Decision **PROPOSED DECISION OF ALJ BEMESDERFER** **(Mailed 6/22/2010)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of SFPP, L.P. for authority, pursuant to Public Utilities Code Section 455.3, to increase its rates for pipeline transportation services within California.	Application 09-05-014 (Filed May 12, 2009)
And Related Matters.	Application 08-06-008 Application 08-06-009

INTERIM DECISION DENYING APPLICATION TO CHARGE MARKET-BASED RATES

1. Summary

The applications of SFPP, L.P. and Calnev Pipe Line L.L.C. (collectively, Applicants) to charge market-based rates for transportation of refined petroleum products on their respective pipelines are denied. Applicants shall file tariffs including rates based on their costs of service for the Test Year 2009.

2. Background

On June 6, 2008, SFPP, L.P. (SFPP) and its sister affiliate, Calnev Pipe Line L.L.C. (Calnev) filed rate applications to comply with the Commission order in Decision (D.) 07-05-061, issued May 24, 2007. The order directed:

> … that both SFPP and Calnev file general rate applications with this Commission for a test year 2009. Each filing shall be made within 12 months of the effective date of today's decision.[1]

SFPP'S application was assigned Application (A.) 08-06-008 and Calnev's application was assigned A.08-06-009.

The applications were protested by BP West Coast Products, Chevron Products Company, ConocoPhillips Company, ExxonMobil Corporation, Southwest Airlines Co., Tesoro Refining and Marketing Company, and Valero Marketing and Supply Company and Ultramar, Inc. (collectively, Shippers).

On September 26, 2008, SFPP filed an amendment to A.08-06-008 requesting an additional increase in rates pursuant to Public Utilities Code Section 455.3.[2] The amendment was protested by Shippers and the Commission's Division of Ratepayer Advocates.

On May 12, 2009, SFPP filed A.09-05-014 for an additional rate increase. Shippers protested this new application. On August 20, 2009 the assigned Commissioner issued a scoping ruling consolidating A.09-05-014 with the two previously filed applications and setting a schedule for the consolidated proceeding.

Evidentiary hearings were held from February 23, 2010 to March 3, 2010.

On March 3, 2010, pursuant to a petition, the Air Transport Association of America, Inc. was added as an additional party to the consolidated proceeding.

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[1] Interim Opinion Approving, With Conditions, Transfer of Indirect Control and Authorizing, With Conditions, Exemption from Public Utilities Code Section 852 for Some Investors in Knight Holdco at 30.

[2] Compliance Filing of SFPP/Calnev in accordance with D.07-05-061 (hereinafter SFPP Compliance Filing).

On April 30, 2010, Applicants made a compliance filing setting forth their actual results of operations for the year 2009.[3] We take judicial notice of this filing for purposes of this decision.

3. Issues Presented and Burden of Proof

The assigned Commissioner's scoping ruling identifies two broad questions for decision as well as a number of subsidiary issues. The two broad questions are:

- Should Applicants' future rates be set by some form of light-handed regulation in place of traditional cost-of-service ratemaking? and
- Are Applicants' current rates and charges, including rate increases subject to refund adopted pursuant to Public Utilities Code Section 455.3, just and reasonable?

The burden of proof on all substantive issues in the proceeding is on Applicants.[4]

In this interim decision, we address only the application to charge market-based rates.[5] We will set rates based on Applicants' cost of service and determine if shippers are due refunds for prior periods in a subsequent opinion.

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[3] The statute authorizes pipeline corporations to raise transportation rates by not more than 10% per year on 30 days' notice to the commission and shippers and subject to refund by later commission decision.

[4] "[T]he ultimate burden of proof of reasonableness…never shifts from a utility which is seeking to pass its costs of operations on to ratepayers on the basis of the reasonableness of those costs." *Pacific Gas and Electric Co.*, D.00-02-046.

