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BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

ARCO Products Company, Mobil Oil Corporation, Texaco Refining and Marketing, Inc., and Equilon Enterprises, LLC, Complainants, v. Santa Fe Pacific Pipeline, L.P., Defendant.	)	C.97-04-025
And Related Matters.	)	C.00-04-013 A.00-03-044 A.03-02-027 A.04-11-017 A.06-01-015 A.06-08-028 C.06-12-031

<u>JOINT MOTION TO SET ASIDE SUBMISSION AND REQUEST FOR OFFICIAL NOTICE</u>

In accordance with Rules 11.1, 13.9 and 13.14 of the Rules of Practice and Procedure of the California Public Utilities Commission ("Commission"), BP West Coast Products LLC, Chevron Products Company, ConocoPhillips Company, ExxonMobil Oil Corporation, Southwest Airlines Co., Tesoro Refining and Marketing Company, Ultramar, Inc., and Valero Marketing and Supply Company (collectively the "Shipper Parties") respectfully move that the presiding Administrative Law Judge set aside submission of the captioned proceedings for the purpose of taking official notice of the Initial Decision issued by Judge Carmen A. Cintron of the Federal Energy Regulatory Commission ("FERC") on February 10, 2011 in *SFPP, L.P.*, 134 FERC ¶ 63,013 (2011) ("FERC ID"). A copy of the FERC ID is provided herewith as Attachment A.

Rule 13.14(b) states, in relevant part:

> A motion to set aside submission and reopen the record for the taking of additional evidence . . . shall specify the facts claimed to constitute grounds in justification thereof, including material changes of fact or of law alleged to have occurred since the conclusion of the hearing. It shall contain a brief statement of proposed additional evidence, and explain why such evidence was not previously adduced.

Rule 13.9 states: "Official notice may be taken of such matters as may be judicially noticed by the courts of the State of California." Under Section 452(c) of the California Evidence Code, the courts of the State of California may take judicial notice of "[o]fficial acts of the legislative, executive, and judicial departments of the United States and of any state of the United States." "Official acts" is interpreted broadly, and includes, among other things, the "records, reports and orders of administrative agencies." *Rodas v. Spiegel*, 87 Cal.App.4th 513, 518 (2001). It is not essential that an "official act" be a final decision. For example, in *Western States Petroleum Ass'n v. State Dep't of Health Serv.*, 99 Cal.App. 4th 999 (2002), the court took judicial notice of the federal Environmental Protection Agency's notice of intent to initiate rulemaking regarding methyl tertiary-butyl ether ("MTBE") in the context of the court's discussion of growing concerns about the effects of MTBE. *Id*. at 1002, n.1; *see also City & County of San Francisco v. Int'l Union of Operating Eng'rs*, 151 Cal.App.4th 938, 942 (2007) (judicial notice of tentative decision by an administrative law judge); *As You Sow v. Conbraco Indus.*, 135 Cal.App.4th 431, 438-39, n. 4 (2006) (judicial notice of agency's initial statement of reasons and proposed amendments).

The Shipper Parties recognize the Proposed Decision and the Alternate Proposed Decision, if adopted, would deny prior requests that the Commission take notice of initial decisions issued by FERC ALJs. However, Shipper Parties do not seek to cite the FERC ID as decisional authority. Rather, they respectfully submit that the FERC ID is an important development that provides necessary context for Opinion No. 511, which is the subject of

SFPP's February 23, 2011 Motion to Set Aside Submission and Request for Official Notice. The FERC ID challenges the factual assumptions and legal conclusions set forth in the FERC Policy Statement on Income Tax Allowances, *Inquiry Regarding Income Tax Allowances,* 111 FERC ¶ 61,139 (2005). Like Opinion No. 511, the FERC ID finds that an income tax allowance provides investors in an MLP pipeline with a substantially greater after-tax return than investors in a corporate pipeline. *See* FERC ID at P 172; *SFPP, L.P.*, Opinion No. 511, 134 FERC ¶ 61,211 at PP 239, 245-49 (2011). Unlike Opinion No. 511, the FERC ID does not find that this preferential treatment of partnership pipelines was authorized by Congress.

The FERC ID demonstrates that FERC's policy regarding the entitlement of Master Limited Partnerships ("MLPs") such as SFPP to collect an income tax allowance is far from a settled matter. The ALJ observed that "[i]t is not clear from this record whether the Commission has considered evidence similar to the evidence in this record in its prior decisions." FERC ID at P 165. She thoroughly examined the record and found that "significant evidence has been presented in this case demonstrating that an income tax allowance for SFPP results in an over-recovery for its investors." FERC ID at P 1. Although the ALJ ultimately considered herself bound by existing FERC precedent, she agreed with the shippers that

> The evidence in this case demonstrates that the Commission's DCF ROE (pre-tax to investors) will set to a level sufficient to attract investor capital. Or stated another way, the DCF ROE will be sufficient after investor income taxes, to attract investor capital. . . . [The] evidence provided in this proceeding shows that ITAs cause MLPs to double recover their taxes. First, MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return. Two, the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base. Further, the evidence in this case demonstrates the income tax allowance for MLPs does not equalize the after tax returns from a corporation and investors in an MLP.

FERC ID at P 171. Thus, the only FERC ALJ to examine detailed evidence of SFPP's double recovery agreed that SFPP will in fact recover the tax liability of its investors twice if it is granted an income tax allowance.

The FERC ID is pending review by the full FERC and Opinion No. 511 is subject to rehearing by the full FERC, which the Shipper Parties intend to request. Thus, both the FERC ID and FERC's Opinion No. 511 are subject to further administrative and judicial review. While this Commission is not bound by FERC policy or precedent, to the extent the Commission considers such policy and precedent to be informative, the Commission should be aware that FERC policy remains subject to change.

The FERC ID was issued following the submission of the captioned proceedings, so it could not have been presented to the Commission for its consideration prior to submission. As an "[o]fficial act" of an executive department of the United States, it is appropriate for the Commission to take notice of the FERC ID to the same extent as a court of the State of California under Section 452(c) of the California Evidence Code.

WHEREFORE, Shipper Parties respectfully request that the presiding Administrative Law Judge set aside the submission of the captioned proceedings and that the Commission take official notice of the FERC ID.

Respectfully submitted,

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Dated: March 9, 2011

ATTACHMENT A

134 FERC ¶ 63,013
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

SFPP, L.P.	Docket No.	IS09-437-000
	Docket No.	IS10-572-000

INITIAL DECISION

(Issued February 10, 2011)

APPEARANCES

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Thomas J. Eastment, Esq., Gregory S. Wagner, Esq., Christina M. Vitale, Esq., Denise C. McWatters, Esq., and Lowry Barfield, Esq. on behalf of Navajo Refining Company, L.L.C. and Western Refining Company, L.P.

Marcus W. Sisk, Jr., Esq. and Frederick G. Jauss IV, Esq. on behalf of ConocoPhillips Company.

Steven A. Adducci, Esq. and Christopher K. Diamond, Esq. on behalf of Valero Marketing and Supply Company.

George L. Weber, Esq. on behalf of Chevron Products Company.

Richard E. Powers, Jr., Esq. on behalf of Southwest Airlines Co.

Derek L. Anderson, Esq., Joel M. Cockrell, Esq., and James W. Bixby, Esq. on behalf of Commission Trial Staff.

CARMEN A. CINTRON, Presiding Administrative Law Judge

INTRODUCTION

1. This proceeding involves a tariff filing, FERC Tariff No. 182, to increase the costs and associated transportation rates of the East Line portion of the SFPP pipeline. The tariff was submitted for filing to the Commission July 31, 2009, and docketed as Docket No. IS09-437-000. On May 28, 2010, pursuant to the Commission's annual rate indexing methodology for oil pipelines, SFPP filed FERC Tariff No. 187 (2010 Index Filing), to become effective July 1, 2010. FERC Tariff No. 187 cancelled FERC Tariff No. 182. The 2010 Index Filing decreased the rates for movements on SFPP's East Line. Pursuant to an arrangement, during the proceeding, SFPP filed a new East Line tariff – FERC Tariff No. 192 – on August 16, 2010, to become effective September 1, 2010 (Interim Rate Tariff Filing). FERC Tariff No. 192 cancelled FERC Tariff No. 187, and decreased the rates on SFPP's East Line. On September 15, 2010, the Commission issued an order accepting and suspending SFPP's interim rates, effective September 1, 2010, subject to refund, and consolidating Docket Nos. IS10-572-000 and IS09-437-000. The parties filed a joint stipulation which resolved the issue of the nominal rate of return on equity, the real rate of return and the inflation factor for purposes of calculating SFPP's East Line cost of service. This decision resolves the remaining issues. It finds and concludes that SFPP failed to meet its burden of proof in the majority of the components in the calculation of its cost of service based rates. Additionally, it concludes that significant evidence has been presented in this case demonstrating that an income tax allowance for SFPP results in an over-recovery for its investors. However, previous Commission decisions bar a holding against SFPP concerning this matter. The decision nevertheless orders modifications to the income tax allowance and certain costs that flow from that calculation in SFPP's rates.

BACKGROUND

2. SFPP, L.P. (SFPP) owns and operates the East Line, a common carrier pipeline that transports refined petroleum products – including gasoline, diesel, and jet fuel – in interstate commerce. The East Line originates in El Paso, Texas or Diamond Junction, Texas and delivers to Lordsburg, New Mexico; Tucson, Arizona; Phoenix, Arizona; and various military destinations. Until recently, SFPP experienced growth in the demand for transportation of refined petroleum products in the markets served by the East Line. Between 2002 and 2007, SFPP responded to an increased demand for transportation on the East Line by investing approximately $350 million to expand the capacity of the East Line (East Line Expansion). The first phase of the expansion went into service in June 2006 (EL Phase I). All issues regarding EL Phase I were resolved by settlement in November 2007 (EL Phase I Settlement).[1] The second phase went into service in

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[1] *SFPP, L.P.*, 122 FERC ¶ 61,107 (2008). The EL Phase I Settlement resolved the protests in Docket No. IS06-283-000.

December 2007 (EL Phase II). All issues regarding EL Phase II were resolved by settlement in October 2008 (EL Phase II Settlement).[2]

3. The EL Phase II Settlement contained a volume-based rate adjustment mechanism that would adjust East Line rates within the structure of the settlement to reflect changes in annual average daily East Line volumes above or below certain thresholds at defined measurement periods.[3] Pursuant to this provision, SFPP was obligated to adjust its East Line rates down/ward if total East Line annual average daily volumes exceeded 182,500 barrels per day (bpd).[4] If total East Line annual average daily volumes fell below 162,500 barrels per day, SFPP was permitted to terminate unilaterally the EL Phase II Settlement, or to replace the East Line settlement rates with replacement rates.[5]

4. In the third quarter of 2008, economic conditions in Arizona declined. As a result, demand in Arizona for refined petroleum products – and consequently the demand for transportation of such products via SFPP's East Line – steadily decreased. Average East Line volumes dropped below the lower threshold in the EL Phase II Settlement as of May 31, 2009 – the end of the first 12-month measurement period under the EL Phase II Settlement.[6] SFPP therefore exercised its right to terminate the EL Phase II Settlement, effective August 31, 2009

PROCEDURAL HISTORY

5. On July 31, 2009, SFPP filed FERC Tariff No. 182, to be effective September 1, 2009 (East Line Tariff Filing).[7] FERC Tariff No. 182 cancelled FERC Tariff No. 177, and increased the rates for movements on SFPP's East Line from El Paso, Texas or Diamond Junction, Texas to Lordsburg, New Mexico; Tucson, Arizona; and Phoenix, Arizona. The East Line Tariff Filing was docketed as FERC Docket No. IS09-437-000.

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[2] *SFPP, L.P.*, 126 FERC ¶ 61,076 (2009). The EL Phase II Settlement resolved the protests in Docket Nos. IS08-28-000 and IS08-389-000, as well as the East Line portions of the complaints in Docket Nos. OR08-13-000 and OR08-15-000.

[3] EL Phase II Settlement Agreement, Section III.D.(3)(b).

[4] EL Phase II Settlement Agreement, Section III.D.(3)(b)(i).

[5] EL Phase II Settlement Agreement, Section III.D.(3)(b)(ii).

[6] Transmittal Letter Transmitting the East Line Tariff Filing at 2-3 (July 31, 2009) (Transmittal Letter).

[7] *Id.* at 1.

6. On August 14, 2009, BP West Coast Products, LLC (BP), and ExxonMobil Oil Corporation (ExxonMobil) and Navajo Refining Company, L.L.C. (Navajo) filed motions to intervene and protest.[8] On August 17, 2009, Valero Marketing and Supply Company (Valero), Chevron Products Company (Chevron), and Southwest Airlines Co. (Southwest) filed a joint motion to intervene and protest.[9] ConocoPhillips Company (ConocoPhillips) and Western Refining Company, L.P. (Western) also filed motions to intervene and protest on August 17, 2009.[10]

7. On August 31, 2010, pursuant to Section 15(7) of the Interstate Commerce Act (ICA),[11] the Federal Energy Regulatory Commission (Commission or FERC) issued an order accepting and suspending FERC Tariff No. 182, subject to refund, to become effective January 1, 2010, and set the matter for hearing (August 31 Order).[12] Accordingly, the Chief Administrative Law Judge (Chief Judge) designated the Presiding Administrative Law Judge (Presiding Judge) on September 8, 2009.[13] On September 16, 2009, the Presiding Judge held a prehearing conference and issued an order establishing the procedural schedule.[14]

8. On September 24, 2009, the Presiding Judge certified to the Commission the following question regarding paragraph (P) 20 of the August 31 Order:

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[8] *Motion to Intervene and Protest of BP West Coast Products, LLC*, Docket No. IS09-437-000 (Aug. 14, 2009); *Motion to Intervene and Protest of ExxonMobil Oil Corporation and Navajo Refining Company, L.L.C.*, Docket No. IS09-437-000 (Aug. 14, 2009).

[9] *Joint Motion to Intervene and Protest of Valero Marketing and Supply Company, Chevron Products Company, and Southwest Airlines Company*, Docket No. IS09-437-000 (Aug. 17, 2009).

[10] *Motion to Intervene and Protest of ConocoPhillips Company*, Docket No. IS09-437-000 (Aug. 17, 2009); *Motion for Leave to Intervene, Protest, and Motion of Western Refining Company, L.P. for Appointment of Settlement Judge*, Docket No. IS09-437-000 (Aug. 19, 2009).

[11] 49 U.S.C. App. § 15(7) (1988).

[12] *SFPP, L.P.*, 128 FERC ¶ 61,214 (2009) (August 31 Order). SFPP filed a request for rehearing of the August 31 Order on September 21, 2010. *Request for Rehearing and for Expedited Consideration of SFPP, L.P.*, Docket No. IS09-437-000 (Sept. 21, 2009).

[13] *Order of Chief Judge Designating Presiding Administrative Law Judge, Establishing Track III Procedural Time Standards and Scheduling a Prehearing Conference*, Docket No. IS09-437-000 (Sept. 8, 2009).

[14] *Order Establishing Procedural Schedule*, Docket No. IS09-437-000 (Sept. 16, 2009).

> Should the Commission provide guidance concerning paragraph 20 of the order designating this case for hearing [August 31 Order] []. It is recommended that the question be answered affirmatively. The paragraph should be clarified to indicate the following: whether the Commission intended to modify the filed base and test periods, what these periods will be, whether the effective date will remain January 1, 2010 and whether the hearing should be held in abeyance.[15]

In response, the Commission issued an *Order on Certified Question* on October 22, 2009 (October 22 Order).[16] The Commission clarified that P 20 of the August 31 Order did not intend to alter the base period ending June 30, 2009 and the test period ending March 31, 2010 as established in the East Line Tariff Filing.[17] The Commission reiterated that the effective date for the East Line Tariff Filing of January 1, 2010 will sufficiently mitigate the effects of SFPP's proposed rate increase.[18]

9. On November 11, 2009, SFPP filed Correction No. 2 to FERC Tariff No. 182 in Docket No. IS09-437-003.[19] That filing corrected a typographical error and reflected lower rates to each destination set forth in the East Line Tariff Filing. SFPP requested that the revised rates be made effective January 1, 2010, and that the Correction Supplement be consolidated with the ongoing proceeding in Docket No. IS09-437-000.

10. On December 11, 2009, SFPP filed direct testimony. On March 29, 2010, ConocoPhillips, Valero, Chevron, Southwest, Western, Navajo, and Commission Trial Staff (Staff) filed answering testimony. SFPP filed rebuttal testimony on May 14, 2010. On June 28, 2010, SFPP filed a motion to file supplemental rebuttal testimony.[20] The Presiding Judge granted SFPP's motion on June 30, 2010.[21] Accordingly, SFPP filed the supplemental rebuttal testimony of SFPP witnesses Thomas A. Turner and Thomas R. Knudsen on July 1, 2010.

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[15] *SFPP, L.P.*, 128 FERC ¶ 63,019, at P 1 (2009).

[16] *SFPP, L.P.*, 129 FERC ¶ 61,050 (2009) (October 22 Order).

[17] *Id.* P 8.

[18] *Id.*

[19] Correction Supplement No. 2 to FERC Tariff No. 182, Docket No. IS09-437-003 (Nov. 11, 2009).

[20] *Motion of SFPP, L.P. for Leave to File Supplemental Rebuttal Testimony*, Docket No. IS09-437-000 (June 28, 2010).

[21] *Order Confirming Ruling at Hearing*, Docket No. IS09-437-000 (June 30, 2010).

11. On April 28, 2010, SFPP and Staff filed a joint stipulation resolving the issue of the environmental remediation test period adjustment to Account 320 for El Paso Suction Line for purposes of calculating the SFPP's East Line cost-of-service (COS).[22] Pursuant to the stipulation, Staff filed a motion to withdraw portions of Staff witness Kathleen Sherman's testimony and exhibits.[23] The Presiding Judge granted Staff's motion on May 4, 2010.[24] Accordingly, Staff filed revised testimony and exhibits of Kathleen Sherman on June 23, 2010.

12. On May 28, 2010, pursuant to the Commission's annual rate indexing methodology for oil pipelines, SFPP filed FERC Tariff No. 187 (2010 Index Filing), to become effective July 1, 2010. FERC Tariff No. 187 cancelled FERC Tariff No. 182. The 2010 Index Filing decreased the rates for movements on SFPP's East Line from El Paso, Texas or Diamond Junction, Texas to Lordsburg, New Mexico; Tucson, Arizona; and Phoenix, Arizona. The 2010 Index Filing was docketed as FERC Docket No. IS10-402-000. No comments or protests were filed.

13. The hearing commenced on June 29, 2010 and concluded on August 2, 2010. During the hearing, 21 witnesses offered testimony and 590 exhibits were admitted into evidence. On August 4, 2010, the Chief Judge issued an order extending the deadlines for initial briefs, reply briefs, and the initial decision to accommodate the unanticipated duration of the hearing.[25] On August 12, 2010, the participants filed a joint index of exhibits, which identifies the exhibit and notes the status of each exhibit as public, confidential, Section 15(13) confidential and/or highly confidential.[26] On September 1,

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22 *Joint Stipulation of SFPP, L.P. and Commission Trial Staff Regarding Environmental Remediation Expenses at El Paso Station*, Docket No. IS09-437-000 (Apr. 28, 2010).

23 *Expedited Motion of Commission Trial Staff to Withdraw Testimony and Exhibits*, Docket No. IS09-437-000 (May 3, 2010).

24 *Order Granting Motion to Withdraw Testimony and Exhibits*, Docket No. IS09-437-000 (May 4, 2010).

25 *Order of Chief Judge Extending Procedural Schedule*, Docket No. IS09-437-000 (Aug. 4, 2010). On September 16, 2010, the Chief Judge issued another order extending the deadlines for the initial briefs, reply briefs, and the initial decision. *Order of Chief Judge Extending Procedural Schedule*, Docket Nos. IS09-437-000 and IS10-572-000 (Sept. 16, 2010). On January 5, 2011, the Chief Judge issued an order extending the deadline for the initial decision to February 11, 2011. *Order of Chief Judge Extending Initial Decision Deadline*, Docket Nos. IS09-437-000 and IS10-572-000 (Jan. 5, 2011).

26 *Jointly Proposed Index Identifying Status of Exhibits as Public, Confidential, Section 15(13) Confidential and/or Highly Confidential*, Docket No. IS09-437-000 (Aug. 12, 2010).

2010, the participants filed jointly proposed hearing transcript corrections.[27] The Presiding Judge approved the joint transcript corrections on September 2, 2010.

14. On July 22, 2010, Navajo/Western filed a motion for partial summary disposition, the imposition of interim rates, and the payment of refunds.[28] On August 6, 2010, Valero and Chevron filed answers in support of the motion.[29] SFPP filed an answer in opposition to the motion.[30] On August 9, 2010, ConocoPhillips also filed a motion for partial summary disposition, the imposition of interim rates, and the payment of refunds.[31] On August 12, 2010, Southwest filed an answer in support of ConocoPhillips' motion.[32] An oral argument regarding the pleadings was held on August 13, 2010. At oral argument, the parties reached an arrangement obviating the need for a ruling on Navajo/Western and ConocoPhillips' motions for partial summary disposition.[33]

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[27] *Jointly Proposed Hearing Transcript Corrections*, Docket No. IS09-437-000 (Sept. 1, 2010).

[28] *Motion of Navajo Refining Company LLC and Western Refining Company, L.P. for Partial Summary Disposition, Imposition of Interim Rates and Refunds*, Docket No. IS09-437-000 (July 22, 2010).

[29] *Answer of Valero Marketing and Supply Company in Support of Motion for Partial Summary Disposition, Imposition of Interim Rates and Refunds*, Docket No. IS09-437-000, (Aug. 6, 2010); *Answer of Chevron Products Company in Support of Motion for Partial Summary Disposition and Imposition of Interim Rates and Refunds*, Docket No. IS09-437-000 (Aug. 6, 2010).

[30] *Answer of SFPP, L.P. to Motion of Navajo Refining Company LLC and Western Refining Company, L.P. for Partial Summary Disposition, Imposition of Interim Rates and Refunds*, Docket No. IS09-437-000 (Aug. 6, 2010).

[31] *Motion of ConocoPhillips for Partial Summary Disposition*, Docket No. IS09-437-000 (Aug. 9, 2010).

[32] *Answer of Southwest Airlines Co. in Support of Motion for Partial Summary Disposition*, Docket No. IS09-437-000 (Aug. 12, 2010).

[33] *See* Tr. 3038-3043. On June 29, 2010, the parties filed a joint stipulation, which resolved the issue of the appropriate nominal rate of return on equity (ROE), the real ROE, and the inflation rate for purposes of calculating SFPP's East Line COS. *Joint Stipulation of SFPP, L.P., Navajo Refining Company, L.L.C., BP West Coast Products, LLC, ExxonMobil Oil Corporation, Chevron Products Company, ConocoPhillips Company, Valero Marketing and Supply Company, Southwest Airlines Co., Western Refining Company, L.P., and Commission Trial Staff Regarding Return on Equity*, Docket No. IS09-437-000 (June 29, 2010). Navajo/Western and ConocoPhillips filed the motions for partial summary disposition because inclusion of the

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15. Pursuant to the arrangement, SFPP filed a new East Line tariff – FERC Tariff No. 192 – on August 16, 2010, to become effective September 1, 2010 (Interim Rate Tariff Filing). FERC Tariff No. 192 cancelled FERC Tariff No. 187, and decreased the rates on SFPP's East Line from El Paso, Texas or Diamond Junction, Texas to Lordsburg, New Mexico; Tucson, Arizona; and Phoenix, Arizona. The Interim Rate Tariff Filing was docketed as FERC Docket No. IS10-572-000. In the transmittal letter, SFPP requested that the Commission consolidate the Interim Rate Tariff Filing with Docket No. IS09-437-000, and that the Commission make the investigation of the Interim Rate Filing subject to the outcome of the Docket No. IS09-437-000 proceeding.

16. On August 16, 2010, the Presiding Judge held Navajo/Western and ConocoPhillips' motions for partial summary disposition in abeyance pending SFPP's filing of interim rates and the Commission's action on the Interim Rate Tariff Filing.[34] On August 18 and 19, 2010, Navajo/Western and ConocoPhillips filed motions to withdraw their motions for partial summary disposition. The motions to withdraw were contingent upon Commission acceptance of the Interim Rate Tariff Filing, effective September 1, 2010, subject to refund, and the consolidation of Docket Nos. IS10-572-000 and IS09-437-000.[35]

17. On August 24, 2010, BP, ExxonMobil, Navajo, and Western filed a joint protest of the Interim Rate Tariff Filing in Docket No. IS10-572-000.[36] ConocoPhillips filed a protest on August 26, 2010.[37] Valero, Chevron, and Southwest filed a joint protest on August 30, 2010.[38] All protests requested that the Commission consolidate the Interim

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stipulated ROE in SFPP's COS resulted in rates significantly lower than the rates being collected by SFPP at the time.

34 *Order Confirming Rulings*, Docket No. IS09-437-000 (Aug. 16, 2010).

35 *Contingent Motion of Navajo Refining Company, L.L.C and Western Refining Company, L.P. to Withdraw Motion for Partial Summary Disposition, Imposition of Interim Rates and Refunds*, Docket No. IS09-437-000 (Aug. 18, 2010); *Conditional Notice and Motion of ConocoPhillips Company for Withdrawal of Motion for Partial Summary Disposition*, Docket No. IS09-437-000 (Aug. 19, 2010).

36 *Motion to Intervene and Protest of Navajo Refining Company, LLC, Western Refining Company, L.P., BP West Coast Products LLC, and ExxonMobil Oil Corporation*, Docket No. IS10-572-000 (Aug. 24, 2010).

37 *Motion to Intervene and Protest of ConocoPhillips Company*, Docket No. IS10-572-000 (Aug. 26, 2010).

38 *Motion to Intervene and Protest of Valero Marketing and Supply Company, Chevron Products Company, and Southwest Airlines Co.*, Docket No. IS10-572-000 (Aug. 30, 2010).

Rate Tariff Filing in Docket No. IS10-572-000 with the Docket No. IS09-437-000 proceeding. On August 30, 2010, SFPP filed an answer to the protests. SFPP again requested that the Commission consolidate the Interim Rate Tariff Filing with the Docket No. IS09-437-000 proceeding.[39]

18. On September 15, 2010, the Commission issued an order accepting and suspending SFPP's interim rates, effective September 1, 2010, subject to refund, and consolidating Docket Nos. IS10-572-000 and IS09-437-000.[40] The Presiding Judge therefore granted the motions to withdraw the motions for partial summary disposition filed by Navajo/Western and ConocoPhillips' on September 21, 2010.[41]

19. SFPP; Navajo and Western (collectively, "N/W"); Chevron, ConocoPhillips, Southwest, and Valero (collectively, the "VCC Shippers"); and Staff filed initial and reply briefs on October 5, 2010 and November 2, 2010, respectively.[42] On November 4,

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39 *Answer of SFPP, L.P. to Protests of Navajo Refining Company LLC, Western Refining Company, L.P., BP West Coast Products LLC, and ExxonMobil Oil Corporation, of ConocoPhillips Company, and of Valero Marketing and Supply, Chevron Products Company and Southwest Airlines Co*., Docket No. IS10-572-000 (Aug. 30, 2010).

40 *SFPP, L.P.*, 132 FERC ¶ 61,235 (2010) (September 15 Order). On November 30, 2010, the Commission issued an order granting SFPP's narrow request for rehearing of the September 15 Order. *SFPP, L.P.*, 133 FERC ¶ 61,188 (2010). Pursuant to SFPP's request, the Commission deleted and modified certain language in the September 15 Order to clarify that SFPP agreed to reduced East Line rates for purposes of the current litigation and did not agree to provide interim refunds. *Id.* at P 3.

41 *Order Granting Motions to Withdraw*, Docket Nos. IS10-572-000 and IS09-437-000 (Sept. 21, 2010).

42 *Initial Post-Hearing Brief of SFPP, L.P.*, Docket No. IS09-437-000 (Oct. 5, 2010) (SFPP IB); *Initial Post-Hearing Brief of Navajo Refining Company, L.L.C. and Western Refining Company, L.P.*, Docket Nos. IS09-437-000, IS10-572-000, and IS09-437-002 (Oct. 5, 2010) (N/W IB); *Initial Brief of Chevron Products Company, ConocoPhillips Company, Southwest Airlines Co., and Valero Marketing and Supply Company*, Docket Nos. IS09-437-000 and IS10-572-000 (Oct. 5, 2010) (VCC IB); *Initial Brief of Commission Trial Staff*, Docket No. IS09-437-000 (Oct. 5, 2010) (Staff IB); *Post-Hearing Reply Brief of SFPP, L.P.*, Docket No. IS09-437-000 (Nov. 2, 2010) (SFPP RB); *Reply Brief of Navajo Refining Company, L.L.C. and Western Refining Company, L.P.*, Docket Nos. IS09-437-000, IS10-572-000, and IS09-437-002 (Nov. 2, 2010) (N/W RB); *Reply Brief of Chevron Products Company, ConocoPhillips Company, Southwest Airlines Co., and Valero Marketing and Supply Company*, Docket Nos. IS09-437-000 and IS10-572-000 (Nov. 2, 2010) (VCC RB); and *Reply Brief of Commission Trial Staff*, Docket No. IS09-437-000 (Nov. 2, 2010) (Staff RB).

2010, Staff filed an answer to SFPP's reply brief.[43] Staff opposes SFPP's request to take judicial notice of a document related to costs recorded by SFPP in FERC Account No. 590 to determine whether these costs should be considered distance-related costs.[44] On November 15, 2010, SFPP filed a response in opposition to Staff's answer.[45]

20. On January 28, 2011, Holly Refining & Marketing Company LLC (Holly) filed an out-of-time, unopposed motion to intervene.[46] Holly is an affiliate of Navajo, and became a shipper on the SFPP East Line in place of Navajo on January 1, 2011. Holly has demonstrated good cause and has agreed to accept the record as developed. Therefore, Holly's motion to intervene is hereby granted.

ISSUES

ISSUE I - Base Period and Test Period

21. Staff recommends a test period of calendar year 2009 to develop SFPP's cost of service (COS). Staff and SFPP agree that the purpose of a test period is to develop a COS that represents conditions that will occur during the period in which the rates will be in effect. Staff IB at 6. However, SFPP and Staff disagree regarding which test period more accurately represents East Line costs on a going-forward basis. According to Staff, a test period based on actual data from the most recent twelve month period more accurately represents East Line costs on a going-forward basis. Specifically, Staff witness Sherman recommends a test period of calendar year 2009 because it is "the most recent time frame for which volume and cost information was available." Staff RB at 1-2. Staff argues that its proposed test period is superior to SFPP's proposed test period because Staff based its test period on actual data, whereas SFPP based its test period on actual data and estimates.

22. Staff notes that a calendar year 2009 test period falls within the parameters of Commission regulations. The Commission does not prohibit participants from recommending use of actual or projected data from within the twenty-one month base/test period window established in Section 346.2. *See* 18 C.F.R. § 346.2(a) (1) (i)-(ii) (2010).

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43 *Answer of Commission Trial Staff in Opposition to SFPP, L.P.'s Request to Take Judicial Notice*, Docket No. IS09-437-000 (Nov. 4, 2010).

44 *Id.* at p. 1-2. *See* SFPP RB at p. 99, n.195.

45 *Motion of SFPP, L.P. for Leave to Answer and Answer*, Docket No. IS09-437-000 (Nov. 15, 2010).

46 *Unopposed Motion of Holly Refining & Marketing Company LLC for Leave to Intervene Out-Of-Time*, Docket Nos. IS09-437-000, IS09-437-002, and IS10-572-000 (Jan. 28, 2011).

Section 346.2 is titled "Material in support of initial rates or changes in rates". According to Staff, such designation indicates that Section 346.2 sets forth a filing requirement, nothing more. Staff clarifies that it does not recommend discarding the base/test period data in the East Line Tariff Filing. Rather, Staff believes that such data is merely the starting point to analyze the appropriate throughput volumes, revenues, and expenses. Staff contends that a stark difference exists between data that pipelines must file to conform to Commission regulations and data upon which the Commission sets pipelines' rates.

23. According to Staff, a calendar year 2009 test period is particularly appropriate in this proceeding because the Commission raised concerns about SFPP's proposed test period in the August 31 Order. Specifically, the Commission stated as follows:

> The Commission is also concerned that SFPP's test period ending June 30, 2009, may not be representative for the reasons discussed above in this order. This expression of concern is not a conclusion that SFPP failed to adequately conform to the mechanics of the requirements for an oil pipeline filing or failed to reasonably apply current Commission policies in developing the COS included in the instant filing. Given the magnitude of the increase here and the breadth of its impact, the Commission finds that a delay in the effective date will provide time to determine if a test period ending December 31, 2009, is more representative and would result in a proposed rate increase that appropriately limits its impact on all parties. The delay required here will allow exploration of this matter prior to the effective date of the proposed rate increases.[47]

Staff believes that that the Commission's consideration of a test period ending December 31, 2009 supports a calendar year 2009 test period.

24. However, as acknowledged by Staff, the Commission clarified that it did not intend to alter the base and test periods established in the East Line Tariff Filing. October 22 Order at P 2. In fact, the Commission stated that SFPP's East Line Tariff Filing conformed to Commission regulations. Staff IB at 8-9. Nevertheless, Staff contends that the Commission did not change its statement at paragraph twenty of the August 31 Order that a delay in the effective date of the East Line Tariff Filing will provide the participants time to determine whether a test period ending December 31, 2009, is more representative for ratemaking purposes. According to Staff, paragraph twenty of the August 31 Order is an open invitation to the participants to propose different test periods within the twenty-one month base/test period window. Staff notes that a calendar year 2009 test period is the precise time frame alluded to by the

[47] August 31 Order at P 20.

Commission in the August 31 Order. Staff also contends that SFPP witness Ganz failed to show that SFPP's COS more accurately represents the East Line going-forward costs than Staff's COS.

25. SFPP argues that Staff's proposed calendar year 2009 test period does not comport with Commission standards. First, SFPP states that Staff misinterprets the August 31 Order. Specifically, the Commission stated that the East Line Tariff Filing conformed to Commission regulations, as acknowledged by Staff. Second, SFPP states that Commission regulations do not establish a twenty-one month period from which participants may choose a twelve month test period. Rather, Section 346.2 sets forth specific criteria that establish an appropriate test period. *See* 18 C.F.R. § 346.2(a) (1) (i)-(ii) (2010). SFPP argues that, if the base/test period regulations applied only to pipelines for filing purposes, participants would disregard the filed base/test period data in favor of their own preferred data. Third, SFPP states that Staff performed no analysis to determine whether calendar year 2009 data is more representative of going-forward costs than the test period data in the East Line Tariff Filing. Rather, Staff's proposed test period is based on the assumption that more recent data is more representative of going-forward costs. SFPP IB at 7. According to SFPP, its proposed test period accounts for seasonal fluctuations in volumes and operating expenses because it consists of twelve months of actual data, as adjusted pursuant to Section 346.2(a)(1)(ii). Finally, SFPP clarifies that the nine month adjustment period does not represent an extension of the base period. Rather, the nine month reference in Section 346.2(a) (1) (ii) simply limits how far into the future SFPP and the participants can look when making adjustments to base period data.

Discussion/Findings

26. The base and test periods in the East Line Tariff Filing are consistent with Commission regulations and precedent. SFPP, N/W, and the VCC Shippers support use of a base period of July 1, 2008 through June 30, 2009, and a test period that consists of the base period adjusted for changes that were known and measurable with reasonable accuracy at the time of the East Line Tariff Filing (July 31, 2009) and which would become effective within nine months (March 31, 2010). However, it is concluded based on the evidence in this proceeding that the appropriate period to develop SFPP's COS based on cost information is the most recent twelve months within the twenty-one month base/test period ending March 31, 2010, as set forth in the East Line Tariff Filing and Section 346.2(a) (1) (i) and (ii) of the Commission's regulations. *See* 18 C.F.R. § 346.2(a) (1) (i)-(ii) (2010). The appropriate period to develop SFPP's COS for throughput volume information is addressed *infra*, at ISSUE V.

27. Commission regulations set forth the appropriate base and test periods. No party disputes that the base period consists of twelve consecutive months of actual experience adjusted to eliminate nonrecurring items and that the test period consists of the "base period adjusted for changes in revenues and costs which are known and are measurable

with reasonable accuracy at the time of filing and which will become effective within nine months after the last month of available actual experience utilized in the filing." *Id.* SFPP's East Line Tariff Filing comports with these requirements. Specifically, SFPP's base period consists of twelve months of actual data for the period July 1, 2008 through June 30, 2009. Ex. SPE-47 at 4. SFPP adjusted the base period actual data for changes that were known and measurable with reasonable accuracy at the time of the East Line Tariff Filing and that would become effective within nine months after June 30, 2009. *Id.*; Ex. VCC-78hc at 2. In the August 31 Order, the Commission expressed concern regarding the impact of SFPP's proposed rate increase on SFPP shippers in light of the depressed state of the national economy. August 31 Order at PP 19-20. Nevertheless, the Commission indicated that the East Line Tariff Filing was consistent with the Commission's regulations. *Id.* at P 20; *see SFPP, L.P.*, 128 FERC ¶ 63,019, at P 12.

28. The appropriate data to develop SFPP's COS is the actual cost data from the prescribed twelve month test period ending March 31, 2010. As acknowledge by the Commission and all participants, the prescribed test period in this proceeding is the twelve month period ending March 31, 2010. October 22 Order at P 2. Commission policy supports the use of actual data from the prescribed twelve month test period to develop a pipeline's COS. In *High Island*, the Commission affirmed that the use of actual test period data comports with Commission policy. *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005)). The Commission explained its test period policy in *Trunkline Gas*.[48] Specifically, the Commission is not bound to accept a pipeline's test period projections for purposes of determining a pipeline's rates. *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000). Rather, "the key issue is what projection, based on known and measurable data for the whole test period, is most likely to be representative of what will occur during the period the rates are in effect." *Id.* Further, in Opinion 486, the Commission found that using test period actual costs, rather than test period filed costs, is just and reasonable because test period actual costs represents the best available information. *Kern River Transmission Co.*, 117 FERC ¶ 61,077, at P 263 (2006) (Opinion 486). The Commission also explicitly determined that "the use of actual data updated for the last twelve months of the test period should be used in the calculation of a pipeline's cost-of-service." *Id.* (referencing *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027 (1999)). Although *High Island* and Opinion 486 involved natural gas pipelines, and this proceeding involves an oil pipeline, the test/base period issues in those proceedings are sufficiently similar to the test/base period issue in this proceeding to apply the Commission's policy regarding actual test period data to the development of the East Line COS.

29. No party has shown good cause to deviate from the *prescribed* test period in this proceeding. SFPP and Staff are correct that section 346.2 permits the Commission to

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48 *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000).

allow reasonable deviation from the prescribed test period for good cause shown. 18 C.F.R. § 346.2(a) (1) (ii) (2010). SFPP believes that Staff failed to show good cause for deviating from the test period set forth in the East Line Tariff Filing pursuant to Section 346.2(a)(1)(i) and (ii). According to SFPP, Staff bases its proposed calendar year 2009 test period on the unsupported assumption that more recent data more accurately represents East Line costs going-forward. SFPP asserts that the record does not support Staff assumption that a calendar year 2009 test period is more accurate or representative than SFPP's proposed test period. SFPP contends that, without analysis in support of its assumption, Staff failed to show good cause to adopt a calendar year 2009 test period. Alternatively, Staff contends that SFPP's proposed test period is inferior to a calendar year 2009 test period because SFPP's test period includes both actual data and estimates, while Staff's calendar year 2009 test period includes only actual data. The inference from Staff's argument is that use of actual data constitutes good cause to deviate from compliant test period data, which includes actual data and estimates. Staff's argument is not persuasive. The clear language of the Commission's regulations allows SFPP to use actual data and estimates in the East Line Tariff Filing. Further, calendar year 2009 is not the most recent time period from which cost information is available. Although SFPP is correct that Staff did not show good cause to use a calendar year 2009 test period, SFPP's compliance with the Commission's filing requirement does not automatically justify use of the base/test period data in the East Line Tariff Filing for developing the East Line COS. As stated *infra*, Commission policy dictates use of actual data from the most recent twelve month test period to calculate a pipeline's COS.

30. The purpose of a test period is to develop a COS that reasonably represents the conditions that will occur during the period in which new cost-based rates will be in effect. The data that most accurately represents the costs that will occur during the period in which the rate will be in effect is "the latest available data". Opinion 486 at P 263 (2006). At the pre-filed testimony stage of the proceeding, Staff's proposed calendar year 2009 test period may have been the most recent cost information that falls within the twenty-one month period established by the East Line Tariff Filing and Section 346.2. However, at this time, the most recent actual cost information that falls within the twenty-one month period is the actual data from the twelve month period ending March 31, 2010. Therefore, it is concluded that the appropriate data upon which to develop the East Line COS for cost inputs is the actual data from the twelve month test period ending March 31, 2010.

ISSUE II - Allowed Return

ISSUE II.A - Rate Base

31. SFPP addresses ISSUE II.A *infra* at ISSUE II.C. SFPP proposes $372,032,000 as the appropriate test period rate base. N/W contend SFPP overstated its rate base by calculating deferred return incorrectly, as discussed *infra* at ISSUE II.C. VCC Shippers and Staff do not address this issue.

Discussion/Findings

32. ISSUE II.A is discussed *infra* at ISSUE II.C.

ISSUE II.B Inflation-Adjusted Deferred Return

33. SFPP addresses ISSUE II.B *infra* at ISSUE II.C. SFPP proposes that the appropriate test period inflation-adjusted deferred return is $19,252,000. N/W contends that the appropriate inflation-adjusted deferred return is $14,983,000 for the base period and $17,992,000 for the test period. N/W notes that these calculations incorporate Navajo witness Horst's recommendations regarding capital structure from 2000 forward and adjustments for state accumulated deferred income taxes (ADIT). The VCC Shippers and Staff do not address this issue.

Discussion/Findings

34. ISSUE II.B is discussed *infra* at ISSUE II.C.

ISSUE II.C – What Is the Appropriate Methodology for Calculating the Inflation-Adjusted Deferred Return?

35. SFPP contends that the appropriate methodology for calculating the annual deferred return is the methodology used by its witness Ganz in Statement E2 of Exhibit No. SPE-222. SFPP IB at 8. Statements E4 and E2 of Exhibit No. SPE-222 show witness Ganz' calculation of SFPP's deferred return. Specifically, in Statement E4 of the East Line COS, witness Ganz derived the equity portion of the SRB Write-Up of $8,834,000 (Line 15, Statement E4) by multiplying the full SRB Write-Up of $22,501,000 (Line 13, Statement E4) by the equity ratio of 39.26 percent (Line 14, Statement E4). Witness Ganz characterizes the $8,834,000 as the "Equity Portion of SRB Write-Up/Net Starting Rate Base Write-Up" in Lines 15 and 20 of Statement E4. SFPP IB at 8. He carried this amount to Line 9 of Statement E2 to calculate the deferred return. SFPP IB at 8.

36. N/W contend that SFPP incorrectly calculated the SRB Write-Up for each year since 1984. According to N/W, SFPP treats the entire SRB Write-Up as equity. Specifically, SFPP includes the entire SRB Write-Up in the equity rate base for purposes of calculating the deferred return. N/W argue that Commission precedent dictates that SFPP include only the equity portion of the SRB Write-Up in the computation of deferred return. As a result, SFPP should multiply the SRB Write-Up by the equity percentage of its capital structure in a given year to compute the equity portion of the SRB Write-Up for that year. SFPP should then multiply the equity portion by the applicable inflation rate to yield the deferred return on the SRB Write-Up portion of the rate base. N/W assert that as a result of incorrectly calculating its deferred return, SFPP overstated its

deferred return by approximately $2.5 million for the base period and almost $3 million for the test period.

37. The VCC Shippers and Staff do not address this issue.

Discussion/Findings

38. The evidence in this case demonstrates that SFPP's methodology for calculating its SRB Write-Up failed to comply with Commission policy. The Commission set forth the appropriate methodology to calculate the SRB Write-Up in Opinion 154-B.[49] Under Commission policy, only the equity portion of the SRB Write-Up is used to calculate the deferred return. Specifically, oil pipelines must multiply the SRB by the equity percentage of their capital structures in a given year to calculate the equity portion of the SRB for that year. This amount is then multiplied by the inflation factor to yield the deferred return or the SRB Write-up portion of the rate base. SFPP did not follow this methodology to calculate its SRB Write-Up. Although the SRB Write-Up in this case is fully amortized, the error in its calculation has a continuing effect on rates since it has been on the books as deferred return and any prior overstatements continue to have an effect on current rates. Accordingly, SFPP is ordered to calculate the SRB Write-Up as discussed *infra*.

39. The Commission established the SRB as a compromise between the Interstate Commerce Commission's [ICC] valuation rate base methodology and the Commission's net depreciated trended original cost (TOC) methodology, also known as a depreciated original cost (DOC) rate base. The Commission adopted the new TOC methodology in Opinion 154-B on June 29, 1985 (154-B Methodology). Opinion 154-B at 61,833. To mitigate the impact of the change in methodologies, the Commission established a one-time transitional adjustment, the SRB. The Commission established the SRB "for existing assets consisting of the sum of a pipeline's debt ratio times book net depreciated original cost and the equity ratio times the reproduction cost portion of the valuation rate base depreciated by the same percentage as the book original cost rate base has been depreciated." *Id.*[50] The SRB is the "middle ground" between the ICC's valuation rate base and the Commission's DOC rate base. *Id.* at 61,836.

40. In Opinion 154-B, the Commission explained that the real rate of return (the rate of return without an inflation component) times the equity share of the rate base yields

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49 *Williams Pipe Line Co.*, Opinion No. 154-B, 31 FERC ¶ 61,377 (1985) (Opinion No. 154-B).

50 In formula form SRB = O (1-e) + R (e). *Id.* at n.40. SRB = starting rate base, O = book net depreciated original cost, R= net depreciated reproduction cost and e= ratio of equity to total capitalization.

the yearly allowed equity return in dollars. Second, the inflation factor is multiplied by the equity rate base to yield the equity rate base write-up or deferred return. The write up, like depreciation, is written-off or amortized over the life of the property. *Id.* at 61,834. The write up is added to the rate base and amortized. Importantly, the deferred return (or the write-up of the starting rate base) is only a write-up of the equity portion of the rate base. Opinion 154-B at 61,835 ("We have chosen to trend only the equity portion of the rate base").[51] The SRB Write-Up is reduced over the fixed remaining life of carrier property in existence on December 31, 1983. *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022, at 61,090 (1999). Pipelines must amortize the SRB Write-Up, but cannot recover the amortization as an expense. Opinion 351[52] at 61,237, 61,241; Opinion 351-A at 62,383-86.

41. The Commission clarified the 154-B Methodology in Opinions 435-A and 351. In Opinion 351, the Commission stated that the SRB was a single amount rate base value which adjusts to the debt and equity ratio as would a net original cost rate base. The SRB thus consists of an equity and debt component of the pipeline's capital structure ratio. Opinion 351 at 61,241-42; Opinion 351-A at 62,386-89. An example in Opinion 351 clarifies the point. "For example, assume the same debt and equity ratios {debt 70%, equity 30%} and net reproduction cost of $1667 and net original cost of $1000. The starting rate base would be $1200 (30% x $1667 + 70% x $1000). *Id*. at 61, 241. The rate base write-up would be $25.20. *Id.* The $25.20 is determined by multiplying 7% (inflation rate) times 30% (equity ratio) times $1200 (SRB). *Id.* at 61,242 n.46. In Opinion 435-A,[53] the Commission stated that SFPP's SRB was fixed by the capital structure in place in 1983, the year that SFPP initially calculated its SRB. Opinion 435-A at 61,507 (clarifying Opinion 435 at 61,089-90). The Commission also stated that the return on SFPP's entire 154-B rate base, including the SRB Write-Up, fluctuates annually as a result of changes to SFPP's capital structure. Opinion 435-A at 61,507.

42. In Opinion 435 the Commission [54] held that the equity component of a pipeline's capital structure is the appropriate basis to determine the amount of total return that will be capitalized and amortized under the trended original cost methodology (TOC).[55] SFPP

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51 The rate base write-up represents deferred earnings on capital and not a return on capital. *Id.* at n.20.

52 *ARCO Pipe Line Co.*, Opinion No. 351, 52 FERC ¶ 61,055 (1990) (Opinion No. 351), *order on reh'g*, Opinion No. 351-A, 53 FERC ¶ 61,398 (1990) (Opinion No. 351-A).

53 *SFPP, L.P.*, Opinion No. 435-A, 91 FERC ¶ 61,135 (2000) (Opinion No. 435-A).

54 *SFPP, L.P.*, Opinion No. 435, 86 FERC ¶ 61,022 (1999) (Opinion 435).

55 Opinion 435 at 61,091.

made compliance filings implementing Opinion 435 and the subsequent orders on rehearing. Ex. SPE-154 at 29. The Commission accepted SFPP's compliance filing in a letter order dated June 5, 2003 (OR92-8 Compliance Filing).[56] Navajo requested clarification with respect to the calculation of the deferred return, which the Commission provided in Opinion 435-A.[57] SFPP notes that Navajo did not request clarification or rehearing of Opinion 435-A with respect to the SRB Write-Up and deferred return addressed by witness Horst in the previous and the current proceeding. SFPP therefore argues that the Commission orders regarding these matters are final. The Commission, indeed, accepted the Compliance Filing in 2003 after Navajo's last request for clarification of Opinion 435 and Commission issuance of Opinion 435-A.

43. In March 2006, SFPP used the same methodology to calculate the SRB Write-Up and deferred return in its compliance filing (OR96-2 Compliance Filing). Again, Navajo protested the OR96-2 Compliance Filing and challenged SFPP's methodology for calculating the deferred return.[58] SFPP argues that N/W witness Horst's arguments in Docket No. OR96-2 are almost identical to his arguments in this proceeding. *Id.* Specifically, Navajo argued that SFPP used the entire SRB Write-Up, not the equity portion of the SRB Write-Up, to calculate the deferred return. December 2007 Order at P 122.[59] SFPP responded that Navajo misread the OR96-2 Compliance Filing. Specifically, SFPP asserted that "Schedule 1 shows for 1999 an entire starting rate base of $ 20,942[,000], but that only 39.26 percent of that amount, or $8,222[,000], is included in the rate base and in the deferred equity component." *Id.* at P 123. As in this proceeding, SFPP argued that it used the method in Opinion 435 and related compliance

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56 *SFPP, L.P.*, 103 FERC ¶ 61,287 (2003).

