC methodology is competition. (OPL Br. at ¶ 46). As we noted above, FERC's rationale has no application here because Olympic lacks effective competition in this state.[12]

26 **Trended Original Cost.** Olympic argues it will "never … recover[]" or "never earn a return" on the amounts Olympic alleges were "deferred" based on its prior tariff filings. (OPL Br. at ¶ 19 and 49). This argument cannot be sustained, given the excessive returns Olympic historically has enjoyed (Ex. 2102-R), and the fact that Olympic never actually deferred any equity returns and had no authority to do so. (Staff Br. at ¶ 97-98).

27 Olympic does not deny it collected more than enough revenues in the past to cover any alleged "deferred" equity return. Instead, Olympic wants the Commission to ignore Olympic's actual returns because that is FERC's policy. (OPL Br. at ¶ 48). There is no legal or factual basis to perpetuate such a poor policy choice. The Commission should reject TOC.

28 **Starting** Rate **Base Write-Up (SRB).** If Olympic needs to recover the "real costs" of operating a safe pipeline (OPL Br. at ¶ 20), then SRB fails to qualify because it is a fiction: No facilities related to SRB exist. (Staff Br. at ¶¶ 89-90, 100-103)(Tesoro Br. at ¶¶ 72-75). Olympic

[12] *See also* Staff Br. at ¶¶ 59-66, 84-88; Tesoro Br. at ¶¶ 61, 88-90; and Tosco Br. at ¶¶ 49, 118-121. Actions speak louder than words. If Olympic had true competition, it certainly would have done research on its competitors. Dr. Schink asked for it: Olympic found nothing. (Schink, Tr. 2239:25 to 2240:15).

does not contest this basic fact. Instead, Olympic again relies on FERC policy without proving that policy has a factual and legal basis here. (OPL Br. at ¶51). The record and law do not support including SRB in rate base. (Staff Br. at ¶¶ 89-90, 100-103).

V. TEST YEAR[13] AND JURISDICTIONAL SEPARATIONS

29 The Commission has stated it would consider only allocated intrastate results of operations. (3rd Supp. Order at 7, ¶ 27). Staff's case presented such results. Olympic proposes to use total-company results, suggesting it is difficult to defend allocations of common costs for jurisdictional separations purposes. (OPL Br. at ¶ 66). In fact, jurisdictional allocations such as those used in Staff's case are commonplace (Elgin, Tr. 4825:23 to 4826:8 and 4914:8-19), and are accepted by the courts. (Staff Br. at ¶ 139). But if total company results are to be used, a rate reduction is warranted. (Twitchell, Ex. 1904 at 1, col. G).

VI. OPERATING EXPENSES

30 **Pro-Forma Adjustments.** The Commission defines pro-forma adjustments as adjustments that "give effect for the test period to all known and measurable changes which are not offset by other factors." (WAC-480-09-330(2)(b)(ii)). That is the definition Staff applied. (Colbo, Ex. 2001T at 14: 3-6)(Twitchell, Ex. 1901 at 10:8-10).

31 Olympic says pro-forma adjustments "reflect the effects of different assumptions concerning the assets that should be included in the rate year base and the level of throughput." (OPL Br. at ¶ 71). Olympic's definition is confusing and wrong.

32 **Whatcom Creek Costs.** Olympic argues it could have sought recovery of Whatcom Creek costs, but did not. (OPL Br. at ¶ 69). If it ever does, among other things, Olympic must

[13] *See* Section III, *supra*, at ¶¶ 12-13 for a discussion related to the appropriate test year.

affirmatively prove those costs were prudently incurred and were not the result of mismanagement. That will be difficult given the record. (*See* Staff Br. at ¶ 229).

33 **Mr. Cummings' Whatcom Creek-Related Payroll.** Olympic opposes Staff's removal of the $100,623 (total company) Olympic paid to its lobbyist, Mr. Cummings, for his activities related to the Whatcom Creek explosion. Olympic argues most of his time is now devoted to community relations efforts and that his future activities will not be directly related to Whatcom Creek.[14] (OPL Br. At ¶ 79).

