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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of SFPP, L.P. for authority, pursuant to Public Utilities Code Section 455.3, to increase its rates for pipeline transportation services within California.	)))))	Application No. 09-05-014 (Filed May 12, 2009)
And Related Matters.	)))	Application No. 08-06-008 Application No. 08-06-009 (Filed June 6, 2008)

CONCURRENT REPLY BRIEF
OF
SFPP, L.P. AND CALNEV PIPE LINE LLC

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In accordance with the adopted procedural schedule, SFPP, L.P. ("SFPP") and Calnev Pipe Line LLC ("Calnev") (together referenced as "Applicants") hereby respectfully submit their Concurrent Reply Brief in the above-referenced consolidated proceedings in response to the individual submittals of Tesoro Refining and Marketing Company ("Tesoro"), BP West Coast Products LLC and ExxonMobil Oil Corporation ("BP/E"), and Air Transport Association of America, Inc., Chevron Products Company, ConocoPhillips Company, and Southwest Airlines Co. ("C/CP/SWA") (collectively referred to as "Shippers").

I. INTRODUCTION

The Shippers are uniform in their contention that SFPP has not demonstrated the reasonableness of the $10 million in rate increases that are the subject of these proceedings. In support of their conclusion that SFPP's current rates are not justified, Shippers advance various assertions and arguments, including the following:

- Because SFPP can exercise market power "in nearly all of its markets," its rates must be evaluated <u>solely</u> on the basis of a cost-of-service analysis.[1]
- SFPP's cost-of-service analysis is flawed in various respects:

  (i) it improperly incorporates an income tax allowance.[2]

  (ii) it understates throughput volumes and revenues.

  (iii) it incorporates an excessive return on equity; overstates the cost of debt; and reflects an inappropriate capital structure.

  (iv) it overstates operating expenses by: (a) improperly allocating and assigning corporate overhead expenses to SFPP; (b) including expenses related to dismantlement, removal, and restoration ("DR&R"); and (c) claiming unreasonable levels of expense with respect to environmental remediation, fuel and power, losses and shortages, and litigation.

As set forth more fully below, SFPP will demonstrate that its existing rates are just and reasonable based upon consideration by the Commission of all relevant factors, including SFPP's cost of service ("COS"). SFPP fully recognizes the significance of cost of service in evaluating whether its current rates are justified. Accordingly, SFPP will show that the various assumptions reflected in its cost-of-service analysis are reasonable. SFPP will further demonstrate that Shippers are sponsoring cost-of-service results that lack credibility. Specifically, SFPP will cite

[1] Tesoro Opening Brief at 9.

[2] As stated in its Opening Brief at p. 3, fn. 2, SFPP recognizes that the presiding ALJ has issued his ruling deferring consideration of the federal income tax allowance ("ITA") question, pending its resolution in the consolidated proceedings before ALJ Long. In accordance with that ruling, SFPP understands that the Commission's ultimate resolution of the ITA issue will become the law of the case with respect to the subject proceedings. In view of the foregoing, SFPP will not herein specifically reply to ITA-related arguments advanced by Shippers in their respective opening briefs submitted in this proceeding.

facts and expert opinion evidencing various flaws in the Shippers' COS analyses, including the following: (1) throughput volumes, which in the face of the worst recession since the Great Depression and amidst continuing, historical declines in SFPP volumes (from 241 million barrels in 2008 to 234 million barrels in 2009), are nevertheless forecasted by Shippers to "jump" up to 245 million barrels in the 2010 Test Year ("TY");[3] (2) failure to adjust SFPP's forecasted revenues downward to reflect actual throughput reduction of 2 million barrels at Miramar Station and diversion of throughput (from the higher-tariffed Concord-Fresno segment to the lower-tariffed Bakersfield-Fresno segment) expected to occur as a consequence of resumed operation of the Flying J refinery in Bakersfield;[4] (3) self-serving creation of and reliance on an artificially constructed allocation of overhead expenses that not only ignores cost-causation principles but violates them; (4) an analytically incorrect and erroneous estimate of the dividend yield component of the DCF model; (5) understating SFPP's cost of debt by more than 200 basis points by improperly adjusting SFPP's long-term debt to include variable rate debt associated with interest rate swap agreements; (6) ignoring the average capital structure of the comparable company group upon which Shippers themselves relied in conducting their DCF analyses; and (7) arbitrarily excluding reasonable, forecasted operating expenses associated with DR&R, environmental remediation, losses and shortages, and litigation.

With respect to the question of the proper standard of review for the Commission to employ in evaluating the reasonableness of SFPP's rates, SFPP agrees that cost-of-service is an essential – but not necessarily the only – consideration that should govern the Commission's ultimate determination. The record in this proceeding reflects conflicting views regarding the

[3] SFPP Opening Brief at 11-12.
[4] SFPP Exhibit No. 9; Dito at p. 4; SFPP Exhibit No. 10; Dito at 23.

extent and degree to which SFPP has the potential to exercise market power. SFPP acknowledges that in 7 of 9 markets the evidence of record indicates levels of concentration in excess of the thresholds at which the FTC or DOJ would consider a market to be highly concentrated. However, the unrebutted evidence of record also shows that the greater Los Angeles and San Francisco Micro-Markets were determined to have HHI's of 1151 and 1905, respectively, below the thresholds at which the FTC or DOJ would consider a market highly concentrated.[5]

While SFPP may have the potential to exercise market power with respect to certain longer-haul movements, the evidence shows – and Shippers do not disagree[6] – that SFPP faces competition, certainly in the shorter-haul markets. Indeed, in eight (8) of its markets, SFPP faces direct competition from trucks making short-haul movements, i.e. movements ranging from 40-to-80 miles between supply origin and destination markets.[7] SFPP acknowledges that it has not made a market power showing sufficient to justify Commission-endorsement of market-based authority; however, SFPP is not requesting any such authority. Rather, SFPP is asserting that the degree of moderate competition that it does face makes it inappropriate to evaluate the reasonableness of its rates solely by reference to COS. Shippers, on the other hand, present no policy reason why SFPP rates must be evaluated solely on a cost-of-service basis - the ratemaking methodology that the Commission has reserved for application to its regulated monopoly providers of essential utility services, such as electricity, natural gas, and water.

SFPP recognizes that it is neither a pure monopoly provider of a utility service nor a participant in a fully competitive market for the provision of pipeline transportation services.

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[5] Exhibit SFPP No. 2; EAI at 2-3; Exhibit SFPP No. 1; Webb at 18.
[6] Tesoro Opening Brief at 5 and 9.
[7] SFPP Opening Brief at 54.

While it may possess market power with respect to certain long-haul movements, it just as certainly faces substantial competition with respect to short-haul movements. How then should the Commission evaluate the rates of an entity which both does and does not have the potential to exercise market power? SFPP submits that the Commission does not need to impose a strict COS rate regime on SFPP in order to restrain SFPP from otherwise exercising the market power that it may possess by attempting to raise rates for long-haul movements to a supra-competitive level. The Commission's continuing regulatory oversight itself serves to restrain SFPP from charging supra-competitive rates. Similarly, shipper access to Commission process and the related ability to challenge the reasonableness of any rate proposed by SFPP and to call upon Commission authority to reject any proposed rate change effectively serves as a bar to an attempt by SFPP to exercise any ostensible market power that it might possess.