57 *SFPP, L.P.*, 91 FERC ¶ 61,135, at 61,508 (2000) (Opinion 435-A) ("Navajo also requests clarification of the Commission's prior ruling on the calculation of the deferred equity component. Consistent with the prior subject, the prior order held that once the deferred equity component is determined for a given year, the amount of the deferred equity remains fixed thereafter and is then amortized over the remaining useful life of the pipeline's assets. Navajo requests clarification that this is the intent of the Commission's prior order. The requested clarification is granted. The amount the deferred equity return is determined by the capital structure applicable to the year in which the deferred equity component is initially calculated. Navajo also requests clarification that, as with starting rate base, the return on the amount of the deferred equity component varies with the capital structure in effect for each year in which the pipeline's cost of service is actually calculated, even though the amount itself does not increase once it has been established. The requested clarification is granted." (footnote omitted)).

58 *Protest and Comments of Navajo Refining Company, L.P. on SFPP's March 7, 2006 Compliance Filing*, Docket Nos. OR92-8, *et al.*, at 10-11 (April 21, 2006).

59 *SFPP, L.P.*, 121 FERC ¶ 61,240, at P 122 (2007).

filings to calculate the deferred return. N/W asserts that SFPP misled the Commission to believe that SFPP multiplied the entire SRB Write-Up by the equity ratio to compute the deferred return; when in fact, SFPP treated the entire SRB Write-Up as the equity portion of the SRB Write-Up. The Commission accepted SFPP's deferred return calculation. December 2007 Order at P 124.

44. Based on this procedural history, SFFP makes several arguments. First, N/W's challenge to SFPP's deferred return calculation in the OR96-2 Compliance Filing is substantially the same as witness Horst's challenge to SFPP's deferred return calculation in this proceeding. Second, the Commission preformed the "substantive analysis" in Docket No. OR92-8 that N/W claim the Commission failed to performed in Docket No. OR96-2. Third, the Commission correctly concluded in the December 2007 Order that "that the time for arguing over the methodology for calculating deferred return had long passed." December 2007 Order at PP 122-24. According to SFPP, the Commission has repeatedly endorsed SFPP's calculation of deferred return.

45. The Commission's prior acceptance of SFPP's methodology to calculate its deferred return does not justify deviation from the 154-B Methodology in this proceeding.[60] Although the Commission has accepted SFPP's previous compliance filings, which included the same methodology proposed by SFPP in this proceeding the evidence in this case demonstrates that SFPP has not followed previously clear Commission mandates and has not followed Commission precedents. On the contrary as N/W argue the Commission clearly accepted the compliance filings on the belief that SFPP had complied with Commission precedent. Based on the record evidence discussed *infra*, SFPP's proposed methodology does not comply with Commission policy. Although the Commission may deviate from precedent, the Commission has not stated that it intends to depart from the 154-B Methodology. Further, the Commission has not stated that good cause has been demonstrated by SFPP supporting departure from the 154-B Methodology. *See Dillmon v. NTSB*, 588 F.3d 1085, 1089 (D.C. Cir. 2009); *see also Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 57 (1983) ("[A]n agency changing its course must apply a reasoned analysis."). The new evidence in this case forecloses SFPP from asserting that the issue is a closed matter. If their previous calculations are proven wrong, then they cannot assert that the matter is closed. *See Transcontinental Gas Pipe Line Corp.*, 85 FERC ¶ 61,357, at 62,386 n.9 (1998) (citing *Tagg Bros. v. Moorhead*, 280 U. S. 420, 445 (1930) (a rate order is not *res judicata*, every rate order may be succeeded by another)).

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60 SFPP witness Ganz testified that the calculation that he used to develop the SRB Write-Up and resulting deferred return in this proceeding are identical to the calculations in the OR92-8 Compliance Filing. Ex. SPE-154 at 29-30.

46. The record evidence indicates that SFPP did not follow Commission precedent as indicated *supra*. Specifically, in Statement E4 of Exhibit No. SPE-222, SFPP subtracted the DOC rate base of $9,970,000 (Line 12, Statement E4)[61] from the ICC rate base of $32,470,000 (Line 11, Statement E4), and multiplied the result $22,501,000 (Line 13, Statement E4) by the equity ratio of 39.26 percent (Line 14, Statement E4), yielding $8,834,000 (Line 15, Statement E4).[62] SFPP labels the $8,834,000 (Line 15, Statement E4) as the "Equity Portion of SRB Write-Up". Ex. SPE-222 at 14.[63] Next, SFPP amortized the $8,834,000 (Line 15, Statement E4) "Equity Portion of SRB Write-Up" in Lines 16 through 20 of Statement E4 to derive the "Net Starting Rate Base Write-Up" of $8,834,000 for year 1983, $8,308,000 for year 1984, $7,783,000 for year 1985, and so forth (Line 20, Statement E4). Ex. SPE-222 at 14-15. SFPP carried the "Net Starting Rate Base Write-Up" amounts in Line 20 of Statement E4 to Line 9 of Statement E2. Ex. SPE-222 at 10-11. To calculate the deferred return for years 1983 and forward, SFPP added the "Net Starting Rate Base Write-Up" amounts (Line 9, Statement E2) to the equity portion of the DOC rate base (the "Original Cost RB Included in Trending Base") (Line 8, Statement E2) and to the "Accumulated Net Deferred Return" (Line 10, Statement E2) to derive the "Trending Base" (Line 11, Statement E2). Finally, SFPP multiplied the "Trending Base" (Line 11, Statement E2) by the annual inflation factor (Line 12, Statement E2) to derive the deferred return for years 1983 and forward (Line 13, Statement E2). Ex. SPE-222 at 10-11; N/W IB at 11. In this manner, SFPP overstated the deferred return by using the entire SRB Write-Up, rather than the equity portion of the SRB Write-Up, in its calculation. *Id.*

47. It is concluded that SFPP's calculations of the SRB Write-Up are contrary to Commission precedent and they are in error. SFPP's first error was that it did not properly calculate the SRB. First, SFPP should calculate the SRB by multiplying the DOC by the debt ratio, and the reproduction cost portion of the valuation rate base (depreciated) by the equity ratio (Ex. SPE-22 at 14-15, Statement E4, Line 11). These

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61 The "Line" references refer to the lines in Statement E4 of Exhibit No. SPE-222 at p. 14. Exhibit No. SPE-222 is an update to SFPP's COS in Exhibit No. SPE-34C. Exhibit No. SPE-222 reflects the stipulated ROE and other matters.

62 Exhibit SPE-222 referenced presents the cost figures in the "$000's." The figures are stated in relative full value. Also, apparent inconsistencies in arithmetic are attributed to rounding, as the hard copy of the spreadsheet displayed in Ex. SPE-222 does not reveal the absolute amounts.

63 Dr. Horst testified that this amount $8,834,000 is essentially the difference between the SRB and the DOC rate bases, which is the entire SRB Write Up. Ex. NAV-1C at 102:1 to 103:3. It is this figure which must be multiplied by the equity ratio to calculate the equity portion of the SRB-Write Up.

two figures are then added. This is the SRB. Second, N/W witness Horst testified that SFPP should subtract the DOC rate base from the SRB to yield the SRB Write-Up.[64] However, Opinion 351 at page 61,241 n. 46 and Opinion 154-B do not support this statement. Specifically, the cited decisions conclude that the SRB is multiplied by the inflation factor and the equity ratio and this yields the rate base write-up. However, witness Horst is correct that the SRB must be multiplied by the equity ratio and inflation factor to calculate the SRB Write-Up or deferred return for the SRB.[65] In this regard, witness Horst testimony is given more weight since his methodology more closely follows Commission precedent.

48. The crux of the disagreement regarding the Commission's methodology to calculate the deferred return relates to the application of the equity ratio in the formula to calculate the SRB Write-Up. The two component operations of the methodology account for the equity ratio. First, calculation of the SRB accounts for the equity ratio. As discussed *supra*, the SRB equals the DOC rate base times the debt ratio plus the reproduction portion of the ICC valuation rate base times the *equity* ratio. Second, the final calculation to derive the deferred return also accounts for the equity ratio. The deferred return or SRB Write-Up equals the SRB times the *equity* ratio, and then times the inflation rate. The methodology's application of the equity ratio to calculate the SRB does not dictate nor eliminate the need for the subsequent calculation, the SRB Write-Up calculation, is intended to be only and entirely equity. In fact, the inputs (SRB and DOC rate base) used to calculate the SRB demonstrate that the SRB Write-Up is both equity and debt because the SRB and DOC rate base include both equity and debt components. Finally, the SRB Write-Up is an adjustment to the overall 154-B rate base, rather than an adjustment to only the equity component. Opinion 351 at 61,241-42; Opinion 351-A at 62,386-89).

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64 Opinion No. 351 at 61,236 ("The difference between the starting rate base and net depreciated original cost is known as the write-up in starting rate base").

65 SFPP witness Ganz agrees with this statement of the Commission's methodology to calculate deferred return.

"Q Now, the final is the SRB write-up component. That's treated like the depreciated original cost component, isn't it? You multiply the SRB write-up by the equity percentage and then by the inflation rate to determine the contribution to defer return; right?

A Generally, yes.

Q Generally? Is there an exception to that?

A No, not that I can think of." Tr. 2199.

49. Although the SRB Write-Up is fully amortized, the incorrect calculations of the SRB Write-Up since 1983 impact the current balance of deferred return and East Line revenue requirement.[66] In Opinion 435-B, the Commission held that SFPP must amortize the East Line SRB Write-Up over 16.8 years. Opinion 435-B at 62,076; Ex. SPE-154 at 30. SFPP calculates the SRB Write-Up beginning at the end of 1983. Thus, the East Line SRB Write-Up was fully-amortized by the end of 2000. Ex. SPE-154 at 30. N/W also acknowledges that the SRB Write-Up is fully amortized. Nevertheless, the contribution of the SRB Write-Up to the deferred return during the period before it became fully amortized has a continuing effect on rates. Specifically, the incorrect SRB Write-Up calculations overstated the deferred return each year. In turn, the overstatements inflate the current balance of deferred return, which is the net of annual additions and amortizations to such balance. Ex. NAV-1 at 101, 104.

50. Accordingly, SFPP is ordered to correct the SRB Write-Up calculations as discussed above. The company is ordered to re-calculate the SRB since 1983 and pass thru the corrections in Ex. SPE-222. Statements A, C, and E1. The equity portion of the SRB must be multiplied by the applicable inflation rate to calculate the deferred return or the SRB Write-Up.

ISSUE II.D - Capital Structure

51. SFPP requests that the Commission adopt the capital structures (i) approved by the Commission in prior proceedings for the periods 1884 through 1999 and (ii) calculated by SFPP witness Vander Weide for the periods 2000 through 2009 for the base and test periods in this proceeding. SFPP proposes a base period capital structure of 57.74 percent debt and 42.26 percent equity and a test period capital structure of 57.43 percent debt and 42.57 percent equity.[67] SFPP IB at 10-11. N/W propose a capital structure of 63.21 percent debt and 36.79 percent equity. N/W IB at 18. The VCC Shippers do not

[66] N/W quantified the effect of SFPP's deferred return calculation on its overall COS and the resulting rates. Ex. NAV-38. SFPP argues that N/W's quantification is false because it incorporates witness Horst's recommendations regarding capital structure from 2000 forward and state ADIT. SFPP's argument is not persuasive. The incorporation of other recommendations does not affect that there is a distinct impact due to the miscalculation of the SRB Write-Up of the deferred return of SFPP's overall revenue requirement.

[67] Exhibit No. SPE-222 (Schedule 9) shows SFPP's recommended capital structures for 2000 through 2009 and the quarter ending March 31, 2010. *See* Ex. SPE-222 at 96. To calculate KMEP's debt capital, SFPP adopted KMEP's reported "Long-Tern Debt Outstanding" of $9,282 million. *Id.* at ln.1. To calculate KMEP's equity capital, SFPP adopted KMEP's "Partners' Capital" of $6,879 million. *Id.* at lns.2-6. To calculate KMEP's capital structure, SFPP summed the debt and equity figures to derive $16,161 million. *Id.* at ln.7. Finally, SFPP calculated the debt ratio of 57.43 percent and the equity ratio of 42.57 percent. *Id.* at lns.8-9.

propose a capital structure. Staff proposes a capital structure of 62.57 percent debt and 37.43 percent equity. Staff IB at 12.

52. If the Commission grants N/W and Staff's proposed adjustments, SFPP alternatively proposes a hypothetical capital structure of 53.82 percent debt and 46.17 percent equity. SFPP contends that the proposed adjustments will cause the equity portion of KMEP's capital structure to become anomalous, and to fall outside the range of capital structures normally approved by the Commission. According to SFPP, if the capital structure is anomalous, the Commission will use a hypothetical capital structure based on the average capital structure of a selected group of comparable firms. The proposed equity ratios of 36.79 and 37.43 percent, N/W's and Staff's respectively, fall below the 45 percent to 55 percent equity range set forth in Opinion No. 502 and are below the average equity ratio and the lowest equity ratio of the oil pipeline proxy companies. SFPP IB at 11-12.

<u>Discussion/Findings</u>

53. All participants agree that SFPP should use Kinder Morgan Energy Partners, L.P.'s (KMEP) capital structure to set the East Line rates because KMEP provides the financing for SFPP. In such circumstances, the Commission generally uses the capital structure of the parent company.[68] Ex. SPE-107 at 56; Ex. NAV-32 at 1; Ex. S-16 at 11. However, as discussed *infra* at ISSUE II.D.1 and ISSUE II.D.2, N/W and Staff propose certain adjustments to KMEP's capital structure. Specifically, N/W propose (i) to add the "Current Portion of Long-Term Debt" (Current LT Debt) to the debt portion of KMEP's capital structure and (ii) to remove Purchase Accounting Adjustments (PAAs) from the debt and equity portions of KMEP's capital structure.[69] Staff proposes to remove PAAs from the equity portion of KMEP's capital structure.[70]

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68 *See BP Pipelines (Alaska) Inc.*, 123 FERC ¶ 61,287, at P 174 (2008) (Opinion 502) ("If the entity does not provide its own financing, the Commission will generally use the capital structure of the parent company that does the financing.").

69 Exhibit No. NAV-32 shows N/W's recommended capital structures for 2000 through 2009 and the quarter ending March 31, 2010. *See* Ex. NAV-32 at 1. To calculate KMEP's debt capital, N/W adopted KMEP's reported "Long-Tern Debt Outstanding" of $9,282 million. *Id.* at ln.1; SPE-222 at 96 (Schedule 9, line 1). First, N/W added KMEP's "Current Portion of Long-Term Debt" of $1,734 million to yield a "Total Long-Term Debt" of $11,016 million. Ex. NAV-32 at 1, lns.2-3. Second, N/W removed the impact of the $49 million SFPP PAA to derive a "PAA Adjusted Debt Capital" of $10,968 million. *Id.* at lns.9, 11. To calculate KMEP's equity capital, N/W started with KMEP's "Partners' Capital" of $6,879 million, *id.* at lns.4-8, and removed the impact of the $496 million SFPP PAA to derive a "PAA Adjusted Equity Capital" of $6,383 million. *Id.* at lns.10, 12. To calculate KMEP's capital structure, N/W summed the debt and equity figures to derive $17,350 million. *Id.* at lns.11-13. Finally, N/W calculated the

(continued)

54. KMEP's actual capital structure, as adjusted *infra*, is not anomalous, thereby warranting a hypothetical capital structure. In Opinion No. 502, the Commission rejected proposed actual capital structures as anomalous because they fell outside the "45 percent to 55 percent equity range typically found just and reasonable by the Commission for oil pipelines." Opinion No. 502 at PP 175-76. The Commission also found that adoption of a hypothetical capital structure was appropriate. *Id.* at P 178. However, the 45 percent to 55 percent equity range in Opinion No. 502 is not a rigid benchmark. Although KMEP's actual adjusted equity ratio falls below 45 percent, it is not anomalous for several reasons. First, all participants including SFPP propose equity ratios (42.57 percent, 36.79 percent, and 37.43 percent) slightly below the 45 lower percent threshold. In Opinion No. 502, the Commission rejected proposed actual capital structures of 85 percent, 87 percent, and 71.42 percent, all significantly higher than the 55 percent upper threshold. Second, the Commission has approved 35.24 percent equity, albeit in an electric utility case. Ex. S-16 at 16; *Allegheny Power Co.*, 106 FERC ¶ 61,241 at PP 25-26 (2004). As Staff notes, the approved 35.24 percent equity ratio is lower than all proposed equity ratios in this proceeding. Third, use a pipeline's actual capital structure is an important component of the 154-B Methodology. Opinion No. 154-B at 61,836.[71] SFPP is therefore ordered to adopt KMEP's actual capital structure, as adjusted pursuant to this initial decision, to set East Line rates.

<u>ISSUE II.D.1 – What Are The Appropriate Adjustments To Capital Structure For The Current Portion Of Long-Term Debt?</u>

55. SFPP proposes to use the long-term debt balance on KMEP's balance sheet to calculate KMEP's capital structure for ratemaking purposes. SFPP also proposes to exclude certain short-term debt from the debt balance to calculate KMEP's capital structure. SFPP IB at 12-13. SFPP contends that it properly excluded short-term debt from the long-term debt balance for several reasons. First, KMEP does not intend or have the ability to refinance the excluded short-term debt on a long-term basis, as of the measurement date.[72] Rather, KMEP finances its long-term assets with long-term debt

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debt ratio of 63.21 percent and the equity ratio of 36.79 percent. *Id.* at lns.14-15.

70 Exhibit No. S-16 sets forth Staff's adjustments to the equity portion of KMEP's capital structure. *See* Ex. S-16 at 15-16; *see also* Ex. S-18 at 4-37.

71 Opinion No. 154-B at 61,836 ("The Commission recently expressed for gas pipelines a general policy of using actual capital structures rather than hypothetical capital structures. The Commission believes that this approach is appropriate for oil pipelines. The actual capital structure could be the actual capital structure of either the pipeline or its parent." (footnote omitted)).

72 The measurement date is December 31, 2009 with respect to the short-term debt in KMEP's Form 10-K for the period ending December 31, 2009. SFPP IB at 13.

and equity. Second, the Statement of Financial Accounting Standards No. 6 requires KMEP to classify the short-term debt as short-term debt on KMEP's balance sheet. SFPP IB at 13. Third, application of the Generally Accepted Accounting Principles (GAAP) demonstrates that KMEP does not use short-term debt on a forward-looking basis to finance long-term pipeline assets. Rather, GAAP demonstrates that KMEP uses long-term debt on a forward-looking basis to finance long-term pipeline assets. SFPP IB at 13.

56. N/W propose to add KMEP's Current LT Debt[73] to the debt portion of KMEP's capital structure for ratemaking purposes. N/W contend that KMEP's Current LT Debt forms an integral part of KMEP's long-term financing. Although KMEP's Current LT Debt has maturity dates within one year, KMEP uses the Current LT Debt to finance long-term pipeline assets. Further, KMEP routinely refinances Current LT Debt into new long-term debt. N/W therefore aver that KMEP should treat the Current LT Debt as long-term debt for purposes of determining the debt portion of KMEP's capital structure.

57. The VCC Shippers and Staff do not address this issue.

Discussion/Findings

58. The Commission uses an oil pipeline's long-term debt to calculate the debt portion of capital structure for ratemaking purposes.[74] Long-term debt is debt with a maturity date beyond one year and short-term debt is debt with a maturity within one year.[75] Generally, oil pipelines do not include short-term debt in the long-term debt balance used to calculate the debt component of capital structure. SFPP correctly states that a pipeline's capital structure should reflect the "forward-looking" debt and equity percentages used to finance long-term pipeline assets. Ex. SPE-107 at 62. However, in certain circumstances, the Commission requires pipelines to treat short-term debt as long-term debt for ratemaking purposes.

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73 For purposes of the capital structure section, ISSUE II.D, and the cost of debt section, ISSUE II.E *infra*, the Current LT Debt (or, Short-Term Debt) comprises the following types of debt: (i) debt outstanding for multiple years but currently due within one year, (ii) bank borrowings under KMEP's line of credit, and (iii) commercial paper.

74 *See Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 57 (D.C. Cir. 1999) ("This figure [the ROE], combined with the long-term debt and preferred stock figures, represents the overall rate of return used to calculate the pipeline's profit allowance.").

75 *See Old Dominion Electric Coop.,* 70 FERC ¶ 62,065 at 64,187 (1995) ("The Commission's regulations require that all debt having maturities of not more than one year from the date of issuance be classified as short-term debt and all debt securities having maturities of more than one year from date of issuance be classified as long-term debt." (footnote omitted)).

59. In *Transok, Inc.*, the Commission states that "[w]hile it is true generally that the Commission does not include short-term debt in capital structures, it is appropriate to do so when the pipeline company is using short-term debt to finance long-term assets." *Transok, Inc.*, 70 FERC ¶ 61,177 at 61,555 (1995). Also, in the December 2005 Order,[76] the Commission ordered KMEP to treat short-term debt as long-term debt for purposes of calculating capital structure because KMEP routinely refinanced the short-term debt with new debt. December 2005 Order at P 69.[77] As discussed *infra*, the record evidence in this proceeding demonstrates that KMEP treats the Current LT Debt as long-term debt. SFPP is therefore ordered to treat $950 million of senior notes, $675 million of outstanding borrowings under the revolving bank credit facility, and $65 million of commercial paper borrowings as long-term debt for purposes of calculating the debt component of KMEP's capital structure.[78]

60. KMEP treats $950 million in senior notes due within one year of March 31, 2010 as the current portion of long-term debt. Ex. NAV-48 at 11. The senior notes include $700 million of 6.75 percent senior notes due March 15, 2011 and $250 million of 7.50 percent senior notes due November 1, 2010.[79] The third column titled "Due Date" in Exhibit No. SPE-109 demonstrates that KMEP has debt scheduled to mature in every year from 2010 through 2021 except 2016, and to mature in every year from 2031 through 2039 except 2034 and 2036. Ex. SPE-109 Additionally, Exhibit No. NAV-32

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[76] *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005) (December 2005 Order).

[77] In the December 2005 Order, the Commission found that SFPP treated certain short-term debt like long-term debt. The Commission stated as follows:

> [T]he sharp increase in the net sums due affiliates from $14,651,890 to $272,980,742 in 2000 establishes that SFPP was borrowing so called short-term funds from KMEP but treated those funds like long term debt by continuing to carry them as sums due affiliates for several years on SFPP's balance sheet. In fact, both KMEP and SFPP were treating SFPP's affiliated obligations as long term debt that was being used to finance SFPP's capital plant. Even in 2001, the sums SFPP owed affiliates remained at $258,203,692. Therefore the Commission concludes that SFPP's 1999 debt due in one year was long term debt. December 2005 Order at P 69 (footnote omitted).

[78] The evidence discussed in this section, ISSUE II.D.1, establishes that KMEP treats the Current LT Debt or Short-Term Debt as long-term debt. Based on this finding, SFPP is ordered to treat the Current LT Debt as long-term debt for purposes of determining both the capital structure and the cost of debt discussed at ISSUE II.E.

[79] SFPP did not include these senior notes in the debt portion of KMEP's capital structure. Ex. SPE-109 at 1, lns.1-2.

demonstrates that when KMEP reported Current LT Debt at the end of years 2000 through 2009, KMEP reported an increase of long-term debt in the following year. Ex. NAV-32 at 1, lns.17-19.

61. SFPP states that the annual increase of reported long-term debt is irrelevant. SFPP's statement is not persuasive. The routine annual expiration of what SFPP classified as short term debt in its SEC filings (or in reality the current portion of long-term debt) in conjunction with the annual increase in KMEP's long-term debt shows that KMEP rolls-over the debt into long-term debt. Specifically, KMEP routinely acquires new long-term debt when older long-term debt expires. SFPP responds that even if KMEP rolls-over short-term debt as a mix of new short-term debt, new long-term debt, and new equity, KMEP should not automatically classify the replaced short-term debt as long-term debt. For instance, short-term debt replaced by new short-term debt is short-term debt, not long-term debt. And, short-term debt replaced by new equity capital is new equity capital, not long-term debt. SFPP also states that KMEP cannot determine what percentage of replaced short-term debt is refinanced by new short-term debt, new long-term debt, and new equity. However, as discussed *supra*, the record establishes a KMEP pattern of refinancing the senior notes as long-term debt. The senior notes were long-term when issued[80] and they are refinanced as long term within their year of expiration. The evidence in this record establishes that KMEP routinely acquires new long-term debt whenever older long-term debt has expired. Ex. NAV 32 at 1:17-19. Accordingly, it is found that SFPP is to treat $950 million in senior notes as long-term debt for capital structure purposes.

62. KMEP treats $675 million in outstanding borrowings under the revolving credit facility as long-term debt. Ex. NAV-48 at 11. In its Form 10-K filed February 23, 2010, KMEP describes how it utilizes the revolving credit facility. Specifically, KMEP states that "we initially fund both our discretionary capital spending . . . and our acquisition outlays from borrowings under our long-term revolving bank credit facility. From time to time, we issue senior notes and equity in order to refinance our credit facility borrowings." Ex. NAV-49 at 74. The record evidence supports N/W's assertion that KMEP uses the revolving credit facility to finance long-term spending. KMEP uses the revolving credit facility as the "initial financing tool" to fund discretionary long-term capital spending. Tr. 179:15 to 180:9 (Vander Weide). In its Form 10-K, KMEP states that "[t]he credit facility matures August 18, 2010 and currently, we plan to negotiate a renewal of the credit facility before its maturity date." Ex. NAV-49 at 144. Based on this statement, KMEP had the ability and intended to refinance the debt under the revolving credit facility as long-term debt. Accordingly, it is found that SFPP treats this revolving credit facility as long-term debt and SFPP is therefore order to treat the $675

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80 The debt was long-term when issued, but at the time of the rate filing it is within maturity. Tr. 171:1-2 (SFPP's Vender Weide).

million in outstanding borrowings under the revolving credit facility as long-term debt for capital structure purposes.

63. KMEP treats $65 million in commercial paper borrowings as long-term debt. Ex. NAV-48 at 11. In its Form 10-Q for the period ending March 31, 2010, KMEP states that it could not issue commercial paper throughout 2009 due to a lowered credit rating. *Id.* at 12. However, in the first quarter of 2010, KMEP's short-term credit rating increased. *Id.* KMEP therefore resumed issuance of commercial paper in March 2010.[81] *Id.* SFPP uses the commercial paper as an interim financing tool for long-term projects that is periodically refinanced. Tr. 183:24-184:10 (SFPP's Vander Weide). In its Form 10-K, KMEP states that "[w]e used the proceeds from the first two 2008 debt offerings to reduce the borrowings under our commercial paper program. We used the proceeds from our December 2008 debt offering and from all of our 2009 debt offerings to reduce the borrowings under our bank credit facility." Ex. NAV-49 at 147. SFPP witness Vander Weide conceded that based on its statement in the Form 10-K, KMEP replaced its commercial paper (and the borrowings under the credit facility) with long-term debt. Tr. 183:18-184:10. Thus, the record evidence demonstrates that KMEP had the ability and intended to refinance its commercial paper as long-term debt. SFPP is therefore ordered to treat the $65 million in commercial paper borrowings as long-term debt for capital structure purposes.

ISSUE II.D.2 – What Are The Appropriate Adjustments To Capital Structure For Purchase Accounting Adjustments?

64. SFPP opposes the removal of any PAAs from KMEP's capital structure for ratemaking purposes. N/W propose to remove the depreciated balance of the PAA related to KMEP's March 6, 1998 acquisition of SFPP (SFPP PAA) from KMEP's capital structure.[82] Specifically, N/W propose to remove ninety percent of the SFPP PAA from the debt component of KMEP's capital structure and ten percent of the SFPP PAA

81 In its Form 10-Q for the period ending March 31, 2010, KMEP states that "[a]s a result of these revisions [lowered short-term credit rating] and the commercial paper market conditions, we were unable to access commercial paper borrowings throughout 2009. . . . [W]e resumed issuing commercial paper in March 2010, and as of March 31, 2010, we had $65.0 million of commercial paper outstanding with an average interest rate of approximately 0.49%." Ex. NAV-48 at 12.

82 Navajo witness Horst focused on the March 6, 1998 acquisition of SFPP by KMEP because "the [SFPP] PAA to SFPP's equity accounts for approximately 74% of the total PAAs to equity resulting from KMEP's acquisition of companies with FERC-regulated pipelines." N/W IB at 26.

from the equity component of KMEP's capital structure.[83] To fund the March 6, 1998 acquisition of SFPP, KMEP assumed SFPP's debt and other liabilities, and obtained SFPP's equity in exchange for KMEP's equity. According to N/W, the total consideration for SFPP's equity was $1,040.9 million, which includes $92.2 million in cash, $5.2 million of a minority interest retained by SFPP's former general partner, and $943.2 million of newly-issued KMEP MLP units. N/W state that KMEP borrowed the $92.2 million in cash. N/W also state that KMEP typically finances acquisitions of jurisdictional assets with cash or newly issued debt, rather than with KMEP's own equity.

65. Staff proposes to remove the depreciated balance of six PAAs related to the acquisitions by KMEP of SFPP, Kinder Morgan Interstate Gas Transmission Company LLC, Trailblazer Pipeline Company, Kinder Morgan Wink Pipeline, L.P., Tran Colorado Gas Transmission Co., and Calnev Pipe Line LLC (collectively, the "six PAAs") from the equity portion of KMEP's capital structure.

66. If the Commission orders the removal of any PAAs from KMEP's capital structure, SFPP alternatively requests that the Commission remove them from KMEP's debt and equity ratios in proportion to KMEP's current capital structure. The VCC Shippers do not address this issue.

67. SFPP makes two arguments in support of its position that accounting principles support inclusion of the six PAAs in KMEP's capital structure: First, SFPP argues that when a company acquires another company, the type of financing causes an increase to the acquiring company's debt or equity, rather than the associated PAAs. SFPP explains that, if an acquiring company finances an acquisition solely with cash, the acquisition does not impact the debt or equity components of the acquiring company's capital structure. Further, if an acquiring company finances an acquisition solely by the issuance of debt, the debt component of the acquiring company's capital structure increases. The acquisition will not impact the equity component. Alternatively, if an acquiring company

[83] Exhibit No. NAV-32 sets forth witness Horst's adjustment to KMEP's capital structure. Ex. NAV-32 at 2. N/W clarify two aspects of the adjustment. First, KMEP obtained 8.9 percent of SFPP's equity in exchange for borrowed cash, KMEP obtained 0.5 percent of SFPP's equity in exchange for a minority interest retained by SFPP's former general partner, and KMEP obtained 90.6 percent of SFPP's equity in exchange for KMEP's equity. Ex. NAV-32 at 2-3. Further, the SFPP PAA impact on KMEP's equity equals 90.6 percent of the total $793.0 million SFPP PAA adjustment to SFPP's equity and the SFPP PAA impact on KMEP's debt equals 8.9 percent of the total $793.0 million SFPP PAA adjustment. Ex. NAV-32 at 2, lns. 11, 16-19; N/W IB at 26-17. Second, witness Horst amortized the initial SFPP PAA amount to approximate the reduction of the underlying SFPP PAA resulting from depreciation, amortization, and other adjustments to the assets acquired by KMEP. Ex. NAV-32 at 1, lns. 9-13. N/W state that the amortization adjustments to the SFPP PAA by SFPP witness Petersen and by Navajo witness Horst are similar. N/W IB at 27; Ex. SPE-208 at 1, lns. 25-28.

finances an acquisition solely by the issuance of equity, the equity component of the acquiring company's capital structure increases. The acquisition will not impact the debt component. SFPP IB at 19. Witness Petersen acknowledged that when an acquiring company finances an acquisition with the issuance of debt or equity, the debt or equity increases (as applicable) on the acquiring company's balance sheet. However, he testified that PAAs associated with the acquisitions do not cause the increase of debt or equity. Rather, the type of financing causes the increase of debt or equity on the acquiring company's balance sheet.[84] *Id.*

68. In response, N/W argue that SFPP overlooks the effect of the SFPP PAA on the amount of equity paid. Specifically, if an acquiring company paid solely equity in an acquisition without a PAA, the capital structure would not be distorted even though the capital structure would change. Alternatively, if an acquiring company paid primarily equity in an acquisition with a PAA, the PAA would distort the capital structure "because the amount of equity issued by the acquiring company exceeds the level of equity that would have been issued if the acquisition were priced at book value without a PAA." N/W RB at 21. N/W thus aver that the PAA directly affects the acquiring company's resulting equity balance. *Id.*

69. Second, SFPP argues that although the acquisition of SFPP by KMEP increased the equity component of SFPP's capital structure, the acquisition did not increase the equity component of KMEP's capital structure because KMEP eliminated the equity balances of KMEP subsidiaries through the consolidation of the subsidiaries' balance sheets.[85] SFPP IB at 20. SFPP explains that when subsidiaries (SFPP) are separately incorporated under a larger business combination (KMEP), consolidation eliminates the target companies' (the six KMEP subsidiaries with PAAs at issue in this proceeding) stockholder equity accounts. As a result of the elimination of the equity accounts, only the target company's "assets and liabilities remain to be combined with the parent

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[84] SFPP asserts that the Commission acknowledged this concept in the 2006 Sepulveda Order. In support of its assertion, SFPP cites the following Commission statement:

> As SFPP points out, the 1988 PAA increased the size of the asset base when the assets were transferred to a new owner, SFPP, L.P. This new owner then raised financing that resulted in a roughly 60 percent debt and 40 percent equity structure after the size of the asset base was determined. There is no reason now, nor was there then, to believe that this market established debt-equity ratio would have changed if the 1988 asset base resulting from the 1988 sale was the same, smaller, or larger. 2006 Sepulveda Order at P 32 (footnote omitted).

[85] Specifically, KMEP's acquisition of SFPP affected SFPP's balance sheet, from which SFPP's capital structure is derived, but did not affect KMEP's balance sheet, from which KMEP's capital structure is derived.

company figures." SFPP IB at 20. According to SFPP, witness Petersen reviewed KMEP subsidiaries' consolidated balance sheets with respect to capital structure. Based on his review, witness Petersen confirmed that KMEP eliminated any PAAs from the equity balances on its consolidated balance sheet. SFPP therefore concludes that the PAAs do not distort KMEP's capital structure. SFPP IB at 20.

70. In response, N/W state that KMEP's consolidated balance sheet reflects the acquisition of SFPP because KMEP adds the value of all subsidiary assets in its consolidated balance sheet.[86] N/W IB at 32-33. And, the consolidated balance sheet reflects the amount of equity KMEP issued to purchase SFPP at the premium-to-book value. N/W further explain that, if a company writes up the book value of its assets due to a PAA, the increased book value of the company's equity is due to the PAA. *Id.* at 33; N/W agree that SFPP witness Petersen may have accurately testified that the consolidation eliminated the SFPP PAA, as a matter of accounting. N/W IB at 33. N/W contend, however, that the acquisition nevertheless increased the balances of KMEP's assets and equity to reflect the amount of KMEP equity that KMEP issued to pay the SFPP above-book value. N/W also state that the investment of Kinder Morgan Operating Limited Partnership "D" (OLP-D) in KMEP MLP units fully offset the PAA-adjusted value of SFPP's equity, thereby eliminating it from KMEP's consolidated balance sheet. N/W contend that the PAA-adjusted value of SFPP's equity nevertheless impacts KMEP's capital structure because KMEP used "mostly" its own newly-issued equity to fund the purchase of SFPP's equity, which in turn reflected the written-up value of SFPP's equity and assets. *Id.* at 32-33.; N/W RB at 22.

71. According to N/W, SFPP witness Vander Weide effectively contradicts SFPP's position that accounting principles support the inclusion of PAAs in KMEP's capital structure. N/W IB at 31-32. N/W explain that witness Vander Weide's calculation of KMEP's actual capital structure does not rely on the amount of "Total Partners' Capital" reflected on the SEC Forms 10-K. Beginning in 2001, the SEC required companies to adjust their reported equity to reflect their "Accumulated Other Comprehensive Income or Loss." KMEP reported a positive amount in 2001. However, in years 2002 through 2009, KMEP reported substantial Accumulated Other Comprehensive Losses, thus reducing KMEP's Total Partners' Capital. N/W IB at 31. N/W states that witness Vander Weide excluded KMEP's Accumulated Other Comprehensive Losses from the equity capital amount used to calculate KMEP's capital structure, thereby increasing the Total Partners' Capital on equity reported on KMEP's balance sheet. Witness Vander

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[86] When KMEP purchased SFPP, SFPP adjusted "its net carrier property, its net non-carrier property, certain other assets and liabilities (but *not* its long-term debt), and its stockholders' equity." (emphasis added). N/W IB at 32. Thus, the consolidated assets and liabilities on KMEP's consolidated balance sheet reflect the values of SFPP's assets and liabilities, as adjusted for the PAAs. N/W IB at 32.

Weide excludes these losses despite the GAAP requirement to include such losses in the computation of equity for accounting purposes. N/W IB at 31-32. N/W argue that witness Vander Weide's exclusion is an effective acknowledgment that amounts properly reported under GAAP do not dictate a pipeline's capital structure for ratemaking purposes. *Id.* at 32.

72. According to SFPP, N/W's proposal to remove the SFPP PAA is inappropriate for two reasons. First, SFPP contends that N/W propose to remove the SFPP PAA in a manner different from how KMEP currently finances the SFPP PAA. Specifically, N/W propose to remove the SFPP PAA in the same proportion that KMEP financed the acquisition of SFPP in 1998. SFPP IB at 21. SFPP argues that removal of the SFPP PAA in such proportion is unreasonable because the proper capital structure to set rates in this proceeding is KMEP's capital structure as of March 31, 2010. SFPP IB at 21.

73. In response, N/W state that SFPP overlooks that KMEP acquired SFPP largely through newly-issued KMEP MLP units. Further, N/W state that the SFPP PAA increased the amount of the newly-issued KMEP equity, which the books of KMEP continues to reflect (net amortization) today. N/W conclude that, until the SFPP PAA is fully amortized, the impact of the PAA continues to inflate the equity in KMEP's capital structure. N/W IB at 33-24.

74. SFPP contends that N/W incorrectly calculated the acquisition value of SFPP. N/W summed $92.5 million of cash, $5.2 million of a minority interests retained by SFPP's former general partner, and $943.2 million of newly issued KMEP MLP units to derive a $1.05 billion SFPP acquisition value. SFPP argues that N/W incorrectly ignore $355 million of SFPP debt that KMEP assumed in connection with the acquisition of SFPP by KMEP. SFPP IB at 21-22. SFPP states that the total acquisition price of SFPP is $1.4 billion, not $1.05 billion, as confirmed by KMEP's Form 10-K. *Id.* at 22. SFPP concludes that if N/W had correctly calculated the acquisition price, N/W and SFPP's recommended removal percentages would be more closely aligned. *Id.*

75. In response, N/W acknowledges that SFPP witness Petersen testified that Navajo witness Horst ignored $755 million of SFPP's purchase price "by failing to take into account the assumption of SFPP's debt." N/W IB at 34. N/W state that, when an acquiring company issues equity to acquire the equity of a target company, and the acquiring company assumes the debt of the target company, the assumed debt is not consideration for the equity of the target company. Rather, the acquiring company simply assumes the debt of the target company dollar for dollar. The acquiring company's cash or *new* debt or equity finances the purchase of the target company's equity. Thus, N/W state that "[i]t is preposterous for SFPP to argue that KMEP used SFPP's $355 million in debt, which remained outstanding, to pay for the equity held by SFPP's owners in SFPP in part with SFPP's own debt." N/W IB at 35. According to N/W, KMEP simply assumed SFPP debt, and paid cash and newly-issued KMEP MLP units to the owners of SFPP in an amount equal to the value of their old equity shares in

SFPP. N/W therefore conclude the witness Horst correctly did not treat KMEP's assumption of SFPP debt as consideration for SFPP's equity. *Id.*

Discussion/Findings

76. SFPP is hereby ordered to remove the depreciated balance of six PAAs related to the acquisitions by KMEP of SFPP, Kinder Morgan Interstate Gas Transmission Company LLC, Trailblazer Pipeline Company, Kinder Morgan Wink Pipeline, L.P., Tran Colorado Gas Transmission Co., and Calnev Pipe Line LLC from the equity portion of KMEP's capital structure for ratemaking purposes.[87] The record evidence establishes that the six PAAs distort KMEP's capital structure increasing KMEP's equity component by 5.14 percent and the acquisitions of the six pipelines did not provide SFPP ratepayers with new services or specific benefits.

77. The Commission typically removes PAAs from a pipeline's capital structure for ratemaking purposes if the PAAs distort the capital structure. PAAs are "accounting adjustment[s] that adjust the book value of the entity's assets . . . to reflect an acquisition price that exceeds that value."[88] December 2005 Order at P 64. The Commission removes PAAs to protect ratepayers from paying for an asset twice. Once, for the original cost of the asset, and again, for the write-up value of the asset from the premium paid for its acquisition. *ARCO Products Co.*, 106 FERC ¶ 61,300 at P 80 (2004). However, the Commission will allow a pipeline to include PAAs in its capital structure if the pipeline demonstrates that they benefit ratepayers. *Sepulveda Order* at P 32;[89] June 2005 Order.[90] Specifically, the pipeline must show that the PAAs provide new services or substantial benefits to ratepayers that exceed the additional costs (the "substantial benefits test"). December 2005 Order at P 65.[91]

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87 Staff is correct that the determination of the proper treatment of PAAs is not contingent upon the type of financing used by the acquiring company. Rather, the standards discussed *infra* dictate the proper treatment of PAAs.

88 December 2005 Order.

89 Sepulveda Order. The Commission stated that "the Commission normally requires the removal of a PAA unless the pipeline demonstrates that the increase in the carrier's rate base resulting from a PAA benefits the rate payers." Sepulveda Order at P 32.

90 *SFPP, LP*., 111 FERC ¶ 61,334 (2005) (June 2005 Order). The Commission stated that PAAs "cannot be reflected in rates absent a showing of specific benefits to ratepayers." June 2005 Order at P 67.

91 In the December 2005 Order, the Commission performed a two-stage inquiry, determining (i) whether the PAA distorted the capital structure used to set rates, and (ii) whether

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78. The Commission has previously ordered SFPP to reduce the equity component of its capital structure by the amounts of PAAs related to the acquisition of jurisdictional entities. For instance, in the December 2005 Order, the Commission stated that, "to prevent a un/warranted increase in the cost-of-service to the ratepayers, the PPA must be removed unless it meets the new service and benefits to ratepayer standards." December 2005 Order at P 65. The Commission found that SFPP failed to show that it provided ratepayers with new services or substantial benefits that exceeded the additional costs. *Id.*[92] Also in the December 2005 Order, the Commission explained that PAAs can materially affect a pipeline's debt and equity ratios. *Id.* at P 64.[93] In the February 2006 Order, the Commission stated that "the inclusion of the PPA in KMEP's capital structure distorted the debt to equity ratio of both SFPP's and KMEP's capital structures for regulatory purposes." *SFPP, L.P.*, 114 FERC ¶ 61,136 at P 15 (2006) (February 2006 Order). Finally, in the June 2005 Order, the Commission made clear that whether SFPP uses its own capital structure or KMEP's capital structure for ratemaking purposes is irrelevant to whether the PAAs are properly included in the capital structure used to set rates. June 2005 Order at P 67. Specifically, the Commission stated that PAAs, "*regardless of [the] [] entity's books [on which they] [] may be recorded*[,] . . . [] cannot be reflected in rates absent a showing of specific benefits to ratepayers." June 2005 Order at P 67 (emphasis added). Any suggestion that Commission precedent removes PAAs from the capital structure of the acquiring company, but not the target company, is therefore not persuasive.[94] Ex. SPE-83 at 3.

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the PAA provided any substantial benefits to ratepayers. December 2005 Order at P 64-65.

92 December 2005 Order at P 65 ("SFPP has not shown that it provided new service or substantial benefits to its ratepayers that exceeded the additional cost. Given that its operations were unchanged and there would be no material change in its capital structure without the PPA, it could hardly do so.").

93 In the December 2005 Order, the Commission stated as follows:

> The PPA is an accounting adjustment that adjusts the book value of the entity's assets (original cost less accumulated depreciation) to reflect an acquisition price that exceeds that value. This is done by stating the purchase price of the assets as the gross plant as of the time of purchase and reducing prior depreciation to zero. The company then begins a new depreciation or amortization curve based on the restated gross plant as valued by the purchase. *Both changes can materially affect the entity's property accounts and its debt and equity ratios*. December 2005 Order at P 64 (emphasis added).

94 According to Staff, SFPP contends that purchase accounting principles dictate that purchases are recorded differently on the books of the acquiring company (KMEP) and the target company (SFPP) and that PAAs increase the equity ratio of the target company, not the acquiring

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79. In the 2006 Sepulveda Order, the Commission allowed SFPP to include a 1998 PAA (not at issue in this proceeding) in its capital structure for two reasons. 2006 Sepulveda Order at P 32. First, the Commission found that the 1988 PAA could not impact the rate base for depreciation purposes because the rate base was fully amortized before the case was filed. No rate base therefore existed to inflate. *Id.* Second, the Commission found that the 1998 PAA did not distort KMEP's capital structure due to the unique financing arrangement used in the acquisition and the relative stability of SFPP. *Id*;[95] The Commission, however, reiterated that it "normally requires the removal of a PAA unless the pipeline demonstrates that the increase in the carrier's rate base resulting from a PAA benefits the rate payers." 2006 Sepulveda Order at P 32. SFPP discusses the 2006 Sepulveda Order in support of its position to include the six PAAs in KMEP's capital structure. SFPP suggests that the 1998 PAA and the six PAAs at issue in this proceeding are similar because they do not distort KMEP's capital structure. However, as discussed *infra*, the record evidence in this proceeding establishes that the six PAAs materially distort the equity component of KMEP's capital structure.

80. The evidence establishes that the six PAAs distort KMEP's capital structure. The test to determine whether PAAs distort a pipeline's capital structure is "whether the inclusion of the PAAs results in a different capital structure than their exclusion." In the December 2005 Order, the Commission evaluated whether the PAA materially affected

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company.

[95] In the 2006 Sepulveda Order, the Commission explains why it allowed SFPP to include the 1998 PAA in SFPP's capital structure. The Commission stated as follows:

> [T]he Commission concludes here that the 1998 PAA will not have a distorting impact of SFPP's capital structure for purposes of determining the debt equity ratio. In contrast to the instant case, the Commission's December 16, 2005 order directed the removal of the 1999 PAA from SFPP's rate making capital structure in part because the entire dollar amount of the PAA was added to the equity component of the balance sheet and there was no demonstrated benefits to the rate payers. Unlike the situation involving the 1999 PAA, in the instant case there are no grounds for concluding that the entire PAA was added to theequity [sic] component of SFPP's capital structure or that the revised capital structure would cause any harm to the ratepayers. As SFPP points out, the 1988 PAA increased the size of the asset base when the assets were transferred to a new owner, SFPP, L.P. This new owner then raised financing that resulted in a roughly 60 percent debt and 40 percent equity structure after the size of the asset base was determined. There is no reason now, nor was there then, to believe that this market established debt-equity ratio would have changed if the 1988 asset base resulting from the 1988 sale was the same, smaller, or larger. This is because SFPP's risk profile was quite stable at the time. 2006 Sepulveda Order at P 32 (footnotes omitted).

"the entity's [SFPP] . . . debt and equity ratios." December 2005 Order at P 64. Specifically, the Commission compared several proposed SFPP capital structures that included and excluded the relevant PAA. *Id*. The Commission stated that, while the participants disagree regarding the proper PAA calculation and resulting debt and equity ratios, the impact on SFPP ratepayers is clear. *Id.* Specifically, the Commission explained that "[t]he issue with the PPA is the impact of the debt to equity ratio on the total dollars billed [to] the ratepayers because *a greater equity component increases the relative weight of the equity component in the cost-of-service*." *Id.* at P 64, n.92 (emphasis added). In this proceeding, the evidence shows that inclusion of the six PAAs results in an equity ratio of 42.57 percent and the exclusion of the six PAAs results in an equity ratio of 37.43 percent. Ex. S-37 at 1. Thus, allowing SFPP to include the six PAAs would materially increase the equity component of KMEP's capital structure by 5.14 percent.

81. Further, SFPP failed to demonstrate that the six PAAs provided new services or specific benefits to ratepayers. First, SFPP witness Petersen conceded that the acquisitions of the six companies with PAAs did not provide SFPP ratepayers with new or different services. Tr. 2118-19.[96] Second, witness Petersen conceded that the acquisitions of the six companies with PAAs did not provide SFPP ratepayers with any substantial benefits.[97] SFPP argues that application of the substantial benefits test is

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[96] On cross-examination, SFPP witness Petersen agreed that the six PAAs provide SFPP ratepayers with no new or different services. He stated as follows in Tr. 2118-19:

Q Would you agree that each of these six pipelines was in FERC jurisdictional service prior to its purchase by KMEP?

A That's my understanding.

Q So KMEP didn't put any of these pipelines into FERC jurisdictional service for the first time after being purchased?

A I believe that's correct.

Q Did KMEP or SFPP convert any asset with a PAA to provide a different type of service to customers than the asset provided prior to its purchase?

A Not that I'm aware of.

[97] On cross-examination, SFPP witness Petersen agreed that the six PAAs provide SFPP ratepayers with no new or different services. He stated as follows: "Q And did the acquisition of any of these six companies with PAAs provide any substantial benefits to SFPP customers attributable solely to the acquisition of those companies at greater than net book value? A I have no reason to believe that it has." Tr. 2119-20.

unnecessary because the six PAAs do not distort KMEP's capital structure or impact rate base. However, as discussed *supra*, the six PAAs distort KMEP's capital structure by 5.14 percent. Therefore, witness Petersen's admission that the six PAAs provide SFPP ratepayers with no new services or specific benefits is a sufficient basis to exclude them from KMEP's capital structure.

