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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)

JOINT CLOSING BRIEF
OF BP WEST COAST PRODUCTS LLC AND
EXXONMOBIL OIL CORPORATION

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Pursuant to the "Scoping Memo and Ruling" issued by President Michael R. Peevey, the Assigned Commissioner, on August 20, 2009 ("Scoping Memo"), in the above-captioned proceedings pending before the Public Utilities Commission of the State of California ("Commission"), BP West Coast Products LLC ("BP West Coast") and ExxonMobil Oil Corporation ("ExxonMobil") respectfully submit this Joint Closing Brief.

I. BACKGROUND

This case was initiated by the filing of two general rate applications on June 6, 2008, one by SFPP, L.P. ("SFPP") in A.08-06-008, and the other by Calnev Pipeline LLC ("Calnev") in A.08-06-009.[1] On September 26, 2008, SFPP amended its application to increase its proposed rates by $5 million. On May 12, 2009, SFPP filed Application No. 09-05-014, which sought to increase SFPP's proposed rates by an additional $5 million ("2009 Application").

[1] All references to SFPP in this brief should be deemed to refer to Calnev as well, unless context dictates otherwise.

SFPP's Applications and its testimony put forward cost-of-service rates, but SFPP also has proposed that the Commission limit its oversight of SFPP's rates. Specifically, SFPP claims that it faces competition on its intrastate pipeline system, and that it qualifies for a form of light-handed regulation. SFPP's Opening Brief argues that its existing rates are reasonable under a cost-of-service analysis, but argues, apparently in the alternative, that if SFPP's rates are not strictly defensible by reference to costs alone, additional non-cost factors justify the rates nevertheless.

This Closing Brief demonstrates that SFPP is incorrect on both counts. Its rates are not supported by a cost-of-service analysis, nor has SFPP shown that its rates are reasonable on any non-cost basis.

II. SUMMARY OF ARGUMENT

A. Cost Of Service Issues.

BP and ExxonMobil have several areas of disagreement with SFPP regarding its rate of return on equity ("ROE"), cost of debt and capital structure. In each instance, SFPP has incorrectly calculated these inputs to its cost of service in a way that would increase SFPP's rates.

As to ROE, ExxonMobil's witness Dr. Horst provided several criticisms of SFPP's witness Dr. Vander Weide's calculations, none of which SFPP has rebutted. First, Dr. Vander Weide selected data from the middle of the 2009 test period rather than the more recent end-of-test-period data used by Dr. Horst. SFPP's earlier data was from a time in the depths of an economic downturn when stock prices were lower, which drove dividend yields higher and ultimately led to a higher ROE as calculated under the Discounted Cash Flow ("DCF") method. Indeed, use of the mid-test-year data yields an ROE that is atypically high. SFPP has failed to justify ignoring market conditions in the second half of the 2009 test year, during which the relevant economic data yields a more historically typical ROE. Accordingly, the Commission should adopt the ROE proposed by Dr. Horst that is based on the more current end-of-test-period data.

Second, SFPP claimed that it was entitled to an ROE in the median of the top half of its proxy group, based on the claim that SFPP bears more risk than the members of the proxy group. SFPP offered no supporting evidence on the relative risk levels of SFPP and the proxy group members, and on brief, has simply stated the proposition without record support. In contrast, Dr. Horst submitted unrebutted evidence demonstrating that SFPP's risk is comparable to the members of the proxy group. Exh. No. ExxonMobil-1 at 17-20 and Schedule 2. Accordingly, SFPP's ROE should be drawn from the median of the proxy group.

Third, in employing the DCF method to determine SFPP's ROE, Dr. Vander Weide ignored long-term growth projections in favor of higher short-term growth projections,[2] and he calculated an adjusted dividend yield by multiplying each proxy group member's dividend yield by an exaggerated growth factor. Both of these facets of SFPP's ROE calculations should be corrected.

As to cost of debt, SFPP refused to acknowledge the substantial savings its parent, KMEP, has enjoyed through the use of interest rate swaps. Rather than use its actual cost of debt as reported to the SEC, SFPP has offered a much larger figure based on the fixed-rate debt that KMEP contracted for prior to swapping a large portion of that debt for variable-rate debt. Those swaps allowed KMEP to save approximately 200 basis points in interest costs during the test year, but SFPP is attempting to charge customers as if it paid the higher interest rates. BP and

[2] As discussed below in Section III.A.1.c, long-term growth projections should be reduced by 50% to account for the fact that partnerships like SFPP distribute more cash to their investors than corporations, and therefore grow at a slower rate.

ExxonMobil explained in their Opening Brief that Commission precedent requires SFPP to pass through its interest cost savings. In its Opening Brief, SFPP did not even acknowledge, let alone distinguish, the precedent on this issue and has proceeded as if those savings do not exist. SFPP must be required to recalculate its rates using the proper interest costs.

Finally, SFPP has inflated the higher-cost equity portion of its capital structure. It has done this by ignoring the actual capital structure of its parent, KMEP, in favor of a hypothetical capital structure derived from a proxy group. SFPP has provided no credible basis for rejecting its own parent's capital structure, and it should be required to use that structure in calculating its rates.

B. Competition Issues.

SFPP expressly has disavowed seeking authority to charge market-based rates. *See* SFPP Opening Brief at 2, n.1. Yet its Opening Brief contains a lengthy argument that it faces sufficient competition to justify its rates under the *Unocap* standards even if they cannot be justified on the basis of cost. This position is contradictory because it is under the *Unocap* standards that the Commission assesses on a case-by-case basis whether to approve market-based rates. Having conceded that it is not seeking market-based rates, SFPP's *Unocap* arguments are pointless. In any event, BP and ExxonMobil demonstrate that SFPP's arguments that its rates can be justified on the basis of competition rather than costs cannot be sustained under *Unocap*.

In the Change of Control Order,[3] in which the Commission ordered SFPP to file the applications that commenced these proceedings, the Commission prohibited SFPP from seeking to recover costs associated with the transfer of control of SFPP and Calnev. That prohibition necessarily means that SFPP may not propose rates in excess of its cost of service.

[3] *SFPP, L.P.*, D.07-05-061, slip op. at 70, 2007 WL 2066307 at *28, Interim Order at ¶ 3 (2007) ("Change of Control Order").

Thus, SFPP's request for market-based rates effectively was barred from the outset of these proceedings. But even if SFPP's arguments for non-cost-based rates were not foreclosed by the Change of Control Order, the record demonstrates that SFPP possesses far too much market power in essentially all its markets for the Commission to rely on non-cost factors to set reasonable rates. SFPP has not demonstrated that it faces effective competition on any of its intrastate segments, other than a few short-haul movements. Based on that extremely limited competition, SFPP is seeking to charge non-cost-based rates on the whole of its intrastate system. SFPP has not carried its burden to demonstrate that such a ratemaking method would be just and reasonable in these circumstances.

SFPP attempts to deflect attention from its market power and lack of meaningful competition by attacking the validity of cost-based ratemaking, which SFPP claims to be subjective and wasteful. In its place, SFPP would substitute a nearly standardless regime designed to rubber stamp practically any rates the pipeline could propose. SFPP plays the "big oil" card, arguing that the size and sophistication of its customers somehow justifies its unconstrained exercise of market power. As the Commission affirmed in the Change of Control Order, "big oil" companies are as entitled to just and reasonable rates as any other utility customers in California. SFPP is a public utility and must provide its services at just and reasonable rates. In the absence of meaningful competition that would ensure that the market would yield just and reasonable rates, the Commission should continue to set SFPP's rates on the basis of its cost of service.