The Commission has expressly recognized that the outcome of pipeline rate cases, rather than affecting any identifiable consumer interest, primarily involves the allocation of transportation costs between the pipeline and its shippers:

> One of the more noticeable characteristics of this case is the nature of the central issue: a dispute between oil producers and oil pipeline companies over the allocation of transportation costs. Since our decision will not affect the price refineries pay for oil, ordinary Californians will see no change in the price of refined products.[8]

SFPP does not question the right of its shipper/oil companies to make their case before the Commission regarding the appropriate allocation of transportation costs between SFPP and themselves. SFPP does dispute whether such cost allocation should be dictated solely by application of a strict COS methodology. To evaluate the reasonableness of SFPP's rates and

[8] 66 CPUC 2d 28, at 33 (1996).

make the associated allocation of transportation costs between the pipeline and its shippers, the Commission is asked to decide between widely divergent, often contradictory COS analyses and related assumptions. The Commission is asked to make a choice between two forecasted cost-of-service outcomes – neither of which is knowable. To the extent the Commission were to rely only upon COS as the metric for distributing costs and benefits between the pipeline and its shippers, public policy suggests that the Commission's evaluation of the reasonableness of the competing, widely disparate COS analyses advanced by the pipeline and Shippers should err on the side of favoring the public utility pipeline rather than the oil companies. Presumably, in allocating transportation costs between the pipeline and its shippers, public policy would suggest allocation of costs in favor of the public utility entity responsible for operating and maintaining important transportation fuel-related infrastructure needed to serve California's interests rather than in favor of oil companies that would not be expected to pass any reductions in their cost of pipeline transportation along to consumers.

Of course, SFPP does not believe that the Commission should rely solely upon COS to evaluate its rates, nor does the Commission itself. The Commission has noted as follows:

> While the Public Utilities Code establishes that we must ensure just and reasonable rates, nothing in sections 451, 455 or 728 requires the exclusive use of cost-of-service ratemaking to ensure reasonableness. Cost-of-service ratemaking is an important – perhaps even the pre-eminent - ratemaking technique. However, there is no single yardstick by sole reference to which rates may be judged reasonable. A number of different standards exist to judge the reasonableness of rates…[9]

Consistent with the Commission's stated views, SFPP asks that the evaluation of the reasonableness of its current rates give consideration not only to SFPP's COS but also to the size

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[9] *Id.* at 31.

and sophistication of SFPP's customers, their ready access to competitive alternatives, the degree to which SFPP rates compare favorably with other pipeline rates, and the fact that SFPP rates have declined in real terms between 1992 and the present. SFPP is confident that the Commission, whether considering COS alone or in conjunction with other factors, will exercise its discretion to determine that SFPP's existing rates are just and reasonable.

II. REPLY ARGUMENT

In reviewing pipeline rates, the Commission has indicated its intention to determine the reasonableness of the rates at issue "based on the totality of the circumstances" surrounding the utility services.[10] Such "totality of circumstances," as defined in *Unocap*, necessarily includes: (i) the size and sophistication of SFPP's customers; (ii) the availability of competitive alternatives to SFPP's services; (iii) the degree to which SFPP's rates compare favorably to other pipeline rates; and (iv) the rate of return to be earned under a cost-of-service analysis of SFPP's existing rates.

The Commission itself has recognized that COS considerations are an essential component of the totality of circumstances that must be evaluated in determining the reasonableness of a pipeline utility's rates. In the subject proceeding, the Commission is essentially asked to choose between two widely divergent COS showings, one presented by SFPP and a collective showing presented by Shippers. SFPP's COS showing reflects volumes of approximately 227 million barrels, associated revenues of approximately $112 million and a 2009 TY cost of service of approximately $113.3 million.[11] If the Commission were to find

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[10] *City of Long Beach v. Unocal California Pipeline Company ("Unocap")* (1996); 66 CPUC 2d 28, at 30.
[11] SFPP Opening Brief at 7.

SFPP's COS showing to be credible, the COS evidence would itself justify a determination that SFPP's current rates are just and reasonable.

Shippers, however, have a diametrically opposed view of SFPP's cost of service. Shippers' COS showing reflects volumes of approximately 245 million barrels, associated revenues of $123 million to $126 million, and a 2009 TY COS ranging from $85 million to $90 million.[12] With regard to specific elements of SFPP's and Shippers' cost-of-service calculations that are in dispute, the table below reflects the adjustments that witnesses Ashton and O'Loughlin would make to SFPP's COS of $113.3 million, producing their respective COS recommendations of $84.6 million and $89.9 million.[13]

	Tesoro	CCS
SFPP's Cost of Service	$113,291	$113,291
Operating Exp Adjustments:		
KMEP OH	($10,394)	($11,690)
DR&R	($2,027)	($1,420)
Environmental Exp	($1,942)	
Oil Gains / Losses	($504)	
Fuel & Power	$520	$823
Cost of Capital Adjustments:		
Income Tax Allowance	($10,017)	($11,102)
Equity ROR	($4,607)	
Capital Structure	($3,924)	
Cost of Debt	($37)	
Net Cost of Capital Adjustments	($14,366)	
Tesoro / CCS Cost of Service	$84,917	$89,902

As discussed in detail in Section II.A below, SFPP will demonstrate the unreasonableness of Shippers' forecast of 2009 TY volumes of 245 million barrels and associated revenues of $123 million to $126 million. SFPP will further demonstrate the myriad fallacies inherent in the

[12] SFPP Opening Brief at 6-7 and 11-12.
[13] Tesoro Exhibit No. 14; Ashton; Exhibit 7; CCS-2; O'Loughlin; MPO-7. Note in the table above, cost of capital adjustments have a greater impact on COS when evaluated individually. Therefore, the sum of the individual cost of capital adjustments shown in the table is greater than the combined impact shown on the line "Net Cost of Capital Adjustments."

Shippers' COS analyses; in particular, SFPP will show that Shippers: (i) propose a disallowance of $10.3 million in allocated overhead expenses that is arbitrary and violates fundamental principles of cost causation; (ii) propose an ROE-related adjustment of SFPP's COS by $4.6 million that is premised on an analytically incorrect and erroneous estimate of the dividend yield component of the DCF model; (iii) understate SFPP's cost of debt by more than 200 basis points by improperly adjusting SFPP's long-term debt to include variable rate debt associated with interest rate swap agreements; (iv) propose a capital structure that ignores the average capital structure of the comparable company group upon which Shippers themselves relied in conducting their DCF analysis; and (v) arbitrarily exclude reasonable, forecasted operating expenses associated with DR&R, environmental remediation, losses and shortages, and litigation.

As discussed in Section II.B, SFPP will show that Shippers have premised their case challenging the reasonableness of SFPP's rates entirely on a skewed and flawed COS analysis, with no consideration whatsoever given to the "totality of circumstances" that the Commission has indicated should be considered in evaluating the reasonableness of a pipeline utility's rates. SFPP did present evidence, the majority of which is unrebutted, establishing the totality of circumstances that bear upon the Commission's evaluation of the reasonableness of its rates, including evidence of (i) a reasonable COS to be attributed to SFPP; (ii) the size and sophistication of SFPP's customers; (iii) the availability of competitive alternatives to SFPP's services; (iv) the degree to which SFPP's rates compare favorably with other pipeline rates; and (v) data indicating that SFPP's rates have declined in real terms since 1992.

Upon the Commission's anticipated consideration of the totality of circumstances related to its rates, including reasonable assumption regarding its COS, SFPP is confident that the

Commission will conclude that its existing rates are just and reasonable.

A. SFPP's COS Showing Is More Reasonable Than The Shippers' COS Analyses and Demonstrates That SFPP's Existing Rates Are Just and Reasonable.