82. SFPP's argument that the six PAAs do not distort KMEP's capital structure is not persuasive. SFPP notes that its proposed 42.57 percent equity ratio, which includes the six PAAs, is below the 45 percent to 55 percent just and reasonable equity ratio range for oil pipelines. Ex. SPE-120. In contrast, N/W and Staffs' proposed equity ratios of 36.79 and 37.43 percent, respectively, "fall well outside the range of reasonableness set forth by the Commission, meaning that they are distorted." Thus, SFPP argues that removing the six PAAs from KMEP's debt and equity ratios will distort KMEP's capital structure. *Id.* N/W respond that removing the SFPP PAA will only slightly expand the range of capital structures of the proxy group. Staff responds that 45 to 55 percent range set forth in Opinion No. 502 "has absolutely nothing to do with the inclusion of PAAs in capital structure." Rather, the range is a standard to determine whether a pipeline's actual capital structure is anomalous such that a hypothetical capital structure is appropriate. *Id.* Opinion No. 502 at P 174, 178-179. Staff is correct. No Commission order addressing KMEP's PAAs uses the range set forth in Opinion No. 502.

83. N/W demonstrate that the SFPP PAA distorted the capital structures of both SFPP and KMEP. Specifically, the respective debt ratios of SFPP and KMEP immediately before and after the March 6, 1998 acquisition of SFPP by KMEP changed significantly. The respective debt ratios of SFPP and KMEP on December 31, 1997 and March 31, 1998 are as follows:

	SFPP		KMEP	
	12/31/97	3/31/98	12/31/97	3/31/98
Long-Term Debt	$355.0	$355.6	$146.8	$636.7
Partners' Capital	$274.3	$1,041.1	$150.2	$1,083.6
Total	$629.3	$1,396.7	$297.0	$1,720.3
Long-Term Debt %	56.4%	25.5%	49.4%	37.0%

See Ex. NAV-33. N/W correctly attributes the reduction of SFPP's debt ratio from 56.4 to 25.5 percent and the reduction of KMEP's debt ratio from 49.4 percent to 37.0 to the $793.0 million premium (over-book-value) paid by KMEP to acquire the equity of SFPP. The record evidence directly above indicates that KMEP's equity balance increased from

$150.2 million to $1,083.6 million as a direct result of the SFPP PAA. SFPP provides no alternative explanation for the significant increase in the equity balances of SFPP and KMEP immediately after the March 6, 1998 acquisition of SFPP by KMEP.

84. SFPP's argument that accounting principles support inclusion of the six PAAs in KMEP's capital structure for ratemaking purposes is not persuasive because the Commission does not base its ratemaking principles on GAAP. The Commission articulated its policy in the December 2005 Order, stating that "the use of a PPA is consistent with generally accepted accounting principles and is acceptable under Commission accounting practices for booking, *but not rate-making*, purposes." October 2005 Order at P 65 (emphasis added). PAAs are properly reflected in the Form 6 that oil pipelines file with the Commission. However, the Commission does not include PAAs to carrier property and accrued depreciation accounts in an oil pipeline's rate base. SFPP's accounting and financial arguments, set forth *supra*, are rejected as inconsistent with Commission policy. Accordingly, SFPP is ordered to remove all six PAAs from the equity component of its capital structure.

ISSUE II.E - Cost of Debt

85. All participants agree that SFPP should use KMEP's cost of debt for ratemaking purposes because KMEP finances SFPP. SFPP IB at 23; N/W IB at 35-36; Staff IB at 16, n.51. SFPP requests that the Commission adopt the cost of long-term debt input values (i) approved by the Commission in prior proceedings for the periods 1984 through 1999 and (ii) calculated by SFPP witness Vander Weide for the periods 2000 through 2009 and for the base and test periods in this proceeding. SFPP proposes a base period cost of debt of 6.56 percent and a test period cost of debt of 6.48 percent. SFPP excludes the cost of commercial paper (Short-Term Debt, or Current LT Debt as defined *supra* at ISSUE II.D.1) and the cost of tax-exempt or special purpose bonds (Special Purpose Debt)[98] from the cost of debt calculation. SFPP also excludes cost savings related to KMEP's interest rate swap agreements (Interest Rate Swaps) from the cost of debt calculation.

86. SFPP states that pursuant to basic ratemaking concepts, the Commission excludes commercial paper from cost of debt because (i) it has a maturity date less than one year, (ii) it has an interest rate that does not represent long-term debt, and (iii) its debt level and interest rate fluctuate frequently. According to SFPP, these characteristics apply to KMEP's commercial paper in this proceeding. First, SFPP explains that KMEP's revolving credit facilities are agreements which set forth the amount of money that KMEP may borrow from financial institutions through the issuance of short-term

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[98] SFPP witness Vander Weide refers to Special Purpose Debt as debt that is "specifically associated with KMEP subsidiaries other than SFPP and is not available for use by SFPP." Ex. SPE-107 at 55.

commercial paper. SFPP states that the commercial paper is short-term debt. However, the credit facility agreements, which may have maturity dates beyond one year, are not debt.[99] Second, between 2000 and March 31, 2010, the average cost of long-term debt ranged from 6.39 to 7.73 percent. The average interest rate for commercial paper ranged from 0.49 to 7.02 percent. Further, the amount of commercial paper outstanding ranged from more than one billion dollars in 2006 to zero dollars in 2008 and 2009. *Id.* at 24. SFPP thus avers that Short-Term Debt interest rates are not appropriate to project the long-term cost of debt because they are volatile and do not represent the long-term cost of debt. *Id.* at 24-25.

87. N/W propose a 4.34 percent cost of debt. N/W include the Current LT Debt in the cost of debt calculation for the same reasons that they recommend including the Current LT Debt in the debt portion of KMEP's capital structure. *See* ISSUE II.D.1 *supra*. Further, N/W adjusts "the reported cost of debt to remove tax-exempt debt [Special Purpose Debt] . . . ." N/W IB at 42, n.18. Finally, N/W include cost savings related to the Interest Rate Swaps in the cost of debt calculation. N/W note that KMEP did not report SFPP's proposed 6.48 percent cost of debt to KMEP investors because, in reality, KMEP paid 4.32 percent for its cost of debt (at least, during the last quarter of the test year). The VCC Shippers support N/W's position regarding cost of debt.

88. Staff proposes a 6.49 percent cost of debt. Staff included Special Purpose Debt in the cost of debt calculation and excluded cost savings related to the Interest Rate Swaps from the cost of debt calculation. Staff does not address the appropriate treatment of Short-Term Debt for purposes of the cost of debt calculation.

89. In support of their position to exclude any cost impacts attributable to the Interest Rate Swaps from the cost of debt calculation, SFPP and Staff make two primary arguments: (i) Interest Rate Swaps do not result in overall cost reductions, and (ii) any cost impacts of Interest Rate Swaps are variable, speculative, and uncertain. First, SFPP argues that the variable and fixed interest rates of Interest Rate Swaps and the debt obligations are the same over the long term, and therefore do not provide KMEP with overall long-term cost savings.[100] SFPP and Staff acknowledge that Interest Rate Swaps

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[99] SFPP witness Vander Weide explained the difference between a credit facility agreements and commercial paper as follows:

> I would like to clarify that there's a difference between the credit facility and the debt that is actually drawn down from that. The credit facility is generally negotiated to have funds available for several years at a time, but if the company decides to call on the credit facility, normally, the practice is to issue short-term commercial paper. So the debt that occurs under the credit facility is all short-term debt. Tr. 181.

[100] SFPP witness Vander Weide testified that Interest Rate Swaps are "generally priced so

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may produce cost savings at certain times. However, they note that Interest Rate Swaps may also produce cost increases at other times. SFPP IB at 26; Staff IB at 26. SFPP assumes that Interest Rate Swaps result in timing differences with respect to interest rate costs, rather than an overall reduction of the cost of debt. SFPP IB at 26.

90. N/W state that SFPP's argument is unsupported for several reasons. First, SFPP falsely assumes that KMEP would not enter Interest Rate Swaps unless it expects to break even. Second, SFPP recommends a cost of debt higher than the cost of debt reported by KMEP to the SEC. Third, SFPP's cost of debt calculation deviates from Commission policy, which recognizes that cost fluctuation is an inherent quality of test period ratemaking.

Discussion/Findings

Discussion/Findings - Short-Term Debt

91. Generally, the Commission excludes short-term debt from a pipeline's long-term cost of debt calculation for ratemaking purposes.[101] However, the Commission includes short-term debt in the cost of debt calculation when the pipeline uses the short-term debt to fund long-term assets.[102] As discussed *supra* at ISSUE II.D.1, the evidence establishes that KMEP uses the Current LT Debt or the Short-Term Debt to fund long-term assets. SFPP is therefore ordered to include the Short-Term Debt in the cost of debt calculation for ratemaking purposes. SFPP's argument to exclude Short-Term Debt from the cost of debt calculation is not persuasive because KMEP treats the Short-Term Debt like long-term debt. As discussed *supra* at ISSUE II.D.1, KMEP treats the Short-Term Debt like long-term debt. SFPP must therefore include the Short-Term Debt in the cost of debt calculation for ratemaking purposes.

Discussion/Findings - Interest Rate Swaps

92. Interest Rate Swaps are agreements between two parties that separately hold debt. One party holds variable-rate debt and the other party holds fixed-rate debt. Pursuant to the terms of the Interest Rate Swap, the party with variable-rate debt pays the party with

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that the effective interest rate on the floating-rate obligation in the swap agreement is equal to the effective interest rate on the fixed-rate obligation in the swap agreement." Ex. SPE-107 at 54.

101 *ITC Holdings Corp.*, 121 FERC ¶ 61,229, at 62,099 (2007); *Old Dominion Electric Coop.*, 70 FERC ¶ 62,065, at 64,187 (1995) (Letter Order).

102 *Transok, Inc.*, 70 FERC ¶ 61,177, at 61,555 (1995) ("While it is true generally that the Commission does not include short-term debt in capital structures, it is appropriate to do so when the pipeline company is using short-term debt to finance long-term assets.").

fixed-rate debt an amount equal to the interest due on the fixed-rate debt, and the party with the fixed-rate debt pays the party with the variable-rate debt an amount equal to the interest due on the variable-rate debt. Ex. NAV-1 at 92.[103] Interest Rate Swaps provide benefits to both parties. For instance, the party with fixed-rate debt exchanges the certainty of fixed interest payments with the possibility of lower variable interest payments. Such benefit is possible because short-term interest rates are typically less than long-term fixed interest rates. However, the party also assumes the risk of higher variable interest payments if market rates increase. The party with variable-rate debt exchanges the uncertainty of variable interest payments with the certainty of fixed interest payments. The party avoids the risk of increases in short-term interest rates, but relinquishes the benefits of lower short-term interest rates. Neither party exchanged their respective debt obligations. Rather, they continue to hold the debt that they originally issued. Thus, Interest Rate Swaps are fundamentally contractual agreements, not separate debt issuances. Tr. 314. Utilities, investment banks and other large investors enter into these types of swaps to hedge their risks by mixing fixed and variable rate debts. Ex. NAV-7 at 200 (fourth paragraph).

93. Interest Rate Swaps allow KMEP to hedge its risk with a mixture of fixed and variable rate debt. Ex. NAV-7 at 90. Initially, KMEP obtains most of its long-term debt on a fixed rate basis. Ex. NAV-7 at 90. KMEP then enters Interest Rate Swaps to lower its interest rate payments on a portion of its fixed rate debt. KMEP targets a mixture of 50 percent fixed-rate debt and 50 percent variable-rate debt. Ex. NAV-7; Ex. NAV-39. N/W are correct that such mixture is integral to KMEP's overall financial strategy. Ex. NAV-7 at 200 (fourth paragraph).[104] For instance, KMEP converted approximately *half*

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[103] Under the interest rate swap, one party agrees to pay the other the amount of interest on a stipulated amount (sometimes called the notional principal amount) of fixed interest rate debt in exchange for receiving the variable amount of interest on floating interest rate debt having the same principal amount. Ex. NAV-1 at 92:11-16. The variable rate is typically a short-term London Inter-Bank Offered Rate (LIBOR) plus a fixed premium, or spread. Exs. NAV-1 at 92:16-19; NAV-7 at 200. The parties net out the payments on the fixed and variable rates due in a given month. Ex. NAV-7 at 109(third paragraph). Witness Vander Weide testified that "[a]n interest rate swap agreement is an agreement between two parties in which one party agrees to pay a fixed interest rate on a notional principal to another party in exchange for receiving a variable interest rate on the same sum of money." Ex. SPE-107 at 52.

[104] In its February 23, 2010 Form 10-K, KMEP explains that Interest Rate Swaps are integral to its overall financing strategy. KMEP states as follows:

> In order to maintain a cost effective capital structure, it is our policy to borrow funds using a mix of fixed rate debt and variable rate debt. We use interest rate swap agreements to manage the interest rate risk associated with the fair value of our fixed rate borrowings and to effectively convert a portion of the underlying cash flows related to our long-term fixed rate debt securities into variable rate cash

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of its long-term fixed rate debt into variable rate debt. Ex. NAV-1 at 93; Ex. NAV-7 at 200; Ex. NAV-48 at 19. Importantly, the termination dates of the Interest Rate Swaps are the same as the termination dates of the associated debt issuances. In its February 23, 2010 Form 10-K, KMEP states that "[a]ll of our swap agreements have termination dates that correspond to the maturity dates of the related series of senior notes." Ex. NAV-7 at 200 (seventh paragraph). Although Interest Rate Swaps are not technically debt, they operate in conjunction with the associated debt to reduce KMEP's overall actual cost of long-term debt, as discussed *infra*.

94. The Commission has not specifically addressed whether pipelines may properly include cost savings attributable to Interest Rate Swaps in the cost of debt calculation for ratemaking purposes. Staff notes that under current policy, the Commission has never allowed ratepayers to receive the cost benefits associated with Interest Rate Swaps. Staff is correct. However, the Commission typically requires pipelines to design rates based on the actual costs incurred to obtain debt financing.[105] SFPP and N/W reference cases from the New York Public Service Commission (NYPSC) and the California Public Utilities Commission (CPUC) that address the issue. N/W note that the CPUC requires pipelines to pass cost reduction benefits from "interest rate swaps, caps, floors and collars" to ratepayers.[106] Alternatively, SFPP notes that the NYPSC requires shareholders to assume both the benefits and risks of derivative transactions.[107] These cases shed light as to how some State Commissions have addressed the issue. As discussed *infra*, the evidence in this proceeding establishes that including cost savings attributable to Interest Rate Swaps better achieves the fundamental Commission policy to reflect the actual cost of long-term debt in the cost of debt calculation. *See Transok supra.*

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flows in order to achieve our desired mix of fixed and variable rate debt. Ex. NAV-7 at 200 (fourth paragraph). *See also* Ex. NAV-7 at 109; Ex. NAV-39.

[105] *Transok, Inc.*, 70 FERC ¶ 61,177 at 61,555 (1995) ("The Commission finds that Transok's 8.69 percent debt cost does not reflect the *true cost* at which Transok could obtain debt financing. . . . The Commission therefore adopts . . . [the] proposed 5.9 percent cost of debt, which represents Transok's *actual cost of obtaining debt financing*." (emphasis added)).

[106] *Southwest Gas Corp.*, 1992 WL 596550, at *9 (Finding of Fact #6), D.92-05-016 (Cal. P.U.C. May 8, 1992); *Golden State Water Co.*, 2007 WL 570571, at *4, D.07-02-014 (Cal. P.U.C. Feb. 15, 2007); *Pacific Gas & Elec. Co.*, 2004 WL 2533627, at *17 (Finding of Fact #19), D.04-10-037 (Cal. P.U.C. Oct. 8, 2004); *Southwest Gas Corp.*, 2005 WL 578172, D.05-02-049, slip op. at 18 (Cal. P.U.C. Feb. 24, 2005); *Southern Calif. Gas Co.*, 2003 WL 21918950, D.03-07-008, slip op. at 10 (Cal. P.U.C. July 10, 2003)).

[107] *National Fuel Gas Distribution Corp.*, 1999 WL 909818, No. 99-G-0541, at *1 (N.Y.P.S.C. July 28, 1999)).

95. Variable rate debt is half of KMEP's debt portfolio. Ex. NAV-7 at 109 (fourth-sixth paragraphs), 200; NAV-39; NAV-48 at 19. KMEP's reported weighted average interest rate is 4.32 percent. Ex. NAV 48 at 11. However, for rate making purposes Dr. Vander Weide assumes a weighted average interest rate of 6.48 percent. This is accomplished primarily by excluding the variable debt obligations obtained through interest rate swaps. Navajo is correct that the 6.48 percent figure is more reflective of a hypothetical cost of debt done principally for rate making purposes. The difference amounts to 200 basis points in debt costs. If the variable interest rate swaps are not included in the cost of debt SFPP would charge rates reflective of a 6.48 percent cost of debt when it is in actuality paying only 4.32 percent during the test period in question in this proceeding.

96. Contrary to SFPP and Staff's position, the evidence establishes that the Interest Rate Swaps provide KMEP with overall cost savings on a consistent and annual basis. KMEP entered Interest Rate Swaps for at least the past eight years. Ex. NAV-39. Exhibit No. NAV-32 at 5 shows the percentage differences between KMEP's actual cost of debt (which reflects cost savings attributable to Interest Rate Swaps)[108] and fixed-rate cost of debt (which does not reflect cost savings attributable to Interest Rate Swaps) for the years 2000 through 2009. Ex. NAV-32 at 5. KMEP's actual cost of debt was below its fixed-rate cost of debt by 1.97 percent in 2009, 1.10 percent in 2008, 0.00 percent in 2007, 0.27 percent in 2006, 1.30 percent in 2005, 1.95 percent in 2004, 2.18 percent in 2003, and 2.00 percent in 2002. Ex. NAV-32 at 5, ln.20. In every year except 2007, KMEP's actual cost of debt was lower than its fixed-rate cost of debt, which KMEP uses to determine its cost of debt for ratemaking purposes. Further, Exhibit No. NAV-49 at 81 shows that during the base/test period in this proceeding, KMEP unwound certain Interest Rate Swaps which provided KMEP with several hundred million dollars of profits. Ex. NAV-49 at 81 (second bullet); Tr. 210:9 to 211:11 (Vander Weide).

97. SFPP and Staff's arguments are not persuasive. First, their arguments contradict the Commission's test period ratemaking policy, which relies on actual cost information from a snapshot in time.[109] Second, SFPP's argument contradicts its prediction that, over the long term, the variable and fixed interest rates associated with the Interest Rate Swaps and the debt obligations are the same. Third, as discussed *supra*, the evidence establishes that KMEP realizes an overall, consistent cost of debt reduction attributable to Interest Rate Swaps. Arguments concerning debt costs for potential out-of-period time frames are currently speculative and cannot appropriately be considered in this proceeding as

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[108] N/W point out that Navajo witness Horst adjusted the reported cost of debt to remove tax-exempt debt. Ex. NAV-32 at 5.

[109] Cost fluctuation is part of the test period ratemaking and ratemaking inputs, which will vary over time; for instance, the fixed rate cost of debt, rate of return on equity and inflation.

they will constitute a differing test period than the one considered here. Further, the pipeline may always file for changes in its rates when its revenues and costs deviate enough from those embedded in the rates, which result from this proceeding – at any time it chooses. The pipeline is protected by the ICA in this regard. Accordingly, it is found that it is consistent with Commission policy to use the actual costs of debt for rate making purposes. Therefore, SFPP is ordered to use its actual cost of debt for ratemaking purposes, which necessarily includes the effect of the reduction in overall debt costs by its use of interest rate swaps during the test period of this case.

<u>Discussion/Findings - Special Purpose Debt</u>

98. As discussed *infra*, the evidence establishes that SFPP's proposal to exclude Special Purpose Debt in the cost debt calculation does not comport with Commission policy, precedent, or regulations. SFPP is therefore ordered to include the Special Purpose Debt in the cost of debt calculation for ratemaking purposes.

99. The Commission typically requires pipelines to design rates based on the actual costs incurred to obtain debt financing.[110] Ex. SPE-107 at 55. Contrary to Commission policy,[111] SFPP witness Vander Weide testified that SFPP's proposed cost of debt does not capture the costs that KMEP actually incurred to obtain long-term debt financing for SFPP. Tr. 401.[112] When asked "in proposing a cost of debt, would it be fair to say you've attempted to capture as accurately as possible the costs actually incurred by KMEP to obtain debt financing for SFPP?," witness Vander Weide responded "No." Tr. 401. He explained that he "found it unreasonable to assume that SFPP would have the same cost of debt as KMEP" because the Special Purpose Debt was not available to SFPP. Tr. 402.

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110 *See Transok, Inc.*, 70 FERC ¶ 61,177, at 61,555 (1995) ("The Commission therefore adopts . . . [the] proposed 5.9 percent cost of debt, which represents Transok's *actual cost of obtaining debt financing*." (emphasis added)).

111 SFPP states that pursuant to Commission policy, a consolidated company allocates costs to the subsidiary pipeline based on a causal link between the costs and the services that the subsidiary pipeline provides ratepayers. SFPP IB at 27. As discussed in this section, *infra,* dollar tracing is not appropriate or possible to support such causal link.

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Q Now, in proposing a cost of debt, would it be fair to say you've attempted to capture as accurately as possible the costs actually incurred by KMEP to obtain debt financing for SFPP?

A [SFPP witness Vander Weide] No. Tr. 401.

100. Commission policy develops cost of debt for ratemaking purposes based on a pipeline's (KMEP) *actual* cost of debt. *See Transok, Inc.*, 70 FERC ¶ 61,177 at 61,555 (1995); December 2005 Order at P 69. The Special Purpose Debt contributes to KMEP's actual cost of debt. In fact, when asked whether "[s]pecial-purpose bonds are reported as *long-term debt* on KMEP's for 10-Q; correct?," witness Vander Weide responded "Yes." Tr. 401 (emphasis added). Witness Vander Weide's testimony is therefore a sufficient basis to reject SFPP's cost of debt calculation.[113] Further, Staff is correct that the Special Purpose Debt contributes to KMEP's consolidated total debt amount and total cost of capital. Ex. S-16 at 34.

101. SFPP's proposal to exclude Special Purpose Debt from the cost of debt calculation conflicts with Opinion No. 486. In Opinion No. 486, a shipper group opposed the use of a weighted average of two debt classes with different interest rates to calculate cost of debt. Opinion No. 486 at P 183;[114] The Commission ruled against the shipper group for three reasons. SFPP's proposal to exclude Special Purpose Debt from the cost of debt calculation exhibits the same three flaws identified in Opinion No. 486. First, the Commission found that the two debt classes were sufficiently interrelated to warrant use of a weighted average. Opinion No. 486 at P 194;[115] In this proceeding, the Special Purpose Debt is sufficiently interrelated to KMEP's other long-term debt used in the cost of debt calculation. Second, the Commission concluded that "there is no way to demonstrate that one group of shippers pays the interest and principal only for one specific debt issue." Opinion No. 486 at P 196. The evidence in this case demonstrates that the same finding is applicable. There is a lack of evidence and no logical basis exists to assume that the payments made by KMEP on the Special Purpose Debt originate from only non-SFPP operations. For instance, if non-SFPP operations funded by Special Purpose Debt fail, KMEP will service the Special Service Debt with the proceeds from other operations, which possibly include the proceeds from SFPP operations. The

113 According to Staff, Special Purpose Debt contributes to the actual cost of debt not only through interest payments made on the debt, but also through its integration into KMEP's credit rating. Staff states that credit rating agencies include Special Purpose Debt in the calculation of credit ratings, which lenders consider to determine the interest rate that they charge to companies like KMEP.

114 The shipper group argued that "using a blended cost of debt, as proposed by Kern River, would constitute a subsidy of the rolled-in shippers . . . ." Opinion No. 486 at P 183. The group also argued that "the lower debt cost of the Series B notes was partly attributable to the pooling effect created by the addition of the 2003 Expansion shippers and the general downward trends in interest rates at the time the debt was issued." *Id.*

115 The Commission found that "the Series A and Series B debt financing to be sufficiently interrelated as to warrant a blended cost of debt." Opinion No. 486 at P 194.

evidence in this case shows that KMEP may use the proceeds from SFPP operations (rates paid by SFPP ratepayers) to make Special Purpose Debt payments.

102. The Commission's third reason rejects SFPP's claims that tracing the Special Purpose Debt is possible. SFPP argues that the Commission should exclude Special Purpose Debt because it is specifically associated with KMEP subsidiaries other than SFPP and is not available for use by SFPP. Yet, in Opinion No. 486, the Commission rejected attempts to trace the proceeds. Opinion No. 486 at P 195.[116] It is correct that SFPP (or, KMEP) designates the purpose of Special Purpose Debt. However, as the Commission has concluded it is nevertheless impossible to trace the proceeds of the Special Purpose Debt to determine whether they are attributable to SFPP. SFPP responds that "un/workable" dollar tracing is not required. Rather, a simple review of KMEP's Form 10-K reveals that the exclusion of the Special Purpose Debt is proper. For instance, SFPP states that debt for operations in Louisiana or Canada is properly not attributable to SFPP because SFPP does not have operations in either state. However, there is no evidence to prove that the proceeds from the Special Purpose Debt are traceable to non-SFPP operations. In any event, the Commission determined that "'dollar tracing' is not only inappropriate, but impossible." Opinion No. 486 at P 195. Therefore it is found that "it is impossible to determine which exact dollars are directed" to specific facilities.

103. SFPP's proposal is also not consistent with Commission regulations. Section 346.2 of the Commission's regulations requires that an oil pipeline include "a weighted cost of capital, combining the rate of return on debt capital and the real rate of return on equity capital." 18 C.F.R. § 346.2(c)(3) (2010). According to Staff, the plain language of Section 346.2(c)(3) encompasses all long-term debt. Staff is correct. Section 346.2(c)(3) does not exclude long-term debt based on the purpose or tax-status of the debt. Further, as noted above, SFPP witness Vander Weide testified that KMEP records Special Purpose Debt as long-term debt on its Form 10-Q. Tr. 401. Together, Section 346.2(c)(3) and witness Vander Weide's testimony persuasively indicate that KMEP's Special Purpose Debt is properly includable in the cost of debt calculation.

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116 The Commission explained as follows:

> "[A]fter a company engages in a financing, whether debt or equity, the proceeds from the financing are commingled with other liquid assets, derived from other financings and/or internally generated funds, which are then used to pay the company's operating and non-operating expenses. Thus, there is no way to tell which dollars are used to pay which expenses. Therefore . . . *"dollar tracing" is not only inappropriate, but impossible*." Opinion No. 486 at P 194 (footnote omitted) (emphasis added).

104. SFPP and Staff dispute whether SFPP must treat the Special Purposes Debt consistently in the context of capital structure and the cost of debt calculation. SFPP does not treat the Special Purposes Debt consistently. Specifically, SFPP witness Vander Weide included the Special Purpose Debt in the capital structure calculation and excluded the Special Purpose Debt from the cost of debt calculation. For capital structure purposes, SFPP states that witness Vander Weide reasonably assumed that KMEP finances its investments in SFPP and its entire operations with the same debt and equity percentages. For cost of debt purposes, SFPP states that witness Vander Weide reasonable assumed that SFPP does not have the same cost of debt as KMEP because the Special Purpose Debt is not available to SFPP. Staff responds that "[i]t is simply inconsistent to leave the debt amount in capital structure, but exclude it from the cost of debt. Staff is correct. Accordingly, SFPP is ordered to include Special Purpose Debt in the cost of debt calculation based on the findings set forth *supra*

ISSUE II.F - Return on Equity

105. The participants address this issue through the ROE Stipulation.[117]

Discussion/Findings

106. On June 29, 2010, the participants stipulated to a real ROE of 9.08 percent, an inflation rate of 2.14 percent, and a nominal ROE of 11.22 percent to calculate the East Line COS. N/W note that the stipulation reserves SFPP shippers' right to argue that the ROE should be adjusted downward if the Commission grants SFPP an ITA. N/W IB at 45; ROE Stipulation at P 6. Although SFPP Shippers' right is preserved, the shippers request for a downward adjustment associated with the ITA is denied. *See* ISSUE II.J, below.

ISSUE II.G - What Is The Appropriate Methodology For Deriving A Rate Of Return Of Equity (Including Any Concerns About The Policy Statement On Composition Of Proxy Groups)?

107. N/W, the VCC Shippers, and Staff take no position regarding this issue. N/W state that this issue is addressed by the ROE Stipulation *supra* at ISSUE II.F. SFPP does not specifically address this issue.

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117 *Joint Stipulation of SFPP, L.P., Navajo Refining Company, L.L.C., BP West Coast Products, LLC, ExxonMobil Oil Corporation, Chevron Products Company, ConocoPhillips Company, Valero Marketing and Supply Company, Southwest Airlines, Co., Western Refining Company, L.P., and Commission Trial Staff Regarding Return on Equity*, Docket No. IS09-437-000 (June 29, 2010) (ROE Stipulation).

Discussion/Findings

108. The ROE Stipulation sufficiently addresses this issue.

ISSUE II.H - Where Should SFPP Be Placed In The Range Of The Appropriate Proxy Group?

109. N/W, the VCC Shippers, and Staff take no position regarding this issue. N/W state that this issue is addressed by the ROE Stipulation *supra* at ISSUE II.F. SFPP does not specifically address ISSUE II.H.

Discussion/Findings

110. To the extent relevant, ISSUE II.H is discussed *infra* at ISSUE II.J.

ISSUE II.I – Should An Adjustment Be Made To The ROE To Credit Ratepayers For The Benefits That Flow From Some Aspects Of The Partnership Structure? If So, What Should That Adjustment Be And How Should It Be Made?

111. N/W, the VCC Shippers, and Staff take no position regarding this issue. SFPP addresses ISSUE II.I *infra* at ISSUE II.J.

Discussion/Findings

112. ISSUE II.I is discussed *infra* at ISSUE II.J.

ISSUE II.J - Should An Adjustment Be Made To The ROE To Reflect The Inclusion Of An ITA In The COS? If So, What Should That Adjustment Be And How Should It Be Made?

113. If the Commission grants SFPP an ITA, N/W requests a 2.38 percent downward adjustment to the stipulated real ROE (9.08 to 6.70 percent) and the stipulated nominal ROE (11.22 to 8.84 percent).[118] This is recommended to equalize SFPP's equity cost of capital to that of a corporation. According to N/W, empirical evidence indicates that the cost of equity capital of a corporation is 2.38 percent lower than the cost of equity capital of an MLP. N/W IB at 46; N/W RB at 40. N/W therefore assert that a 2.38 downward adjustment matches the ROE of SFPP with an ITA to the ROE of a corporation with an ITA. N/W IB at 46-47; N/W RB at 39-40. According to N/W its witness Dr. Horst measured empirically the amount by which the return earned by MLPs systematically

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[118] This adjustment is the subject of the reservation of rights in paragraph six of the ROE Stipulation. ROE Stipulation at P 6.

exceeds the return earned by corporations of equivalent risk with a differential of 238 basis points. N/W RP at 40. N/W believe that the Commission should not equate the after-tax return of MLP investors to the pre-tax return of corporate investors (same as corporate pipeline's after-tax return). Rather, the Commission should ensure that investors in similar risk enterprises receive similar after-tax rates of return. The VCC Shippers do not address this issue, except as discussed *infra* at ISSUE III. Staff takes no position regarding this issue.

114. SFPP argues that Commission policy and case law do not support N/W's recommended adjustment to SFPP's ROE. According to SFPP previous orders have concluded that a partnership pipeline does not have a higher DCF-method rate ROE than a comparable corporate pipeline; a partnership pipeline does not have a higher revenue requirement than a comparable corporate pipeline; there is no double-recovery of the income tax allowance in the allowed return and there is no need to reduce the ROE to account for the tax benefits of deferrals because those benefits are already factored into the DCF-method ROE. SFPP IB at 33; SFPP RB at 23.

115. SFPP witness Vander Weide explains SFPP's position as follows: Investors sell investments earning lower after-tax returns and buy investments with higher after-tax returns until the market achieves equilibrium. Capital markets thus achieve equilibrium when investors earn the same after-tax returns on equal risk investments. SFPP IB at 33. Further, investors' after-tax returns on investments of comparable risk are equal only when the cost of equity for the MLP pipeline is less than the cost of equity for the corporate pipeline. SFPP IB at 33. SFPP criticizes Navajo witness Horst's regression analysis for two reasons. SFPP IB at 34. First, the regression analysis does not include sufficient companies with significant oil pipeline operations or comparable companies. *Id*. Second, SFPP states that witness Horst used variables that are not direct measures of a company's cost of equity and did not control for risk. SFPP IB at 34.

116. Second, SFPP contends that MLP pipelines with ITAs have lower revenue requirements than corporations with ITAs because the partnership pipeline with an ITA has a lower before-tax allowed ROR on rate base than that of the corporate pipeline with an ITA. SFPP maintains that shippers receive significant benefits from the MLP organizational structure, resulting in lower rates under the MLP than under the corporate structure. Vander Weide testified that the revenue requirement of a regulated company is equal to its operating expenses plus the product of its before-tax required return and its rate base. Assuming that the operating expenses, rate bases, interest costs, and capital structures of MLP and corporate pipelines are equal (all things being equal), the difference in the revenue requirements of the MLP and corporate pipelines depends only on their before-tax required (allowed) return on rate base. For instance, the higher the before-tax allowed return on rate base, the higher the revenue requirement. The lower the before-tax allowed return on rate base, the lower the revenue requirement. Witness Vander Weide concluded that the MLP pipeline revenue requirement is less than the

corporate pipeline revenue requirement because, all things being equal, the MLP pipeline's before-tax allowed return on rate base is less than the corporate pipeline's before-tax allowed return on rate base. SFPP also contends that SFPP shippers receive significant benefits from the MLP organizational structure because the MLP structure allows pipelines to avoid the double taxation of a corporate structure. According to witness Vander Weide, SFPP shippers' rates are significantly lower under the MLP structure than under the corporate structure because the MLP pipeline's revenue requirement reflects the tax savings from the MLP structure. SFPP IB at 35. SFPP argues that, if the Commission eliminates ITAs for MLPs, costs to ratepayers will increase due to decreased capital for investment, disincentive to invest in large infrastructure, and elimination of efficiencies attributable to the reconversion of MLPs to corporate form. SFPP IB at 35.

117. Third, SFPP contends that permitting an MLP to have an ITA does not allow MLP unit holders to double-recover income taxes or attain a higher before-tax return than shareholders in a comparable corporation. SFPP IB at 36. According to SFPP, N/W bases its recommended 2.38 percent downward ROE adjustment on the false claim that MLP unit holders with an ITA will increase their after-tax required return, thereby allowing them to recover both income taxes and the after-tax required return. SFPP IB at 36. SFPP asserts that, in the corporate context, the ITA recovers corporate taxes rather than shareholder taxes. Shareholders therefore increase their required after-tax return to allow for the recovery of investor-level taxes and the required after-tax return. SFPP IB at 37. In the MLP context, MLP unit holders understand that the ITA recovers their income taxes. MLP unit holders therefore do not increase their after-tax return. SFPP IB at 37; SFPP RB at 23. Once MLP unit holders pay their income taxes, "the after-tax return they earn is equal to the after-tax return they require." SFPP IB at 37. SFPP therefore concludes that MLP unit holders with an ITA do not require a higher before-tax return to recover their income taxes. SFPP IB at 37. Alternatively, MLP unit holders without an ITA must increase their after-tax required return to recover income taxes and the required after-tax return. SFPP IB at 37. SFPP asserts that exclusion of the ITA will decrease the price of partnership units.[119] For instance, when the Commission disallowed ITAs for limited partnership interests held by individuals in *Lakehead*,[120] the price of

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[119] In Opinion 486-B, the Commission recognized this phenomenon. *Kern River Gas Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at P 115 (2009) (Opinion 486-B) ("If the Commission excludes the income tax allowance from the cash available for distribution, the price of the partnership units would drop to reflect the loss of the cash flow necessary to pay the imputed tax cost of the distribution stream.").

[120] *Lakehead Pipe Line Co., L.P.*, 71 FERC ¶ 61,338, at 62,315 (1995) ("However, the Commission concludes that Lakehead should not receive an income tax allowance with respect to income attributable to the limited partnership interests held by individuals. This is because those individuals do not pay a corporate income tax. Since there is no corporate income tax paid,

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Lakehead units and other oil pipeline units (all MLPs) decreased, thereby increasing the DCF-method cost of equity. During the same time period, Standard and Poor's 500 index increased. SFPP IB at 37-39. SFPP therefore concludes that without an ITA, SFPP would not recover its income taxes and SFPP unit holders would not earn the required after-tax return. SFPP IB at 39-40.

118. Fourth, SFPP argues that oil pipelines do not have to reduce their ROEs to account for tax deferral benefits because Commission policy dictates that the DCF-method ROE incorporates tax deferral benefits.[121] The Commission stated that "the benefits of any tax deferrals are for the enterprise and should not be credited back to the ratepayers." SFPP IB at 40-41. According to SFPP, MLP unit holders are aware of tax deferral benefits when they purchase MLP units. MLP unit holders therefore include the estimated value of the deferrals in both the price of MLP units and the DCF-method ROE as calculated using a proxy group of MLPs. SFPP IB at 40. SFPP asserts that reduction of the marginal tax rate of KMEP unit holders to reflect the potential present value of tax deferrals is unnecessary. SFPP IB at 40.

119. Navajo witness Horst disputes witness Vander Weide's testimony. Specifically, witness Horst testified that based on a regression analysis, the DCF-method cost of equity for an MLP is higher than the DCF-method cost of equity for a comparable corporation. N/W responds to SFPP's criticism of Dr. Horst's study stating that the purpose of the study is not to analyze the effects of conducting oil pipeline operations but to isolate,

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there should be no corporate income tax allowance built into Lakehead's rates with respect to income attributable to individual limited partners. This comports with the principle that there should not be an element in the cost-of-service to cover costs that are not incurred." (footnote omitted)) (*Lakehead*).

[121] In Opinion 486-B, the Commission stated as follows:

> [W]hile the pricing of a MLP instrument may reflect the tax deferral components of such instrument, as the Income Tax Policy Statement explains, this is a matter of timing. The difference in timing of the tax payments may lead the unit holder to pay a higher price for the unit and reduce the equity cost of capital to the firm, although not necessarily the amount of the income tax allowance included in the MLP's rates and borne by the ratepayers. However, in reviewing the profile of firms to be included in a proxy group, the Commission looks only at information on the relative prices and yields of the securities issued by the candidate firms. Thus, for purposes of the Commission's DCF model, tax factors are assumed to be reflected in the unit prices and resulting dividend yields of the MLP. Therefore, there is no requirement to adjust the results to reflect the tax difference between a Subchapter C corporation and a MLP. Opinion 486-B at P 116 (footnotes omitted).

using a broad array of companies, the effect on ROE due to the MLP business format. Rather, the purpose is to isolate the MLP structure's impact on ROE. N/W RB at 40. Further, N/W respond that witness Horst controlled for risk with six variables derived from a statistical analysis cited by witness Vander Weide. N/W RB at 40.

Discussion/Findings

120. Although N/W has submitted significant evidence proving its arguments, it is found that Commission policy prevents a ruling in its favor. As a result, N/W's request to reduce the stipulated real and nominal ROEs by 2.38 percent is denied. In the Policy Statements,[122] the December 2007 Order, and Opinion 486-B,[123] the Commission sets forth its policy regarding the DCF-model used by the Commission to calculate ROE (or, the equity cost of capital) and ITAs as they relate to MLPs. Such policy does not permit adjustments to the ROEs of MLPs as a consequence of the ITA.

121. Commission policy allows an ITA for an MLP pipeline as a matter of Commission policy. Further, Commission policy does not permit a downward adjustment to an MLP pipeline's ROE to equalize an MLP's cost of capital to that of a corporation. For instance, in the *ITA Policy Statement*, the Commission reversed its prior ITA holdings in the *Lakehead* orders,[124] and concluded that partnership and other pass-throughout entities (MLPs) are permitted an ITA on the income imputed to the partners or members of the pass-through entities (MLP unit holders), provided that the partners or members have an actual or potential income tax liability on the income of the public utility. *ITA Policy Statement* at P 32-33. The Commission rejected the argument that an ITA results in a phantom tax because pass-through entities do not pay income taxes.[125] *Id.* at P 33. The

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122 *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (*ITA Policy Statement*); *Policy Statement on Composition of Proxy Groups*, 123 FERC ¶ 61,048 (2008) (*Proxy Group Policy Statement*) (collectively, the "Policy Statements").

123 *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034 (2009) (Opinion 486-B).

124 *ITA Policy Statement* at P 33 ("[T]he Commission expressly reverses the income tax allowance holdings of its earlier Lakehead orders."). *See Lakehead Pipe Line Co., L.P.*, 71 FERC ¶ 61,338, at 62,315 (1995) ("However, the Commission concludes that Lakehead should not receive an income tax allowance with respect to income attributable to the limited partnership interests held by individuals. This is because those individuals do not pay a corporate income tax. Since there is no corporate income tax paid, there should be no corporate income tax allowance built into Lakehead's rates with respect to income attributable to individual limited partners. This comports with the principle that there should not be an element in the cost-of-service to cover costs that are not incurred." (footnote omitted)) (*Lakehead*).

125 The D.C. Circuit Court of Appeals upheld the Commission's rationale in the *ITA Policy Statement* that ITAs do not create phantom tax liability for partnership pipelines. *ExxonMobil*

(continued)

Commission stated that the owners of pass-through entities pay income taxes on the income generated by the assets of the pass-through entities and that the income taxes are "just as much costs of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation."[126] *ITA Policy Statement* at P 33. The Commission also stated that the return to the owners of the pass-through entities will decrease below the return to a corporation investing in the same assets if the Commission does not allow the pass-through entities to have an ITA. *Id.* Finally, the Commission held that such policy does not increase costs to ratepayers.[127] *Id.* at P 37.

122. In the December 2007 Order[128], the Commission rejected the argument that an ITA allows a pass-through entity to double recover its income tax costs through the DCF-model. December 2007 Order at P 52. The Commission stated that "[t]he distributions made to the partners represent pre-tax dollars and without the income tax allowance would not equal the first tier after-tax return of a corporation that receives an income tax allowance on the same amount of net income." *Id.* at P 53. The distributions to MLP unit holders are not distributions for which an ITA was included in the MLP's COS. The distributions to shareholders are distributions for which an ITA was included in the corporation's COS. For MLPs, the ITA compensates the MLP unit holders for the tax implications of the distributions. For corporations, the ITA compensates the corporation for the tax implications of its income. As Commission policy currently stands, the ITA equalizes the after-tax dividends from the corporation to shareholders with the before-tax distributions from the MLP to the MLP unit holders. In essence, the ITA compensates the corporations for its tax liability and the MLP unit holders for their tax liability. For corporations, the dividends are the inputs to the DCF-model. The Commission therefore concluded in the December 2007 Order that the ITA has a neutral impact on the DCF-

Oil Corp. v. FERC, 487 F.3d 945, 954-55 (D.C. Cir. 2007) ("In sum, in the Policy Statement and the Remand Order, FERC has reasonably explained why its new ITA policy does not result in the creation of "phantom" tax liability for regulated pipelines that operate as limited partnerships.") (*ExxonMobil*).

126 *ITA Policy Statement* at P 33 ("While the pass-through entity does not itself pay income taxes, the owners of a pass-through entity pay income taxes on the utility income generated by the assets they own via the device of the pass-through entity. Therefore, the taxes paid by the owners of the pass-through entity are just as much a cost of acquiring and operating the assets of that entity as if the utility assets were owned by a corporation.").

127 *ITA Policy Statement* at P 37 ("[T]he policy the Commission is adopting should not result in increased costs to public utility ratepayers, and may actually reduce them if a partnership or LLC has a lower weighted marginal tax rate and fewer administrative expenses than the normal corporate ownership form.").

128 *SFPP, L.P.*, 121 FERC ¶ 61240 (2007).

model.[129] *Id.* In *America We*st[130] and Opinion 486-B,[131] the Commission affirmed that an ITA does not cause MLPs to double recover their income tax cost. *American West* at P 10; Opinion 486-B at P 114.

123. N/W's recommended downward adjustment is based upon its position that the Commission should equate the before-tax return of MLP unit holders with the before-tax return of shareholders (or the after-tax return of MLP unit holders with the after-tax return of shareholders). Such parity represents N/W's belief that investors in enterprises with similar risk levels should receive similar after-tax returns. However, as discussed *supra*, Commission policy does not support parity at the investor-to-investor level (MLP unit holders-to-shareholders).[132] Rather, Commission policy supports parity between the after-tax return of MLP unit holders and the pre-tax return of shareholders (or, the after-tax return of the corporation). *See* Opinion 486-B at P 114. Assuming that witness Horst's calculation of 2.38 percent accurately represents the difference between the cost of equity capital for a corporation and an MLP, a downward adjustment of 2.38 percent to SFPP's ROE will indirectly achieve the level of parity supported by N/W, not by Commission policy. Such adjustment effectively eliminates the cost benefit provided by the ITA. In Opinion 486-B, the Commission specifically stated that, for purposes of the DCF-model, no requirement exists to reflect the tax differences between corporations and

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[129] December 2007 Order at P 53 ("Thus, if distributions are utilized in the Commission's DCF model, these are not dividends for which a prior income tax allowance has been included in the cost of service, as is done with the corporate model. Rather, the income tax allowance compensates the partners for the tax cost of the distributions they receive and thus equalizes the after-tax cash flows that would be available from a corporation and are used as inputs to the DCF model. Therefore the impact on the DCF model of the income tax allowance is neutral, although there may be an additional return to the partners due to the income tax deferral elements of the partnership." (footnote omitted)).

[130] The Commission affirmed in *American West* that an ITA does not cause a double recovery. *America West Airlines, Inc. v. Calnev Pipe Line, L.L.C.*, 121 FERC ¶ 61,241, at P 10 (2007) ("Specifically, regarding a partnership income tax allowance, the Commission has affirmed its prior conclusions that . . . there is no double recovery of the income tax allowance in the allowed equity return.") (referencing December 2007 Order at PP 35-39, 52-53, 54-58) (*America West*).

[131] *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034, at P 114 (2009) (Opinion 486-B) ("[T]he Commission's DCF model does not double count the income tax aspects of a MLP partnership instrument.").

[132] SFPP correctly states that the Commission rejected the comparison between the returns of MLP unit holders and corporate shareholders, which comparison N/W and the VCC Shippers assert in support of their double-recovery argument. SFPP RB at 24.

MLPs.[133] Opinion 486-B at P 116. Therefore, N/W's recommended adjustment is denied.

ISSUE III - Income Tax Allowance

ISSUE III.A - Is SFPP Entitled to an Income Tax Allowance as a Matter of Law or Fact?

124. SFPP contends that it is entitled to an ITA as a matter of law and fact. N/W and VCC Shippers contend that SFPP is not entitled to an ITA as a matter of law or fact. Staff takes no position on this issue. However, Staff uses SFPP's weighted average income tax rate and net-to-tax multiplier to calculate an ITA.

Discussion/Findings

125. The *ITA Policy Statement*,[134] June 2005 Order,[135] *ExxonMobil*,[136] December 2005 Order,[137] 2006 Sepulveda Order,[138] and December 2007 Order[139] permit SFPP an ITA to the extent that SFPP demonstrates that its partners incur an actual or potential income tax

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133 *Kern River Gas Transmission Co.*, 126 FERC ¶ 61,034, at P 116 (2009) (Opinion 486-B) ("Moreover, while the pricing of a MLP instrument may reflect the tax deferral components of such instrument, as the Income Tax Policy Statement explains, this is a matter of timing. The difference in timing of the tax payments may lead the unit holder to pay a higher price for the unit and reduce the equity cost of capital to the firm, although not necessarily the amount of the income tax allowance included in the MLP's rates and borne by the ratepayers. However, in reviewing the profile of firms to be included in a proxy group, the Commission looks only at information on the relative prices and yields of the securities issued by the candidate firms. Thus, for purposes of the Commission's DCF model, tax factors are assumed to be reflected in the unit prices and resulting dividend yields of the MLP. Therefore, there is no requirement to adjust the results to reflect the tax difference between a Subchapter C corporation and a MLP.").

134 *Policy Statement on Income Tax Allowances*, 111 FERC ¶ 61,139 (2005) (*ITA Policy Statement*).

135 *SFPP, L.P.*, 111 FERC 61,334 (2005) (June 2005 Order).

136 *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945 (D.C. Cir. 2007) (*ExxonMobil*).

137 *SFPP, L.P.*, 113 FERC ¶ 61,277 (2005) (December 2005 Order).

138 *Texaco Ref. & Mktg., Inc. v. SFPP, L.P.*, 117 FERC ¶ 61,285 (2006) (2006 Sepulveda Order).

139 *SFPP, L.P.,* 121 FERC ¶ 61,240 (2007) (December 2007 Order).

liability.[140] As a matter of fact, the evidence presented by SFPP in this proceeding demonstrates that SFPP's partners incur an actual or potential income tax liability. SFPP is therefore ordered to calculate the ITA as directed *supra* at ISSUE II.J and *infra* at ISSUES III.A thru III.G.

126. Commission ITA policy permits SFPP an ITA to the extent that SFPP demonstrates that its partners incur an actual or potential income tax liability. In *BP West Coast*,[141] the Court of Appeals for the District of Columbia (D.C. Circuit Court) vacated portions of prior Commission orders granting SFPP an ITA based on its *Lakehead* policy.[142] The D.C. Circuit Court found that SFPP was not entitled to an ITA for "phantom income taxes" that it did not pay. *BP West Coast*, 374 F.3d at 1288. In response to *BP West Coast*, the Commission issued the *ITA Policy Statement*. The *ITA Policy Statement* shifted the analysis to whether the pipeline could prove that the utility owners, rather than the utility, had an "actual or potential income tax liability on that public utility income." *ITA Policy Statement* at P 32.[143] In the June 2005 Order, the

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[140] The December 2005 Order, 2006 Sepulveda Order, and December 2007 Order are collectively referred to as the "Modification Orders."

[141] *BP West Coast Prods., LLC v. FERC*, 374 F.3d 1263 (D.C. Cir. 2004) (*BP West Coast*).

[142] Under the *Lakehead* policy, a pipeline's eligibility for an ITA depended upon whether the pipeline partners were individuals or corporations. *ExxonMobil*, 487 F.3d at 948; *see Lakehead Pipe Line Co.,* 71 FERC ¶ 61,338, 62,313-15 (1995), *reh'g denied*, 75 FERC ¶ 61,181 (1996) (*Lakehead*). Specifically, a pipeline was entitled to an ITA only for income attributable to its corporate partners. *ExxonMobil*, 487 F.3d at 948-49; *see Lakehead*, 71 FERC at 62,314.