[5] Applicant's specific request, as set out in A.09-05-014, is that the Commission "review the competitiveness of the market in which SFPP provides regulated, intrastate petroleum product transportation services…to determine that market-based factors, rather than traditional cost-of-service measures, constitute a proper standard for the Commission to evaluate the reasonableness of prospective changes in the rates, terms

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4. Discussion

Applicants argue that the Commission may approve rates, including market-based rates, that exceed rates derived from the application of traditional cost of service ratemaking principles[6] so long as Applicants meet the "five factor test" set out in the Commission's so-called *Unocap* decision.[7] Those factors are:

- Actual competitors
- Large, sophisticated customers
- Comparable rates
- Potential competitors
- Reasonable achieved returns

Applicants argue that if a pipeline has significant competition and large, sophisticated customers, charges rates that are comparable to those charged by similar pipelines, faces meaningful potential competition in the event it raises rates, and achieves a reasonable return on its rate base, then its existing rates and, by implication, its future rates, should be approved as "just and reasonable" and need not be set on a cost of service basis.

At the outset, we observe that the *Unocap* factors do not carry equal weight. In particular:

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and conditions proposed by SFPP." (Emphasis in original.) We interpret this language as an application for authority to charge market-based rates. *Application of SFPP, L.P.* at 11 (May 12, 2009).

[6] Q: [By Administrative Law Judge (ALJ) Bemesderfer] As an economist, do you believe that rates derived by the application of cost of service principles function as an upper bound on reasonableness?

A: [By Michael Webb, economic expert for Applicants] No.

Reporter's Transcript (Tr.) Volume 2 at 223. (February 24, 2010).

[7] *City of Long Beach vs. Unocal California Pipeline Company (Unocap)* D. 96-04-061.

(a) If an applicant proves that it operates in a fully competitive market, we have little need to examine other factors.

(b) No matter how large and sophisticated a pipeline's customers may be, if the pipeline faces no meaningful actual or potential competition, the composition of its customer base is of small consequence.

(c) Even if a pipeline had a monopoly over transportation in a certain geographic area, it might choose to hold its rates and achieved return equal to the average of other pipelines in order to forestall regulation.

In short, consideration of all the *Unocap* factors is appropriate when no one factor is decisive. We now consider each of the *Unocap* factors in turn as they apply to Applicants.

4.1. Extent of Competition faced by Applicants

Applicants' economic expert Webb adopted the testimony of SFPP witness Leto regarding the degree of concentration in the markets served by SFPP as measured by the so-called "HHI Index." Briefly, the HHI index measures market concentration by summing the squares of market share enjoyed by various competitors. For example, an HHI Index of 10,000 indicates a monopoly. (100% share of market squared equals 10,000). If that market had ten participants each capable of supplying[8] 10% of demand, the HHI Index would be

[8] The HHI analysis assumes that all pipelines serving a given market have equal ability to meet the needs of shippers up to the limit of their throughput capacity and that all pipelines will take as much of the market as possible. In other words, the HHI analysis does not necessarily reflect the relative capacities of the various pipelines. For example, in a market served by five competing pipelines in which shippers send a total of 100,000 barrels per day (bpd), one pipeline might have a capacity of 80,000 bpd while the other four have a capacity of 20,000 bpd each. For HHI purposes it is assumed that each pipeline handles 20,000 bpd, even though the largest pipeline could handle four times

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1,000 (10 share of market squared = 100; 10 times 100 = 1,000). An HHI of 1,000 indicates a competitive market.

