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BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

ARCO Products Company, Mobil Oil Corporation, and Texaco Refining and Marketing, Inc., Complainants, vs. SFPP, L.P., Defendant.	Case 97-04-025 (Filed April 7, 1997)
And Related Matters.	Case 00-04-013 Case 06-12-031 Application 00-03-044 Application 03-02-027 Application 04-11-017 Application 06-01-015 Application 06-08-028

REPLY COMMENTS OF CHEVRON PRODUCTS COMPANY, CONOCOPHILLIPS COMPANY, ULTRAMAR INC., VALERO MARKETING AND SUPPLY COMPANY, AND SOUTHWEST AIRLINES CO.

Martha C. Luemers
Dorsey & Whitney LLP
1717 Embarcadero Road
Palo Alto, CA 94303
Telephone: (650) 857-1717

Marcus W. Sisk, Jr.
Frederick G. Jauss, IV
Dorsey & Whitney LLP
1801 K Street, N.W., Suite 750
Washington, D.C. 20006
Telephone: (202) 442-3000

Attorneys for ConocoPhillips Company

Richard E. Powers, Jr.
Venable LLP
575 7th Street, N.W.
Washington, D.C. 20004
Telephone: (202) 344-4360

Attorney for Southwest Airlines Co.

Steven A. Adducci
Christopher K. Diamond
Venable LLP
575 7th Street, N.W.
Washington, D.C. 20004
Telephone: (202) 344-4361

Attorneys for Valero Marketing and Supply Company and Ultramar Inc.

George L. Weber
Weber & Associates, P.C.
1629 K Street, N.W., Suite 300
Washington, D.C. 20036
Telephone: (202) 628-0200

Attorney for Chevron Products Company

Dated: May 10, 2010

REPLY COMMENTS OF CHEVRON PRODUCTS COMPANY, CONOCOPHILLIPS COMPANY, ULTRAMAR INC., VALERO MARKETING AND SUPPLY COMPANY, AND SOUTHWEST AIRLINES CO.

2003 Test Year Rate Base. CCUV support the PD's well-reasoned determination to exclude the North Line expansion project ("NL Project") from SFPP's rate base for the 2003 Test Year ("TY") as well as any related costs. Further, both the Shippers and SFPP are in agreement that the PD erred by including an attrition rate adjustment for SFPP.[1]

SFPP's erroneously argues that under *Pacific Telephone*, its NL Project must be included in its 2003 TY rate base. SFPP OC at 26-27. SFPP's claims run counter to the 2003 TY as specifically defined by Resolution O-0043. Further, SFPP's assertions regarding its alleged expectations and the 2003 costs for the NL Project are refuted by the undisputed record. SFPP could not identify what the NL Project costs were in 2003 and could only comment that some funds had been spent. A.03-02-027, Tr. 327 (Turner). As to SFPP's purported expectations of a late 2004 in-service date, SFPP conceded at hearing that the projected capacity constraint that allegedly formed the basis for the project would be "delayed at least a year" (*i.e.*, into the year 2005), refuting any assurance of an expected 2004 in-service date. A.03-02-027, Tr. 33 and 38 (Morgan).

SFPP's reliance on *Pacific Telephone* is misplaced. In *Pacific Telephone*, there is no mention of a defined TY as established in Resolution O-0043. Moreover, *Pacific Telephone* stands for the proposition that a Test Year should include costs "reasonably expected to prevail during the future period *for which rates are to be fixed*." SFPP OC at 27 (emphasis added). The rates to be fixed in A.03-02-027 apply to the time period from October 24, 2002, through SFPP's next rate filing (*i.e.*, Docket A.04-11-017, submitted November 9, 2004), wherein SFPP sought to recover NL Project costs. Thus, under *Pacific Telephone*, the "period for which rates are to be fixed" is October 24, 2002 through November

[1] *See* SFPP Opening Comments noting that the PD's attrition rate adjustment proposal "was mooted by the filing of SFPP 2004 rate case, which included the full costs of the North Line expansion." SFPP OC at 27 n.9.

2004.[2] As the NL Project did not prevail during any part of "the future period for which rates are to be fixed," it cannot be included in rate base.