[143] In the *ITA Policy Statement*, the Commission stated that the owners of partnership interests must have an actual or potential income tax liability. The Commission stated as follows:

> Thus a tax-paying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, have an *actual or potential income tax liability on that public utility income*. Given this important qualification, any pass-through entity seeking an income tax allowance in a specific rate proceeding must establish that its partners or members have an *actual or potential income tax obligation* on the entity's public utility income. To the extent that any of the partners or members do not have such an *actual or potential income tax obligation*, the amount of any income tax allowance will be reduced accordingly to reflect the weighted income tax liability of the entity's partners or members. *ITA Policy Statement* at P 32 (emphasis added).

Commission affirmed that owners of partnership interests must have an actual or potential income tax liability, stating as follows:

> Given the Commission's Policy Statement [*ITA Policy Statement*] and the application of its policy in this opinion, the Commission concludes that SFPP, L.P. should be afforded an income tax allowance on all of its partnership interests *to the extent that the owners of those interests had an actual or potential income tax liability* during the periods at issue here.

June 2005 Order at P 27 (emphasis added).

127. The D.C. Circuit Court affirmed the *ITA Policy Statement* and the June 2005 Order in *ExxonMobil*.[144] The court cautioned that the *ITA Policy Statement* "incorporates[s] some of the troubling elements of the phantom tax we disallowed in *BP West Coast* . . . ." *ExxonMobil*, 487 F.3d at 948. The court also clarified that it vacated the *Lakehead* policy in *BP West Coast* because the Commission did not provide a reasoned explanation for its *Lakehead* policy. *Id.* at 949. However, the D.C. Circuit Court held that "in the Policy Statement [*ITA Policy Statement*] and the Remand Order [June 2005 Order], FERC has *reasonably explained* why its new ITA policy does not result in the creation of 'phantom' tax liability for regulated pipelines that operate as limited partnerships." *Id.* at 954-55 (emphasis added). Importantly, the D.C. Circuit Court also held that "SFPP will be eligible for a tax allowance only to the extent it can demonstrate -- in a rate proceeding -- that its partners incur 'actual or potential' income tax liability on their respective shares of the partnership income." *Id.* at 954 (citing June 2005 Order at P 27). Thus, the extent to which SFPP partners incur an actual or potential income tax liability is a factual determination in each proceeding.

128. The rulings above are based upon the Commission's ITA policy.[145] As the VCC Shippers acknowledge, the Modification Orders created "a newly-minted presumption that SFPP [] is entitled to an income tax allowance." They argue, however, that SFPP is not entitled to an ITA as a matter of law because *BP West Coast* is controlling. In *BP West Coast*, the D.C. Circuit Court noted that "[t]he 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." *BP West Coast*, 374 F.3d at 1293.[146] However, the D.C.

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144 *ExxonMobil*, 487 F.3d 945.

145 SFPP contends that the ITA issue is closed. VCC Shippers and N/W contend that the ITA is not closed.

146 N/W state that the D.C. Circuit Court and the Commission share the same view of Congress' intent regarding the MLP tax exemption. Specifically, the Commission held that the

(continued)

Circuit Court subsequently held in *ExxonMobil* that the Commission "reasonably explained" that the ITA policy set forth in the *ITA Policy Statement* and June 2005 Order does not create a phantom tax. *ExxonMobil*, 487 F.3d at 954-55. The court also stated that the Commission has broad discretion to implement an ITA policy. *Id.* at 955. In fact, the court noted that "policy decisions are for the Commission and not the court." *Id.* Accordingly, the Commission further developed its ITA policy in the more recent Modification Orders. Nevertheless, the VCC Shippers argue that policy statements do not have the "force of law," and therefore the Commission must analyze the evidence in each proceeding to determine whether application of a policy statement is appropriate.[147] Their argument does not impact the ITA issue for two reasons. First, the *ITA Policy Statement* does not by itself embody Commission ITA policy. Since *BP West Coast*, the *ITA Policy Statement*, the June 2005 Order, the D.C. Circuit Court's *ExxonMobil* case, and the Modification Orders collectively embody ITA policy. Second, the analysis regarding application of the *ITA Policy Statement* addresses whether SFPP presents evidence demonstrating that its partners incur an actual or potential income tax liability.[148] SFPP must also follow the procedures set forth in the Modification Orders to calculate the ITA.

MLP tax exemption is "advantageous on its own merits without the addition of phantom taxes in a cost-of-service . . . ." *Lakehead*, 75 FERC at 61,596. N/W note that the Commission discarded the ITA methodology in *Lakehead*. However, they contend that the Commission never disavowed its reading of the IRC tax exemption for MLPs.

[147] The Commission recently affirmed that policy statements must by applied on a case-by-case basis, stating as follows:

> The Policy Statement also conveyed the Commission's intent to evaluate specific proxy group and ROE proposals based on the facts relevant to a particular pipeline and to address any concerns regarding the Policy Statement on a case-by-case basis. Accordingly, the Policy Statement is not a final action of the Commission but an expression of policy intent. As the U.S. Court of Appeals for the District of Columbia Circuit has held, a statement of policy "is not finally determinative of the issues or rights to which it is addressed;" rather, it only "announces the agency's tentative intentions for the future." *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,259, at P 5 (2008) (citing *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 (D.C. Cir. 1974)) (footnote omitted).

[148] To demonstrate that its partners incur an actual or potential income tax liability, the "pass-through entity . . . must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred." *ITA Policy Statement* at P 42.

129. As required, SFPP demonstrates that its partners incur an actual or potential income tax liability on SFPP income, thus entitling SFPP to an ITA. The Commission described the evidence required to make such demonstration in the December 2005 Order and the December 2007 Order. In the December 2005 Order, the Commission stated that "if a partner is required to file a Form 1040 or Form 1120 return that includes a partnership income or loss, the Commission concludes that such partner that has an actual or potential income tax liability for the partnership income." December 2005 Order at P 28.

130. Further, in the December 2007 Order, the Commission stated that "if the partner receives a K-1 and must report distributive ordinary income or loss on the partners' annual income tax return, that partner will have an actual or potential income tax liability." December 2007 Order at P 34. SFPP presents the required documentary evidence in Exhibit No. SPE-25C through Exhibit No. SPE-28C. *See* Ex. SPE-25C; Ex. SPE-26C; Ex. SPE-27C; Ex. SPE-28C. Specifically, SFPP presented the 2008 Form 1065 (including Schedules K-1 and Schedule K-1 information)[149] for the partnerships SFPP, OLP-D, and KMEP. SFPP also presented the 2008 Form 1120 for KMI, which is a Subchapter C corporation. *See* Exs. SPE-25C; SPE-26C; SPE-27C and SPE-28C. The 2008 Forms 1065 show the taxable income for the partnerships and the Form 1120 shows the taxable income of KMI and its subsidiaries, and KMI's income tax liability on that taxable income. The 2008 Forms 1065 and 2008 Form 1120 conclusively establish that SFPP partners incur an actual or potential income tax liability on SFPP income.

131. The Modification Orders describe the methodology to calculate the ITA. First, SFPP must separate KMEP unitholders into six categories: (i) Subchapter C corporations, (ii) individuals, (iii) mutual funds, (iv) other unitholders such as pension funds, IRAs, Keogh Plans that are not normally tax-paying entities, but would be expected to have tax-paying beneficiaries or owners (pension funds), (v) entities listed in (iv) that receive Unrelated Business Taxable Income (UBIT) (UBIT entities) from SFPP or KMEP, and (vi) tax-exempt entities such as municipalities that have no obligation to pay out income or to declare income (tax-exempt entities). December 2005 Order at P 45. To the extent that the unitholders are pass-through entities, SFPP must "identify the nature of the entity or individual ultimately subject to an actual or potential income tax liability and place that entity or individual in the appropriate category of unit owner."

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[149] A Schedule K-1 is an Internal Revenue Service prescribed document prepared by a partnership for each partner showing that partner's share of the current year income, deductions, and other items. Exhibits SPE-25C to SPE-27C include the SFPP, OLP-D, and KMEP Schedules K-1 for SFPP partner SFPP, Inc. and Kinder Morgan-related companies. *See* Ex. SPE-25C through Ex. SPE-27C. Exhibit Nos. SPE-219 and SPE-220C contain information regarding the more than 200 million non-Kinder Morgan public unitholders that received KMEP Schedules K-1. *See* Ex. SPE-219 and Ex. SPE-220C.

December 2005 Order at P 45. After SFPP categorizes the unitholders, SFPP must calculate the percentage of unitholders that fall into the six categories. December 2005 Order at P 45.

132. Second, SFPP must calculate the percentage of taxable partnership income imputed to each category. December 2005 Order at P 46. The Commission recognized that the percentage of taxable partnership income imputed to each category "may not be the same as the percentage of the actual units held by each group depending on how expenses, deductions and income are allocated among the partners." December 2005 Order at P 46. The Commission also recognized that the allocation of income, credits, and deductions among the partners "does not affect the total taxable income of the partnership reported on the partnership's 1065 information return it files with the Internal Revenue Service, the annual report it must file with the Commission, or the collective income tax liability of the partners." December 2005 Order at P 26; Ex. SPE-32 at 20.

133. Third, SFPP must calculate the weighted federal income tax rate using the marginal income tax rate established for each type of partner. 2006 Sepulveda Order at P 57 ("[T]he actual or potential tax liability of the individual partner is determined by the marginal tax rate burden on the partner's taxable income, which is then imputed and applied to the income of the partnership."). The rebuttable marginal income tax rates are as follows: For Subchapter C corporations and limited liability companies filing a Form 1120 income tax return, the marginal income tax rate is 34 percent unless SFPP demonstrates that the marginal income tax rate is 35 percent. For municipalities and other tax exempt entities, the marginal income tax rate is zero percent. For all other entities, the marginal income tax rate is 28 percent. December 2005 Order at PP 29-32; 2006 Sepulveda Order at P 60; December 2007 Order at P 37.

134. Fourth, SFPP must calculate its state income tax allowance. In the December 2007 Order, the Commission stated that state income taxes are a "traditional cost-of-service element." December 2007 Order at 59. The Commission also stated that SFPP is entitled to a state ITA if SFPP is entitled to a federal ITA and if SFPP's state ITA methodology is reasonable. *Id*. The Commission clarified that the weighted state income tax rate is "the weighted marginal tax rate of all KMEP partners that are required to declare KMEP's income, not SFPP's, in the states where KMEP operates." December 2007 Order at P 59.

135. SFPP calculated the ITA pursuant to the Modification Orders, except as discussed *infra* at ISSUE III.B, ISSUE III.D, ISSUE III.E, ISSUE III.F, and ISSUE III.G. First, SFPP separated the KMEP unitholders into the six Commission-specified categories. *See* Ex. SPE-219; SPE-220C. For instance, of the total 230,108,138 public units, SFPP attributes 25,267.902 (10.98 percent) to Subchapter C corporations; 83,442,400 (36.26 percent) to individuals; 3,779,054 (1.64 percent) to mutual funds; 25,827,629 (11.22 percent) to unit holders such as pensions, IRAs, and Keogh Plans; 1,811,282 (0.79 percent) to UBIT; 1,023,429 (0.44%) to tax-exempt entities; and so forth. Ex. SPE-219.

SFPP bases the categorization of public unitholders on information from brokerage firms, as discussed *infra* at ISSUE III.E. *See* Ex. SPE-239 through Ex. SPE-242; Ex. SPE-19 at 10-15; Ex. SPE-219; Ex. SPE-220C. Second, SFPP presented the limited partnership agreement for SFPP, OLP-D, and KMEP. *See* Ex. SPE-20 through Ex. SPE-24. The agreements govern the allocation of income among the partners of each partnership. *See* Ex. SPE-32 at 13-16. Third, SFPP presented the 2008 state income tax returns and the 2008 state income apportionment factors that KMEP used to divide its total income among the states in which it operates. *See* Ex. SPE-30C; Ex. SPE 31.

136. Based the information above, SFPP calculated the ITA as follows: First, SFPP determined the number of limited partner units in each category of partner and the percentage of units in each category. *See* Ex. SPE-32 at 8-28; Ex. SPE-254C at 2.[150] Second, SFPP determined the total SFPP taxable income in each category of partner and the percentage of income in each category. Specifically, SFPP witness Ganz traced the taxable income reported on SFPP Form 1065 through each level of ownership to determine the share of SFPP taxable income allocated to each partner or partner category. *See* Ex. SPE-32 at 18-19; Ex. SPE-254C at 3; Ex. SPE-37C. He determined that the share of SFPP taxable income allocated to the SFPP partners (OLP-D and SFPP Inc.), to the OLP-D partners (KMEP and KMGP), and to the KMEP general partner (KMGP) and the KMEP limited partners. Ex. SPE-25C at 6 ln.1; *see* Ex. SPE-254C at 3; Ex. SPE-37C.

137. Then, witness Ganz determined the total SFPP taxable income allocated to each category of KMEP partner, and the income percentages for each category. *See* Ex. SPE-254C at 1. Third, SFPP calculated the weighted federal income tax rate. Specifically, witness Ganz applied the Commission-approved marginal income tax rates to the income percentages for each category. *Id.* SFPP notes that although the marginal income tax rate for entities that receive UBIT is 28 percent, SFPP used a 34 percent marginal income tax rate for UBIT entities because the Internal Revenue Code (IRC) specifies the corporate rate for UBIT. Ex. SPE-32 at 21. Fourth, SFPP determined the weighted state income tax rate for 2008 in Exhibit No. SPE-32. Ex. SPE-32 at 22-25; Ex. SPE-255 at 2-60. SFPP also determined the weighted federal and state income tax rate of 36.12 percent in Exhibit No. SPE-255. Ex. SPE-255 at 1; Ex. SPE-222 at 7 ln.9; Ex. S-2 at 94. Finally, SFPP developed the net-to-tax multiplier of 56.53 percent used to calculate the ITA of $9,320 million for the SFPP COS. Ex. SPE-222 at 7 lns.10, 13.

138. In support of the position that providing MLP pipelines with ITAs causes MLP investors to double-recovery their income tax cost, N/W and VCC Shippers contend that SFPP witnesses Vander Weide and Schink present contradictory theories. According to witness Vander Weide's theory in the current SFPP East Line case, ITAs do not cause

150 SFPP notes that Exhibit No. SPE-254C updates Exhibit No. SPE-36C.

MLP investors to over-recover their income tax liability because they reduce their required ROE in response to Commission policy granting pass-through entities ITAs.[151] Thus, the "built-in" tax allowance in the ROE disappears.

139. According to witness Schink's theory in the prior SFPP West Line case, Docket No. IS08-390, MLP pipelines receive the same ROE with or without an ITA. For instance, ITAs provide MLP pipelines with an ITA additional revenue (return) compared to MLP pipelines without an ITA. Thus, the MLP pipeline has a greater amount of cash to distribute to investors, thereby attracting additional investors. Ex. NAV-26 at 7-9. As investors buy more units, unit prices increase. Ex. NAV-26 at 4, 5, 7. Ultimately, unit prices increase until the higher distribution yields return to a level necessary to provide the MLP investors with their required after-investor-tax return.[152] VCC Shippers argue that SFPP switched theories, and witnesses, because the Commission's rationale for granting ITAs is to promote parity between the corporate and partnership format. *ITA Policy Statement* at PP 34-36. However, witness Schink's theory recognizes that providing ITAs eliminate parity between corporate and MLP investors. Both N/W and VCC Shippers point out that witness Vander Weide testified that witness Schink's theory is incorrect. Tr. 295-97.

140. N/W explain how over-recovery of an expense such as an ITA increases the market capitalization of an MLP pipeline. The increased market capitalization occurs through fundamental "market equilibrium mechanics," described as follows: First, investor return increases because the over-recovery increases the MLP pipeline's revenue and cash available for investor distributions. Second, the increased distribution yields attract additional investors who pay more money for the MLP units. In turn, the MLP

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151 SFPP witness Vander Weide testified that "[b]ecause the partners are aware of the Commission's policy to include an income tax allowance in SFPP's revenue requirement, they feel no need to recover their income taxes through an increase in their required return." Ex. SPE-107 at 38.

152 N/W state that SFPP recognized that witness Schink's testimony in the SFPP West Line case undercuts current Commission ITA policy. Specifically, in *Lakehead*, the Commission made clear that it did not base its ITA policy on the notion that inclusion of "phantom" income tax costs in the COS should advantage MLP pipelines over corporate pipelines. *Id.*; *Lakehead*, 75 FERC at 61,596. Rather, the Commission justifies its current ITA policy on the notion that MLP and corporate pipelines must achieve equal footing by ensuring sufficient revenue for the pipeline-level income tax liability. *ITA Policy Statement* at P 32. Witness Schink believes that MLP pipelines with ITAs have an extra return which increases the MLP's stock price and thus a double recovery. Ex. NAV-26 at 4-10. Thus, N/W conclude that an ITA is unnecessary to place MLP and corporate pipelines on parity. VCC Shippers also argue that there is absolutely no merit to the notion that providing MLP investors with this double recovery is necessary to maintain parity with corporate pipeline investors.

unit price increases. Ex. NAV-1 at 41-42; Ex. NAV-26 at 7-8; Tr. 2372. Third, the increased unit price reduces the distribution yields to a level sufficient to attract capital investment.[153] Thus, the phenomenon of market equilibrium occurs. Ultimately, the MLP pipeline earns a market-based, after-investor-tax return sufficient to attract investment capital. *Id.* And, the over-recovery of expense increases the market capitalization (unit price) of the MLP pipeline.[154] Tr. 2372; Ex. NAV-26 at 4; Ex. NAV-68, col. <c> lns. 21, 24.

141. According to N/W, witness Vander Weide testified that cash from ITAs does not increase the market capitalization of MLP pipelines, even though he agrees with the market equilibrium mechanics. Rather, witness Vander Weide believes that MLP investors decrease their required ROE because the Commission allows MLP pipelines ITAs. N/W and the VCC Shippers respond that no record evidence supports such theory. N/W explains that MLP investors pool all cash received by an MLP pipeline, and do not attribute the pooled revenue to the ITA, the ROE, or any other cost item in the COS. According to N/W, MLP investors do not reduce their required ROE because the Commission permits MLP pipelines to recover additional cash through ITAs. Rather, MLP investors analyze MLP pipeline revenue on an aggregated basis, and do not attribute the revenue to specific cost items.

142. N/W describes the DCF model as follows: The Commission develops the ROE from the actual market returns of a proxy group of comparable companies. Specifically, the ROE for an MLP equals the median distribution yield of the MLP proxy group plus growth.[155] The distribution yield equals the MLP distributions divided by unit (stock) price. Ex. SPE-1 at 19. And, the distributions equal the cash paid by the MLP pipeline to MLP investors. N/W note that the MLP pipeline's various sources of revenue contribute to the distributed cash. For instance, the MLP pipeline and investors do not attribute

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[153] N/W note that the increased unit price drives down the distribution yield because the distribution yield equals the distributions divided by the unit price. Thus, an increased denominator (unit price) and constant numerator (distributions) produce a decreased result (distribution yield).

[154] Alternatively, if investor return is too low, investors will sell their MLP units and invest their money elsewhere. As a result, the unit price will decrease. The decreased unit price will increase the dividend yield to a level sufficient to attract investment. Ultimately, the MLP pipeline earns a market-based, after-investor-tax return sufficient to attract investment. However, the MLP pipeline's market capitalization is decreased.

[155] N/W state that for purposes of the ITA issue, growth is unimportant. N/W therefore assume that growth is constant. Also, SFPP provides a mathematical explanation of the DCF ROE. *See* Ex. SPE-1 at 19.

distributed cash to the ITA, ROE, or other COS components. Rather, MLP investors base their investment decisions on the pooled distributions.

143. Two aspects of the DCF model suggest that MLP investors do not decrease their required ROE because the Commission allows MLP pipelines ITAs. First, the ROE represents the before-investor-tax return because it originates solely from cash distributions to investors. If the pipeline distributes more cash, the before-investor-tax return increases, regardless of the source of the cash. Tr. 275, 2373; Ex. NAV-1 at 16-18, 44. Second, the DCF model establishes an ROE that attracts investors. Tr. 144; Ex. SPE-1 at 7-8, 16; NAV-1 at 29, 35. Thus, the ROE must be sufficient to attract investment after the investors pay income taxes on the distributed cash. N/W explains that investors make investment decisions based on their required investor after-tax return. Ex. NAV-1 at 37; Tr. 238. Thus, investors change their investor after-tax return by changing their before-tax return. Further, investors base their investor after-tax return on the risk of the investment.[156] Witness Vander Weide acknowledges that the ITA does not impact the after-investor tax return. *Id.*; Tr. 246-47.[157] Therefore, investors do not change their required after-investor-tax return or before-investor-tax return based on the ITAs.

144. Although Commission policy permits SFPP an ITA, SFPP, N/W, and VCC Shippers discuss a hypothetical that suggests that ITAs increase MLP pipelines' revenues, distributions, and unit price. The parties develop the hypothetical, and its various iterations, in Exhibit Nos. NAV-25, NAV-68, VCC-78hc; SPE-107, and SPE-215. *See* Ex. NAV-25; Ex. NAV-68; Ex. VCC-78hc at 48 Figure 16, 52 Figure 17; Ex. SPE-107 at 28 Table 3, 34 Table 4, 37 Table 5; Ex. SPE-215 at 3 Example 3. The hypothetical is discussed in detail below.

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[156] N/W state that the after-tax return that investors requires, as computed under the DCF model, is "commensurate with returns on investments in other enterprises having corresponding risks." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); N/W IB at 50. N/W therefore conclude that the degree of pipeline business risk determines the ROE, not Commission ITA policy. *Id.*

[157] SFPP witness Vander Weide acknowledges that the ITA does not affect the after-investor tax return, stating as follows:

> Q So when the investor comes to look to the pipeline that's regulated, the announcement by FERC of an income tax allowance is not going to affect what the investor can get somewhere else in the marketplace; right? . . . A *I'm agreeing with you that it will not affect the required after-tax return*. It will affect the stock price if the investor did not previously expect there to be an income tax allowance. Tr. 246 (emphasis added).

145. The hypothetical in Exhibit No. NAV-25 suggests two conclusions: First, MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return. Ex. NAV-25 at ln. 18. Two, the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base. Ex. NAV-25 at ln.23. The hypothetical in Exhibit No. NAV-25 measures the ability to attract capital of a corporate pipeline with an ITA and an MLP pipeline with and without an ITA.[158] Exhibit No. NAV-25 is as follows:

	Pipeline Investors	<a> Corporation with ITA	<b> MLP without ITA	<c> MLP with ITA	<d> Explanation
1	New Equity Issued - $	$100.00	$100.00	$100.00	Assumed Value
2	Investors' Required After-Tax Rate of Return - %	9.00%	9.00%	9.00%	Assumed Value
3	Investors' Marginal Tax Rate - %	15.0%	30.0%	30.0%	Assumed Value
4	Investors' Required Before-Tax Rate of Return - %	10.59%	12.86%	12.86%	#2 / (100% - #3)
5	Investors' Required Before-Tax Rate of Return - $	$10.59	$12.86	$12.86	#4 x #1
	Pipeline Company				
6	Original Cost Equity Rate Base - $	$100.00	$100.00	$100.00	#1

158 N/W agree with SFPP witness Vander Weide' statement that MLP investors without an ITA will recover their income tax cost via the ROE. N/W IB at 48. Witness Vander Weide states as follows:

> The only difference between the MLP with an income tax allowance and the MLP without an income tax allowance is that the partners in the MLP with an income tax allowance recover their income taxes through the income tax allowance, while the partners in the MLP without the income tax allowance recover their income taxes by demanding a higher before-tax required return on investment. Ex. SPE-107 at 37.

7	Cost of Equity - %	10.59%	12.86%	12.86%	Assumed Value
8	Return on Equity in Cost of Service - $	$10.59	$12.86	$12.86	#7 x #6
9	Tax Rate for Income Tax Allowance - %	35.0%	0.0%	32.0%	Assumed Value
10	Income Tax Gross-Up - %	53.8%	0.0%	47.1%	#9 / (100% - #9)
11	Income Tax Allowance - $	$5.70	$0.00	$6.05	#10 x #8
12	Pipeline's Before-Tax Return - $	$16.29	$12.86	$18.91	#8 + #11
13	Pipeline's Actual Tax Rate	35.0%	0.0%	0.0%	Assumed Value
14	Pipeline's Actual Tax	$5.70	$0.00	$0.00	#13 x #12
15	Pipeline's Actual After-Tax Return	$10.59	$12.86	$18.91	#12 - #14
	Capital-Attraction Test				
16	Pipeline's Actual After-Tax Return	$10.59	$12.86	$18.91	#15
17	Investors' Required Before-Tax Rate of Return - $	$10.59	$12.86	$12.86	#5
18	Capital-Attraction Test Ratio	1.000	1.000	*1.471*	#16 / #17
	Memo: Rates of Return				
19	Cost of Equity - %	10.59%	12.86%	12.86%	#7
20	Pipeline's Actual After-Tax Return on Original Cost - %	10.59%	12.86%	18.91%	#15 / #9
21	Market Value of Equity - $	$100.00	$100.00	$147.06	#6 x (#20 / #19)
22	Investors' Return on Stock Market Value - %	10.59%	12.86%	12.86%	#15 / #21

23	Market Value of Equity - $ / Original Cost Equity Rate Base - $	1.000	1.000	*1.471*	#21 / #6

Ex. NAV-25.

146. On line one, Navajo witness Horst assumes that each pipeline issues $100 in equity. On line two, he assumes that the pipeline investors require an equivalent after-tax rate of return of 9 percent. Ex. NAV-25 at ln.1. On line three, he assumes that the corporate investors have a 15 percent marginal tax rate, and that the MLP investors have a 30 percent marginal tax rate. *Id.* at ln.3. As demonstrated on lines four and five, the corporate investor requires a 10.59 percent ($10.59) annual return on their $100 investment, and the MLP investors require a 12.86 percent ($12.86) annual return on their $100 investment. Presumably, the $10.59 and $12.86 amounts allow the corporate and MLP investors, respectively, to pay their income taxes and to earn their required after-tax ROR of 9 percent. *Id.* at ln.4-5. On line seven, witness Horst assumes that each pipelines' cost of equity equals its required before-tax return, as represented on line four. Ex. NAV-25 at ln.7. On line eight, he calculates each pipelines' return by multiplying their cost of equity (line 7) by their original cost of equity issued (lines 1 and 6). *Id.* at ln.8.

147. On line eleven, witness Horst calculates the ITAs for the pipelines with ITAs. The corporate pipeline with an ITA in column <a> has an ITA equal to $5.70, and the MLP pipeline with an ITA in column <c> has an ITA equal to $6.05. He calculates the respective ITAs by multiplying the grossed-up income tax rate for the ITAs (line 10) by the ROEs (line 8). *Id.* at ln.11. On line twelve, witness Horst calculates each pipelines before-pipeline-tax return by adding the ITAs (line 11) to the ROEs (line 8). *Id.* at ln.12. Importantly, the before-pipeline-tax return of the MLP pipeline without an ITA in column <b> (line 12) equals its ROE (line 8) because it does not have an ITA (lines 9 and 10). On line 15, witness Horst calculates each pipelines after-pipeline-tax return by subtracting the actual tax liabilities (line 14) from the pre-pipeline-tax returns (line 12). *Id.* at ln.15. The pipelines' actual tax liabilities (line 14) equal the pipelines' actual tax rates (line 13) times their pre-pipeline-tax returns (line 12). *Id.* at lns.12-14. Importantly, the MLP pipelines' actual tax rates (line 13) equal zero percent, and the corporate pipeline's actual tax rate (line 13) equals 35 percent. *Id.* at ln.13; N/W IB at 65.

148. The "Capital-Attraction Test Ratio" portion of the hypothetical appears to support the first conclusion: MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return. For instance, on line eighteen, witness Horst calculates the Capital Attraction Test ratio by dividing each pipelines' after-pipeline-tax return (lines 15 and 16) by the pipeline investors' required pre-investor-tax return (lines 5 and 17). Ex. NAV-

25 at 18. The resulting ratios demonstrate whether the pipeline investors receive more than their required before-investor-tax return. Specifically, the 1.00 Capital Attraction Test ratio (line 18) of the corporate pipeline with an ITA in column <a> and the MLP pipeline without an ITA in column <b> suggests that the investors in these pipelines receive their required after-investor-tax return, and no more. Alternatively, the 1.471 Capital Attraction Test ratio (line 18) of the MLP pipeline with an ITA in column <c> suggests that the investors in this pipeline receive almost 50 percent more money than is necessary to pay the investor-level income taxes and to earn the required after-investor-tax return. *Id.*

149. The "Memo: Rate of Return" portion of the hypothetical appears to support the second conclusion that the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base. In this portion of the hypothetical, witness Horst calculates the impact of the Capital Attraction Test on the market value of each pipeline. The increased equity market value appears to occur because the ITA provides the MLP pipeline with more before-investor-tax return than required by the existing MLP investors and its market value rises. For instance, on line twenty-one, witness Horst calculates each pipelines' equity market value by multiplying their original cost of equity issued (lines 1 and 6) times the result of their after-pipeline-tax return on original cost (line 20) divided by their cost of equity (line 7 and 19). The equity market value of the corporate pipeline with an ITA in column <a> and the MLP pipeline without an ITA in column <b> remains $100. Ex. NAV-25 at ln.21.

150. Importantly, the equity market value of the MLP pipeline with an ITA in column <c> increases to $147.06. *Id.* On line twenty-two, witness Horst demonstrates that all pipeline investors ultimately receive their required after-investor-tax return.[159] He calculates the pipeline investors' return on stock market value by dividing each pipelines' after-pipeline-tax return (lines 15 and 16) by equity market value of each pipeline (line 21). *Id.* at ln.22. Finally, on line twenty-three, witness Horst calculates each pipelines' equity market value ratio by dividing their equity market value (line 21) by their original cost of equity issued (lines 1 and 6). The 1.00 ratio (line 23) of the corporate pipeline with an ITA in column <a> and the MLP pipeline without an ITA in column <b> demonstrates that cash from the ITA did not increase their equity market value. Alternatively, the 1.471 ratio (line 23) of the MLP pipeline with an ITA in column <c> suggests that cash from the ITA increase the pipeline's equity market value by almost 50 percent of the original cost of equity rate base. *Id.* at ln.23.

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[159] The pipeline investors' return on stock market value (line 22) equals their required pre-investor-tax return (line 4). Ex. NAV-25 at lns. 4, 22. For instance, the return on stock market value/required pre-investor-tax return for the corporate pipeline with an ITA equal to 10.59 percent, for the MLP pipeline without an ITA equals 12.86 percent, for the MLP pipeline with an ITA equals 12.86 percent. *Id.*

151. Figures 16 and 17 of VCC Shippers witness O'Loughlin's testimony demonstrate that cash from an ITA increases the income and equity market value of an MLP pipeline. Ex. VCC-78hc at 48, 52. Figures 16 and 17 compare pipelines under MLP and corporate business structures. In Figures 16 and 17, each pipeline requires a before-investor-tax return of 13.54 percent and an after-investor-tax return of 9.207 percent. Ex. VCC-78hc at 48 lns.1, 3; *id.* at 52 lns.1, 3. In Figure 16, the MLP pipeline receives a 32 percent ITA, and the corporate pipeline receives a 35 percent ITA. Ex. VCC-78hc at 48 ln.4. In Figure 17, the MLP pipeline receives a zero percent ITA, and the corporate pipeline receives a 35 percent ITA. Ex. VCC-78hc at 52 ln.4. In each hypothetical, only the corporate pipeline pays income taxes. Ex. VCC-78hc at 48 ln.20; *id.* at 52 ln.20.

152. As a result, in Figure 16, the before-investor-tax income of the MLP unit is 47 percent greater than that of the corporate share. Specifically, the before-investor-tax income of the MLP pipeline equals $9,955,666 and of the corporate pipeline equals $6,769,853. Ex. VCC-78hc at 48 ln.21. The before-investor-tax MLP unit equals $13.5397 and before-investor-tax corporate share equals $9.2070. *Id.* at ln.22. In turn, the after-investor-tax income of the MLP unit is also 47 percent greater than that of the corporate share. Specifically, the after-investor-tax MLP unit equals $9.2070 and the after-investor-tax corporate share equals $6.2608. *Id.* at ln.24. Ultimately, the market price of the MLP unit is 47 percent higher than that of the corporate share. Specifically, the MLP unit equals $100 per unit and the corporate share equals $68 per share. *Id.* at ln.25; VCC IB at 22. Conversely, in Figure 17, the before-investor-tax income of the MLP unit and the corporate share is equal. Specifically, the before-investor-tax income of the MLP and corporate pipeline equals $6,769,853. Ex. VCC-78hc at 52 ln.21. The before-investor-tax MLP unit and corporate share equal $9.207. *Id.* at ln.22. In turn, the after-investor-tax income of the MLP unit and the corporate share are equal. Specifically, the after-investors-tax MLP unit and corporate share equal $6.2608. *Id.* at ln.24. Ultimately, the MLP unit and corporate share equal $68.00 per unit/share. *Id.* at ln.25. Thus, the comparison of Figures 16 and 17 demonstrates that the ITA increases the MLP unit price. Ex. VCC-78hc at 48, 52.

153. Figures 16 and 17 also demonstrate that the ITA causes MLP investors to double recover their income tax cost. For instance, in Figure 16 and Figure 17, the $68 share price of the corporate pipeline with an ITA multiplied by the 735,294 outstanding shares equals an equity value of $50 million. Ex. VCC-78hc at 48 lns.25, 11; *id.* at 52 lns.25, 11. The $50 million equity value appears consistent with the $50 million equity portion of the corporate pipeline's rate base, which equals the $100 million rate base times the 50 percent equity capitalization. Ex. VCC-78hc at 48 lns.7-8; *id.* at 52 lns.7-8. Similarly, in Figure 17, the $68 unit price of the MLP pipeline *without an ITA* multiplied by the 735,295 outstanding units equals an equity value of $50 million. Ex. VCC-78hc at 52 lns.25, 11. The $50 million equity value appears consistent with the $50 million equity portion of the MLP pipeline's rate base, which equals the $100 million rate base times the 50 percent equity capitalization. Ex. VCC-78hc at 52 lns.7-8. Conversely, in Figure 16,

the $100 unit price of the MLP pipeline *with an ITA* multiplied by the 735,294 outstanding units equals an equity value of $73.5294 million. Ex. VCC-78hc at 48 lns.25, 11. The $73.5294 million equity value does not appear consistent with the $50 million equity portion of the MLP pipeline's rate base, which equals the $100 million rate base times the 50 percent equity capitalization. Ex. VCC-78hc at 48 lns.7-8. In fact, the $73.5294 million equity value of an MLP pipeline *with an ITA* is substantially higher than its $50 million equity rate base. *Id.* Based on the evidence in Figures 16 and 17, the $3,185,813 ITA appears to cause a $23.5294 increase in the MLP pipeline's equity value.[160] Ex. VCC-78hc at 48 ln.14; VCC IB at 22-23.

154. Further, Figures 16 suggests that providing MLP pipelines with ITAs eliminates parity between MLP and corporate investors. For instance, in Figure 16, the MLP and corporate investors require a 13.54 percent ROE. Ex. VCC-78hc at 48 ln.3. However, the MLP pipeline with an ITA achieves a 19.91 percent ROE and the corporate pipeline with an ITA achieves a 13.54 percent ROE. Ex. VCC-78hc at 50-511. The achieved ROE for the MLP and corporate pipelines equals the before-investor-tax income divided by the equity portion of rate base, which equals the total rate base times the equity capitalization. Ex. VCChc-78 at 50. Thus, the MLP pipeline ROE of 19.1 percent equals the $9,955,666 before-investor-tax income divided by the $50 million equity rate base, as calculated in the preceding paragraph. Ex. VCChc-78 at 48 ln.21; *id.* at 50 n.78. The corporate pipeline ROE of 13.54 percent equals the $6,769,853 before-investor-tax income divided by the $50 million equity rate base, as calculated in the preceding paragraph. *Id.* at 48 ln.21; *id.* at 50-51. Based on Figure 16, providing MLP pipelines with ITAs appears to advantage MLP investors over corporate investors. Thus, the ITA appears to eliminate investor parity. *Id.*[161]

155. SFPP Table 3, Table 4, Table 5, and Example 3 are not accurate. *See* Ex. SPE-107 at 28, 34, 37; Ex. SPE-215 at 3. In Table 3, SFPP presents alleged corrections to the hypothetical in Exhibit No. NAV-25. N/W state that SFPP bases Table 3 on the same

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[160] According to VCC Shippers, SFPP witness Schink ultimately admitted that "one cannot look at the after-tax return on the MLP pipeline or the Commission's DCF return on equity to determine whether the Commission has set the correct income tax allowance level." Ex. VCC-98. Witness Schink further admitted that "if the Commission was overly generous to a pipeline in its income tax allowance or in any other operating expense level, the result would be a higher level of revenue and, thus, a higher MLP unit value." *Id.* Based on witness Schink's admissions, VCC Shippers argue that the MLP pipeline's increased $73.5 million equity value proves that cash form an ITA overcompensates the MLP pipeline. *Id.*

[161] VCC Shippers argue that shippers subsidize the MLP pipeline's higher achieved ROE via the ITA. They state that a pipeline does not incur an entity-level income tax cost after conversion from a corporation to an MLP. Thus, contrary to principles of cost-of-service ratemaking, shippers are charged an amount exceeding the pipeline's tax cost.

assumptions underlying the hypothetical in Exhibit No. NAV-25, with two exceptions: First, SFPP equates the partners' before-tax and after-tax returns. Ex. SPE-107 at 28 lns.3, 9-10. Second, SFPP equates the investors' marginal tax rate and the tax rate used to calculate the ITA.[162] Ex. SPE-107 at 28 lns.2, 5; Ex. SPE-107 at 28. In Table 4, SFPP compares the revenue requirement of a corporate pipeline with an ITA and an MLP pipeline with ITA. Ex. SPE-107 at 34. In Table 5, SFPP compares the cost of equity of an MLP pipeline without and with an ITA. Ex. SPE-107 at 36. In Example 3, SFPP revises Table 3, Table 4, and Table 5 as follows:[163]

Line	Pipeline Investors	Corporation with Corporate ITA	MLP with Partner ITA
1	Investors' Marginal Tax Rate	15.00%	30.00%
2	Investors' Required Before-Tax Return	11.50%	9.78%
3	Pipeline Company		
4	Cost of Equity	11.50%	9.78%
5	Tax Rate for Income Tax Allowance	35.00%	30.00%
6	Pipeline's Before-Tax Return	17.69%	13.97%
7	Capital Attraction Test		
8	Return Passed through to Investors	11.50%	13.97%
9	Investors' Marginal Tax Rate	15.00%	30.00%
10	Investors' After-Tax Return	9.78%	9.78%

Ex. SPE-215 at 3.

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162 N/W correctly state that SFPP witness Vander Weide's change to the tax rate is irrelevant. N/W IB at 66 n.26. Any tax rate that does not equal zero works equally well in Navajo witness Horst's hypothetical. *Id.* Regardless of any difference between the marginal tax rate on MLP investors, and corporations, the Commission sets the DCF ROE to result in an equal after-tax ROE for investors provided that the pipelines at issue are of equal risk. Ex. SPE-107 at 34 n.12; Ex. NAV-1 at 37; Tr. 238, 244-246.

163 Example 3 revises Table 3, Table 4, and Table 5. *See* Ex. SPE-215 at 3; Ex. SPE-107 at 28 Table 3, 34 Table 4, 37 Table 5.

156. SFPP Table 5 illustrates SFPP witness Vander Weide's theory, discussed *supra*. In Table 5, for the MLP without an ITA, the 12.86 percent cost of equity equals the MLP investors' 12.86 percent required before-tax return, or ROE. Ex. SPE-107 at 37 lns.4, 3. For the MLP with an ITA, the 9 percent cost of equity equals the MLP investors' 9 percent required before-tax return. *Id.* Under witness Vander Weide's theory, MLP investors attribute a certain portion of cash distributions as ITA dollars. Tr. 433.[164] Presumably, under the theory, the DCF model disregards the portion of cash distributions identified as ITA dollars from the before-investor-tax return. And, the DCF methodology accounts for the portion of cash distributions not identified as ITA dollars in the before-investor-tax return. No evidence adequately explains how the provision of an ITA reduces the MLP pipeline's before-investor-tax return by 30 percent – from 12.86 percent to 9.00 percent. Ex. SPE-107 at 37 ln.4. In fact, as discussed *supra*, SFPP witness Schink testified in the West Line case that provision of an ITA does not change the before-investor-tax return, or ROE. Ex. NAV-26 at 4-10. The unsupported ROE reduction set forth in Table 5 appears to reveal the manner in which SFPP accounts for the extra cash from the ITA.

157. Table 3, Table 4, Table 5, and Example 3 appear to have similar flaws. First, investors' required before-tax and after-tax return cannot be equal. As discussed *supra*, distributions are cash amounts sufficient to pay the investor-level income taxes on the cash amounts, and to provide investors with their required after-tax return. Thus, simple mathematics dictates that investors' required before-tax return and required after-tax return cannot be equal amounts. MLP investors required before-tax and after-tax returns inaccurately equal 9.00 percent in Table 3, Table 4, and Table 5, and inaccurately equal 9.78 percent in Example 3. Ex. SPE-107 at 28 lns.3, 10; *id.* at 34 lns. 3, 10; *id.* at 37 lns.3, 10; Ex. SPE-215 at 3 lns. 2, 10.

158. Second, the calculations in Table 3, Table, 4, Table 5, and Example 3 are not consistent with the DCF model. SFPP appears to have calculated the ROE pursuant to the DCF model. Specifically, SFPP calculated the ROE from before-investor-tax returns that members of the proxy group actually received.[165] These returns constitute the ROE

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[164] SFPP witness Vander Weide identified the MLP investors' before-tax return in two parts. He testified as follows in Tr. 443:

"Q And that pipeline is passing through to the investors in our dollar example now $13.97; is that right?

A Yes, $9.78 of which was their return and the other $4.19 was the income tax allowance."

[165] N/W clarify that the returns reflect the actual cash distributions received by the investors in those MLPs [members of the proxy group].

that SFPP will collect. However, inconsistent with the DCF model, the before-tax return actually distributed to MLP investors is greater than the before-tax return required by MLP investors.[166] For instance, in Table 3, Table 4, and Table 5, MLP investors' required before-tax return and the MLP pipeline's cost of equity equal 9.00 percent. Ex. SPE-107 at 28 lns.3-4; *id.* at 34 lns.3-4; *id.* at 37 lns.3-4. Yet, the MLP pipeline passes a 12.86 percent before-tax return to MLP investors. SPE-107 at 28 ln.7; *id.* at 34 ln.7; *id.* at 37 ln.7. In Example 3, the same circumstance occurs with revised numbers. For instance, MLP investors' required before-tax return and the MLP pipeline's cost of equity equal 9.78 percent. Ex. SPE-215 at 3 lns.2, 4. Yet, the MLP pipeline passes a 13.97 percent before-tax return to MLP investors. *Id.* at ln.8.

159. Further, the DCF model uses the entire distribution to calculate the distribution yield.[167] Thus, with a 13.97 percent distribution yield on line eight of Example 3, the DCF model will calculate (assuming zero growth) a 13.97 percent cost of equity, not the 9.78 percent cost of equity on line four of Example 3. Ex. NAV-68 at 1 ln.7; Tr. 447-51; Ex. SPE-215 at 3 lns.4, 8. When asked whether the MLP pipeline in Example 3 passes $13.97 (or, percent)[168] to MLP investors, witness Vander Weide responded "[y]es, $9.78 of which was their return and the other $4.19 was the income tax allowance." Tr. 443.

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[166] As stated by N/W, the before-investor-tax return equals the DCF ROE for each member of the proxy group. SFPP witness Vander Weide correctly sets forth the DCF ROE methodology in Exhibit No. SPE-1. *See* Ex. SPE-1 at 19 ("I estimate the distribution yield component of the Commission's DCF model by: (i) dividing each proxy company's current annualized distribution by the average of its high and low stock prices in the last six months; and (2) multiplying the result by the factor (1 + 0.5 g)."). However, on cross-examination, witness Vander Weide contradicts his pre-filed testimony. Specifically, when asked "[i]f the median proxy group has a before-tax return passed through to investors of 12.86 percent, what would FERC's DCF return say is the before-tax rate of return for that pipeline," witness Vander Weide responded "9 percent." Tr. 285; N/W IB at 67.

[167] *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at PP 58-61 (2008) (ROE Policy Statement), *reh'g denied*, 123 FERC ¶ 61,259 (2008) ("In short, under the DCF model, all cash flows, whatever their source, contribute to the value of stock. The Commission agrees that, since the DCF model uses the total unadjusted cash flows to determine a stock's value, it is theoretically inconsistent to use lower adjusted cash flows when using the DCF model to determine the return required by investors purchasing the stock . . . . The DCF analysis presumes that the market value of an MLP's units is a function of the entire present and future cash flow provided by an investment in those units").

[168] VCC Shippers explain that one can convert the before-investor-tax return from percentages to dollars for purposes of discussion. Thus, a 13.97 percent before-investor tax return equals $13.97 per unit distribution on the $100 unit price.

He also acknowledged that the 13.97 percent before-investor-tax return is sufficient to pay MLP investor's income tax liability and to achieve MLP investors' required after-tax return of 9.78 percent. Tr. 448.[169] Yet, no evidence explains how an MLP pipeline with a 9.78 percent cost of equity and an ITA produces a 13.97 percent distribution yield under the DCF model. Rather, pursuant to the market equilibrium mechanics discussed above, if the MLP pipeline provides MLP unitholders with an amount 4.19 percent[170] greater than required, additional investors will buy the MLP units and the MLP unit price will increase. Eventually, the before-tax return received by the MLP investors will return to the before-tax return required by the MLP investors.

160. In response, SFPP suggests that an inconsistency does not exist between the 9.78 percent cost of equity and the 13.97 percent before-tax return received by the MLP investors because the 9.78 percent cost of equity equals the 9.78 percent after-tax return that MLP investors ultimately receive. Ex. SPE-107 at 29; Ex. SPE-215 at 3 lns.4, 8, 10; Ex. NAV-68 at 1 ln.7. Specifically, witness Vander Weide testified as follows:

> The pipeline's before-tax return passed through to investors is greater than the investor's required before-tax return because investors realize that there is no need for them to gross up their required after-tax return to recover their income taxes when an income tax allowance is included in the MLP pipeline's revenue requirement. Because the MLP pipeline is a pass-through entity, the Commission should only be concerned with whether the income tax allowance permits the partners to earn more than their required after-tax return. As shown in Table 3, the income tax allowance does not permit investors to earn more than their required after-tax return on investment.

Ex. SPE-107 at 29.

161. He notes that "that the cost of equity is determined prior to the distribution to the investors, and that cost of equity is 9.78 in this example, and the investor actually earns a

[169] SFPP witness Vander Weide identifies a certain amount of the before-investor-tax return as the ITA as follows:

> At the pipeline level, there's an income tax allowance, and that allowance is intended to not only generate the $9.78 for the investor, but also to pay their taxes. So the investor requires $9.78. They get $13.97, but $4.19 of that pays their taxes. So when they actually pay their taxes, they end up only getting $9.78, which is exactly equal to their 9.78 required return. Tr. 448.

[170] 13.97 percent before-investor-tax return received minus 9.78 percent before-investor-tax return required equal a 4.19 percent difference. *See* Ex. SPE-215 at 3 lns.4, 8.

return of 9.78." Tr. 452. According to witness Vander Weide, N/W "assum[es][] that the return passed through to the investors is the cost of equity." Tr. 450. He stated that "[i]t's not the cost of equity. That's just the . . . earned return of the investors before the payment of their taxes." *Id.*

162. However, as the VCC Shippers note, the DCF model assumes that the before-tax return received by investors comprises a significant portion of the cost of equity. *ROE Policy Statement,* 123 FERC at PP 58-61. Nevertheless, witness Vander Weide does not believe "that the 13.97 represents how the FERC estimates the cost of equity. However they estimate the cost of equity, *the assumption* is that they get 9.78." Tr. 454 (emphasis added). When asked to reconcile the 9.78 percent cost of equity and the 13.97 percent before-tax return received by the MLP investors, witness Vander Weide "guess[ed] that the stock price would adjust." Tr. 452. He also responded that he has "not thought about it that way." Tr. 452. Importantly, witness Vander Weide ultimately conceded that to achieve a cost of equity lower than 13.97 percent (such as the 9.78 percent cost of equity in SFPP Example 3), the MLP unit price must increase to reflect the increased cash from the ITA.[171],[172] Tr. 454-55;[173] Ex. SPE-215 at 3 ln.4; Ex. VCC-98 at 14-16. Thus, the evidence shows that if the MLP pipeline receives both an ITA and the full after-tax return required by MLP investors, the MLP unit price increases. Ex. SPE-215 at 3 lns.8; Tr. 447-455. As N/W state, the increased MLP unit price causes the after-investor-tax return of the MLP with an ITA, MLP without an ITA, and corporate pipeline with an ITA to "reach the same after-tax equilibrium point." Ultimately, the extra money from the ITA results in an inflated unit price. Ex. NAV-26; Ex. NAV-68; Ex. VCC-98 at 14-16.

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[171] N/W state that SFPP witness Vander Weide "reluctantly admitted that the only way for the Commission to derive a rate of return on equity other than 13.97% under his example would be if the pipeline's stock price would go up to reflect the revenues from the ITA and so that the distribution yield could go down." Tr. 545:24 to 455:5 (Vander Weide).

[172] VCC Shippers state that the only way a $13.97 MLP distribution could yield Dr. Vander Weide's assumed 9.78 percent DCF cost of equity is if the equity price increased well above $100.

[173] SFPP witness Vander Weide ultimately conceded that to reduce the 13.97 percent return on equity to a 9.78 percent return on equity presented in SFPP Example 3, the MLP unit price must increase. Witness Vander Weide's concession is as follows in Tr. 454-55:

Q Are you suggesting that the stock price will change when the investors actually get $13.97 in distributions, and because the stock price we began with was $100, that that would yield a 13.97 percent rate of return on equity? You're suggesting that the stock price of $100 will go up to bring that 13.97 down to 9.78?