C. Income Tax Allowance.

In place of an argument based on the record in these proceedings, SFPP addressed the income tax allowance issue by attaching to its Opening Brief portions of its brief from another case. Much of that old brief is inapposite in this case, but BP and ExxonMobil have included a response to the extent SFPP's arguments may be relevant.

SFPP first claims that shippers have not acknowledged the income tax liability of its investors. That is nonsense. Of course some of SFPP's investors may pay taxes on income attributable to SFPP's operations. But there is no basis to charge pipeline customers for taxes, if any, that may be borne by investors. Utilities organized as corporations do not include the taxes borne by their shareholders in their cost of service, and partnership pipelines such as SFPP should be no different. SFPP has been able to reduce its income tax burden through an act of Congress, which exempts partnership pipelines from the pipeline-level income tax borne by corporate pipelines, yet SFPP now wishes to charge its customers as if it still paid taxes as a corporation. This is impermissible under California law, which requires that public utilities pass through tax savings to their ratepayers.

As BP and ExxonMobil explained in their Opening Brief, the ROE calculated under the DCF method from a proxy group of partnership pipelines is pre-tax to investors. That is, it reflects the real-world returns received by the proxy group members before making distributions to investors. Those investors make investment decisions mindful of the fact that they may bear income tax liability on income attributable to their investments. Thus, the ROE is designed to provide a return to investors sufficient to attract their investment after the investors take into account any income taxes they may bear on their investment. For a given investment, investors will demand a higher ROE the greater is their tax burden on the investment. This is vividly illustrated in the marketplace for bonds of comparable risks: taxable bonds have a higher yield than tax-exempt bonds because investors demand a higher return on the taxable investment to cover their income tax liability. Exh. No. ExxonMobil-1 at 41:17 to 42:8 and Chart 1.

For these reasons, SFPP is highly misleading in claiming that BP and ExxonMobil are ignoring the taxes borne by owners of pipeline partnerships. No income tax allowance is needed to cover such income taxes, if any, on investors. Investor-level taxes are reflected in the DCF ROE calculations that determine the level of pre-tax ROE that investors demand to attract capital. Therefore, there is no rational basis to provide a partnership with an income tax allowance to cover the taxes borne by the investing partners because pre-tax DCF ROE will account for whatever tax burden investors may bear on their investments in the pipeline.

III. ARGUMENT

A. Cost Of Service Issues.

1. SFPP Failed To Rebut Dr. Horst's Corrections To Its Rate Of Return on Equity Calculations.

Dr. Horst made several corrections to SFPP witness Dr. Vander Weide's calculation of SFPP's ROE. *See* BP-ExxonMobil Opening Brief at 6-17. SFPP has failed to provide any reasonable rebuttal in support of Dr. Vander Weide's calculations and, as a result, the Commission should require SFPP to adopt Dr. Horst's recommendations.

SFPP has not justified its failure to update the ROE to better reflect the economic climate at the end of the test year. Instead, it has left in place outdated data that were plainly selected to inflate the ROE to an unreasonable level unrepresentative of economic conditions going forward. It also has sought to adopt an ROE in the upper portion of the proxy group results based on an assertion that its risks exceed those of other pipeline companies, even though that assertion has no foundation in the record. In addition, SFPP refused to use the time-tested DCF methodology as it is applied at FERC, and instead proposed a modified DCF method, again designed to inflate the ROE to an unreasonable level. Lastly, SFPP devoted significant portions of its brief responding to testimony that was not even offered into evidence, and those portions of the brief should be disregarded.

a. SFPP Ignored Market Conditions In The Second Half Of The Test Year In Order To Inflate Its Rate Of Return On Equity.

SFPP's ROE calculations included portions of both 2008 and 2009, even though the Scoping Memo stated plainly that "there shall be only one test year for all issues, including but not limited to cost of service and competition, and that test year will be 2009." Scoping Memo at 3, Issue VI. Dr. Vander Weide's calculations covered the period July 1, 2008 through June 30, 2009. Exh. No. SFPP-12 at 15. As Dr. Horst observed in his testimony, "[s]tock market prices were severely depressed from October 2008 through March 2009. Although market prices recovered significantly by June 2009, the FERC's traditional six-month averaging period for stock market prices, which Dr. Vander Weide adopts, produces distribution yields that are higher than the yields for the period before October 2008 or in the latter half of 2009." Exh. No. ExxonMobil-1 at 8:5-10. Thus, Dr. Vander Weide's decision to use data from a period ending June 30, 2009 results in a substantially higher ROE than would obtain in the far more normal months prior to or following that period.

Dr. Horst updated Dr. Vander Weide's calculations using data as of November 30, 2009, the latest date within the test year available at the time he prepared his testimony. Exh. No. ExxonMobil-1 at 8:11-18. SFPP claimed in its Opening Brief to support this approach:

> The most recently available 12 months of data at the time of testimony preparation were July 2008 through June 2009 data. Appropriate test period adjustments were then made to reflect changes that have occurred or may be expected to occur in the reasonable and foreseeable future and that are reasonably estimable . . . . SFPP tends to agree with [this] understanding of base period and test period principles . . . .

SFPP Opening Brief at 13. But SFPP but did not apply these principles when filing its rebuttal testimony in January 2010. At that time it did not update its ROE calculations through the end of the 2009 test year, where the effect of doing so would have been to decrease SFPP's rates. In defense of this selective approach to principle, SFPP lamely asserts that the Scoping Memo did not specify that the 2009 test year referred to calendar year 2009. SFPP Brief at 13. SFPP is manufacturing ambiguity. By not specifying that the test year was to encompass only a part of 2009, the Commission's reference to 2009 plainly referred to the calendar year - otherwise the Commission's designation of 2009 as the test year was wholly indefinite.

It is customary at FERC for a pipeline to update its ROE to reflect the most recently available data within the test year, so as to best approximate market conditions in the future, so long as the update does not result in an anomalous result.[4] SFPP itself follows this practice - indeed when it yields a higher ROE, SFPP has even asserted that ROE should be updated beyond the test year. *See SFPP, L.P.*, 129 FERC ¶ 63,020 at PP 368, 622, 650 (2009).

Here SFPP's sudden divergence from principle has a transparent reason. SFPP has decided to diverge from ordinary practice in this case in order to take advantage of the anomalous market conditions in late 2008 and early 2009. During that period, the economy was in recession, which drives stock prices down and dividend yields up. The end result is to artificially inflate the ROE obtained using the DCF method. Dr. Vander Weide and Dr. Horst used the same proxy group. *See* Exh. No. SFPP-12 at Schedule 1; Exh. No. ExxonMobil-1 at Schedule 1. Comparing Dr. Vander Weide's Distribution Yield to Dr. Horst's Dividend Yield

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4 *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,117 (2000); *Williston Basin Interstate Pipeline Co.*, 84 FERC ¶ 61,081, at 61,382 (1998); *Transcontinental Gas Pipe Line Corp.*, 84 FERC ¶ 61,084, at 61,427 (1998); *Panhandle Eastern Pipe Line Co.*, 74 FERC ¶ 61,109, at 61,362-63 (1996).

for the same companies illustrates that Dr. Vander Weide avoided updating his data to avoid decreasing his ROE results.