<u>Sepulveda/Watson</u>. SFPP erroneously disputes the PD's finding that Watson Station ("Watson") and the Sepulveda Line ("Sepulveda") require cost-based rates. In addition to its flawed UNOCAP demonstration, SFPP completely failed to address a critical UNOCAP factor: rate of return. SFPP's own witness demonstrated that the pipeline is – even with an inappropriate income tax allowance and an inflated capital structure and return on equity – massively over-recovering its Sepulveda revenue requirement by some 59% (*i.e.*, a $188,000 over-recovery) and its Watson revenue requirement by some 559% (*i.e.*, a $2.747 million over-recovery). *See* CCUV OC at 17. Further, Shippers' testimony established that, with a non-hypothetical capital structure, reasonable return on equity, and no income tax allowance, SFPP is obtaining achieved returns of some 38% for Sepulveda and 196% for Watson

As established in *Tejas Power*, "[i]n a competitive market . . .it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that *price is close to marginal cost, such that the seller makes only a normal return on investment*."[3] SFPP cannot plausibly claim that the excessive returns being achieved and the over-recoveries obtained from Watson and Sepulveda are normal or the result of a competitive market.

With respect to Sepulveda, SFPP puts forth skewed logic regarding its claimed 50% drop in throughput. SFPP OC at 23-24. If SFPP lacked market power and was losing throughput to alleged competitors, one would not rationally expect the substantial overrecoveries it has enjoyed. Further, one would also rationally expect to see SFPP reduce its rates to match its purported competition. SFPP has not reduced its Sepulveda Line rate and continues to charge the same approximately 5-cent rate in 2010 that it did in 2003. The only logical conclusion is that SFPP has a captive market where it continues to

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2 SFPP acknowledged that the NL Project was "scheduled to become operational on or about December 15, 2004." *See* SFPP Application in Docket A.04-11-017 at 1-2.

3 908 F.2d 998, 1004 (D.C. Cir. 1990) (emphasis added).

exercise its undue market power. With respect to Watson, the exorbitant returns and the findings of the FERC and the D.C. Court of Appeals completely refute SFPP's specious claims of competition.[4]

Return On Equity. The PD's recommended 12.61% allowed return on equity ("ROE") is fully justified in the record. The thrust of SFPP's argument is that partnership distributions are the equivalent of corporate dividends in performing a standard FERC DCF ROE analysis. It is incorrect to equate partnership distributions with corporate dividends in the DCF analysis. The DCF analysis is premised on the use of dividends or the payout of earnings (*i.e.*, a return *on* capital), with part of the earnings being retained for future growth. *See* Ex. 200A at 24-28. However, as SFPP's witness agreed, partnership distributions include a return *of* capital, as the distributions paid out regularly exceed current earnings.[5]

Shipper witness O'Loughlin used the same proxy group as SFPP's witness. However, Mr. O'Loughlin developed a conservative proxy dividend yield for the MLP proxy group by assuming a dividend or distribution yield equal to 100% of the partnerships' net income per unit, attempting to eliminate any return of capital component in the distributions.[6] Mr. O'Loughlin's recommended ROE was 12.28%, or only 33 basis points below the PD's. Mr. O'Loughlin confirmed the reasonableness of his recommended ROE by comparing his result with contemporaneous allowed returns determined by the CPUC for four gas and electric utilities – finding his recommended ROE for SFPP to be comparable.[7] Ex. 200A at 29-30. Mr. O'Loughlin further confirmed the reasonableness of his ROE by comparing the gas/electric utilities' Betas (a common measure of market risk in finance) with that of the MLPs in the DCF proxy group, finding comparable risk.[8] Ex. 200A at 29-30.

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4 *SFPP, L.P.*, 122 FERC ¶ 61,126 (2008); *SFPP, L.P. v. FERC*, 592 F.3d 189 (D.C. Cir. 2010).

5 *See* Ex. 103A at 7; A.03-02-027 Tr. 246 (Williamson) (agreeing that payout of more than earnings is not net income or a return on capital).

6 The constant growth DCF methodology relies on a dividend payout that is no more than 100% of net income and reinvestment of the remainder to achieve future growth in earnings. Ex. 200A at 24-25.