34 There are two reasons why Olympic's argument fails. First, Staff's removal of these expenses was based on Olympic's response to Staff Data Request No. 401, which proved the amount of time Mr. Cummings devoted to Whatcom Creek issues in the test year. (Colbo, Ex. 2003-C at 19). Second, Mr. Cummings now directs the lobbying for all of BP's West Coast operations. (Cummings, Ex. 1401-T at 1:8-9). Because all his time will no longer be devoted to Olympic, Staff's adjustment best reflects his prospective, Olympic-related compensation.[15]

35 **OTM Costs.** Olympic states Staff's OTM cost adjustments were "arbitrary and unsupported," and alleges Staff used "an extremely broad definition of capitalization" and had a lack of expertise regarding FERC Form 6 and the USoA. (OPL Br. at ¶ 72). However, Olympic supports this argument with a transcript citation that proves only that Mr. Colbo, an accountant with approximately 30 years of experience, does not routinely examine FERC Form 6's filed with the Commission. (Colbo, Tr. 4727:2-21). In fact, Mr. Colbo testified that he was familiar with the USoA, though he is not an "expert" on it. (Colbo, Tr. 4730:1-3).

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[14] Staff listed Adjustment RA-10, Remove D. Cummings Whatcom Creek Payroll as an uncontested issue. (Staff Br. at ¶ 164). However, in light of Olympic's Opening Brief, this is now a contested issue.

[15] Staff acceded, on materiality grounds, to Olympic's claim that $19,636 of Staff's adjustment was for providing information to the public as required by federal rules. (Staff Br. at ¶ 164, fn. 50). The adjustment to payroll for Mr. Cummings' Whatcom Creek activities is a different adjustment.

36 No party advocates denying Olympic recovery for prudent amounts spent on normal, routine pipeline maintenance. However, Olympic's OTM projects are not normal, routine pipeline maintenance. (Staff Br. at ¶ 143). The issue between Staff and Company is the period of recovery.

37 Staff's treatment of OTM costs complies with the USoA.[16] (Ganz, Ex. 1105). The USoA is a permissive, not a restrictive document, with provisions to record every conceivable type of transaction. The facts dictate whether a certain transaction is recorded as a current expense or as an asset to be amortized. For example, a $455,000 line-lowering project undertaken in response to erosion will result in a permanently safer, more stable pipeline. Thus, such a cost is properly capitalized, not expensed. (Colbo, Ex. 2003C at 10)(Kermode, Tr. 4585:12-4586:19).

38 But regardless how a transaction is to be recorded under the USoA, ratemaking principles take precedence when setting rates. Those principles are that costs be: 1) related to the service provided; 2) prudently incurred; 3) the lowest, reasonable cost available; and 4) representative of a future normalized level of expense to be included in rates. (*See* Brown, Ex. 2301-T at 9:7 to 10:4). Staff's proposed normalization of OTM costs embodies these principles by properly matching the costs of such projects with the periods benefited. (Kermode, Tr. 4586:8-13).

39 **HCA Regulations.** Olympic claims that Staff improperly "reclassified OPL costs as nonrecurring," and states Staff did not address the effect of HCA regulations on Olympic's cost of service. (OPL Br. at ¶ 74). Olympic did not quantify the effect of HCA regulations on its cost of service. And no party recommends disallowance of the costs of complying with HCA

[16] USoA Instructions 3-5 for Carrier Property Accounts (Improvements) provide for capitalization of improvements by charging them to the appropriate property account. (Ganz, Ex. 1105). The USoA also allows amortization of other items over a period of time. (*Id.*). USoA Definition 6 defines amortization as "the gradual extinguishments of an amount in an account by distributing such amount over a fixed period, over the life of the asset or liability to which it applies, or over the period during which it is anticipated the benefit will be realized." (*Id.*).

regulations. (Smith, Tr. 4243:3-7)(Staff Br. at ¶ 150). Further, the record in this case amply demonstrates that Olympic is "ahead of the curve:" Olympic was already in compliance with the many of the new regulations before they went into effect. (Staff Br. at ¶ 151). Thus, any costs associated with Olympic's advance compliance are included in Staff's test period and will be reflected in rates. (*See* Wickland, Tr. 4725: 1-7).

40 **Litigation Expenses.** Olympic wrongly states that Staff eliminated litigation expenses. (OPL Br. at ¶ 76).[17] No Staff adjustment removed such costs, so Olympic's 2001 actual litigation expenses of $680,000 are included.[18] If the Commission believes the record supports a higher level, it should consider the $1,004,000 amount proposed for amortization by Tesoro, not the $2.6 million amount advanced by Olympic. (Staff Br. at ¶ 163)(Tesoro Br. at ¶ 114).