When it is advantageous for SFPP to adjust its proposed rates by updating data, it advocates making such adjustments. But here where SFPP's testimony date coincided with an anomalous period in the market, SFPP is seeking to cling to that period in the hopes of basing its ROE on an anomalous period. The Commission should reject SFPP's attempt to selectively calculate its ROE using stale and unrepresentative data and adopt Dr. Horst's recommendation to use the most recent data within the test period.

b. SFPP Did Not Establish That It Bears More Risk Than The Pipelines In The Proxy Group, So Its Rate Of Return On Equity Should Equal The Median Return On Equity Of The Proxy Group.

SFPP seeks an ROE in the median of the top half of the results of its proxy group, based on the claim that SFPP's risks are greater than those of the proxy group pipelines. *See* SFPP Opening Brief at 37. There is no support in the record for SFPP's claim, while reflects yet another artificial attempt to boost to its ROE. SFPP's ROE should be equal to the median of the proxy group results as a whole.

In its Opening Brief, SFPP states, complete with underlining, that "<u>SFPP has greater business risk than the companies in the comparable company group</u>." *Id.* (emphasis in original). For this bold assertion, SFPP cites Dr. Vander Weide's Direct Testimony, which claims that "as described in the testimony of Companies' Witness Dito, the Companies have greater business risk than the companies in the comparable company group." Exh. No. SFPP-12 at 15:A41. Dr. Vander Weide did not cite a particular statement in Mr. Dito's testimony, but presumably was referring to Exh. No. SFPP-10 at 24:18 to 27:9, where Mr. Dito testifies that the intrastate pipeline systems of SFPP and Calnev are in High Consequence Areas ("HCAs") designated by U.S. Department of Transportation.

Mr. Dito's testimony cannot bear the weight placed on it by Dr. Vander Weide and by SFPP's Opening Brief. This is because Mr. Dito did not provide any evidence of differences in the risks borne by the members of the proxy group, either with respect to HCAs or any other risk. Thus, the claims by Dr. Vander Weide and SFPP in its Opening Brief that is has "greater business risk than the companies in the comparable company group" is completely unsupported by the record. Those baseless claims should be given no weight and the Commission should reject SFPP's proposal to increase its ROE by choosing a return above the median.

c. SFPP's Use Of A One-Stage DCF Methodology Inflated Its Rate Of Return On Equity By Ignoring Long-Term Growth Projections.

SFPP used a "One-Stage" DCF methodology to calculate its ROE. This method uses a growth rate derived solely from the median IBES forecast of the growth rate of a given company's earnings per share ("EPS") over the next three to five years. Exh. No. ExxonMobil-1 at 9:5-11. This method places too much weight on short-term growth projections and ignores the second stage of a "Two-Stage" DCF methodology - a synthesis of long-term projections of national GDP. Under the Two-Stage methodology, three GDP projections are averaged, then divided by two to account for the fact that Master Limited Partnerships ("MLPs") distribute more cash than corporations and thus have lower long-term growth prospects.[5]

As BP and ExxonMobil explained in their Opening Brief, IBES growth rates only address the period three to five years out, and therefore fail to reflect long-term growth

[5] *Policy Statement on Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at PP 95-106 (2008).

expectations. BP-ExxonMobil Opening Brief at 11-14. By ignoring long-term growth projections, SFPP fails to account for the limitations of the IBES growth rates. Not coincidentally, using only short-term growth rates increases SFPP's ROE. As shown in Schedule 1 to Dr. Horst's testimony, Exh. No. ExxonMobil-1, the long-term GDP projections, adjusted by 50% to account for the fact that KMEP is an MLP, equal 2.23%, whereas the short-term IBES projections range from 2.70% to 5.00%, with a median of 5.00%.[6]

SFPP's Opening Brief does not justify its refusal to account for long-term growth projections. It simply repeats Dr. Vander Weide's claim that "his studies indicated that the analysts forecasts are the best estimates of investors' expectations of future long-term growth." SFPP Opening Brief at 41. As BP and ExxonMobil explained in their Opening Brief at 10-11, those studies do not compare the One-Stage Method to the Two-Stage Method, and thus have no relevance to the issue at hand. SFPP next claims that it cannot determine which method is a better predictor of growth because "any statistical difference between the two [methodologies] with respect to their correlation to stock prices is masked." SFPP Opening Brief at 41. It then rests on Dr. Vander Weide's belief, unsupported by any evidence, that "his growth rate component, predicated on the analysis of market participants is superior to a growth component that weights analysts' expectations with various governmental projections of GDP." *Id.* This of course does not address the central failing of the One-Stage Method, that it does not account for growth projections beyond the three-to-five year timeframe. Because SFPP cannot overcome this flaw in its proposed method, the Commission should adopt Dr. Horst's recommendation to use the FERC Two-Stage Method.

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[6] Because multiple IBES projections for the proxy group companies were equal to 5.00%, both the median and highest values were 5.00%.

d. SFPP Inflated Its Rate Of Return On Equity By Applying An Inappropriate Adjustment To The Dividend Yields Of The Proxy Group Members.

Dr. Vander Weide testified that he believes it to be inappropriate to calculate SFPP's ROE using the annual DCF formula, and that a quarterly formula would be more appropriate. Exh. No. SFPP-12 at 11:A26. He argued that the annual formula fails to account for the fact that the proxy group members pay dividends quarterly, and that the market value of their investment units reflects the quarterly receipt of dividends. *Id.* On cross examination, Dr. Vander Weide explained that "the annual model will generally slightly underestimate the cost of equity because if you get the distributions quarterly you can reinvest them until the end of the year and earn a little bit more than if you got them just at the end of the year." Tr. 436:5-10. Thus, Dr. Vander Weide advocated accounting for the timing of cash flows to investors by adjusting the DCF formula to recognize that investors receive dividends on a quarterly basis.

But Dr. Vander Weide did not propose to make any offsetting adjustment for the timing of cash flows as they are received by pipelines. As a result, his concern appears one-sided. As Dr. Vander Weide admitted on cross-examination, pipelines receive revenue on a monthly basis and their return is higher when they receive monthly payments, as opposed to annual. Tr. 435:11-14, 438:5-10. In other words, pipelines receive a time-value-of-money benefit by receiving revenues monthly, rather than having to wait a year.[7] Despite this, Dr. Vander Weide did not advocate adjusting the pipeline's ROE to account for the additional return. In the end, however, Dr. Vander Weide used the annual DCF formula for the sake of simplicity. *Id.* As a result, the annual versus quarterly method dispute is moot because both Dr. Vander

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[7] That is to say, Dr. Vander Weide's formula calculates the economically equivalent rate of return if investors had to wait a full year before receiving their cash distributions. This equivalent annual rate would properly be applied to a pipeline's rate base only if the pipeline also had to wait until the end of the year to receive its return on investment.

Weide and Dr. Horst in fact use the annual method (but disagree as to how the annual growth rate should be calculated).