Webb endorsed Leto's testimony regarding the HHI calculations for the nine identifiable sub-markets in which SFPP operates. On cross-examination Webb admitted that, according to Leto, in seven of the nine sub-markets in which SFPP operates the HHI Index exceeds 4,500, indicating the sub-market is non-competitive. Only in the Los Angeles Primary and San Francisco Bay Area sub-markets does SFPP face sufficient competition to bring the HHI Index below 2,500.[9]

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that much on its own. This difference in approach to HHI calculation makes a considerable difference in result. In the example given, the market has an HHI of 2,000 (20% assumed market share squared times 5 pipelines = 400 x 5 = 2,000.). If we calculate the HHI based on relative capacity rather than assumed market share, the market has an HHI of 4,100 (50% capacity squared + 4 times 20% capacity squared = 2500 +1600 = 4,100.) A market with an HHI of 2,000 is generally considered competitive. A market with an HHI of 4,100 is not competitive. The "equal share" approach to calculating HHI is based on the idea that if a pipeline with excess capacity tries to get a larger share of market by lowering its transportation price, the others will immediately follow suit and the market will stabilize at the same percentage allocation as before but at a lower price.

However, pipeline capacity does operate as a lower bound on the HHI calculation. In the example given, if one of the pipelines had a capacity of only 10,000 bpd, the remaining 90,000 bpd would be unequally divided, with three of the pipelines taking 20,000 bpd (their maximum capacity) each and the largest pipeline taking 30,000 bpd. HHI would then equal 100 + (3 x 400) + 900 = 2,200.

[9] Prepared Rebuttal Testimony of Joseph J. Leto on behalf of SFPP, L.P. (January 25, 2010) at 6. (Leto Rebuttal Testimony) According to Leto's calculations, the HHI for the Los Angeles primary market is 1,242 and the HHI for the San Francisco Bay market is 1,843.

4.2. Size and Sophistication of SFPP's Customers

SFPP's customers are large integrated energy companies, in general much larger than SFPP itself. Such customers, unlike individual consumers, have the ability to exert market power on their own behalf up to and including the ability to build their own proprietary pipelines. While it is highly unlikely that any of the shippers would actually take that step, the possibility that they might do so theoretically sets limits on SFPP's ability to raise transportation rates.

Although they are large, sophisticated companies, the shippers do not, for the most part, have the option of shipping product via other pipelines in response to an SFPP price increase. They would have to shift to trucking. While trucks are an imperfect substitute for a pipeline, the shippers could either build and operate trucking facilities of their own or lease trucks from third parties. The greater the cost to the shippers of making such substitutions, the greater the market power of the pipeline. (See the discussion of potential competition in Section 4.4 below.)

4.3. Comparison of SFPP's Rates With Rates Charged by Other Pipelines.

Applicant introduced evidence to demonstrate that its rates for transportation of refined petroleum products fell in the middle range of rates charged by other pipelines for similar transportations services.[10] The rates were undisputed, but shippers pointed out that comparing rates charged by proprietary pipelines for shipping product manufactured by another unit of an integrated energy company with rates charged by an independent pipeline is not

[10] SFPP Exhibit 2, Report of Energy Analysts International (September 21, 2000) at 42-49.

comparing apples to apples. An integrated energy company may have tax or other reasons to allocate costs to various corporate units that may or may not reflect the actual costs of the services supplied by those units. Notwithstanding this caveat, it appears from the undisputed evidence introduced by Applicants that the transportation rates charged by Applicants are similar to, and in some instances less than, the rates charged by other pipelines, both proprietary and independent, for similar services but we cannot be certain that they are the true cost of the service provided.

4.4. Potential Competition

The record on this issue is complex, but it can be summarized as follows: for each shipper, product and market there is a geographic area within which trucks represent a potentially viable alternative to the SFPP pipeline. Trucks could not entirely replace the pipeline as a means of moving refined petroleum products to market within those geographic areas,[11] especially not airplane fuel which in most markets is delivered exclusively via pipeline, but they could theoretically carry a fraction of the product now being shipped via pipeline, particularly in the Los Angeles Primary market.[12] SFPP's witnesses conceded that shifting any significant portion of refined petroleum products from the pipeline to trucks would impose significant social costs, including greenhouse gas emissions, increased traffic congestion, and wear and tear on highways and secondary roads, that would not be borne by either the shippers or the pipeline company.

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[11] At some point, it would become cheaper to build a competing pipeline.