1. Throughput Projections and Related Revenues

Relying upon conventional test period principles, SFPP's TY 2009 estimate of throughput reflects the most recently available 12 months of data available at the time of testimony preparation (July 2008 through June 2009 data), adjusted to reflect changes that have occurred or may be expected to occur in the reasonable and foreseeable future and that are reasonably estimable.[14] Based upon an observed precipitous decline in volumes transported on SFPP's intrastate pipeline in recent years, considered in conjunction with economic and environmental considerations that suggest a continuing, declining trend, SFPP has forecasted 2009 TY volumes of 227 million barrels and adjusted revenues of $111.9 million.

The table below depicts SFPP's actual volumes:[15]

	Actual
2003	254,633
2004	257,021
2005	260,614
2006	262,770
2007	262,522
2008	241,430
2009	234,832

The above-table shows graphically that shippers' TY 2009 projection of 245 million barrels unreasonably assumes a return to throughput levels last seen in 2007, prior to what has been described as the worst economic downturn since the Great Depression. By comparison,

[14] SFPP relied upon a test period approach that is generally advocated by shipper witness Ashton. (*See* SFPP Opening Brief at 13).
[15] SFPP Opening Brief at 14.

SFPP's most reasonable expected scenario of 227 million barrels comports with the declining trend in SFPP volumes. Shippers' projection of 245 million barrels, however, improbably assume a 4.3% increase over 2009 volumes. To justify their proposed reversal of the actual declining trend in throughput, Shippers argue that the historical decline in demand is merely the product of temporary economic dislocations and that demand will likely increase as economic conditions improve.[16] To support the contention that the decline in gasoline demand is a temporary aberration, Shippers interpret studies by the Energy Information Administration ("EIA") as indicating that gasoline demand will increase in 2010 relative to 2009 by 1.35%.[17] Even if we were to accept Shippers' interpretation of the EIA data as assuming a 1.35% increase in U.S. gasoline demand between 2009 and 2010, that would suggest a maximum increase in SFPP throughput from 234.4 million barrels in 2009 to 237.4 million barrels in 2010 – a far cry from the 245 million barrels reflected in Shippers' COS showing.

The evidence of record does indicate that the EIA projects <u>for the whole country</u> a modest economic recovery in 2010 that is expected to increase gasoline consumption by 0.6%. However, in California, any such limited increase in gasoline volumes will be swamped by throughput volumes lost by SFPP due to increased requirements for ethanol blending. Even if the California economy follows the nation and experiences a modest recovery in 2010, and even if gasoline consumption increases 0.6 %, any such limited increase still will not come close to offsetting the 4.3% decrease in gasoline volumes anticipated because of mandated increases in ethanol blend requirements.[18]

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[16] Tesoro Opening Brief at 32.
[17] *Id.* at 34. Even assuming *arguendo* that gasoline demand in California will return to 2008 levels, SFPP's throughput in 2008 was 241.4 million barrels – not 245 million barrels that Shippers forecast as part of their COS showing. (*See* SFPP Opening Brief at 14).
[18] *Id.* at 7.

In light of continuing uncertainty regarding prospects for economic recovery, the 3-year trend of historical decline in SFPP throughput, and the 4.3% reduction of volumes resulting from mandated increases in ethanol blend requirements, it is reasonable, as SFPP recommends, to anticipate a further decline of 3.3% in TY throughput compared to prior year results (from 234.4 million barrels to 227 million barrels).

With regard to forecasts of expected revenue during the forward-looking period, Shippers' revenue projections ranging from $123 million to $126 million are unreasonable. Reflecting a fundamental flaw, Shippers' revenue projections dismiss the current economic dislocation as a temporary phenomenon and arbitrarily adjust SFPP's 2009 volumes to reflect Shippers' unsupported assumption that 2010 volumes would "return to 2008 levels or better."[19] Even assuming that such were the case, Shippers cannot rationally justify their assumption of 245 million barrels of TY throughput when 2008 throughput was 241 million barrels. Just as unreasonably, Mr. Ashton simply ignores the impact of the increased ethanol blend requirement as well as the associated reduction in SFPP throughput that will result from implementation of the ethanol blending mandate. While Mr. O'Loughlin did adjust his volumes to reflect the increased ethanol blend requirement, his volume analysis is fundamentally flawed in that it reflects nothing more than the average of 2005-2007 actual volumes and the actual volume level during July 2008 through June 2009.[20] Volumes in 2005-2007 ranged from 260 to 262 million barrels.[21] As such, Mr. O'Loughlin's projected revenues are not even remotely representative of anticipated conditions during the forward-looking period.

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[19] Tesoro Opening Brief at 31.
[20] *Id.* at 32.
[21] SFPP Opening Brief at 14.

All of the Shippers' revenue projections reflect inclusion of 3.3 million barrels of throughput to Miramar Station. As Mr. Dito has testified, the actual volume to Miramar in 2009 was 1.3 million barrels, or 60% less than originally estimated.[22] Consequently, the Shippers' revenue projections, based upon assumed Miramar throughput of 3.3 million barrels, are overstated by anywhere from $1 million to $2 million on this basis alone.

SFPP's recent cost-of-service compliance filing with the Commission indicates intrastate revenues of $120.3 million.[23] This 2009 revenue figure contrasts with SFPP's forward-looking forecast of $112 million in revenues. However, when two appropriate adjustments are made to the 2009 revenue figure, it can be seen that SFPP's projection of future revenues of $112 million is reasonable. First of all, the 2009 revenue figure needs to be adjusted downward to reflect the anticipated, further decrease of 3.3% in throughput volumes. Secondly, the revenue figure has to further revised downward to reflect the impact of resumed operation of the Flying J Bakersfield Refinery.[24] The closure of the Bakersfield refinery caused volumes which previously moved from Bakersfield to Fresno (on a lower-tariffed SFPP line) to move from Concord to Fresno (on a higher-tariffed SFPP line), thereby increasing SFPP revenues. With resumed operation of the Bakersfield refinery, volumes will return for movement on the lower-tariffed Bakersfield-Fresno segment and will displace volumes that were moving on the higher-tariffed Concord-Fresno segment. As Mr. Ashton properly has recognized, it is appropriate to assume that 15% of the volume previously moving from Concord-to-Fresno will move to Fresno from Bakersfield once

[22] SFPP Exhibit No. 11; Dito at p. 23.
[23] The referenced cost-of-service filing is the subject of Shippers' pending motion to reopen the record. Pending a ruling by the presiding ALJ and in light of SFPP's lack of objection to inclusion of its compliance filing in the record of this proceeding, SFPP does not believe any party will be prejudiced by its reference to matters that are not yet formally part of the record.
[24] Tr. Vol. 1, at p.27; SFPP Ex. 1; Webb at 15.

the refinery resumes operations.[25] This diversion of volumes from the Concord-Fresno segment to the Bakersfield-Fresno segment will reduce SFPP's revenues by more than $3 million. When SFPP's 2009 revenues of $120.4 million are adjusted to reflect the dual impact of a 3.3% reduction in volumes and the loss of revenues associated with resumption of operations at the Bakersfield refinery, SFPP's projection of revenues of $112 million during the forward-looking period is entirely reasonable.

2. Operating Expenses

SFPP's CPUC-jurisdictional operating expenses for TY 2009 are $66.5 million as part of SFPP's overall cost of service of $113.3 million. A principal component of SFPP's $66.5 million in TY 2009 operating expenses consists of $16.8 million in KMEP overhead either directly assigned or allocated to SFPP's intrastate pipeline operations. Of the $66.5 million in operating expenses recommended by SFPP, shipper witness Ashton would adjust (reduce) SFPP's proposed operating expenses as follows: (a) KMEP Overhead Costs - $10.394 million; (b) DR&R - $2.027 million; (c) Environmental Expense - $1.942 million; and (d) Oil Gains/Losses - $.504 million. Shipper witness O'Loughlin would adjust (reduce) SFPP's proposed operating expenses as follows: (a) KMEP Overhead Costs - $11.690 million; and (b) DR&R - $1.42 million.

a. Overhead Costs:

Before addressing the issue of the reasonableness of the overhead cost allocations that are reflected in SFPP's COS, SFPP submits that there are elements of the overhead cost allocation arguments set forth in the briefs of Tesoro and C/CP/SWA that should be ignored by the Commission. At pp. 66-69 of its brief, Tesoro engages in a lengthy disquisition regarding recent

[25] Tesoro Opening Brief at 31.