Even though Dr. Vander Weide applied the annual DCF formula, he criticized Dr. Horst for applying it in the FERC-accepted manner. Both witnesses agree that the dividend yield of each proxy group company should be adjusted by some form of growth factor, but they differ as to specifics - Dr. Horst used a factor of (1 + 0.5g), where g is the growth rate, and Dr. Vander Weide used (1 + g).[8] SFPP argues that Dr. Vander Weide's approach should be adopted.

Dr. Horst's use of the factor (1 + 0.5g) conforms to FERC's methodology as adopted 25 years ago in Order No. 420.[9] The Order No. 420 methodology actually was designed to address the very concern identified by Dr. Vander Weide, that is, to adjust the annual DCF formula to account for pipelines' payment of dividends on a quarterly basis.[10] That methodology is well-reasoned and well-established and should be adopted here.

The DCF methodology calculates a current dividend yield by dividing the annualized dividend by the average of the last six months' high and low prices of the stock.[11] In Order No. 420, FERC considered two versions of the DCF model. In the first, the current dividend yield (d) is simply added to the growth rate (g). As FERC noted, this model "assumes continuous receipt of dividends . . . . " Order No. 420 at 31,339, 50 Fed. Reg. at 21,805. In the second model, the current dividend yield (d) is multiplied by the factor (1 + g) to calculate an

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8 Dr. Horst made this adjustment on Schedule 1 of Exh. No. ExxonMobil-1 at column <f>. Dr. Vander Weide made the adjustment in the "Adjusted Yield" column of Schedule 1 of Exh. No. SFPP-12.

9 *Generic Determination of Rate of Return on Common Equity for Public Utilities*, FERC Stats. & Regs., Regs. Preambles ¶ 30,644, 50 Fed. Reg. 21802 (May 29, 1985) ("Order No. 420").

10 Order No. 420 at 31,339-40, 50 Fed. Reg. at 21805-06.

11 *See* Exh. No. ExxonMobil-1 at Schedule 1, column <b>.

"expected one year forward dividend yield," then added to the growth rate (g). Stated another way, this formula would be d + dg + g. This is the method proposed by Dr. Vander Weide. FERC noted that this method "assumes that investors receive dividends once a year." *Id.*

As FERC explained, "neither correctly characterizes the real world where dividends are generally paid out to investors on a quarterly basis." *Id.* Thus, FERC designed a compromise between the two invalid extremes. Under the Order No. 420 method, the dividend yield (d) is multiplied by a compromise factor, (1 + 0.5g) to account for growth of the dividend yield in the first year, then added to the growth rate (g) to account for future growth. FERC explained its reasoning as follows:

> What [this method] attempt[s] to do is approximate the average expected annual dividends received during the first year. Assuming that some companies will increase their dividend rate within the first quarter, some during the second quarter, etc., these adjustments attempt to approximate the average amount of dividends that the average investor (or, equivalently, investors in the average company) would expect to receive during the first year.

Id. at 31,340, 50 Fed. Reg. at 21,806.

Thus, the method used by Dr. Horst adjusts the dividend yield to account for the reality of quarterly distributions, thereby actually alleviating Dr. Vander Weide's concern with the annual DCF method. SFPP's proposal, on the other hand, increases its ROE without justification, and should be rejected.

e. The Commission Should Disregard SFPP's Criticisms Of Testimony Not In The Record.

SFPP devotes a significant amount of its Opening Brief to testimony of BP witness Ms. Crowe on various ROE, cost of debt and capital structure issues. *See* SFPP Opening Brief at 37-45. But BP did not offer that testimony into evidence. Ms. Crowe's testimony, as actually offered and admitted as Exh. No. BP-1, is five pages long and consists solely of a recommendation that SFPP not be granted an income tax allowance. An earlier, longer version of the testimony addressing other issues was circulated to the parties in advance of the hearing, but the testimony actually placed in the record of these proceedings (without SFPP's objection) is the shorter, five-page version. Tr. 674:24 to 675:10. Accordingly, SFPP's criticisms of the portions of Ms. Crowe's originally circulated testimony that were not entered into evidence are irrelevant and should be disregarded.

2. SFPP Failed To Rebut Dr. Horst's Corrections To Its Cost Of Debt Calculations.

BP and ExxonMobil explained in detail in their Opening Brief that SFPP inflated its cost of debt by ignoring the significant savings it enjoys as a result of interest rate swaps. *See* BP-ExxonMobil Opening Brief at 19-22. Under Commission precedent cited there, those savings must be passed on to ratepayers. SFPP has offered nothing in its Opening Brief to justify its attempt to keep the savings from interest rate swaps, and instead simply repeated Dr. Vander Weide's testimony on the subject without any attempt to acknowledge, let alone distinguish applicable Commission precedent. *See* SFPP Opening Brief at 43-44. SFPP did not bother identifying the savings from interest rate swaps in its initial rate filings or in its testimony, and now has even ignored in its brief the precedent that requires it to pass on those savings. The Commission should apply its precedent and require SFPP to calculate its rates using its actual cost of debt, after factoring in the substantial savings in reported interest expense from its interest rate swaps.

3. SFPP Should Be Required To Use KMEP's Actual Capital Structure Rather Than The Average Capital Structure Of Its Proxy Group.

SFPP proposed to use the average capital structure of its proxy group rather than the actual capital structure of its parent, KMEP. At the time Dr. Vander Weide calculated that capital structure, it would result in a mix of 52.43% debt and 47.57% equity. *See* SFPP Opening

Brief at 44. KMEP, on the other hand, had a capital structure of 60.36% debt and 39.64% equity. Exh. No. ExxonMobil-1 at 29:13-16. SFPP's proposal is designed to increase its overall return by artificially inflating the amount of equity imputed to its capital structure.

Dr. Vander Weide attempted to justify his use of a proxy capital structure by arguing that KMEP's actual capital structure is inappropriate because it is "significantly below its long-run target capital structure of 50 percent debt and 50 percent equity." SFPP Opening Brief at 44. As explained in BP and ExxonMobil's Opening Brief, this sort of alleged aspirational target is irrelevant, which FERC has recognized on multiple occasions. BP-ExxonMobil Opening Brief at 26 (citing *SFPP, L.P.*, 113 FERC ¶ 61,277 at PP 66-67 (2005); *SFPP, L.P.*, 116 FERC ¶ 63,059 at P 72 (2006)). SFPP next states, without support, that in Dr. Vander Weide's opinion, the proxy group's average capital structure "is a reasonable approximation of KMEP's forward-looking capital structure." SFPP Opening Brief at 44-45. There is no need to resort to a proxy capital structure, when the record contains the actual capital structure of KMEP, which entity is responsible for raising capital for SFPP as well as KMEP's other subsidiaries. SFPP is implicitly asserting that KMEP's capital structure during the test period somehow diverges from KMEP's ordinary capital structure. But it has provided no evidence of such a divergence, and in fact, in 1999, the last year in which SFPP issued its own third-party debt without relying on credit support from KMEP, SFPP's stand-alone capital structure reflected 59.9% debt, which is nearly identical to KMEP's actual debt ratio as of September 30, 2009. Exh. No. ExxonMobil-1 at 29-30. This actual capital structure vividly demonstrates that KMEP's alleged target capital structure has no relationship to reality.