7 The gas and electric utilities were granted allowed ROEs of 10.9% to 11.6% by the Commission.

8 While SFPP quibbled with Mr. O'Loughlin's Beta usage, the record demonstrated SFPP's own witness supported the use of Beta coefficients as an equity risk measure, and the Betas used by Mr. O'Loughlin were from the same source – Value Line – that SFPP's witness used in developing his DCF analysis.

SFPP previously criticized this comparison with the four California gas/electric utilities because these utilities were supposedly far too risky for use as a comparison to SFPP, asserting that the gas/electric utilities were in "serious financial condition," paid "no dividends," offer only "speculative appeal" and involve "potential earnings dilution."[9] However, based on these comments, SFPP's allowed ROE should have been *lower* than that of the gas/electric utilities – not higher. Now SFPP argues that SFPP is much riskier than the four gas/electric utilities, thus deserving a much higher allowed ROE. SFPP's flip-flopping positions speak volumes as to the credibility of its arguments and effectively support the PD's ROE determination.

Finally, FERC's ROE Policy Statement does not support SFPP's position that distributions are the equivalent of dividends. SFPP fails to address FERC's line of cases agreeing with Mr. O'Loughlin's concerns regarding the use of unadjusted distributions in place of dividends in a DCF analysis.[10] More importantly, although FERC modified the method for incorporating distributions in its DCF analysis, its ROE Policy Statement implemented a specific adjustment for the fact that MLP distributions are not the equivalent of corporate dividends. Rather than continue to exclude MLPs that paid out distributions in excess of earnings, FERC adjusted the DCF formula to recognize that it could not use its existing growth rate formula given the inherent problems with distributions in excess of earnings. As a result, FERC adjusted the DCF's long-term growth rate portion for MLPs to use only 50% of the GDP growth rate. Accordingly, FERC's ROE Policy Statement directly supports both Shippers' position and the PD's determination that distributions are not the equivalent of dividends in the DCF analysis.

Electricity Surcharge. SFPP has asserted again that it should be permitted to substitute in a new basis for its Advice Letter 14 surcharge, which SFPP has not paid since December 2001. CCUV

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9 SFPP Supplemental Br. at 41-42 (April 26, 2007).

10 *High Island Offshore Sys., LLC*, 110 FERC ¶ 61,043 (2005), *reh'g denied*, 112 FERC ¶ 61,050 (2005) (excluding MLPs from DCF proxy group where distributions were in excess of earnings); *Kern River Gas Transmission Co.*, 117 FERC ¶ 61,077 (2006) (distributions exceeding earnings do not provide growth from investment of retained earnings which underlie the growth component in the DCF analysis); *Texaco Ref. & Mktg., Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006) (MLP excluded from DCF proxy group where distributions were in excess of earnings).

addressed the deficiencies of this argument in their opening comments. *See* CCUV OC at 3-9. The only new element to SFPP's argument is its reliance, at oral argument, on "AB1X and AB17," which according to SFPP, "essentially said that direct-access customers, to the extent they avoided paying the utility bundled service by switching to direct access, had to make the utility whole." May 5, 2010 Tr. 1152-53. What SFPP's argument leaves out, however, is the fact that AB1X/AB17 and the resulting "cost responsibility surcharge" were implemented prior to SFPP's application in A.06-01-015 (filed January 26, 2006).[11] A.06-01-015 specifically sought to recover alleged increases in SFPP's electricity costs.[12] Accordingly, to the extent SFPP has been subject to a "cost responsibility surcharge," it has already included these increased costs by its filing in A.06-01-015. SFPP should not be permitted to profit from its gaming of the Commission's regulations and recover this alleged cost increase twice – *i.e.*, once through A.06-01-015, and as a substitute basis for the Advice Letter 14 surcharge.

Respectfully submitted,

<u>*/s/ Steven A. Adducci*</u>
Steven A. Adducci
Venable LLP
575 7th Street, N.W.
Washington, D.C. 20004
(202) 344-4361

Attorney for Valero Marketing and Supply Company and Ultramar Inc.,
and on behalf of Chevron Products Company, ConocoPhillips Company, and Southwest Airlines Co.