FERC proceedings involving SFPP's West Line (IS08-390), references exhibits from the FERC proceeding that are not part of the subject record, selectively excerpts transcript references from the FERC proceeding (once again, not part of the subject record), and then asks the Commission to draw a variety of conclusion from Tesoro's use of extra-record materials. This portion of Tesoro's brief should be stricken.

C/CP/SWA, at pp. 38-45, asserts that the Commission has historically applied the "Four Factor Method" to allocate general and administrative expenses ("G&A") that cannot reliably be directly assigned to one entity within a larger business organization. Without any foundation, C/CP/SWA asserts that G&A expenses incurred on behalf of SFPP cannot reliably be directly assigned to SFPP. However, other than hollow complaints about the difficulty that shippers would have in auditing/verifying the accuracy of the costs directly assigned to SFPP no basis has been provided by Shippers to call into question the reliability of such direct assignment of G&A costs to SFPP. Nevertheless, rather than recommending that the Commission apply its traditional "Four Factor Method" in these circumstances, C/CP/SWA engages in a wide-ranging discussion of the use of the Massachusetts Formula to allocate overhead costs in circumstances in which corporate overhead cannot reliably be charged on a direct basis and appears to ask the Commission to adopt a new approach to allocation of G&A expenses based upon use of the Massachusetts Formula, as interpreted and modified by C/CP/SWA's witness, Dr. Arthur.[26] The Commission should ignore the portions of C/CP/SWA's brief that request the Commission to undertake fundamental revision of its existing policies for treating allocation of overhead costs.

KMEP's cost allocation methodology is a combination of "shared cost distributions," in which costs that are "shared" by a particular group of subsidiaries are directly assigned to that

[26] C/CP/SWA Opening Brief at 40-44.

group of subsidiaries and then allocated among the members of that group, and a Massachusetts formula allocation, in which costs that cannot be directly assigned to any individual subsidiary or group of subsidiaries are allocated among all KMEP-Operated Entities. KMEP directly assigns corporate overhead costs to individual subsidiaries to the extent possible. Some of KMEP's overhead costs cannot be directly assigned to an individual subsidiary but can be identified with a distinct group of subsidiaries, such as those within a single business division. KMEP uses the shared cost distributions to directly assign these types of shared costs to the particular group of subsidiaries that benefit from the costs and then allocates the costs among the members of the group.

KMEP's use of these shared cost distributions allows it to allocate its shared costs exclusively among the particular group of subsidiaries that benefit from the costs, resulting in a close matching of costs with the entities that caused them to be incurred. This "cost-causation" approach accurately matches overhead service costs with the subsidiaries that caused them to be incurred, including SFPP and Calnev. Contrary to Shippers' assertions, there are no other methodologies used to allocate overhead costs for KMEP.

The Shippers do not contend that KMEP's cost allocation methodology fails to follow basic cost-causation principles when allocating and assigning costs to the entity that causes the cost to be incurred. Instead, the principal complaint that Shippers lodge with respect to KMEP's cost allocation methodology is that it is too difficult for Shippers to be able to verify (presumably by some form of "audit") the accuracy and reasonableness of KMEP's methodology. Of course, the standard of "verification" that the Shippers seem to believe is necessary is unreasonable and impractical, if not impossible. As Mr. Bradley testified, in order to absolutely verify that every minute of every employee's time is being coded with pinpoint precision, someone would literally need to follow around each individual employee all day.[27] However, the same is true of any company and of other professions, such as lawyers and consultants, and such a verification process is unreasonable, though it seems to be what the Shippers expect.

It is patently unreasonable for the Shippers to presume, as they seem to do, that KMEP would countenance the manipulation of time reporting records on a company-wide basis (and thereby disguise the relationship between costs and cost causers) in order to maximize the overhead cost expenses that its regulated utility subsidiaries might be allowed to recover in rates.

Without foundation and as roundly rebutted by SFPP witness Bradley, Shippers attempt to portray KMEP's books and records as so abysmally inaccurate that they are entirely unreliable and should be completely disregarded.[28] In essence, their assertions are such that the result of any effort by KMEP to employ a reasonable cost-causation approach is simply not acceptable to Shippers given their unfounded, and rather self-serving, assertions that the accounting records of KMEP are in some unstated way "cooked" and cannot be believed. Nor, apparently according to Shippers, can the major accounting firm, KPMG, which conducted an intense review of KMEP overhead procedures, be believed.

In sharp contrast to the KMEP cost allocation methodology, as reviewed and approved by KPMG, LLP, the "all-in" approach recommended by both shipper witnesses, Ashton and Arthur, completely disregards cost-matching principles and assumes that simplicity is more important than accuracy. Under the Shippers' approach, it is more important that the process be "transparent" to Shippers and easily verifiable than it is to actually match costs with the services and subsidiaries that caused them to be incurred. Even though direct assignment of costs most

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[27] Tr. Vol. 6 at p. 605.
[28] SFPP Exhibit No. 16; Bradley.

closely matches cost-causation principles, accuracy is sacrificed for ease of administration. It is not surprising that Shippers' readiness to sacrifice accuracy has the collateral effect of reducing SFPP's recommended $16.8 million in prudently incurred KMEP overhead that should be included in SFPP's CPUC-jurisdictional service by more that $10 million.

The flaws in the shipper-recommended "all-in" allocation approaches are readily demonstrable. A particularly glaring example of the unreasonableness of the "all-in" allocation approach is Mr. Ashton's claim that the $5.5 million in legal costs, which KMEP assigns directly to SFPP, are largely unrelated to transportation service provided to Shippers . Mr. Ashton's claim has no basis and is simply wrong. The bulk of these costs were incurred solely for SFPP's ongoing legal matter regarding the value of its pipeline right-of-way yet under Mr. Ashton's recommendations, these SFPP-specific legal costs should be allocated among all KMEP subsidiaries. Dr. Arthur's proposal is even more egregious as he allocates those SFPP-specific costs to KMI's subsidiaries, as well as KMEP's.

In addition, Mr. Ashton and Dr. Arthur both suggest that a simple allocation model is preferred by regulators over accurate, albeit more complex approaches. There simply is no basis for this self-serving claim. While he continually repeats his concerns that KMEP's "complex" approach encourages cross-subsidization, it is Dr. Arthur's rudimentary "all-in" approach that commits the ultimate cross-subsidy. Specifically, in his Table 1 on page 51 of his testimony, Dr. Arthur shows that KMEP's total overhead expense is $297.8 million, and that under his approach, SFPP would be allocated 5 percent of this amount, or $15.6 million. Inherent in Dr. Arthur's "all-in" allocation approach in his Table 1, is that he would allocate more than half of the $297.8 million to the KMEP entities that, as Mr. Bradley explains, receive little or no benefit from KMEP overhead services.[29] Thus, Dr. Arthur allocates more than 50 percent of the overhead costs that are specific to SFPP, to KMEP entities that have nothing to do with the incurrence of these costs, while at the same time, he allocates 5 percent of CO_2 and bulk terminal specific overhead costs to SFPP. Dr. Arthur's recommendation of his "all-in" approach belies any commitment to cost-causation principles and instead directly fosters the "cross-subsidization" that his approach is ostensibly designed to mitigate. In fact, Dr. Arthur would allocate over $150 million of KMEP's overhead to subsidiaries that receive virtually no benefit from these services.[30]

Even if there were merit to Mr. Ashton's and Dr. Arthur's criticisms regarding the accuracy of KMEP's direct assignment of applicable overhead costs – which as SFPP witness Bradley explains, there is not – the remedy would certainly not be the "all-in" allocation approaches employed by Mr. Ashton or Dr. Arthur. Under their "all-in" approaches, all vestiges of accuracy are eliminated and the cost-causation principle previously discussed is entirely ignored. Simply put, their allocation approaches explicitly ignore how and why KMEP's overhead costs are incurred and the amounts that are properly allocated or assigned to each entity.

b. DR&R:

SFPP's proposal for recovery of DR&R costs provides SFPP with the means to collect funds for transportation-related costs that would not be incurred until after the ultimate termination of SFPP services – at which time, funds will no longer be collected from shippers.