A Yes.

163. Exhibit No. NAV-68 shows that providing MLP pipelines with ITAs cause MLP investors to double recover their income tax cost. Moreover, the exhibit shows that SFPP uses an "artificially low" 9.78 percent required before-investor-tax return to justify providing MLP pipelines ITAs. Exhibit NAV-68 sets forth SFPP and N/W's versions of the hypothetical, and compares the respective impacts of the ITA on the MLP pipeline.[174] Selected portions of Exhibit NAV-68 are as follows:

		<c> Navajo witness Horst MLP with ITA	<d> SFPP witness Vander Weide MLP with ITA	Explanation
	Pipeline Investors			
1	New Equity Issued - $	$100.00	$100.00	Tr. 442, 445-47
2	Investors' Required After-Tax Rate of Return - %	9.78%	9.78%	Ex. SPE-215 at 3 ln.10
3	Investors' Marginal Tax Rate - %	30.0%	30.0%	Ex. SPE-215 at 3 ln.1
4	Investors' Required Before-Tax Rate of Return - %	*13.97%*	*9.78%*	<a> - <c>: #2 / (100% - #3) <d>: Ex. SPE-215 at 3 ln.2, n.1
5	Investors' Required Before-Tax Rate of Return - $	$13.97	$9.78	#4 x #1
	Pipeline Company			
6	Original Cost Equity Rate Base - $	$100.00	$100.0	#1 Tr. 442, 445-47
7	Cost of Equity - %	13.97%	$9.78%	#4 <d>: Ex. SPE-215 at 3 ln.4

[174] Exhibit No. NAV-68 builds upon Exhibit No. NAV-25 using the numerical assumptions in Exhibit No. SPE-215. *See* Ex. NAV-68; Ex. NAV-25; Ex. SPE-215.

8	Return on Equity in Cost of Service - $	$13.97	$9.78	#7 x #6
9	Tax Rate for Income Tax Allowance - %	30.0%	30.0%	Ex. SPE-215 at 3 ln.5
10	Income Tax Gross-Up - %	42.9%	42.9%	#9 / (100% - #9)
11	Income Tax Allowance - $	$5.99	$4.19	#10 x #8
12	Pipeline's Before-Tax Return - $	$19.96	$13.97	#8 + #11
13	Pipeline's Actual Tax Rate	0.0%	0.0%	Ex. SPE-107 at 26
14	Pipeline's Actual Tax	$0.00	$0.00	#13 x #12
15	Pipeline's Actual After-Tax Return	$19.96	$13.97	#12 - #14
	Capital-Attraction Test			
16	Pipeline's Actual After-Tax Return	$19.96	$13.97	#15
17	Investors' Required Before-Tax Rate of Return - $	$13.97	$9.78	#5
18	Capital-Attraction Test Ratio	1.429	1.429	#16 / #17
	Memo: Rate of Return			
19	Cost of Equity - %	13.97%	9.78%	#7
20	Pipeline's Actual After-Tax Return on Original Cost - %	19.96%	13.97%	#15 / #6
21	Market Value of Equity - $	$142.86	$142.86	#6 x (#20 / #19) <d>: Tr. 454-55
22	Market Value of Equity - $ / Original Cost Equity Rate Base - $	1.429	1.429	#21 / #6
23	Investors' Before-Tax Return on Stock Market Value - %	13.97%	9.78%	#15 / #21

Ex. NAV-68 (emphasis added).

164. In line four, witness Vander Weide uses a 9.78 percent required before-investor-tax return. Ex. NAV-68 at 1 col. <d> ln.4. The 9.78 percent return flows through Exhibit No. NAV-68 to produce a 6.85 percent after-investor-tax return. *Id.* at col. <d> ln.24. Alternatively, in line four, witness Horst uses a 13.97 percent required before-investor tax return. *Id.* at col. <c> ln.4. The 13.97 percent return flows through Exhibit No. NAV-68 to produce a 9.78 percent after-investor-tax return. *Id.* at col. <c> ln.24. Thus, Exhibit No. NAV-68 shows that SFPP used an artificially low required before-tax-return to justify this provision of an ITA to the MLP pipeline. N/W IB at 70.

165. It is not clear from this record whether the Commission has considered evidence similar to the evidence in this record in its prior decisions. What is clear is the prior Commission pronouncements on these issues. The Commission has decided that an ITA does not cause a pass-through entity to double-recover its income tax cost. December 2007 Order at P 52. The Commission stated that ITAs create an adequate after-corporate-tax return "to support the dividend stream at a pre-tax return satisfactory to the investor." *Id.* Further, the "dividend stream incorporated into the Commission's DCF model reflects the taxes paid at the entity level prior to the dividend payment . . . ." *Id.* Thus, the ITA recovers corporate-level taxes. *Id.* Alternatively, partnerships do not pay entity-level income taxes. *Id.* at P 53. The Commission explained that "distributions made to the partners represent pre-tax dollars and *without the income tax allowance would not equal the first tier after-tax return of a corporation that receives an income tax allowance on the same amount of net income*." *Id.* (emphasis added). The Commission further explained as follows:

> Thus, if distributions are utilized in the Commission's DCF model, these are not dividends for which a prior income tax allowance has been included in the cost of service, as is done with the corporate model. Rather, the income tax allowance compensates the partners for the tax cost of the distributions they receive and thus equalizes the after-tax cash flows that would be available from a corporation and are used as inputs to the DCF model. December 2007 Order at P 53 (footnote omitted).

The Commission therefore concluded that an ITA has a neutral impact on the DCF model. *Id.* Also, the discussion in the December 2007 Order is highly relevant because the evidence in this proceeding also addresses the "generic relationship" between SFPP's partnership structure and the DCF model. *See id.* ("[T]he issue here involves the generic relationship between partnership structures and the Commission's DCF model.").

166. Nevertheless, N/W makes several arguments in support of its position regarding the ITA. First, N/W argues that the Commission must reexamine the *ITA Policy Statement* based on the record in this proceeding. N/W acknowledge that the *ITA Policy Statement* provides that MLPs are entitled to recover the actual or potential income tax

liability of their investors. However, N/W contend that the *ITA Policy Statement* is not binding law because policy statements are not subject to notice and comment requirements under the Administrative Procedure Act. The Commission therefore must support the ITA policy as if the Commission never issued the *ITA Policy Statement*. *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 37-38 (D.C. Cir. 1974)). Further, N/W contend that the Commission predicated the *ITA Policy Statement* on the basis that without an ITA, oil pipelines will receive a lower after-tax return than a corporation. *ITA Policy Statement* at PP 24-27.[175] Challenging such basis, N/W states that the record evidence in this proceeding establishes that ITAs are unnecessary to ensure that MLP pipeline investors receive after-tax returns comparable to corporate pipeline investors.[176]

167. Second, N/W argue that unlike corporate pipelines, MLP pipelines do not require ITAs to attract sufficient capital. N/W explain that, regardless of business organization, regulated pipelines must receive sufficient investment capital to operate its business. In *Hope Natural Gas*,[177] the United States Supreme Court stated that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope Natural Gas*, 320 U.S. at 603. Investors examine the after-investor-tax return to determine whether the level of return is sufficient to attract capital (Capital Attraction Test). To attract capital, corporate and partnership pipelines must generate sufficient income to pass enough cash (dividends or distributions) to investors, allowing them (i) to pay income taxes on the cash, and (ii) to earn a sufficient level of after-investor-tax return.

168. The income tax liability of corporate and MLP pipelines is significantly different because corporations pay income taxes and MLPs do not pay income taxes. As the D.C. Circuit Court acknowledged, income tax costs are no different than any other cost item in the COS.[178] *BP West Coast*, 374 F.3d at 949. Corporate pipelines recover their income

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[175] *See also* December 2007 Order at P 53 ("The distributions made to the partners represent pre-tax dollars and without the income tax allowance would not equal the first tier after-tax return of a corporation that receives an income tax allowance on the same amount of net income.").

[176] N/W state that all witnesses in this proceeding agree that an ITA is unnecessary. (referencing Ex. NAV-1 at 33, 41-42; Tr. 2371; Ex. SPE-107 at 36; Tr. 242-243).

[177] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope Natural Gas*).

[178] The VCC Shippers point out that regardless of the business organization, fundamental principles of ratemaking dictate that pipelines do not receive cost allowances in their COS for costs not incurred.

tax liability in the ITA. The ITA provides corporate pipelines with sufficient cash (i) to pay corporate-level income taxes, and to pass enough cash to investors, allowing them (ii) to pay investor-level income taxes on the cash, and (iii) to earn their required after-investor-tax return. Ex. NAV-1 at 36-37; December 2007 Order at P 52.[179] If the Commission did not permit ITAs for corporate pipelines, they would earn their return via the DCF ROE. N/W contend that, in this circumstance, corporate pipelines would not attract sufficient investment capital because the Commission bases the DCF ROE on the cash received by investors. Such cash is the after-corporate-tax return or the pre-investor-tax return. Tr. 275. N/W state that without an ITA, corporate pipelines must pay taxes from revenues, thus leaving an insufficient amount of cash (dividends) to permit investors (i) to pay investor-level income taxes on the cash, and (iii) to earn their required after-investor-tax return. N/W stress that the ITA recovers corporate-level taxes and the ROE recovers investor-level taxes. Thus, they state that to attract capital, corporate pipelines require an ITA to recover the corporate-level income tax. *Id.* Alternatively, MLP pipelines do not require an ITA because no MLP-level income tax exists. N/W contend that the DCF ROE generates sufficient cash to corporate and MLP pipelines to pay the investor-level income taxes, and to provide the investors with their required return. *Id.* at 55-56.

169. N/W contend that the record evidence demonstrates that MLP pipelines do not require ITAs to attract sufficient capital. First, Navajo witness Horst and SFPP witness Vander Weide agree that MLP pipelines without an ITA "attract investment by providing a return to its investors sufficient to pay their taxes and earn their required after-tax return."[180] Ex. NAV-1 at 33, 41-42; Tr. 2371; Ex. SPE-107 at 36; Tr. 242-243. Second, in the SFPP West Line case, Docket No. IS08-390, SFPP witness Schink agreed with N/W's position that an MLP without an ITA recovers the same ROE as a corporation

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179 In the December 2007 Order, the Commission describes the purpose of the ITA for a corporation as it relates to the after-corporate-tax return and the after-investor-tax return. The Commission state as follows:

> It is true that the Commission affords corporations an income tax allowance so that the corporation's after-tax income is adequate to support the dividend stream at a pre-tax return satisfactory to the investor. As the *Policy Statement* [*ITA Policy Statement*] describes, after the necessary corporate return is determined, the Commission grosses up the return to cover the tax cost, thus assuring that the after-tax corporate return meets the investor's expectations of the corporation. December 2007 Order at P 52.

180 Witness Horst refers to the DCF ROE's provision of sufficient cash (i) to pay investor-level income taxes and (ii) to provide the required after-investor-tax return as a "built-in" tax allowance. Ex. NAV-1 at 33, 38.

with an ITA.[181] Exs. NAV-1 at 41-42; NAV-26 at 4-5. Third, Witness Vander Weide testified that the Commission can adopt a policy that allows MLP pipelines to recover income taxes via an ITA, or a policy that allows MLP investors to recover income taxes via the ROE. He agreed that under each policy, corporate and MLP investors receive the same after-investor-tax return, and the corporate and MLP pipelines attract sufficient capital investment. Tr. 243. Witness Vander Weide recommended a policy that allows MLP pipelines an ITA because ITAs are more transparent. Ex. SPE-107 at 38.

170. Fourth, N/W argue that SFPP witness Vander Weide's theory that MLP pipeline investors reduce their ROE to account for the ITA is unsupported because his theory only applies to purely regulated companies. According to witness Vander Weide, MLP investors recover their income tax liability through the ITA. They therefore reduce the ROE to prevent double recovery of their income tax liability. However, MLP investors cannot recover their income tax liability through an ITA for unregulated MLP operations because Commission-regulated rates with an ITA do not exist for unregulated operations. Thus, MLP investors will not reduce their required return for unregulated MLP operations. In this proceeding, SFPP, KMEP, and the pipelines in KMEP proxy group have substantial unregulated operations, in addition to their regulated operations. Ex. NAV-7 at 16; Ex. VCC 114 at 2; Ex. VCC 115 at 3; Ex. VCC-116 at 3; Tr. 286. 381. Yet, witness Vander Weide's theory assumes that each pipeline in the ROE proxy group derives its revenue from cost-based rates. Thus, his theory applies only to purely regulated pipelines. Even if the Commission grants MLP pipelines ITAs for regulated operations, no evidence suggests that MLP investors in pipelines with mixed operations will reduce their required after-tax returns to account for ITAs. In fact, witness Vander Weide acknowledged that he did not consider the application of his theory to companies with a mix of regulated and unregulated operations. Tr. 288.[182]

171. The evidence in this case demonstrates that the Commission's DCF ROE (pre-tax to investors)[183] will set to a level sufficient to attract investor capital. Or stated another

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181 In the West Line case, witness Schink testified that the ITA properly allowed SFPP to retain cost savings attributable to the MLP form. Ex. NAV-26 at 7-10).

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"Q So for that portion of the enterprise, the investors are going to want enough return to cover their income taxes without reference to the fact that an income tax allowance is being provided on the regulated enterprise; right?

A [SFPP witness Vander Weide] I did not consider the unregulated operations." Tr. 288.

183 As Dr. Horst testified, the DCF ROE includes an embedded allowance to cover the cost

(continued)

way, the DCF ROE will be sufficient after investor income taxes, to attract investor capital. Based on the above it is found that the testimonies of witness Horst and O'Loughlin are entitled to significant weight. Their evidence provided in this proceeding shows that ITAs cause MLPs to double recover their taxes. First, MLP investors with an ITA receive approximately 50 percent more money than is necessary to pay investor-level income taxes and to earn the required after-investor-tax return. Two, the equity market value of the MLP with an ITA is approximately 50 percent greater than the original cost equity rate base.[184] Further, the evidence in this case demonstrates the income tax allowance for MLPs does not equalize the after tax returns from a corporation and investors in an MLP. However, based on clear previous Commission pronouncements on these issues the matter is resolved in SFPP's favor.

<u>ISSUE III.B – What is the Appropriate Income Tax Allowance?</u>

172. SFPP proposes an ITA of $9,293,000. SFPP calculated the ITA as discussed *supra* at ISSUE III.A. N/W state that SFPP is not entitled to an ITA for the reasons discussed at ISSUE III.A *supra*. If the Commission grants SFPP an ITA, N/W propose that the Commission calculate the ITA using a weighted average tax rate of 31.64 percent, discussed at ISSUE III.E *infra*. The VCC Shippers propose an ITA of $2.7 million. Their calculation of the ITA is discussed *infra* at ISSUE III.E. Although Staff takes no position on this issue, Staff uses SFPP's 36.12 percent blended federal and state income tax rate and 56.53 percent net-to-tax multiplier to calculate the ITA.

<u>Discussion/Findings</u>

173. SFPP is hereby directed to calculate the appropriate ITA according to the findings *supra* at ISSUE II.J and ISSUE III.A, and *infra* at ISSUE III.C, ISSUE III.D, ISSUE III.E, ISSUE III.F, and ISSUE III.G.

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of income taxes to investors. Ex. NAV-1 at 33:10-14, 17-22, 35:12-39:11; NAV-25 at 1, column b. SFPP's witness Dr. Vander Weide conceded that an MLP can recover the investor income taxes through the DCF ROE, which yields to the pipeline an after-investor-tax return required by investors in the marketplace. Ex. SPE-107 at 36:11-14; 37:8-12. According to Dr. Vander Weide, the partners in an MLP without the ITA recover their income taxes by demanding a higher before-tax required return on investment. Ex. SPE-107 at 37:8-12; Tr. 242:17-25.

[184] The MLP with an ITA has a substantially higher revenue requirement than a MLP without an ITA. This is because the MLP with an ITA is charging both an ITA and a DCF ROE. The greater revenue requirement drives up stock prices until equilibrium is reached (the point at which the before and after-tax ROEs to investors are equal to the level required by investors. Ex. NAV-26. These higher rates are borne by ratepayers.

ISSUE III.C - Accumulated Deferred Income Taxes (ADIT)

174. SFPP contends that its proposed Accumulated Deferred Income Taxes (ADIT) calculation comports with the December 2007 Order. If the Commission grants SFPP an ITA, N/W propose to increase the ADIT amount to reflect the deferral of state income tax costs associated with accelerated depreciation. Alternatively, if the Commission denies SFPP an ITA, N/W propose to credit the ADIT amount to SFPP ratepayers. VCC Shippers contend that SFPP's ADIT amount is overfunded. They therefore recommend that SFPP amortize the overfunded balance to SFPP ratepayers in prospective rates. Although Staff takes no position on this issue, Staff adopts SFPP's ADIT calculation.

Discussion/Findings

175. The Commission requires pipelines to subtract ADIT from rate base. December 2007 Order at P 140. ADIT represents the tax effects of timing differences between straight-line depreciation used by the Commission for ratemaking purposes and accelerated depreciation used by pipelines for income tax purposes. *Id.*;[185] 18 C.F.R. § 346.2(c)(4)-(5) (2010). This is because, for ratemaking purposes pipelines depreciate their assets on a straight-line basis. However, for tax purposes, they typically depreciate their assets on an accelerated basis. Thus, pipelines' actual income tax liability is lower than the amount recovered in the ITA. Pipelines accumulate the difference between the ITA and their actual income tax cost in the ADIT account. The Commission recognizes that ratepayers fund the ADIT account. It therefore requires that pipelines subtract the ADIT amount from rate base. *Kern River Gas Transmission Co.*, 123 FERC ¶ 61,056 at P 269 (2008) ("Commission policy requires a regulated firm to adjust its rate base to reflect the timing difference between the receipt of cash flows generated by the income tax component of its rates and the timing of its actual tax payments."); *Kern River Gas*

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185 In the December 2007 Order, the Commission describes the ADIT allowance as follows:

> [I]f the pipeline accelerates depreciation, this increases operating expenses in the early years of an investment and reduces the carrier's income and the tax liability that is incurred in that year for IRS purposes. However, the income tax allowance embedded in the carrier's rates is constant. Therefore, that particular year would generate more cash flow than is actually required to meet the income tax liability created by the carrier's IRS income. Th[is] results in an income tax deferral until the rate base declines to a point where the depreciation rate in later years is less than the regulatory rate, at which time there is more IRS income than income under the Commission's accounting methodology. At that point the income tax deferral is amortized as the income tax payments accelerate. The Commission requires the carrier to reduce its rate base by the amount of the deferred tax income liability to recapture the additional return the carrier can earn on the cash generated by the deferred income tax liability. December 2007 Order at P 140.

Transmission Co., 117 FERC ¶ 61,077 at P 228 (2006) (Opinion No. 486); *SFPP, L.P*., 86 FERC ¶ 61,022 at 61,092 (1999). The Commission also recognized that the ADIT calculation accounts for federal and state income taxes. Specifically, the Commission stated that the "ADIT accounts reflect the timing differences between a company's revenue and expense booked for income tax purposes. Timing differences, *multiplied by appropriate Federal and state tax rates*, represent ADIT and a rate base reduction." Opinion No. 486 at P 224 n.330 (emphasis added). In this manner, the ADIT normalizes the ITA collected in rates.[186]

176. N/W contends that the ADIT calculation must account for the deferral of state and federal income taxes. They explain that SFPP includes state and federal income taxes in the ITA. However, SFPP does not include state income taxes in the ADIT calculation. N/W therefore states that SFPP's ADIT calculation is understated. Ex. NAV-1 at 4, 106-107. N/W also state that SFPP witness Ganz did not explain why he excluded state income taxes from the ADIT calculation. Rather, witness Ganz simply stated that he followed the approach that SFPP has used "since the Opinion 435 compliance filings . . ." Tr. 2156. He also acknowledged that in the compliance filings, the Commission did not preclude inclusion of state income taxes in the ADIT calculation. Tr. 2156. N/W also note that witness Ganz included state income taxes in the ADIT calculation in a prior case, Docket No. OR03-5-001. *Id.*

177. SFPP responds that the Commission does not require the ADIT amount to reflect state income taxes December 2007 Order at PP 140-141. SFPP also states that N/W's proposal is improper because the relevant states adopted different depreciation elections under the ITA. For instance, some states adopted less-accelerated depreciation methods. Further, using current income tax rates misstates historical balances because federal and state income tax rates changed over time. Ex. SPE-32 at 8. SFPP states that if the Commission reflects state income taxes in the ADIT calculation, a more detailed analytical approach is necessary. Ex. SPE-154 at 28-29.

178. N/W propose specific adjustments to SFPP's ADIT calculation. Specifically, Navajo witness Horst recommends replacing SFPP's weighted-average federal income

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186 Navajo witness Host describes the Commission's ADIT policy as follows:

> The Commission's policy is referred to as income tax normalization. In a nutshell, the pipeline is provided an income tax allowance as if its return on equity were fully taxable in the current year. Deferred income taxes are added to the pipeline's ADIT balance, which is offset against the pipeline's rate base. Because the rate base is reduced, the economic benefit of the income tax deferral ultimately results in lower tariffs for the pipeline's shippers, not a higher rate of return for the pipeline's owner. Ex. NAV-1 at 59.

tax rate with a weighted-average combined tax rate. Ex. SPE-34 at 96. He multiplied SFPP's ADIT amount by a 1.032 fixed adjustment factor. Ex. NAV-1 at 110. The adjustment factor is the ratio of the 36.12 percent weighted state and federal income tax rate to the 35 percent federal income tax rate for KMI and its corporate subsidiaries. *Id.*; Ex. SPE-34 at 96 col. (d), lns. 4, 2. Witness Horst changed SFPP's ADIT amount by adjusting line 12, and adding lines 12A and 12B to Statement E of the SFPP COS Ex. NAV-38 at 8-9 lns. 12, 12A, 12B. SFPP did not propose an ADIT calculation that accounts for state income taxes.

179. VCC Shippers contend that SFPP's ADIT amount is overfunded because SFPP has collected revenues through the existing East Line ITA using a 35 percent corporate income tax rate. The VCC Shippers believe that the proper income tax rate equals 9.34 percent, not 35 percent. *Id*. They therefore recommend that SFPP amortize the overfunded portion of the ADIT account to ratepayers on a prospective basis.[187] Ex. VCC-78hc at 63-63. SFPP responds that in Docket Nos. OR03-5-000, *et al.*, OR03-5-001, and IS08-390-002, VCC Shippers witness O'Loughlin conceded that SFPP witness Ganz' calculation of the weighted income tax rates complied with the December 2007 Order, while witness O'Loughlin's own calculation did not comply. SFPP points out that in those proceedings and this proceeding, the VCC Shippers calculated the weighted income tax rates in the same manner. SFPP thus concludes that witness O'Loughlin's concession in the prior proceedings is contrary to VCC Shippers' objection to SFPP's ADIT calculation in this proceeding. Ex. SPE-154 at 9-10; Ex. SPE-155.

180. VCC Shippers' concerns are addressed in the discussion of Issue III.E *infra*. The testimony of Navajo's witness Horst concerning this issue is given significant weight. Therefore, it is found that SFPP's ADIT calculation does not comport with Commission policy because it does not reflect state income taxes. Accordingly, SFPP is hereby directed to adjust its ADIT calculation to reflect the deferral of federal and state income tax costs associated with accelerated depreciation. Also, SFPP is hereby directed to calculate the marginal income tax rate for the ADIT calculation pursuant to the findings regarding the marginal income tax rate for the ITA calculation *supra* at ISSUE III.B, at ISSUE III.C, and *infra* at ISSUE III.D, ISSUE III.E, ISSUE III.F, and ISSUE III.G

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187 If the Commission does not grant SFPP an ITA, N/W also recommend that SFPP refund the ADIT amount to SFPP ratepayers. N/W explain that without an ITA, the ADIT no longer serves a normalization function between taxes collected and taxes paid. Thus, the entire ADIT amount is effectively overfunded. *Williston Basin Interstate Pipeline Co.*, 67 FERC ¶ 61,137, at 61,365-66 (1994).

ISSUE III.D – How Should the "Taxable Income" of SFPP and SFPP Partners Be Determined?

181. SFPP, N/W, VCC Shippers, and Staff's positions are summarized *infra* at ISSUE III.E.

Discussion/Findings

182. ISSUE III.D and ISSUE III.E are addressed collectively *infra* at ISSUE III.E.

ISSUE III.E - How Should the "Tax Rate" for the Relevant Partners Be Determined and What Is the Appropriate Weighted Average Income Tax Rate To Calculate the Income Tax Allowance?

183. SFPP proposes to calculate the taxable income and tax rate for SFPP and SFPP partners as discussed *supra* at ISSUE III.A. SFPP sets forth its proposed 2008 taxable income on line one of its 2008 Form 1065. SFPP also proposes a 36.11 percent weighted average federal income tax rate used to calculate the ITA. N/W propose that SFPP use a 31.64 percent weighted average federal and state income tax rate. VCC Shippers propose that SFPP use a 9.34 percent weighted average federal and state income tax rate. Specifically, VCC Shippers propose a zero percent marginal income tax rate for individuals, mutual funds, pension funds, and UBIT entities because the ROE includes an allowance for the income tax cost of non-corporate unitholders.[188] N/W and VCC Shippers oppose SFPP's calculation of the weighted average income tax rate in two respects. First, they contend that SFPP improperly calculated the weighted average income tax rate by using a provision in the KMEP partnership agreement which allocates incentive distributions to KMEP's general partner (KMGP). Second, they contend that SFPP incorrectly classified the KMEP unitholders to determine the weighted average income tax rate. N/W also proposes to adjust the weighted average income tax rate to account for the deferral of federal and state income taxes by public KMEP unitholders, as discussed *infra* at ISSUE III.F. Staff takes no position on this issue.

Discussion/Findings

184. SFPP is a limited partnership, and does not pay taxes. SFPP allocates taxable income to Kinder Morgan Energy Partners (KMEP) limited partners; Kinder Morgan General Partner (KMGP) from KMEP; KMGP from Kinder Morgan Operating L.P. (OLP-D) and Santa Fe Pacific Pipelines, Inc. (SFPP Inc.). Ex. SPE-36C at 3; Ex. NAV-

188 As discussed in detail *supra* at ISSUE III.A, the DCF methodology bases the ROE on distributions that incorporate an investor-level income tax component and a required after-investor-tax return component commensurate with the MLP's risk level. Ex. VCC-78c at 44-46.

1C at 61-62. KMEP is a master limited partnership, and also does not pay taxes. Rather, KMEP unitholders pay taxes on their allocated share of SFPP income and deductions. *Id.* at 7. KMGP is the general partner of both OLP-D and KMEP. Ex. SPE-37.

185. SFPP uses a provision[189] in the KMEP partnership agreement to determine the weights used to calculate the weighted income tax rate. The provision states that KMEP shall allocate income to the general partner (KMGP) "until the amount equals the 'incentive distributions' made to the general partner." Ex. SPE-22 at 35. Such gross income is taxable to the general partner for federal and state tax purposes. Ex. SPE-32 at 19. According to the partnership agreement, cash distributions to KMGP above the KMGP one-percent ownership interest are "incentive distributions". Ex. SPE-32 at 15-16. Further, the partnership agreement allocates KMGP one dollar of taxable income for every dollar of incentive distribution received. Tr. 2136-37. In effect, KMEP distributes an increasing percentage of total distributions to KMGP as the total cash distributions increase. Ex. SPE-32 at 15-16. Thus, SFPP believes that the ITA calculation should reflect the incentive distribution. *Id.* at 19.

186. Pursuant to the provision, SFPP allocated more than 100 percent of SFPP 2008 taxable income to SFPP Inc. and KMGP. Id. at 18-20; Ex. SPE-36C at 1; Ex. VCC-78hc at 35. In turn, SFPP allocated negative percentages of SFPP 2008 taxable income to the six unitholder categories. Ex. SPE-36C at 1; Ex. SPE-37C; Ex. VCC78hc at 36-37. For instance, SFPP allocates a negative percentage of SFPP 2008 taxable income to the "individuals" category even though this category owns more than one half of KMEP. Ex. SPE-36C at 1; Ex. VCC-78hc at 37 Figure 14. Because the allocation to SFPP Inc. and KMGP exceeds 100 percent, SFPP witness Ganz' allocates 100 percent of SFPP 2008 taxable income to SFPP Inc. and KMGP and zero percent to the six unitholder categories. Ex. SPE-32 at 18;[190] Ex. SPE-36C at 1; Ex. VCC-78hc at 37 Figures 14; VCC IB at 14;

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[189] The relevant provision in the KMEP partnership agreement regarding incentive distributions from KMEP to KMGP states as follows:

> After the application of Section 5.1(d)(iii)(A), all or any portion of the remaining items of Partnership gross income or gain for the taxable period, if any, shall be allocated 100% to the General Partner, until the aggregate amount of such items allocated to the General Partner pursuant to paragraph 5.1(d)(iii)(B) for the current taxable period and all previous taxable periods is equal to the cumulative amount of all Incentive Distributions made to the General Partner (or its assignee) from the Closing Date to a date 45 days after the end of the current taxable period. Ex. SPE-222 at 35.

[190] *See* Ex. SPE-32 at 18 ("Because the percentage of SFPP's taxable income allocated to SFPP, Inc. and KMGP exceeds 100 percent, I have used 100 percent for that category, and 0 percent for all other categories, for purposes of weighing the income tax rates . . . .").

SFPP IB at 47. In such manner, SFPP assigns the highest federal income tax rate to all SFPP cash distributions. VCC IB at 14; Ex. VCC 78hc at 37; N/W IB at 79; Ex. NAV-1 at 66.

187. N/W contend that SFPP's allocation method is complicated and results oriented. SFPP calculates the weighted average income tax rate in four steps. *See* Ex. NAV-1 at 65. In step one, witness Ganz computed SFPP taxable income from gross income and deductible expenses, and apportioned the income between SFPP's two partners, OLP-D and SFPP Inc. Ex. SPE-36C at 3; Ex. NAV-1C at 61. In step two, witness Ganz apportioned OLP-D taxable income from SFPP to OLP-D's two partners, KMEP and KMGP, on the basis of OLP-D's allocation of taxable income to its partners. OLP-D's allocation of taxable income to KMEP and KMGP corresponds with OLP-D's capital ownership, ordinary income, and cash distributions. Ex. SPE-36C at 3; Ex. NAV-1C at 61-62. In steps three and four, witness Ganz apportioned KMEP's taxable income from SFPP to KMEP partners. Specifically, he allocated the KMEP income from SFPP to the portion of the incentive distribution attributed to SFPP's taxable income. Witness Ganz attributed only a portion of the incentive distribution to SFPP taxable income because the incentive distribution from KMEP to KMGP originates from various sources in addition to SFPP. He attributed the incentive distribution on the basis of SFPP ordinary income to KMEP ordinary income. Ex. SPE-36C at 3; Ex. NAV-1C at 62. Then, witness Ganz allocated the remaining KMEP income from SFPP to the remaining KMEP partners. Ex. SPE-36C at 3; Ex. NAV-1C at 62-63.

188. As N/W and VCC Shippers correctly argue, such approach produces a nonsensical result: the SFPP income allocated from KMEP to KMGP (attributable to the incentive distribution) exceeds the SFPP income allocated from OLP-D to KMEP. As a matter of fact, SFPP's premise is founded on an incorrect assumption: that the amount of taxable income allocated to SFPP Inc. and KMGP exceeds 100 percent of SFPP's income. Indeed, SFPP allocates 141.5 percent of SFPP's taxable income to SFPP Inc. and KMGP. Ex. SPE-36C at 1. As discussed above, witness Ganz therefore allocated a negative amount of SFPP taxable income to the other KMEP partners. Ex. SPE-32 at 18-20; Ex. SPE-36C at 3; Ex. SPE-222 at 95 n.3; Ex. NAV-1C at 63; Ex. NAV-36C at 3; Ex. VCC-78hc at 35. Or stated in other words, SFPP adjusted the weight of the tax rates attributed to all other unitholders to zero. Ex. NAV-1C at 63:1-64:6 (Horst). However, assigning certain KMEP partners with negative amounts of SFPP taxable income produces a weighted income tax rate higher than the constituent tax rates. Ex. SPE-32 at 19; Ex. NAV-1C at 63-64, 64 n.14. Faced with such result, witness Ganz allocated 100 percent of SFPP taxable income to KMGP and SFPP Inc. Ex. SPE-32 at 19-20; Ex. SPE-36C at 1; SPE-222 at 95 ln.4; NAV-1C at 64. In such manner, SFPP improperly assigns a 35 percent tax rate (the highest federal income tax rate) to all SFPP income or all the SFPP income is treated as corporate unitholders.

189. N/W correctly argue that SFPP's allocation method fails to account for the actual or potential income tax liability of KMEP unitholders for two reasons. One, as discussed above, the allocation method assigns KMGP and SFPP Inc. more than 100 percent of SFPP taxable income. Such result causes witness Ganz' to assign improperly a zero percent tax rate to all other KMEP unitholders. *Id.*; Ex. SPE-36C at 1; Ex. NAV-1C at 63-64. Two, witness Ganz improperly based the allocation of SFPP income on 2008 taxable income. Ex. NAV-1C at 69. For instance, the allocation method reflects only SFPP taxable income earned *and* taxed in 2008. Thus, the allocation method excludes SFPP income earned in 2008 and taxed in a subsequent year.

190. As N/W state the proper basis of the ITA is the SFPP taxable income derived from the pre-tax ROE, not the SFPP taxable income reported in the current year. SFPP's pre-tax ROE exceeds income taxable in the current year because KMEP unitholders reduce the pre-tax ROE by accelerated depreciation and Section 743(b) depreciation, which serve to defer their income tax liability to subsequent years, until the sale of the units as discussed *infra* at ISSUE III.F. Thus, KMEP unitholders do not incur an actual or potential income tax cost in 2008. Rather, KMEP unitholders incur income tax cost on SFPP income when they sell KMEP units.[191] In effect, the use of only 2008 SFPP taxable income in the allocation method and KMEP unitholders' deferral of their tax cost on 2008 SFPP taxable income enable SFPP to disregard KMEP unitholders' lower income tax rates in the weighted average income tax calculation. Thus, N/W is correct that SFPP severs the connection between the allocation method and the SFPP income on which the ITA is calculated. SFPP in effect ignores the taxable income recognized by

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[191] N/W explain that public KMEP unitholders that receive cash distributions and that receive allocated losses in a particular year have potential income tax liability when the unitholders sell their units. For instance, Navajo witness Horst testified that "[c]ash distributions other than incentive distributions reduce a partner's tax basis (but not below zero) in its partnership units and result dollar-for-dollar in taxable ordinary income when and if the units are sold." Ex. NAV-1C at 68 (citing Ex. NAV-23 at Tables 1 and 3). However, under certain circumstances, public KMEP unitholders can incur an income tax liability in the year that they receive the distributions. Specifically, witness Horst testified that "[i]f a partner's tax basis has already been reduced to zero by cumulative distributions received and tax loss allocations in prior periods, further cash distributions result in taxable ordinary income in the year the distributions are received." Ex. NAV-1C at 68. SFPP witness Ganz acknowledged that KMEP unitholders incur tax liability on the cash distributions received from KMEP. Specifically, he testified that "over the life of the partnership each partner will be subject to tax on an amount of income equal to the amount of cash he receives . . . from or with respect to the partnership interest in excess of the amount of cash he paid for that interest." Tr. 2148. He further testified that KMEP public unitholder "get taxed on an economic value that you can reconcile to the cash distributions." Tr. 2149. However, Ganz does not assign any weight to the lower tax rate of KMEP public partners, but does assign 100 percent weight to its corporate general partner and its corporate affiliates.

public unitholders at the time of the sale of their units and as a result does not give weight to the weighted average income tax rate of the public unitholders, many of whom are individuals and entities that have marginal tax rates below the 35 percent of corporate partners such as SFPP Inc. and KMGP.

191. Navajo's witness testimony is given significant weight. N/W's allocation method better accounts for the actual and potential income tax liability of all KMEP unitholders or all categories of investors because it more accurately allocates SFPP income in proportion to the distributions received by SFPP unitholders.[192] The ITA should reflect the tax costs on all distributions because the IRS taxes all distributions at some point. *ITA Policy Statement* at P 1.[193] In the December 2007 Order, the Commission affirmed certain basic principles in the *ITA Policy Statement*. December 2007 Order at P 46. For instance, the Commission affirmed that "the proper distributive income to be used in determining the weighted marginal tax cost is that of the partners that ultimately received that income." *Id.* The Commission explained that the marginal income tax rate is "properly determined based on the relative amounts of income allocated to these various partners based on their relative shares." December 2007 Order at P 46. Such determination is accomplished in two steps. First, SFPP must determine the amount of SFPP income flows to KMEP. Second, SFPP must make an allocation within KMEP based on the relative share of KMEP income allocated to each of the different categories of KMEP partners since at that level the tax burden incurred is based on the distributive KMEP income made to the KMEP partners. Accordingly, it is found that SFPP's methodology in its tariff filing does not comply with prior Commission orders contrary to its representations.

192. Consistent with the Commission principles, Navajo witness Horst weighted each partner's tax rate in proportion to the actual distributions that they receive. Ex. NAV-1C at 66; Ex. NAV-29 at 1, 3. He calculated the weighted average income tax rate in four steps. In step one, witness Horst apportioned SFPP income to OLP-D and SFPP Inc. in proportion to their cash distributions from SFPP. Ex. NAV-1C at 66; NAV-29 at 3. In step two, witness Horst apportioned OLP-D taxable income from SFPP to KMGP and KMEP limited partners in proportion to their *actual* cash distributions. He based the actual cash distributions on the KMEP 2009 SEC Form 10-K. Ex. NAV-1C at 66-67; Ex. NAV-7 at 144; Ex. NAV-29 at 3 lns.2-5.

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192 N/W state that "actual" income tax costs are taxes paid in the year that income is received and that "potential" income tax costs are taxes deferred until the sale of partnership units.

193 *ITA Policy Statement* at P 51 ("The Commission concludes that such an allowance should be permitted on *all* partnership interests, or similar legal interests, if the owner of that interest has an actual or potential income tax liability on the public utility income earned through the interest." (emphasis added))

193. In step three, witness Horst apportioned, on the basis of distributions the income allocated to KMEP limited partners among KMEP units owned by KMI and its affiliates and KMEP units owned by the general public. Ex. NAV-1C at 67; Ex. NAV-7 at 183; Ex. NAV-29 at 3 lns.6-7. In step four, witness Horst apportioned the income allocated to the public KMEP unitholders among the categories of unitholders on the basis of distributions. These categories are corporation, individuals, mutual funds, etc. Ex. NAV-1C at 67; Ex. NAV-29 at 3 lns.8-10; Ex. NAV-46. This method takes into account the fact that the cash distributions from SFPP exceed its taxable income on those distributions in a given year. Accordingly, this allocation method better accounts for the actual and potential income tax liability of all KMEP unitholders and allocates income on a *pro rata* basis to all category of investors. Therefore, SFPP is ordered to follow this methodology in its compliance filing. In other words, SFPP is ordered to account for all its unitholders

194. According to VCC Shippers the appropriate weighted average federal and state income tax rate for SFPP is 9.34 percent.[194] VCC Shippers dispute the calculation of SFPP and SFPP partners' taxable income in three respects. First, VCC Shippers state that SFPP's allocation of SFPP taxable income to OLP-D, KMEP, and ultimately KMEP unitholders is a hypothetical exercise. VCC Shippers witness O'Loughlin stated that SFPP cannot evaluate tax returns or other "ordinary-course" business documents to trace accurately SFPP taxable income. Ex. VCC-78hc at 34. SFPP witness Ganz agreed, testifying as follows:

> [I]t's difficult looking at a tax return to say how much income of OLP[-]D that was flowed through to KMEP and the general partner and all of the unitholders, how much of that is SFPP income. Once it gets to OLP[-]D, it is combined with non[-]SFPP income. So what you see on the tax returns makes it difficult to distinguish SFPP income.

Ex. SPE-156 at 7. VCC Shippers thus argue that SFPP did not base its effort to trace SFPP 2008 taxable income on business records. Rather, SFPP imputed SFPP 2008 taxable income only for purposes of this proceeding.

195. Second, VCC Shippers also criticize SFPP's allocation of SFPP income. Specifically, VCC Shippers contend that SFPP over-allocated SFPP 2008 taxable income to the subchapter C corporation category by incorporating incentive distributions to the six unitholder categories. This distorts the calculations and over allocates taxable income to the subchapter C corporation class, the group with the highest marginal tax rate. Based on the incentive distributions more than 100 percent of SFPP's taxable income was allocated to the SFPP, Inc and KMGP. Resulting in five of the six ownership categories

194 The VCC Shippers aver that the ITA should be $2.7 million.

receiving a 0 percent weight.[195] According to VCC Shippers, such allocation method is contrary to Commission precedent. *Compare* Ex. SPE-32 at 20 *with* December 2005 Order at PP 29-32. For instance, although the Commission stated that allocation of SFPP taxable income does not affect the partnership's total taxable income, the allocation can affect the marginal income tax rate applied to the partnership's total taxable income. December 2005 Order at P 26.[196] The VCC Shippers suggest that determination of the ownership weights and corresponding marginal income tax rates serves no purpose if SFPP can re-allocate SFPP taxable income to the unitholder category with the highest marginal tax rate. They also assert that under SFPP witness Ganz' allocation methodology, KMEP's cash distribution policy, rather than Commission policy, dictates the ITA level.

196. Third, VCC Shippers state that SFPP's failed to adhere to the Commission's stand-alone tax policy in developing its ITA and in calculating the level of SFPP taxable income allocated to KMGP. In essence by including non jurisdictional income pursuant to the incentive distribution. The VCC Shippers assert that SFPP relies on all KMEP-subsidiary generated income flowed into KMEP's incentive distribution rather than just SFPP's. SFPP witness Ganz agreed that the incentive distributions include non-SFPP operations. Ex. VCC-96.

197. As discussed *infra* at ISSUE III.F, under the stand-alone tax policy, the Commission develops an ITA based on the operations of the pipeline, rather than the operations of pipeline affiliates. December 2007 Order at PP 40-41; 2006 Sepulveda Order.[197] Contrary to the stand-alone tax policy, SFPP considers income from all KMEP

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195 VCC Shippers refer to the six ownership categories described in the Commission's December 2005 Order.

196 In the December 2005 Order, the Commission states as follows:

> However, to the extent that income, deductions, and credits are allocated among the partners, this does not affect the total taxable income of the partnership reported on the partnership's 1065 information return it files with the Internal Revenue Service, the annual report it must file with the Commission, or the collective income tax liability of the partners. December 2005 Order at P 26.

197 In the 2006 Sepulveda Order, the Commission explained its stand-alone tax policy as follows:

> At bottom, the stand-alone method provides that the tax allowance for a regulated entity will be determined by looking at the net income of the regulated entity, but excludes non-jurisdictional income or losses generated by the regulated entity and all the losses and income of any affiliate or the corporate parent. The fact that a jurisdictional operating entity may have losses from other activities that offset its

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subsidiaries in the incentive distribution scheme. The VCC Shippers explain how use of incentive distributions violates the stand-alone policy as follows:

> The total amount of "incentive distributions" determines the percentage share of KMEP taxable income assigned to the general partner. That percentage share of taxable income assigned to the general partner is assumed to be the same for SFPP's taxable income, but the percentage share of taxable income assigned to the general partner is not based on the cash flow generated by SFPP on a stand-alone basis. By relying on the percentage of taxable income allocated to the general partner, KMGP, as a result of *aggregate* KMEP subsidiary activity, the level of SFPP taxable income imputed to the general partner is inflated from the level which would be applicable if SFPP were analyzed on a "stand-alone" basis (*i.e.*, without the influence of any affiliate operations whose financial performance varies from year-to-year).

Ex. VCC-94; Ex. VCC-95.

198. The evidence demonstrates that SFPP's reliance on cash flow from all KMEP subsidiaries to KMGP inflates the percentage of SFPP 2008 taxable income allocated to KMGP. More appropriately, SFPP should rely on cash flow only from SFPP to KMGP to calculate the percentage of SFPP 2008 taxable income allocated to KMGP. In fact, SPFF witness Ganz acknowledged that non-SFPP operations affect KMEP's incentive distributions. Ex. VCC-96. The Commission also acknowledged that incentive distributions affect that allocation of income to the general partner. December 2007 Order at PP 55-56.[198] However, in the December 2005 Order, the Commission considered the circumstance in which the general partner's allocated income amount exceeds the income amount reported on the partnership return, leaving limited partners with tax deductions for the losses incurred.[199] The Commission recognized that

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> jurisdictional income or that the operating entity's income may be offset by losses on the part of a parent company or an affiliate will not affect the amount of an income tax allowance. Thus, that amount is calculated by determining the marginal tax rate that applies to the regulated income of the entity. 2006 Sepulveda Order at P 56.

[198] December 2007 Order at P 56 ("While all of the $ 20,000 in partnership gross operating income has been recognized, much of the tax burden has been shifted to the general partner.").

[199] Specifically, SFPP believes that SFPP witness Ganz' approach comports with the following language in the December 2005 Order:

> [I]f income is shifted from one type of ownership interest to another, the weighted average of the differing partnership interests could change resulting in a different

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allocations of income, deductions, and credits among the partners do “not affect the total taxable income of the partnership reported on the partnership’s 1065 information return it files with the Internal Revenue Service, the annual report it must file with the Commission, or the collective income tax liability of the partners.” December 2005 Order at P 26. Contrary to SFPP’s assertions the Commission did not acknowledged that partners have an income tax liability on 100 percent of SFPP’s income from non-jurisdictional sources because any losses allocated to the KMEP limited partners are offset by increases in income tax liability of the KMEP general partner, KMGP. Ex. SPE-32 at 19-20. The finding that SFPP must follow the stand alone policy reconciles all Commission decisions (December 2005, December 2007 and the stand alone policy).

199. VCC Shipper’s witness O’Loughlin calculated the 2008 taxable income flowing from SFPP to KMEP on a stand alone basis. Under this correct calculation SFPP’s distributions result in no incentive distributions to KMGP (less than the amount assumed by SFPP in its rate filing).[200] Exs. VCC-78hc at 39- 41 Figure 15; VCC-97c. This testimony comports with Commission precedent and is given significant weight. Accordingly, SFFP is ordered to develop its weighted marginal tax rate and ITA based on the allotted taxable income that results from applying KMEP’s incentive distribution solely based on SFPP’s income level for the relevant tax year.

200. N/W propose to reclassify 19 KMEP unitholders based on Navajo witness Meyer’s review of SFPP witness Utay’s classification of KMEP unitholders owning 100,000 units or more. Witness Meyer reviewed publically available information to determine the proper classification of KMEP unitholders. Ex. NAV-41C at 9; Ex. NAV-45C. Meyer incorporates the 19 reclassifications into the revised ownership percentages of the KMEP unitholder categories. *See* Ex. NAV-46. Navajo witness Horst, in turn,

> tax allowance for the operating entity, in this case SFPP. The Commission concludes that it is SFPP’s prerogative to allocate income and losses among its partners as it determines as long as the maximum tax rate imputed to individuals does not exceed the maximum corporate rate. Given this, under the Policy Statement, the maximum impact on the ratepayers is the same whether the regulated assets are controlled by a corporation or a partnership. Thus, if all partners are corporations at the maximum tax bracket, then the regulated entity’s rates would be based on the maximum possible tax allowance. December 2005 Order at P 43.

[200] The total amount of incentive distributions determines the percentage share of KMEP taxable income allocated to the general partner. This percentage is assumed to be the same for SFPP’s taxable income, but the percentage share of taxable income assigned to the general partner is based on the cash flow generated by the aggregate KMEP subsidiary activity. Thus the level of SFPP taxable income imputed to the general partner is inflated as opposed to SFPP’s income on a stand alone basis. Exs. VCC-94 and 95.

incorporates the revised ownership percentages in his calculation of the weighted average income tax rate. *See* Ex. NAV-29 at 3 ln.8, 1 ln.5.

201. Witness Utay relied on information provided by Wall Street Concepts (WSC), Automated Data Processing (ADP), and other firms to determine whether SFPP and PricewaterhouseCoopers (PWC) classified KMEP unitholders accurately. Based on such information, witness Utay disagreed with 13 of witness Meyer's proposed reclassifications. Ex. SPE-124 at 2; Ex. NAV-45C. As N/W noted, SFPP receives the classification data from the actual KMEP unitholders. SFPP believes that the classification data is reliable because each unitholder certified its classification to its nominee. N/W respond that human error occurs in the classification process. They therefore suggest that SFPP investigate beyond the information provided by WSC and ADP to determine the proper classification of KMEP unitholders that own a large number of units.

202. SFPP's classification of certain KMEP unitholders skew the weighted average income tax rate towards unitholder categories with higher income tax rates. Witness Utay acknowledged that errors exist in SFPP's classification of KMEP unitholders. To classify KMEP unitholders, SFPP and PWC reviewed the unitholder data. In certain instances, the brokerage firm, bank, or other nominee that purchased the units for a particular unitholder provided the classification data. Ex. SPE-19 at 10. In other instances, the actual unitholder provided the classification data. Ex. SPE-19 at 11. When unitholders open an account with a nominee, they categorize themselves by checking a box on a form.[201] Tr. 519. Witness Utay acknowledged that the information used to classify KMWP unitholders "is likely to contain some incorrect ownership data which, for the purpose of this proceeding, should be analyzed." Ex. SPE-19 at 11. Although PWC reviewed and corrected the unitholder data, witness Utay conceded that "[n]o doubt other errors could also be found." *Id.* at 15.