41 **Federal Income Taxes (FIT).** Olympic never defended its FIT adjustment. It provided no adjustment to tax depreciation, nor any testimony supporting any amount of tax depreciation. Therefore, Olympic did not meet its burden of proof on FIT issues.

42 Olympic criticizes Staff for using total company tax depreciation without adjusting for Cross Cascades. (OPL Br. at ¶ 101). However, no such adjustment is appropriate because Cross Cascades is not plant in service, so it is not depreciated and thus does not affect tax depreciation.

43 Olympic also claims this alleged "problem" is "aggravated by [Staff's] erroneous conclusion that FERC 154-B methodology requires the use of 'actual interest...'" (OPL Br. at ¶ 101). The error is Olympic's: Staff quoted *verbatim* Olympic's representation that its proposed methodology required the use of "actual interest." (Twitchell, Ex. 1901-T at 15:6-8 and 9-11).

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[17] Olympic also wrongly asserts without record support that Staff assumed the entire balance of Olympic's Legal and Other Professional Services account relates to rate case litigation expenses. (OPL Br. at ¶ 75).

[18] Collins, Ex. 728-C at 21 (WP 9-C)(2001 total). The OTM costs in the Outside Services account which Staff proposed be capitalized and amortized, not expensed, were not related to litigation expenses.

44 In any event, contrary to Olympic's assertion, Staff used pro-forma interest in calculating FIT, not actual interest (Twitchell, Ex. 1911), so Olympic again misses the mark. Staff's FIT adjustment should be accepted.

VII. RATE BASE

45 **Bayview.** Because Bayview Terminal is of very limited use and provides no additional level of throughput, it is not surprising that Olympic did not justify its $23.2 million investment in Bayview. Olympic cites no legal authority for its position. The law firmly supports removing Bayview under the facts of this case. (Staff Br. at 176-182).

46 Olympic speculates that Bayview "will enhance" throughput. (OPL Br. at ¶ 109). Yet no one knows Bayview's future role because the mandated design study has not been done. (Staff Br. at ¶ 173). If Olympic's point has merit, Olympic still violates the matching principle by not reflecting that enhanced throughput in rates.[19] Olympic claims Bayview is currently used for "three functions." (OPL Br. at ¶ 111). However, some of those functions are no longer needed, and none require a $23.2 million facility to accomplish. (Staff Br. at ¶ 172). Bayview should be removed from results of operations as Staff recommends.

VIII. CAPITAL STRUCTURE AND RATE OF RETURN

47 **Overview.** Olympic's excessive rate of return request is evidenced by the summary at ¶ 155 of its Opening Brief. There, Olympic admits it wants a before-tax overall return of 21.6% on its rate base. This remarkable request presumes an after-tax ROE of 15.65%, and it burdens shippers with a phantom tax loading of 8.43% on a hypothetical equity amount of 86.85% of total capitalization. All of these amounts are plainly excessive.

[19] If the Commission disagrees and includes Bayview in results of operations, Staff agrees with Intervenors that associated throughput should be included. In that situation, Staff supports Tesoro's calculation of incremental Bayview throughput. (Staff Br. at ¶ 181)(Tesoro Br. at ¶¶ 125-128)(Tosco Br. at 90-92).

48 Olympic actually has negative equity, not equity equal to 86.85% of its rate base, as Olympic proposes. Furthermore, the cost of capital for any enterprise financed exclusively with debt requires no tax loading. Finally, investors require substantially less in today's capital markets,[20] making an ROE allowance of 15.65% clearly excessive.

49 **Causes of Olympic's Financial Situation.** In this case, there were at least four events that caused Olympic's problems: (1) the Whatcom Creek explosion; (2) the ERW seam failure problem; (3) unproductive investments in Cross Cascades and Bayview; and (4) the failure of Olympic's management to timely address rate increase issues. Olympic responded by financing its post-Whatcom Creek losses with debt. (Staff Br. at ¶¶ 8-11). Olympic's prior policy of paying out all or nearly all earnings annually, while no equity infusions were being made, exacerbated the problem. (Wilson, Tr. 2539:8-13)(Elgin, Ex. 2102-R). It is not surprising that the Company's equity balance turned negative.

50 The essential question for the Commission to decide is who should be responsible for these events, shippers or shareholders. Olympic proposes to require shippers to bear the financial burden of these events. Staff's case would require Olympic's shareholders (BP and Shell) to bear the burden of providing cash through an equity infusion. When Olympic makes prudent expenditures with that cash, they will be recovered through rates.