Lastly, SFPP points out that Dr. Horst's proxy group yields an average capital structure of 53% debt/47% equity, which is close to Dr. Vander Weide's proposal, apparently in an attempt to justify rejecting KMEP's actual capital structure. SFPP Opening Brief at 45. SFPP's observation is unsurprising to say the least, given that Dr. Horst accepted Dr. Vander Weide's proxy group and simply updated the calculations to reflect data from the Third Quarter of 2009. Of course the average capital structure of the same six companies was similar at two points only three months apart. That does not demonstrate that a proxy group capital structure should be used in place of KMEP's.

B. Competition Issues.

SFPP's request for non-cost-based regulation has been a constantly shifting target throughout these proceedings. Now in its Brief, SFPP has contradicted itself completely, rendering its request meaningless. On page 2, footnote 1, SFPP states that "Nor do Applicants seek, or have they requested, Commission endorsement of so-called 'market-based' rate authority for either SFPP or Calnev." Instead, SFPP claims to seek evaluation of its existing and proposed rates under the *Unocap*[12] decisions. SFPP misses a critical point here - *Unocap* <u>is</u> a case about market-based rates, and that fact is plain on the face of the decision:

> Based on the evidence presented at hearing, we conclude that <u>Unocap has shown that its market-based rates are reasonable</u> in view of the type of utility service at issue here, and that there are sufficient practical alternatives to the pipeline service such that the initial rates are subject to market discipline.

Unocap, 1994 WL 401065 at *12 (emphasis added).

It makes no sense for SFPP to disavow market-based rates, but then insist that its rates, if not justified by a cost-of-service analysis, should nevertheless be approved because they

[12] *City of Long Beach v. Unocal California Pipeline Company*, D.94-05-022, 54 CPUC 2d 422, 1994 WL 401065 (1994) ("*Unocap*"), *reh'g denied, City of Long Beach v. Unocal California Pipeline Company*, 66 CPUC 2d 28, 1996 WL 228516 (1996) ("*Unocap II*").

purportedly satisfy the *Unocap* factors. SFPP is speaking out of both sides of its mouth here, and should be bound by its statement that it does not seek market-based rates.

SFPP's admission should settle the issue, but to the extent that the Commission still wishes to decide whether SFPP has justified market-based rates in spite of its disavowal, BP and ExxonMobil respond below to the arguments set forth in SFPP's Opening Brief.

1. SFPP Has The Burden To Prove That Its Rates Are Just And Reasonable And That Its Proposed Rate Methodology Is Fair.

SFPP is the proponent of the rates at issue in these proceedings. Thus, it "bears the burden of proof to show that the rates it requests are just and reasonable and the related ratemaking mechanisms are fair." *Pacific Gas & Elec. Co.*, D.07-03-013, slip op. at 4, 2007 WL 725707 at *2 (2007); *Unocap*, 1994 WL 401065 at *11-12. SFPP's proposed rate methodology would consider various non-cost factors to assess whether its proposed rates are just and reasonable even if they exceed SFPP's cost of service. It is not the burden of the shippers to support a cost-based approach, it is SFPP's burden to demonstrate that light-handed regulation is appropriate.

Though SFPP would like it to be otherwise, it is not a given that the *Unocap* factors apply to SFPP,[13] and certainly not a given that those factors are satisfied. Nevertheless, SFPP is portraying both as a *fait accompli*. It claims that the shippers have made "no market power showing whatsoever" and that SFPP has presented "unrebutted testimony" on competition issues. SFPP Opening Brief at 5, 8. It even makes the preposterous assertion that "[s]hippers rest their case on cost of service and cost of service alone." *Id.* at 8. It is the shippers' position

[13] As BP and ExxonMobil explained in their Opening Brief, *Unocap* was not a one-size-fits-all decision, but rather established a case-by-case examination of the particular circumstances of individual pipelines. *See* BP-ExxonMobil Opening Brief at 46-47 (quoting *Unocap II*, 1996 WL 228516 at *5).

that cost-of-service rates are appropriate and light-handed regulation is not. But simply because shippers do not agree with SFPP that light-handed regulation is appropriate does not mean that they ignored the issue. SFPP apparently fails to understand this distinction and claims that "no record exists upon which the Commission could make the finding of market power required to warrant strict reliance on cost of service as the measure of the reasonableness of SFPP's rates." *Id.* at 5.

There is an ample record on which the Commission can and should determine that SFPP does not face competition sufficient to justify light-handed regulation. Shippers sponsored multiple witnesses on competition issues, including Messrs. Fessler and Crowley who were co-sponsored by BP, ExxonMobil and other shippers. Mr. Fessler testified that it would violate public policy to allow SFPP to set rates on any basis other than costs, and Mr. Crowley used SFPP's own methodology to demonstrate that SFPP does not face effective competition from trucking. Other shippers sponsored additional witnesses who addressed other aspects of competition. Yet SFPP is attempting to ignore this testimony and claim that its own case is unrebutted. SFPP cannot simply claim that it satisfied its burden of proof by pretending that it is unopposed on competition issues when in fact shippers have strongly rebutted essentially every element of SFPP's competition claims.

2. The Change of Control Order Presumes That SFPP's Rates Will Be Determined On A Cost-Of-Service Basis.

SFPP's initial rate filing in these proceedings was ordered by the Commission in the Change of Control Order. There, the Commission ordered SFPP to file a Test Year 2009 general rate case in which SFPP "shall request no recovery in utility rates for any cost (including any increase in the cost of KMEP's debt) associated with the transfer of control from KMI to Knight Holdco and shall document that no pass through has occurred or will occur in the future."

Change of Control Order, Interim Order at Ordering ¶ 3. SFPP's Application in A.08-06-008 states at page 1 that it is being made in compliance with Ordering Paragraph 3 of the Change of Control Order.

Despite the Commission's admonition, SFPP's rate proposal in these proceedings expressly seeks to recover higher revenues than can be justified by SFPP's cost of service. At page 9 of its Opening Brief, SFPP states that "non-cost-of-service considerations should be given more substantial weight in circumstances in which cost-of-service analysis would otherwise suggest that rates are either marginally or temporarily excessive." On page 10, it argues that "[i]f [SFPP's] rate-generated revenues exceed cost of service, the Commission can either reject them as unreasonable or, in consideration of the other, so-called *Unocap* factors, conclude that the extent to which the pipeline's rate-generated revenues exceed cost of service does not render the rates unreasonable." Thus, there can be no dispute that SFPP is attempting to collect amounts in excess of its costs.

This attempt necessarily violates the condition in the Change of Control Order that SFPP not seek to collect costs associated with the transfer of control from KMI to Knight Holdco. If SFPP collects revenues in excess of its cost of service, it effectively would be recovering the costs associated with the transfer of control and thus SFPP would violate the Change of Control Order. By prohibiting SFPP from collecting rates in excess of its costs (less the costs of the transfer of control), the Commission implicitly has already prohibited SFPP's request for light-handed regulation in this case.

3. SFPP's Attacks On Cost-Of-Service Ratemaking Are Designed To Increase Rates By Quashing Opposition And Blurring The Just and Reasonable Standard.