203. Witness Meyers identified several misclassifications. For instance, as shown in Exhibit No. NAV-45C, SFPP classified six KMEP unitholders as C Corporations. Yet, the names of the unitholders indicate that they are partnerships, individuals, mutual funds, or trusts. Ex. NAV-45C at 1-2 lns.1, 2, 6, 12, 13, 14. In fact, witness Utay agreed that the reclassifications on lines 1, 2, 6, 12, 13, and 14 in Exhibit No. NAV-45C are correct. SPE-124 at 2. Witness Utay also testified that SFPP and PWC did not reclassify unitholders classified as a corporation with an individual name, or unitholders classified

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[201] N/W point out that SFPP witness Utay is unaware whether nominees correct inaccurate classification data. Tr. 519. Also, SFPP and PWC reviewed the classification data for inaccurate information. N/W assert that SFPP and PWC did not investigate beyond the entities name to determine whether the KMEP unitholder is accurately classified. Tr. 522; Tr. 526-528; Tr. 528-529; Tr. 540-541; Tr. 544; Tr. 555.

as a corporation with "fund" in the name. Tr. 525-24; Tr. 551-52. In certain instances, SFPP and PWC reviewers relied on their person knowledge of the unitholder to determine the accurate classification. Tr. 545-48. Importantly, individuals and mutual funds have a lower tax rate than corporations. *See* December 2005 Order at PP 29-32; 2006 Sepulveda Order at P 60; December 2007 Order at P 37. SFPP is therefore order to reclassify the six KMEP unitholders on lines 1, 2, 6, 12, 13, and 14 as shown in Exhibit No. NAV-45C. Ex. NAV-45C at 1-2 lns.1, 2, 6, 12, 13, 14.

204. SFPP also failed to categorize properly the KMEP unitholders on lines 3, 4, 5, 7, 8, 9, 10, 11, 15, 16, 17, 18, and 19 in Exhibit No. NAV-45C. In the *ITA Policy Statement*, the Commission clarified that SFPP has the burden to categorize properly KMEP unitholders for purposes of calculating the weighted average income tax rate used to determine the ITA.[202] *ITA Policy Statement* at P 42. SFPP contends that witness Meyers failed to demonstrate that the self-reported, classification data is inaccurate for the thirteen KMEP unitholders. Ex. SPE-124 at 4. SFPP is not correct. The names of the thirteen unitholders indicate that they are not corporations. *See* Ex. NAV-45C at 1-2 lns. 3, 4, 5, 7, 8, 9, 10, 11, 15, 16, 17, 18, and 19. Navajo's witnesses Meyer and Horst's testimonies are entitled to significant weight. Accordingly, SFPP is ordered to reclassify the thirteen KMEP unitholders on lines 3, 4, 5, 7, 8, 9, 10, 11, 15, 18, and 19 as shown in Exhibit No. NAV-45C. Ex. NAV-45C at 1-2 lns.3, 4, 5, 7, 8, 9, 10, 11, 15, 16, 17, 18, 19. Further, SFPP is ordered to correct its ownership percentages and weighted average income tax rate to reflect these corrections.[203]

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[202] In the *ITA Policy Statement*, the Commission made clear that SFPP has the burden to place KMEP unitholders in the correct categories for purposes of calculating the weighted average income tax rate. The Commission stated as follows:

> [W]hether a particular partner or LCC member has an actual or potential income tax liability, and what assumptions, if any, should determine the amount of the related tax rate, are matters that should be resolved in individual rate proceedings. This is a fact specific issue for which the relative data is uniquely within the control of the regulated entity. *Thus, any pass-through entity desiring an income tax allowance on utility operating income must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred*. This could be done through determining the distribution of ownership interests at the end of the standard test year. *ITA Policy Statement* at P 42 (emphasis added).

[203] SFPP is also on notice that the evidence in this case demonstrated that there are large unitholders whose self-categorization appears erroneous (the name of the unitholder in KMEP's records is inconsistent with the self-categorization) and SFPP has not undertaken to verify this information. It is unacceptable for a company to take advantage of its mistakes. SFPP should have protocols in place to verify at least large unitholders when the information appears suspect.

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205. In the Modification Orders the Commission created rebuttable presumptions regarding the federal income tax rates for six Commission specified categories of unitholders. A 35 percent rate for subchapter C corporations and a 28 percent rate for all other categories of owners or non corporate unitholders (beneficiaries of all other ownership categories would most likely be individuals). December 2005 Order at P 32. VCC Shippers contend that the evidence rebuts the presumptions, except for certain subchapter C corporations. Specifically, for all other unitholder categories, VCC Shippers propose a zero percent income tax rate. Ex. VCC-78hc at 42-43. VCC Shipper O'Loughlin agrees that for KMGP (both as general partner and for its limited partner common units) and SFPP Inc. a 35 percent corporate class rate is accurate. Ex. VCC-78hc at 42. However, for common units held by other corporations this witness proposed a 34 percent federal income tax rate.[204] As held by the Commission, the tax rate is 0 for non tax paying entities. Ex. VCC-78hc at 43.

206. According to VCC Shippers, the Commission bases the 28 percent marginal income tax rate for the individual, mutual fund, pension fund, and UBIT entity categories on the assumption that individuals ultimately bear the income tax liability. December 2005 Order at PP 31-32; 2006 Sepulveda Order at PP 61-63; December 2007 Order at PP 36-38. VCC Shippers assert that individual investors receive their income tax costs through the ROE. Thus, no need exists to compensate them for their income tax liability through the ROE *and* the ITA. In effect, VCC Shippers contend that the evidence discussed in ISSUE III.A *supra* regarding the ROE and ITA rebuts the Commission's 28 percent income tax presumption for the individual, mutual fund, pension fund, and UBIT entity categories. In this manner, VCC Shippers seek to reduce the impact of the ITA on ratepayers.[205] Ex. VCC-78c at 46. As held in issue III. A., supra the Commission has ruled on this matter and therefore VCC Shippers have not rebutted the presumption based on this argument.

207. VCC Shippers contend that additional evidence rebuts the 28 percent marginal income tax rate for the UBIT[206] and mutual fund categories.[207] First, VCC Shippers state

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Especially in light of the fact that the classifications have a material effect on the weighted average tax rate. Moreover, SFPP can rely on information available online, reports filed with the SEC and double checking the sources such as ADP, WSC or the nominees.

[204] According to O'Loughlin the Commission amended the tax rate for corporations to 34 percent. This witness believes that a 34 percent tax rate for non-parent corporation owners of limited partnership units is conservatively high.

[205] VCC Shippers also assigned a zero percent income tax rate to all non-corporate unitholder categories related to state income taxes.

[206] Unrelated business income tax (UBIT).

that the Commission should assign the UBIT category a zero percent tax rate. They note that the IRS requires tax-exempt entities to file a Form 990-T if they receive $1,000 or more of gross income from UBIT. 26 C.F.R. §§ 1.6012-2(e), 1.6012-3(a)(5) (2010). Exhibit No. VCC-105 contains the IRS summary statistics on tax-exempt entities with UBIT income tax returns. Ex. VCC-105. According to the statistics, 43,520 tax-exempt entities filed returns in 2006. The VCC Shippers assert that 21,329 (49 percent) had less than $1,000 of UBIT, and were therefore not subject to income tax. Moreover, of the remaining filers 22,191 (51 percent) 10,650 (48 percent) had between $1,000 and $10,000 of UBIT. *Id.* VCC Shippers state that the tax rate on UBIT of the tax-exempt entities was below the 28 percent rebuttable tax rate and the 34 percent income tax rate that SFPP assigned to this group. Ex. SPE-32 at 21. Thus, the evidence suggests that 73 percent[208] of tax-exempt entities with UBIT that filed returns had an income tax liability below 28 percent. VCC Shippers therefore conclude that tax-exempt entities with UBIT are properly assigned a zero percent tax rate. *Id.* Moreover, the K-1 data for 2008, for KMEP unitholders shows that for approximately 98 percent of the entities receiving UBIT the amount was less than $1000 from KMEP. Ex. VCC-103; EX. VCC-78hc at 57-58.

208. The testimony of witness O'Loughlin in this regard is given substantial weight. SFPP is correct that Schedule K-1 does not prove the cumulative amounts that most be reported in Form 990-T. However, KMEP Schedule K-1 evidence does not conflict with the evidence submitted by the VCC Shippers. Accordingly, the presumption is deemed rebutted. Therefore, the UBIT category is given 0 percent. SFPP is ordered to make the corresponding changes in its compliance filing.

209. Second, VCC Shippers state that the Commission should assign the mutual fund category a zero percent tax rate.[209] If mutual funds pass at least 90 percent of income to investors as dividends, the IRS does not tax the mutual funds entities. 26 U.S.C. § 852(a) (2010); Ex. VCC-106. However, mutual funds must derive at least 90 percent of gross income from "qualified sources" to qualify for such tax treatment. 26 U.S.C. §

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207 In the December 2005 Order and December 2007 Order, the Commission evaluated IRS statistics to show that taxpayers in the 28 percent bracket paid a larger percentage of taxes in the aggregate. December 2005 Order at PP 31-32; December 2007 Order at PP 37-38. VCC Shippers argue that the Commission did not address the specific evidence to determine whether a particular category of MLP unitholder has a 28 percent income tax liability.

208 21,329 + 10650/43520 = 73 percent.

209 December 2007 Order at P 38 ("[T]he Commission (and SFPP) extended the 28 percent marginal tax rate to entities having fiduciary obligations to individuals that cannot be identified. Such entities include mutual funds, various types of trusts, Individual Retirement Accounts and similar devices available to individual taxpayers, and pension funds.").

851(b)(2)(B). VCC Shippers state that income from a publically traded partnership such as KMEP is treated as a qualified source. Ex. VCC-78hc at 60. Thus, VCC Shippers presume that mutual fund managers manage their funds in a manner to avoid income tax liability.[210] VCC Shippers also note that in a prior proceeding, SFPP witness Bullock "was unaware of any mutual fund that had failed to meet the qualifying income test." Ex. VCC-106 at 2.

210. VCC Shippers state that SFPP witness Ganz' assignment of a 28 percent income tax to mutual funds is incorrect for two reasons. First, VCC Shippers argue that the Commission looks to the mutual fund, not the mutual fund beneficiaries, to determine the appropriate tax rate for the relevant partner. For instance, in the *ITA Policy Statement*, the Commission stated that "rate payers should not incur the expense of an income tax allowance to the extent that an *owning partner or LLC member* has no actual or potential income tax liability for the income generated by the interest it owns." *ITA Policy Statement* at P 41 (emphasis added). VCC Shippers suggest that mutual fund beneficiaries are not "owning partners" of KMEP, and are therefore beyond the scope of the Commission's ITA standard. If a mutual fund owns a share of KMEP, the mutual fund's investors are not owning partners of KMEP. VCC Shippers also state that the Commission's reference to pass-through entities is not relevant because mutual funds are not pass-through entities as used by the Commission in the *ITA Policy Statement*. *Id.*; *see ITA Policy Statement* at P 42 ("Thus, any pass-through entity desiring an income tax allowance on utility operating income must be prepared to establish the tax status of its owners, or if there is more than one level of pass-through entities, where the ultimate tax liability lies and the character of the tax incurred.").

211. Second, VCC Shippers argue that if the Commission looks to the mutual fund beneficiaries to determine the tax rate for the relevant partners, the 28 percent income tax rate is an inaccurate assumption. VCC Shippers explain that mutual funds are regulated investment companies (RICs), not pass-through entities in the way partnerships are. Thus, the gains and losses from all sources are netted at the RIC level "to determine whether the mutual fund distributes ordinary gain dividends, capital gain distributions, or non-dividend distributions (*i.e.*, return of capital).[211] 26 U.S.C. § 852(b) (2010); 26 C.F.R. § 1.852-4 (2010). VCC Shippers further explain that the IRS taxes: ordinary gains dividends at 15 percent if the gains are qualified dividends; capital gains distributions from RICs at the 15 percent long-term capital gains rate, and non-dividend distributions at 15 percent "if the investor's basis in the mutual fund stock has been reduced to zero."

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210 *SFPP, L.P.*, 91 FERC ¶ 61,135, 61,150 (2000) (tax status of entity should be presumed to be the basic legal and investment purpose for which it was created).

211 *See ITA Policy Statement* at P 37 n.35 (gain or loss on sale of partnership unit may be ordinary or capital in character, or a combination of the two).

26 U.S.C. § 1(h) (2010); IRS Tax Topic 404.[212] Thus, the IRS taxes mutual fund beneficiaries at their ordinary income tax rate only if (i) the mutual fund distribution is an ordinary gain dividend and (ii) is not a qualified dividend. *Id.* Therefore, VCC Shippers dispute the Commission's rebuttable 28 percent income tax rate for the mutual fund category. Specifically, they state that the presumption does not account for the 2003 tax cuts that reduced dividend and capital gains rates to 15 percent. *Id.* Further, the presumption incorrectly assumes that the IRS taxes distributions to mutual fund beneficiaries at the beneficiaries' ordinary income tax rate. *Id.* (referencing Jobs Growth and Tax Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752; Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345).

212. VCC Shippers have provided evidence which has not been contradicted by SFPP. Accordingly, the testimony of witness O'Loughlin is given significant weight in this matter. Therefore, it is concluded that the presumption has been rebutted. Consequently, the weighted average tax rate for mutual funds is 0 percent. SFFP is ordered to comply with this finding in its compliance filing.

213. Based on all the evidence described above it is found that SFPP proposes a weighted average income tax rate that does not accurately reflect the income tax rates of SFPP partners. In the December 2007 Order, the Commission affirmed that the development of a weighted marginal income tax rate for jurisdictional pass-through entities shall reflect the income status of the partners. December 2007 Order at P 46; *ITA Policy Statement* at P 41.[213] SFPP is therefore ordered to adopt Navajo witness Horst's allocation of SFPP income to calculate the weighted average federal and state income tax used to determine the ITA, discussed below. Additionally SFPP is ordered to develop its weighted marginal tax rate and ITA based on the allotted taxable income resulting form KMEP incentive distributions solely on SFPP's income level for the relevant year.

214. As discussed *supra* at ISSUE III.A, the Commission established rebuttable marginal income tax rates for partnership categories. In the December 2005 Order, the Commission clarified that parties may present evidence rebutting the marginal income tax rates for specific partners. December 2005 Order at P 32.[214] VCC Shippers have

[212] *Available at* http://www.irs.gov/taxtopics/tc404.html. VCC IB at 35 n.22.

[213] *ITA Policy Statement* at P 41 ("The use of the weighting approach assures that the rate payers will not be charged more than the actual tax cost the investors incur regardless of the ownership form.").

[214] In the December 2005 Order, the Commission stated as follows:

> [U]nless a party provides evidence to the contrary, the marginal tax bracket for partners that are Schedule C corporations or LLCs filing a Form 1120 return of 35 percent, for partners that are tax payers other than a Schedule C corporation

(continued)

presented evidence rebutting the 28 percent presumption for UBIT and mutual funds. Therefore, it is found that both presumptions have been rebutted. Accordingly, SFPP is ordered to give 0 percent weight for the tax rate for UBIT and mutual funds. Moreover, N/W established by preponderance of the evidence that SFPP misclassified a number of unitholders. Consequently, SFPP is ordered to reclassify 13 unitholders as ordered above. Finally, VCC Shippers have also established that Subchapter C corporations have a taxable rate of 34 percent.

ISSUE III.F – What Adjustments, if any, are Appropriate to Account for the Deferral of State and Federal Income Taxes for Public Unitholders?

215. SFPP contends that no adjustments to the ITA are necessary for the deferral of state and federal income taxes. Conversely, if the Commission grants SFPP an ITA, N/W propose that SFPP reduce the average marginal income tax rates for the KMEP unitholder categories to reflect tax savings associated with the deferral of state and federal income tax liability. SFPP and N/W dispute whether reflecting the benefits of tax deferrals associated with depreciation deductions violates the Commission's stand-alone tax policy. SFPP argues that reflecting such benefits violates the stand-alone tax policy. However, N/W argue that reflecting such benefits does not violate the stand-alone tax policy since KMEP's public unitholders do not pay income taxes until they sell their units and during the deferral period they benefit form the time value of money, by lowering their tax burden. Their ability to lower their tax liability results directly from the depreciation method that the Internal Revenue Code (IRC) specifies for investors in an MLP. VCC Shippers and Staff do not address this issue.

Discussion/Findings

216. N/W propose to reduce the marginal income tax rates of the KMEP unitholder categories to reflect the deferral of state and federal income taxes. Generally, KMEP unitholders receive cash distributions each year. According to tax rules for partnerships the distributions are not taxed in the year received. Instead the distributions are treated as a return of capital that reduces the capital accounts of the unitholders. The opening balances of the accounts are the amount paid for the units. KMEP unitholders do not pay income taxes until the tax basis (capital account) is reduced to zero.

217. In the *ITA Policy Statement*[215] the Commission explained that "distributions in excess of earnings are not taxed as long as the limited partner has a tax basis. Rather, the

the marginal tax bracket is 28 percent, and for municipalities and other exempt entities the relevant marginal tax bracket is zero. December 2005 Order at P 32.

[215] *ITA Policy Statement*, 111 FERC ¶ 61,139 at P 37 n.35.

limited partner's tax basis is reduced and any taxes are deferred until the unit is sold." *Proxy Group Policy Statement* at P 15.[216] At the time of sale, the IRS taxes the amount of sales price greater than the tax basis at the unitholders ordinary income tax rate. *ITA Policy Statement* at P 37 n.35. And, the IRS taxes the portion of the sales price greater than the purchase price at the capital gains rate. *Id.* Since MLP investors are able to postpone paying taxes for many years "[o]ver time the real cost of the future taxes declines while the future return of any tax savings that is reinvested increases. This can significantly increase the return to the investor over the holding period of the limited partnership unit."[217] *Proxy Group Policy Statement* at P 15; *see also* December 2007 Order at P 30 ("It is beyond dispute that a delay in tax recognition will increase the enterprise's return beyond that afforded by a conventional regulatory cost of capital . . .").

218. KMEP unitholders typically do not pay income taxes on SFPP income in the same year that SFPP generates the income. SFPP witness Ganz testified that KMEP allocates most public KMEP unitholders large losses each year. Tr. 2168-69. SFPP and KMEP elect to calculate depreciation pursuant to Section 743(b) of the IRC. The depreciation deductions (743(b) Depreciation Deductions) give rise to the large losses allocated to KMEP unitholders. Tr. 2170. KMEP "writes up" the tax basis of its assets to reflect a new KMEP unit purchase price. KMEP "then allocates 100% of the additional depreciation resulting from that write-up to that unitholder." Each time a unit is sold, the unitholder's share of the pipeline assets is written up to the purchase price. KMEP unitholders then depreciate the resulting amount "over the remaining useful life of the pipeline assets." Tr. 2179-2180; Ex. NAV-28 at 25-26. KMEP allocates the depreciation to the KMEP unitholder on its Form K-1, which generally offsets income allocated to the KMEP unitholder. Ex. NAV-1 at 59; NAV-28 at 24-26; Tr. 2169-72. Consequently, public unitholders receive losses pursuant to Section 743(b) depreciation that more than fully offset any SFPP income allocated to the unitholders.[218]

219. N/W argue that as a result of the deferral of the tax liability the KMEP unitholders enjoy a savings in the real cost of the taxes. According to N/W, SFPP must pass through these savings to its customers as a decrease in its costs. Navajo witnesses Meyer and Horst quantified the benefits of the tax deferrals. In Exhibit No. NAV-44, witness Meyer calculated the average period that KMEP unitholders held their units in 2008. *See* Ex.

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216 *Proxy Group Policy Statement*, 123 FERC ¶ 61,048 (2008).

217 *Policy Statement on Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 (2008) (*Proxy Group Policy Statement*).

218 No participant disputes that KMEP public unitholder can defer their income tax liability until they sell their units.

NAV-44 (revised). According to his calculation, the average holding period of KMEP unitholders that owned their units as of December 31, 2007 is 5.3 years.[219] Ex. NAV-44 (revised) at col. <e>; Ex. NAV-41 at 7. In turn, in Exhibit No. NAV-29, witness Horst discounted the average tax rates of the KMEP unitholders to reflect the time value savings of the tax deferral. *See* Ex. NAV-29 at 1 lns.7-8. Specifically, he reduced the marginal average income tax rate used to calculate the ITA by 80.4 percent. Ex. NAV-1 at 71-72; Ex. NAV-29 at 1.

220. SFPP and N/W dispute whether reflecting tax deferral benefits associated with 743(b) Depreciation Deductions in the weighted average income tax rate used to calculate the ITA violates the Commission's stand-alone tax policy. The stand-alone tax policy evolved in Opinion No. 173,[220] *City of Charlottesville*,[221] and the Modifications Orders.[222] The stand-alone tax policy ensures that a regulated pipeline reflect only its

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219 Witness Meyer identified units held by KMEP unitholders as of December 31, 2007, and derived the holding period from KMEP files that contain 2008 ownership and sales schedules for KMEP unitholders that sold units in 2008. Ex. NAV-41 at 5-6. Next, he determined the 2008 sales of the units, and the periods during which KMEP unitholders held the units. Such periods occurred between the purchase of the units on or before December 31, 2007 and the sale of the units in 2008. Ex. NAV-41 at 6-7. The average holding period calculation does not include units bought and sold after December 31, 2007. *Id.*; Tr. 1999, 2001. N/W explain that units bought in 2008 are already included in the average holding period calculation based on the time KMEP unitholders originally sold the units in 2008. They further explain that witness Meyer would have over-weighted the income tax effect of a particular unit if he weighted the unit separately each time it sold in 2008. Therefore, witness Meyer allocated income to each unit. But, if the unit sold multiple times in 2008, he allocated the same amount of income to the particular unit as if the same KMEP unitholder held the unit during the entire year. N/W state that SFPP witness Ganz used the same "snapshot" analysis in his calculation of the weighted average state and federal income tax rates. Ex. SPE-255; Tr. 2141-43.

220 *Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396, at 61,851 (1983) (Opinion 173), *aff'd City of Charlottesville v. FERC*, 774 F.2d 1205 (D.C. Cir. 1985) (*City of Charlottesville*). In Opinion 173, the Commission stated that the stand-alone approach provides the regulated entity with an ITA equal to the tax on the allowed ROE. Specifically, the Commission stated as follows:

> The stand-alone method results in the tax allowance being equal to the tax the utility would pay on the basis of its projected revenues less deductions for all operating, maintenance, and interest expenses included in the cost of service. In short, it results in a tax allowance equal to the tax on the allowed return on equity. Opinion No. 173 at 61,852.

221 *City of Charlottesville*, 774 F.2d 1205 (D.C. Cir. 1985).

222 December 2005 Order; 2006 Sepulveda Order; December 2007 Order.

own tax liabilities and deductions in rates. Thus, the policy ensures that a regulated pipeline does not reflect tax liabilities and deductions of non-jurisdictional activities or pipeline affiliates, even if those liabilities and deductions impact the actual taxes liability of the regulated pipeline.[223] *City of Charlottesville*, 774 F.2d at 1215-16; N/W IB at 96.

221. The Commission discussed the stand-alone tax policy most recently in the December 2007 Order. Specifically, under the stand-alone tax policy, the Commission does *not require the flow-through of tax savings* generated by operations *external* to the "stand-alone" operations. December 2007 Order at P 41.[224] The Commission noted that the D.C. Circuit Court in *City of Charlottesville* acknowledged the possibility that parent corporations might not pay taxes on income generated by subsidiary corporations. *Id.* (referencing *City of Charlottesville*, 774 F.2d at 1215-16). The Commission found that the principles in *City of Charlottesville* "are equally applicable to partners that may have offsetting losses *from sources other than those generated by the regulated partnership* or whose other sources of gross income may influence the level of the partner's marginal tax rate." *Id.* (emphasis added). Thus, the relevant inquiry in this proceeding is whether the 743(b) Depreciation Deductions, and the resulting tax deferral benefits, are attributable to SFPP's jurisdictional operations and assets, as opposed to non-jurisdictional operations or the assets of an SFPP affiliate.

222. SFPP contends that N/W's proposal to account for the 743(b) Depreciation Deductions in the ITA calculation violates the stand-alone tax policy.[225] SFPP witness Ganz recognized that the stand-alone policy considers the tax liabilities and deductions of the regulated entity, and excludes the tax liabilities and deductions of non-jurisdictional activities and pipeline affiliates. Ex. SPE-154 at 25. Further, he agrees with Navajo witness Horst that 743(b) Depreciation Deductions "arise from the difference between the price an investor pays for a unit and the underlying tax basis of assets represented by that ownership share." *Id.* However, witness Ganz testified that tax deferral benefits associated with the 743(b) Depreciation Deductions belong to KMEP unitholders because the deductions do not arise from SFPP operations. *Id.* He explained that under the stand-

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223 SFPP interpreted the stand-alone tax policy, testifying that "[u]nder that approach, it is only the income and deductions of the regulated entity, SFPP, that are relevant to the proper determination of the income tax allowance." Ex. SPE-154 at 25.

224 Based on paragraph forty-one of the December 2007 Order, SFPP contends that the Commission "rejected the idea of using 743(b) depreciation deductions to offset SFPP income." December 2007 Order at P 41 ("Thus, under the stand-alone method the Commission did not require the flow-through of the tax savings that might be generated by operations that were external to the 'stand-alone' operations of the jurisdictional entity.").

225 SFPP also contends that Navajo witness Horst's analysis of "tax deferral" claims are flawed.

alone policy, ratepayers are not entitled to benefits from tax deductions associated with costs not included in the COS. *Id.* Therefore, benefits associated with the 743(b) Depreciation Deductions are not properly reflected in the ITA because their deductions and underlying costs are not in the SFPP COS.[226] *Id.*

223. In response, N/W contend that adjusting the marginal income tax rate used to calculate the ITA to reflect tax deferral benefits associated with 743(b) Depreciation Deductions does not violate the stand-alone tax policy. N/W do not propose to adjust the ITA calculation to reflect tax deferral benefits of SFPP's non-jurisdictional affiliates or tax deferral benefits related to KMEP unitholders' non-SFPP investments. Rather, they propose to reflect tax deferral benefits from 743(b) Depreciation Deductions directly related to unitholders' share of the depreciation of the value of the partnerships' own assets. [T]hose deductions are the unitholders' share of the depreciation of the value of the partnership's own assets. N/W note that in *City of Charlottesville*, the D.C. Circuit Court addressed tax deductions from losses generated by non-jurisdictional activities of pipeline affiliates. *Id.* at 99. N/W correctly state that the court did not address the circumstances in this proceeding.[227] N/W is correct that City of Charlottesville is distinguishable since the issue in this proceeding involves jurisdictional assets.

224. The evidence indicates that the 743(b) Depreciation Deductions, and resulting tax deferral benefits, are attributable to SFPP's jurisdictional assets. SFPP witness Ganz testified that 743(b) Depreciation Deductions qualify under the stand-alone policy only if they arise from SFPP operations.[228] In response, N/W point out that the goal of the stand-alone tax policy is to avoid regulating one company based on the activities of affiliated companies. *Id.*; *City of Charlottesville*, 774 F.2d at 1208. Importantly, the operations test asserted by witness Ganz is contrary to Commission precedent. The 743(b) Depreciation Deductions are related to SFPP activities and operations because

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[226] According to SFPP, the Modification Orders dictate that SFPP must determine the ITA at the entity-level (SFPP-level) (referencing December 2005 Order at PP 26, 44-46; 2006 Sepulveda Order at PP 49, 57; December 2007 Order at P 41).

[227] N/W state that the "deduction for 743(b) depreciation arises directly from the pipeline assets and directly affect the tax liability borne by a unitholder on an investment in a pipeline like SFPP."

[228] SFPP witness Ganz explained the stand-alone tax policy as follows:

> The fact that an individual partner may have other deductions that it can use to offset a portion of that income, which may reduce or eliminate their income tax liability for a given year, is set aside under the stand-alone tax approach because those *are not costs that come from the operation of the pipeline*. Tr. 2184-85 (emphasis added).

they relate to the value of SFPP assets. Specifically, the tax basis of SFPP assets is being depreciated. In Docket No. IS06-283-000, SFPP witness Hrdlicka testified that "[t]he effect of the election on the purchase of a partnership interest is to adjust the inside tax basis of the partnership property to reflect the amount that the partner paid for his partnership interest."[229] Ex. NAV-28 at 25. The fact that the adjustment applies only to the income taxes paid by a particular partner that purchases the partnership interest is not important. As N/W explain, each partner has a proportional ownership interest in all partnership assets. Accordingly, the 743(b) Depreciation Deduction is each partner's proportional share "of the written up value of the partner's share of the pipeline's assets." Ex. NAV-28 at 25. And, SFPP assets are at the "heart" of SFPP operations. Thus, the 743(b) Depreciation Deductions directly relate to SFPP assets and operations.

225. N/W argue that the Commission should normalize tax deferral benefits associated with 743(b) Depreciation Deductions in a manner similar to the normalization of tax deferral benefits associated with accelerated depreciation. In both instances, pipelines (or, MLP unitholders) depreciate the tax basis of their assets differently than the Commission's straight-line method. Each circumstance generates deductions that enable pipelines (or, MLP unitholders) to defer their tax liability. And, pipelines can reinvest the amount of deferred taxes. As discussed *supra*, at ISSUE III.C, pipelines must reduce their rate base by the ADIT amount. Such normalization accounts for pipelines' ability to earn a greater return during the deferral period. 2006 Sepulveda Order at 37. N/W request that the Commission similarly normalize the deferral of taxes resulting from 743(b) Depreciation Deductions.

226. According to N/W, the Commission treated deferred taxes differently in the 2006 Sepulveda Order and December 2007 Order. For instance, in the 2006 Sepulveda Order, the Commission required SFPP to normalize the deferral of tax savings. The Commission recognized that savings related to income tax deferrals "benefit only the public limited partners, and . . . are not normalized as would be the case in the corporate model. This means that the higher stock price comes at the expense of the ratepayers that have provided the additional cash flow through the income tax allowance." 2006 Sepulveda Order at P 45. The Commission therefore required SFPP to "to reduce the

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229 SFPP witness Hrdlicka explained the difference between "inside basis" and "outside basis" as follows:

> Inside basis is the tax basis of the partnership in partnership property. Outside basis is a partner's basis in his partnership interest. . . . Section 754 of the I.R.C. permits a partnership to elect to have the inside tax basis of its assets adjusted if certain events occur, such as the purchase of a partnership interest. Ex. NAV-28 at 24.

allowed equity rate-of-return to provide a result similar to the reduction in rate base that flows from normalization." 2006 Sepulveda Order at P 46.

227. However, in the December 2007 Order, the Commission permitted SFPP to retain savings from tax deferrals. The Commission recognized that permitting SFPP to retain such savings is "a departure from the Commission's historical practice of requiring normalization to capture the present value of such deferrals for the rate payers, as in ADIT, or the adjustment to return that the Commission required in the December 2006 Sepulveda Order." December 2007 Order at P 29. The Commission based its decision on Congress' intent that partners retain the benefits from income tax deferrals. December 2007 Order at P 29. The Commission also recognized that providing partners with such benefits creates incentives for investment. December 2007 Order at P 30. N/W support the Commission's treatment of tax deferral savings in the 2006 Sepulveda Order. They note that for ratemaking purposes, income taxes are a cost similar to any other cost component in the COS. *BP West Coast*, 374 F.3d at 1291 ("[I]ncome tax allowance is no different from the allowance of any other costs."). N/W therefore request that the Commission reflect the tax deferral savings associated with 743(b) Depreciation Deduction in the weighted average income tax rate used to calculate the ITA.

228. N/W are correct that the income tax deferral should be part of the tax rate calculation. N/W's proposal to reflect the benefits of income tax deferrals associated with 743(b) Depreciation Deductions in the ITA does not violate the stand-alone tax policy because the 743(b) Depreciation Deductions directly relate to SFPP assets. Additionally, it is found that N/W proposal is consistent with Commission policy. The December 2007 Order did not address the impact of the Section 743(b) depreciation on the ITA marginal tax rate. Further, SFPP cannot claim an ITA based on its ultimate investors while arguing that the depreciated value of these investors cannot be accounted for in the rate base. SFPP is therefore ordered to reduce the marginal income tax rates of the KMEP unitholder categories to reflect the deferral of state and federal income taxes. Specifically, SFPP is ordered to adopt Navajo witness Horst's recommended 80.4 percent reduction of the marginal average income tax rate.

<u>ISSUE III.G – Should SFPP's Rates Include Compensation for All or Any Part of Any Taxes that May Be Assessed in the Future on the Gain, if Any, on the Cash Received from a New Purchaser? If so, Should Ratepayers Have to Pay All or Any Part of Such Taxes, and if so, How Should an Allowance for such Taxes Be Calculated?</u>

229. N/W propose that if the Commission grants SFPP an ITA, the ITA should reflect the tax liability of all SFPP unitholders. SFPP, N/W, and VCC Shippers address ISSUE.G *supra* at ISSUE III.E and ISSUE III.F. Staff does not address this issue.

Discussion/Findings

230. ISSUE III.G is addressed *supra* at ISSUE III.E and ISSUE III.F.

ISSUE III.H – Are There Unintended Consequences of Applying the Policy Statement on Income Tax Allowances of Which the Commission Should Be Aware?

231. According to SFPP, application of the *ITA Policy Statement*[230] results in no unintended consequences. SFPP states that in the *ITA Policy Statement* and Opinion 486-B,[231] the Commission sufficiently addressed how the ROE and ITA interact in partnership-owned pipelines. According to N/W and VCC Shippers, application of the *ITA Policy Statement* causes SFPP investors to double recover their income tax cost through the ROE *and* the ITA. As discussed *supra* at ISSUE III.A, N/W state that the ROE compensates SFPP investors for their investor-level income tax cost and their required after-investor-tax return. The VCC Shippers state that the double recovery increases the value of SFPP and destroys the parity between the corporate and partnership organizational forms. Staff does not address this issue.

Discussion/Findings

232. ISSUE III.H is addressed in detail *supra* at ISSUE III.A. Although the evidence in this proceeding suggests that providing an ITA to an MLP causes MLP investors to recover their income tax costs twice, the Commission has held that an ITA does not cause a pass-through entity to double-recover its income tax cost. *See* December 2007 Order at P 53 ("[T]he impact on the DCF model of the income tax allowance is neutral . . . .").

ISSUE IV - Operation and Maintenance Expense

ISSUE IV.A - Allocation of General and Administrative Expenses

233. SFPP directly assigns G&A costs of its corporate parent to a subsidiary or group of subsidiaries to the extent feasible.[232] SFPP IB at 59-60. Direct assignments of shared

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230 *See ITA Policy Statement*, 111 FERC ¶ 61,139 (2005).

231 *See* Opinion 486-B, 126 FERC ¶ 61,034 (2009).

232 This is a move away from the Commission's Mass formula to increase the use of direct assignments of G&A overhead costs. Since 2003 SFPP has been making direct assignments of G&A overhead costs. SFPP IB at 86.

costs to groups of subsidiaries are performed through “shared costs distributions,” in which cost are directly assigned to a particular group of subsidiaries, and then allocated among the members of the group. SFPP IB at 60.

234. VCC Shippers argue that SFPP’s costs assignments require heightened scrutiny because they have been designed solely for ratemaking purposes. These shippers maintain that SFPP’s direct assignments are inconsistent, unreliable and not credible. Additionally, they argue that SFPP’s accounting procedures are complex and obscure. VCC Shippers maintain that SFPP’s proposed G&A overhead assignment and allocation methodology as well as the books and records of Kinder Morgan do not accurately reflect time and salary assignments and do not properly match costs with causation.

235. Staff asserts that SFPP failed to capitalize indirect overhead costs associated with capital projects in violation of Commission policy and fails to properly match costs with causation.[233] Additionally, SFPP used an incorrect definition for the term “carrier”. This also violates Commission rules and even SFPP’s own practices. Further, Staff points out that the most glaring of SFPP’s flaws is its application of the KN method. N/W do not address this issue.

Discussion/Findings

Direct Assignments/Mass Formula

236. The indirect parent of SFPP is KMEP an MLP. Ex. SPE-57 at 4. KMEP has no employees. Ex. SPE-57 at 5. KMEP owns (but does not operate some) five business segments. These are: products pipeline (SFPP is member); carbon dioxide; bulk terminal; natural gas pipeline and KM Canada. Ex. SPE-57 at 6-7. The KMEP subsidiaries in the first three segments are referred to as the KMEP-Operated Entities, since they are operated by KMEP. These are the only entities included in KMEP’s Cost Distribution Methodology. KMI is the indirect parent of KMEP. KMI operates and manages the fourth business segment. These entities are referred to as KMI-Operated entities. Ex. SPE-57 at 6. KMEP is the legal owner of these entities. KMEP also owns equity interests in Red Cedar Gas Treating, LLL (Red Cedar) and Endeavor Pipeline (Endeavor).[234] Ex. SPE-57 at 42-46. These entities were excluded form the Cost Distribution Methodology. The KM Canada subsidiaries were not included in KMI’s Mass formula or in KMEP’s Cost Distribution Methodology. Exs. SPE-57 at 40; 66; 62;

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233 VCC Shippers also argued similar points.

234 These are joint ventures operated by the joint venture owner. KMEP owns equity interests in these entities. Ex. SPE-57 at 42-42. KMEP is represented on the Management Committee of both. *Id.*

230; 231. Certain Kinder Morgan entities classified as legal entities are reflected in the accounting system but excluded from the Cost Distribution Methodology. Tr. 1298-1301, 1404-05, 1569-70.

237. Responsibility centers (RCs), entity codes, salary splits, time sheets and share-services accounts track G&A costs for KMEP-Operated entities. KMEP subsidiaries are operated and managed by the employees of the other Kinder Morgan subsidiaries, since KMEP does not have employees. Ex. SPE-57 at 5-8. KMGP Services employees operate and manage the KMEP-Operated subsidiaries. The costs associated with these employees are the bulk of the costs that are distributed through KMEP's Cost Distribution Methodology. Exs. SPE-57 at 7; 62; 230; 231. KMI employees provide support to KMI-Owned and Operated entities, limited support to KM Canada and high level managerial functions for the KMEP-Operated Entities. Exs. SPE-53 at 7-8; SPE-57 at 7-8, 11; SPE-58. KMI employees are either a KMI-dedicated employee or KMI shared (serve KMI owned and operated and KMEP-Operated entities). Exs. SPE-57 at 7-8; 58.

238. The Commission's Massachusetts Formula (Mass) allocates parent overhead (general and administrative "G&A") costs to subsidiaries when the charges cannot reliably be assigned on a direct basis. *Northwest Pipeline Corp*., 71 FERC ¶ 61,253 at 61,984 (1995). The Mass formula utilizes an average of three ratios: (1) the regulated utility's subsidiary's gross operating revenues to total corporate parent gross operating revenues; (2) the regulated utility subsidiary's gross property, plant, and equipment to total corporate parent gross property, plant and equipment; (3) the regulated utility subsidiary's gross payroll or direct labor costs to total corporate parent gross payroll. *KN Interstate Gas Transmission Co.,* 88 FERC ¶ 61,848 (1999); *Williams Natural Gas Co.,* 77 FERC ¶ 61,277 at 62, 188 (1996). If a subsidiary benefits at all from the parent's overhead services the costs of the subsidiary must be included in the Mass formula. If the subsidiary does not benefit at all then it should be excluded. *Williams* at 62,137. The Commission carefully reviews companies costs allocations and has emphasized that marginal activities subsidiaries should be included in the Mass formula. *Williams* at 62,136-37. Further, the Commission has stated that 5 or 10 percent of parent's employees' time on subsidiaries is significant and should be included. Id. at 62,136; December 2007 Order at P 134. SFPP assigns G&A overhead costs associated with employees in the KMI-shared and KMGP Services employees to defined KMEP subsidiaries including SFPP.

239. Application of the Mass formula is a two-step process. In the first step all the costs which can be directly assigned to a specific subsidiary must be assigned to that subsidiary based on an individual review of the costs. VCC Shippers are correct that SFPP's direct assignments are suspect since they are not verifiable and SFPP did not provide sufficient data to verify their accuracy. SFPP asserted in this proceeding that its direct assignments cannot be verified absent sending an army of people to follow Kinder Morgan personnel around. Ex. VCC-4 at 12. Thus, it is found SFPP did not meet its

burden of proof. Evidence in this record demonstrates that Kinder Morgan has incentives to allocate as much G&A overhead costs to SFPP as it can.[235] Tr. 682-683; Ex. VCC-122 at 11. Additionally, the evidence in this proceeding shows that Kinder Morgan does not use its G&A overhead methodology for internal business purposes and SFPP's methodology is contrary to Kinder Morgan's SEC filings (SEC Forms 10-K and 10-Q). Indeed, the record evidence in this case indicates that SFPP developed this methodology for ratemaking purposes.[236] See, e.g., Tr. 1391, 1412-12. Therefore, the Kinder Morgan allocation method cannot be considered an objective business practice. It is highly subjective, easily manipulated and clearly results in a largess of inconsistencies demonstrated by the record evidence submitted by the VCC Shippers. The method as it stands cannot be used for ratemaking purposes and is neither a just nor reasonable allocation process for the Commission's cost-based regulatory scheme.

240. VCC Shipper's witness Dr. Arthur developed two approaches for the Mass formula calculation. He developed a KMEP-only Mass formula overhead allocation. Ex. VCC-75. In addition, Dr. Arthur developed a KMI/KMEP Mass formula allocation of G&A overhead costs. Ex. VCC-1 at 67-69. This is his preferred methodology. For this methodology Dr. Arthur combined KMI/KMEP G&A overhead costs. Ex. VCC-1 at 67-69. The rationale for this approach was the complexity of the KMI and KMEP organization; lack of transparency in the allocation of G&A overhead costs between KMI and KMEP; the fact that KMI or KMGP Services, Inc. employees perform work for any

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235 Kinder Morgan has both regulated and unregulated businesses. If it assigns overhead costs to unregulated subsidiaries, there is no guarantee that these costs will be recovered since competitive forces will set market prices. However, if Kinder Morgan allocates additional overhead costs to a regulated subsidiary with cost based rates, the regulated subsidiary can seek to increase its rates and revenues through that allocation. Consequently, Kinder Morgan is in a better position to recover a greater portion of its total overhead costs through a regulated subsidiary and increase the combined profits of both subsidiaries through cross-subsidies. Even its own witness Webb recognized this as a well-accepted concept in regulatory economics. Tr. 683.

236 SFPP's witness DesLauriers testified that serious questions of reliability are raised where a proffered cost allocation methodology is only used for ratemaking purposes to the exclusion of other company purposes. Ex. SPE-136 at 35. The KPMG Study was conducted to support the overall rate-setting process. Ex. SPE-136 at 34. The result of this study was to replace the Mass and K-N formulae currently used by Kinder Morgan to allocate overhead costs. Ex. VCC-17 at 9. The total costs for this study were allocated to SFPP. Ex. VCC-29. The sworn statements made by Kinder Morgan in its SEC filings contradict SFPP's claims regarding its direct assignments of G&A overhead expenses. Additionally, the SEC filings present financial results by business segments confirming the fact that Kinder Morgan does not use the G&A overhead allocation methodology proposed by SFPP in this proceeding to evaluate the performance of its subsidiaries.

Kinder Morgan entity resulting in a functional integration of the relevant G&A overhead workforce and the inaccuracies, capacity for manipulation, and cross-subsidization created between the subsidiaries of KMI and KMEP in Kinder Morgan's accounting processes and allocation of overhead costs between KMI and KMEP. As a result, Dr. Arthur believes that a KMEP-only Mass formula allocation is not reasonable and does not accurately reflect the amount of Kinder Morgan overhead expense incurred for the benefit of KMEP's operations and subsidiaries. Id. at 29-34, 67-69.

241. The appropriate level of KMI/KMEP combined corporate G&A overhead expenses to be allocated by the Mass formula is $351.4 million. Ex. VCC-1 at 67. This figure comes out of G&A overhead amounts not attributable to any business segment[237] on KMI's 2008 SEC Forms 10-K and 10-Q for the base period. Then Dr. Arthur removed overhead labeled KMI's "going private" and capitalized overhead expenses. Further, Dr. Arthur removed PAAs related to KMI and KMEP regulated subsidiaries. *Id*. at 67. Additionally, Dr. Arthur rejected as unreliable direct G&A overhead cost assignments and exclusions of Kinder Morgan subsidiaries. As a result, Dr. Arthur's combined KMI/KMEP G&A overhead cost allocation methodology allocates $16.4 million of corporate overhead costs to SFPP. This methodology is in stark contrast to SFPP's $46.9 million.

242. SFPP's witness Bradley proposed $55.5 million in KMEP overhead expenses not attributable to any of KMEPs' five business segments. The difference between the two witnesses is Bradley's direct assignment of $247.9 million to individual business segments of KMEP or individual subsidiaries within the business segment. The SEC Forms 10-K and 10-Q are sworn statements by Kinder Morgan officers. This discrepancy between the sworn statements of the company with the SFPP filing in this proceeding is reconciled by giving more weight to the SEC filings. This is particularly so given that KMEP's SEC Form 10-K reports G&A expenses of $330.3 million in 2009 and $297.9 million in 2008 and states that "items not attributable to any segment include general and administrative expenses, unallocable interest income and income tax expense, interest expense and minority interest." Exs. VCC-5 at 63-66; 83-84; VCC-6 at 71-74, 97.

243. KMEP's SEC Form 10-K is prepared in accordance with the Financial Accounting Standards Board (FASB) accounting standards and SEC regulations which require reporting by business segments as used internally to evaluate subsidiary performance (operating decisions, allocating resources and assessing performance). Ex. VCC-6 at

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237 KMEP's Forms 10-K and 10-Q for 2008 and 2009 report earnings and results of operations by five business segments: Products Pipelines, Natural Gas Pipelines, CO2 operations, Terminals operations and Kinder Morgan Canada operations. Exs. VCC-5 at 58-85; VCC-6 at 64-99.

168; Tr. 1535-36. FASB topic 280 (FASB accounting Standards No. 131) among other things states that adjustments and eliminations made in preparing a public entity's general purpose financial statements and allocations of revenues, expenses and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Ex. VCC-170 at 1, 9. Moreover, Kinder Morgan's President of Products Pipelines, Thomas Bannigan testified that he had never looked at the results of the Mass formula calculations proposed by SFPP to see if they produced an accurate representation of the organization's time. Sec. SPE-136 at 16-17; Ex. VCC-28 at 10; Tr. 1548-49. Mr. Bannigan is responsible for internal business reporting to Kinder Morgan's office of the chairman. Tr. 1548-49.

244. Dr. Arthur testified that all overhead expenses allocated to KMEP come out of KMI. He further testified that this is so because KMEP and all of its subsidiaries, including SFPP, have no employees. Ex. VCC-1 at 68. All the employees that provide overhead services to KMEP and its subsidiaries are employed by KMI or its subsidiary KMGP Services, Inc. *Id.* at 30-31. Employees of KMGP Services and KMI are technically employed by separate companies. However, KMGP Services, Inc. is a wholly-owned subsidiary of KMI. As the evidence in this proceeding indicates, these employees operate in an integrated manner, functionally comprising one organization. *Id.* Further, a common group of senior management employees of KMI are the officers of both KMI and KMGP Services, Inc. *Id*. Ex. SPE-233.

245. The evidence in this proceeding shows that Kinder Morgan Management (KMM) is a limited partner in KMEP. KMM manages and controls the business and affairs of KMEP, its operating partnerships and their subsidiaries. This is pursuant to a delegation of control agreement with Kinder Morgan G. P. Inc. the general partner of KMEP. Ex. VCC-132 at 18, 41. See also Ex. SPE-233. KMM states in its SEC Form 10-K that employees of KMGP Services are assigned to work for KMEP or one or more KMEP subsidiary. However, they remain under the ultimate control and management of KMM. Id. at 46. KMI's office of the chairman personnel are principal directors of KMM. Employees of KMI and KMGP Services are integrated as well with the activities of KMEP and its subsidiaries. Ex. VCC-133 at 5-8.

246. SFPP's testimony that KMI and KMGP Services employees are restricted in terms of the entities they can work for is not credible.[238] Contrary to SFPP's claims the

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[238] SFPP proposed to assign or allocate a pool of G&A overhead costs associated with employees identified as KMI-shared (provide G&A overhead support and services to KMI subsidiaries operated by KMI and KMEP subsidiaries that are operated by KMEP) and KMGP Services groups of employees (provide G&A support to KMEP-owned and operated subsidiaries) to a defined set of KMEP subsidiaries including SFPP.

evidence shows that employees of KMGP Services provide overhead services to KMEP subsidiaries such as Kinder Morgan Canada (KM Canada) that are allegedly not operated by KMEP. Ex. VCC-1 at 31. Alleged KMI-dedicated employees (who SFPP claims provide services solely to entities owned and operated by KMI and the KMEP- owned natural gas subsidiaries operated by KMI) provide services to KMEP subsidiaries such as KM Canada which is not operated by KMI. *Id*. Consequently, the evidence shows that there are KMI employees performing overhead services for entities that are not operated by KMI, and KMGP Services employees performing overhead services for entities that are not operated by KMEP. *Id*. There is no evidence in this record showing that there are restrictions placed on the KMI or KMGP Services employees which would limit which KMI or KMEP subsidiary they could perform services for. *Id*. at 31-32.

247. Moreover, the evidence shows, contrary to SFPP's assertions, that the employees of KMI and KMGP Services are functionally integrated and perform services for KMEP subsidiaries that are considered by SFPP to be operated by entities other than KMEP. For instance, KMGP Services employees sit on the boards of directors or managing committees of the KMEP joint venture subsidiaries, which KMEP does not operate. Id. at 32-33. KMGP Services employees manage and have oversight responsibilities over entities allegedly operated by KMI-dedicated employees. KMGP Services personnel are officers of KMM, which has ultimate control and authority over KMEP and all its subsidiaries. Meli Armstrong, Thomas Bannigan, Timothy Bradley, James Kehlet, Adam Foreman and Gary Prim are all officers of KMM and play a role in managing and controlling KMEP and all its subsidiaries. Ex. VCC-133 at 7-8.

248. SFPP witness Bradley assigned $43,972,121 to KMEP associated with KMI-shared employees. Ex. SPE-230 at 6:13. The KMI shared employees direct their G&A overhead costs to three accounts (Account 107001 – Capital Burden Pool; Account 184600 – KMI G&A overhead pool; and Account 184601 – KMEP G&A Overhead Pool or Cross-Charge Account). Costs in these accounts are further allocated to specific groups of KMI or KMEP subsidiaries. However, these cost allocations are not verifiable – either by accuracy or basis. However, VCC Shippers have demonstrated that the charges are arbitrary, inaccurate and unreliable. For instance, KMI-shared employees performed work for Kinder Morgan entities which have been excluded from the cost allocation.