51 Rhetoric aside, it is clear that the pipeline will continue to operate in either event. It is clearly needed as an integral part of Shell and BP's Northwest refining and marketing operations. The rates proposed by Staff will amply cover all reasonable costs of operation and a fair return

[20] *See. E.g.* Wilson, Ex. 302 and Tr. 2548 :22 to 2549:8).

on the facilities serving the public. The only remaining question is who will shoulder the sunk cost burden of these four recent financial events.[21]

52 Ratepayers did not cause any of these events and management was largely responsible for at least some of them. Some may have been truly unavoidable accidents – precisely the sort of unforeseen contingency that equity risk premiums in rate of return allowances were intended to compensate. In short, the financial consequences of these events would normally be deemed a stockholder burden.

53 **Financial and Business Risk.** Olympic premises its capital structure and return allowance arguments on the contentions that: (1) it is an exceptionally risky enterprise with a correspondingly high cost of money; and (2) the average reported capital structure of its parents (BP and Shell) is market-determined and appropriate for determining Olympic's rates.

54 Olympic's argument that it "faces genuine competitive risk" (OPL Br. at ¶ 132) is completely at odds with the undisputed facts: Olympic faces no effective competition and no prospects of same. (Staff Br. at ¶¶ 59-66). Olympic's argument that it has very high operating risks, based on terrain, potential seismic activity, costly maintenance, and ERW pipe (*E.g.,* OPL Br. at ¶ 130) are also without merit. Other pipelines have the same or more significant operational issues. (Wilson, Tr. 2522:2 to 2524:11)(Means, Tr. 3666:2-5). Moreover, Olympic's pipeline is operated above industry safety standards, even in compliance with standards well before they become requirements. (Staff Br. at ¶¶ 149-152). The cost of all this is reflected in Olympic's results of operations. (*Id.*). Shippers should not have to pay twice: once for

[21] Had Olympic's equity cushion been larger, there is little doubt that all or most of the sunk cost burden would have been written off (*i.e.*, as a reduction in shareholders claims to equity value). In this case, Olympic financed its post-Whatcom Creek losses with debt and now has a grossly distorted balance sheet. (Staff Br. at ¶¶ 8-11).

Olympic's aggressive management of risk through higher than average standards and expenditures, and again to compensate for alleged "operational risk."

55 Olympic's claims of financial risk point to its owner's high equity ratios and the assertion that these are market-determined and apply to Olympic, just as they apply to the parents. (OPL Br. at ¶¶ 126-127). But there is no evidence at all that Olympic's operations bear any resemblance to the overall corporate oil and gas industry risks of Shell and BP. Moreover, as Dr. Wilson explained, the capital structures of these two European-based international oil companies are more a consequence of accounting conventions, and the companies' discretionary earnings retention policies over time, than of any market-imposed result. (Wilson, Tr. 2536:20 to 2538:4).

56 In sum, Olympic has not justified its claims of extraordinary operational risk, nor extraordinary financial risk for which Olympic and its owners are not responsible.

57 **Capital Structure.** Olympic premises its arguments on capital structure on the remarkable statement that "[e]quity is not cash," but rather "a claim on assets in favor of shareholders." (OPL Br. at ¶ 117). This statement is at odds with the most fundamental financial principle that equity is the measure of shareholder-provided cash. Equity provides the foundation of the enterprise, and enables it to obtain additional cash by other means, *i.e*. debt.

58 Thus, if the bookkeeping entries accurately reflect asset and liability values, equity is the measure of a firm's ability to absorb unexpected events. In some cases, if unexpected losses are so great as to cause a firm's equity values to become negative, the firm needs more cash via an equity infusion. But make no mistake, equity is infused in the form of cash. Moreover:

> You don't provide for capital investments out of current cash flow. Capital investments … are useful over a long period of time, [and are] typically funded not only in this industry, but all industries by the equity owner and recovered through prices and charges and rates over time.

(Wilson, Tr. 2547:4-9). Olympic goes on to argue that its actual capital structure (*i.e.*, 100% debt) should not be an issue in this case because the parent companies infuse or guarantee the capital that is needed and creditors look to this parent backing, rather than Olympic's capital structure for their security. (OPL Br. at ¶¶ 117-121). However, Olympic proceeds to suggest that this financial guarantee may not be continued in future financings:

> 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.