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[29] Dr. Arthur's "all-in" approach reflected in Table 2 on page 52 of his testimony is equally flawed in that it combines subsidiary entities and overhead incurred from two parent companies – KMI and KMEP.

[30] SFPP Ex. No. 15; Turner at 10; SFPP Ex. No. 16; Bradley at 26-39.

Absent a DR&R provision, SFPP will have no proper means to recover these costs.

DR&R is a legitimate cost recognized by the Commission for many utilities; and no one can plausibly dispute that these costs will ultimately be incurred. Contrary to Shippers' claims that retirement and dismantlement of SFPP system facilities is speculative and highly unlikely, there is a high probability that SFPP will incur costs associated with the retirement and dismantlement of facilities in the future. In anticipation of inevitable retirement and removal of utility facilities, the Commission has expressly noted that: "[accrual] accounting for removal costs is fair to ratepayers because it ensures that ratepayers pay for the removal costs of those assets that serve them."[31] The FERC has acknowledged the propriety of a DR&R provision, referencing its awareness "that a number of oil pipelines are currently collecting an allowance in jurisdictional rates to cover the future cost of retiring and removing facilities …"[32] In light of the reasonable expectation that SFPP will incur costs associated with the retirement of facilities in the future, it is appropriate for each barrel moving through the pipeline, from now until termination date, to bear its fair share of these estimated future costs.[33]

Witness Ashton proposes to eliminate DR&R expense entirely from SFPP's operating expenses, while witness Arthur acknowledges the propriety of collecting DR&R expenses but reduces the amount to be collected by SFPP by extending the period the DR&R funds are to be collected from approximately 24 years to 40 years.[34] The principal shipper argument in opposition to SFPP's DR&R proposal is that it is inappropriate to collect from ratepayers estimated costs that are speculative in nature and which may never be incurred.

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[31] SFPP Exhibit No. 15; Turner at 18.
[32] 101 FERC ¶ 61, 102 at P 65 (October 2002).
[33] SFPP Exhibit No. 15; Turner at 21.
[34] SFPP Opening Brief at 28.

Shippers' criticism that SFPP is not incurring any DR&R at the current time is rather eccentric given the very nature of DR&R renders it virtually impossible to be incurred while the pipeline is in operations. A DR&R provision provides SFPP with the means to collect funds for dismantlement, removal and restoration of the pipeline systems upon the <u>ultimate</u> <u>termination</u> of SFPP's services. No one disputes that upon termination of service, SFPP's pipelines, at a minimum, must be purged of dangerous hydrocarbons and filled with nitrogen. This activity is a legitimately recoverable cost that the carrier must bear, but won't be incurred until after operations cease. The only means for a carrier to recover these costs, under traditional cost of service regulation, is through a provision in current tariff rates. By definition, SFPP's DR&R provision relates only to *future* costs because DR&R is not performed until after facilities are removed from service and SFPP terminates its operations.

Nor is there any merit to Shippers' contention that using remaining useful life is unreasonable since SFPP's California intrastate service is likely to continue to function indefinitely. It is Shippers who are unreasonable in their assumption that the pipeline will operate in perpetuity. While no one knows with certainty when SFPP will ultimately terminate services, it is quite reasonable to expect that service will terminate at some point in time, and that SFPP will be required to expend funds to perform DR&R. In a regulatory proceeding such as this, it is quite common to have to make reasonable judgments or forecasts based upon the information available. That a judgment is premised upon probabilities or approximations does not make it suspect or unreasonable. SFPP's DR&R calculation is based on the system-wide remaining life determined by depreciation rates approved by the FERC, which is the most reasonable proxy for the ultimate termination of SFPP services.[35] In this context, it can be seen

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[35] *Id.* at 19.

that witness Arthur's recommendation that the remaining life assumption used to calculate SFPP's DR&R provision be extended from 24 to 40 years is completely arbitrary. A remaining life assumption based on approved depreciation rates is the most reasonable proxy for the ultimate termination of SFPP services. Taking their illogical arguments further, Tesoro states that by virtue of SFPP using a remaining useful life, SFPP is claiming its operations will definitely cease in 24 years.[36] The record proves otherwise. Like any other test year cost-of-service component, the DR&R estimate would be reassessed over time to determine if the DR&R amount is reasonable. SFPP's current system-wide remaining useful life of 24 years is the best available proxy of the ultimate termination of SFPP's operations, but it too is influenced by expansions and interim retirements, and subject to reassessment.[37]

DR&R is a cost of performing transportation service, and including a DR&R provision in SFPP's cost of service is the only means to recover this cost. The fact that DR&R costs will not be incurred until after the ultimate termination of SFPP services does not make them any less a cost of doing business nor does it mean that Shippers should not bear them.

c. Environmental Expense:

Witness Ashton proposes to arbitrarily reduce SFPP's environmental remediation expenses of $8 million by over 1.6 million.[38] Mr. Ashton does not provide any meaningful basis for his adjustment other than his belief that SFPP picked the wrong 12 months of actual data as the basis for the 2009 test period. Mr. Ashton's criticism of SFPP's recommended environmental remediation expenses is based upon innuendo, not facts. Specifically, Mr. Ashton speculates that SFPP "seems" to be continually incurring higher environmental expense – yet he

[36] Tesoro Opening Brief at 78.
[37] Evidentiary Hearing Transcript, Vol. 5 at p. 568.
[38] After acknowledging an error, Tesoro Opening Brief at 79.

does not support this speculation with any facts whatsoever, nor does he say why environmental cost increases over time is wrong or even unusual.[39] Further, he provides no rationale, much less an evidentiary basis, justifying a reduction of $2 million in SFPP expenses – rather than $1 million or $5 million or the entire $8 million. His recommended disallowance of $2 million in environmental expenses is arbitrary and should be rejected.

d. Oil Losses/Shortages:

Witness Ashton reduces SFPP's operating expense for oil losses and shortages by approximately $0.5 million. Mr. Ashton's adjustment is a concoction of the average losses and shortages recorded by SFPP in total during the years 2003 through 2007 multiplied by the 2007 ratio of CPUC-jurisdictional costs to total costs, then averaged again with the average of SFPP's CPUC-jurisdictional oil losses and shortages for 2007 and the 12-months ended June 30, 2009. Simply stated, Mr. Ashton's number is an average of two averages and represents a manipulation of data to improperly exclude SFPP's recorded 2008 gains/losses.