249. Witness Utay (SFPP) testified that KMI shared employees in Responsibility Center (RC) 0066 (Income Tax) file tax returns for all KMI and KMEP organizations. Tr. 565; Ex. VCC-30 at 2. This witness also testified that the KMI-shared employees in RC 0066 do not allocate or assign their costs to all of the entities for which they perform services. The amount of $10 million in overhead costs in this RC are split between account 184600 and 184601. There are significant subsidiaries excluded from subsequent allocation of costs out of these two accounts or stated another way, there are numerous subsidiaries that are not allocated costs from these accounts. Mr. Utay also

testified that he is not responsible for his own cost assignments. Tr. 569-70. Moreover, employees in RC 0066 prepared and filed taxes for KMM, KMOLP-D, KM Mid-Co, LLC, KMI, KMGP, Inc., KM Services, LLC, KM Nat Gas Operator, LLC. etc. None of these entities are assigned or allocated G&A overhead costs associated with RC 0066. Thus, VCC Shippers have shown that the G&A cost splits associated with RC 0066 are inaccurate and results in cross-subsidies. They have also demonstrated that the costs in RC 0066 and in the Cross Charge Account 184601 are inaccurate and create cross-subsidies.[239] The same inconsistencies were demonstrated with respect to other Cross-Charge RCs. For instance, RC 0010 (Office of the Chairman) which is involved in overseeing all entities. However, entities were excluded from the allocation of costs of RC 0010. Ex. VCC-133 at 4.

250. The costs associated with KMI are also suspect. KMI has its own separate books and records reflected in RC 0065.[240] This company has over $1 billion in gross revenue, over $600 million in other expenses, around $37 million in direct labor, and close to $1.5 million in gross property, unrelated to its subsidiaries. Ex. VCC-144 at 4. However, SFPP witness Bradley testified that KMI has no G&A overhead costs assigned to it on its own right. Tr. 1411-12. It is incredible that a company with such financial wherewithal does not receive G&A overhead support and services from KMI-shared employee RCS, including those contributing to the Cross-Charge. VCC Shippers are correct that the cost splits related to the KMI-shared RCs is not accurate.

251. Additionally, KMI-shared primary employees RCs (RC0010, 0066, 0065, 0070-0092 (IT) do not include G&A costs associated with payroll taxes, benefits or bonuses for the employees working in these RCs. These costs are contained in RC 0999. Tr. 1400. However, there is a lack of transparency for the charges to RC 0999 (roughly $10.3 million assigned to KMEP by the Cross-Charge). There is no explanation for the exclusion of entities that benefit and receive support and services from the KMI-shared RCs including having the employee taxes, benefits and bonuses recorded in another RC.

252. SFPP had $2.5 million in G&A overhead costs allocated to KMEP-operated subsidiaries that were subsequently capitalized and assigned to KMI and KMEP subsidiaries originally excluded from Mr. Bradley's methodology. If after the initial allocation KMI has the discretion to unilaterally shift G&A overhead costs between KMEP and KMI by reassigning dollars to the KMI capital burden pool (Account 107001)

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[239] Mr. Bradley calculated $10 million in G&A overhead costs for RC 0066, approximately $6 million were assigned to Account 184601 and allocated to KMEP subsidiaries, including SFPP. Ex. VCC-133 at 5.

[240] RC 0065 is responsible for over $2 million in KMI-shared employee G&A overhead costs, $200,000 assigned to KMEP by the cross-charge. Ex. VCC-30 at 5.

from the KMI Cross-Charge, VCC Shippers correctly point out that the G&A costs allocated to KMEP by the KMI Cross-Charge are inaccurate. Ex. VCC-1 at 51-52.

253. It is also found that SFPP's proposal to allocate G&A overhead labor costs based on KMGP Services employees is unreasonable. In mid-2009 SFPP conducted interviews and surveys with 15 managers and 21 KMGP Services employees and as a result of these interviews and surveys directly assigned G&A labor-related costs for 295 employees to individual KMEP subsidiaries and groups of subsidiaries, including SFPP. Ex. VCC-1 at 27-29. However, SFPP excluded various KMEP subsidiaries with respect to the cost allocation. Ex. VCC-1 at 3. SFPP then further separates the total KMEP G&A overhead costs into multiple tiers and these in turn are assigned to specific KMEP subsidiaries or subsets of KMEP subsidiaries. This cost allocation is contrary to the Mass formula. Moreover, the allocation cannot be audited, verified and its reasonableness cannot be tested contrary to Commission rules.[241] See *Williston Basin*, supra at 116-19. Consequently, it is found that SFPP has not met its burden of proof and thus its proposal is deemed unreasonable.

254. As VCC Shippers witness Dr. Arthur testified SFPP's witness Bradley did not follow the KPMG study to support his methodology. Ex. VCC-1 at 15. The KPMG Study made recommendations on direct assignment of salary and wages of Kinder Morgan employees providing G&A overhead services, and certain non-labor G&A overhead costs.[242] Ex. SPE-57 at 15-20. Mr. Bradley conducted his own surveys in mid-2009. Ex. VCC-1 at 16. The results of Mr. Bradley's studies were not verified or audited. Fifteen managers of RCs were interviewed along with 21 employees to make direct assignments for 295 employees. There are numerous inaccuracies in the direct assignments of labor related costs.[243] For instance, at least two employees the vice president of logistics and the director of regulatory affairs directly assigned 100 percent of the time to SFPP while they were clearly performing work for entities other than the Pacific Group (SFPP, Calnev, or West Coast Terminals). Ex. VCC-1 at 19-20 & n. 57.

255. Dr. Arthur reviewed GP Services RC and personnel (excluding KMEP subsidiaries to test validity) to test the reasonableness of the direct assignments of KMGP Services G&A overhead labor costs. VCC Shippers maintain they are unable to fully

[241] Kinder Morgan has in excess of 7,000 employees with at least 3,000 individual employee allocations. Ex. VCC-4 at 12.

[242] Specifically the study recommended salary splits for KMGP Services employees to directly assign labor G&A costs to individual KMEP subsidiaries such as KMEP.

[243] Employees in the five RCs directly assigning overhead costs to SFPP were surveyed. The results showed that 64 percent of the employees surveyed had incorrect direct assignments of overhead expenses recorded on the books.

quantify the level of G&A overhead costs assigned or allocated to SFPP due to the inaccuracies and lack of supporting justification. For instance, Dr. Arthur found that $89,170 excluded from RC 1007 (KMGP Services Accounting) is in error. Exs. VCC-1 at 40; 20 at 3-8. Moreover, three employees allocated 100 percent of their time to the KMEP tier which did not include KM Canada an entity for which at least two of the employees performed services. Mr. Miller is responsible for maintaining KMEP's general ledger and preparing KMEP's and all of its subsidiaries financial statements including KM Canada and KMEP's natural gas pipeline subsidiaries which were excluded by Mr. Bradley in the direct assignment. Additionally, Mr. Miller's supervisor's time did not accurately reflect her supervision of Mr. Miller. Further, the cash management aspects of KMEP's natural gas pipeline subsidiaries (Trailblazer, KMIGT and TransColorado were totally excluded even though these subsidiaries have cash management agreements with KMEP. Exs. VCC-49, 50, and 51.

256. Further evidence of inaccuracies is demonstrated by Dr. Arthur. For instance, the financing functions of KMOLP-A which is essentially the financial clearing house for KMEP subsidiaries, are not included in RC 1007. Even though RC 1007 is responsible for maintaining the books and records of KMOLP-A on a daily basis. Exs. VCC-133 at 4; 164. VCC Shippers are correct that KMGP Services personnel operating and supervising KMEP's Accounting Department (RC 1007) are actively performing G&A overhead services in connection with the accounting for the billions of dollars in receivables and payables generated by KMOLP-A or its subsidiaries.[244] Additionally, even though Ms. Armstrong is an officer of Trailblazer, TransColorad, KMIGT and others these subsidiaries were ignored by Ms Armstrong in the assignment of the G&A overhead costs. This is contrary to Commission precedent. See *Williams, supra*, 85 FERC at 62,140-41. At a minimum as an officer for all these subsidiaries this employee has a fiduciary duty to all of them.

257. The direct assignments for RC 1030 (President Product Pipelines) is also suspect. First, in a previous proceeding Mr. Bradley testified that these overhead costs should be 100 percent directly allocated to the products pipeline group since they could not be directly assigned to individual KMEP product pipeline subsidiaries. However, in this proceeding he now assigns them to individual pipeline subsidiaries. In the SEC filings, KMEP stated such overhead expenses are not identifiable with any specific business unit or subsidiary. Ex. VCC-1 at 26-27. Additionally, the direct assignments are incomplete since they do not include subsidiaries that should have been included. Mr. Bannigan, Mr.

[244] SFPP argued that KMOLP-A is a roll up entity and does not have costs of its own. However, KMOLP-A had over $41 million in gross revenue, $217,374 of direct labor, and $39,463 of other expenses separate from its subsidiaries. Ex. VCC-133 at 4. Additionally, RC 1007 would have to account for all these revenues and expenses, but Mr. Bradley did not mention his work in this overhead methodology.

R.T. Bradley and Mr. Armstrong are all principal officers of various entities but failed to identify or allocate costs for these entities. Ex. VCC-161 at 13-15; 1 at 61-62.

258. Concerning the Canadian subsidiaries Dr. Arthur also showed that Mr. Bradley incorrectly excluded them from the G&A calculations. Kinder Morgan Canada (KM Canada) is a number of KMEP subsidiaries or one of the business segments in the SEC filings. These subsidiaries include oil and product pipelines located in the U.S. and Canada and terminal operations in Canada. Ex. VCC-5 at 31-33. KM Canada has employees in Canada who provide some overhead services. All the Canadian employees are supervised by the personnel located in the U.S. Moreover, Canadian employees oversee employees operating in the U.S. Therefore, exclusion of these subsidiaries makes the cost allocations inaccurate.[245] SFPP witness DesLauriers testified that the KPMG Surveys corroborated their expectation that the KMI-shared employees could not make meaningful time-based identifications to individual entities or activity levels. Ex. SPE-53 at 18. However, Mr. Bradley directly assigned $1,098,121 in KMI-shared G&A overhead costs to KM Canada subsidiaries. This inconsistency is resolved in intervenors favor. Moreover, as discussed above KMGP Services employees performed G&A services for KM Canada. Further, the record establishes that RC 1007 maintains the daily books and records of KM Pipeline USA (KM USA) but no costs were allocated to this entity. KM USA employs the individuals who operate the KM Canada assets located in the US. Tr. 1362-63.[246] Accordingly, it is found that these entities should be included in the G&A for KMEP/KMI.

259. The evidence in this record also demonstrates that the KMEP natural gas pipeline and joint venture subsidiaries that Mr. Bradley excluded from his G&A overhead cost methodology benefit from KMEP G&A oversight. Consequently, these subsidiaries must be included in the allocation of corporate parent overhead costs. The operating agreements show that KMEP is the owner of the subsidiaries, retains managerial,

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[245] The president of KM Canada reports to KMI's office of the chairman. The KMI-shared employees are corporate-level employees who provide high-level executive and generic corporate-type functions to all entities within the Kinder Morgan family. Ex. SPE-57 at 40. Bradley assigned $1,187,291 of Kinder Morgan G&A to KM Canada. This includes $1,098,121 for KMI-shared employees and $89,170 for KMGP Services employees.

[246] Mr. Bradley testified that since the end of 2009, KMEP invoiced KM Canada for KMGP services employees provided to KM Canada that year. However, the invoices for these employees show that the $89,170 proposed by Mr. Bradley is wrong. Ex. VCC-156. Annualizing the invoices results in $1.75 million of KMGP Services G&A overhead support for KM Canada for 2009, instead of $89,170 reflected by Mr. Bradley. Ex. VCC-156. Mr. Bradley did not supply the back-up data for the invoices to VCC Shippers even though he stated he would. A negative inference is drawn against SFPP on this matter. Mr. Bradley surveyed one KMGP Services employee for the KM Canada survey.

supervisory and oversight responsibilities which is deemed to generate G&A overhead expenses. Consequently, KMEP G&A overhead must be allocated to these entities. Exs. VCC-45 at 7; 46 at 8; 47 at 7; 48. Further, as discussed above KMGP Services employees also perform services for these subsidiaries. Additionally, the fixed fee arrangements[247] are unrelated to the actual overhead costs incurred on behalf of the subsidiaries that pay fixed fees. SFPP has conceded this in prior proceedings. This admission is given significant weight in this proceeding. Ex. VCC-58 at 6-7; at 46-47. It is also found that this creates a cross-subsidy between subsidiaries.[248] Rockies operating agreement lists Kinder Morgan NatGas Operator LLC (KMNG) as the operator. KMNG is wholly owned by KMOLP-A which is wholly owned by KMEP. Employees of KMI or KMGP Services performing services for Rockies are doing so as agents or on behalf of KMEP. Therefore, some of that employees' time has to be allocated to KMEP. However, no G&A overhead costs were allocated to KMNG even though the evidence shows that KMI-shared employees in RC 0065 are responsible for the daily books and records and day-to-day accounting for this KMEP subsidiary. Exs. VCC-133 at 4; 59; 60; 233;164; Tr. 1390-91.[249]

260. Based on the evidence above it is found that SFPP's methodology is unjust and unreasonable. Accordingly, SFPP is ordered to use the Mass formula to assign its G&A overhead costs to SFPP.

Insurance Costs

261. The direct assignment of KMI insurance costs is also found to be unreasonable. Kinder Morgan obtains insurance as a single, integrated entity. This includes common property and general liability insurance for all KMI and KMEP subsidiaries. Ex. VCC-65 at 4. SFPP proposes to allocate $2.7 million of the insurance costs directly to SFPP based on "replacement values" internally generated by Kinder Morgan personnel. Exs. SPE-57 at 8; VCC-64 and 66. This direct assignment is unreliable and unverifiable and can create cross- subsidies if the replacement values of subsidiaries are misstated. First, these costs are not reported as such in the SEC filings and indeed are contradicted by the SEC filings statements that these costs are not attributable to any business segment or

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[247] TransColorado, KM North Texas, KM Mexico are operated by KMI pursuant to an operating agreement and pay a fixed fee for G&A to KMI. Rockies Express (Rockies) also pays a variable fee to its alleged operator KMI (the SEC filings state that it is KMEP). Ex. VCC-1 at 49; Ex. SPE-57 at 37.

[248] On the record of this proceeding, quantification of the individual subsidiary cross-subsidy is not possible.

[249] The evidence also shows that Red Cedar was excluded from the allocation even though a KMEP representative is on its Management Committee. Ex. VCC-1 at 44.

individual subsidiary. Tr. 1522-27; 1550-55; Ex. VCC-8 at 2; Ex. SPE-61. Second, the replacement values were not supported by underlying data.[250] Ex. SPE-57 at 18; Exs. VCC-64;66;1 at 53-55. SFPP's witness DesLauriers, could not verify and expressed concern over the replacement values. He stated in an e-mail, "[t]he problem is that the $$ [replacement] asset value on a percentage basis over KMP assets is MUCH different than the Gross Property % shown in the development of the KMP Mass formula. This is throwing wild swings in the allocation of insurance costs using this approach versus mass formula and I'm going to have difficulty supporting." Ex. VCC-144 at 1; Tr. 1021-25. This admission is given significant weight.[251]

262. The initial allocation to SFPP is on the replacement value of above-ground facilities. These would be for SFPP primarily the non-carrier terminal facilities. As a result, SFPP inconsistently allocates the insurance costs to SFPP's jurisdictional facilities based on direct investment, or gross property. Ex. SPE-47 at 13; 49 at 17; Tr. 1021, 2823-27. If SFPP's non-carrier terminal facilities are primarily responsible for the total amount of insurance costs allocated to SFPP, the insurance costs are allocated disproportionately to SFPP's jurisdictional facilities when using gross property as the allocation factor and an unreasonable inconsistency is created. This inconsistency is not present when the Mass formula is used to allocate insurance costs because the initial allocation is based on the objective gross property, gross revenue, and direct labor factors, instead of subjective replacement costs which are then artificially manipulated through a subsequent allocation scheme.[252] Therefore, SFPP is ordered to use the Mass formula to allocate these costs.

Legal Expenses

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[250] Based on publicly available data, the values appear unrealistic. For example, the replacement value for Calnev pipeline is estimated to be less than half of Calnev's reported carrier property additions in 2007 and 2008. The same applies for Kinder Morgan Tejas Pipeline, LP. Exs. VCC-67; 64 at 3; 68 at 23 and 62;69 at 21 and 52.

[251] There is a lack of cost-causative basis between the replacement values and the insurance premiums. For instance, insurance policies for below-ground facilities were not included. Tr. 1456-57. Moreover, the replacement value is not related to the liability insurance premiums, which is over 50 percent of Kinder Morgan's total insurance costs. Tr. 1455-65; Ex. VCC-64 at 3.

[252] Kinder Morgan has its own Bermuda-based insurance company which issues policies to Kinder Morgan. Tr. 1470-72; Ex. VCC-6 at 209. The record is not clear how the replacement values are used by Kinder Morgan, nor whether there are other values used to determine the level of insurance premiums.

263. SFPP proposed to directly assign $20.6 million out of $22.6 million in KMEP legal expenses during the base period. SFPP is directly assigned $12.3 million in legal expenses. Exs. SPE-34 at 118; 68; 139 at 53-54. As stated above, these are in the category of costs not attributable to any business segment in SEC filings. Tr.1522-27; 1550-55; Exs. VCC-8 at 2; SPE-61; SPE-139 at 56. The costs are unsubstantiated. Instead of providing invoices SFPP provided a spreadsheet which is on its face inconsistent and unreliable.[253] Ex. VCC-70c. For instance, SFPP directly assigns the entirety of costs to SFPP for legal proceedings even though SFPP was part of multiple defendants. This was a proceeding involving Union Pacific Railroad Company (UPRR). Tr. 1593-1601; Exs. SPE-237 at 1; NAV-55 at 2. In this lawsuit the other entities are: KMOLP-D, KMEP, KMGP, KMI and KMM, since SFPP has no employees.[254] Exs. SPE-19 t 2-6; 57 at 4; 233; VCC-132 at 41, 45-46. Kinder Morgnan attributed $10.6 million in litigation expenses related to FERC and CPUC matters to SFPP for SEC Form 10-K reporting. Exs. VCC-1 at 55; SPE-139 at 53-54. However, the UPRR litigation was not attributed to any specific subsidiary in the SEC filing. Further examples of inaccuracies in the spreadsheet are for instance, a February 2009 invoice for a certain law firm was assigned to SFPP while other invoices with identical descriptive terms were assigned to different Kinder Morgan entities. There is no explanation for this in this record. Exs. VCC-166c at 3:4-14; SPE-148; Tr. 1513. Another example of erroneous assignment of legal expenses are expenses from one law firm which are solely attributable to KMEP while Canadian subsidiaries, natural gas pipeline or joint venture subsidiaries and other subsidiaries benefitted from these expenses. Ex. VCC-166c at 7:25-30; Tr. 1517. As a result, it is concluded that the direct assignment of legal expenses is rejected and the allocation must be done in accordance with the Mass Formula. SFPP is ordered to comply with these findings in its compliance filing.

PAAs

264. The evidence in this record also shows that SFPP removed PAAs from the gross property, plant and equipment allocation factor of KMEP's unregulated subsidiaries in contravention of precedents. Dr. Arthurs's testimony in this regard is given significant weight. The proper methodology is to remove the PAAs from the gross property, plant and equipment factors only for regulated subsidiaries. Ex. VCC-1 at 58-59. *Arkla Energy Resources*, 61 FERC ¶ 61, 004, at 61,037-38 (1992) (if a party purchases jurisdictional facilities for a price in excess of their net book value, it is not entitled to

[253] The spreadsheet was a summary and shows internal Kinder Morgan accounting information associated with invoices and a brief description of the legal matter and subsidiary to which the legal invoice was assigned. Tr. 1501-08; Ex. VCC-70c.

[254] The caption to the proceeding did not specifically list these entities but instead caption "DOE" defendants or entities responsible for SFPP.

recover the excess through its jurisdictional rates. The purpose of removing the PAAs is to ensure that the gross property balances of regulated facilities reflect the original cost of the asset. *Chevron Products Co*., 125 FERC ¶ 63,018, at P 795. Dr. Arthur is correct that this issue does not arise for unregulated utilities. Accordingly, SFPP is ordered to remove the PAAs from the property, plant and equipment Mass formula factor solely for rate regulated subsidiaries.

Net Revenue vs. Gross Revenue Factor

265. SFPP's proposal to use a net revenue factor (gross revenue minus cost of goods sold) instead of a gross revenue factor for KMEP's G&A overhead costs allocations pursuant to the Commission's three-factor Mass formula is rejected as unreasonable and without foundation. As a matter of fact this would under-allocate revenues to Tejas Consolidated resulting in over-allocations of overhead to the remaining KMEP subsidiaries (including SFPP). As an example Tejas Consolidated (Tejas) had approximately $6.3 billion in gross revenue during the base period (approximately 55 percent of the combined KMI and KMEP total gross revenue) and SFPP had $370 million (3 percent of KMI and KMEP's total gross revenues or 6 percent of base period gross revenues of Tejas). If net revenue were used as a factor, Tejas revenue factor would drop substantially and it would be reflected as having only approximately $96.8 million in base period net revenue (2 percent of KMI and KMEP's total base period net revenue) and SFPP would have $370 million (7 percent of KMI and KMEP total base period net revenue). SFPP's revenue allocation factor thus becomes three times higher than Tejas and Tejas' factor is reduced 96 percent. Exs. SPE-191; 193; 168 at 45-46. VCC Shippers are correct that SFPP's proposal is contrary to Commission precedent and that *Distrigas*[255] is entirely distinguishable (this case unlike *Distrigas* does not involve regulated subsidiaries passing through costs to rate payers).

G&A overhead cost Allocation Comparison

266. It is uncontroverted that SFPP is being assigned more in overhead allocations as compared to other roughly comparable subsidiaries. Significant weight is given to the following comparison: SFPP is assigned approximately $46.9 million in G&A overhead. In comparison Tejas Consolidated is allocated $24.6 million. Tejas Consolidated has 20 times the gross revenues of SFPP, twice the property plant and equipment and more labor. KM Canada has double the gross revenues of SFPP, more pipeline miles and

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255 *Distrigas of Massachussetts Corp.*, 41 FERC ¶ 61, 205 at 61,557 (1987). See also *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61, 036 at P 74 (2003) (in *Distrigas*, we required the use of net operating revenues before interest and taxes in allocating corporate overheads due to the effect of significant revenue associated with purchased gas costs, and especially the automatic pass-through of those costs under the pipeline's PGA clause).

separate systems, nearly three times the property, plant and equipment of SFPP, and double the labor but it is assigned $32.2 million in overhead. Rockies which has significantly more gross revenue and nearly four times the level of property, plant and equipment as SFPP is assigned $5.4 million in overhead costs.[256] This record does not contain explanations which can be merited as credible for these disparities.[257]

267. Based on the evidence above it is found that SFPP failed to meet its burden of proof concerning its G&A costs. Specifically, SFPP excluded (did not assign or allocate related costs) subsidiaries that indeed benefitted from oversight and G&A overhead support and services provided by KMEP and KMGP Services personnel, KMEP's direct assignments of overhead G&A are unsupported, inaccurate and do not link cause with the costs. Further, the shared-distribution G&A costs groups are interrelated and therefore managers in each shared-distribution group are performing G&A overhead support and services for subsidiaries outside their group. The KMI personnel performing G&A overhead support and services are a complex, non-transparent, and integrated G&A workforce. These employees are moving targets. The KMI and KMGP Services employees perform G&A services, directly or indirectly for any Kinder Morgan entity. On the other hand, the testimony of VCC Shipper's witness Dr. Arthur is found credible and given significant weight. Accordingly, it is ordered that SFPP include all of the appropriate G&A overhead costs in one pool and objectively allocate the costs to all the subsidiaries in accordance with the Mass formula.[258]

268. Staff is also correct that SFPP failed to justify its costs. Staff correctly points out that SFPP failed to capitalize indirect overhead costs associated with capital projects in violation of Commission policy and failed to properly match costs with causation. Additionally, SFPP used an incorrect definition for the term "carrier". This also violates Commission rules and even SFPP's own practices. Further, Staff correctly points out that the most glaring of SFPP's flaws is its application of the KN method. Staff is correct that SFPP continues to violate well established Commission precedent and disregards prior Commission directives concerning this matter. In addition, SFPP withheld critical

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256 Figure 1 VCC Shippers IB at 100.

257 For instance, in Docket No. OR96-2 the Kinder Morgan overhead expense allocated to SFPP in 1999 (the second year of SFPP being in the Kinder Morgan family) was $21.6 million using the Mass Formula with no direct assignments. Exs. VCC-77; 1 at 69-70. At that point in time SFPP was 50 percent of KMEP's operations based on the Mass Formula metrics, a level that has decreased to 5 percent as of 2009.

258 SFPP's proposal cannot simply be corrected since the errors are endemic to the entire cost allocation. Use of the Mass formula is a more reasonable approach.

information from its pre-filed testimony which undermines its filing by failing to divulge in a timely manner fundamental changes to its accounting practices.

Capitalized Overhead Expenses

269. Capitalized overhead expenses are not "residual costs" and cannot be allocated through the Mass formula. SFPP incorrectly included capitalized overhead expenses in the costs to be allocated through the Mass formula. Ex. S-10 at 5. Under Commission regulations, capitalized overhead costs include all overhead costs associated with facilities under construction and not in service. These costs include engineering, supervision, general office salaries and expenses, construction engineering and supervision by others than the accounting utility, law expenses, insurance, injuries and damages, relief and pensions, taxes and interest. These costs are charged to particular jobs or units on the basis of the amounts of such overheads that can reasonably be applied to the project, such that each job or unit shall bear its equitable proportion of such costs. Uniform System of Accounts Gas Plant Instruction 4. FED-REGS, FERCSR ¶ 20, 044, PT 201, *Overhead construction costs*. Capitalizing overhead expenses related to construction projects allows a company to recover its entire capital investment in the project from the customers who benefit from the investment over the entire life of the project. In this manner SFPP recovers its direct overhead capital costs. *Id.* However, SFPP does not capitalize its indirect overhead costs related to construction projects. Instead, the costs are expensed and recovered immediately. There is no justification for this treatment of the indirect overhead capital costs. Direct and indirect overhead capital costs should both be capitalized and recovered through depreciation expense.

270. Staff correctly points out that Commission regulations require that both direct and indirect costs be included in the cost of carrier property constructed. Section 3-3 of the Instructions for Carrier Property Accounts under the Uniform System of Accounts for Oil Pipelines states as follows: the costs of constructing property chargeable to the carrier property accounts shall include direct and other costs as described hereunder. 18 CFR Pt. 352, Instructions for Carrier Property Accounts 3-3 (2010). Staff is correct that the appropriate interpretation of this section is that other costs include indirect costs. It is inconsistent for SFPP to capitalize direct costs and expense indirect ones. Staff testimony in this regard is given significant weight. Accordingly, SFPP is ordered to correct this error.

The K-N Method

271. The Kansas-Nebraska (K-N)[259] method is used to allocate A&G expenses among divisions or functions within a subsidiary, such as SFPP. A&G expenses are indirect,

[259] *Kansas-Nebraska Natural Gas Co. Inc.,* 53 FPC 1691 (1975), *order on reh'g,* 54 FPC 923*, aff'd,* 531 F.2d 227 (10th Cir. 1976).

corporate level expenses that cannot be directly assigned to any one function. Ex. S1-10 at 17. Staff is correct that SFPP's allocation of A&G expenses as presented by SFPP witness Turner, violates Commission precedent and is a flawed methodology which fails to match costs with causation.

272. The K-N methodology requires that all A&G costs be properly characterized according to the nature of the expense. Further, the Commission has stated that under this methodology it considers that A&G costs relate primarily to a company's expenditure of labor. In Appendix C, of Opinion No. 731[260] the Commission details eleven A&G expense categories and describes that they are to be functionalized among labor, plant and other. Under labor the Commission included: (1) administrative and general salaries; (2) office supplies and expenses; (3) administrative expenses; (4) workmen's compensation; (5) third-party liability; (6) injuries and damages; (7) employee pensions and benefits. A&G expenses characterized as plant include fire and other insurance as well as general plant maintenance. The characterization for other includes: outside services employed and miscellaneous general expenses. The other expenses should be allocated on the basis of the relative amounts of A&G expenses directly attributable to direct labor and plant in service. This is required to give appropriate recognition to both the labor and plant costs, and the fact that the vast majority of the directly assignable costs are allocated to labor. The Commission calculated the labor and plant ratios in relation to the total labor and plant-related A&G costs. The other expenses were allocated to labor and plant based on these ratios. As a result, in the final allocation there are no other costs since these are incorporated into labor and plant based on the appropriate ratios. *Id.* at 1691, 1722.

273. SFPP, Intervenors and Staff agree that the K-N method is the proper methodology to allocate A&G costs in this proceeding. However, Mr. Turners' simple average methodology does not comply with the K-N method. The K-N formula has been affirmed by the Commission in numerous decisions.[261] Moreover, the record in this proceeding conclusively establishes that SFPP has consistently disregarded previous orders requiring SFPP to comply with the K-N formula.[262] The testimony of witness Turner which uses a simple average (or combined labor and plant ratio) to allocate A&G

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260 *Id*.

261 *Id.*, 55 FPC 1818 (1976). *Idaho Power Company*, 3 FERC ¶ 61,108 (1978); *Missouri Power and Light,* 5 FERC ¶ 63,003 (1977)(other functionalized on an equal ratio since the record did not allow a precise determination of the division between labor and plant); *Panhandle Eastern Pipeline Co.,* 46 FERC ¶ 61,183 (1989); *Questar Pipeline Company*, 74 FERC ¶ 61,126 (1996); *Transcontinental Gas Pipeline Corp*., 101 FERC ¶ 63, 022 (2002).

262 *SFPP, L.P.,* Opinion 435, 86 FERC ¶ 661, 022, 61083 (1999).

is contrary to the K-N formula. Commission Staff is correct that Opinion 435 was an exception and not the rule. Further, the December 2005 Order[263] clearly rejected Mr. Turners' simple average approach. This order directed SFPP to eliminate the PAA from its gross property balance and use direct labor costs (a single factor approach) to allocate the appropriate A&G costs to its carrier and non-carrier operations. *Id.* In a December 2007 Order[264] the Commission again rejected an SFPP compliance filing for the same reasons. Consequently, contrary to SFPP's allegations it must follow the K-N formula.

274. The K-N formula requires A&G costs to be characterized as labor, plant or other. For instance, costs such as salaries, benefits, office supplies, and insurance are primarily labor. Plant maintenance and property insurance are plant. Turner however testified that SFPP's corporate overhead expenses cannot be categorized as plant or labor. Ex. SPE 162 at 39. According to Turner, accounts 500 (salaries and wages), 550 (pensions and benefits) and 560 (insurance) should be allocated using his interpretation of the K-N formula (a simple-average two factor KN formula).[265] Tr. 1898. However, his methodology does not account for the cost and the activity that generated the cost, it fails in causation. Staff correctly points out that SFPP argued against application of the Mass formula stating that it has the information it needs to make direct assignments of overhead costs. This statement contradicts Turners testimony that he cannot categorize the costs as plant or labor. If SFPP has the information it needs to make direct assignments of costs then it has the information it needs to appropriately categorize the costs in accordance with the K-N formula as specified by the Commission.

275. A&G expenses are recorded in the 500 series of accounts. Account 500 (salaries and wages), Account 520 (outside services), Account 550 (employee benefits) and Account 560 (insurance). In 1998, all costs that had been previously recorded in Accounts 500, 550 and 560 were instead recorded in Account 520. Before the end of the base period in this proceeding SFPP changed its method of recording in the 500 series of accounts. It did not adjust its K-N formula calculations to reflect the changes and did not mention these changes in its testimony. As a result of the KPMG Study all costs that had been previously solely recorded in account 520 were reclassified into Accounts 500, 550 and 560 starting on July 2009. Ex. S-34 at 16. SFPP did not make this change known to Staff until its response to a data request on February 25, 2010. In the interim, it had provided responses in November 12, 2009 that only showed Account 520 and had filed

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263 *SFPP, L.P.,* 113 FERC ¶ 61,277, at P 89 (2005).

264 SFPP, L.P., 121 FERC ¶ 61,240, at P 137 (2007).

265 His approach in fact treats labor and plant as the Commission's "other" expenses. Totally disregarding Commission precedent. Ex. SPE-162 at 40. Mr. Turner was the sole SFPP witness who refused to categorize the costs in accordance with the K-N formula.

testimony in December 11, 2009, which did not refer to the accounting changes. Mr. Turner testified on May 14, 2010 and did not mention the changes and instead stated that SFPP was still following the same methods it had followed since 1999. It is found that this testimony was misleading. On February 25, 2010 Mr. Turner in a data response had demonstrated that the costs were being recorded in the various 500 series Accounts. In April 2010 Mr. Turner was aware of the accounting changes having assisted in the preparation of SFPP's FERC Form 6 which reflected the 500 series Accounts. Furthermore, SFPP had an obligation to change its cost of service based on these changes and it did not. The failure to make appropriate changes to its cost of service not only undermines the credibility of Turner's testimony but the entire SFPP tariff filing. Consequently, Turner's testimony overstates the total A&G costs.

276. Based on the record in this proceeding, where it is clearly evident that SFPP has failed to comply with Commission orders directing it to file the correct K-N formula calculations and Turner's testimony that he would continue to utilize his methodology, it is found that SFPP has a practice of non compliance. Accordingly, Staff witness Sosnick's testimony which has been previously given significant weight is adopted as the proper K-N methodology. Mr. Sosnick first calculated the respective percentages of labor costs, plant costs, and other costs by reviewing the $36,389,204 in direct assignments to SFPP from KMEP. Ex. S-10 at 25. He applied these percentages to the amount of KMEP corporate overhead allocated to SFPP through his Mass Formula $9,925,502. This resulted in residual labor costs of $5,162,827, residual plant costs of $1,403,057 and $3,359,618 in residual other expenses. Adding these amounts to the direct assignments, Mr. Sosnick calculated total labor costs of $24,090,954 and total plant cost of $6,546,991. Then Mr. Sosnick calculated percentages for labor costs and plant costs to the combined plant and labor costs. Deriving a 21.37 percent for total plant and 78.63 percent for total labor. Mr. Sosnick applied these percentages to the total of other expenses. This resulted in $3,349, 951 of other expenses being allocated to plant and $12,326,811 being allocated to labor. This results in $9,896,942 of corporate overhead allocated on plant and $36,417,765 corporate overhead costs allocated on labor. These costs were then allocated between jurisdictional and non-jurisdictional operations of SFPP and SFPP's East Line and its other jurisdictional services.

277. Mr. Sosnick calculated a plant ratio of 46.237 percent which applied to $9,896,942 of plant-related corporate overhead costs generate a carrier plant amount of $4,576,105. Additionally, a carrier labor ratio was calculated by Mr. Sosnick. This factor was 30.8515 percent resulting in a carrier labor of $11,235,425. These amounts were then allocated between SFPP's East Line and its other jurisdictional services. The East Line has a property investment that is 57.95 percent of the total property investment of SFPP. The labor percentage for the East Line is 41.26 percent. These percentages applied to the total carrier amounts results in $4,635,582 East Line corporate overhead in labor related costs and $2,651,878 in plant-related costs. Thus, the total corporate overhead cost allocation is $7,287,460. *Id.* at 26. SFPP is directed to adopt this

methodology in its compliance filing including compliance with the findings above that it must follow the Mass Formula.

ISSUE IV.B - Allocation Factors for Expenses Between Interstate and Intrastate Service and Between Jurisdictional and Non-Jurisdictional Services

278. The East Line provides interstate service and service to the military (a non-jurisdictional service). SFPP claims that it appropriately allocated investment and operating costs for Phoenix Terminal to the East Line based on deliveries to this terminal as a percentage of total deliveries. SFPP asserts that investment and operating expenses are directly assigned to these two classes of service using unique location codes. Deliveries are made to the Phoenix Terminal via both the East and West lines, therefore, Phoenix Terminal investment and operating expenses must be allocated between both lines. SFPP IB at 94. Staff avers that SFPP improperly defines the term “carrier.” N/W and VCC Shippers do not address this issue.

Discussion/Findings

279. Part 341 of the Commissions Regulations, 18 C.F.R. Part 341.0 (a)(1)(2010) defines the term “carrier” as “an oil pipeline subject to the Commission’s jurisdiction under the ICA.” However, SFPP witness Turner defines Carrier as: “SFPP has carrier pipeline transportation services regulated by the FERC and the CPUC, (and services for the military (which are not regulated by the FERC or the CPUC).” [266] Staff is correct that witness Turner’s definition is contrary to the rules by including non-jurisdictional facilities. Mr. Turner’s definition is inconsistent with SFPP’s internal accounting methods as well as the testimony of SFPP’s other witnesses. Witness Des Lauriers testified that KMEP employees can identify whether they are working on an activity that is carrier, non-carrier or military. Tr. 1076. Mr. Bradley also testified that KMEP accounting codes classify labor as “carrier, non-carrier and military. Tr. 1342. However, under Mr. Turner’s definition the sub-categories would be unnecessary since all costs would be carrier. Accordingly, SFPP is ordered to comply with Commission rules and the definition of carrier.

ISSUE IV.C - Fuel and Power Costs

280. SFPP argues the appropriate fuel and power expenses are those it proposes as reflected in Schedule 15 of SFPP COS. SFPP IB at 94. VCC Shippers and N/W recommend that the fuel and power costs be adjusted to reflect their proposed test period volumes. Staff used actual amounts for fuel and power for calendar year 2009

[266] Ex. SPE-47 at 22.

corresponding to the throughput amounts sponsored by its witness McComb. She made one adjustment for the Navajo's refinery's turnaround.

Discussion/Findings

281. SFPP identified the cost of energy and the cost of drag reducing agent (DRA) as the East Line's primary fuel and power costs. Ex. SPE 43-3. The costs are incurred at the East Line's four significant energy usage points which correspond to the six line segments on the East Line. Ex. SPE-43-3. The costs at each of the four energy usage points vary in correlation to the number of barrels transported through each point, the product mix, the cost and amount of electric energy used at each point, and the cost and amount of DRA used at each point. Ex. SPE-43 at 5-8. According to SFPP, each line segment has a different per-barrel energy cost. Ex. SPE-43 at 6; 212 at 3-5. SFPP witness Knudsen calculated a per-barrel energy cost for each of the six line segments based on expected changes in energy costs that will occur during the test period due to SFPP's adjustment to test period volumes. Ex. SPE-43 at 6; 8; 222 at 113. For El Paso Station the per-barrel energy cost reflected changes in energy as a result of pumping modifications at the location. Ex. SPE-43 at 7. SFPP witness Turner reduced the per-barrel energy cost for each line segment to account for changes in the electric utility tariffs and DRA costs that were expected to occur during the test period. Exs. SPE-47 at 8-9; 222 at 113. This is the test period per-barrel energy costs, which Turner then multiplied by the barrels SFPP anticipates will pass through each segment to arrive at his East Line fuel and power costs. Exs. SPE-47 at 8-9; SPE-22 at 110, 113.

282. SFPP witness Knudsen testified that Ms. Sherman's fuel and power adjustment design is incorrect. According to Knudsen the Phoenix Terminal is the terminus of the East Line and has no mainline pumps and no DRA. Knudsen argues that fuel and power expenses would be incurred at the four East Line pump stations located east of Phoenix Terminal and Station. As a result, this witness claims that Staff's fuel and power costs are understated. Ex. SPE-125 at 3. As a result of Staff's modifying Ex. S-2 Mr. Knudsen testified that use of an average per barrel fuel cost for the entire East Line as proposed by Staff is incorrect. Knudsen states that there are six line segments on the East Line but only four of the line segments (1, 4, 5 and 6) are used to transport throughput volumes identified by witness McComb to Phoenix. Ex. SPE-214.

283. Staff responds that the monetary difference between both approaches is only $26, 272. Mr. Knudsen's approach is based on the fact that line segments 2 and 3 stop at Tucson and Phoenix bound incremental volumes would not flow through these segments. Tr. 1641. Mr. Knudsen testified that he was not aware whether line segments 2 and 3 are physically connected to line segment 6 going to Phoenix or whether it was possible for oil to flow through segments 2 and 3 and then move to Phoenix through an operational change in the East Line System. Id.

284. SFPP witness Kehlet who testified on throughput testified that line segments 2 and 3 are dedicated to Tucson and line segments 4 and 5 are dedicated to Phoenix under the current configuration for the East Line. He further testified that if there is some emergency interruption, product could be channeled up the Tucson line segments (2 and 3) and then moved over to segment 6 (a 12 inch line) going to Phoenix and *vice versa*. Tr. 1138-39. According to this witness there are physical connections between the lines and only an operational procedure is required to make this change. The system would not have to be reconfigured. Tr. 1139.

285. Mr. Kehlet's pipeline operational testimony in this regard is given significant weight; as a result, Mr. Knudsen's criticisms of the Staff approach do not stand. Consequently, it is found that Staff witness's testimony is a better approach for determining the fuel and power expense. Therefore, SFPP is ordered to use the average fuel cost at all six lines segments to measure fuel and power expenses. These per-barrel energy costs are then multiplied by the barrels determined reasonable in Issue V below as the volumes relate and move through each pipeline segment to arrive at his East Line fuel and power costs. Exs. SPE-47 at 8-9; SPE-22 at 110, 113.

ISSUE IV.D - Regulatory Litigation Expense

286. SFPP argues that the correct litigation expense amount is $2.4 million. SFPP IB at 96. SFPP avers that its litigation expenses comport with SFPP's actual historical experience in other FERC proceedings and allows SFPP to recover its actual regulatory litigation expenses over the period of time during which the expenses will be incurred. SFPP will continue to incur litigation expenses in this docket and it claims it is entitled to recover East Line litigation expenses from several other dockets.

287. N/W claim that SFPP's expenses should not be embedded in the cost of service because there is no evidence that they are recurring expenses and will be fully expended in three years. N/W IB at 104. As a result, N/W propose that the actual rate case expenses be recovered in a separate five-year surcharge that is removed from rates at the end of the five years. N/W IB at 105. All expenses up to July 1, 2011 would go into the surcharge and amortized over a five-year period. In the five years and for each year, SFPP would develop a revised litigation expense surcharge for additional costs attributable to this case. At the end of the five years there would be a true-up of any uncollected or over-recovered amounts.

288. VCC Shippers contend that the appropriate amount for this expense is SFPP's normalized base period East Line litigation expense of $495,981. VCC Shippers IB at 111. This amount is the base period litigation expense for East Line interstate operations, with the expense of the Cost Allocation Study normalized over a five year period. VCC IB at 113. They argue that there is no basis for SFPP's proposed test period adjustment for the litigation expense.

289. Staff proposed $1.167 million annually for three years. Staff used actual regulatory litigation expenses for calendar year 2009. Staff witness recommended $890,459 after normalization as regulatory litigation expenses attributable to cases other than the instant case.

Discussion/Findings

290. It is clear that consistent with Commission precedent SFPP is entitled to recover costs arising out of litigation related to its cost of service and tariff. *Iroquois Gas Transmission Sys., L. P. v. FERC,* 145 F. 3d 398 (D. C. Cir 1998); *SFPP, L.P.,* 91 FERC ¶ 61,135 at 61,512 (2000) (Opinion 435-A).

291. SFPP reached its number by starting with $1.9 million incurred in regulatory litigation expenses from July 1, 2008 – June 30, 2009 for the East Line. SFPP witness Turner made a $1.4 million normalizing adjustment to the base period amount accounting for legal services and costs for specific matters which were greater during the base period than they would be in other years. Ex. SPE-47 at 14-15. He normalized the expenses over three years. Ex. SPE-47 at 15. Mr. Turner reduced the amount by $0.6 million as a result of a Partial Settlement in another proceeding. He added a test period adjustment of $2.2 million. Ex. SPE-47 at 15-18. Mr. Turner estimates that $6.5 million will be spent in litigating this proceeding through its final compliance filing. *Id*. at 16-17. To arrive at the $2.2 million test period figure the witness amortized his total costs over a three year period. Ex. SPE-47 at 16-17.It is also clear that during the base period, SFPP incurred $27,544 in litigation expenses.

292. The UPRR litigation[267] is over the rents for the right-of-way of each category of pipeline.[268] Tr. 1677:25 to 1678:12; 1679:8-16 (Turner). SFPP pipe on UPRR right-of way is classified in four categories, each with different fees per mile. Tr. 140:12-14(Melle). Class 1 is the most expensive. Tr. 140:20-21. N/W are correct that the right of way litigation expenses are overstated. First $7 million in legal fees for the "2004 Rental" matter reflect a base period, which included the actual trial. Typically the most costly period in a litigation. Exs. NAV-51 at 2; NAV-52 at 1; NAV-7 at 217; Tr. 1689:21 to 1609:4 (Turner). A decision in this matter was expected by the end of 2010. A percentage of the right-of-way legal fees was allocated to the East Line based on a mileage ratio: the ratio of East Line pipeline miles located on UPRR easements to total

267 This is litigation with Union Pacific.

268 The right-of-way expenses are described in SFPP's Ex. SPE-47 at 9-12; SPE-222 (Schedules 15 & 18); SPE-222 at 110; 114-17; SPE-39.

SFPP pipeline miles located on UPRR easements. Ex. SPE-222 at 114 (Schedule 18, at 1 of 4); 118 (Schedule 19, ln. 8); Tr. 1678:13-18 (Turner). The East Line was allocated 10.46 percent. N/W contend that this is unreasonable since the East Line goes mostly through dessert and therefore its easements are less per mile than other SFPP pipelines. SFPP witness Melle testified that out of 1,477 miles of SFPP pipe on UPRR easements the East Line comprises 154 miles. Ex. SPE-22 at 114. Of the 154 miles about two-thirds are classified class 4 which has the lowest right-of-way fees, zero miles are in class 1 (the highest fees). Tr. 143:23 to 144:1; 1677:10-14 (Turner). SFPP witness Turner allocated 4.87 percent of the right-of-way costs to the East Line. Ex. SPE-47 at 9:13 to 11:20; Tr. 1677:19-21 (Turner); Ex. SPE-22 at 114 (Schedule 18, page 1 of 4). However, for legal fees for the right-of-way litigation Turner allocated 10.46 percent to the East Line. N/W are correct that the East Line legal fees for this litigation are not reasonable and are over-allocated. N/W are correct that it is more reasonable to allocate the legal expenses in the same proportion as the cost. This is more in line with cost causation principles. Accordingly, SFPP is order to allocate these legal expenses using 4.87 percent.

293. A portion of SFPP's proposal includes legal fees arising from a right-of-way case with UPRR. Exs. SPE-222 at 118; NAV 51 at 2. These cases involve relocations of SFPP pipelines that do not involve the East Line. N/W are correct that these cases do not involve the East Line and litigation costs related to these proceedings should not be included in this proceeding.

294. VCC Shippers are correct that SFPP's litigation expense test period adjustment of $2,169,981 is a projection of its litigation expenses of $6,509,942 amortized over a three year period.[269] This is contrary to Commission rules. 18 C.F.R. § 346.2(a)(1)(ii)(2010). SFPP's projections are not adjustments to be known and measurable with reasonable accuracy. It is not reasonable to take the expenses of another litigation and use them to calculate the expenses in this case. Each litigation is different with its own uniqueness. For instance, in this case major items were agreed to by stipulation, which narrows the focus of briefs and review. Moreover, an indicia of unreasonableness is found by comparing the percentage of the litigation expense with total operating expenses on the East Line. The proposed $2,339,645 represents more than 8 percent of the $38.7 million SFPP recommends for total operating expenses on the East Line.[270] Ex. SPE-222 at 4-5,

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[269] The test period litigation expense proposed by SFPP includes this normalized amount and the base period amount of $169,664 for a total of $2,339,645 per year.

[270] Another example cited by the VCC Shippers is SFPP's proposed litigation expense in a California Public Utilities Commission proceeding. SFPP proposed $558,000 in litigation expenses (on a total SFPP intrastate basis) out of operating expenses of $72.9 million or less than 1 percent. Ex. VCC-175 at 13; Tr. 1719-23.

119-22; Ex. VCC-78hc at 27-28. Additionally, SFPP included in its base period expense of $169,664 the ULSD fee proceeding in Docket No. IS06-508-000, general FERC legal assistance, and the KPMG Cost Allocation Study. VCC Shippers are correct that it is not reasonable to normalize $173,673 for three years for costs related to a study. Consistent with the findings above this study is found to be a litigation expense. Accordingly, VCC Shippers are correct that a portion of this cost has to be allocated to SFPP's intrastate volumes since it was used as evidence in the state rate proceeding (Bradley January 2010 before the California PUC). Ex. VCC-79hc at 29.

295. During the base period $1.9 million was attributable to the East Line out of the reserve liability. Exs. SPE-47 at 14; 49C (page 1 of Schedule 20). After the amount is normalized the litigation expense requested by SFPP for cases other than this case is $798,639. Ex. SPE-49C at 18. This amount included costs for several historical dockets which were settled. In accordance with the terms of the settlement litigation expenses for all those dockets were removed from the litigation expense in this proceeding. The only base period expenses still included in the SFPP proposed cost of service for the East Line are those for Docket No. IS06-508, general FERC legal assistance and for the Cost Allocation study. Ex. SPE-162 at 2-3. The revised base period litigation expense after normalization is $0.2 million. Staff questions this figure and proposes instead $104,144. According to Staff, SFPP's proposed figure is based on dockets which were part of the settlement and the regulatory litigation expense from those dockets should not have been considered in his calculations. Staff testimony in this regard is given significant weight. Staff is correct that the figure should not have included the settled dockets. Additionally, as Staff points out the amounts after normalization of the original figure compared to the normalization after the settled dockets were removed, makes no sense. As a result, Staff's number is adopted for purposes of the based period amount.

296. Staff, like the VCC Shippers, points out that the test period adjustment is based on an estimated number using as a proxy Docket No. IS08-390 (a West Line rate case). Further Staff points out that SFPP used litigation costs incurred by SFPP in two complaint cases (Docket Nos. 0R03-5-001 and OR03-5-000) to estimate the litigation costs for the instant case after the hearing phase. Ex. SPE-47 at 15. Ms. Sherman for Staff measured actual cost for calendar year 2009. She determined these to be $1,062,987. Ex. S-2 at 115. She recommended that SFPP recover this amount for a three year period which would result in a recovery of $3.2 million in litigation expenses for this proceeding. Ms. Sherman posits that the actual amounts spent for this litigation so far are a reasonable proxy for litigation costs for the proceeding. Ex. S-1 at 27. Staff strongly opposes embedding litigation costs into the rate base on a permanent basis. *Id.* at 27-28; Tr. 2685.