SFPP attacks the concept of cost-of-service ratemaking on the ground that it is inexact and encourages potentially wasteful opposition to the utility. On page 9 of its Opening

Brief, SFPP claims that cost-of-service ratemaking depends on "varied, untestable assumptions and informed speculation." *Id.* at 9. In leveling this broadside against cost-of-service ratemaking, SFPP makes no reference to the fact that such ratemaking principles effectively have been developed by the Commission, FERC and other agencies over many decades. The resulting underlying principles are reasoned and informed by long experience. In place of cost-of-service ratemaking, SFPP would have the Commission institute a subjective "totality of the circumstances" regime, wherein SFPP would justify its rates using "not easily quantifiable metrics," even though "SFPP has no ready formulation for how such qualitative factors should be incorporated in the Commission's evaluation of the reasonableness of its rates." *Id.* at 48. It is absurd to criticize a system for its purported inaccuracy, only to propose a replacement that SFPP itself cannot even explain. Any inexactness of the cost-of-service method would be exacerbated by instituting the subjective light-handed system advocated by SFPP.

SFPP also points to the differences between the shippers' estimates of a just and reasonable cost of service and SFPP's own estimate as evidence that the cost-of service system is flawed. Incredibly, SFPP claims that this "extraordinarily wide disparity . . . emphasizes the inherent imperfection of reliance on cost of service, with its dependency on myriad forecasts, estimates and assumptions, as the sole standard for evaluating the reasonableness of SFPP's rates." SFPP Opening Brief at 7. SFPP goes on to claim that the shippers are "rent seeking," that is, seeking to extract undeserved value from SFPP by exploiting inefficiencies in the regulatory process. *Id.* at 50-51. BP and ExxonMobil explained in their Opening Brief that SFPP's witness Dr. Webb's rent-seeking theory goes both ways, as even Dr. Webb admitted. BP-ExxonMobil Opening Brief at 63-64. When the pipeline proposes rates that are higher than the Commission later finds to be justified, it is "rent-seeking" in the same way that Dr. Webb alleges that a shipper would be "rent-seeking" if it sought to decrease rates below what the Commission ultimately deems to be just and reasonable.

The disparity between the parties' positions is no basis to cede the field to the pipeline. Rather, it highlights the need for vibrant shipper participation and informed Commission decisionmaking in a system designed to be as objective as is practicable. It is apparent that SFPP's goal is to eliminate opposition and to blur the just and reasonable standard to the maximum extent possible so that it can impose whatever rates it wants and maximize its distributions. In the Change of Control Order, the Commission recognized the aggressive cash extraction goals of Kinder Morgan. Change of Control Order at 62, Findings of Fact 15 & 16. Cost-of-service ratemaking is essential to check the exercise of SFPP's market power and ensure that the rates of this public utility are just and reasonable.

4. The Identity Of SFPP's Customers Does Not Justify Higher Rates.

SFPP argues that the size and sophistication of its customers favors light-handed regulation. *See* SFPP Opening Brief at 47-48, 50-51. The obvious purpose of seeking light-handed regulation, which SFPP freely admits, is to justify rates that could not be justified under a strict cost-of service regime. *See* SFPP Opening Brief at 48 ("[S]ome weight should be afforded these real-world facts, if on no other basis to support a finding, if appropriate, that SFPP rates are reasonable even if cost-of-service results might suggest otherwise.").

Taken together, these propositions expose SFPP's true position. In SFPP's view, the presence of large, sophisticated customers justifies light-handed regulation, and light-handed regulation justifies higher rates. In the end, SFPP is arguing that it should be able to charge its customers higher rates because they are unsympathetic big oil companies. It even attempts to garner sympathy by comparing its own market capitalization to those of its customers. *See* SFPP Opening Brief at 50-51. But as the Commission held in the Change of Control Order, "Even large, sophisticated entities like the oil companies who ship refined petroleum products over SFPP and Calnev are entitled to the assurance of fair and reasonable rates, terms and conditions of service." Change of Control Order, slip op. at 27. That should have put to rest any argument that SFPP can charge its customers more because they are large corporations. Cost-of-service rates are essential to check SFPP's exercise of market power. The size of shippers is of little moment in the California transportation market where SFPP has the market power to exact monopoly rents in the absence of continued Commission regulation of its rates.

5. SFPP's Attempt To Demonstrate That It Faces Competition Has Several Shortcomings.

SFPP claims that it is "undisputed" that it faces "moderate competition." SFPP Opening Brief at 5. Ignoring the shippers' testimony does not make it any less real. Mr. Crowley demonstrated, by updating SFPP's own study, that SFPP faces minimal competition from trucking, and that any such competition is limited to a few short-haul movements. Exh. No. BCES-2 at 3:15 to 7:7. Even SFPP's own application contradicts its assertion of moderate competition by admitting that "[a]t least with respect to its shorter-haul pipeline movements, market forces act as a check on the rates that SFPP can charge with respect to many of its pipeline movements.." A.08-06-008 Application at 5. Mr. Crowley's testimony simply provided more detail for SFPP's initial assertion by demonstrating that the *only* competition SFPP may face is limited to a few short-haul movements. Thus, there is no dispute that SFPP does not face competition in long-haul markets. Despite this, SFPP's proposal leaves long-haul customers unprotected. SFPP is focusing on the minimal competition that exists in a few short-haul markets in order to attempt to justify light-handed regulation on the entirety of SFPP's intrastate pipeline system.[14]

Even if trucking were to provide some constraint on SFPP rate increases, Mr. Fessler testified that relying on such competition necessarily would give rise to increased truck hauls, which would be contrary to the public interest. Exh. No. BCES-1 at 44:10 to 47:7. Other shippers sponsored other witnesses who also showed SFPP's claims of competition to be unsupported. SFPP's claim that its evidence is unrebutted is simply not true.

BP and ExxonMobil also showed that SFPP did not properly compare SFPP's rates to those of other pipelines. In *Unocap* the Commission compared that pipeline's rates with the rates of competing pipelines. *Unocap*, 1994 WL 401065 at *4-*5. In contrast, the EAI Report offered by SFPP compares SFPP's rates to those of pipelines outside of California that obviously are not SFPP's competitors. This is unsurprising given the lack of competition faced by SFPP. Not only were the pipelines not SFPP's competitors, but SFPP also did not show that they shared any relevant characteristics with SFPP's California pipelines. *See* BP-ExxonMobil Opening Brief at 53-54 (citing Mr. Leto's testimony at Tr. 296:16 to 297:5, 297:25 to 298:9, 299:11-20). In fact, EAI prepared its Report in only three weeks, Tr. 248:22 to 249:8, even though Mr. Leto admitted that "to ascertain whether there was a comparable amount of competition for all of the pipelines [EAI] used in [its] comparability test to the level of competition that is experienced by SFPP would have required more than three weeks." Tr. 297:26 to 298:3.

[14] SFPP's Application sought nearly the maximum rate increase allowable under the Public Utilities Code except on a few segments. *See* Application at 4. On pages 19 and 20 of the Application, SFPP explained that competition constrained it from seeking the maximum increase on those few segments. *See also* Tr. 93:15 to 95:25 (Webb).