SFPP presented testimony rebutting Mr. Ashton's assertion that 2008 oil losses/shortages costs were in any way anomalous. Such testimony showed SFPP's oil losses and shortages for the calendar years 2003 through 2007 by pipeline system. It also included SFPP's July 2008 through June 2009 base period costs. The proffered evidence demonstrates that for each pipeline system that is in CPUC-jurisdictional service, SFPP's base period oil losses and shortages cost, is well within the range experienced by SFPP in 2003 through 2007.[40] Therefore, even if 2008 were an anomalous year as Mr. Ashton claims – which by pipeline system it was not – SFPP's base period cost is not anomalous. Tesoro claims that in order for SFPP to prove 2008 was not

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[39] *Id.* at 23.
[40] *Id.* at 27.

anomalous, that all of the high or low observations during the years 2003 through 2007 must have occurred in a single year.[41] Such a claim is utterly nonsensical, and furthermore, disregards the fact that it is Tesoro recommending a test year adjustment – not SFPP – and it is Tesoro that must prove why 2008 was allegedly anomalous and a test year adjustment is necessary. Mr. Ashton's attempt to evaluate SFPP's oil losses and shortages at the total company level is irrelevant for CPUC-jurisdictional purposes and is misleading. As such, his proposed reduction of SFPP's operating expenses associated with losses and shortages should be rejected.

e. Litigation Expenses:

Witness Ashton recommends SFPP's litigation expense associated with this proceeding be amortized over a five-year period and then be removed from the cost of service. His recommendation violates his own general test period principles. Mr. Ashton does not specify when he believes this litigation will disappear; but, in all likelihood, it is well beyond what is reasonably known and estimable for test period purposes. Specifically, SFPP has been in litigation with the same group of shippers at the FERC for over 20 years, and over 10 years at the CPUC. Mr. Ashton has provided no basis for his assessment that these costs will disappear in the reasonably foreseeable future. Therefore, SFPP's litigation expense should be treated as any other operating expense in its test period cost of service.

3. Cost of Capital

Based upon his analysis of the required return on common equity for a set of publicly traded oil pipeline proxy companies, Professor Vander Weide concludes that a reasonable determination of the cost of equity for SFPP is 15.01%. He further recommends a cost of debt equal to 6.56 percent and a capital structure containing 52.43 percent debt and 47.57 percent

[41] Tesoro Opening Brief at 80.

equity.[42]

The Shippers, like Dr. Vander Weide, estimate SFPP's cost of equity by applying the DCF model to groups of proxy companies. Witness Ashton recommends a cost of equity of 12.43%;witness Horst recommends a cost of equity of 12.21%; witness Crowe recommends a return on equity of 10.25%.[43] With respect to cost of debt, Mr. Ashton recommends a cost of debt equal to 6.53 percent; Ms. Crowe recommends a cost of debt equal to 4.66 percent; and Dr. Horst recommends a cost of debt equal to 4.35 percent.[44] With respect to capital structure, Dr. Horst recommends 60.36 percent debt and 39.64 percent equity; Mr. Ashton recommends 61.7 percent debt and 38.3 percent equity; and Ms. Crowe recommends 69.5 percent debt and 30.5 percent equity.[45]

As discussed below, the Commission should endorse SFPP's cost-of-capital recommendations as reasonable.

a. Cost of Equity:

The Shippers' various cost of equity recommendations reflect fundamental, analytical flaws that produce results that do not represent a reasonable basis for determining SFPP's cost of equity. All parties relied upon the DCF model to formulate their respective recommendations regarding cost of equity. The DCF model provides an equation that relates a company's stock/unit price to: (1) the future cash flows investors expect to receive from owning the stock/unit; and (2) the investors' required rate of return on investments of similar risk. Since a company can attract capital only by offering investors a return that is commensurate with returns

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[42] *Id.*
[43] Tesoro Exhibit No. 14; Ashton at 32; ExxonMobil – 1; Horst at 4; BP-1; Crowe at 17.
[44] *Id.* at 17.
[45] *Id.* at 20.

they can receive on other investments of similar risk, the company's cost of equity is equal to the investors' required rate of return. Thus, the cost of equity can be estimated by solving the DCF equation for determining the investors' required rate of return.

The essential components of a proper DCF analysis require identification of an appropriate group of proxy companies, a valid estimate of the distribution yield component of the annual DCF model, and a valid estimate of the growth component of the DCF model. The respective shipper cost-of-equity analyses suffer from some or all of the following defects: (1) the selected proxy companies are not comparable to SFPP; (2) the dividend yield component of the DCF model is wrongly estimated; and (3) the growth component is wrongly estimated. As discussed below, the various DCF modeling results produced by the Shippers are unreliable and should be rejected.

While Dr. Horst and Mr. Ashton recommend essentially the same group of oil pipeline MLPs recommend by Dr. Vander Weide, Ms. Crowe recommends use of a proxy group consisting of ten oil and gas corporations that, according to Ms. Crowe, own at least one major interstate oil or gas pipeline. While SFPP is involved primarily in the oil pipeline business, none of Ms. Crowe's proxy companies are involved primarily in the oil pipeline business. Most of Ms. Crowe's proxy companies are involved primarily in regulated and unregulated natural gas operations.[46] It has been recognized that oil pipelines generally have higher risk than natural gas pipelines and that natural gas pipelines generally have higher risk than natural gas local distribution companies and electric utilities.[47] Ms. Crowe's selected proxy companies are not

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[46] *Id.* at 15.
[47] *See, e.g.*, Opinion No. 486-B at PP 47-51, 53, 90; *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077, at P 158 (2006); *Rate Regulation of Certain Natural Gas Storage Facilities*, 115 FERC ¶ 61, 343, at P 56 (2006), (stating that "determining whether an oil pipeline has market power in individual cases reflects the specific competitive circumstances affecting oil pipelines," including the fact that oil pipelines "face competition not only from other oil pipeline providers but also from other modes of delivering oil

(footnote continued)

comparable to SFPP, rendering the results of her DCF analysis unreliable.[48]

Assuming the selection of a proper group of proxy companies, the DCF model essentially estimates the cost of equity by adding the investor's expected growth rate to the company's expected distribution or dividend yield. It is with respect to estimates of the dividend yield component and the growth component of the DCF model that Dr. Vander Weide disagrees with Dr. Horst and Mr. Ashton. Dr. Horst and Mr. Ashton estimate the distribution yield component of the DCF model by dividing each company's current annual distribution by the average unit price over the last six months, and multiplying the result by the first-year growth factor (1 + 0.5 g). The Shippers estimate the dividend yield at the end of the first year by multiplying the current or beginning of year dividend yield by the factor (1 + 0.5 g).

Dr. Vander Weide has explained the flaw in Shippers' decisions to first assume that dividends are paid annually at the end of each year (as required under the annual DCF model) and then to estimate the expected end-of-year dividend yield by multiplying the company's current dividend yield by the factor (1 + 0.5 g). The flaw in the Shippers' DCF has the effect of understating the cost of equity to the proxy companies. <u>As Dr. Vander Weide testified, the annual DCF model requires that the cost of equity be calculated by multiplying each company's current dividend yield by the factor (1 + g), not 50% of expected growth (1 + 0.5 g) as shippers have done.</u>[49]

To justify their substitution of the factor (1 + 0.5 g), rather than reliance upon the factor (1 + g) normally incorporated in running the annual DCF model, shipper witnesses must assume

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such as rail, barges, and trucks" and that "there are not similar alternative modes of delivering or storing natural gas").

[48] In addition to using an inappropriate group of proxy companies, Ms. Crowe also includes highly unreliable results from two of her proxy companies in her analysis. SFPP Opening Brief at 42.