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11 *See*, *e.g.*, *Opinion on Cost Responsibility Surcharge Mechanisms for Customer Generation Departing Load*, D.03-04-030, 2003 WL 1916755, at *28 (2003).

12 *See* A.06-01-015, SFPP Application, at 2.

CERTIFICATE OF SERVICE

I hereby certify that I have served the foregoing

REPLY COMMENTS OF CHEVRON PRODUCTS COMPANY, CONOCOPHILLIPS COMPANY, ULTRAMAR INC., VALERO MARKETING AND SUPPLY COMPANY, AND SOUTHWEST AIRLINES CO.

via U.S. Mail or e-mail delivery upon the following:

Parties

JOHN B MERRITT
TRAVIS & GOOCH
34820 N DESERT RIDGE DR.
SCOTTSDALE, AZ 05282-1104
FOR: EXXON OIL CORP.

RICHARD E. POWERS, JR.
ATTORNEY AT LAW
VENABLE, LLP
575 7TH STREET N.W.
WASHINGTON, DC 20004

STEVEN A. ADDUCCI
ATTORNEY AT LAW
VENABLE, LLP
575 7TH STREET N.W.
WASHINGTON, DC 20004-1601
FOR: VALERO MARKETING AND SUPPLY COMPANY/ULTRAMAR INC.

THOMAS J. EASTMENT
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-2400
FOR: COUNSEL FOR EXXONMOBIL OIL CORPORATION/BP WEST COAST PRODUCTS LLC

MARK R. HASKELL
ATTORNEY AT LAW
TRAVIS & GOOCH
SUITE 1010
1101 15TH STREET, N.W.
WASHINGTON, DC 20005-5002

MARCUS W. SISK, JR
DORSEY & WHITNEY LLP
1801 K STREET, N.W., SUITE 750
WASHINGTON, DC 20006
FOR: CONOCOPHILLIPS COMPANY

GEORGE L. WEBER
WEBER & ASSOCIATES, P.C.
SUITE 600
1000 CONNECTICUT AVENUE, N.W.
WASHINGTON, DC 20036
FOR: CHEVRON TEXACO PRODUCTS COMPANY

MATTHEW A. CORCORAN
GOLDSTEIN & ASSOCIATES, P.C.
1757 P STREET, N.W.
WASHINGTON, DC 20036
FOR: TESORO REFINING AND MARKETING COMPANY

MELVIN GOLDSTEIN
ATTORNEY AT LAW
GOLDSTEIN & ASSOCIATES, P.C.
1757 P STREET, N.W.
WASHINGTON, DC 20036
FOR: TESORO REFINING & MARKETING CO.

ROBERT W. KNEISLEY
ASSOCIATE GENERAL COUNSEL
SOUTHWEST AIRLINES CO.
1901 L STREET, N.W., SUITE 640
WASHINGTON, DC 20036

ANDREW J. DALTON
VALERO ENERGY COMPANY
ONE VALERO PLACE, ROOM 264
SAN ANTONIO, TX 78212-3186

BARRON DOWLING
ASSOCIATE GENERAL COUNSEL
300 CONCORD PLAZA DRIVE
SAN ANTONIO, TX 78216
FOR: TESORO REFINING AND MARKETING COMPANY

JAMES D. SQUERI
ATTORNEY AT LAW
GOODIN, MACBRIDE, SQUERI, DAY & LAMPREY
505 SANSOME STREET, SUITE 900
SAN FRANCISCO, CA 94111
FOR: SANTA FE PACIFIC PIPELINE, L.P.

JEFFREY P. GRAY
ATTORNEY AT LAW
DAVIS WRIGHT TREMAINE, LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO, CA 94111-6533
FOR: SFPP, L.P.