(OPL Br. at ¶ 136). This, of course, makes no sense so long as the Commission allows rates that adequately cover reasonable costs and provide for a fair rate of return on those assets Olympic has prudently employed to serve the public. A parent-financed equity infusion is now not only the logical consequence of the funding course that Olympic's owners have admittedly chosen (*i.e.*, infusion when needed), it is the inevitable and correct going-forward business decision.

59 An equity infusion, which provides new cash, is a necessary condition for Olympic to produce a rational balance sheet. When that happens, Olympic's balance sheet will no longer show liabilities vastly exceeding assets devoted to public service. This concrete action by Olympic's owners will provide a clear picture to any future provider of capital that there is a sound financial future plan for this company.

60 Contrary to Olympic's argument that "[n]o party has argued that OPL's actual capital structure of 100% debt should be used for ratemaking purposes" (OPL Br. at ¶ 115), that is precisely what Tesoro has recommended (absent Olympic's infusion of equity so as to actually establish a higher applicable equity ratio). (Hanley, Ex. 401-T at 5:3-5). Staff agrees that equity infusions sufficient to establish an actual equity ratio of up to 50% is appropriate. Absent a significant equity infusion, it is Staff's position that the adoption of an equity ratio of more than 20% for ratemaking purposes would be excessive. (Wilson, Ex. 301-T at 49).

61 **Return on Equity (ROE).** Olympic's proposed equity return rate of 15.65% is excessive and unwarranted. The credible evidence, with the exception of a severely limited DCF calculation based on data for only 5 oil pipeline limited liability partnerships, demonstrates that a reasonable cost of equity capital allowance is now less than 10%. Dr. Wilson's CAPM, comparable earnings and DCF studies of integrated oil companies and natural gas pipelines all show this. (Wilson, Ex. 309).

62 Olympic's only argument in light of this compelling evidence is that the ROE evidence in this case should be restricted to the FERC DCF methodology, which is limited to only 5 selected oil pipeline limited partnerships. (OPL Br. at ¶ 147). Such an artificial and excessively restrictive limitation in these circumstances is illogical and unwarranted. Even the older Commission cases Olympic cites for its position (*see* OPL Br. at ¶¶ 145-146) fail to support the FERC methodology Olympic advocates.[22] In those cases, the Commission stated it will not rely on non-DCF methods as the "sole basis for determining a utility's cost of capital,"[23] but will consider them as an "interesting" and "useful" check on DCF results.[24]

63 Dr. Wilson adhered to this policy. He did not use any non-DCF method as a sole basis for his recommendation. Using DCF results based on a single growth model applied to an

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[22] Olympic also says the Commission has "relied solely on analysts' projections of dividend growth" (citing *Avista Corp.*, 2000 Wash. UTC LEXIS 558 at 157-58 and 163) and "has determined that the five-year analysts' forecasts are sufficiently long-run in nature to qualify them as appropriate estimates of long-term expected dividend growth" (citing *WUTC v. Wash. Water Power Co.*, 1978 Wash. UTC LEXIS 3, at 47-48 (Mar. 24, 1978) (OPL Br. at ¶ 56). Staff has reviewed the orders Olympic cites and they do not support Olympic's statements. Moreover, the estimates of "analysts" referred to by the Commission are those of rate of return expert witnesses, not the estimates of stock analysts required to be used by FERC.

[23] *WUTC v. Washington Water Power Co.*, Docket No. U-77-53 (3rd Supp. Order at 23)(1978).

[24] *WUTC v. GTE Northwest, Inc.*, Docket No. 931591 (3rd Supp. Order at 8)(1994).

extraordinarily limited universe of only 5 oil pipeline limited partnerships requires a check. (Staff Br. at ¶¶ 108-113, 206-217). Limiting and restricting ROE analysis to such a small and unrepresentative sample that produces results that are so out of line with all other cost of capital indications at the present time, is not consistent with this Commission's precedent, conventional DCF analysis, or sound regulatory or financial policy. (Wilson, Tr. 2531:2 to 2532:7).

64 **Coverage Ratio.** In its brief, Olympic argues that another measure of fair return is operating ratio.[25] Olympic mistakenly asserts that the "normal industry" coverage ratio is 2 times (OPL Br. at ¶ 125), though its witnesses used different figures.[26] Because Olympic provided no analysis of the rates of return on rate base that were related to such a ratio, Olympic has not proven its proposed ratio is reasonable or the "norm."