The EAI Report compared outdated lower rates for SFPP against the rates of other pipelines. It did not attempt to justify the rates actually at issue in this case. The SFPP rates in the EAI Report at Appendix Table 1 are the rates from SFPP's September 26, 2008 amended application in A.08-06-008, not the still further increased rates from A.09-05-014. See the A.09-05-014 Application at 4, which shows "Existing Rates" in effect as of May 12, 2009, the date of that application, and the "Proposed Rates" under the 2009 application.[15] Pursuant to section 455.3(b)(2) of the Public Utilities Code, the "Proposed Rates" went into effect on June 15, 2009. *See* A.09-05-14 Application at 2. The EAI Report is dated September 21, 2009. There was no reason for SFPP not to have used the rates that SFPP was charging its customers at the time the report was prepared. Yet Mr. Leto, the author of the EAI Report testified that he did not even read the application in A.09-05-014. Tr. 233:24-26. He further testified that EAI was brought in to the process "in the late stages" and assembled the report in "probably three weeks of time." Tr. 248:22 to 249:8. Clearly that was not enough time to prepare a report comparing SFPP's actual rates to those of other pipelines in any meaningful way. Not only have the shippers amply rebutted SFPP's evidence, it is apparent that SFPP's evidence is insufficient on its face.

6. SFPP's Proposal To Assess The Justness And Reasonableness Of Its Rates By Reference To An Indexing Regime Is Misplaced.

BP and ExxonMobil explained in their Opening Brief the many reasons that the Commission should reject SFPP's proposal to measure its historical rates against the rates that it would have been able to charge if it had increased those rates according to an annual inflation index. *See* BP-ExxonMobil Opening Brief at 66-67. SFPP's witness Mr. Dito admitted that

[15] For example, the rate for Bakersfield to Fresno, the first SFPP intrastate rate on Appendix Table 1, is shown as 32.79 cents per barrel, effective November 1, 2008. On page 4 of the A.09-05-014 Application, the rate for Bakersfield is shown as being changed from 32.79 to 34.41 cents per barrel, to be effective June 15, 2009, an increase of 4.93%.

indexed rates would substantially exceed SFPP's cost of service, Tr. 366:4-11, which immediately should disqualify indexed rates as a useful point of comparison.

When rates are indexed, all elements of that rate are increased by an inflationary factor, regardless of whether each element is affected by inflation. Costs such as depreciation, rate of return, right-of-way expenses and property taxes fluctuate independently of inflation, and it is inappropriate to increase them on an annual basis. Comparing SFPP's rates to such an inherently flawed measuring stick is meaningless. SFPP's Opening Brief contained a simple recitation of its testimony in support of its proposal and requires no further response. *See* SFPP Opening Brief at 57-58.

C. Income Tax Allowance.

BP and ExxonMobil support the Proposed Decision in C.97-04-025, *et al.* and believe that it should be adopted by the Commission and applied here.

SFPP's Attachment A, containing its argument in support of a "full income tax allowance," is simply transplanted from a 2007 brief in C.97-04-025, *et al.* As a result, portions of it are inapplicable to this proceeding. For example, SFPP responds at length to arguments made by CCUV, an ad hoc group of shippers in that earlier proceeding. In addition, SFPP argues that the denial of an income tax allowance can be prospective only, based on SFPP's perception of the procedural status of C.97-04-025, *et al.* Plainly, that argument is irrelevant in the present context as this is a consolidated group of general rate applications in which SFPP and Calnev were ordered to justify their existing rates, as well as two rounds of proposed rate increases made pursuant to Section 455.3 of the Public Utilities Code. SFPP's stale arguments are entirely irrelevant to these proceedings.

1. There Is No Basis To Allow SFPP To Charge Its Customers For The Income Tax Liability Of Its Investors.

SFPP claims that shippers "cling to the false notion that none of the income generated by SFPP and distributed to its owners is taxable . . . ." SFPP Opening Brief, Att. A at 4. That assertion is a vestige of SFPP's position in the earlier proceeding; it clearly is not accurate here. Dr. Horst recognized that SFPP's investors may pay taxes on the income they receive from SFPP. Exh. No. ExxonMobil-1 at 37:4-6, 41:13-16. The real question is whether SFPP, which itself pays no taxes, should be permitted to pass through to its customers the tax liability of its investors. SFPP is simply attacking a straw man in its recycled brief and has not engaged the actual issues presented in this case.

The tax liability of a pipeline's investors is not properly included in the pipeline's cost of service. Pipelines organized as corporations receive a tax allowance to pay the tax liability of the corporation; the allowance is not designed to recover the income tax borne by investors. Exh. No. ExxonMobil-1 at 35:1-4. A partnership like SFPP does not pay taxes so it should receive no tax allowance. Whether or not the investors in a partnership bear taxes is irrelevant, just as the taxes borne by corporate shareholders are irrelevant to the determination of an income tax allowance for corporate pipelines.

An income tax allowance is necessary for corporate pipelines, but not partnership pipelines, because the DCF ROE is calculated on an after-tax basis from the pipeline's tax perspective, but a pre-tax basis from the investors' tax perspective. An income tax allowance is necessary for the corporate pipeline in order to reimburse the pipeline for its income taxes so that the resulting rates will provide investors with their full allowed return. Partnership pipelines are able to recover their full allowed return without an income tax allowance because the partnership pipeline bears no income taxes.

Income taxes, if any, borne by investors are relevant not to income tax allowance, but rather to ROE. As noted, the ROE is pre-tax from the perspective of investors. That is, the DCF ROE method determines the ROE needed to attract investment from market data on yields provided in the marketplace to a proxy group of comparable pipelines. Specifically, the DCF ROE reflects the rate of return necessary to attract investors who factor in their own tax liability on investment income when making investment decisions. Exh. No. ExxonMobil-1 at 40:8-18, 41:13 to 42:8. The ROE necessary to attract investment will be high enough to take into account that investors may be subject to income tax liability on their income attributable to their investment. All other things being equal among available investment choices, an investor will demand a higher ROE from investments on which the investor will bear higher income taxes. This is illustrated in the marketplace, for example, where the yields on tax-exempt bonds are consistently lower than the yields on taxable bonds of comparable quality. Exh. No. ExxonMobil-1 at 41:17 to 42:8 and Chart 1. Thus, the DCF ROE includes a component to cover the investors' taxes and still yield the required post-investor-tax return. If a pipeline of any business form is permitted to pass through the tax liability of its investors, it will receive double compensation for those taxes, once in the DCF ROE and once again in the tax allowance.[16]

The Commission's goal should be to treat pipelines consistently, regardless of business form. It should do this by compensating the pipeline for its tax liability, if any, and allowing the pipeline to collect a DCF ROE sufficient to satisfy investors who still must pay their own taxes. Neither business form, corporation or partnership, should receive an additional

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[16] FERC's Income Tax Policy Statement allows partnership pipelines to collect an income tax allowance based on the tax liability of the partnership's investors. *See Policy Statement on Income TaxAllowances*, 111 FERC ¶ 61,139 (2005). However, FERC did not consider the double-counting argument made in this record. This record demonstrates that an income tax allowance in addition to a DCF ROE that is pre-tax to the investor would be duplicative and therefore unjust and unreasonable. *See* BP-ExxonMobil Opening Brief at 34-36.

allowance for the purpose of paying its investors' taxes. Thus, SFPP's claims that failure to provide an income tax allowance to a partnership pipeline is "punitive" and a "bill of attainder" are groundless. *See* SFPP Opening Brief at 4.[17]

2. The Commission's Stand-Alone Tax Policy For Corporate Utilities Filing A Consolidated Tax Return Is Irrelevant To The Issues In This Proceeding.