[49] SFPP Exhibit No. 14; Vander Weide at 5.

that: (1) the proxy companies will increase their dividends in different quarters of the next year; and (2) on average, the proxy companies will increase their dividends at the end of the second quarter, that is, half way through the year. <u>However, the shippers' assumption that the proxy companies will increase their dividends, on average, at the end of the second quarter, is inconsistent with the fundamental assumption of their annual DCF model that dividends are only paid annually at the end of the year.</u> If a company pays dividends quarterly, as the shippers assume in their justification for using the factor (1 + 0.5 g), the quarterly DCF model should be used to estimate the cost of equity.[50]

Shippers appear to mix and match assumptions, claiming to rely upon an annual DCF model, while incorporating assumptions appropriate for application in a quarterly DCF model. In order to be conservative, Dr. Vander Weide used an annual DCF model, rather than a quarterly DCF model formula. Dr. Vander Weide further demonstrated the inaccuracy of Dr. Horst's claim that Dr. Vander Weide's use of the annual model produces a higher cost of equity result than the quarterly model. Contrary to Dr. Horst's assertion, a correctly applied quarterly DCF model typically produces a higher cost of equity result than the annual model used by Dr. Vander Weide to estimate SFPP's cost of equity.[51] Of course, Shippers did not present either a correctly applied quarterly DCF model or a correctly applied annual model.

The shipper witnesses and Dr. Vander Weide also differed in their estimation of the growth component of the DCF model. Dr. Vander Weide used the analysts' estimates of future earnings per share ("EPS") growth reported by I/B/E/S Thomson Reuters. The shipper witnesses estimate the growth component of the DCF model in three steps. First, they obtain data on the

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[50] *Id.*
[51] *Id.* at 6.

analysts' median expected earnings per share ("EPS") growth rate published by I/B/E/S Thomson Reuters and the long-run GDP growth forecasts of EIA, Global Insight, and the Social Security Administration. Second, they adjust the average long-run GDP growth forecast from these three sources by dividing the average by two. Third, they calculate a weighted average of the analysts' median growth forecast and the adjusted long-term GDP forecast, giving the I/B/E/S growth rate a two-thirds weight and the adjusted average GDP growth rate a one-third weight.

SFPP submits that it is appropriate to estimate the growth component of the discounted DCF formula using a one-stage growth model based only on the I/B/E/S short-term growth rate forecasts of the proxy companies. Dr. Vander Weide's growth rates rely upon direct, market-based information developed from analysts' forecasts as the best estimates of investors' expectations of future long-run growth. While Shippers do give weight to the I/B/E/S short-term growth rate forecasts in estimating the growth component, they also incorporate more generic data reflecting long-run growth forecasts of GDP primarily developed by governmental agencies. SFPP submits that Dr. Vander Weide's growth rate component, predicated on the analysis of market participants is superior to the Shippers growth component that weights analysts' expectations with various governmental projections of GDP.

Dr. Vander Weide's correct application of the DCF model to his comparable companies produces a median result of 14.69 percent, and a range of results from 12.62 percent to 15.33 percent. Based upon this range of results, Dr. Vander Weide recommends that a cost of equity of 15.01 percent be used in evaluating whether SFPP's existing rates are likely to produce cost of service results that are within the Commission's acceptable range. The recommended 15.01 percent cost of equity is the midpoint of the median cost of equity for the comparable company group, 14.69 percent, and the high estimated cost of equity for the comparable company group, 15.33 percent. Dr. Vander Weide recommends a cost of equity in the upper half of the cost of equity results rather than recommending the median result because SFPP has greater business risk than the companies in the comparable company group.[52]

b. Cost of Debt:

Dr. Vander Weide recommends a cost of debt equal to 6.56 percent, by calculating the weighted average cost of the long-term debt shown on Kinder Morgan Energy Partners' ("KMEP") balance sheet. Mr. Ashton recommends a cost of debt equal to 6.53 percent; Ms. Crowe recommends a cost of debt equal to 4.66 percent; and Dr. Horst recommends a cost of debt equal to 4.35 percent.[53]

As did Dr. Vander Weide, Mr. Ashton arrived at his recommended cost of debt by calculating the weighted average cost of the long-term debt shown on KMEP's balance sheet. Ms. Crowe and Dr. Horst, however, contend that Dr. Vander Weide has overstated SFPP's cost of debt by more than 200 basis points, asserting that Dr. Vander Weide failed to take into account KMEP's interest rate swap agreements.

As set forth in SFPP's Opening Brief at pp. 43-44, it is quite apparent that interest rates swap agreements should not be taken into account when calculating the cost of long-term debt because the effective interest rate on the floating rate obligation over the term of the agreement can only be estimated with great uncertainty, and, in any case, is likely to approximate the effective interest rate on the company's fixed-rate long-term debt.

There is no substantial difference between the cost of debt as recommended by Dr.

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[52] *Id.* at 14.
[53] *Id.* at 17.

Vander Weide and shipper witness Ashton. Accordingly, the Commission should adopt a cost of debt equal to 6.56 percent.

c. Capital Structure:

SFPP's recommended capital structure of 52.43 percent debt and 47.57 percent equity is the average capital structure for the comparable company group at June 30, 2009 that was used in connection with Dr. Vander Weide's DCF analysis.[54] Shippers ignore the capital structure of the proxy companies that are the subject of their DCF analyses and instead first look to KMEP's actual debt and equity balances at different points in time and then make extraordinary adjustments to the equity balances to incorporate what are called "purchase accounting adjustments" during the test period.[55]

SFPP's Opening Brief, at pp. 45-47, sets forth the reasons why the Shippers' proposed PAA adjustments to capital structure are inappropriate. As explained by Dr. Vander Weide, the accounting entries made at the time of an acquisition reflect the fair value of the asset acquired and the actual financing, if any, used to acquire the asset. If the asset is acquired with cash, there will be no changes to the acquiring company's debt and equity balances at the time of the acquisition. If the asset is financed with a mix of debt and equity financing, the acquiring company's debt and equity balances will both increase to reflect the actual financing of the acquired asset. In no case will the debt and/or equity balances be "inflated" or "restated" to reflect anything other than the actual amounts of debt and equity that financed the acquisition.

If the Commission were to adjust a company's capital structure to reflect acquisition financing, the Commission would have to adjust both the debt and equity balances for the actual

[54] *Id.* at 19.
[55] SFPP Opening Brief at 45.

financing of the acquisition. Given KMEP's policy to finance its acquisitions with 50 percent debt and 50 percent equity, if the Commission were to adopt a recommendation such as Mr. Ashton's to remove purchase accounting adjustments, it should reduce both debt and equity in equal amounts.

Finally, with respect to the issue of capital structure, attention should be called to Tesoro's arguments that repeatedly reference the proposed decision of ALJ Long in Case No. 97-04-025 et al. as ostensible support for various recommendations that Tesoro is advancing in the subject proceedings. At. p. 3 of its opening brief, Tesoro, with approval, cites ALJ Long's proposed decision as holding that the capital structure of KMEP is appropriate for use in determining SFPP's return. Tesoro notably omits to mention that ALJ Long's proposed decision, while looking to KMEP's capital structure for guidance, incorporates a capital structure of 60% equity-40% debt as appropriate in determining SFPP's return. ALJ Long's proposed capital structure is a far cry from Tesoro's recommended capital structure of 39.64% equity-60.36% debt.