65 Olympic also has not demonstrated the ratio it advocates is a proper measure. As Mr. Elgin explained, the Commission uses operating ratio in regulating firms that have a high capital turnover rate. Such a ratio is not appropriate for firms like Olympic, which have high fixed costs and low capital turnover. (Elgin, Tr. 4912:9 to 4913:12). Using and operating ratio is also improper in this case because it is highly influenced by the return on equity. Since equity costs more than debt, increasing the amount of equity in the capital structure will significantly impact the coverage ratio. In this instance, Olympic's proposal for an excessive equity ratio and equity cost produces an unreasonable result.

66 **Conclusions.** In summary, absent a major equity infusion by Olympic's owners, the Commission should adopt a hypothetical equity ratio of no more than 20% for ratemaking

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[25] The ratio Olympic advocates is Revenue ÷ [(Total Operating Expense) – (Depreciation & Amortization)].

[26] For example, Dr. Schink testified that "financially strong pipelines" had coverage ratios of 1.65 to 2.41 and in 1998, Olympic was a "financially healthy pipeline company" with a 1.855 coverage ratio. (Schink, Ex. 4-T at 35:4-7). Mr. Fox said a "normal ratio" is in the range of 1.75 to 2.25. (Fox, Tr. 4523:7-11).

purposes together with an ROE allowance of 9% and a debt cost of 7%. This result is sufficient given the circumstances of this case.

IX. THROUGHPUT

67 Olympic asserts that Staff's throughput calculation is not the most accurate estimate of future throughput. (OPL Br. at ¶ 160).[27] However, Staff's 108,324,000 bbls/yr. estimate is the only representative estimate in this case. (Staff Br. at ¶¶ 226-230). Olympic failed to prove that its proposed throughput level is representative, thus failing the known and measurable standard. (Staff Br. at ¶ 228).

68 Olympic also asserts that accepting Staff's recommended throughput level would result in a windfall for shippers and a shortfall for Olympic. (OPL Br. at ¶ 157). That is only true if Olympic's estimate is accurate, and Olympic has not proven that.

69 Olympic unfairly argues Staff "abandoned" the throughput approach it used during the interim phase of this case. (OPL Br. at ¶ 159). The interim relief phase was conducted on a short record with simplifying assumptions. Staff's further analysis in the general rate case provides a more defensible throughput recommendation.

70 Olympic is wrong to claim it is "undisputed" that the level of downtime experienced from July 2001 to April 2002 will continue during the rate year. (OPL Br. at ¶ 161). That fact is disputed because Olympic has failed to even identify the level of downtime between July 2001 and April 2002. Olympic also mis-cites the record in trying to prove its point.[28]

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[27] Olympic is incorrect to say that July 2001 contained no downtime. (OPL Br. at ¶ 160). In fact, only the first 10 days of that month (2 cycles) contained no downtime. (Hammer, Ex. 819, Sch. 22, line 35).

[28] The record Olympic cites for this point (Colbo, Tr. 4748:8-19), simply shows that Staff agreed that the representative level of throughput was an issue. Staff did not agree with the proposition that the level of downtime Olympic experienced between July 2001 and April 2002 would continue. In fact, when asked whether using actual figures incorporated downtime, Mr. Colbo stated: "Yes, but because of the uncertainty with regard to throughput, we don't know what's going to be happening in the future or not." (Tr. 4748:10-12).

71 Staff's throughput recommendation captures the net impact of the pressure reduction currently affecting Olympic. Prospectively, Olympic will enjoy the throughput benefits from new scheduling, batching, and other efficiencies that have recently been implemented by the Company. (Talley, Ex. 1619-T at 10:6-11:19). Therefore, Staff's proposed throughput calculation is appropriate for use in this case.

X. REFUNDS

72 The only significant change since the interim relief phase of this case is that the Commission now has a much clearer picture of Olympic's situation. Olympic argues that refunds would thwart the original intended purposes of the Commission's order on interim relief and would deprive OPL of the financial integrity it needs to operate the pipeline safely and efficiently. (OPL Br. at ¶ 176). A primary purpose of the Commission's order was to set rates subject to refund, as Olympic specifically requested. The record is clear: Olympic cannot justify an increase as great as the interim rates and Olympic should refund the difference to the shippers.

RESPECTFULLY SUBMITTED this 28th day of August, 2002.

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