The Commission has a policy allowing utilities who file as part of consolidated corporate return to collect an income tax allowance based on taxes that the consolidated group does not necessarily pay. *Income Tax Expenses for Ratemaking Purposes*, D.84-05-036, 15 CPUC 2d 42 (1984). Instead, the utility is deemed to have paid the applicable income tax rate on its return on equity. This policy recognizes that a utility may have non-jurisdictional affiliates that incur losses during the relevant time period. Under that circumstance, the utility's positive tax liability would be offset by those tax losses, allowing the group as a whole to avoid paying some or even all of the utility's tax liability. FERC has a corresponding policy that the D.C. Circuit affirmed, holding that "[i]t is certainly reasonable to regard as no less real an economic detriment than cash payment of tax assessments, the consumption of otherwise usable tax losses to forestall those assessments." *City of Charlottesville v. FERC*, 774 F.2d 1205, 1215 (D.C. Cir. 1985).

The Commission's stand-alone tax policy for corporate utilities that are part of a consolidated tax return is entirely irrelevant to this case. Judge Long's Proposed Decision in C.97-04-025, *et al.* agreed that the policy is irrelevant here and recommended that the

[17] SFPP also claims that it would be discriminatory for the Commission to differentiate between the tax treatment accorded to SFPP and other utilities operating as partnerships. SFPP Opening Brief, Att. A at 4, n.6. The obvious answer is that this proceeding concerns SFPP only; it is not a general rulemaking. If the Commission denies SFPP an income tax allowance, its decision will have precedential value in cases relating to other partnership pipelines when those cases come before the Commission, and it may be addressed at that time.

Commission deny SFPP's request for an income tax allowance. As Judge Long described it, the stand-alone policy ensures that "[b]y excluding the effects of affiliates, the only expense included in rates is the expense for liability attributable to the utility's income . . . ." Proposed Decision at 18. Importantly, Judge Long noted that the policy is "based on an assumption that the utility's income will be taxable." *Id.* The stand-alone policy is a method of identifying the tax liability of a regulated utility in the midst of the complexities of its corporate family's tax return. But that policy assumes as a threshold matter that the utility itself is subject to taxes.

SFPP does not avoid income taxes because of offsetting losses of non-jurisdictional affiliates. It avoids income taxes because the United States Code provides that it is exempt from the two-tier taxation imposed on corporate income. As a partnership pipeline, SFPP is not subject to income taxes. Therefore, SFPP's citation of the stand-alone policy is misplaced and should be disregarded.

After its misguided quotation of the stand-alone policy, SFPP makes a puzzling claim: "According to Commission policy, a regulated utility, like SFPP, is allowed an income tax allowance at the rates applicable to corporations, based on the authorized return on equity." SFPP Opening Brief, Att. A at 1-2. It cites nothing for this assertion, nor could it as there is no such policy. The Commission grants an income tax allowance for actual taxes paid,[18] or in the case of a consolidated return, taxes incurred but avoided through the tax losses of affiliates. It has no policy allowing partnerships to collect a tax allowance as if they paid taxes as a corporation.

[18] *Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Inc.*, D.04-02-063, slip op. at 114, 117, 2004 WL 474133 at *58 (2004).

3. Congress Did Not Intend For This Commission To Allow Partnerships Like SFPP To Charge Their Customers As If They Pay Corporate Income Tax.

SFPP claims that the purpose of an income tax allowance is to effectuate Congress's intent to incentivize investment in pipeline infrastructure by relieving partnership pipelines of income taxes. SFPP Opening Brief, Att. A at 6-7. Setting aside the fact that SFPP is quoting testimony from Dr. Williamson that is not in this record, SFPP is entirely wrong, both as to the purpose of an income tax allowance and as to Congressional intent.

Dr. Horst explained, in this record, that the purpose of an income tax allowance is to compensate a pipeline for its own tax liability so that the pipeline can provide a pre-investor-tax return to investors sufficient to attract investment in the pipeline. Exh. No. ExxonMobil-1 at 33:7 to 36:2. Dr. Williamson's explanation of the purpose of income tax allowances, quoted in Attachment A to SFPP's Opening Brief at 6-7, is an inscrutable and wholly irrelevant dissertation on depreciation, and should be disregarded.

BP and ExxonMobil explained in their Opening Brief that Congress did not intend for regulatory agencies to allow partnerships to include an allowance for taxes they no longer had to pay. *See* BP-ExxonMobil Opening Brief at 36-40 (citing *BP West Coast Prods. LLC v. FERC*, 374 F.3d 1263, 1293 (D.C. Cir. 2004) ("The mandate of Congress in the tax amendment was exhausted when the pipeline limited partnership was exempted from corporate taxation. It did not empower FERC to do anything, let alone to create an allowance for fictitious taxes.")). Even if Congress had directed FERC to allow partnerships to collect an allowance for phony taxes, this Commission has held that California utilities must pass through tax savings to ratepayers because such a directive does not apply to state regulatory agencies. The California Supreme Court agreed. *Pacific Tel. & Telegraph Co. v. Pub. Utils. Comm'n*, 401 P.2d 353, 375-77 (Cal. 1965).

Even if SFPP did receive additional revenues in the form of an allowance for phony taxes, there is no reason to believe that those revenues would be spent on infrastructure. Quite the contrary, as the Commission observed in the Change of Control Order:

> KMEP's partnership agreement requires that it distribute 100% of 'Available Cash,' as defined in the partnership agreement, to its partners within 45 days following the end of each calendar quarter in accordance with their respective percentage interests. . . .
>
> KMEP pays out more cash than it earns in income, partially funding distributions by 'regularly' borrowing money . . . . The cash flow from SFPP and Calnev (about $250 million annually) constitutes a substantial portion of the cash distributed to KMEP. KMI received approximately 42% of all quarterly cash distributions in 2005 in its role as general partner and 9% in its role as a limited partner, for a total of 51%.

Change of Control Order, slip op. at 62, 2007 WL 2066307 at *27, Findings of Fact 15 and 16 (2007).

> Because of the high reliance upon regular cash infusions from the pipeline utilities, impetus exists at every level within the KMI organization to maximize the distributions from SFPP and Calnev and send them upward. Post-transaction no change is contemplated.

Id., Finding of Fact 26. SFPP would not spend the revenue from an income tax allowance on California infrastructure; it would send it up the ownership tree to its ultimate owners.

IV. CONCLUSION

The Commission should reject SFPP's proposal for light-handed regulation and require SFPP to make a compliance filing recalculating its cost-of-service rates in accordance with the recommendations herein, and to pay refunds to shippers to the extent it has collected rates in excess of the filed compliance rates.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served by electronic mail the foregoing Joint Closing Brief of BP West Coast Products LLC and ExxonMobil Oil Corporation upon the persons listed below:

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Dated at Washington, D.C. this 24th day of May, 2010.

/s/ Thomas J. Eastment
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