MARTHA C. LUEMERS
ATTORNEY AT LAW
DORSEY & WHITNEY, LLP
1717 EMBARCADERO ROAD
PALO ALTO, CA 94303
FOR: CONOCOPHILLIPS

D. T. SHERMAN
ASSOCIATE GENERAL COUNSEL
CHEVRON PRODUCTS COMPANY
PO BOX 5044
SAN RAMON, CA 94583

Information Only

CHRISTINA M. VITALE
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-2400

GREGORY S. WAGNER
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-2400

JOSHUA B. FRANK
BAKER BOTTS L.L.P.
1299 PENNSYLVANIA AVENUE, NW
WASHINGTON, DC 20004-2400

GLENN S. BENSON
ATTORNEY AT LAW
TEXACO, REFINING AND MARKETING, INC.,
1101 15TH STREET N W SUITE 1010
WASHINGTON, DC 20005

FREDERICK G. JAUSS IV
DORSEY & WHITNEY LLP
1801 K STREET, N.W., SUITE 750
WASHINGTON, DC 20006

NOREEN M. TAMA
EXXONMOBIL OIL CORPORATION
3225 GALLOWS ROAD
FAIRFAX, VA 22037
FOR: EXXONMOBIL OIL CORPORATION

JENNIFER LIGHT MCGRATH
MOBIL OIL CORPORATION
3225 GALLOWS ROAD, ROOM 8B115
FAIRFAX, VA 22037-0001

THOMAS A. NOTO
ATTORNEY AT LAW
MOBIL OIL CORPORATION
ROOM 8B313
3225 GALLOWS ROAD
FAIRFAX, VA 22038-0001

BARBARA HICKEL
EQUILON ENTERPRISES
910 LOUISIANA
HOUSTON, TX 77210
FOR: EQUILON ENTERPRISES

TODD NORMANE
BP AMERICA, INC.
6 CENTERPOINTE DRIVE; LPR 6-552
LA PALMA, CA 90623

JOHN BURKHOLDER
BETA CONSULTING
2023 TUDOR LANE
FALLBROOK, CA 92028

BRUCE FOSTER
SOUTHERN CALIFORNIA EDISON COMPANY
601 VAN NESS AVENUE, STE. 2040
SAN FRANCISCO, CA 94102

EDWARD W. O'NEILL
ATTORNEY AT LAW
DAVIS WRIGHT TREMAINE, LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO, CA 94111-6533

JUDY PAU
DAVIS WRIGHT TREMAINE LLP
505 MONTGOMERY STREET, SUITE 800
SAN FRANCISCO, CA 94111-6533

MARGARET J. STORK
DORSEY & WHITNEY, LLP
1717 EMBARCADERO ROAD
PALO ALTO, CA 94303

DOUG GARRETT
COX CALIFORNIA TELCOM, LLC
2200 POWELL STREET, SUITE 1035
EMERYVILLE, CA 94608-2618

PAUL M. PREMO
ENERGY ECONOMICS CONSULTING
310 HAZEL AVENUE
MILL VALLEY, CA 94941-5054
FOR: ENERGY ECONOMICS CONSULTING

LARRY E. FARRENS
CALIFORNIA TRUCKING ASSOCIATION
3251 BEACON BOULEVARD
WEST SACRAMENTO, CA 95691

SCOTT BLAISING
ATTORNEY AT LAW
BRAUN BLAISING MCLAUGHLIN P.C.
915 L STREET, STE. 1270
SACRAMENTO, CA 95814

ANDREW BROWN
ELLISON, SCHNEIDER & HARRIS L.L.P.
2600 CAPITOL AVE, SUITE 400
SACRAMENTO, CA 95816-5905

State Service

VAHAK PETROSSIAN
CALIF PUBLIC UTILITIES COMMISSION
RAIL SAFETY & CROSSING BRANCH
320 WEST 4TH STREET SUITE 500
LOS ANGELES, CA 90013

DOUGLAS M. LONG
CALIF PUBLIC UTILITIES COMMISSION
DIVISION OF ADMINISTRATIVE LAW JUDGES
ROOM 5023
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

MAURICE MONSON
CALIF PUBLIC UTILITIES COMMISSION
ENERGY DIVISION
AREA 4-A
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

PAUL WUERSTLE
CALIF PUBLIC UTILITIES COMMISSION
TRANSPORTATION ENFORCEMENT BRANCH
ROOM 2107
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3214

Dated at Washington D.C., this 10th day of May 2010.

/s/ Steven A. Adducci
Steven A. Adducci