[12] SFPP Exhibit 2 at 21-41.

4.5. Achieved Return

In his proposed decision resolving A.03-03-027, an earlier rate case filed by SFPP, ALJ Douglas Long ruled that SFPP is not entitled to charge an income tax allowance as an expense against revenues because it does not pay any taxes. In keeping with an earlier ruling of the presiding ALJ, we adopt Judge Long's disposition of the tax allowance issue as the law of this case.

SFPP's Compliance Filing indicates that for calendar 2009 it calculated its authorized return on rate base as $22,663,132 by multiplying a proposed overall rate of return of 10.14% times a stated rate base of $223,417,197. The same Compliance Filing indicates that SFPP's total intrastate operating revenues were $120,303,959 and total cost of service was $110,746,048, the difference representing an achieved return of $9,557,911. On these assumptions, SFPP's achieved return in 2009 was approximately $13 million less than its authorized return.

Included in the cost of service is an income tax allowance of $10,409,250. Since we disallow the income tax allowance, it needs to be deducted from cost of service and added to the achieved return resulting in a total achieved return of $19,967,161, approximately $2.5 million less than SFPP's proposed authorized return.

Shippers vigorously dispute these calculations. For example, Tesoro's expert Ashton contends that (a) SFPP's 2009 operating expenses are overstated by $14.4 million and (b) the 2009 overall rate of return should be set at 8.79%,

rather than the 10.14% proposed by SFPP,[13] resulting in an estimated over-recovery by SFPP of more than $17 million in 2009.

We do not address this issue here other than to note the wide discrepancy in these calculations.

5. Conclusions Regarding Applicability of *Unocap* Factors

We sum up our analysis of the *Unocap* factors as follows:

- Applicants face modest-to-minimal competition in the provision of transportation services for refined petroleum products rather than the "moderate" competition urged by their expert. Of the nine identified sub-markets to which Applicants supply refined petroleum products, only the Los Angeles Primary market has an HHI Index indicative of an un-concentrated market; of the eight remaining sub-markets, only San Francisco has an HHI Index indicative of moderate concentration. All other markets are highly concentrated;
- Applicants' customers are large, sophisticated companies capable of applying modest market pressure on Applicants;
- Applicants' self-reported transportation rates fall in the middle of the range of rates for transportation of refined petroleum products on other pipelines;
- There is potential competition for transportation of refined petroleum products, other than aircraft fuel, by truck in the Los Angeles Primary market, but Applicants have failed to account adequately for the environmental, safety, and traffic impacts of switching from pipeline transportation to truck transportation. While trucks can provide theoretical competition in other sub-markets, the practical difficulties of doing so make such competition unlikely; and

[13] Prepared Answering Testimony of Peter K. Ashton on behalf of Tesoro Refining and Marketing Company at 25 (December 22, 2009) (Ashton Answering Testimony).

- Estimates of Applicants' achieved return for 2009 vary too widely to be useful in this analysis. A more accurate calculation of achieved return requires resolution of the issues of capital structure and cost of capital which will be addressed in the final opinion in this matter.

The purpose of the *Unocap* analysis is to estimate the extent to which Applicants possess market power. Simply put, the question is: Can Applicants raise transportation rates without suffering an offsetting loss of volume? The above analysis suggests that Applicants possess significant market power. Shippers have meaningful alternatives to Applicants' pipelines only in the Los Angeles Primary market. In all other markets, shippers would have to put up with significant rate increases because shifting to alternate transportation would be either prohibitively expensive or, in the case of airline fuel delivered to airports, physically impossible. Though trucking can replace piping for a fraction of the refined petroleum products currently piped, it would be prohibitively expensive outside of Los Angeles and environmentally damaging everywhere to significantly increase the proportion of product carried by truck. Even though the shippers are larger and wealthier than Applicants and could theoretically create alternative delivery systems, the time, regulatory uncertainty and expense required to do so make that option unrealistic. While it is a positive point for Applicants that their transportation rates do not appear to be out of line with the rates charged by other pipelines, this pricing may be more a product of corporate accounting policy or tactical restraint than competitive pressure.