B. Other Empirical Data Validates the Reasonableness of SFPP's Existing Rates as Demonstrated by Its COS Showing.

SFPP does not seek freedom from Commission oversight of the rates it charges for its intrastate pipeline transportation services. Nor is SFPP requesting authority to charge whatever rates that it deems appropriate or believes the market can bear. Fully recognizing the Commission's statutory obligation to regulate the rates charged for its common carrier services, SFPP instead is asking the Commission to evaluate the reasonableness of its rates in a context that recognizes the differences in status between a franchised, monopoly utility and a utility that faces competition, even if it is only "moderate" competition. Specifically, SFPP asks the Commission to give some consideration and weight to the factors pertaining to the comparability of pipeline rates; the size and level of sophistication of SFPP's customers; the availability of competitive alternatives to SFPP's services; and the minimal impact of SFPP's rates on the ultimate consumer,[56] along with its evaluation of SFPP's rates based upon cost of service. While SFPP recognizes the difficulty of quantifying the weight that the Commission should give to non-COS factors in its evaluation of SFPP's rates, it seems just as obvious that the Commission should not employ COS as the exclusive measure of the reasonableness of SFPP's rates.

SFPP shares both the characteristics of a public utility with potential to exercise market power and the characteristics of a public utility that faces competition for its services. This hybrid nature of SFPP suggests that neither the model of strict COS regulation nor market-based authority works as a uniformly appropriate approach to the regulation of SFPP's rates and services. For example, if the Commission were to see evidence that SFPP was, in certain circumstances, charging non-comparable pipeline rates to shippers who had no alternatives to use of the particular pipeline service and thereby insulated from any competitive consequences, it would be appropriate to apply a stricter standard of scrutiny to SFPP's costs. By the same token, it would not be good policy for the Commission to discount evidence that a shipper has economic alternatives to a particular SFPP pipeline movement and nevertheless declare the rate unreasonable based simply upon a strict cost-of-service analysis.

Instead, it would seem that the Commission should adopt a more flexible approach to discharging its duty to ensure that SFPP's rates are just and reasonable – an approach that considers the totality of circumstances relating to SFPP's intrastate pipeline utility services.

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[56] Specifically, using the most extreme positions of any party in this proceeding – O'Loughlin's revenue of $126.4 million and Ashton's COS of $84.6 million would imply SFPP excess revenue of $41.8 million. Dividing $41.8 million by the lowest recommended total intrastate volumes transported on SFPP's pipelines (Dito's 227.4 MMBBLS x 42 gallons per barrel) means that AT MOST $0.004 per gallon is at issue (see also Tr. at 89).

Shippers have premised their challenge to the reasonableness of SFPP's rates based exclusively upon application of a strict COS methodology. Only SFPP has presented evidence of the "totality of circumstances" that are relevant to proper evaluation of its rates. The unrebutted evidence shows that: (i) SFPP's customers have competitive alternatives, both actual and potential, and the wherewithal to avail themselves of such alternatives; (ii) SFPP faces moderate competition, particularly from trucking; (iii) SFPP's rates compare favorably with other pipeline rates; and (iv) over the past 18 years and as they stand at current levels, SFPP rates have increased less than the common measures of inflation. It is in the context of SFPP's "totality of circumstances" that the Commission can readily find justification for determining that SFPP's rates are just and reasonable.

1. The Size and Sophistication of SFPP's Customers Does Matter.

SFPP asks the Commission to acknowledge that, in SFPP's case, strict regulatory oversight is unnecessary to protect captive customers who might otherwise be subject to potential exploitation by SFPP. The customers of SFPP are large sophisticated corporations that have the financial and technical wherewithal to protect their own commercial interests. In fact, SFPP's shippers are owned by corporations whose market capitalization exceeds that of SFPP's parent, KMEP by a large factor.

2. SFPP Faces Moderate Competition; Its Shippers Have Competitive Alternatives.

The evidence of record demonstrates that shippers, principally in the form of trucking, have economically viable, competitive alternatives to use of SFPP's pipeline transportation services. The evidence is equally compelling that the availability of such alternatives constrains the prices SFPP can charge for such shorter-haul movements without risking the loss of significant throughput.[57]

3. SFPP's Existing Rates Pass the Competitive Rate Test.

The only evidence of record that compares SFPP's existing rates with the rates of other pipelines, or to the pipeline industry as a whole, shows that SFPP's rates are quite comparable to other pipelines with substantial intrastate components.[58] This evidence remains unrebutted.

4. SFPP's Rates Have Declined in Real Terms.

From 1992 to the present, the total increase in SFPP rates has been substantially lower than the various, standard measures of inflation. The fact that SFPP rates have, if anything, declined in real terms over time is further, empirical evidence of their reasonableness.[59]

5. SFPP's California Operations Incur Additional Risk.

In addition to generalized risks of operating a product pipeline in CA, SFPP faces additional high risks associated with its California operations. Major portions of SFPP's intrastate pipeline system are either located within or near heavily urbanized areas and/or sensitive environmental habitat. 87.9% of SFPP pipelines under CPUC jurisdiction in California are in High Consequence Areas. Major portions of SFPP's pipeline system are getting older and more difficult to maintain.[60]

III. CONCLUSION

SFPP provides important pipeline transportation services. It is certainly the role of the Commission to exercise its regulatory authority over SFPP in a manner that ensures that SFPP

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[57] SFPP Opening Brief at pp. 51-55.
[58] *Id.* at 55-57.
[59] SFPP Opening Brief at 57-58.
[60] *Id.* at 59.

continues to safely and reliably operate its intrastate pipeline infrastructure and to provide transportation fuel-related services at just and reasonable rates. Proper discharge by the Commission of its constitutional and statutory duties does not, however, require levels of rate scrutiny comparable to those applied to monopoly providers of essential services, such as PG&E. In setting rates for monopolies like PG&E, an essential element of the Commission's exercise of its authority is to ensure the continued (and reasonably priced) availability of essential services, such as heating, light and power, for which no alternative exists.

SFPP's shippers are not "captive" customers lacking any alternative to SFPP's services. Its shippers are predominantly large oil company enterprises, who posses, at least to some degree, the ability and wherewithal to transport their refined petroleum products to market without any need to use any portion of SFPP's intrastate pipeline system. The Commission's exercise of its rate authority over SFPP, rather than focusing on the allocation of costs between the pipeline and its shippers, should concentrate on ensuring that SFPP is not exercising market power and attempting to charge supra-competitive rates. There is, of course, no evidence of record in the subject proceeding that remotely suggests that any of SFPP's current rates constitute a supra-competitive rate.

There also is no compelling evidence, or related policy reason, that supports the Shippers' request that the Commission order the transfer of substantial and inordinate sums of money from SFPP to themselves. When all of the evidence is considered, including COS evidence as well as the other indicators of the reasonableness of SFPP's rates, the Commission has all the required justification for dismissing the Shippers' claims and finding that SFPP's existing rates are just and reasonable.

Respectfully submitted this 24th day of May, 2010 at San Francisco, California.

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CERTIFICATE OF SERVICE

I, Lisa Chapman, certify that I have on this 24th day of May 2010 caused a copy of the foregoing

CONCURRENT REPLY BRIEF OF SFPP, L.P. AND CALNEV PIPE LINE LLC

to be served on all known parties to A.09-05-014, A.08-06-008, A.08-06-009 listed on the most recently updated service list available on the California Public Utilities Commission website, via email to those listed with email and via U.S. mail to those without email service. I also caused courtesy copies to be hand-delivered as follows:

Commissioner President Michael R. Peevey
California Public Utilities Commission
Executive Division
505 Van Ness Avenue Room 5218
San Francisco, CA 94102

ALJ Karl Bemesderfer
California Public Utilities Commission
505 Van Ness Avenue, Room 5006
San Francisco, CA 94102

I declare under penalty of perjury that the foregoing is true and correct. Executed this 24th day of May 2010 at San Francisco, California.

/s/ Lisa Chapman
Lisa Chapman

2539/001/X119449.v1
05/24/10

Service List
Consolidated / Updated 5/20/10
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