297. Staff is correct that SFPP's proxy is not reasonable. This was a West Line case and the West Line has substantially larger throughput than the East Line. It is a reasonable assumption that such litigation would be costlier since the amounts involved

would be greater. Moreover, the issues were more expansive, including depreciation which is not an issue in the instant proceeding. The West Line proceeding included litigation of the ROE which was settled in this proceeding. Additionally, environmental remediation was settled in the instant proceeding whereas in the West Line case no issues were settled. Depositions amounting to $1.5 million were taken in the West Line case, none were conducted in this proceeding. Ex. SPE-162 at 8. In addition, it is determined that the evidence does not support the testimony of SFPP witness Turner who claims that by the end of the test period $2 million had been spent in litigation expenses. However, the base period litigation expenses are only $169,664 (normalized). Consequently, it is found that Turner's testimony is not credible. Finally, it is found that a three year amortization period is reasonable and appropriately recovers the expected litigation expenses in this proceeding. Even SFPP's witness Turner agreed that a three year period "represents the time period over which the estimated cost for litigating this proceeding are expected to be incurred." Ex. SPE-162 at 13.[271] Staff's amount of $3.2 million is reasonable and is adopted. Further, this regulatory litigation expense must be removed from the pipeline's rates after the three year amortization period expires, as they will have been collected in total at that time.

ISSUE IV.E – Allocation of Expenses to Interstate and Intrastate Service

298. This issue is addressed *supra* at ISSUE IV.A.

ISSUE IV.F – Right of Way Expense

299. This issue is addressed *supra* at ISSUE IV.D.

ISSUE IV.G – The Appropriate Environmental Remediation Test Period Adjustment to Account 320

300. This issue was resolved by stipulation between Staff and SFPP. Accordingly, it is found that $183,257 is the appropriate environmental remediation adjustment for Fort Bliss (Alamogordo Junction) and $23,008 is the appropriate stipulated environmental remediation adjustment for the El Paso Suction Line.

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[271] Turner also testified that proceedings of the type at issue in this case usually last around three years (from tariff filing to initial compliance filing after a Commission order). *Id.* If Turner's numbers are embedded into rate base in four years, SFPP will recover more than their claim estimate of $6.5 million.

ISSUE V – Throughput Volume Level

301. SFPP calculated its proposed throughput of 55,090,184 barrels per year (150,932 bpd) based on its proposed test period.[272] SFPP RB at 92-93. Specifically, SFPP based its test period throughput to Lordsburg, Alamogordo Junction, and Davis-Monthan AFB on actual volumes delivered to each destination during the second half of the base period, January to June 2009. SFPP based its test period throughput to Tucson on actual volumes delivered to Tucson during the second half of the base period, plus the projected deliveries for July 2009, the first month of the test period. SFPP believes that its proposed volumes for Lordsburg, Alamogordo Junction, Davis-Monthan AFB, and Tucson will yield the most accurate prediction of future volumes because they were the most current volumes available to SFPP at the time of the East Line Tariff Filing. SFPP calculated its throughput to Phoenix in a different manner because certain operational and logistical issues impacted East Line throughput to Phoenix in early 2009. First, SFPP calculated the average demand in Phoenix for the base period by taking the average level of deliveries to Phoenix on its East and West Lines. Second, SFPP adjusted the average demand downward to account for the declining economic conditions in Phoenix. Third, SFPP subtracted actual West Line deliveries to Phoenix for the base period. The resulting calculation is SFPP's proposed test period East Line throughput level. Ex. SPE-73 at 13.

302. According to SFPP, the record evidence supports its proposed throughput. For instance, a 2010 report from the Eller College of Management at the University of Arizona (Eller Report) predicts weak economic growth in Arizona. Further, reports from the United States Energy Information Administration (EIA) predict weak growth in the consumption of liquid fuels during the next several years. SFPP maintains that these reports are important because economic conditions in Arizona directly affect demand for refined petroleum products. Accordingly, SFPP infers from these reports that demand for petroleum products in Arizona will increase only slightly in the foreseeable future. Further, several parties in this proceeding made statements indicating their belief that demand for refined petroleum products will not rebound in the near future. SFPP also contends that the VCC Shippers inappropriately base their proposed throughput volumes on throughput levels that may occur in the next few years, rather than on current East Line throughput. SFPP RB at 94. SFPP concludes that the current East Line throughput volumes most accurately represent future throughput.

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[272] SFPP's throughput recommendation breaks out between the East Line destinations as follows: 37,360,018 barrels to Phoenix (102,356 bpd), 15,109,778 barrels to Tucson (41,397 bpd), 1,294,849 barrels to Lordsburg (3,548 bpd), 919,552 barrels to Davis-Monthan AFB (2,519 bpd), and 405,987 barrels to Alamogordo Junction (1,112 bpd).

303. SFPP disputes N/W and the VCC Shippers' assertions that SFPP's test period throughput levels are too low. First, SFPP argues that growth in East Line volumes will be slow and gradual, not quick and steep. In the first half of 2010, demand in Phoenix declined while demand in Tucson increased only slightly. Second, SFPP argues that the VCC Shippers' comparison of its throughput volumes in this proceeding with the throughout volumes in the West Line proceeding (Docket No. IS08-390) is inappropriate. SFPP notes that the West Line proceeding involved a different pipeline, a different base period, a different test period, and rates that became effective one and a half years before the rates in this proceeding became effective. SFPP RB at 93. SFPP also notes that demand has declined significantly in Phoenix since SFPP calculated the test period in the West Line proceeding. Third, SFPP argues that N/W and the VCC Shippers present an inappropriate "back-door" prudency challenge. According to SFPP, they assert that SFPP's throughput is too low in light of the EL Phase II capacity expansion. N/W and the VCC Shippers contend that an increased throughput is not justified because the test period throughput is only slightly greater than the East Line capacity prior to the EL Phase II capacity expansion. SFPP responds that ample evidence shows that the EL Phase II capacity expansion was warranted and resulted in many benefits. Although N/W and the VCC Shippers deny raising prudency challenges, SFPP argues that their high throughput recommendations will achieve the same outcome as a prudency challenge – precluding SFPP from earning a return on prudent investments. Finally, SFPP argues that both N/W and the VCC Shippers fail to comply with the Commission's base/test period regulations to calculate an appropriate throughput because their test period adjustments are not based on volume changes that were known and measurable at the time of filing and that were expected to become effective within nine months.[273] SFPP RB at 93-94. SFPP notes that N/W's test period volumes exceed the East Line actual test period throughput by eight percent. *Id.* at 95. SFPP argues that N/W's test period volumes will cause SFPP to under-recover its COS in violation of the *Hope*[274] and *Bluefield*[275] standards. *Id.*

304. Staff recommends a calendar year 2009 test period for developing the East Line COS throughput volumes.[276] Staff witness McComb, however, makes one adjustment to

273 SFPP disputes the VCC Shippers' test period throughput calculation for only Tucson and Phoenix. The VCC Shippers recommend using SFPP's test period throughput calculations for Alamogordo Junction, Lordsburg, and Davis Monthan AFP. SFPP RB at 93-94.

274 *FPC v. Hope Natural Gas Co*., 320 U.S. 591, 605 (1944).

275 *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 692-93 (1923).

276 Staff's throughput recommendations for the East Line destinations are as follows: 38,596,128 barrels to Phoenix, 15,118,034 barrels to Tucson, 1,379,332 barrels to Lordsburg,

(continued)

Phoenix throughput to account for turnaround activity that affected throughput during a six-week time period at the Navajo refinery. Staff IB at 102. The Navajo refinery turnaround caused a 77 percent reduction of throughput from the refinery. Ms. McComb therefore calculated the monthly average Phoenix throughput for months not affected by the turnaround. She used this average throughput for the throughput volume during the time period of the turnaround. Staff believes that SFPP should base throughput volumes on actual throughput and the most recent available data. According to Staff, SFPP and Staff agree that use of actual data to calculate throughput is appropriate. However, Staff asserts that SFPP did not use the most recent available actual data to calculate throughput. For instance, SFPP witness Kehlet used actual data from January through June 2009, plus estimated volumes from July 2009. Witness Kehlet then annualized the amounts to calculate SFPP's test period adjustments. Staff IB at 103. Staff asserts that more recent data is available to calculate SFPP's throughput volume.

305. N/W support a throughput of 59,971,266 barrels per year (164,305 bpd). Western witness Eberst calculated SFPP's throughput volume in two steps. First, he calculated a baseline throughput volume of 54,776,688 barrels (150,073 bpd). The baseline volume equals the actual deliveries on the East Line for the twelve months ending March 31, 2010. According to N/W, their method to calculate throughput is more accurate than SFPP's method because witness Eberst uses twelve months of data to calculate throughput, instead of annualizing throughput from a shorter time period. N/W point out that SFPP witness Kehlet annualized throughput for Tucson, Lordsburg, Alamogordo Junction, and Davis-Monthan AFB from the traditionally low-volume months of January, February, and March. N/W state that their twelve month method eliminates the effects of seasonality, and therefore more accurately represents going-forward volumes.

306. Second, witness Eberst added 14,232 bpd to the East Line baseline throughput to reflect the underutilization of the EL Phase II capacity expansion. N/W note that the EL Phase II capacity expansion added 60,000 bpd of capacity to the East Line. Further, ninety-five percent, or 56,927 bpd, is underutilized with a shortfall of 56,068 bpd. Witness Eberst allocated the underutilization risk based on two factors: (i) market conditions and (ii) the over-estimation by SFPP and SFPP shippers of future market demands at the time of the EL Phase II capacity expansion. He attributed fifty percent of the throughput shortfall to each factor. He then attributed 100 percent of the "market conditions" shortfall to SFPP shippers, and attributed the "over-estimated" shortfall

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932,282 barrels to Davis-Monthan AFB, and 387,570 barrels to Alamogordo Junction. SFPP contends that Staff's proposed throughput volumes do not comply with the Commission's base/test period methodology set forth in Section 346.2(a)(ii). *See* 18 C.F.R. § 346.2(a)(1)(ii) (2010). SFPP further contends that Staff failed to show that SFPP's throughput volumes are not reasonably representative of the volumes that will occur during the period in which the rates will be in effect.

equally between SFPP and SFPP shippers. According to N/W, the adjustment properly shares the underutilization risk of the EL Phase II capacity expansion between SFPP and SFPP shippers. N/W argue that absent such adjustment, SFPP will not only recover its COS, but will also over-recover its COS if throughput increases.

307. N/W cite several cases which discuss the Commission policy to calculate pipeline rates using design capacity rather than throughput. According to N/W, the Commission's concern was that pipelines could over-recover their costs if they used projected volumes that are less than the pipeline's design capacity. More specifically, these cases stand for the Commission policy that in oil and natural gas proceedings, "a pipeline cannot place all of the risk of under-utilized capacity on its shippers."[277] N/W IB at 121. *See* N/W IB at 119-21; N/W RB at 73-74. For instance, in *White Cliffs*, the Commission required the pipeline to use its actual design capacity because the pipeline did not propose safeguards against over-recovery of costs. *White Cliffs* at PP 31-32. As stated in *Enbridge Energy*, Commission policy dictates the use of actual design capacity for initial rates. *Enbridge Energy* at P 44. Further, pipelines are at risk for unsubscribed capacity costs based on actual capacity. *Id.* N/W argue that no basis exists to distinguish these cases from the present proceeding. N/W explain that East Line rates have been determined through settlement since the EL Phase II capacity expansion. This proceeding represents the first time that SFPP and SFPP shippers have litigated the rates associated with the EL Phase I and II capacity expansions. On the basis of this procedural posture, N/W argue that the policy set forth in these cases is binding upon SFPP. Specifically, SFPP cannot place the entire risk of underutilized capacity on its shippers, and over-recover its costs if throughput volumes increase. N/W conclude that witness Eberst's adjustment ensures that SFPP will incur a fair proportion of the underutilized capacity. N/W IB at 121-22; N/W RB at 72-74.

308. N/W argue that SFPP failed to justify placing the entire risk of the EL Phase II capacity underutilization on SFPP shippers. First, N/W note that SFPP shippers' letters of support for the EL Phase I expansion did not reference the EL Phase II expansion. Further, the estimated rate in the letter of support tendered by SFPP is significantly lower than the rate resulting from the EL Phase II expansion. N/W point out that Navajo

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277 N/W cite the following cases in support of their contention that a pipeline cannot place all of the risk of underutilized capacity on its shippers: *White Cliffs Pipeline, L.L.C.*, 126 FERC ¶ 61,070, at PP 29-31, 32 (2009) (*White Cliffs*); *Enbridge Energy Co.*, 110 FERC ¶ 61,211, at P 44 (2005) (*Enbridge Energy*); *Enbridge Pipelines (Southern Lights) LLC*, 122 FERC ¶ 61,170, at P 10 (2008); *Great Lakes Gas Transmission*, 66 FERC ¶ 61,118, at 61,210 (1994); *Equitrans, Inc.*, 63 FERC ¶ 61,070, at 61,304 (1993); *Arkansas W. Pipeline Co.*, 63 FERC ¶ 61,006, at 61,027 (1993); *Mississippi River Transmission Corp.*, 95 FERC ¶ 61,460, at 62,658-59 (2001); *El Paso Natural Gas Co.*, 84 FERC ¶ 63,004, 65,006 (1998); and *Natural Gas Pipeline Co.*, 73 FERC ¶ 61,050, 61,129 (1995).

opposed the expansion, and refused to execute the letter of support. Second, N/W argue that SFPP incurred the business risk that SFPP shippers may not utilize all of the capacity associated with the EL Phase II expansion. Specifically, SFPP built the EL Phase II expansion without FERC review or a public interest approval, which indicates that SFPP voluntarily adopted the business risk associated with the expansion. N/W note that the twenty-five percent risk allocated to SFPP via witness Eberst's method will decline as East Line throughput recovers.

309. Third, N/W contend that the purported "extensive benefits" of the East Line expansion does not absolve SFPP from bearing a reasonable portion of the EL Phase II expansion. N/W state that SFPP witness Webb does not show that lower commodity prices in Tucson and Phoenix are attributable to the East Line expansion, and in particular the EL Phase II expansion. N/W note that commodity prices are primarily a function of crude oil prices. N/W RB at 75-76. Finally, N/W argue that monthly throughput variation does not support placing the entire cost of underutilization on SFPP shippers. SFPP notes that East Line capacity is more fully utilized during certain months. N/W respond that Western witness Eberst's capacity figures are a monthly average during the test year. The degree of underutilization varies from month to month. According to N/W, SFPP believes that the monthly variation shows that SFPP shippers use at least some of the unused expansion capacity identified by witness Eberst in some months. N/W respond that, even in months of peak use, significant unused capacity exists on the East Line. N/W therefore contend that the monthly variation of throughput does not support placing the entire cost of unused capacity on SFPP shippers. N/W also state that no basis exists for the position that the EL Phase II expansion capacity was necessary to accommodate the months of above-average throughput. *See* N/W RB at 76-77.

310. The VCC Shippers support a throughput volume of 59,549,200 barrels per year.[278] VCC Shipper witness O'Loughlin calculated SFPP's Phoenix throughput in the following manner. First, he calculated a total Phoenix demand level under normal economic operating conditions. The total Phoenix demand level equals the East and West Line deliveries. Second, witness O'Loughlin averaged the total Phoenix demand level with the actual base period demand level in the current proceeding. Third, he subtracted his recommended West Line throughput in the West Line proceeding (Docket IS08-390) from the averaged total Phoenix demand level. According to the VCC Shippers, witness

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278 The VCC Shippers recommend 40,840,945 barrels to Phoenix (111,893 bpd) and 16,088,105 barrels to Tucson (44,077 bpd). The VCC Shippers adopt SFPP witness Kehlet's recommendations for the three smaller East Line destinations: 1,294,849 barrels to Lordsburg (3,548 bpd), 919,552 barrels to Davis-Monthan AFB (2,519 bpd), and 405,987 barrels to Alamogordo Junction (1,112 bpd).

O'Loughlin used an average of 2007 actual volumes and base period volumes based on evidence that demand for petroleum products is resuming.[279]

311. The VCC Shippers throughput volumes for Phoenix and Tucson are greater than those of SFPP. They contend that SFPP's proposed throughput volume of 55,090,184 barrels per year is artificially low and unreasonably assumes that East Line throughput will remain below the lowest level reached during the most recent recession. Witness O'Loughlin identified two apparent flaws in the method SFPP used to develop throughput. First, he testified that the East Line volume level is very close to the volume level prior to the EL Phase II expansion.[280] In connection with the EL Phase II expansion, SFPP projected a steady two and one half percent annual growth rate in Phoenix demand between 2008 and 2017. The VCC Shippers suggest that SFPP's projections are inconsistent with its position in this proceeding that demand for petroleum products will remain at a low point. Second, witness O'Loughlin testified that SFPP witness Webb relied on unemployment data to support SFPP's position that throughput on the East Line will remain at a low point. However, in the West Line Proceeding (Docket No. IS08-390), witness Webb relied on gross domestic product as the primary factor to determine demand for petroleum products. The VCC Shippers imply that witness Webb's shift from a gross domestic product factor in the West Line proceeding to an unemployment factor in the current proceeding calls into question the credibility of the method SFPP used to calculate East Line throughput.

312. The VCC Shippers argue that the evidence does not support SFPP's position that recessionary conditions on the East Line will continue. First, the VCC Shippers note that SFPP cites the Eller Report to show that expansion will not resume until 2013. They respond that the Eller Report does not refer to demand for petroleum products. Second, the VCC Shippers note that SFPP cites projections from the EIA to show that demand for liquid fuels will return to 2007 levels by 2020 to 2030. The VCC Shippers respond that SFPP's discussion regarding when demand levels will return to 2007 levels is irrelevant because no participant recommends that SFPP rely on the actual 2007 volume level for purposes of developing a test period volume recommendation for the East Line. The VCC Shippers note that the EIA data referenced by SFPP projects a 2010 demand level higher than the 2007-2008 average level. Third, the VCC Shippers note that SFPP relies on national level data, rather than Arizona-specific data, to predict demand for petroleum

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279 Witness O'Loughlin examined projections developed by the Eller School of Management at the University of Arizona and the Energy Information Association. He also considered a report from the consulting firm Energy Analysts International. *See* VCC Shippers IB at 117 (predicting growth in demand for petroleum products in Arizona).

280 The East Line capacity before to the EL Phase II expansion was 147,000 bpd and SFPP proposes 150,932 bpd for the East Line in this proceeding. VCC RB at 94; SFPP IB at 111.

products in Arizona. They respond that no reason exists to assume that change in petroleum product demand in Arizona matches change in petroleum product demand nationally. VCC Shippers RB at 89-93.

313. The VCC Shippers assert that SFPP's argument in support of its throughput proposal in the West Line proceeding (Docket No. IS08-390) undermines SFPP's throughput proposal in this proceeding. In the West Line proceeding, SFPP did not recognize certain Phoenix volumes on the West Line because SFPP temporarily shifted the volumes from the East Line to the West Line due to non-reoccurring events. According to SFPP, East and West Line throughput volumes would likely revert to their respective 2008 levels. SFPP therefore argued that West Line rates should not include the rate impacts of the non-recurring events. However, in the current proceeding, SFPP proposes to calculate East Line throughput by subtracting West Line actual throughput volumes from total Phoenix demand, calculated as the sum of East and West Line deliveries to Phoenix. Yet, the West Line actual throughput volumes are overstated due to the volumes shifted from the East Line to the West Line. Accordingly, SFPP's proposed East Line throughput volumes are understated due to the overstated West Line volumes. Thus, in each proceeding, SFPP claims that the shifted volumes are properly attributable to the pipeline not at issue. The VCC Shippers state that not accounting for these volumes artificially lowers the East Line throughput, and therefore increases SFPP rates. VCC Shipper witness O'Loughlin therefore accounted for these volumes.

314. According to the VCC Shippers, SFPP attempts to obscure the fact that its does not account for these Phoenix-bound barrels. First, they argue that SFPP's distinction between East Line and West Line volume projections is a "bizarre tactic" because SFPP relied on East Line and West Line volumes to calculate its Phoenix throughput proposal in this proceeding. VCC Shippers RB at 96. Specifically, SFPP calculated its proposed Phoenix volume by subtracting West Line volumes from the sum of East Line and West Line volumes. Second, the VCC Shippers argue that SFPP's suggestion that the East Line and West Line proceedings involve different time periods is inconsistent with SFPP's claims in both proceedings with respect to the first part of 2009. The VCC Shippers point out that early 2009 is part of the base period at issue in this proceeding, and is part of the time period during which SFPP claims that West Line volumes were overstated.

315. The VCC Shippers argue that the Commission's objective to encourage infrastructure investment cannot override its statutory obligation to prevent excessive rates. Pursuant to Section 1(5) of the ICA, the Commission has a duty to maintain just and reasonable rates. 49 U.S.C. app. § 1(5)(a). The Commission may not deviate from its statutory duty. *See Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984) (*Farmers Union*). According to the VCC Shippers, SFPP's primary theme regarding throughput volumes resembles the Commission's argument that the D.C. Circuit Court rejected in *Farmers Union*. Specifically, the D.C. Circuit Court rejected

the Commission's rationale that underinvestment in oil pipelines is a real threat to the public, and therefore oil pipeline ratemaking should err on the side of "liberality". *Id.* at 1494-95, 1501-07. The Commission may not err on the side of excessive rates because "not even a little unlawfulness is permitted." VCC Shippers IB at 120 (citing *Farmers Union* at 1508). The VCC Shippers note that any additional revenues received by SFPP will increase distributions to SFPP unit holders, rather than encourage infrastructure investment, because SFPP's partnership agreement requires distribution of 100 percent of available cash.

Discussion/Findings

316. The appropriate volumes to develop the East Line COS throughput are the most recent twelve months of actual volumes ending March 31, 2010. As discussed *supra*, ISSUE I, Commission policy is to use actual data from the most recent twelve month test period to calculate a pipeline's COS, absent good cause.[281] Also discussed *supra*, ISSUE I, the Commission affirmed that the base period is the twelve months ending June 30, 2009, and the test period ended March 31, 2010. October 22 Order at P 2; *see* 18 C.F.R. § 346.2(a)(1)(i)-(ii) (2010). Further, in Opinion 435, the Commission ordered SFPP to set its rates for the East Line and West Line using different COS. *SFPP, L.P.*, 86 FERC ¶ 61,022, at 61,080-81 (1999) (Opinion 435). The Commission found that "SFPP's rate structure in its current format reflects the fact that the underlying transportation economics of the East and West Lines are different, *particularly as regards their relative volumes* and investment bases." *Id.* (emphasis added). Commission policy and precedent therefore dictate that the appropriate test period for throughput volumes and all issues impacted by throughput volumes in this East Line proceeding should be the actual data from the twelve month test period ending March 31, 2010.

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281 *See High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043, at P 49 (2005) ("The Commission affirms the use of actual end-of-test-period data for O&M expenses, and affirms the ALJ's finding that HIOS has supported the inclusion of O&M costs charged to HIOS under the Operating Agreement. The use of actual test period figures is consistent with Commission policy and precedent."); *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 315 (2002) ("The Commission finds convincing KPC's argument that test period actual figures--figures for the last twelve months of the test period--should be used. Use of these figures is in keeping with Commission policy and the Commission finds it is reasonable to follow that policy here." (footnote omitted)); *Trunkline Gas Co.*, 90 FERC ¶ 61,017, at 61,048-49 (2000) ("Therefore, the fact Trunkline's test period projections may have been reasonable when made does not require the Commission to accept those projections for purposes of determining Trunkline's rates. Rather, the key issue is what projection, based on known and measurable data for the whole test period, is most likely to be representative of what will occur during the period the rates are in effect."). *See also* Opinion 486 at P 263 (2006) (referencing *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027 (1999)).

317. SFPP's argument that Staff misinterpreted *High Island*[282] and Opinion No. 486[283] as supporting the use of actual test period data to calculate a pipeline's throughput is not persuasive. According to SFPP, *High Island* and Opinion No. 486 do not support Staff witness McComb's statements that the use of actual test period data is consistent with Commission policy and precedent, and that the Commission found that using actual test period data rather than filed test period data is just and reasonable because actual test period data is the best available data. SFPP IB at 121-122. SFPP states that the language relied upon by witness McComb in *High Island* and Opinion No. 486 address the treatment of O&M expenses, not throughput volumes. *Id.* at 122. SFPP therefore argues that Staff incorrectly assumes that the Commission's statements regarding O&M expenses apply equally to volumes, particularly since the Commission made these statements in natural gas proceedings rather than oil proceedings. *Id.*; *see* Staff RB at 49-50. SFPP's distinctions are not persuasive. For instance, the Commission in Opinion No. 486 references *Northwest Pipeline*[284] in support of the policy that a pipeline should use actual test period data updated for the last twelve months to calculate its COS. Opinion 486 at P 263 (referencing *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,027 (1999)). In the relevant discussion in *Northwest Pipeline*, the Commission affirmed the administrative law judge's decision to use actual test period data updated for the last twelve month to calculate the pipeline's COS, throughput, and billing determinants. *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,028 (1999). Therefore, Commission policy to use actual test period data is applicable not only to O&M expenses. Accordingly, witness McComb's recommendation to use "the most recent twelve months of actual throughput, for which data is available . . . up through the end of the adjustment (or test) period" is correct. Ex. S-19 at 10. However, calendar year 2009 volumes are not the most recent twelve months of actual throughput. At hearing, Staff presented volumes updated through the end of the test period ending March 31, 2010. SFPP should adopt these volumes to develop its COS. *See* Ex. S-20. This testimony is given significant weight.

318. The comparison of SFPP's proposed East Line test period volumes and the actual East Line deliveries during the test period persuasively demonstrates that SFPP's test period volumes accurately represent going-forward volumes on the East Line. For instance, SFPP projected a total test period throughput level of 150,932 bpd, and actually delivered 150,703 bpd on the East Line during the test period. Ex. SPE-127 at 3. Regarding Phoenix throughput, SFPP projected a total test period throughput level of 102,356 bpd, and actually delivered 102,233 bpd to Phoenix during the test period. Ex.

282 *High Island Offshore System, L.L.C.*, 110 FERC ¶ 61,043 (2005).

283 *See* Opinion 486.

284 *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266 (1999).

SPE-127 at 2. Regarding Tucson throughput, SFPP projected a total test period throughput level of 41,397 bpd, and actually delivered 41,051 bpd to Tucson during the test period. *Id.* The difference between SFPP's projected and actual deliveries is less than one percent. SFPP is correct that the minimal difference in volumes between its projected and actual deliveries confirms the reasonableness of SFPP's proposed test period throughput volumes. The VCC Shippers argue that the comparison between SFPP's projected throughput level and test period actual data is "irrelevant". They state that SFPP is comparing two recessionary time periods that are not representative of the East Line historical experience or the time period during which the rates will be in effect. They cite evidence regarding fluctuation in demand for petroleum products in connection with prior recessions in Arizona. Specifically, in the recession of the 1970s, 1980s, and 1990s, demand declined and recovered within two or three years from the end of the recession. Ex. VCC-78hc at 18-19, Fig. 8; Ex. VCC-87. Although such evidence is instructive, historical analysis and predictions are not as persuasive as the twelve months of actual throughput data ending March 31, 2010.

319. N/W and the VCC Shippers' concern that SFPP may over-recover its COS as the economy recovers and East Line throughput increases does not compel deviation from Commission policy and precedent. To remedy their concern, N/W and the VCC Shippers propose higher throughput volumes. Specifically, N/W propose a throughput of 59,971,266 barrels per year and the VCC Shippers propose a throughput of 59,549,200 barrels per year.[285] Their proposals are significantly higher than SFPP's throughput proposal of 55,090,184 barrels per year. Ex. SPE-127 at 3. The VCC Shippers argue that the Commission's complaint procedures provide insufficient protection against the potential for over-recovery. In support of their argument, the VCC Shippers make two claims. First, the complaint procedures protect only those shippers that file complaints. Second, years may elapse before the Commission sets a complaint for hearing. In contrast, the Commission can suspend a filed rate increase for a maximum of only seven months. The VCC Shippers' concerns are legitimate. However, adopting a throughput volume on the basis that the Commission's complaint procedures will not adequately protect SFPP shippers if the East Line volumes increase is inappropriate. SFPP has a statutory right to file for a rate increase at any time just as SFPP shippers have a right to file a complaint at any time. Evaluating the procedural equities between these rights is not an appropriate exercise in this proceeding. Rather, the appropriate question is what throughput volume reasonably represents the conditions that will occur during the period in which the rates will be in effect. Accordingly, SFPP is ordered to adopt Staff's volumes updated through the end of the test period ending March 31, 2010, to develop its COS. *See* Ex. S-20.

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[285] Ex. WNR-1 at 15; Ex. WNR-6 at 2; Ex. VCC-78hc; Ex. VCC-81hc – Ex. VCC91hc; Ex. VCC-180 at 48.

ISSUE VI - Rate Design

320. The sole issued in this proceeding regarding the classification of costs is whether costs in Account 590 are distance-related fees. N/W and the VCC Shippers do not address this issue. SFPP contends that costs in Account 590 are distance-related fees and Staff contends that costs in Account 590 are not distance-related fees.

321. According to SFPP, three types of costs classifications in Account 590 are distance-related. First, Account 590 includes user fees (DOT Fees) paid to the Department of Transportation (DOT). SFPP contends that DOT Fees are distance-related because they are based on a dollar amount per mile multiplied by the number of miles. The DOT Fees are the largest component of East Line costs in Account 590. SFPP acknowledges that the statute authorizing the DOT Fees does not specify the manner in which the DOT must assess pipeline user fees.[286] SFPP argues, however, that relevant legal authority demonstrates that the Secretary of Transportation assessed DOT Fees based solely on mileage. Further, SFPP states that "pipeline user fees continue to be assessed based on pipeline mileage today."[287] SFPP RB at 98-99. Second, Account 590 includes regulatory fees paid to the Commission (Regulatory Fees). SFPP contends that Regulatory Fees are distance-related because they are based on operating revenues. SFPP explains that, since its "revenue per barrel increases with distance, these regulatory

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[286] The statute authorizing the DOT Fees is 49 U.S.C. § 60301 (2010).

[287] In support of its position that pipeline user fees are based on mileage, SFPP requests that the Presiding Judge take official notice of the "DOT, Pipeline and Hazardous Materials Safety Administration, Notice of Fiscal Year 2010 User Fee Assessment (2010)" (User Fee Assessment). SFPP bases its request on Rule 508(d)(1), which states that "[t]he presiding officer may take official notice of any matter that may be judicially noticed by the courts of the United States, or of any matter about which the Commission, by reason of its function, is expert." 18 C.F.R. § 385.508(d)(1) (2010); SFPP RB at 99, n.195. SFPP argues that the assessment formula of DOT pipeline user fees is appropriate for official notice because the courts of the United States can judicially notice the matter. SFPP also argues that the assessment formula is a public fact and capable of verification through the Hazardous Materials Safety Administration and DOT. Finally, SFPP states that this fact is directly relevant to an issue in this proceeding. SFPP RB at 99, n.195. On November 4, 2010, Staff filed an answer in opposition to SFPP's request for official notice. *See Answer of Commission Trial Staff in Opposition to SFPP, L.P.'s Request to Take Judicial Notice*, Docket No. IS09-437-000 (Nov. 4, 2010) (Staff Answer). On November 15, 2010, SFPP filed a response in support of its request for official notice. *See Motion of SFPP, L.P. for Leave to Answer and Answer*, Docket No. IS09-437-000 (Nov. 15, 2010) (SFPP Response). The Presiding Judge hereby waives Rule 213(a)(2) and accepts the SFPP Response because the SFPP Response assisted with the decision-making process. *See Exelon Corp.*, 111 FERC ¶ 61,065, at P 22 (2005); *Jersey Central Power & Light Co.*, 111 FERC ¶ 61,179, at P 14 (2005). *See also* 18 C.F.R. § 385.213(a)(2) (2010).

fees are sensitive to mileage." SFPP RB at 99 (citing Ex. SPE-154 at 36). Third, Account 590 includes pipeline safety fees based on the number of mailings and related postage costs (Safety Fees). SFPP contends that the Safety Fees are distance-related because pipeline safety mailings increase as the length of the pipeline increases. SFPP states that Staff's argument that the Safety Fees may change independent of mileage is irrelevant. For instance, fifty miles of pipeline through a densely populated area will require more mailings and associated costs than fifty miles of pipeline through a sparsely populated area. According to SFPP, the relevant facts include the individuals or entities located along the East Line that require notification. SFPP thus believes that the Safety Fees are partially sensitive to mileage, and therefore concludes that the Safety Fees are appropriately classified as distance-related costs.

322. SFPP makes three arguments in support of its request for judicial notice of the "DOT, Pipeline and Hazardous Materials Safety Administration, Notice of Fiscal Year 2010 User Fee Assessment (2010)" (User Fee Assessment).[288] First, SFPP argues that the timing of its request is proper because the User Fee Assessment addresses an issue brought into dispute by Staff at the initial briefing stage of the proceeding. Specifically, the User Fee Assessment rebuts Staff's assertion that the statute authorizing the DOT Fees raises only the possibility that the DOT Fees are based in part on mileage. *See* 49 U.S.C. § 60301 (2010). Second, SFPP argues that judicial notice of the User Fee Assessment will not prejudice Staff. SFPP contends that no prejudice will result from the judicial notice of a government document that Staff accepts as accurate and which sheds light on the dispute. Third, according to SFFP, Staff's statement that it is unclear whether the User Fee Assessment applies to the East Line is inconsistent from its previous position. SFPP notes that Staff introduced exhibits which show that SFPP paid East Line user fees based on 49 U.S.C. § 60301 to the DOT during the base/test period. SFPP Response at 5; Staff IB at 105. Finally, if its request for judicial notice is denied, SFPP request that the Presiding Judge take official notice of Appendix A to Staff's Answer.[289] Appendix A consists of four reports to member of the United States Congress, which SFPP believes confirm that DOT pipeline user fees are assessed according to mileage. SFPP Response at 6.

323. Staff addresses three arguments that SFPP witness Ganz made in support of SFPP's position that costs in Account 590 are distance-related fees. First, Staff disputes

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[288] Staff questions whether the User Fee Assessment is properly subject to official notice. Although Staff does not challenge the accuracy of the User Fee Assessment, Staff states that it is unclear whether it applies to the East Line. Staff therefore argues that the User Fee Assessment is in dispute, and thus not eligible for judicial notice pursuant to Federal Rule 201(b). Staff Answer at 7.

[289] Staff Answer, Appendix A.

witness Ganz' argument that DOT Fees are distance-related because they are based on mileage. Staff notes that the statute authorizing DOT Fees dictates that DOT Fees shall be based on pipeline usage. *See* 49 U.S.C. § 60301. Staff states that the statute only raises the possibility that DOT Fees are based in part on mileage. According to Staff, SFPP failed to provide any evidence that the DOT Fees are based solely on East Line mileage. Second, Staff disputes witness Ganz' argument that the Regulatory Fees are distance-related because they are based on operating revenues which increase with distance. Staff notes that witness Ganz conceded that revenues can change even if the pipeline's mileage remains the same. Thus, the costs in Account 590 can also change, regardless of the pipeline's mileage. Staff therefore argues that the Regulatory Fees are not distance-related. Third, Staff disputes witness Ganz' argument that Safety Fees associated with mailings and postage increase as pipeline mileage increases. Staff notes that witness Ganz conceded that the same mileage of pipeline may generate different numbers of mailings and associated costs depending on the population density of the pipeline route. Staff contends that Safety Fees relate to factors such as population density, environmental sensitivity, and local and regional governmental dynamics. Staff therefore avers that Safety Fees are not distance-related.

<u>Discussion/Findings</u>

324. SFPP failed to meet its burden of proof that the costs in Account 590 are distance-related. SFPP makes an initial showing that the DOT Fees, Regulatory Fees, and Safety Fees are distance-related. For instance, SFPP witness Ganz testified that these costs are sensitive to mileage (vary with distance), and are therefore distance-related. Ex. SPE-154 at 36-37. Specifically, he testified that the DOT are assessed on the basis of mileage, the Regulatory Fees are assessed on the basis of operating revenues, which are sensitive to mileage, and the Safety Fees reflect charges based on mailings, which increase with mileage. *Id.*

325. Staff witness McComb, on the other hand, testified that costs in Account 590 are more appropriately classified as non-distance related. Ex. S-19 at 17. She explained that non-distance related costs are non-mileage sensitive costs such as administrative and general expenses. *Id.* She also noted that Commission regulations define Account 590 as an expense account for administrative and general services.[290] According to witness Ganz, witness McCombs simply declared that Account 590 is non-distance related by

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[290] *See* 18 C.F.R. Pt. 552, at p. 982 (2010) ("This account shall include the cost of expenses expended for administrative and general services including, the expenses of aircraft, vehicles, and work equipment used for general purposes; travel, lodging, meals, memberships, and other expenses of general employees and officers; utilities services; and all other incidental general expenses not defined or classified in other accounts.").

fiat, rather than by determining whether Account 590 costs vary with distance. Ex. SPE-154 at 36-37.

326. However, Staff does not bear the burden of proof in this proceeding to demonstrate that Account 590 costs vary with distance. SFPP bears this burden. *See* 49 U.S.C. app. § 15(7). In response to witness McCombs' testimony, SFPP failed to present record evidence that demonstrates that the DOT Fees, Regulatory Fees, and Safety Fees in Account 590 vary with distance. Rather, SFPP simply classifies the Account 590 costs as distance-related. Ex. SPE-34 at 125, ln.16. Thus, SFPP failed to meet its burden of proof with sufficient evidence. Therefore, the Account 590 costs should not be classified as distance-related. As discussed *infra*, SFPP's presentation of certain evidence in its reply brief is appropriately excluded from the record at this late stage of the proceeding.

327. SFPP's request for official notice of the "DOT, Pipeline and Hazardous Materials Safety Administration, Notice of Fiscal Year 2010 User Fee Assessment (2010)" (User Fee Assessment) is denied as untimely. The Presiding Judge may take official notice of any matter that the courts of the United States may judicially notice. 18 C.F.R. § 385.508(d)(1) (2010). The courts of the United States may judicially notice the User Fee Assessment. The User Fee Assessment appears on the website of the United States Department of Transportation Pipeline and Hazardous Materials Safety Administration.[291] As acknowledged by SFPP and Staff, federal courts have taken judicial notice of documents located on government websites. *Denius v. Dunlap*, 330 F.3d 919 (7th Cir. 2003). Also, the Commission determined that it may take official notice of the actions of sister agencies. *System Energy Resources, Inc.*, 96 FERC ¶ 61,165, at 61,737 (2001). SFPP is correct that the Commission can officially notice the User Fee Assessment because the DOT is a sister agency of the Commission.

328. However, the Presiding Officer must provide requesting participants with an opportunity to refute an officially noticed fact. 18 C.F.R. § 385.508(d)(2) (2010). The purpose of Rule 508(d) is to ensure that the participants have a meaningful opportunity to oppose official notice.[292] SFPP requested official notice of the User Fee Assessment on page ninety-nine, footnote 195 of its reply brief, filed on November 2, 2010. At this late

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[291] *See* http://www.phmsa.dot.gov/pipeline/library.

[292] *See Lear Petroleum Corp.*, 42 FERC ¶ 61,015, at 61,061 (1988) ("Rule 508(d) . . . permits an ALJ to take official notice of facts that would be subject to official notice in a federal court or about which the Commission possesses expertise. However, a participant requesting official notice after the conclusion of the hearing must satisfactorily explain the failure to request notice prior to the close of the hearing. The purpose of this requirement is to ensure that participants wishing to oppose a request for official notice have a meaningful opportunity to express their opposition." (footnote omitted)).

stage of the proceeding, Staff does not have a meaningful opportunity to oppose SFPP's request. Staff requires substantial time and resources to conduct a complete examination of the issues raised by the User Fee Assessment. Further, providing Staff with the time required by Rule 508(d)(2) to refute the User Fee Assessment will needlessly delay the proceeding, especially at this late stage.

329. SFPP also did not justify its failure to request official notice of the User Fee Assessment after conclusion of the hearing. Pursuant to Rule 508(d)(3), participants who request official notice of a fact after the hearing concludes must provide reasons justifying their failure to request official notice in timely manner. *See* 18 C.F.R. § 385.508(d)(3) (2010). The requirement of Rule 508(3) cannot be disregarded. *Producer's Gas Co.*, 35 FERC ¶ 63,042, at 65,126 (1988). In it reply brief, SFPP set forth no reasons justifying its failure to request official notice of the User Fee Assessment prior to the close of the hearing. Although SFPP provided such reasons in its response, filed November 15, 2010, the untimely nature of the request overrides any subsequent compliance with Rule 508(d)(3). Accordingly, it is found that the disputed costs in account 509 are not distance related. Witness McComb's testimony in this regard is given significant weight.

ISSUE VII - Just and Reasonable Rates

330. Each participant proposes that the just and reasonable East Line rates are those adjusted according to their recommendations in this proceeding. SFPP states that the just and reasonable East Line rates are the rates calculated by SFPP in Exhibit No. SPE-34, as adjusted July 1, 2010 in accordance with the Commission's rate indexing methodology, and as modified by Exhibit No. SPE-222. N/W recommend that after a Commission order in this proceeding, SFPP make a compliance filing reflecting rates adjusted by the proposed adjustments of N/W, the VCC Shippers, and Staff. The VCC Shippers propose that the just and reasonable East Line rates are $1.2183 per barrel to Phoenix, $0.8851 per barrel to Tucson, $0.5037 per barrel to Lordsburg, $0.1034 per barrel to Alamogordo, and $0.8851 per barrel to Davis Monthan AFB. Ex. VCC-180 at 3. Finally, Staff developed East Line rates reflected in Exhibit No. S-19hc. Staff notes, however, that the appropriate East Line rates will reflect the positions adopted by the Presiding Judge and the Commission.

Discussion/Findings

331. The just and reasonable East Line rates will reflect the findings and determinations set forth in this initial decision, subject to Commission approval. Upon order by the Commission, such rates will be appropriately calculated by SFPP in a compliance filing.

ISSUE VIII - Refunds

332. To the extent that the Commission orders refunds, SFPP requests that the Commission deduct from the refunds the amount under-collected by SFPP during the suspension period of the East Line Tariff Filing, September 1, 2009 through December 31, 2009. SFPP also requests that the Commission account for the August 16, 2010 Interim Rate Tariff Filing, which the Commission accepted on September 15, 2010.[293] N/W and the VCC Shippers recommend a refund level equal to the difference between the rates that the Commission determines just and reasonable and the rates charged by SFPP since January 1, 2010. The VCC Shippers also recommend multiplying the resulting amount by the volumes shipped by each shipper, plus interest. Staff requests that the Commission calculate refunds, with interest, based upon Staff's proposed rate level.

Discussion/Findings

333. The appropriate refunds are equal to the difference between the rates that the Commission determines just and reasonable and the rates charged by SFPP since January 1, 2010, plus interest at the Commission prescribed rate. 49 U.S.C. app. § 15(7). Such calculation accounts for the interim rates as effective September 1, 2010, the rate indexing as effective June 1, 2010, and any future rate indexing that may occur prior to final resolution of this proceeding.

334. SFPP's proposed refund adjustment is improper. In the August 31 Order, the Commission suspended the rates proposed by SFPP in the East Line Tariff Filing for four months, to become effective January 1, 2010.[294] Pursuant to Section 15(7) of the ICA, the Commission may, upon a new rate filing, "suspend the operation of such schedule and defer the use of such rate . . . but not for a longer period than seven months beyond the time when it would otherwise go into effect . . . . If the proceeding has not been concluded and an order made within the period of suspension, the proposed change of rate . . . shall go into effect at the end of such period . . . ." 49 U.S.C. App. § 15(7) (1988). The ICA and Commission regulations do not contain a provision that allows pipelines to recover rates that they would have recovered during the Commission-ordered suspension period.[295] SFPP proposed adjustment is therefore contrary to the ICA and

[293] *SFPP, L.P.*, 132 FERC ¶ 61,235 (2010).

[294] August 31 Order at PP 18-21.

[295] The VCC Shippers point out that Rule 713 of the Commission's Rules of Practice does not provide parties with a second request for rehearing if their first request for rehearing is denied. *See* 18 C.F.R. § 385.713(b) (2010). The VCC Shippers argue that SFPP is therefore not entitled to a second attempt to recover rates that it would have recovered during the

(continued)

Commission regulations. Further, SFPP adopts inconsistent positions regarding this issue. For instance, in its request for rehearing of the August 31 Order, SFPP states that the Commission's four month suspension of the East Line Tariff will foreclose its recovery of more than nine million dollars of East Line costs. Specifically, "[t]he filed rate doctrine and the rule against retroactive ratemaking effectively ensure that SFPP can never recover this $9.2 million."[296] Now, at the post-hearing stage of the proceeding, SFPP requests recovery of the same costs without citation to any supporting authority or precedent. SFPP's proposed refund adjustment is directly contrary to its prior position in this proceeding and, more importantly, unsupported by the ICA or Commission regulations.

<u>CONCLUSIONS</u>

335. Based on the evidence in this proceeding and as acknowledge by the Commission and all participants, the prescribed test period in this proceeding is the twelve month period ending March 31, 2010. In addition, after careful weighing of the evidence SFPP is ordered to correct the SRB Write-Up calculations as discussed above. It has to calculate the SRB since 1983 and pass thru the corrections in Ex. SPE-222. Statements A, C, and E1. The equity portion of the SRB must be multiplied by the applicable inflation rate to calculate the deferred return or the SRB Write-Up. It is further concluded that SFPP is to adopt KMEP's actual capital structure to determine its cost of service in this proceeding. Based on the evidence in this record it is concluded that SFPP is to treat $950 million in senior notes, $675 million in outstanding borrowings under a revolving credit facility and $65 million in commercial paper borrowings as long-term debt for capital structure purposes.

336. It is further concluded based on the evidence in this proceeding SFPP is to remove six PAAs from the equity component of its capital structure. Additionally, it is concluded that SFPP is to include Special Purpose Debt in the cost of debt calculation for ratemaking purposes. Further, in order to make SFPP's COS consistent with Commission policy it is to use its actual cost of debt for ratemaking purposes. It is further concluded that there is significant evidence in this proceeding to determine that ITAs granted under Commission Policies for MLPs result in double recovery for such costs by their investors. Further, those Policies do not appear to equalize the corporate ITA situation in ratemaking to that of MLP investors as intended. In addition, this evidence indicates that the ROE compensates SFPP investors fully for both their investor-

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Commission-ordered suspension period.

[296] *Request for Rehearing and for Expedited Consideration of SFPP, L.P.*, Docket No. IS09-437-000, at p. 9 (Sept. 21, 2009) (referencing *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116, 126 (1990)).

level income tax costs and their required after-investor-tax return. However, based on the standing Commission precedent, it is concluded that SFPP is entitled to an ITA in this proceeding.

337. Related to the immediate determination above, it is concluded that SFPP has to adjust its ADIT calculation to reflect the deferral of federal and state income tax costs associated with accelerated depreciation. In addition, it is further concluded that SFPP must follow the methodology utilized by N/W witness Horst to calculate the ITA for all unitholders. SFPP also must develop its weighted marginal tax rate and ITA based on allotted taxable income that results from applying KMEP's incentive distribution solely based on SFPP's income level for the relevant tax year. Moreover, SFPP must correct the categorization of 13 unitholders in accordance with the directions in this Initial Decision. Further, SFPP is ordered to correct its ownership percentages and weighted average income tax rate to reflect these corrections. It is concluded that VCC Shippers rebutted the presumptions for UBIT and mutual funds resulting in the conclusion that a 0 percent rate is appropriate for these investors. Finally, it is concluded that SFPP must account for the Section 743 (b) depreciation in its ITA calculation.

338. Concerning G&A overhead costs it is concluded that SFPP's multi-tiered direct assignment of costs is unjustified and unreasonable. It is further concluded that allocation of these costs using the Mass formula is a more reasonable approach. Accordingly, SFPP is ordered to follow the Mass formula to allocate all of its G&A costs to SFPP. Further, it is concluded that SFPP's proposal to use replacement value to allocate insurance costs is also unreasonable. Consequently, SFPP is directed to use the Mass formula to allocate insurance costs. Legal expenses are also directly assigned in an unreasonable and unjust manner. As a result, SFPP is ordered to use the Mass formula to allocate these costs. The removal of PAAs for unregulated subsidiaries is concluded to be incorrect. SFPP is ordered to remove the PAAs from the property, plant and equipment Mass formula factor solely for FERC rate regulated subsidiaries. The proposal to use a net revenue factor for G&A overhead costs allocations in the three factor Mass formula is unreasonable, without foundation and contrary to Commission policy. A gross revenue factor is to be used instead. It is further concluded, that SFPP did not capitalize overhead costs associated with capital projects in violation of Commission policy. Further, SFPP incorrectly applied the K-N method. Therefore, SFPP is directed to follow these directives in its compliance filing. Furthermore, it is concluded that SFPP must use an average fuel cost for its six line segments to measure fuel and power expenses. Finally, it is concluded that SFPP overstated its regulatory litigation expenses and the correct amount is $3.2 million ($1,062,987 million per year) to be amortized for three years and then removed from rates.

339. Consistent with the record evidence SFPP is to adopt Staff's volumes updated through the end of the test period ending March 31, 2010, to develop its COS. Furthermore, it is concluded that the expenses in account 590 are not distance related.

ORDER

340. IT IS ORDERED, subject to review by the Commission on exceptions or on its own motion, as provided by the Commission's Rules of Practice and Procedure, that:

a. Within thirty days from the issuance of the final order of the Commission in this proceeding, SFPP shall make a compliance filing establishing rates in conformance with this initial decision.

b. Within thirty days from the issuance of the final order of the Commission in this proceeding, the Carriers must prepare and file a refund report and refund shippers in accordance with this initial decision.

Carmen A. Cintron
Presiding Administrative Law Judge

CERTIFICATE OF SERVICE

I hereby certify that I have this day served by electronic mail the foregoing Joint Motion to Set Aside Submission and Request For Official Notice upon the persons listed below, or by first-class U.S. mail for those recipients for whom electronic mail was unavailable:

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Executed this 9th day of March 2011 at Washington, District of Columbia.

/s/ Gregory S. Wagner

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