In summary, we conclude that Applicants have not proven their case for market-based rates and their rates should be set on traditional cost-of-service principles.

6. Comments on Proposed Decision

The proposed decision of ALJ Bemesderfer in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were received from SFPP, L.P., BP West Coast Products, Tesoro Refining and Marketing Company, and CCS Shippers (Air Transport Association of America, Inc.,) Chevron Products Company, Conoco Phillips Company, and Southwest Airlines Co.) on July 12, 2010. Reply Comments were filed by BP West Coast Products and CCS Shippers on July 19, 2010.

In its comments, SFPP, L.P. acknowledges that the Proposed Decision "does not reflect any legal, factual or technical errors" and its rates will be set on traditional cost-of-service ratemaking principles. Nonetheless, applicant argues that the Commission should give added weight to the competitive constraints faced by SFPP, L.P. and find that its existing rates are just and reasonable.

BP West Coast Products, Tesoro Refining and Marketing Company, and CCS Shippers support the Proposed Decision subject to a correction discussed in the following paragraph and oppose any adjustment of cost-of-service rates for economic or environmental reasons. They also propose that the Findings of Fact in the Proposed Decision be modified to reflect more fully the conclusions reached in the text of the Proposed Decision.

The shipper comments point out that the Proposed Decision erroneously interprets the information contained in the Federal Energy Regulatory Commission (FERC) compliance filing made by SFPP, L.P. on April 30, 2010. The Proposed Decision calculates SFPP, L.P.'s achieved return as $19.97 million. The comments point out that the correct amount, calculated on the basis of the data

in the compliance filing, is $42.63 million, consisting of $22.66 million in allowed return, $10.41 million in disallowed income tax allowance, and $9.56 million in over-recovered revenue.

Findings of Fact and Conclusions of Law have been modified to reflect this correction and to more fully reflect the conclusions reached in the text of the Proposed Decision.

7. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Karl J. Bemesderfer is the assigned ALJ in this proceeding.

Findings of Fact

1. Applicants face modest-to-minimal competition and do not face moderate competition.

2. Seven of the nine markets in which Applicants provide pipeline transportation of refined petroleum products are highly concentrated.

3. The Los Angeles primary market is at the high end of the moderately concentrated range, and the San Francisco market is at the low end of the highly concentrated range.

4. Applicants' customers include large integrated energy companies, captive airline shippers, and other shippers which are not large integrated energy companies.

5. There is no competition for delivery of jet fuel to commercial airports served by Applicants' pipeline.

6. Applicants failed to demonstrate that their rates are comparable to rates for competing pipelines or for pipelines influenced by substantially similar factors.

7. Comparing rates charged by proprietary pipelines with rates charged by independent pipelines is not an apples-to-applies comparison.

8. Any significant shift of transportation from pipeline to trucking would impose social costs, including greenhouse gas emissions, increased traffic congestion, and wear and tear on highways and secondary roads, that would not be borne by either the shippers or the Applicants.

9. The costs and revenues reported in SFPP, L.P.'s 2009 FERC compliance filing for 2009 produce an unusually high "achieved return" which is evidence of market power.

Conclusions of Law

1. Applicants possess market power in the transportation of refined petroleum products in California.

2. Applicants may not charge market-based rates for transportation of refined petroleum products in California.

3. Applicants' rates for the transportation of refined petroleum products within California should be set on traditional cost-of-service principles.

O R D E R

IT IS ORDERED that:

1. The applications of SFPP, L.P. and Calnev Pipe Line, L.L.C. to charge market-based rates for transportation of refined petroleum products within California are denied.

2. Application 09-05-014, Application 08-06-008, and Application 08-06-009 remain open.

This order is effective today.

Dated _____, at San Francisco, California.